PN-ACA-346

EAPS ENVIRONMENTAL ACTION PROGRAMME SUPPORT PROJECT

Environmental Action Programme Support Project
Contract DHR-0039-C-00-5034-0
United States Agency for International Development

ANALYSIS OF THE PROPOSED SFZP GUARANTEE FOR THE BENEFIT OF ECO GAIA, a.s., WITH RECOMMENDATIONS

Submitted to:
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and
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October 1996

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EXECUTIVE SUMMARY

A. Overview and Background

Chemonics International, under a consultancy with the Czech State Fund for the Environment (SFZP) funded by USAID, has agreed to evaluate the economic aspects of proposed guarantees being considered by the Ministry of the Environment and SFZP. The six pending guarantees originated from resolutions signed by the former Minister of the Environment. This report and analysis examines one proposed guarantee in detail and offers a standard analytical framework that could be adopted for the remaining projects under SFZP evaluation.

ECO GAIA, a.s. submitted to the SFZP a standard application for financing of a thermal industrial waste disposal facility. The project applicant identifies the project site in the city of Mlada Boleslav, approximately 50 km northeast of Prague. The original application was submitted in mid-1995, with a revised application presented on October 18, 1995. In conversations with SFZP Finance Director Nevyjel, the Chemonics consultants learned that SFZP management did not recommend the application for approval based on economic and technical weaknesses in the application. However, the ECO GAIA principals persuaded the then-Minister of Environment to approve the transaction as a guarantee from the SFZP for a financing source to be named later. This resolution (No. 03929541) was signed by the minister on December 7, 1995 (see Annex A to this report). The guarantee was approved in the amount of kc 710 million, or nearly $28 million. The guarantee resolution conditions are vague, with no maturity or repayment term specified.

The resolution was scheduled to expire on May 7, 1996. However, SFZP file documents reflect correspondence to SFZP management from ECO GAIA dated July 11, 1996, requesting an extension from the May 7, 1996, deadline. In a July 18, 1996, letter to ECO GAIA, SFZP Director Beneš agreed to postpone the deadline until October 7, 1996, making August 7, 1996, an interim deadline. This situation indicates an undisciplined approach to deadlines.

From December 7, 1995, until the present, ECO GAIA presumably tried to arrange financing from Czech banks. Apparently this failed. The current financing source originates from the Zurich, Switzerland-based Interasset Management Company AG (IMC). A one-page credit contract signed in Bremen, Germany, on August 29, 1996, on behalf of IMC in favor of ECO GAIA was notarized for accuracy of translation on September 16, 1996, in Prague. The contract provides for a kc 710 million loan payable in a single payment at maturity of 15 years at a 6.5 percent interest rate. As a condition to this loan, the SFZP guarantee is required. A letter of September 18, 1996, from IMC to ECO GAIA outlines construction loan draws in installments of kc 235 million on or before October 31, 1996; kc 235 million on or before October 31, 1997; and a final disbursement of kc 240 million on or before October 31, 1998.

The applicant provided a rudimentary business plan, cash flow projections through the year 2009, financial statements for the period ending December 31, 1995, and letters of intent from potential suppliers of industrial and hospital waste. Our analysis uses only the limited data available through the SFZP. However, at our suggestion, a field visit was made to the proposed waste incineration plant site at Mlada Boleslav. No preliminary site work was in progress, as claimed in the business plan. The audited financial statements of December 31, 1995, reflected an asset value of kc 64,150,000. The only assets in evidence were several small prefabricated construction sheds and the raw land.

B. Summary of Analysis and Recommendations

The analysis of the ECO GAIA guarantee resolution indicates that the creditworthiness of the applicant is extremely weak, that the risk of default by ECO GAIA is high, and that a default could cause losses to the SFZP of as much as kc 710 million. Accordingly, the resolution to guarantee should be reversed.

The attached report details the reasons for this conclusion. Among many reasons for rejecting the application, we draw attention to the falsification of data by ECO GAIA; their lack of experience operating a facility such as that proposed; the lack of financial history; the uncertain registration, ownership, and interrelationship of the parties; and the lack of a sensible business plan. More particularly:

- Limited information for evaluating the proposal. The business plan as submitted is insubstantial and lacks objectivity.
- Uncertainty over who actually owns ECO GAIA, and its connections to IMC.
- No evidence from the proposed ECO GAIA management that they possess the qualifications to construct, operate, and control a waste treatment plant of this size.
- Severely imbalanced projected debt-to-capital ratio (9:1) due to the modest capital contribution from investors.
- No evidence of any short-term working capital to join with the construction and long-term loan.
- Potential that some loan proceeds may be used to repay obligations of Gaia, the predecessor to ECO GAIA.
- No background on IMC and its experience and capacity to control the construction loan disbursements and monitor the credit.
- Implication of a failure in the construction of a waste incineration plant begun by the predecessor company by virtue of closure of Gaia operations and cessation of plant construction.

This report strongly recommends against SFZP endorsement of the ECO GAIA construction project through its guarantee.

We understand there is a possibility that the Ministry may, despite these recommendations, proceed to extend the guarantee. If it does so, the Ministry should consider the following additional recommendations, which are designed to reduce the risk of loss to the SFZP should it be called on to honor its guarantee. While these actions may offer some protection, the Ministry should recognize that the protection is only partial and that, even if each proposed protective action is adopted, still the Ministry will be subjected to substantial risk of a large financial loss.

- Get more and better information for continued in-depth analysis
- Ensure the SFZP guarantee contains covenants and collateral agreements to protect its interests
- Establish effective procedures to monitor and control disbursement of the construction loan as well as monitor the financial condition of ECO GAIA

This report is organized as follows. First, a standard analysis is performed that could be adopted for the other guarantees and other project-financing. Next, ECO GAIA data are evaluated against this standard. Finally, the report reviews variances between ECO GAIA data and the standard and makes recommendations for the SFZP based on the analysis.

