SUMMARY OF OPERATION EVALUATION

A chemical manufacturer

Central Asia

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EBRD EVALUATION DEPARTMENT

European Bank
for Reconstruction and Development

The Evaluation Department (EvD) at the EBRD evaluates the performance of the Bank's completed projects and programmes relative to objectives in order to perform two critical functions: reinforcing institutional accountability for the achievement of results; and, providing objective analysis and relevant findings to inform operational choices and to improve performance over time. EvD reports directly to the Board of Directors, and is independent from the Bank's Management. Whilst EvD considers Management's views in preparing its evaluations, it makes the final decisions about the content of its reports.

This report has been prepared by EvD and is circulated under the authority of the Chief Evaluator. The views expressed herein do not necessarily reflect those of EBRD Management or its Board of Directors. Responsible members of the relevant Operations team were invited to comment on this report prior to internal publication. Any comments received will have been considered and incorporated at the discretion of EvD.

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Executive summary

The Evaluation department conducted an evaluation of an EBRD project with a private chemical manufacturer (“the Company”) in Central Asia. The EBRD provided a loan to support the restart of operations and increase yearly production of iodine including the installation of a third production line and revamp a large number of additional wells (“the Project”). The Project represented the opportunity to support the restructuring of a former soviet company and contribute to the diversification of the highly oil dependent economy, in line with the EBRD country strategy. Transition impact would be achieved through the demonstration effect of the Company's restructuring and improvements in corporate governance standards.

Implementation of the Project proved challenging. The state of the wells was unknown at inception and several had to be abandoned altogether. The operational efficiency also proved difficult as iodine extraction was affected by low temperatures in the winter. The Bank's facility had to be restructured a couple of years in, postponing the grace and repayment period by one and a half years. The Company has now managed to put over a hundred wells into operation but acknowledges that to reach the desired production targets it will be necessary to rehabilitate another few dozen wells, which it plans to do between 2014 and 2015. Project completion has not yet been achieved. As of 2013 production of iodine was still well below the initial target but with a growing trend despite the seasonality effect.

Overall ratings

EvD rates the project *party successful.* The difficulties in implementation and lower production parameters lead to a merely *satisfactory* achievement of objectives. Transition impact has been constrained by project performance, but some positive demonstration effects and improvements in corporate governance are observed; among the former is the re-start of decrepit soviet-era facilities. Additionality is *fully verified* given that financing on the terms provided for a quasi-start-up situation in Azerbaijan was not available at the time. Financial performance has been affected by the delays in implementation and operational difficulties and is rated *marginal*, while the Bank's investment performance is rated *unsatisfactory* due to the increased risk rating leading to negative project contribution and IRR. Bank handling is rated *satisfactory* as the combined result of some positive aspects related to the project structuring and handling while also a recognition of failures in due diligence that led to overoptimistic projections. Finally environmental performance/change is rated *satisfactory/some* reflecting the degree of implementation of the environmental and social action plan.

Findings

The evaluation produced the following findings:

b) Transition impact to be directly connected with project related outcomes

A number of expected transition benefits of the project were related to actions beyond the scope of the project itself, namely the reorganization of the parent group holding vis a vis a listing of any of its subsidiaries in a European stock exchange. Minority shareholders rights protection actions were to be protected with the support of an external legal firm. When the situation of the Company deteriorated and restructuring was required these non-key non-project related aspects were dropped in the interest of safeguarding the Company’s financial situation. Transition impact expectations that support the project rationale need to be connected in some plausible way to specific project activities and design elements.

While collateral aspects and/or second-order effects related to the activities or intentions of other entities may be of interest they should not be drawn within the net of claimed benefits.

c) Need for adequate technical expertise and realistic expectations - a recurring lesson

The Bank invested in a Company in a quasi-start-up stage following its privatisation and restart of operations. The Company owners had no previous experience in the sector. Operational and financial projections were presented based on theoretical expectations about project implementation and production capacity. The Bank supported the client with technical expertise, yet some important and partially predictable impediments to production and efficiency were overlooked. These referred mainly to low winter temperatures affecting iodine extraction, the need for repair and maintenance periods and energy costs for the transportation of the brine from the wells to the plant. Also, it appears that unrealistic expectations were formed about rehabilitation of wells on the basis of inadequate knowledge of their actual condition, causing project implementation delays.

