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Deloitte Touche Tohmatsu

Macedonia Enterprise Restructuring Final Report

Delivery Order No. 34

Contract No. EUR-0014-I-00-1056-00
Eastern Europe Enterprise Restructuring and Privatization Project

USAID

U.S. Agency for International Development
EUR/ENI

March 1995

Deloitte Touche Tohmatsu International

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March 13, 1995

Mr. Lawrence Camp
USAID
ENI/PER/EP
Room 3206, SA-15
Washington DC 20523

Re: Contract No. EUR-0014-I-00-1056-00, Delivery Order No. 34, Macedonia Enterprise Restructuring Project - Final Report

Dear Mr. Camp:

This is our final report under the Macedonia Enterprise Restructuring Project (Delivery Order No. 34 - Contract EUR-0014-I-00-1056-00). This report covers the technical assistance rendered by Deloitte Touche Tohmatsu International (Deloitte) to the Agency for the Republic of Macedonia for the Transformation of Social Capital (MPA) to review and assess the restructuring plans of 5 loss-making companies. The technical assistance provided under this delivery order was part of a larger project, organized by the World Bank, to review and assess the restructuring plans of 25 loss-making companies. USAID provided the funding to Deloitte Touche Tohmatsu International under the above-referenced contract to conduct the reviews of five of the 25 companies.

This technical assistance project was the enterprise "diagnostic" step under the Macedonian "Special Restructuring Program" (SRP). The SRP was designed with two objectives: The first was to protect the Macedonian banking system by isolating the 25 largest loss-making companies from the overall economic system. The second objective was to provide temporary, "on budget" support to potentially viable companies. (The second objective, and the one we were more closely involved with under this USAID contract, was to provide support to the large loss-making enterprises in an effort to improve operations and overall viability and to reduce losses. This support was to come in the form of technical assistance for the review of enterprise restructuring plans, quick diagnostic studies, and developing recommendations that could improve the operating efficiency and viability of the firms quickly without large infusions of working capital.)

This report contains the following sections: Project Scope, Project Implementation, Lessons Learned/Recommendations, Impact of USAID Assistance, and Budgetary Information. In addition, copies of the loss-reduction plans produced under this delivery order are attached.

PROJECT SCOPE

The initial scope of this delivery order included two functions:

A. To perform short-term diagnostic studies of five loss-making enterprises by reviewing and assessing the restructuring/privatization plans. These plans were to have been prepared by the enterprises prior to our work beginning. Through these reviews it was envisioned that we would identify other additional loss reduction measures and would help management plan to implement the measures quickly to stem cash losses.

B. To generate "Lessons Learned" from the project and our CEE privatization experience with which to assist the MPA in developing a broader enterprise debt restructuring and bank recapitalization program. It was envisioned that this piece might have application to other countries facing similar economic hardships and changes.

The project as initially envisioned was to be a quick assessment of the enterprise restructuring plans. Once the assessments were completed, reports would be prepared outlining the situation at the particular enterprise (financial and operational) and making recommendations as to the steps which needed to be followed (undertaken) to improve operations and the financial position of the company. These reports would than be presented to review committees formed by the Macedonian government.

Deloitte Touche Tohmatsu International was assigned the following companies: Gazela (shoes), Hemteks (synthetic fibers), Mikron (electric motors), Tresca (furniture) and Zelezarnica (steel). As will be explained in the Project Implementation section, we were in fact called upon to prepare the restructuring/loss-reduction plans rather than to review and assess existing plans and help identify additional loss-reduction measures. This significantly expanded Function A and resulted in a larger percentage of the budget being expended to adequately perform Function A. Since Function B could not be performed without the information and experience produced by Function A, it was postponed until a future project. (*Note:* It was also deemed that in order for Function B to be of value, it was essential that it be coordinated with World Bank and IMF programs. By September 1994, the World Bank and the Government had already agreed on a conceptual framework for debt restructuring and bank recapitalization in Macedonia devoting resources to Function B without this coordination would most likely lead to irrelevant recommendations. During our frequent discussions with the World Bank, we pushed the need for a "road-map" to ensure that all impediments to the debt restructuring process could be identified. It was decided that this "bigger picture" of enterprise debt restructuring and bank recapitalization would be postponed to a future project.)

PROJECT IMPLEMENTATION

Project Start Up. This project started extremely rapidly. Deloitte was notified by USAID of a new project in Macedonia on August 3, 1994. The next day we were asked to attend a meeting with USAID and World Bank representatives to discuss the project. A scope of work for the potential project was provided to us on August 4, 1994, the day of our first meeting with USAID and the World Bank. We were asked to submit a cost proposal to the contracts office immediately. Deloitte submitted one to the Contracts Office on August 5, 1994. The project started August 14, 1994 when the Deloitte project coordinator accompanied the World Bank to Macedonia on a scoping mission at the request of USAID and the World Bank.

Scoping Mission. The project coordinator accompanied representatives of the World Bank, and consultants assigned to the other loss-making companies, to Macedonia during the week of August 14, 1994. The purpose of the visit was to review the status of enterprise restructuring plans, to gather financial and operational information and to make logistical arrangements for the arrival of the work teams on August 29, 1994. During the enterprises visits, it became evident that not only were the enterprise restructuring plans not prepared or completed as requested by the World Bank, but enterprise management would not be able to prepare credible restructuring plans without significant assistance.

Further, due to the existence of workers councils, enterprise management could not recommend significant labor reductions. In order to encourage management "buy-in" to any loss reduction measures it was decided that each team would need to spend between 8 to 10 days at each enterprise. During the mission, logistical arrangements were made to translate as much information as the enterprise management had available. This typically consisted of some (dubious) financial and operating information. In addition, translators, transportation and lodging were arranged for the teams that would be arriving in late August 1994.

Diagnostic Reviews. Four teams of two to three specialists, consisting of industry, insolvency and financial experts, arrived in Skopje, Macedonia during the week of August 29,1994. Following a short orientation meeting, the teams commenced work at Gazela (shoes), Hemteks (synthetic fibers) and Tresca (furniture), located in Skopje; and, Mikron (electric motors) located in Prelip, approximately 100 km away. The fifth team for Zelezarnica (steel) arrived during the first week of September 1995. Each team spent between 8 and 10 days on-site at the enterprises working with enterprise management. A concerted and concentrated effort was made by our teams to work closely with enterprise management to locate, gather and compile the necessary financial and operational information crucial to preparing restructuring plans, conducting reviews and making assessments. During this process, the Deloitte team members made every effort to transfer knowledge and understanding about what they were doing, why it was important, what and how it would be used in assessing the firm's operations, viability and financial situation. Accounting information was compiled and cash flow models were constructed. The teams also spent much time questioning management about the company's markets, suppliers, operations, impediments to production and operations and explaining why these elements are important and how they fit into a viable enterprise's financial and operational planning.

Due to the relationships developed during the scoping mission and pressure put on management by the government, no significant difficulties were encountered getting materials or management's attention. However, at most enterprises we were unable to get translated copies of management's plans, when they existed, until well into the analysis. Converted financial statements for some of the enterprises, prepared by a Macedonian accounting firm under another World Bank contract, were not ready until the end of the first week. Management at most enterprises was helpful and receptive to our consultants. Although management at Gazela (shoes) and the Zelezarnica were occasionally distracted by strikes and protest visits. At both enterprise employees invaded the General Manager's office at least twice during our stay. No abuse or threats were directed towards our teams.