The analysis framework includes the following:

- Legal, functional, and historical profile of the borrower
- Loan purpose
- Economic, political, industry, and company dynamics
- Financial condition of the borrower's profitability, debt service capacity, liquidity, capital, and debt structure
- Collateral security
- Sources of repayment
- Disbursement and monitoring capabilities of direct lenders

SECTION I

PROFILE OF THE BORROWER AND RELATED INTERESTS

SECTION I
PROFILE OF THE BORROWER AND RELATED INTERESTS

This section provides a framework for understanding a borrower's history and operations. This information is the starting point for any credit analysis.

A. Legal Status and Structure

A borrower's legal status and organizational structure have serious implications for a lender, as they affect the structure and terms of loans. Much relevant information is found in corporate resolutions and by-laws and should be requested at the outset (see box on next page). It is essential for a lender to know the owners' identity, other participants in the project, and how they are related. Equally important is understanding what legal jurisdiction governs the transaction. Failure to clearly understand legal considerations could easily result in the diversion of loan proceeds to unintended users with no potential for making claims against those parties in case the loan goes into default. The objective is to have loan documentation in support of various agreements that will reduce if not eliminate the chance that funds will be diverted to parties outside of SFZP control.

A1. ECO GAIA Legal Profile

According to ECO GAIA's December 31, 1995, audited financial report, the company was formed on October 11, 1995, and is located at Ptacka 30/IV, 293 01 Mlada Boleslav.

The report reveals the company had an initial capitalization of kc 85.2 million ($3.2 million based on an exchange rate of 26.6 at December 31, 1995.) There are 1,704 registered shares issued and outstanding with a nominal value of kc 50,000 each. There is no indication of the distribution or registration of the shareholders, full membership of the board of directors, or listing of the firm's executive management.

The audit report lists Josef Chlada as chairman of the board. The company's application to the SFZP dated October 18, 1995, also indicates JUDr. Jaroslav Mudra is authorized to negotiate with the SFZP on behalf of ECO GAIA. No other information is given concerning JUDr. Mudra's official capacity. The business plan submitted to the SFZP lists Ing. Ryszard Sikorski as director of ECO GAIA and coordinator of the incineration plant construction. Mgr. Richard Tischer, listed as vice chairman of the board of directors, serves as a representative of Stanfor Anstalt and is responsible for business strategy at ECO GAIA. Ladislav Smutny, an ECO GAIA board member, is involved in technical management. Ing. Milos Pruckner and Ing. Ladislav Moc are shown as financial advisors, with no indication of their official status within the company. All other information in our possession relative to the legal standing of the borrower flows back to a predecessor company, GAIA, s.r.o. (Gaia).

Gaia, as indicated in the trade register of the District Court Prague 1, was registered on October 16, 1991, and was located at Kosmonosy, Bradlec 96, 293 06.

Gaia, through a collective agreement dated August 28, 1991, had initial equity of kc 157,000 and partners consisting of Josef Chlada (contribution of kc 78,000) and Ladislav Smutny (contribution of kc 79,000). Both persons were listed as secretaries to this partnership.

The register indicates the prospect of additional unmentioned partners through the following proviso: "The secretaries are permitted to borrow up to kc 100,000, with any higher liability requiring the written authorization of the remaining partners."

The same register reflects Gaia engaged in waste disposal, purchase of goods for resale, locksmith activities, glazier activities, and production of sharpening and polishing tools.

The undated business plan submitted to the SFZP by ECO GAIA and prepared by Josef Chlada and Ladislav Smutny confirms that ECO GAIA assumed all the rights and obligations, receivables, and payables concerning waste disposal, construction, and operation of an incinerating plant, ECO BLOCK GAIA. The same business plan indicates the ECO GAIA structure consists of the legal entity Gaia, s.r.o. and Stanfor Anstalt International Engineering. There is no further information on the contractual or ownership relationships among ECO GAIA, Gaia, ECO BLOCK GAIA, and Stanfor Anstalt International Engineering.

The business plan indicates conditional operating permits were issued to Gaia by the municipal authorities in Mlada Boleslav for construction of the incineration plant. Several letters of intent and contracts for future cooperation between Gaia and potential suppliers of industrial and hospital waste also are attached to the business plan. Most of the letters of intent were issued in mid-1994 through early 1995. It is assumed these agreements may be assignable and transferable to ECO GAIA from Gaia, but this should be reconfirmed given the time lapse and the change in the ownership entity.

Information a Lender Would Typically Require

A borrower should have the following information readily available, and it should be an integral part of a company prospectus or detailed business plan.

- Company name and list of trade names
- Names of subsidiaries or affiliates
- Name of parent company if applicable
- Legal address of borrower; same for all related entities
- Tax jurisdictions
- Date of legal registration and where registered
- Form of ownership
  - Corporation or joint stock company, (a.s.)
  - Limited liability company, (s.r.o.)
  - Cooperative
  - Branch office of a foreign enterprise
  - General partnership, (v.o.s.)
  - Limited partnership, (k.s.)
- Initial capitalization and list of principal shareholders
  - Breakdown of shareholders with ownership interest of 5 percent or greater
  - Manner and form in which initial capital was contributed (e.g., cash, assets from a predecessor company, stock transfer)
- Name of predecessor company, if any, and the way ownership was transferred
- Percentage of foreign ownership
- Ownership by key suppliers, customers, former creditors
- Percentage of ownership of investment funds, if any
- Classes of stock and their respective voting rights
- Company charter showing activities it may engage in
- By-laws and other provisions on company governance:
  - Composition and powers of the board of directors
  - Minutes of required board and committee meetings
  - Description of key financial and operating reports to shareholders, investors, owners, and when issued
  - Description of general powers granted to operating management from general directors, e.g., ability to buy, lease, and sell assets; ability to borrow money from trade suppliers or financial institutions; ability to enter into contracts with suppliers, customers, workers, etc.; list of officers and the company resolutions

A2. ECO GAIA Ownership and Governance Issues

The owners of this enterprise are not known. Also, there is no information on the number of stockholders and their potential future role in the company. As a result, the following legal matters need to be clarified:

- Who are the registered owners of ECO GAIA, and what is their share of investment in the company? What is their interest in this company? For example, what are the facts surrounding involvement of Stanfor Anstalt International Engineering? Who owns Stanfor, and does Stanfor own a portion of ECO GAIA?

