



FLAG MONTENEGRO

CALENDAR YEAR 2001- 1st QUARTER REPORT

JANUARY 1–MARCH 31, 2001

INTRODUCTION

The first quarter of 2001 saw the decline in Montenegrin economic activity continue as many of the necessary institutional reforms were put on hold while the Republic prepared for elections in April. Until the issue of Montenegrin independence is resolved, economic relations with Serbia, Montenegro's largest potential market, will continue to stagnate. The most promising prospect for Montenegro in 2001 is a tourist season that could see a markedly greater number of visitors than in recent years due to the relatively peaceful situation in the immediate region.

FLAG SME activity began slowly in 2001 as we awaited release of funding to support our new strategy, developed early in the quarter, and because of a continuing lack of legislative reforms to help the SME sector realize its potential. The latter leads businesses to continue to operate in the gray area, limiting their desire to fully provide internal information that could speed up assistance efforts. Nevertheless, we managed to begin rebuilding the client base later in the quarter and defining client needs. Client building activities will continue into the second quarter, but at a more rapid pace as we now have the staffing and facilities to carry out work more efficiently.

Tourism activities began the quarter with the announcement by the government of several international tenders and its desire to organize an investment conference by May. In the middle of the quarter, we were asked by USAID (AID) to begin winding down tourism privatization activities for a post-conference handover to Pricewaterhouse Coopers (PWC). In order to prevent a disruption in this economically vital area, we began cooperating more fully with PWC to make this handover as smooth as possible. Our tourism activities have now begun to focus on SME activities and client building along these lines.

Management assistance activities at Kombinat Aluminijuma Podgorica (KAP) have been largely successful in terms of training management, but frustrating with regard to the implementation of needed changes. The bulk of the managerial and operational initiatives were hampered by KAP's continuing inability to reach a deal with creditors on a debt restructuring agreement (DRA). Once this hurdle is cleared, KAP will immediately have

access to a USD 11.3 million credit line that will enable it to acquire needed inventories and make critical improvements to the plants. It is still believed that this will be the first year in a decade that KAP will show a positive net income.

SMALL AND MEDIUM ENTERPRISE DEVELOPMENT

General Activities

FLAG's new SME strategy involves the identification of hubs and the building of a web of businesses around these. To date, this strategy has been successful in developing a client base and formulating assistance strategies to impact a still wider range of enterprises. The strategy has necessarily evolved somewhat as we have met resistance from the "downstream" companies and found that many of our clients are most interested in expanding the web laterally, i.e., to include competitors.

Downstream firms, which tend to be state owned, are much more reticent to enlist our assistance as it means providing information on the company. Many of these firms are wary of our research activities. In addition, most do not have any credible internal systems that would make that research effective. Due to a lack of efficient management and control systems, state-owned firms often make difficult partners for our clients as they regularly place orders on an ad hoc basis and bills to them frequently go unpaid or result in barter arrangements. We have encouraged the lateral spread of the webs as it may assist us in developing industrial associations capable of winning legislative support to their sectors.

Upstream activities have provided fewer leads to expand the client base. Many of our clients have learned from dealing with a variety of companies, and through the sharing of information with competitors, with whom they can conduct business successfully. Often, they have chosen to restrict themselves to dealing with private local companies and/or with foreign firms.

Our work with KAP has also led to SME activities as the restructuring of the Kombinat will involve the spinning off of several activities not essential to its core business. In addition, we have arranged a contract for one client, Progress & Co., to provide hydraulic cylinders and cooling circuits to KAP. Progress will

likely see an extra DM 500,000 in annual revenues because of this. Implementation of the contract has been delayed while the DRA is pending.

We have begun developing two hubs centered around Progress & Co., a metal works, and Storing, a start-up abattoir. Together these webs have 15 firms, 237 employees and report CY 2000 revenues of nearly DM 11 million.¹ In addition, we have 5 active clients that are not part of any web. These clients employ 63 people and report CY 2000 revenues of DM 607,000.¹ We will have our client base complete by the end of the second quarter, have 3-4 webs established and will begin more active technical assistance with the beginning of the second quarter of the calendar year.