Field work at Gazela, Hemteks, Mikron and Tresca was completed on September 8, 1994. Work at Zelezarnica was completed on September 20, 1994.

Report Preparation/World Bank Review. The enterprise diagnostic reports were prepared during the following weeks and reviewed with the World Bank on August 26-27, 1994. During the review with the World Bank the issue of working capital infusions was raised. Even with considerable discussion between ourselves, other consultants and the World Bank during field work, there was significant differences in the interpretation of what was said and agreed to. It was our understanding that the Reports should answer the question of whether or not the enterprise was viable and/or under what conditions it would be viable. Our assessments therefore concentrated on whether the enterprises or pieces of them were viable in its current state and where the main problems lay. By establishing where the main or primary problems lay it was possible to further assess what would be the necessary conditions under which the company could survive and prosper.

Unfortunately, during the World Bank reviews in Washington, DC, the World Bank maintained that all presentations and analysis were not to include assumptions of any working capital infusions. Extensive discussions ensued around this point. A number of the enterprises we (and the other firms) evaluated were/are viable given a modicum of working capital infusion. Macedonia as a country, its enterprises and economy have suffered greatly under the border blockades and war-time conditions. A number of (political) decisions outside of the control of the enterprises have served to place the enterprises in no-win situations, e.g. the existence of the SOK and the resulting inability of the firms to access any foreign currency earned through their sales. Our original analysis and presentations focused on whether the enterprises were viable in their current state, if not whether they were viable at all and what it would take to make them viable. A number of our original plans included provisions for some level of working capital infusions. This was rejected by the World Bank and the presentations had to be revised to accommodate this. This again required additional time not anticipated in the original planning of the project. With regard to the changes, we did try to integrate information about what it would take in terms of working capital infusions for the enterprises to become viable wherever possible.

In our opinion, the miscommunication regarding project parameters and assumptions was primarily due to the lack of a World Bank representative or senior project coordinator in Skopje during the field work and did affect project efficiency.

Review by Government Commissions. In order to build a consensus for the loss-reduction plans the government formed four groups or commissions: steel, heavy industry, light industry, and agro-industry. Gazela, Tresca and Hemteks were classified as light industry; and Mikron as heavy industry. Due to its size and importance, Zelezarnica (steel) was placed in a class by itself. The commission members usually included representatives from the Economics Ministry, Chamber of Commerce, the Ministry of Labor, the Ministry of Finance and some of the larger banks.

The revised reports were reviewed with the Macedonian government commissions during the week beginning October 10, 1994. The reviews were determined to be beneficial to both the enterprises and the Government. Sufficient information was evidently gathered and presented in the report to enable each commission to hold later discussions and approve the loss-reduction plans. However, at the time of the hearings we were quite concerned that not enough attention was being focused on the reports and presentations and that the reviews were being wasted.

Just after the completion of field work, the government decided to hold elections. These elections were scheduled for the end of October 1994. As a result, the hearings/reviews were much more sparsely attended then might otherwise have been. Usually no more than two or three people attended from the Government. At one review, Tresca, only one member, a representative from the Economics Ministry attended. Frequently, no questions were asked by commission members and the hearing became primarily a dialog between the enterprise management and the consultant. Due to the additional time taken by our teams to build relationships and obtain management "buy-in" to the extent possible from the enterprises, the discussions following the presentations were usually focused on the amounts of redundant labor as opposed to some of the other issues raised in the analysis and presentations.

LESSONS LEARNED/RECOMMENDATIONS

This was short project spanning only two months, September and October 1994. The project was a "study" for all practical purposes, in that it involved performing a quick diagnostic of the viability of each enterprise and the preparation and presentation of a report. There were two important differences, however, from other projects and/or "studies." First, this project was able to develop sound, viable recommendations and courses of actions for these enterprises to take in order to survive (where the possibility existed) as opposed to just studying and presenting the situation. Second, and what made it valuable from a developing program stand point, was that the quick reviews really did not give anyone, either in the government or in management, any time to build the political support for delay that plagues most longer term projects.

Another important contributor to the effectiveness of this project was that its focus was very simple: what short term actions requiring only limited capital infusions, can be taken to reduce cash losses sufficient to enable the company to cover its operating cash requirements. This kept the consultants focused and limited the tangential areas that might have otherwise been explored. This also meant that the government, through its designated review commissions, was limited to challenging consultant assumptions regarding the effectiveness of identified loss reduction measures.

So far this project should be judged as a success. The government accepted most of the loss reductions measures identified by the project teams. It has agreed to labor reductions of approximately 5,000 employees from the five loss-making companies diagnosed under this project. In fact, the government has accepted reductions of almost 19,000 employees from the 25 loss-making companies. The government has also, as of the date of this report, suspended all workers councils, appointed a Macedonian trustee to oversee changes in the enterprises and has appointed a Board of Representatives to 17 of the 25 loss-making companies. This Board has been granted majority control to ensure that management implements the loss reduction plans. It has also authorized the SRP companies to stop payment of bank and publicly-owned enterprise obligations - converting the liabilities into special non-voting shares that must be auctioned into private hands by the end of 1995.

As of March 1995, the Macedonian government, working in conjunction with the World Bank, has extended a tender that moves the SRP to its next stage. The next phase of the project will be to engage foreign consultants to act as advisors to the Macedonian trustee and as "shadow managers" to guide enterprise management and the Board representatives in the implementation of the restructuring plans.

It is anticipated that this next phase will begin in Spring 1995 and will have a significant impact on these enterprises' operations and ultimately the economy as a whole.

Regardless of how this next stage plays out, there are always lessons learned that can be applied to future projects. The "Lessons Learned" on this project, and our recommendations for similar projects in the future, are discussed below.

LESSONS LEARNED

1. **Up front coordination meetings with other consultants on the project are invaluable.** By accompanying the other World Bank consultants to Skopje we were able to hold repeated discussions regarding the focus of the project, its difficulties and potential implementation methods. While imperfect in areas, we were able to reach a reasonable consensus regarding the focus of the project on short-term loss reduction actions. The areas where weakness on this particular project arose stemmed primarily from the different interpretations of the scope of work. By meeting ahead of time and having adequate time to discuss the issues, we were able to reach a reasonable starting consensus.

2. **There is a definite need for an on-site coordinator when multiple consultants are used.** While we were responsible under this project for diagnostic reviews of 5 of the 25 loss-making companies, there were six other firms reviewing other companies at the same time. At various times each of us had questions regarding the project scope and report. We attempted to coordinate amongst ourselves by holding periodic meetings; but there was no real final say as to how things should be done. This led eventually to remarkably different assumptions used in preparing the cash forecasts and in the report formats, which added a degree of confusion to the work of the Government review commissions. In the future, we recommend that one project manager or "coordinator" be designated who can make policy decisions regarding assumptions, data reported and format, etc., to guide all consultants.

3. **The use of a template would have significantly improved implementation.** This was as much our failing as anyone else's. We had fourteen consultants working in five

enterprises. While coordination meetings were held frequently, the data collected and reported and the format of the loss reductions measures varied significantly. In the future a report template should be prepared by the project manager and used by all teams. In this particular case, a template should have been prepared by the overall project coordinator, discussed above, so all of the consulting teams would have gathered the same type of data, prepared similar cash flow and loss-reduction measure tables. This would have greatly assisted the reviews by the Government commissions and would have made it considerably easier for the results to be consolidated.

