



**FLAG MONTENEGRO**

**CALENDAR YEAR 2001 - 2nd QUARTER REPORT**

**APRIL 1 – JUNE 30, 2001**

## **OVERVIEW**

As the economic situation in Montenegro continues to worsen, SMEs find it more difficult to conduct business. While FLAG's clients have had moderate gains, it is clear that the overall economic environment in Montenegro will continue to deteriorate without significant change at the macroeconomic level. The most significant problems in the SME sector are the extensive black/gray market activities (60-70% of entrepreneurial activity by some estimates), the poor tourism market, and the stagnation of legislative reform and implementation that could help curb illegal business activities and level the playing field.

To counter these problems, FLAG is concentrating its assistance efforts on finding international markets for client products and preparing management for the increased financial scrutiny necessitated by doing business in formal market economies – the latter is proving difficult as the market economy in Montenegro was born in times of sanctions and war. Managers see the need for transparency in reporting but find it difficult to implement as they have no experience and find it unfair when so many compatriots maintain informal business activities.

Our web approach to SME development has assisted in this battle as companies pressure others in their web to conform to modern standards. We have used this opening to approach the newly formed Association of Entrepreneurs about its plans and offer assistance in legislative initiatives aimed at moving the market to international standards for accounting, quality, inventory management, and procurement. Working with the Agency for Development of SMEs and the Association of Entrepreneurs, we are taking a two-pronged approach by working both from within the government and outside of it to effect improvements in the entrepreneurial environment.

Tourism privatization activities have ceased and our tourism efforts have shifted to assisting private hotel operators. To date we have accumulated a client base of six operators and are planning a training seminar for the fall on financial management and accounting to ensure that they are up to date on international management standards. Further assistance will involve applying international hospitality standards

to rooms and restaurants and, where feasible, linking these clients with others in Montenegro in order for them to provide quality goods and services and to maintain their advantage over other hospitality options currently available.

Our management assistance at KAP continues to provide results. In the past quarter, KAP signed a Debt Restructuring Agreement with the government and creditors that will allow it to continue operations, provide for a credit line to increase inventories and improve plant maintenance, and allow for international investment in the near term. We hired a financial accountant who is training staff in international accounting standards for plant operations and setting up a computerized financial accounting system. Current forecasts for KAP are USD 12,000,000 operating income for the plant this year. While we envision the need for management assistance to continue for at least six months into the following calendar year, significant progress will have been made in modernizing plant operations and financial management by the end of 2001. This extra assistance will ensure that the plant is operating in line with international standards and will be ready for privatization sooner rather than later.

## **Small and Medium Enterprise Development**

### **General Activities**

Our second quarter SME activities have significantly improved from the first quarter, albeit program funds were not received until the end of the second quarter. We have secured a working relationship with 52 private SMEs in Montenegro. The legal structure of most of these businesses is that of sole proprietorship. Very few are structured in domestic partnerships and fewer with an international partner. The number of individuals employed by these firms range from 3 to 40, the majority of them having fewer than 10.

We continue to embrace our Hub and Web Strategy (HAWS) targeting private businesses that have direct suppliers and customers that can also benefit from technical business assistance. The objective is to build strong integrated networks of businesses in which the businesses can learn from each other and expand the web with their own networks, applying business practices and individual experiences to spur growth and sustainability in their industries. Adopting modern open-market business principles will allow the companies to build a foundation and prepare themselves to compete in the world markets.

Executing the HAWS has resulted in the identification of numerous challenges facing private businesses in Montenegro. Two of the firms, which were earmarked as HUBs, Storing and Progress & Co., are conducting business with about 15 firms. Most of the 15 firms are state owned; a few are private firms located outside of Montenegro. The owners have expressed serious discontent with conducting business with state-owned firms. Apart from challenges mentioned in the overview, others, though not new, include:

- Difficulties in collecting receivables
- Lack of inventory planning
- Acceptance of barter payments in lieu of cash