Projects in niche markets, and especially if in an early stage of development, should adequately address the needs for specialized technical expertise to identify upfront possible contingencies affecting project implementation and operation and produce realistic production forecasts. Where possible contingencies are identified take a prudent approach to be reflected in financial projections.

Table 1: Ratings summary

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

Annex: Management Comments

The team found the Operation Evaluation to be fair and reasonable in its comments, and accepted the overall evaluation ratings given in the Executive Summary, with one exception, detailed below. The team agreed with the finding b) and its responses to specific issues within the evaluation are set out below:

- The evaluation report contains comments and findings on the Company's access to subsoil resources. In particular, the evaluation states that the Company continues to operate under a special permit to extract resources, and suggests that the Company does not have the required subsoil licence. The Company in fact obtained required permits and mining allotments before the project was signed, but at the time of due diligence we discovered that a new subsoil licensing requirement had been introduced by the authorities but its implementing legislation had not been adopted. We requested that the Company obtains a new licence when licensing requirements are clarified by the authorities, and introduced a covenant to that effect in the loan agreement. The Company obtained the required licence. The Company's mining allotment rights have not yet expired. At present, the Company sees no reason why the licence and mining allotments rights would not be extended. The findings suggest that the due diligence was inadequate and that no effective actions to mitigate the relevant risks were incorporated in the project design. However it should be noted that the regulatory requirements for operation of an iodine extraction and refining business were thoroughly analysed and assessed by the team. Due diligence revealed that a new subsoil license would be required and identified uncertainties in the licensing regime, which were explained in the Board document. Remedial actions regarding potential breaches of regulatory requirements by the Company are set forth in the financing agreements. The team believes that due diligence was adequate and that against the background of uncertainties in the legal framework governing grant and extension of mining rights in the country, as much mitigation is incorporated in the project design as possible.
- The evaluation raises the issue again under the section on project design. It is noted that the licensing issue had been identified and remedial action in the form of specific covenants is incorporated in financing agreements. Likewise, uncertainties in the legislative framework should be taken into account when commenting on the Company's access to mineral resources.

In relation to EBRD's investment performance, Management would like to highlight the capital contribution that was made by the Sponsors in 2011 to ensure that the Company had adequate resources to maintain its operations and ongoing capital expenditures. All payments due have been honoured to date in spite of the numerous problems faced by the Company. Management notes the tangible support from the owners, and their continued engagement with the Bank.

Management does not concur with the statement– "Transition impact to be directly connected with project related outcomes". The Bank has always been ambitious in terms of structuring projects in order to achieve maximum systemic transition impact ex-ante. In the case of this project, given that the sponsor was a prominent business in the context of the country and also had ambitions to undertake an IPO, it was considered to be important that the rights of the minority shareholders were protected during this process. It was considered that this will not only set a good example but also mitigates potential reputation risks to the Bank if EBRD was associated with a process that was less than the best practice. Unfortunately, the sponsor decided not to proceed with IPO due to the market environment – therefore, the Bank has waived a condition for the second disbursement that the sponsor submits a report on its reorganisation and confirmation that the rights of minority shareholders will be fully respected during and after such reorganisation. It should be noted that the decision to waive was only given after the sponsor confirmed its intention to continue to consider minority shareholders' rights issues if reorganisation would take place.

Since certain intended events have not taken place the evaluation "highlights the importance of identifying realistic transition impact objectives that are connected with the project rather than with collateral aspects related to other group's or sponsor's intentions that can be easily disregarded for the more immediate project's needs". Management, however, maintains that transition impact objectives should be ambitious ex-ante and incorporated into the project design as much as possible. However, the Bank should be carefully re-considering and reassessing the project objectives, if they cannot be achieved due to negative changes in business environment.