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DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D.C. 20523

CAPITAL ASSISTANCE PAPER

Proposal and Recommendations
For the Review of the
Development Loan Committee

TURKEY - EREGLI STEEL MILL

AID-DLC/P-506
2/1/67

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AID-DLC/P-506
February 1, 1967

(Ref. DLF/P-262)

MEMORANDUM FOR THE DEVELOPMENT LOAN COMMITTEE

SUBJECT: Turkey - Eregli Steel Mill (Loans Nos. 277-A-020 and 277-E-047
Rescheduling of Payments

Attached for review is a proposal recommending the rescheduling of the payment of principal and interest on a loan of the Development Loan Fund and two Cooley loans made to Eregli Demir ve Celik Fabrikalari T.A.S. ("Eregli").

This proposal is scheduled for consideration by the Development Loan Staff Committee at a meeting on Friday, February 3, 1967.

Rachel C. Rogers
Assistant Secretary
Development Loan Committee

Attachment: a/s

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February 1, 1967
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TURKEY: EREGLI IRON AND STEEL WORKS INCORPORATED

AID has under consideration a proposal to defer temporarily interest on such of its loans to Eregli Demir ve Celik Fabrikalari T.A.S. ("Eregli") as are payable in local currency.

The loans in question are DLF loan 169 (277-A-020) and two Cooley loans (both numbered 277-E-047). The DLF loan, authorized in 1961, is for $129.6 million; only $98.6 million, however, is payable in local currency. The interest rate is 5 3/4% per annum. The Cooley loans, authorized in 1964 and 1965, aggregate $16.7 million equivalent. The interest rate is 8% per annum. At December 31, 1965, the outstanding principal amount (including deferred interest) of the DLF loan payable in local currency and the Cooley loans aggregated $135.7 million. Interest on this amount (the weighted average interest rate is approximately 6% per annum) is approximately $8 million.

The proposal is to divide the present interest rate into two parts: fixed interest, which would accrue irrespective of earnings; and additional interest, which would accrue to the extent of 80% of Eregli's net income (as calculated after deducting fixed interest but before deducting additional interest). The fixed interest rates would be 1% in 1966, 1½% in 1967, 2% in 1968 and 3% in 1969; after 1969, fixed interest would accrue at the present rates. The rate of additional interest would be equal to the difference between the present rates and the fixed interest rates. To the extent not earned in any year, additional interest would be accumulated and carried forward and would be accrued and paid in subsequent years when it would be so earned. Thus, except for interest on the unearned additional interest that would be accumulated and carried forward, the above proposal does not entail the ultimate loss of any interest.

The Eregli steel mill project, the largest private-sector AID project in the world, is a 470,000 ingot ton steel mill that was built by a consortium of U.S. companies (Koppers Company, Inc., Blaw-Knox Company and Westinghouse Electric International Company) in a 42-month period from 1961 to 1965. Eregli started up operations in the spring of 1965. In that year and in 1966 it showed a loss; the amount of loss in 1966 (before adjustment of interest rates) is about $15.5 million. The project has just now reached the stage where it can break even on a cash basis <u>before</u> paying interest or principal on the local currency loans from AID (mentioned above) and the Government of Turkey (approximately $65 million). As the project now stands, without adjustment in interest rates and after paying interest and principal on all loans, it would not reach the cash break-even point until 1968 and would never show a profit.

Faced with this state of affairs, in the middle of 1966 AID contracted for an extensive study of the project by Armco Steel Corporation and a professor of economics at Massachusetts Institute of Technology. The Armco report has been received, and the MIT economist's report is expected shortly. Armco recommends certain changes in operating practices and procedures (including importing 50% of iron ore requirements, reorganization of management and reduction of labor force), and expansion of certain facilities (estimated cost $21 million) to provide for additional ingot tonnage capacity and for the continuous casting of billets. (These recommendations will be presented to the Eregli Board of Directors and the GOT in mid-February.) If these recommendations were put into effect at the beginning of 1967, Armco projects that Eregli could show a profit in 1968 and reach the cash break-even point in 1967. AID's projections, based on Armco's but allowing for delay not only in commencing but also in implementing the recommendations, shows Eregli incurring losses through 1968 and not reaching the cash break-even point until 1968.

If the interest rates are not reduced, Eregli will show a $15.5 million loss in 1966 and (by AID's calculations) an $11 million loss in 1967 and an $8 million loss in 1968, before showing a small profit in 1969. The effect on management, it is believed (and stated by the Chairman of the Board of Eregli), would be very deleterious in this critical period when management must throw its full weight behind the Armco proposals. It is also believed that the effect on the morale of the company as a whole would be adverse and that the hostility to the project among elements in the country, the Government and even the Board of Directors would be increased, all to the detriment of the project. A potentially more menacing result is that Eregli would be subject to involuntary (perhaps mandatory) bankruptcy under Turkish law in 1968 (and possibly in 1967) because its accumulated losses would have by then exceeded one-third of its paid-in capital. On the other hand, if interest rates are reduced, Eregli will be assured of generating sufficient funds to finance the local currency costs of the expansion (approximately $5 million) that it might not otherwise be able to generate or borrow. Finally, because of the reduction in interest rates Eregli will reduce its deficit in earned surplus at an earlier date than would otherwise be possible, thus enabling the GOT, which presently owns 60% of Eregli but is under an obligation to sell its interest when buyers are available, to sell off its shares to the private sector at an earlier time.

With the uncertainty of future cash generations and the need to finance the local currency expansion, AID also proposes to defer repayment of the loans in question until Eregli shall have paid off the accumulated arrearages in additional interest. (AID's projections show this happening about 1971.) But Eregli will also be required to apply any excess funds to the prepayment of the loans in question. In particular, Eregli will be obligated to apply 50% of the funds provided by its operations (net income plus depreciation and other non-cash charges to income), after payment of fixed installments on foreign exchange loans, to the prepayment of the loans as to which the interest rates are to be reduced, to the extent that these funds are not applied to the prepayment of Eregli's bank loans (which carry a burdensome interest rate of 13% or more per annum) or to the local currency costs of the expansion. (The other 50% is what is estimated to be required for working capital and other operating needs.) The prepayment requirement may cause AID to lose a small amount (estimated to be well under $1 million) of accumulated interest -- that is, the interest accumulated on the prepaid principal.

A condition to the whole proposal is that the GOT agree to do likewise with respect to its local currency loans (approximately $65 million equivalent) to Eregli.

In summary, the proposal envisages (a) temporary reduction of fixed interest rates, with an amount equal to the reductions to be paid to the extent earned and, to the extent not earned, accumulated and carried forward and eventually paid when earned, (b) deferment of principal payments until such time as all accumulated interest has been paid, and (c) mandatory prepayment during the period of the deferment to the extent excess funds are available. While the deferment of the Cooley loans may extend the final maturity of one or both, the final maturity of the DLF loan will not be extended.

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