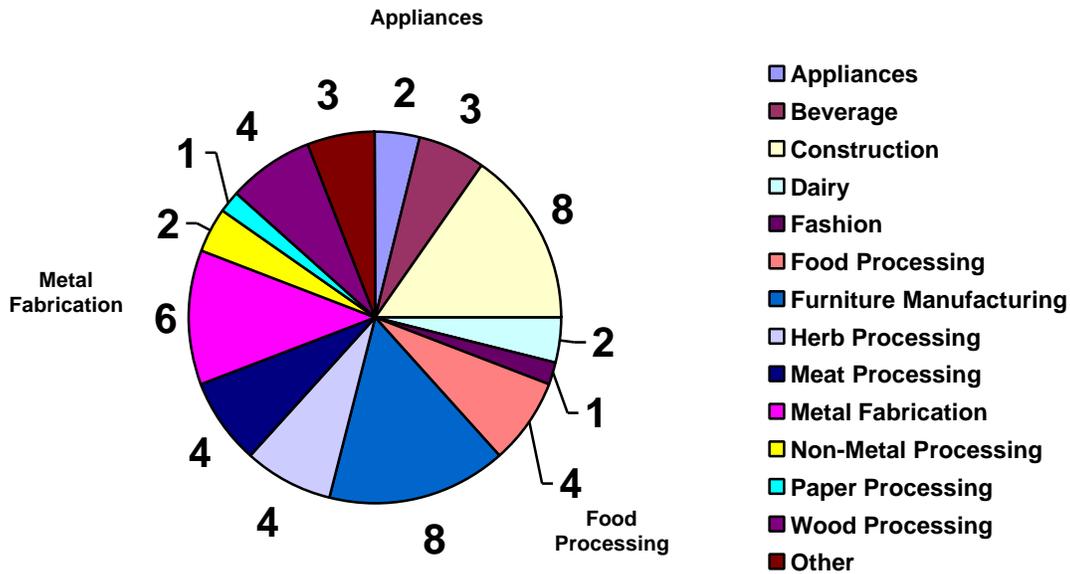
These challenges arise not only in conducting business with Montenegrin state-owned firms but also dealing with state-owned firms located in FRY and neighboring countries, which do business with these clients.

The Web of companies that surround the respective HUBs will only improve as the foundation for private businesses improves. Conducting business with the state owned enterprises would only restrain private companies from evolving into competitive businesses. FLAG will focus its energy on private enterprise. Our current client base provides opportunities to build each company into an effective HUB and also to integrate each one with other firms to make it a vital part of the other firm's WEB. These linkages are desperately needed for the domestic firms to thrive.

### **Clients**

Our active client base has increased to 52 SMEs throughout Montenegro. We have reached private entrepreneurs from the Northern city of Pljevlja to the Southern municipality of Ulcinj and have included a broad range of industries – refer to the chart below. The range of businesses present in Montenegro is surprising, indicating that the entrepreneurial spirit is not obsolete, but merely in need of a functional economic infrastructure that provides a level playing field for all sectors and industries. Technical assistance in all areas of business functions, marketing, finance, accounting, corporate governance, etc. is needed to help the SMEs succeed.

## SME Active Clients, 2nd Qtr



### Technical Assistance

The quarter began with an aggressive campaign to rebuild the active client base and to strengthen relationships with our clients. We solidified many relationships and were able to proceed with problem identification. When posed with the question, “What business challenges are you currently facing?” most of the entrepreneurs only state a need for favorable financing. Further exploration, however, reveals underlying challenges such as:

- Limited access to markets, both domestic and international
- Lack of marketing strategies
- Organizational management problems
- Delayed receivables and bartering form of payment
- Lack of current technologies

The ultimate result from repeatedly meeting with our clients is the establishment of a relationship of trust and integrity – the two key aspects for being able to provide effective technical assistance.

Several scopes of work have been defined including marketing/organizational management for a meat processor, marketing strategy for a furniture manufacturer, marketing strategy for a rope/net manufacturer, organizational management/marketing and current technology for wood processing, marketing strategy for beverage producer. Many of the projects were identified in May/June and will be completed in the 3<sup>rd</sup> Quarter CA 2001.

One project that was successfully implemented with a volunteer expert (VE) from IESC was the marketing/organizational management for the meat processing company Trojica, based in Pljevlja, about 3 hours Northeast from Podgorica. The company's meat products are primarily distributed via its own retail outlets throughout Montenegro. Raw materials are primarily imported, as there is not enough supply in the region, or Montenegro for that matter, to meet their demand for inputs. The client made available most of its management in the factory and also in the retail outlets to the VE – they were very committed to working with him and learning from his experience. Since the VE is a former owner of several meat processing facilities, he easily understood the general business issues that Trojica has and identified several key areas in which they can make changes and see noticeable short-term results.