- What are the conditions of the ownership interest suggested by the business plan that the City of Mlada Boleslav will receive a 10 percent share in ECO GAIA "as soon as possible"?

- What obligations, if any, did ECO GAIA assume from Gaia? The business plan indicates the 1994 construction on the incineration plant for Gaia was funded through the then-general supplier PSG Zlin. Who is PSG Zlin, and is there any continuing obligation to this company? If so, what is it? The business plan continues to indicate that the current proposed general contractor will be BOSTAS, Ltd. of Mlada Boleslav, and that the plant technical design will come from SIATA, Fornovo, Bergamo, Italy. The December 31, 1995, audited financial statement for ECO GAIA reflects no debt but does indicate land valued at kc 24,898,000 and fixed assets (construction in progress and equipment) valued at kc 39,252,000.

- Why was Gaia, s.r.o. discontinued?

- Is there any legal consideration over the use of ECO BLOCK GAIA as an operating company separate from ECO GAIA? Is ECO BLOCK GAIA anything other than a trade name? Does it have any assets or liabilities? What is its legal affiliation to ECO GAIA?

- Who has effective control over decision-making at ECO GAIA? Is it Stanfor Anstalt International Engineering?

- Do the letters of intent given to Gaia by potential suppliers of waste in 1994 and 1995 need to be reconfirmed?

- Is there a separate resolution from the ECO GAIA board of directors authorizing the proposed debt of kc 710 million for 15 years? Does such a resolution empower officers to pledge collateral and enter into agreements that would include restrictive covenants?

SFZP options related to these questions are addressed at the end of this report.

B. Operational Profile

The nature of the borrower's lines of business is relevant to the analysis as each type of business involves different credit risks. For example, some businesses are more influenced by the general business cycle, whereas others are in industries that are subject to a rapid rate of technical obsolescence.

The analysis of a borrower (see box on next page) should distinguish between contributions from each line of company business and review these lines and associated credit risks separately.

The business plan, financial statements, and SFZP internal files all indicate that a project to construct the ECO GAIA incineration plant was begun in early 1994 and is now pending completion of the proposed financing. The information suggests that the Mlada Boleslav location is

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well suited for this plant because of the concentration of large industrial and hospital waste producers, most notably the Skoda automobile plant.

At present, we do not know what led to termination of construction on the plant begun under Gaia ownership, or how to answer the business profile questions. The business plan is particularly lacking on the question of potential operational risks..

Building the Business Profile

The business profile of the borrower should consider the following questions:

- Is the technology to be used cost effective for the potential suppliers of waste?
- Is the technology subject to obsolescence in the near future from more advanced and lower cost processes?
- What are the maintenance requirements for this facility? Has the company anticipated costs to equipment failure and consequent downtime? What is the preventive maintenance program plan?
- What environmental safeguards are built into the plant to prevent hazardous emissions from escaping into the surrounding community?
- Are there secondary sources of supply for critical parts to continue the operation?
- How dependent is the plant on outside vendors, i.e.; power providers, waste transport to the plant, telecommunications, computer systems, etc.?
- How critical is the need for skilled technicians, and what is their availability?

C. Background and Management's Track Record

The SFZP should gain an understanding of how the company has operated over the years. This may be difficult in the Czech Republic today given its brief experience with a transitional economy. In developed market economies, it is standard to expect a borrower to have at least three years of operating experience to qualify for a loan. (Start-up ventures are considered high risk and usually receive financing through venture capital sources and not through conventional credit channels.)

In the absence of the company's operating history, the quality and depth of management must be considered. For instance, where, when, and for how long have they managed similar operations, and what have been the operating results of their management? What, if any, experience, has been gained through association or partnership with foreign enterprises?

ECO GAIA has no operating history. Even the predecessor company, Gaia, has no historical operating performance other than initiating construction of the proposed waste incineration plant. Also, no data are available on the entities that may offer expertise to this start-up company.

SECTION II

PURPOSE OF THE FINANCING

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PURPOSE OF THE FINANCING

There are three general purposes for issuing loans. They include:

- Acquisition of assets. Examples include purchasing inventory, supporting a build-up in accounts receivable, buying additional equipment, or investing in the purchase or reconstruction of a long-term asset such as a manufacturing plant or office building.

- Restructuring of existing liabilities, such as refinancing existing debt on different terms. Examples include payment of accrued liabilities such as taxes, accounts payable, payroll, dividends, and the refinancing of other debt (e.g., refinancing of short-term debt to long-term).

- Supporting a reduction in the equity of the borrower. Loan proceeds might be used to support the borrower's operating losses, which would result in a reduction in debtor capital through reduced retained earnings. This is a very risky type of loan and is made only on a temporary basis in anticipation of improved borrower performance.

The challenge for the SFZP is to recognize the true purpose of the loan request. A borrower often has a combination of financing needs that may be disguised under a general purpose request. A request to finance a capital improvement project could easily contain elements of refinancing other debt as well as subsidizing unstated operating losses.