4. **Adequate time must be scheduled for the work.** During the scoping mission it became obvious that management of the five enterprises was not going to have credible plans prepared for us to review. There were two reasons for this:

   a) Regardless of the prior training, management was not able to prepare cash flow forecasts. Enterprise managers were primarily administrators. They were good managers of people. They understood the technical operations. They understood the need for cash to meet payroll, but they were not used to planning beyond the next payroll period. Generally speaking, they did not understand how to tie their cash requirements, sales proceeds, etc., together in a forecast.

   b) In most of the five enterprises, management was essentially "elected" by workers councils. This of course gave the council the ability to over rule management decisions. In fact, during the project, our teams were told story after story describing situations where the companies were micro-managed by the councils. As a result, management was extremely reluctant to recommend - that is to put on paper - loss reduction measures that the workers councils would not accept.

Due to the inability of management to prepare credible loss-reduction plans, the project teams were forced to prepare loss-reduction plans of their own. Thus in future projects we should anticipate at the outset that the teams will have to prepare the plans so adequate time and budget should be built-in to the project. This does not mean that management should be relieved of their responsibility, rather that the reality of the situation should be accepted and planned for. In most developing countries and emerging markets, enterprise management will not have the skills to develop adequate financial plans and cash forecasts on their own. Therefore, the training of management as well as the development of these plans should be provided for in this type of a project in order to both conduct the necessary analysis essential to this project and leave behind the skills for those remaining to continue this practice in the future.

5. **The need for management buy-in into the process cannot be over stressed.** Probably the most significant difference between the way this project was run as compared to the methods of the other consultants, was that we assigned separate teams to each enterprise. The other consulting organizations used one team and moved from company to company. Our approach was partly due to the need for expertise in five different industries (shoes, furniture, electric motors, synthetic fibers and steel); but more importantly, we realized that there was a need to "sell" management on the loss-reduction measures identified. Without management understanding and "buy-in," we would not have benefited from management's understanding of the company and its local markets. Furthermore, without management's buy-in we would have faced significantly more difficulties during the Governmental review commission hearings then we did. This is not to say that management agreed with our recommendations 100%. Rather, they at least clearly understood our recommendations and the reasons for them; While they may not have supported all of our recommendations for internal political reasons, they also did not attack them during the hearings.

6. **Set up trade finance mechanisms.** The Macedonian economy suffered enormously as the result of the collapse of the centrally planned block of economies in Eastern Europe, the UN embargo against Serbia and Montenegro, and the Greek blockade. While many Macedonian enterprises attempted valiantly to shift to other markets and other distribution channels, the loss-makers in particular did not appear to respond very quickly. This was undoubtedly due to (1) early easy credit as a result of the almost incestuous relationships between the large enterprises and the social-owned banks and (2) the inability of management to make labor reductions due to the worker council control discussed above. Whatever the reason, most of the loss-makers in this exercise hemorrhaged cash working capital during 1991-1993. Thus when the project was initiated in mid-1994, most had no cash available to pay workers nor buy raw materials necessary to generate sales. Their businesses had just about wound down. Thus some capital was necessary to give the loss-makers any chance of turning around.

   Whether or not to permit trade capital flows to the loss-making enterprises was one of most discussed issues during the project. Most of the consultants felt quite strongly that turnarounds were possible with relatively minor capital infusions; provided there was reasonably good management of it. In addition, most consultants also felt that there was little chance of turning anything around if there were no funds were available to prime the sales pump. The World Bank did not initially approve; and only agreed to self-liquidating loans (trade finance) after considerable discussion. The World Bank wanted initially to limit the enterprises to internally generated funds or Government on-budget subsidies. Since the government had limited capacity to fund the enterprises, this meant that many could not be restarted. In fact, due to the lack of trade finance arrangements in the country, this may still occur. Hopefully, technical assistance will be provided to facilitate trade finance mechanisms.

This is not all that unusual in developing economies, especially if they have suffered significant external economic shocks. Trade finance mechanisms must be developed to enable enterprises to finance the raw materials needed for new sales. In the future, on similar projects, we should permit loss-makers access to trade finance provided adequate management, such as the Trustee management arrangement in Macedonia can be put in place.

7. **Address governance impediments before starting similar projects.** The impact of the workers councils on this exercise has been discussed above. Had the worker councils and the future corporate governance arrangements been addressed before starting the project, management would have been much more receptive to loss-reduction measures and the rules of the game would have been clearer to the consultants. This would have improved the process immensely. In the future it would probably be best to agree to the receivership governance structure before starting similar diagnostic studies.

8. **Social safety net issues should be addressed up-front, and quickly.** In our opinion the quick reviews or loss-reduction studies were well timed considering the financial condition of the loss-making enterprises. Actually, the program should have been started earlier, before all cash working capital had been bled away. Implementation of this project would have been much easier if the planned projects for the safety net had been start earlier or at least at the same time. This would have made it easier for management to recommend and the employees to accept the large lay-offs necessary to match cost and revenues in most of the loss-making enterprises. Hopefully in the future all components: the safety net, corporate governance arrangements and the development of trade finance mechanisms are thought of a package that must be implemented in a coordinated fashion.

IMPACT OF USAID ASSISTANCE

Estimating the long range impact of technical assistance is extremely difficult and even more so in this environment, where the long range political stability of the region is questionable. However, the technical assistance appears to have played a major role in changing perceptions as to the solutions available to these companies and galvanizing both the government and the enterprise management into action.

Many of the enterprises diagnosed in this project were actually prosperous companies just four short years ago. In 1989, the steel company had been operating at over 100% of its rated capacity. This eroded rapidly during the following three years; but few believed that the down turn was permanent. Most felt that if the government could keep them going the sun would rise when war in Bosnia ended, or to a lessor degree when Greece ended its blockage of the Southern border. Few understood that many of the products produced were really of poor quality and not competitive in the changed world that allowed essentially free movement of goods. Even fewer realized the lack of value that remained in most of these companies. This became apparent during the reviews, particularly of Mikron, Tresca and Zelezarnica. In the end, management understood that they needed to exit certain product lines and that the lines would not be revived as expected. In Zelezarnica's case, while management fought us, the Government generally accepted our conclusion that the enterprise was no longer viable. This project also played an important role in the later refinement and implementation of the Special Restructuring Program. As a result of this project and Deloitte Touche Tohmatsu's role, the government adopted the trustee/receivership method of governance during the restructuring period and adopted our concept of "shadow managers" to guide the restructuring process.

PRESENTATIONS

Deloitte & Touche

Agency of the Republic of Macedonia for the Transformation of Enterprises with Social Capital

Special Restructuring Program (SRP)

Gazela

USAID

Sponsored by the U.S. Agency for International Development in conjunction with The World Bank

October 1994

Delivery Order No. 34

Project No. 180-0014
Contract No. EUR-0014-I-00-1056-00
Eastern European Enterprise Restructuring and Privatization Project

Deloitte Touche Tohmatsu International

Table of Contents

Introduction

- We have been engaged under the Macedonia Special Restructuring Project (SRP) to:
  - *Review and assess the restructuring plan prepared by Gazela management*
  - *Evaluate the viability of Gazela*
  - *Work with management to develop a preliminary restructuring/liquidation plan*

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Gazela

Introduction

- Our definition of a viable company is a company that is reasonably expected to generate sufficient cash to cover its operating costs and to maintain its productive assets. Following World Bank guidelines, each company assessed under the SRP program is to be classified as:
  - *Not viable under any realistic scenario; or*
  - *Potentially viable and competitive, but requiring a full fledged restructuring study to eliminate long-term structural losses; or*
  - *Viable once short-term measures are adopted.*

This report includes our findings and recommendations.

