Operation Evaluation

Summary

Pulp and paper mill (south-eastern Europe)

(A private sector investment operation)

February 2012

Evaluation Department (EvD)

European Bank for Reconstruction and Development

Executive summary

In 2006 the Bank provided a loan to a recently privatised integrated pulp and paper mill company ("the Company") in south-eastern Europe to support the reconstruction of facilities that had been severely damaged ("the Project"). The brownfield character of the Project led to larger than anticipated investment costs and delays. Furthermore the global downturn and weakness in the paper market in particular in 2008-09 extended the period of losses, putting the Company in a challenging financial situation. The sponsors' support for the Project, including funding of liquidity shortfalls and capital injection, and the Bank's continued support through a new working capital facility, helped achieve a significant positive demonstration effect in a challenging country very much in need of further investments for reconstruction and economic integration.

The Project evaluation delivered the following main findings:

(i) *Demonstration effect of successful turnaround following privatisation:* While the Bank did not participate directly in the privatisation process, its financing of the post-privatisation investments contributed to the successful turnaround of a company with a strong regional presence, resulting in a positive demonstration effect. Privatisation goes beyond the transfer of ownership and the Bank can reinforce transition impact (TI) by supporting companies in the follow up of their privatisation. In addition, the Project had positive effects on country/regional economic integration.

(ii) TI opportunities worth further exploring: The potential impact of a project goes beyond the Company level; project design, measurement and monitoring needs to incorporate this wider perspective. This Project presented an opportunity to strengthen upstream links with wood suppliers. While the Company's relationship with suppliers is a commercial one, the Bank could have explored more assiduously whether its further engagement might be a vehicle for deepening country integration through deeper buyer-supplier relationships and promoting sustainable forestry management practices in the country and the region.

Secondly, the Bank observed that "legislation [in the forestry sector] needs significant reform to bring it in line with international standards [for sustainable wood procurement]". The government is, in fact, developing a new forestry law, expected to be passed early this year. This is potentially a good opportunity for the Bank through, for example, a focused technical cooperation (TC) operation. Indeed TC has been considered as part of the extended working capital facility but the difficulties to identify a credible counterparty given the political situation put this initiative on hold. In any event the Bank might look for an opportunity to bring the experience of this Project to the attention of those working on implementation of the legislation.

Table: Ratings summary

Overall rating	★★★☆	Successful
Transition impact	●●●●●○	Good
Additionality	■■■■	Fully verified
Achievement of objectives	●●●●●○	Good
Environmental and social impact	●●●●●○	Good
Company financial performance	●●●●○○	Satisfactory
EBRD's investment performance	●●●●○○	Satisfactory
Bank handling	●●●●●○	Good

Overall assessment

★★★☆ Successful

Despite a challenging period during the Project implementation phase and delayed production and financial performance, the final outcome of the Project has been positive. Project selection and design was consistent with the Bank's policies on development of the private sector and modernisation of energy-intensive industries and transition impact has been good mainly thanks to the demonstration effect of a successful turnaround of a recently privatised company.

Additionality ■■■■ Fully verified

Financing in the terms and amounts necessary for a large-scale brownfield project by foreign investors was not available from local commercial banks at the time and the Bank's support contributed to mobilise parallel funds from other foreign banks. The Bank's country knowledge brought confidence to the sponsors with no previous experience in the country.

Effectiveness

Achievement of objectives ●●●●●○ Good

Achievement of objectives is rated overall as "*Good"*, taking into account the difficult environment under which the Project has taken place. Although with significant cost overruns and delays, the renovation of the facilities has taken place to the required capacity and quality standards and a turnaround of the Company has ultimately been achieved.

The main operational objective of the Project was the restart of the pulp production line and overall renovation and upgrade of the facilities, which included energy efficiency and environmental improvements. The pulp line restarted production in 2007 and steadily increased output. Production for 2011, at the time of writing, was expected to reach close to full capacity. Refurbishment of another line, the other major element in the investment programme, has also been achieved with installed production capacity of this line of 86,000 tonnes on an annual basis. A report commissioned by the Bank in April 2009 confirmed that the facilities are fully operational, with technology of European standards providing a competitive cost structure. Technical completion was declared in September 2009 but financial completion is pending on performance with the debt service coverage ratio, but capital injection from the sponsors in 2010 is expected to contribute and achieve financial completion by end 2012.

Company financial performance ●●●●○○ Satisfactory

Due to delays in Project implementation and low demand during 2008-09, production has been behind expected levels at Project appraisal. As result, financial performance has also lagged projections. Sales levels were around 50 per cent of those projected for the 2007-09 period while EBITDA and net income were negative. The Company achieved positive EBITDA in 2010 and in 1Q 2011. Thanks to a pick up in demand and prices and to changes implemented by new management, the Company returned to bottom line profitability for the first time since privatisation. The Company is catching up with the initially planned levels of production, sales and financial performance.

Efficiency

Bank handling ●●●●●○ Good

A period of low performance and a difficult relationship with the Company led to the Project being referred to Corporate Recovery under Category 3. The Bank took actions to rebuild trust and intensify follow up with the Company, which led to an additional capital injection from the sponsors and a new working capital facility from the Bank.

Bank’s investment performance ●●●●○○ Satisfactory

Despite the challenges, the Company has met all repayments to date thanks to the sponsors’ contributions. The estimated return for the Bank after risk adjustment is a low 1.5 per cent.