A standard approach should require the borrower to substantiate the request with evidence of specific invoices accompanied by a detailed disbursement schedule. As further assurance of the proper use of loan proceeds, the SFZP may directly make payment to the proposed recipients, such as suppliers, contractors, other creditors, or shareholders.

The stated purpose of the ECO GAIA loan is to complete the construction of a waste incineration plant begun by the predecessor company Gaia. The SFZP has neither a detailed estimate of construction costs, which should be verified by qualified engineers, nor a detailed schedule of how funds will be disbursed and to whom. The IMC loan disbursement schedule of three separate and nearly equal draws in 1996, 1997, and 1998 is loose, with no evident controls in place.

The business plan indicated that the original plant construction was funded through general supplier PSG Zlin. This suggests that part of the loan proceeds may be needed to pay off that obligation. On the other hand, the ECO GAIA financial statement recognizes no such liability. This matter deserves further investigation. The SFZP will then have to determine whether it is willing to guarantee a loan where partial proceeds may be used to refinance old debt.

SECTION III

ECONOMIC, POLITICAL, INDUSTRY, AND COMPANY DYNAMICS

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ECONOMIC, POLITICAL, INDUSTRY, AND COMPANY DYNAMICS

Evaluation of economic, political, industry, and company dynamics can be the most demanding part of credit analysis given their unlimited number of variables. This section highlights only the most common factors to be considered for investigation and review.

A. Economic and Political Dynamics

Macroeconomic and political influences and associated risks are usually beyond the influence and control of the borrower. But such factors must be considered by the SFZP analysis, particularly for long-term loans (see box).

The current economic and political environment in the Czech Republic is favorable compared to other transition economies. Environmental issues still receive a high priority in the national budget. Regional and local political leaders have voiced their support for the proposed project, according to the ECO GAIA business plan. However, the plan does not raise issues of potential health risks to the community and public disclosure.

The business plan does not consider the impact of closure or relocation of the major industries in Mlada Boleslav from whom ECO GAIA will obtain its waste products. A conservative business plan would address the prospect of a shrinking customer base and what should be the appropriate response. Overall, the plan does not offer a long-term view of the regional and local economy. Only current conditions are taken into account.

The political factor of greatest consequence is the approval of the guarantee resolution granted by the former environmental minister. Given SFZP management's preliminary rejection of the application on both technical and economic merits, it is possible to assume political motivations for the subsequent approval. If that is correct, then the viability of this project may depend on continued political support at the highest levels of government. If that support is withdrawn or restricted, the project and its long-term success may be in jeopardy.

Analyzing Political and Economic Factors

Following are questions to be asked in conducting an analysis of economic and political dynamics:

- Does the business plan anticipate increasing demands for full public disclosure of the borrower's activities and compliance with all environmental regulations?
- Does the financial plan include the prospect of a major capital expense to retrofit the process due to growing public pressure for environmental safeguards?
- Are the national, regional, and local economic indicators favorable for the industry and company?
- What effect would abnormal inflationary or deflationary elements in the economy have on the profitability of the borrower?
- Is the political environment stable?
- Is the borrower's industry regulated? Has the business plan given proper attention to regulatory influences?
- What priority do different levels of government, especially the national level, give to funding environmental programs? Have these priorities been committed to, or can they be changed?
- What influence will cross-border and European Union agreements have on financing and regulation of Czech projects?
- Is the local government able and committed to upgrading critical infrastructure?

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B. Industry Trends

This analysis does not attempt to examine the technical issues facing the waste treatment industry in Europe today as many of the factors are beyond the scope of this report. Nevertheless, the SFZP should be sensitive to issues such as those in the box.

The business plan suggests ECO GAIA's plant will have certain technical advantages over other incinerating plants of similar capacity in the Czech Republic. It is also likely, given the high capital required for such a project, that this is not an easy market to enter as a competitor.

The competitive advantages that ECO GAIA lists in the plan are:

- Proximity to major industrial and hospital waste producers, which will contribute to short transport routes and decreased transport costs
- Large capacity cooler for storing hospital waste
- Medium size of the proposed plant, which is assumed to be more efficient than the smaller facilities already in place

The business plan gives no further substantive recognition to industry factors, thus leaving room for deeper analysis.

C. Company Factors

Beyond evaluating the impact of industry influences on the borrower's ability to repay, the SFZP should examine the basic elements of the company, with special emphasis on the borrower's management team.

An established company should provide a report on its existing customers, selling terms to each account, customers' payment practices, and strategies to alleviate

Analyzing Industry Trends

Following are questions to be asked in analyzing industry trends:

- Is the industry technology in developed economies considered mature, or is it relatively new? Is the market still growing or is it contracting?
- To what degree is the industry creating improved processes, and what is the rate of technical obsolescence? What is the rate of development of substitute processes?
- Is there evidence from developed economies on when a current technology is replaced, and can the transition phase be predicted?
- Have competitors successfully employed this waste treatment process, and for how long?
- What is the structure of the industry in Central Europe, and what market share do the major competitors hold? Do any competitors hold monopoly positions?
- In a shrinking market, will competitors undertake predatory pricing?
- Is the industry subject to regulatory control?
- Do any competitors have alliances with key regulatory agencies?
- On what basis does the borrower have competitive advantages in the industry?
  - □ A technological leader
  - □ Significant price advantage
  - □ Geographical convenience to markets and suppliers
  - □ Assurance of high quality service; no interruption in process flow
  - □ High profile image developed by reputation and aggressive marketing
- Does the industry have a history of favorable or hostile labor relations? Are working conditions recognized as safe for laborers?
- Is there a high incidence of protest and litigation from residents in communities nearby waste treatment facilities in European nations, and what has been the trend in judicial awards on cases brought to court?
- What has been the trend in insurance premiums for catastrophic coverage in this industry?