Executive Summary

- Three business units:
  1. *Footwear manufacturing and export*
  2. *Footwear retail*
  3. *Rubber and adhesives*
- The company has suffered from the political, social and economical problems of the region.
- The restructuring plan presented by the company is overly optimistic and appears difficult to achieve.
- The historical Bank Debt and related interest cannot be repaid by the company.
- The company is overstaffed at the current level of workers for the expected level of production over the next two years.
- The company's facility and production equipment has the capability of producing a product of average quality. However, a technology plan and an equipment upgrade program must be implemented in order to continue producing a competitive product.

Executive Summary

- The company could be considered viable. However, it is currently trapped with a blocked bank account, labor problems and production interruptions which could lead to order cancellations.
- The proposed restructuring plan will size the company at a realistic level of production for the markets served.
- The three business units will each contribute positive operating results.
- The company will be positioned to capture a greater market share with a more competitive product.
- After funding in the early stages of the restructuring, the company will be able to generate sufficient working capital and repay the new debt incurred over a reasonable period of time.
- In order for the restructuring plan to succeed the management group must be reinforced with a shadow manager.

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AD Gazela -- General Information

- Established 1960
- Three company units
  - *Footwear*
  - *Rubber and adhesive*
  - *Retail network in Macedonia and other former Yugoslavia countries*

  Supported by Administrative Unit
- Major footwear manufacturer in Macedonia
- Monopolistic manufacturer of several rubber and adhesive products in Macedonia
- Has staff of 2,044 employees

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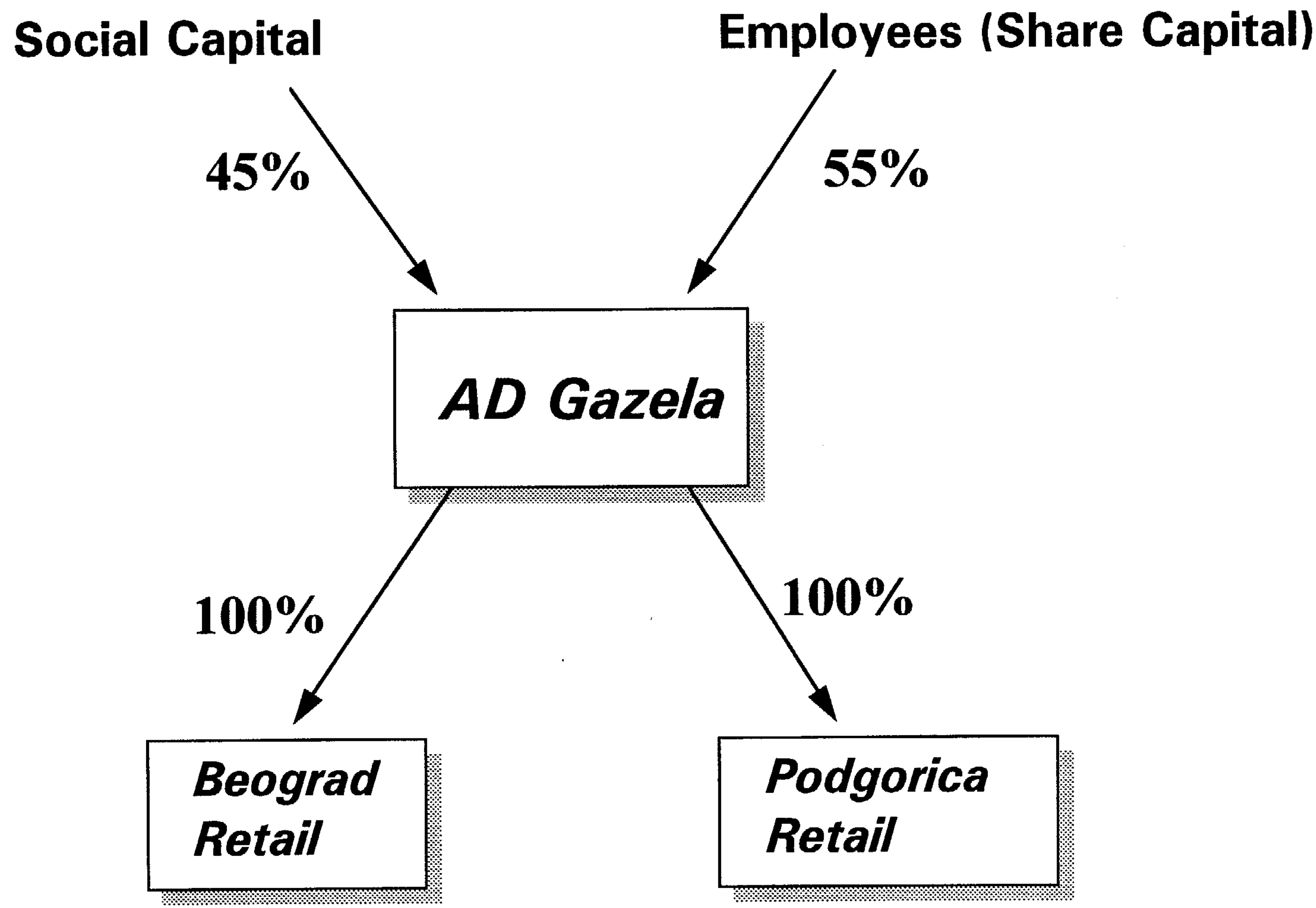
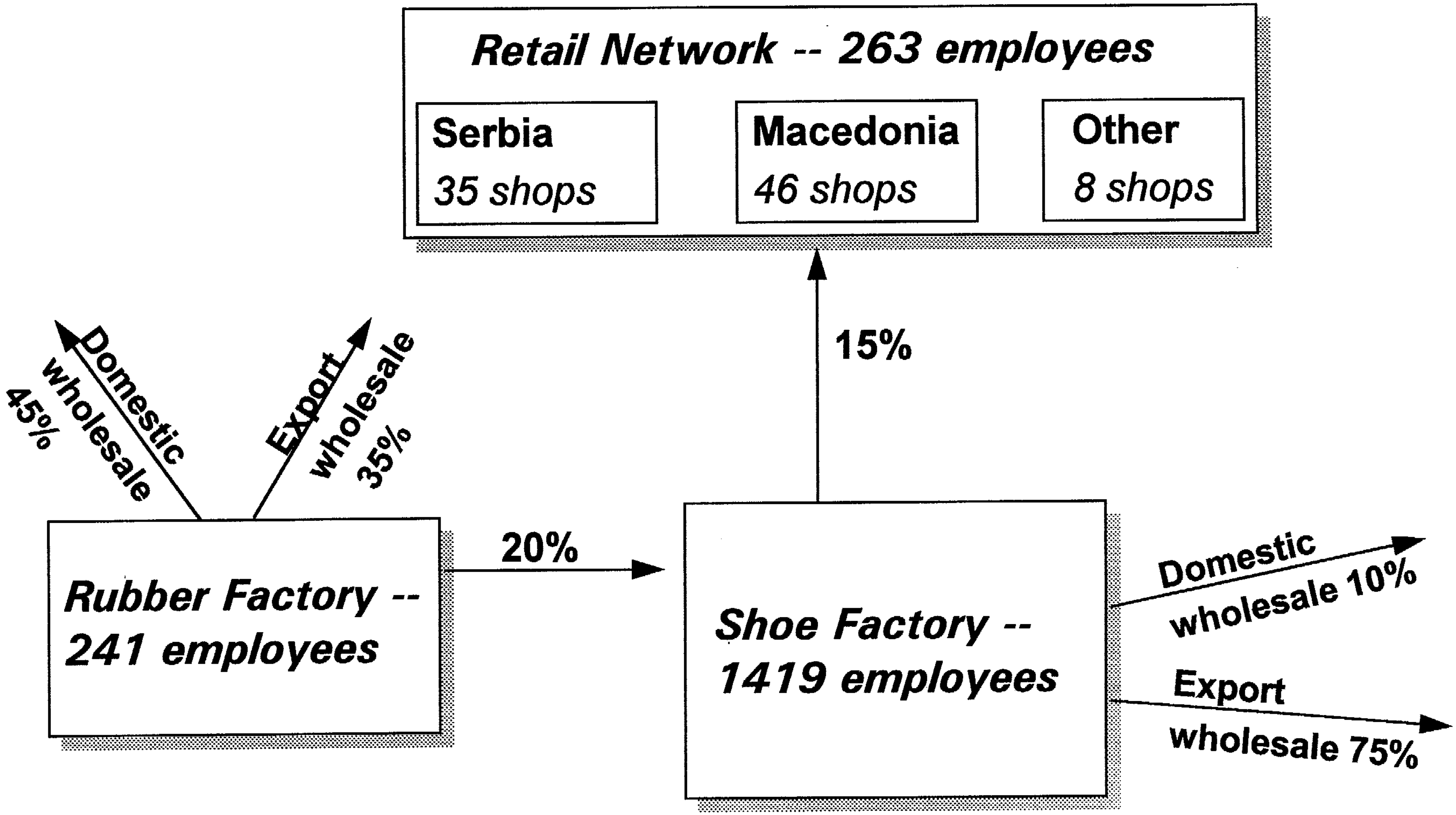
AD Gazela -- Group Structure