Cooperation

Cooperation with other NGOs and with local support service firms has been developing slowly. The former is due to the late start of SME activities, as already described in the Introduction, and the latter due to a lack of coordination on the part of the primary local firm, the Center for Entrepreneurship. Consequently, we have developed a relationship with the Agency for Development of Small and Medium Enterprises. The Agency is a government-sponsored organization intended to promote legislative reform and provide direct assistance to the SME sector. We are using institutional knowledge developed from our success working with a similar agency in Bulgaria to further this relationship. To date, we have provided legislative suggestions and comments regarding pending legislation offered by the Agency. We will also use lessons learned from our work with Chambers of Commerce in Croatia to coordinate the Agency's activities with Montenegrin Chambers in order to increase their reach and help avoid duplication of efforts.

We also established relationships with existing domestic banks and with international organizations operating in the Republic of Montenegro in this

¹ These numbers are incomplete, as not every company has provided revenue or employment figures. These firms have expressed a willingness to work with FLAG but will be removed from the client base if they show they cannot provide information necessary for us to develop our assistance strategies.

quarter. Each local bank was visited and data collected to compile information regarding potential financial sources available for small and medium enterprises.

We also established a relationship with the Development Fund of the Republic of Montenegro and acquired information on its loan terms and conditions for entrepreneurs. We obtained a copy of the Fund's client database and visited some of its clients chosen from those who repaid or are close to repayment of loans obtained from the Development Fund.

In addition, we contacted SEAF – the Small Enterprise Assistance Fund – part of the Southeast Europe Trade Initiative, at its main office in Bulgaria, and obtained useful information.

All the financing information from the local banks, international organizations, RM Development Fund, and SEAF has been consolidated in a brochure that we provide to clients looking for financing options.

We also organized meeting with an EBRD delegation that visited Montenegro in early February to discuss future EBRD activity in Montenegro's SME sector. The EBRD is currently researching establishment of a possible SME credit line through domestic banks, or through an independent fund.

Finally, in this quarter, we contacted the Washington-based CEEBIC – the Central and Eastern Europe Business Information Center – and requested that our information be presented on their web site. The web listing will include basic information about our activity and projects.

Trade Development

We continued cooperation with GTN but again met with minimal success for our clients. Nevertheless, all of our new clients were introduced to GTN and its capabilities and were registered in the GTN database. We only created and disseminated one trade lead in this quarter, but as the result of cooperation with GTN, we did identify specific US companies that could offer a potential market for our export-oriented clients. Further, we began researching and promoting the

export potential of several clients who produce essential oils, olive oil, and herbal products.

Business Plans

In this quarter, we began work on developing a business plan for one of our clients, DERASCO, a producer of fitness equipment. As has often been the case, research into the company and discussions with the manager allowed us to pinpoint some practical technical assistance that could reduce costs for the manufacturer and ease its financial needs. While FLAG has the capability to produce complete and varied business plans, it does try to discourage most clients from utilizing debt financing because of past problems meeting obligations and because, many times, funds can be acquired internally by reducing production costs through simple reorganization. In DERASCO's case, we managed to find cost savings by rearranging the shop floor and implementing better financial management. As a result, the business plan will recommend a credit line at half the amount of debt financing originally envisioned.

In cooperation with the Center for Entrepreneurship, we also worked with another client, STORING, interested in building a chicken farm and slaughterhouse for broilers.

TOURISM DEVELOPMENT

We are currently in the process of closing out our tourism privatization activities in preparation for a post-conference handover to PWC. During this quarter, however, there was much activity involved in preparing for the conference and assisting the government in preparing materials for the sale of three hotel assets and the implementation of management contracts for two other properties.

In the quarter, we prepared information memoranda and assisted in preparing the tender advertising the sale of three hotel properties: Maestral, Avala, and As. After the announcement of the sale, we prepared the tender documentation and

information memoranda used in direct mailings to 180 leading industry addresses. We were not surprised at the disappointing level of response on the tender, however, due to the government's decision to allow no more than 30 days for responses. No bids were offered for Avala. Responses on Maestral and As were encouraging as the bids were made by reputable international owners with transparent financing and international backing of funds. We worked with the Tender Committee on coordinating the responses to, and the evaluation of, the bids received. Currently, the government is engaged in final negotiations on the sale of these two assets.