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concentrations where any customer represents more than 10 percent of total sales. Questions the SFZP should ask of management are listed in the box below.

A company should also explain its procurement process, providing information on key suppliers, concentration of purchasing activity, payment terms, and suppliers' reputation in collecting past due accounts. Questions the SFZP should ask of management are listed in the box.

With so little evidence of how managers will perform as a team in this new enterprise, the evaluation of the ECO GAIA company dynamics is speculative at this stage.

With the company's business plan as the only available indicator of collective skills, the lack of management team experience appears considerable. ECO GAIA's stated marketing strategy lacks the serious, in-depth analysis necessary for an investment of this scope.

The ECO GAIA management team appears to have limited, if any, experience in the business of industrial waste incineration. Mr. Chlada started a construction company in 1988 and has indicated he has some experience in the management and disposal of waste material. Mr. Smutny has some background in the technical side of the chemical industry, particularly in the research and development of organically bound grinding and polishing tools. Mr. Tischer is on the pedagogical faculty of Charles University and claims to have experience in management and organization. Mr. Sikorski appears to have an extensive background as a manager in various industrial companies, with recent focus on the reconstruction of industrial and civil buildings in the Czech Republic. The team presents little sophistication in financial management other than the presentation of cash flow projections in the business plan, which are reviewed in the next section.

Analyzing Company Factors

Following are questions to be asked in analyzing company factors:

- Does management have a solid understanding of the business and the industry?
- What is the educational and professional background of the key managers, and what is their experience in the relevant aspects of the waste management business?
- What is the company's organizational structure, and how is the decision-making process implemented?
- What are the company's relationships with key suppliers, customers, and complementary enterprises?
- What is the firm's reputation in the marketplace? Does it have a history of being fair and ethical, or is it known to compromise standard behavior to achieve results?
- How is performance measured and reported? To whom is it reported, and who is responsible for remedial actions?
- How does the company determine pricing strategies? How much is determined by the market and how much is based on actual costs? How much control does the company have over selling prices? How does it react to unexpected results?

SECTION IV

FINANCIAL CONDITION

SECTION IV
FINANCIAL CONDITION

Financial analysis evaluates a borrower's historical and projected profitability, debt service capacity, liquidity, and capital structure. A standard review would examine at least the past three years of the borrower's historical financial performance, if available. As a start-up, the ECO GAIA application is based solely on projections with no historical performance data.

A. Financial Performance and Debt Service Capacity

Most loans are expected to be repaid primarily from cash generated by operations. Analysis of a borrower's profitability is the first step in evaluating ability to generate cash flows and should focus on the factors highlighted in the box.

Because the ECO GAIA application is supported by projections only, no historical earnings review is possible. The projections are aggressive and suggest unrealistic profit levels beyond 2000.

B. Liquidity

The analysis of the liquidity of a company is essential for estimating the degree of coverage offered by the borrower's liquid assets (cash, near-cash items, and assets easily convertible to cash) to its current liabilities. The most common liquidity indicator is the current ratio, or the amount of current assets in relation to current liabilities. A fair standard is a ratio of 2:1, or two times the amount of current assets to current liabilities. Working capital is another term used to define the positive difference between current assets and current liabilities. A liquidity review should include the following:

- Analyze the composition or mix of current assets to determine whether there are components in the asset mix that are slow turning, i.e., stale inventory, etc.

Analyzing Financial Performance

Following are factors to consider in evaluating financial performance:

- *Trends in a borrower's financial performance*. This should include a detailed review of individual revenue and expense categories, distinguishing between earnings from normal business operations and extraordinary non-recurring gains.
  - In a non- or moderately cyclical industry, the analysis of the trend over three years or more is generally a fair predictor of future earnings. However, industry cycles can easily reverse three- to five-year historical trends. Thus, historical performance of enterprises in post-socialist economies, which have not been exposed to cycles, may be a poor indicator of future performance.
  - Performance indicators vary considerably by industry. Thus, the borrower's performance should be compared to an industry peer group. Comparison of like-size companies and within specific geographic regions is also important.

- *Debt-servicing capacity*. This is generally measured by calculating a ratio of a borrower's cash flow before financing activities to the principal payments due in the current period, and by calculating a ratio of earnings before interest and taxes to interest expense (both should be greater than 1)
  - Because loans are repaid from cash flows and not profits, analysis of cash flows is essential to the lending decision. Cash flows must be sufficient to: (1) pay current principal installments of term loans, (2) increase the capital base to support investment in new productive assets, and (3) pay an appropriate dividend to the shareholders after the company has achieved a strong capital base and a history of consistent earnings growth, provided the payments do not jeopardize debt servicing.

- Analyze asset values to determine how much of a price reduction may be necessary to convert them quickly to cash, and what impact such an action would have on earnings

- Examine borrower's access to sources of liquidity, such as bank lines of credit adequate to support any short-term working capital deficiencies

The ECO GAIA December 31, 1995, audited balance sheet shows no current debt and cash of kc 6,303,000, or $250,000. There are subscriptions receivable of kc 14,775,000, or roughly $590,000. The business plan is undated and is thus difficult to compare with the December 31, 1995, audited statement. The business plan shows a bank debt of kc 5 million and kc 1,863,000 owing to Pr.myslove stavby, Zlin, (possibly the former general contractor), representing a combined debt of approximately $275,000. The difference in the disclosure of the debt between the plan and the audit is material to estimating the firm's start-up liquidity position.