AD Gazela -- Overview of Operations



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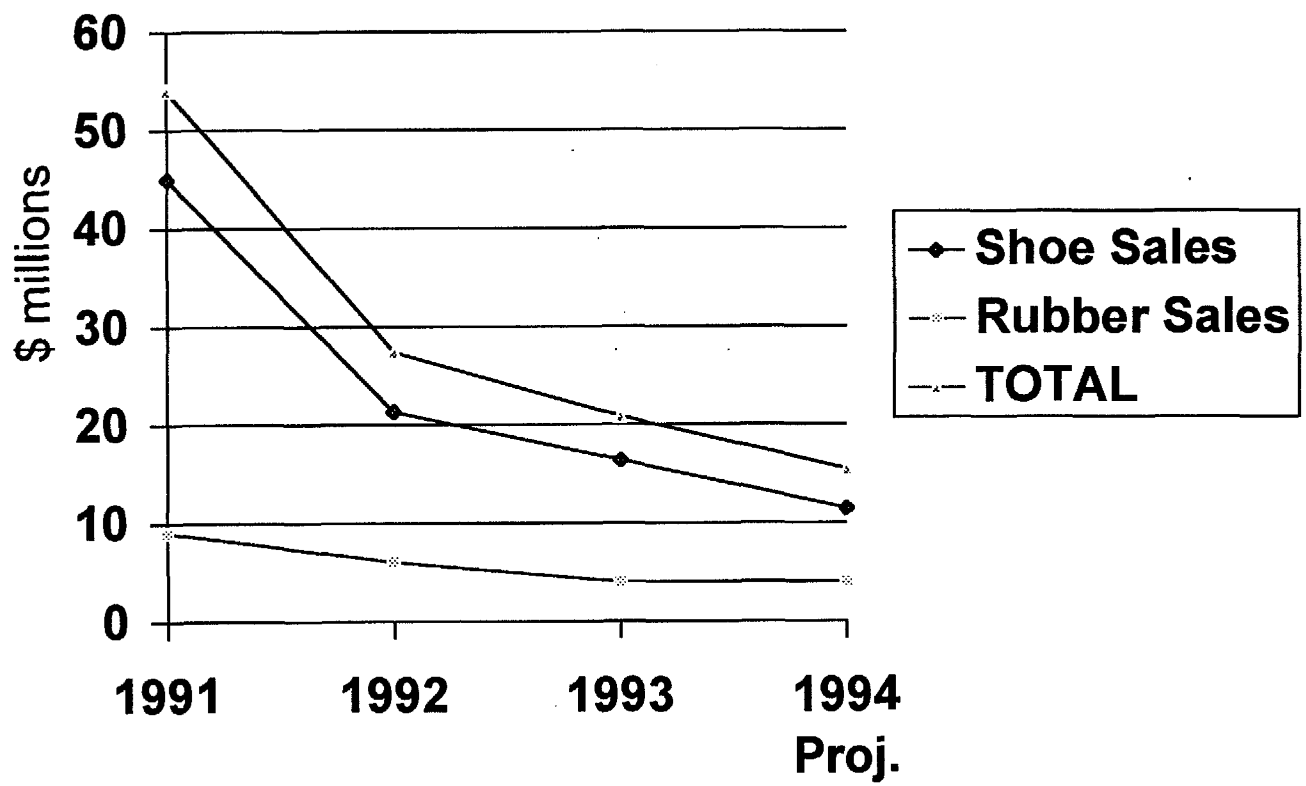
AD Gazela -- Sales (in $'000,000)

Significant decrease in sales due to the political, social and economic problems of the region.