Impact/sustainability

Overall transition impact ●●●●●○ Good

Transition impact is rated overall as “*Good”*. As expected, the main transition impact outcome has resulted from the successful restructuring of a recently privatised company providing a positive demonstration effect. Some achievements have taken place in corporate governance but the transfer of skills has been limited to date. The strengthening of upstream links with wood suppliers, a real opportunity to influence sustainable forestry management, could have provided better transition results. Long term potential is rated “*Good”* as the new highly experienced manager is keen on addressing organisational and managerial changes (training, IT systems, HR, environmental performance), once the more urgent rebuilding phase has been completed. Risk to long-term transition impact is rated “*Low/Medium”* and associated with the market risks, which may affect financial performance and as a result affect the demonstration effect and the management’s capacity to focus on the managerial needs.

Company impact

Private ownership: While the Bank did not participate directly in the privatisation process in 2005 it contributed to its success by helping to finance the post-privatisation investment programme committed by the sponsors to increase capacity and performance.

Skills transfer: Achievements have been limited. The sponsors had no previous experience in the sector. The majority of senior management remains from the pre-privatisation period. A new, experienced general manager appointed in 2009 has contributed significantly to the turnaround of the Company, bringing skills at the highest management level. While some training has taken place to respond to specific needs, a structured training programme has not been put in place.

New standards of business conduct: Some achievements have taken place regarding implementation of International Financial Reporting Standards accounting and corporate governance – a supervisory board has been put in place with representation of minority shareholders, which meets regularly on a quarterly basis and as necessary to attend specific needs.

Industry and wider impact

Demonstration effect: The main transition impact of the Project has resulted, in line with that foreseen at project appraisal, from the demonstration effect of a successful turnaround of a recently privatised company. Although with delays, the Project ultimately achieved the overall refurbishment of the facilities of a company with a strong regional presence, regained activity in local and international markets and ultimately achieved financial profitability.

Market expansion – strengthening of upstream linkages: A substantial impact could derive from strengthening links with wood suppliers on which the Company depends entirely, leading to a more sustainable management of forestry resources as well as positive upstream financial effects. The Company is making efforts to source wood from only legal and managed forests. However, incentives to suppliers to obtain Forest Stewardship Council certification have been scarce to date.

Frameworks for markets: The Government is developing a new forestry law (expected to be passed early in 2012) that could have presented an opportunity for the Bank to be involved in policy dialogue to secure sustainability of forestry management. As stated in the working capital facility board document, "legislation needs significant reform to bring it in line with international standards". Indeed the Bank considered a further technical cooperation project with the ministries of forestry of two countries as a follow up to the technical cooperation to the forestry sector, but difficulties in identifying a credible counterparty (given the political situation in the country) put the initiative on hold.

Environmental and social impact ●●●●●○ Good

Environmental impact is rated "*Good*" as the combined result of a "*Satisfactory*" environmental performance of the Company (delays in implementation of the Environmental Action Plan as results of delays in Project implementation) and "*Substantial*" environmental change based on (i) upgrades to waste water treatment; (ii) improvements to air quality; and (iii) increased focus on health and safety.

Findings and recommendations

– *Demonstration effect of successful turnaround following privatisation.* The Project foresaw potential transition impact in increased private ownership and demonstration effect of a successful turnaround. Indeed, although the Bank did not participate in the privatisation process of the Company, by supporting the Company's investment plan it contributed to its successful completion. The strong presence of the Company and linkages with the supply sector have contributed to the visibility of the Project. While difficult to establish a cause-consequence relationship between the Company's success and other foreign direct investment in the country, in the Evaluation department's (EvD) view the project has had a significant demonstration effect of a successful privatisation and turnaround.

  The Bank should not underestimate the potential transition impact of the support to companies that, having been already privatised, still present significant operational challenges. Continued support to the post-privatisation process can lead to a significant demonstration effect in terms of increased private ownership and foreign direct investment.

- *Regional economic integration.* The Company sources wood in roughly equal amounts from two areas of this country with very limited economic integration. Thus wood is harvested in one area of the country and brought to the plant in the other. This is a constructive and positive demonstration of country economic integration.

- *Minimisation of project implementation risks and market volatility risk.* Risks in project implementation were identified at inception (although optimistically rated medium to low) and the possibility of cost overruns was highlighted from the beginning. Furthermore the paper market is characterised by volatility in prices and demand. A guarantee structure was put in place that relied on the sponsors to guarantee and to provide additional funds as needed for the completion of the Project. The sponsors' additional equity contribution secured the completion of the Project and had a positive demonstration effect of strong commitment of foreign direct investment in the country as one of the largest in the private sector.

  It is important to count on financially strong sponsors to secure repayment to the Bank from a credit perspective; but it is also important to have a good understanding of the sponsors' weaknesses with regards to sector and country expertise and to address these upfront in order not to jeopardise the potential transition impacts.

- *TI opportunities worth further exploring: strengthening of backward linkages and policy dialogue.* A number of potential transition impacts mentioned in the Board document only as an additional source of TI could have been further explored in the implementation of the Project. These include the strengthening of backward linkages with wood suppliers and the development of policy dialogue with the government (central and cantonal) to guarantee sustainable management of the forestry resources.

  In sectors with strong linkages to natural resources, raw material supply, infrastructures or urban design, among others, there is potential for impact by promoting the development of frameworks that secure better management of the resources for its future sustainability. This can be done by promoting company or sector practices or legislation development. A more holistic approach beyond the scope of the Company/Project could lead to higher transition impact.

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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