The business plan does not address ECO GAIA working capital requirements in its start-up phase, nor does it mention bank lines of credit that may have been negotiated. This is a serious oversight in the plan and must be addressed. There is also confusion over Gaia preceding debts. If there are preceding debts and they are to be assumed by ECO GAIA, there may be additional claims on the working capital of this start-up operation (depending on the terms), which leads to the question of how the kc 710 million loan proceeds are to be used. The cash flow forecast does not reflect payment of any short-term debt, but shows collection of subscription receivables and proceeds from the construction loan as the sole sources of cash through 1997. Closing cash in 1996 and 1997 is stated at zero. The forecasts are necessarily based on the accuracy of the construction estimates. The plan does not indicate whether contingencies or cost overruns are built into the cost estimates, and provides no detail on the breakdown of construction costs. The cash flow forecast could be extremely tight, leaving little room for error.

C. Capital and Debt Structure

While the standard levels of equity in relation to debt will vary by industry, a general guideline is that an investor should have at least enough capital to match the company's total debt. This translates into an equity-to-debt ratio of 1:1. The higher the amount of debt in relation to the firm's capital, the higher the leverage ratio. For example, a leverage ratio of 3:1 means there is three times as much debt on the company's balance sheet as there is capital, suggesting a precarious financial position.

Capital is necessary to support investment into assets, provide for overall growth in the company, absorb losses, and serve as the fundamental measure of value for the business. It would be customary for a lender to expect investors' capital to be at least equal to if not greater than the total debt of a start-up project. A higher degree of leverage may be acceptable when there is a history of good earnings growth to support debt repayment.

The ECO GAIA December 31, 1995, balance sheet indicates total assets of kc 85 million, or nearly $3 million. The shareholders' equity is the same as there are no liabilities. Fixed assets consist of the above-mentioned land, and construction in progress assumed from Gaia. Liquid assets are comprised of cash and subscriptions receivable.

The picture changes dramatically after the full kc 710 million construction loan is disbursed. At the end of 1997, assets are projected to grow to kc 817,950,000 from completion of the new

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plant, while equity will still be kc 85,200,000, translating into a debt-to-capital ratio of 9.6:1. In addition, all assets will be in illiquid form in a highly specialized processing plant. With a ratio above 2:1 considered risky for a new enterprise in this industry, the ratio of 9:1 is well beyond an acceptable risk level. A borrower with a well-developed operation and excellent earnings history might support a leverage ratio higher than 5:1 due to the capital-intensive nature of the business.

The potential for capital support from other parties is unknown. It is not clear whether the Swiss investment firm plans to add more capital to the business. The loan terms are already generous and well below market rates. The assumed interest rate of 6.5 percent for 15 years is suitable for highly rated, investment-grade government debt from developed economies, but is rarely seen in credits with the risk characteristics of ECO GAIA.

The financial analysis of ECO GAIA raises more questions than it answers. The lack of detail in the business plan and cash flow forecast leave many areas to be investigated.

SECTION V

COLLATERAL

SECTION V
COLLATERAL

SFZP management is encouraged to review this writer's report on collateral as prepared for the Fund in the summer of 1995. The fundamentals of reliance on collateral as a source of repayment apply to the ECO GAIA case.

All forms of collateral should be taken for control purposes in negotiation with the borrower, and not necessarily as assets to be liquidated for debt repayment.

The processing plant ECO GAIA wants to construct should be taken as collateral. Because of its specialized nature, the plant may have limited liquidation value. All other assets should be pledged to the extent possible under the current provisions of Czech civil law. More specific recommendations on collateral are offered in the final section of this report.

The major credit risk to the SFZP may occur during the construction phase of the project. If the project is stopped or discontinued due to ECO GAIA defaulting on its obligations, the SFZP may be called on to honor its guarantee to IMC. In that case, the SFZP will have to decide it wants to complete the project with another developer, sell the uncompleted plant to the highest bidder, or leave it unfinished and shut it down. In all cases, the Fund will be exposed to potentially large expenses for the maintenance and possible closure of the construction site. Documentation on the Fund's collateral rights must be carefully prepared by skilled lawyers.

SECTION VI

PRIMARY AND SECONDARY SOURCES OF REPAYMENT

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Fundamental to credit analysis is the evaluation of the primary and secondary sources of repayment. As discussed earlier, the primary source of loan repayment should be cash generated from operations. A secondary source may be the refinancing of existing debt or the voluntary sale of assets. The third and least desirable option is liquidation of collateral.

The lack of historical financial performance, the limited amount of capital in relation to debt, and the absence of sufficient operating funds in the construction and start-up phases suggest that this company's survival is in question. And while the Swiss financing source IMC has offered ECO GAIA generous financing terms, these terms—deferral of principal payments for 15 years and the 6.5 percent interest rate—raise questions about the relationship between ECO GAIA and IMC.

The analysis of the cash flow forecast and the December 31, 1995, audit report revealed the following:

- ECO GAIA equity contribution not in cash or securities, but in the form of a waste treatment plant construction project as reported in the business plan and listed on the ECO GAIA December 31, 1995, financial statement. A visit to the reported plant site revealed no construction in progress. The only evidence of assets was the land and several small construction structures used by the general contractor as a field office.

- Projected level of debt at more than nine times the borrower's equity before any revenues are generated.

- Zero cash at year end of 1996 and 1997. As a general rule, a company such as ECO GAIA should maintain a cash level equal to at least 30 to 60 days of projected expenses.

- No interest payments on the construction loan until 1998.

- No assumptions to support sales projections or operating expenses. A 10 percent inflation rate is assumed in prices for 1998 and the years thereafter. Wages are projected to increase 8 percent annually and the tax rate is projected at 41 percent.

- Conservative limitation on dividend payments until the year 2000.

- Straight-line amortization of the loan principal beginning in 1998. This varies from the credit agreement with IMC, which allows no payment of principal until maturity in 15 years.