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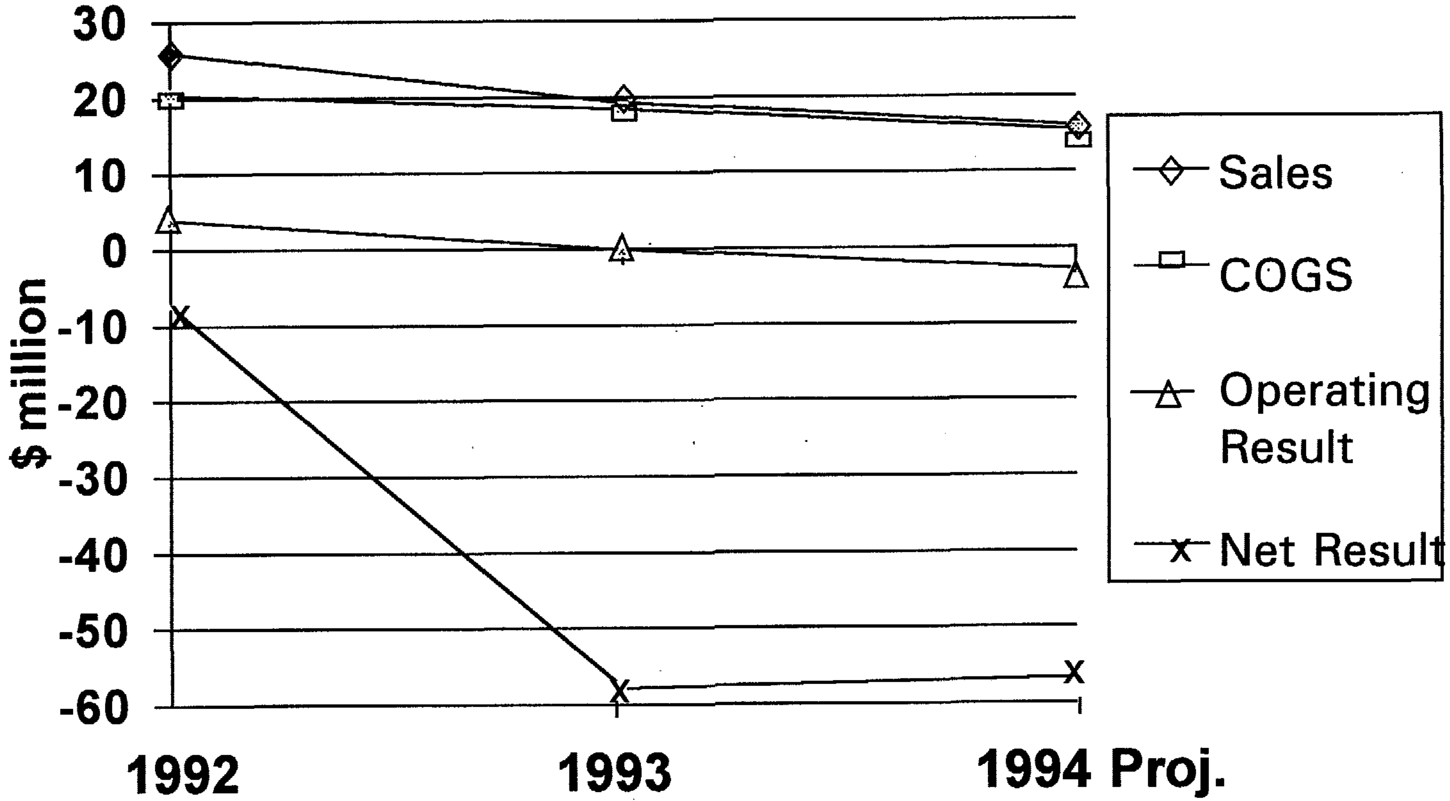
AD Gazela -- Financial Results

Reduced profit margins due to the lack of working capital, excessive workers for current production levels and high interest rates.



Gazela

AD Gazela -- Debt Situation

The current debt level as of August 31, 1994 cannot be repaid by the company.

I. Current bank debt structure (as of 31 August 1994)

	$'000	*% of Total*
Principal	13,223	13.67
Interest	83,498	86.33
Total	96,721	100.00

II. Bank creditors

	Total debt (interest + principal) (in $'000)
1. Stopanska	12,708
2. Ljublanska	81,433
3. Other	2,579
Total	96,721

III. Principal to be repaid

- *Part of principal due but not repaid by 31 August 1994: $10,643,311*
- *Part of principal due by the end of 1994: $2,579,578*

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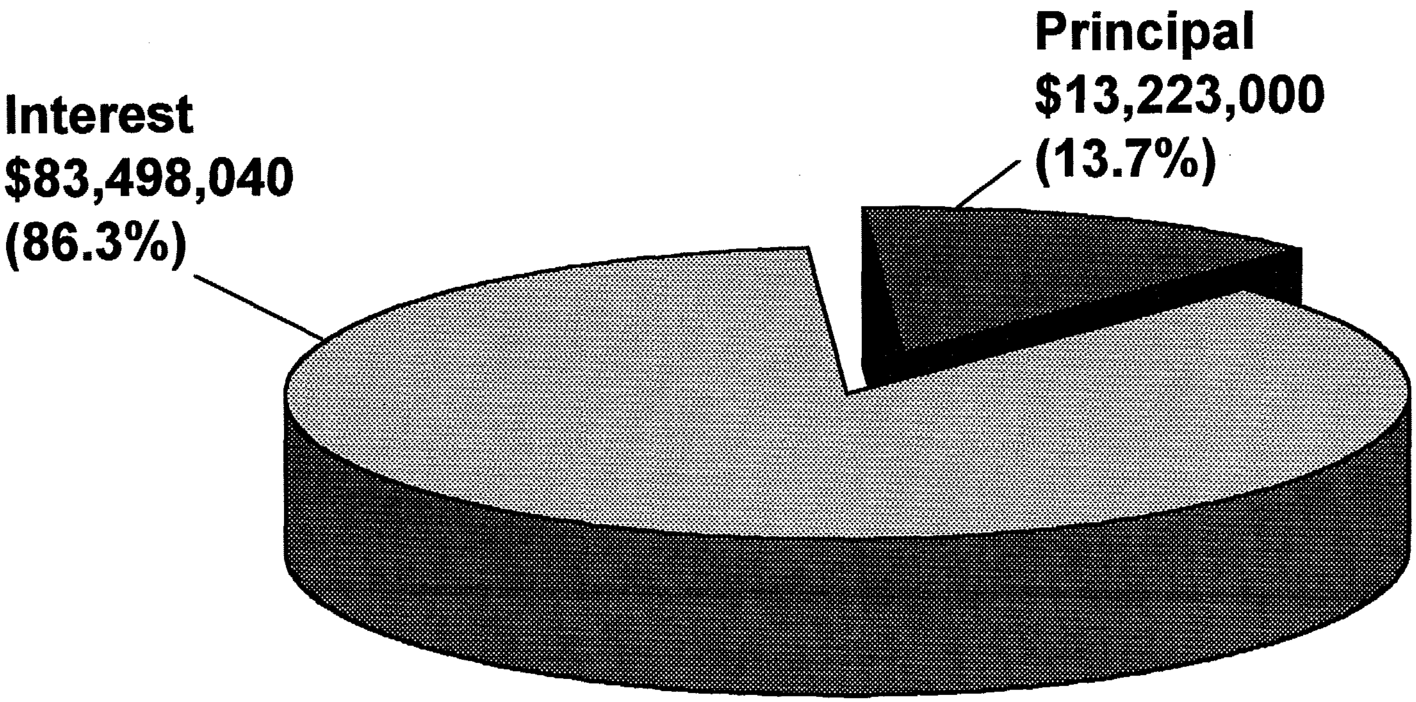
AD Gazela -- Current Debt Structure (31 August 1994)

Disproportionate relationship between interest and principal.



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AD Gazela -- Facility Capacity

The existing facilities are highly under utilized.