The government has expressly stated that it will not sell the assets of Milocer and Sveti Stefan. However, they are interested in attracting reputable international operators to manage these promising properties to international standards and develop their potential. To this end, we developed information memoranda needed to attract management contractors for these two properties. A longer horizon was sensibly given for responses to this offering; the government expects to receive formal responses at its tourism investment conference in May.

We also worked extensively with the German government consultants, DEG, in creating a master plan for Montenegrin tourism. We provided much of the background data based on our experience working in Montenegro and our relationships with government officials, municipalities, and property managers. FLAG was granted first review of the final document and we provided general approval of the findings and presentation. This activity was part of our effort to work with the Ministry of Tourism on privatization initiatives for 2001, which resulted in the adopted Privatization Plan for 2001. This plan helped develop the agenda for the Montenegro Tourism Investment Conference.

Much of the first quarter's efforts involved preparations for the investment conference to take place in May. We worked with an internationally recognized tourism conference operator, developed the list of potential attendees, and worked with the government in preparing and mailing the invitations. To date, the government has received 150 confirmations. We have worked on all levels of

conference preparation from organizing speakers to arranging for suppliers to ensure that attendees' hotel rooms are properly outfitted. With the receptiveness of the government to our suggestions, the overwhelmingly favorable response of the investment community, and the preparatory activity of the Montenegrin government, we are confident the conference will be a success.

Finally, we established an office in Budva to situate us closer to tourism-related small and medium enterprises along the coast. With this office in place, and building on our initial contacts, we will be able to move very quickly to supporting these businesses once we are done with our conference duties. Initial SME targets include three private hotels, various restaurant and shop franchising opportunities, and suppliers to hotels and restaurants.

KAP

Management assistance at KAP should lead to the first positive net income for the plant in 10 years. The most critical hurdle is the completion of the DRA. Until this is in place, the plant will continue to operate at a loss, without adequate spare parts, and with limited inventory. Fortunately, KAP officers have been very responsive to our suggestions to restructure the management at KAP, improve the financial function, and eliminate excess employees on the plant floor. We prepared a plan for refurbishment of facilities which addresses the most pressing needs, and coordinated the approval of a credit line to accomplish this. The credit line awaits the completion of the DRA – at that time funds will be made immediately available.

Finance

The first task tackled after starting in January was the budget for 2001. The preparation of an operating budget in a format understandable to Western readers proved a major task. The traditional KAP budget is in a format that few can understand and in Serbian. A more comprehensible budget was eventually prepared, but took a major push from our side.

Debt Restructuring Agreement

This is a necessity to turning around the KAP plant. Although we are not part of the DRA Negotiating Team, various documents associated with this Agreement have been reviewed by us and we have made recommendations to KAP management. We have also directly assisted in some of the negotiations at the request of KAP and Montenegrin Government lawyers. The DRA has been under negotiation for over 6 months and remains unsigned. We have assisted KAP and the Government lawyers in preparing various cash flow and budget data to include in this document. These have had to be updated on a monthly basis. We have also assisted KAP by meeting with its major creditors to discuss and review the documents and the related reporting procedures that will need to be followed once the documents are signed. These reporting and compliance requirements will place a heavy burden on KAP.

Staffing

We are currently formulating reorganization plans but are restricted by the quality of the people available. The reorganization involves recruiting a professional trained in international standards to develop financial and accounting systems. The reorganization will ultimately involve creating financial accounting and cost accounting functions. The finance function at KAP is currently ill equipped to handle even existing management requirements. The standard of professionalism is low and it is, at present, unrealistic to impose Western style reporting. Salary structures are low, even by local standards, and this, not surprisingly, makes attracting suitably qualified personnel difficult. We are currently in the process of recruiting a Serbian and English speaking finance professional to assist in the transition to Western style reporting. From almost 100 applications, only 5 have been suitable to interview. Given the total inadequacies in this area, additional resources will be required.