- After-tax profit margin of 8 percent for the year 2000, the second full year of operation. This profit margin steadily escalates to 23 percent in 2009. These are liberal projections, but little information is provided on assumptions and on how this level of profitability will be achieved.

Considering the favorable repayment term and below-market interest rate offered by IMC, perhaps the same financing source will provide additional short-term financing if required. It is also important to examine IMC's standard responsibilities in relation to the SFZP.

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SECTION VII

DISBURSEMENT AND MONITORING CAPABILITIES OF DIRECT LENDERS

SECTION VII
DISBURSEMENT AND MONITORING CAPABILITIES OF DIRECT LENDERS

The recent report detailing the development of a loan guarantee program for the SFZP pointed out nine fundamental duties of the financing source, or in this case, IMC.

Key among those responsibilities were the following:

- Conduct a thorough analysis of the borrower's ability to repay the proposed debt.
- Prepare and execute the proper loan documents.
- Manage the disbursement of the loan proceeds and engage field personnel to ensure proper use of the proceeds.
- Collect interest and principal in a timely fashion.
- Report promptly to the SFZP any evidence of deterioration in the borrower's financial condition.
- Exert full collection efforts and maintain a detailed written record of that activity.
- Assign and transfer all documentation to SFZP prior to payment on the guarantee.
- Advise SFZP immediately if the creditor, due to operational deficiencies, is unable to properly monitor the borrower's activities.

At this date, very little is known about IMC and its capabilities. Answers to the above questions could help determine this firm's experience in providing project financing of this size and type. The SFZP has recently written the IMC requesting answers to many of the above questions.

SECTION VIII

RECOMMENDATIONS

SECTION VIII
RECOMMENDATIONS

The principal recommendation of this report is that the Ministry not undertake the guarantee of the loan to ECO GAIA.

Should the Ministry choose to undertake the guarantee despite the manifold risks, the SFZP should pursue several approaches to enhance its position as guarantor. Primary is the need to eliminate the many gaps in the information provided by ECO GAIA. The SFZP should also adopt the suggested guarantee agreement covenants, collateral options, loan disbursement controls, and loan monitoring procedures that are described below.

These guarantee agreement covenants, disbursement controls, monitoring devices, and collateral options will give the SFZP some protection against loss if properly enforced. They will not, however, compensate for cash flow deficiencies in ECO GAIA that are likely to occur. Even if all of the protective actions are taken, the transaction will remain highly risky.

A. Correct Information Deficiencies

Much information is missing from the ECO GAIA business plan, financial reports, and other data submitted with its application to the SFZP. The following recommendations are a guide to the SFZP for developing a more complete information base for analyzing this and other applications. The list is tailored to this case and does not represent all possible information needs in every case.

- Obtain a detailed explanation of the circumstances of Gaia operations, reasons for discontinuing construction, and settlement of debts and ownership structure prior to transfer to ECO GAIA.

- Determine ECO GAIA's present owners, their investment interest, and names of any companies affiliated with ECO GAIA.

- Determine conditions of proposed 10 percent ownership interest in ECO GAIA by the city of Mlada Boleslav.

- Verify what control, if any, the supplier of the equipment and process technology may have over the management of ECO GAIA.

- Determine if there is any ownership or controlling interest in the equipment supplier by IMC, and if so, to what degree.

- Obtain from ECO GAIA a detailed engineering study with accompanying detailed cost estimates for the construction of the incineration plant. This should include funds already spent on previous construction for the Gaia work.

- Obtain references from the general contractor and process equipment supplier regarding their last five contracts in this size category.

- Ensure the business plan is expanded to reflect the entire ECO GAIA management structure.

- Ensure the business plan reflects where the proposed technology is presently being used and how long it has been successful. Review should offer specifics on the technical modifications made to similar plants since they were first brought on line.

- Ensure the business plan presents financial performance ratios from industry peers, in particular profitability ratios, debt-to-equity ratios, and the sales and profitability trend over the past three years.

- Ensure owners examine a worst case scenario in case they do not have the ability to bring the plant on line according to their own time table. Are there other companies or operators with the necessary experience to assume management of the plant and who can be obtained in a reasonable time? The SFZP should become familiar with the names and credentials of companies engaged in this process technology in case a default occurs that would require a transfer of ownership and management to a more qualified operator.

- Ensure business plan details its approach and technical requirements for reprocessing material in existing land fills.

- Request from IMC a statement of its position on assisting or replacing the proposed management team of this project. This large and environmentally critical operation requires skilled and experienced entrepreneurs.

- Obtain an explanation from the borrower on where it will obtain operating funds during the construction and start-up phase. The cash flow forecast presents no source other than the proceeds of the construction loan.

- From IMC, obtain detailed procedures on control of loan disbursements and methods for ongoing monitoring of ECO GAIA's financial condition during the term of the loan.

B. Guarantee Agreement Provisions

In the event a loan were to close, the SFZP should have in place covenants in a guarantee agreement to protect its interests. This agreement should be agreed to and signed by the SFZP, ECO GAIA, and IMC. Covenants are designed to give the SFZP some control over the borrower's financial and managerial activities and may provide a way out of the guarantee. Covenants are normally affirmative or negative. Affirmative covenants require the borrower to take action, whereas negative covenants restrict the borrower's activities without prior SFZP consent. Consent, when given, is usually written. Following are some examples of covenants:

Affirmative covenants, which must be monitored rigorously, may read as follows. ECO GAIA will:

- Provide all financial and any other operating reports as requested by the SFZP

- Maintain a current ratio of 2:1 (current assets to current liabilities)

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- Pay all interest and principal payments when due
- Contribute equal annual payments into a sinking fund, which fund will be used to pay the principal of kc 710 million when due in 15 years
- Provide adequate insurance for all productive assets
- Remain in compliance with all laws, regulations, or other governmental rulings that apply to its business
- Pay all taxes, fees, duties, or similar obligations when due
- Maintain management satisfactory to the SFZP
- Use the loan proceeds only for the purposes outlined in a detailed disbursement schedule and related to specific cost estimates
- Maintain in the best and highest use the collateral offered to the SFZP

The following negative covenants also require rigorous monitoring by the SFZP. Any waiver of these covenants typically will require SFZP prior written consent.