Footwear (pairs)

Full Capacity	2,200,000	pair/year
1991	1,500,190	68.2%
1992	1,404,020	63.8%
1993	1,264,533	57.5%
1994 (proj.)	699,769	31.8%

Rubber/adhesive (tons)

Full Capacity	4,800	tons/year
1991	4,158	86.6%
1992	3,878	80.8%
1993	3,414	71.1%
1994 (proj.)	2,668	55.6%

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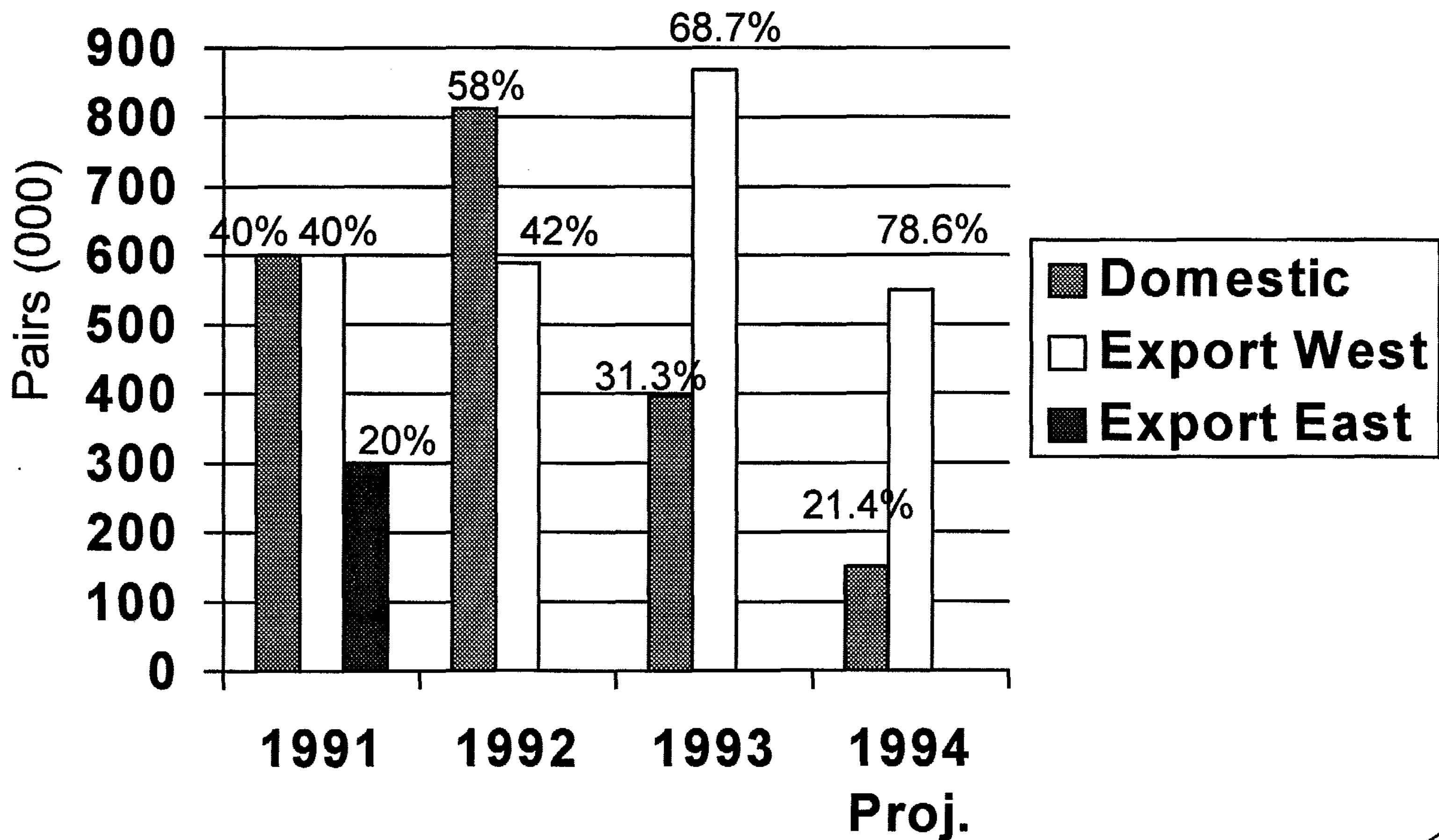
AD Gazela -- Market Contribution Footwear

The company is dependent upon its ability to export to Western markets.



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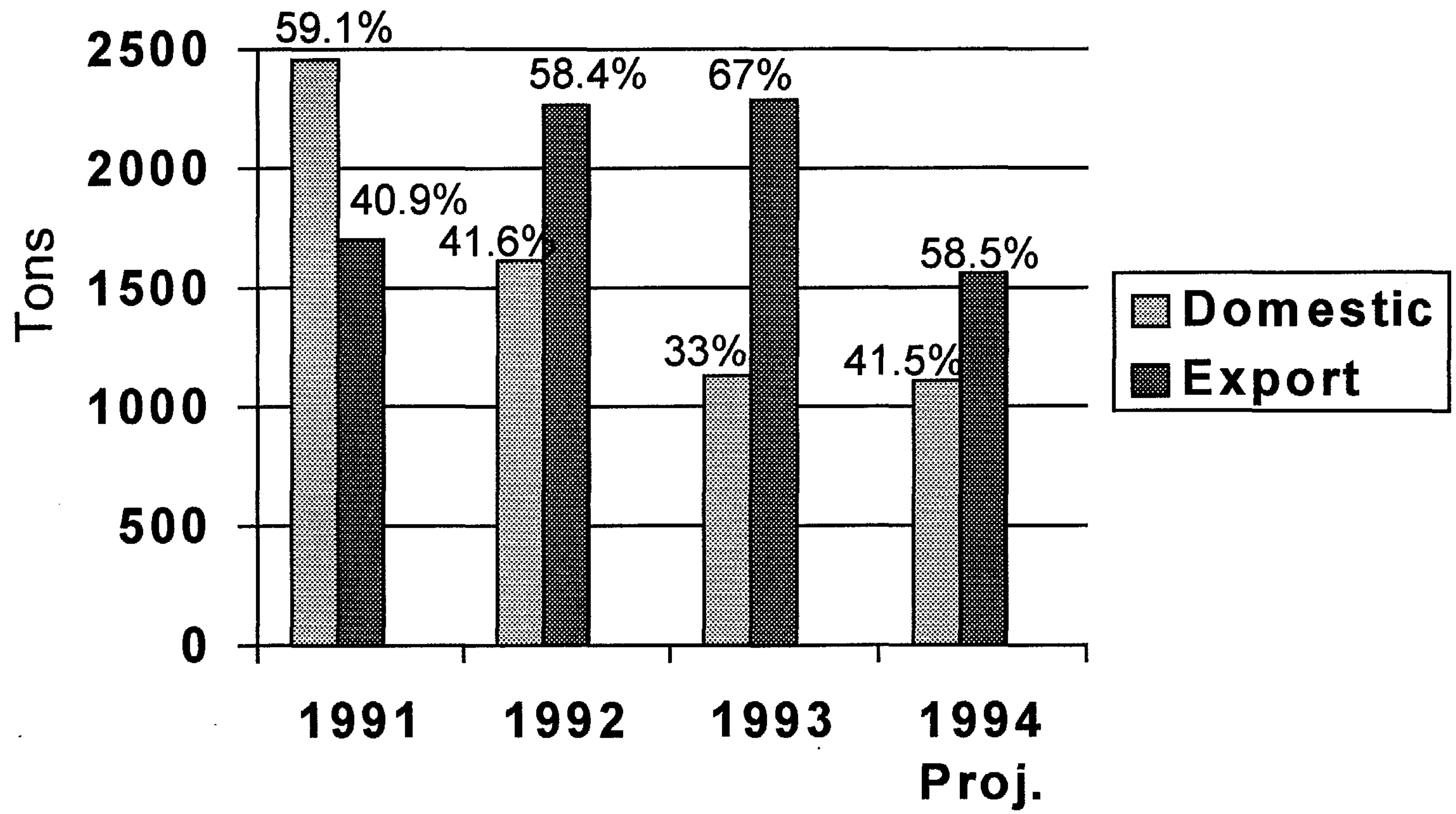
Gazela

AD Gazela -- Market Contribution Rubber and Adhesive

Over the last three years, 58% or more of the company's rubber and adhesive sales were to export markets.