Simple recommendations were made to bring better organizational and management structure to the business. Trojica has been experiencing growth over the past few years and management was more involved in managing its workforce of 40 than in dealing with strategic business issues. The VE's visit spurred management to prepare job descriptions, thus opening a dialogue with the employees to collaborate on a work plan. Since most of Trojica's sales are in retail and their products are edible, it is important for Trojica to convey an image of cleanliness and a friendly environment. Consequently, a customer relationship management (CRM) program has been developed and was committed to not only by the management but also by the retail workers. The program details the basics of CRM and includes wearing a name badge, wearing clean attire, having good hygiene, and presenting oneself to customers in a friendly fashion. One significant item that could only have been identified by an industry expert was that Trojica has an opportunity to maximize the ratio of meat-to-fat in its processed products. The VE recommended the purchase of a fat tester (approximately USD 200) which, when used properly, could identify the percentage

of fat in the processed products and thus effectively reduce costs by USD 50,000 annually if management takes corrective action. As Trojica increases its production levels, the cost savings will significantly impact its bottom line. Trojica enjoyed working with the VE and is satisfied with FLAG's ability to help Trojica's management to successfully implement the VE's recommendations.

### **Linkages**

One of the more important areas in which we can help the private SME sector is to provide them business linkages. Our clients have requested help in locating new domestic customers, locating domestic producers, penetrating international markets, preparing Internet presentations, and networking with the government and with state owned firms. We have had some success in making the 48 requested linkages; however most have been challenging to execute, particularly when attempting to connect private domestic firms with international entities.

One of our beverage producers asked us to locate a supplier of .25 liter bottles, which can be used to bottle fruit juices. We received more than ten offers from manufactures located in Hungary, Bulgaria, Italy, Croatia, and as far away as South Africa. Each supplier had its own requirements for selling the bottles, whether it was minimum quantities or fixed prices, and all of the selling offers have not come to fruition. Offers have ranged from as low as DEM 20,000 to as high as DEM 95,000 including customs duties and transportation. The suppliers also mandated advance payment including all shipping and customs duties. Currently it is impossible for our client to purchase the bottles because the most they can spend is 10,000 DEM. Being a small producer of fruit juices hinders their purchasing power and thus their ability to conduct smart business.

An essential oils producer submitted samples of its products to two U.S. buyers and one buyer from U.K. The potential international customers have been slow to respond to the Montenegrin producer primarily due to the small quantities they can produce. Another of our clients, a meat processor, has had difficulty in obtaining supplies of pork from European countries due to the ban the Montenegro government has imposed on imports. Some of its former suppliers, Holland and Hungary, are still

banned from exporting to Montenegro, and Serbia does not have a surplus of pork to sell to its smaller neighbor.

### **Business Plans**

The business plan for Derasco, manufacturer of fitness equipment, was completed and submitted to the Fund for Development (FD) for evaluation and approval. After several scenarios of funding and reiterations of the business plan, which were completed by our consultant, a final decision was made not to seek funding that could possibly strain Derasco's cash flow, but to prepare the business plan to secure funding for initial business expansion and growth. Derasco is seeking DEM 50,000 to purchase a few pieces of manufacturing equipment, hire one welder, and prepare a promotional campaign. FD verbally approved the loan and is waiting for available funds before processing the agreement.

The evaluation of other business plans is currently being pursued. One potential business plan involves helping one wood processor in Kolasin expand their current business to include a finishing process. Several finishing processes can be implemented, each requiring different amounts of financing and expertise. A consultant from the industry is being sought to evaluate our client's current situation and make recommendations on a finalization process that would integrate well with his current business. Exploring the feasibility of the project is the basis for preparing an executable business plan. Another potential business plan involves securing working capital for a recycling operation; the current amount requested by the client is DEM 2.0 million. The owner invested in new technology to make his operation more efficient and to increase the capacity by 200% from current levels. The main obstacle confronting our client is finding a financial institution that would support such an investment. In anticipation of such an institution making its way into the Montenegro financial system, we are providing technical assistance in preparing Western style financial reports, which can be integrated into a business plan and submitted for approval and subsequent funding.

### **Capacity Building**

This quarter we solidified good working relationships with the Agency for SME Development, the Association of Entrepreneurs, and the Montenegro Association of

Accountants and Auditors. Our objective is to provide technical assistance to each organization and establish a collaborative dialogue among them. Their activities should complement one another and provide an avenue for entrepreneurs and SMEs to voice their opinions and also a means for the organizations to efficiently disseminate information to Montenegro's SMEs and professionals.