- Change in the ECO GAIA ownership, nature of business, capital structure, or management is prohibited.
- Sale or leaseback of fixed assets above a certain kc amount is prohibited.
- Acquisition, purchase, or lease of fixed assets above a certain amount is limited.
- All new loans beyond the current kc 710 million loan are prohibited.
- No dividend payments to shareholders are permitted.
- No payments are allowed on the previous debts of Gaia.
- No assets will be pledged as collateral to any other creditor.

If ECO GAIA fails to comply with such covenants and does not correct defaults within an agreed-on time, the SFZP would have the right to notify IMC and ECO GAIA that the guarantee is no longer valid.

C. Collateral

The SFZP should also obtain collateral to its guarantee. The collateral listed below should be taken by the SFZP to permit sale of the entire business if necessary. The list may include assets that are not recognized as proper collateral under current Czech law. The SFZP should have an assignment of such assets even though its claims may be difficult to enforce. The class known as "movable" assets currently are not recognized as legal security unless certain rules of possession are followed. The assets to be considered as collateral include the following:

- Land, building, equipment, furnishings, and fixtures now owned or hereafter acquired
- All capital stock of ECO GAIA and any of its subsidiary companies
- All patents, copyrights, licenses, or permits for operating the waste incineration plant
- All other assets now owned or hereafter acquired

D. Control of Loan Proceeds and Monitoring Future Activities

Controls are also needed for disbursement of loan proceeds and ongoing monitoring of the borrower's financial and operating condition. The first step is for the borrower to submit a detailed breakdown of cost estimates for each project phase. These estimates should be verified by independent engineering or other construction experts for accuracy and legitimacy. The loan disbursements would be allowed only after detailed invoices are submitted for payment and compared to the cost estimates. Actual work performed or material supplied should also be verified by on-site inspections of independent experts. At that point, the SFZP might direct the lender to make disbursements directly to the suppliers, contractors, or other service providers.

The SFZP may also direct the lending source to disburse only 90 percent of invoiced amounts from the general contractor. The 10 percent retained would be paid only after final inspection confirmed that work was completed according to plan specifications and cost estimates. Because this disbursement control is costly and time consuming, a fee is usually charged to the borrower. The absence of disbursement controls could result in misuse of loan proceeds and could require an even larger loan to complete the project.

Controls for monitoring the borrower's ongoing financial performance are the responsibility of the project lender. However, the SFZP should tell the lender what information it will need in support of its guarantee. Generally, the SFZP should require the following after the loan has been fully disbursed:

- Annual financial statements on ECO GAIA as prepared by independent auditors satisfactory to the SFZP.
- Quarterly financial statements prepared by ECO GAIA management.
- Copies of an annual credit review of ECO GAIA's financial condition prepared by the lender.
- Periodic collateral evaluations by independent appraisers every four or five years in case there is no other evidence of deterioration in the ECO GAIA financial condition.
- Annual statement from ECO GAIA certifying that all taxes, license fees, and insurance premiums have been paid when due.
- Annual letter from the lender to the SFZP certifying that there are no violations of any loan or guarantee agreement covenants, or a listing of violations, if any, and what actions are being taken to correct them.

- Copies of all loan documents that have been amended from the originals.

- Copies of regulatory examination reports of the waste treatment plant.

These guarantee agreement covenants, disbursement controls, monitoring devices, and collateral options will give the SFZP additional protection against loss if properly enforced. They will not, however, compensate for cash flow deficiencies in ECO GAIA should they occur.

ANNEX A

RESOLUTION

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ANNEX A
RESOLUTION

Prague, December 7, 1995
Ref. No. 8145/D/95

RESOLUTION

No. 03929541
on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc 710,000,000 (100% of the base) (the base for setting the support is Kc 710,000,000)
For a project:	Construction of ECO BLOCK GAIA—objects for thermal industrial waste disposal
Realized in:	1993-1997
For an applicant:	ECO GAIA a.s., Ptacka 30/IV, 239 01 Mlada Boleslav

Under the following basic conditions:

The collateral will be provided for the annuities of the loan provided by a contractual bank. After completion of the construction, the collateral obligations will be passed on to the investor.

- The amount of the loan will be specified by the applicant no later than the conclusion of the contract with the Fund by submitting a specific loan contract with the financing bank in which the amount of interest rate and term of the loan will be specified.

- The level of the support is set at its maximum and the condition for providing it is to carry out a tender in accordance with law No. 199/94 Coll. and to conclude respective contractual agreements.

- Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources; when decreasing the base for setting the support, the % share remains unchanged.

The project will be realized in accordance with the approved documentation.

While operating the installed equipment, the emission limits will be met in accordance with the regulation of the Federal Committee for the Environment dated June 23, 1992, which amends the regulation of the Federal Committee for the Environment dated October 1, 1991, of law No. 309/91 Coll. on the protection against pollutants.

In order to conclude a written contract between the Fund and the applicant, it is necessary to submit the documents mentioned in Appendix No. 3a of the Directive.

Based on this resolution, the Office of the Fund and the realizator under the §5, article 3 letter f) of the Statute of the SFZP will conclude a contract which will also include other conditions for providing the support. If the contract is not concluded within five months after the date of the issuance of this resolution, the Fund has a right to withdraw from it, by which the validity of this resolution terminates.

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