Reporting

We have attempted to introduce Western-style reporting for profit/costs & cash flow, but have met only with limited success. Work is stuttered as officers explain they are too busy and, unless the General Manager directs them to do specific things, not much gets done in terms of training the current professional staff. What is done is done very slowly. For example, we are still waiting for a cash flow statement for the month of January 2001. Despite numerous explanations on our part, several training sessions, and a reduction of the task practically to one of "form filling", it remains a concept difficult for KAP staff to understand or accept.

Systems

Most of the finance systems are manual. By recruiting a dual language finance professional (see above--Staffing), we plan to take the first steps toward automation.

Training

We have conducted a number of formal and informal training sessions. There is an obvious need for a further training effort, which we will undertake in future quarters.

General

We continue to assist KAP in day-to-day management and consult regularly with the General Manager who has been very responsive to the need and plans for reorganization of the plant.

Operations

Refurbishment

The plan, the budget, and the schedule for the Refurbishment and the Major Repair was prepared in January and a presentation made to KAP's senior management. A summary of the budget estimate is as follows:

* Alumina plant	\$ 5,009,911
* Smelter	\$ 4,840,705
* Rectifier, transformers, distribution	\$ 903,204
* Laboratory	\$ 356,818
Total	\$ 11,110,638

The proposed schedule for the work covers an eight-month period and was due to start in January. Owing to the delay in the signing the DRA, the refurbishment has still not started. Consequently, several revisions and updates of the budget and schedule have been prepared. The organization to handle this refurbishment work is in place. Ongoing discussions are continuing with the Purchasing Department regarding the best means to expedite procurement and deliveries for this effort.

Operation of Production Facilities

While waiting for completion of the DRA, KAP is attempting to keep its equipment running without adequate spare parts. This has created a critical situation in all operating areas, as KAP's cash flow during the quarter has been insufficient to provide sufficient funding for spare parts for ongoing maintenance. During a breakdown of the alumina calcination kiln, for example, alumina had to be purchased to keep the smelter going during the repair. Since that incident both the alumina plant and the smelter have managed to maintain production, but it has not been possible to build an alumina inventory. Notwithstanding all these problems, aluminum production for the quarter has been close to a record high.

A contractor, Anotech, handles anode production and is responsible for supplying KAP with anodes and with upgrading the carbon facilities. The Anotech anode carbon quality represents a serious problem for potroom operation and performance. In a letter to Anotech, KAP put Anotech on notice that it is in breach of contract concerning anode quality and anode dimensions and that it is behind schedule on repair of the baking furnace. Subsequent to the notice to Anotech, anode quality has improved. KAP needs quality anodes in order to carry out the production increases and achieve the positive net income we are planning on. In order to carry out diagnostic work and find ways to rectify problems in

KAP's carbon plant, expert assistance from a western-trained professional will be needed.

Reorganization

A plan for reorganization of the alumina plant, the smelter, and central maintenance has been completed and presented to the General Director for approval. The reorganization will be carried out in three phases with the third phase being implemented only after completion of the refurbishment. Each of these reorganization phases will result in significant reductions in personnel. The reorganization of the rest of the plant has also been discussed with the General Director and will start as soon as we get his approval. A complete reorganization of the production facilities is required for several reasons. The ultimate objective is to give KAP a flat and scaled-down organization in order to help it be internationally competitive.

Operational Improvements and Cost Savings

A number of improvements and cost savings have begun, or are in the planning process. If the DRA is signed by the end of April, it is planned to have the refurbishment completed by the end of December. At the same time, it is planned to increase the alumina production to 220,000 t/y and the aluminum production to 110,000 t/y. After the completion of the refurbishment, KAP will be ready for still further production increases and significant operating cost reductions.

In the smelter, a number of improvements have been implemented. The anodes that are taken out of the pots are now being cleaned in the potrooms before the carbon is recycled back to the anode plant. This reduces the fluoride contamination of the carbon and improves the anode quality.

It is our opinion that the company has the potential and management a willingness to undertake the streamlining necessary to make KAP a competitive producer capable of paying back its creditors.

Management Improvements and Training

Part of the reorganization process involves the selection and training of new leaders. FLAG's daily management work involves working with alumina, smelter and central maintenance managers regarding operational improvement, management, and cost savings. We hold weekly cost savings and production improvement meetings with the process engineering departments from the alumina plant and smelter. These meetings also function as on-the-job training.