Technical assistance planned for two of the above organizations is as follows:

- For the Agency for SME Development - training in business plan writing for members of the organization, entrepreneurs, and our SME clients.
- For the Association of Entrepreneurs – assistance with the institutional building of the association, and developing business training programs for its members.

### **Anticipated Challenges for the 3<sup>rd</sup> Quarter of CA 2001**

Although our current client base is strong, we anticipate attrition and plan to replace these SME clients with new clients that have the initiative and desire to succeed. Two-thirds of the third quarter will be privy to holiday vacations for most of our clients. Although most will be unavailable to work on projects that have been identified, there are several in which consultants have been secured to execute the desired technical assistance. In addition to the above, the political instability for Montenegro and the unknown future for the Federation is still a major obstacle to achieving the required reform. This situation slows down and may prevent foreign investment and development in the banking sector that could provide necessary assistance and support for SMEs in Montenegro - this will undoubtedly affect SME activities until it is resolved.

### **Tourism Development**

FLAG tourism privatization activities in the 2<sup>nd</sup> quarter of CY 2001 were quite intensive, as we worked to move ourselves out of this aspect of the program. In fact, the final preparations for the "Montenegro Hotel Investment Conference" occupied most of our time, requiring close cooperation with respective Montenegrin authorities, such as the Tourism Ministry, the Privatization Council, the Agency for Foreign

Investments and all the companies presenting their investment projects at the conference. FLAG coordinated activities with these institutions, as well as with the appointed organizer, “BHN Network,” from Los Angeles.

A hundred investment projects and several infrastructure projects related to general economic needs and the legal and institutional framework of the Montenegro hotel and tourism industry were presented to the Conference’s 130 foreign attendees. The numerous contacts established there are already resulting in serious business contacts and proposals. The FLAG team took an active part in the presentations and the logistics of the daily program.

In addition to the Conference preparations, FLAG was asked to prepare two asset sale information memoranda for hotel “Olympic” in Ulcinj and hotel “Avala” in Budva. They were distributed to 14 companies upon receiving their written requests in accordance with the privatization legal procedure in Montenegro. As FLAG’s tourism privatization activities were terminated with the completion of the Conference, the follow-up on those tenders has been entrusted to PricewaterhouseCoopers and the Agency for Foreign Investments.

After the Conference, FLAG’s tourism engagement switched to tourism related SME activities, focusing on private investment projects presented in Igalo and also private hotels operating in Montenegro. Initial preparations have been completed and screening meetings scheduled. Within our SME scope we intend to propose a series of training seminars introducing international hospitality accounting standards to local accountants, engaged both in state-owned hotel companies and private accounting firms.

## **KAP**

### **Accounting**

KAP is using accounting software that was installed approximately 15 years ago. From the technical side, the software is old, difficult to handle, does not meet international accounting standards, and is useless for any modern management reporting. The bookkeeping as organized is not professional or automated, and covers the data for 16 separate legal entities and 16 bank accounts. These are all consolidated to prepare the KAP financial reports. While these reports meet the requirements of Montenegrin law, they do not meet any of the established international standards.

In the short term, we have created an income statement from the first 5 months of 2001, in line with the Debt Restructuring Agreement. There have been difficulties in matching accounts, as listed in the ledgers, but we have made changes to the software that will bring these in line across business segments. Sub accounts are not automatically connected with the General Ledger, causing duplicate entries across statements.

Without the needed investment in modern accounting software, reprogramming of the old software has been necessary and this work will continue through completion unless new software is introduced. This work includes creating automated connections between the General Ledger and sub accounts, renaming account codes to enable simplified analysis of financial statements, and bringing the system in line with international reporting requirements.

Cash flow statement forecasts still create difficulties as, until recently, all receivables and payables were handled through hand written ledgers by only one department. A search through one of the offices turned up nearly DEM 2,000,000 in invoices payable. A simple program in Excel has been established to handle the automated recording of all invoices, but this will need to be modernized to bring the system in line with international standards and for the sake of control. This ad hoc set up will, however, alleviate the problem of all payables, suddenly surfacing as urgent, and will

allow KAP to be in line with the Debt Restructuring Agreement, which dictates payment of liabilities every ten days.

## **Operations**

After the Debt Restructuring Agreement was signed in late April, a revised schedule and a budget from May through December 2001 were prepared for the refurbishment project, with the balance being completed during the first part of CA 2002, which is subject to KAP's cash flow situation. The procurement process will be KAP's near-term challenge for both the refurbishment project and for keeping equipment running. The capability of the purchasing department is limited and it is, for example, difficult to obtain timely quotations for parts from Western Europe. In order to assist purchasing, we have placed the buyers for the refurbishment project in the engineering/maintenance department.

During the quarter, KAP managed to keep equipment running without needing spare parts on a daily basis. The alumina plant increased production and finished the quarter with the highest monthly production for the year. In order to improve the alumina quality, we plan to bring in an alumina process expert to help KAP make a coarser alumina product. A coarser alumina would benefit smelter production, reduce consumption, and make it possible to sell excess alumina.

The smelter had production upsets due to the poor Anotech anode quality and a number of long electric power curtailments. The pot rooms managed to increase the number of pots in operation to 517, which is the highest it has been for years. Anotech has been supplying approximately 75% of KAP's anode requirement. There have been gradual improvements of the anode quality, but based on R&D Carbon's quality analysis for April and May, 80 - 100% of the anode production did not meet the contract specifications. Erik Jensen, an anode carbon expert, visited KAP for two weeks in May/June. A summary of his report points out the following:

- The Anotech anodes are of substandard quality and do not meet contract specifications for chemical and physical properties;

- The fundamental cause of this is under-baking of anodes, although high ash content of butts can be a contributing factor;
- The baking furnace is in poor condition. It needs major refractory repairs and proper fire control,
- The green mill needs some equipment modification and improved operating procedures to produce good green anodes. The low anode densities are probably caused by too low mixing temperature, insufficient mixer energy input and lack of granulometry control.

FLAG met with Dragon Brkovic, the majority owner of Anotech and the largest KAP creditor, to discuss the anode quality problems and Erik Jensen's report. FLAG was informed that Anotech had secured a USD 7,000,000 loan to start the major repairs of the baking furnace and other upgrading projects. The baking furnace repair project is scheduled to be completed in November 2001.

On 29 May, KAP held its board meeting. Foreign Management Committee members now include Werner Herbertz from Glencore, former State Department Ambassador Sklar, and a representative of FLAG. The next board meeting was to be held on 26 July.

The reorganization of the operations departments has been completed. The first personnel reductions have been made and more will follow during and after refurbishment. We have had a continuous on-the-job training program for several months. The training program combined with the personnel changes we made have resulted in a stronger management group. We have a long way to go before this job is completed, but we are underway. The General Director has approved the reorganization of the front office and all the overhead functions.

The recommendations for a revised bauxite supply contract have been submitted to the General Director and include the weighing of all full and empty cars and certain improvements of the quality control. For this year, a contractor, which is a subsidiary of Vectra, handles the purchase of raw materials such as caustic, fuel, aluminum fluoride, cryolite, sodium sulfide, and cathode blocks. KAP's purchasing department

did not have, and currently does not have, the capability to handle this, but we hope they can improve their capability so they can take over the full purchasing function by the start of next year.

The purchasing capability is one of KAP's major problems and it has a serious impact on the production department's ability to keep the equipment running and on the success of the refurbishment project. One important note is that the Director of the Commercial Department left KAP in June.

## **Finance**

The FLAG team's work on the Debt Restructuring Agreement hastened its signing in Podgorica on 27 April. The signing of the document was the culmination of lots of work on numerous drafts and various amendments. Following the signing, efforts focused on ensuring compliance with the terms and conditions of the Agreement. After working on the conditions precedent to the use of the Working Capital Facility, the first drawdown thereunder was made on 14 June 2001. Compliance with this Agreement, and the reporting conditions thereof, entail a considerable effort by the FLAG team.

The first Board Meeting under the terms of the Debt Restructuring Agreement was held on Tuesday, 29 May 2001. Subsequent to that meeting a revised Business Plan and Operating Budget was prepared and distributed on 4 June 2001.

A new system for the registration, distribution, and approval of invoices was implemented on 28 June. It took a persistent effort to have our recommendations accepted, as there was a strong initial resistance to change. Revised authority levels for purchase orders and contracts were implemented from the same date.

There is an obvious need for training in the Accounting/Finance area as well as in other areas of the plant. Further work is required to define these needs. FLAG will bring in a trainer in the third quarter to work with the accounting and finance departments on measures of cost/management accounting and cost controls. FLAG is

also assisting KAP in its search for a Western-trained CFO to manage all aspects of finance and accounting.