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Gazela

Adverse Market Conditions

Major adverse conditions have had a significant negative impact on the company.

- Political situation in the former Yugoslavia
- Loss of the Serbian retail market
- High inflation in the region
- Loss of export sales to the former USSR
- Difficulty in obtaining raw materials
- Freezing of the company's bank account

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Gazela

Company Assessment

Company strengths can be used as a foundation for future growth.

Strengths	**Shoes**	**Rubber**	**General**
Established name	✓		
Domestic market share	✓	✓	
Established retail network	✓		
Well organized production	✓	✓	
Sound management		✓	
Product diversification			✓
Single site manufacturing facility			✓

Gazela

Company Assessment

The lack of working capital has caused severe financial constraints.

Lack of working capital

- Historical losses
- SOK blockade
- Poor credit control
- Stock building
- Major bad debt ($8.5 million - Central/Textile/Russia)

Company Assessment

60% of the company's retail sales were lost due to the Serbian conflict.

Serbian conflict

- Loss of retail network
- Loss of wholesale sales
- Loss of supplies
- Increased transport costs (by 2/3)

Gazela

Company Assessment

Work stoppages, the inability to pay salaries and strikes have resulted in poor labor relations

Labor relations

- Overstaffing
- Restrictive legislation (lack of a safety net)
- Strike history

Gazela

Company Assessment

The lack of a marketing plan has resulted in poor product focus.

Marketing

- No agency network
- Limited product range (shoes)
- Quality of retail network
- Merchandising capability (retail)

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Gazela

Company Assessment

Product pricing strategies have been negatively affected by the company's production environment.

Pricing

- Barter costs
- Pressure to buy turnover
- No standard cost verification

Gazela

Company Assessment

The company lacks management stability and a clear company direction.

Management

- Third group in 3 months
- Limited decision making
- Poor labor relations
- Distraction

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Gazela

Company Assessment

The outdated technology used in production is starting to negatively affect product quality.

Technology

- Pattern engineering and grading performed manually
- Organization and work flow of the stitching room
- Manual stitching equipment
- New line development
- Inability to accept technical data in electronic format from Western importers

Gazela

Recommendations

Access to working capital must be obtained in order for the company to operate effectively.

Working capital

Historical losses

SOK blockade

Poor credit control

Stock building

Major bad debt

Solutions:

- *Negotiate release of SOK blockade*
- *Re-negotiate existing orders*
- *Sell excess inventory ($2.6m/$925,000)*
- *Establish maximum inventory levels*
- *Resolve/settle bad debts*

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Recommendations

The Serbian market can provide a significant outlet for shoe production.

Serbian conflict

Loss of retail network

Loss of wholesale market

Increased transport costs

Solutions:

- *Obtain license to import*
- *Determine method of payment*
- *Hire local management*
- *Analyze own fleet option*

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Gazela

Recommendations

The work force must be matched to expected production levels and management should maintain open lines of communication with the workers.

Labor relations

Overstaffing

Restrictive legislation

Strike history
(approx. 3 months wage arrears)

Solutions:

- *Reduce workforce by 1,031*
  - *consultative process*
  - *look for job-share opportunities*
- ***Swift** resolution of **total** problem*

Recommendations

Establish a clear and focused marketing plan for each business unit.

Marketing

No agency network

Limited product range (shoes)

Quality of retail network

Merchandising capability (retail)

Solutions:

- *Establish target markets (Russia)*
- *Brokers vs. direct*
- *Introduce athletic footwear (import and/or manufacture)*
- *Review individual shop profitability*
- *Enhance product pull*
- *Establish merchandising responsibility*

Gazela

Recommendations

Establish company pricing policies and product pricing formulas in order to maintain profitable lines.

Pricing

Problems	*Solutions:*
Barter costs	*Minimize effect on margin*
Pressure to buy turnover	*Renegotiate marginal contracts*
No standard cost verification	*Sample cost verification*
Minimal retail mark-up	*Test price elasticity*

Gazela

Recommendations

Management must take a pro-active role in providing company direction and establishing worker confidence.

Management

High management turnover

Poor labor relations

Distraction

Limited decision-making

Solutions:

- *Install shadow manager*
- *Establish business plans*
- *Establish monitoring systems*
- *Assign task accountability*

Gazela

Recommendations

A technology plan should focus on both production and quality improvements with a reduced unit cost.

Technology	***Solutions:***
Pattern engineering and grading performed manually	■ *Install low cost PC-based pattern engineering and grading system ($26,000)*
Organization and work flow of the stitching room	■ *Reorganize from single line to multiple cells*
Manual stitching equipment	■ *Programmable sewing machine ($3,000-$10,000 each)*
New line development	■ *2D sketch system for shoe design ($12,000)*
Inability to accept technical data in electronic format from Western importers	■ *Adhere to industry standards for electronic data interchange*

Gazela

Crisis Management Plan: Next 4 Months

Cost associated with restarting the company and returning to positive cash flow.

Item/Period	Sept.	Oct.	Nov.	Dec.	($'000) Total
Cash contribution from continuing operations					
Retail network, net	34	34	129	77	274
Wholesale -- domestic	0	138	0	0	138
Wholesale -- export	0	270	1223	1224	2717
Rubber factory	335	335	335	335	1340
Total contribution	**369**	**777**	**1687**	**1636**	**4469**
Cash payments					
Materials -- footwear	0	338	1015	1015	2368
Materials -- rubber	261	261	261	261	1044
Factory running costs	614	346	346	346	1652
Restart cost A/P	2093				2093
Capital expenditure	0	0	0	0	0
Total production related payments	**2968**	**945**	**1622**	**1622**	**7157**
Gross cashflow	**-2599**	**-168**	**65**	**14**	**-2688**
Other items					
Inventory reductions	**0**	**100**	**100**	**200**	**400**
Severance pay (12 months at 100%)	**3216**	**0**	**0**	**0**	**3216**
Net cashflow	**-5815**	**-68**	**165**	**214**	**-5504**

Note: Figures included above are based on completing existing customer contracts. However, if the current labor problem is not resolved quickly, it could result in order cancellations and/or severe financial penalties.

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Gazela

Sales (in $'000)

1995 and 1996 sales plan as compared to four year historical figures.

Item/Year	1991	1992	1993	1994 Proj.	1994 1st half	1995 Plan	1996 Plan
Shoes	**31,679**	**18,763**	**13,797**	**9,294**	**5,982**	**15,158**	**16,640**
Domestic	14,478	7,478	2,199	2,603	1,676	960	960
ExportWest	8,410	9,531	11,174	6,691	4,306	14,198	15,680
Export East	8,791	0	0	0	0	0	0
Other Yugoslavia	0	1,774	424	0	0	0	0
Rubber	**9,085**	**6,062**	**4,433**	**4,033**	**2,200**	**5,122**	**5,379**
Domestic	6,607	3,736	2,478	2,289	1,249	2,019	2,069
Export west	2,478	2,327	1,955	1,744	951	3,103	3,310
Retail	**13,313**	**2,523**	**2,603**	**2,141**	**1,177**	**2,660**	**3,040**
Total	54,077	27,368	20,832	15,468	9,360	22,940	25,059

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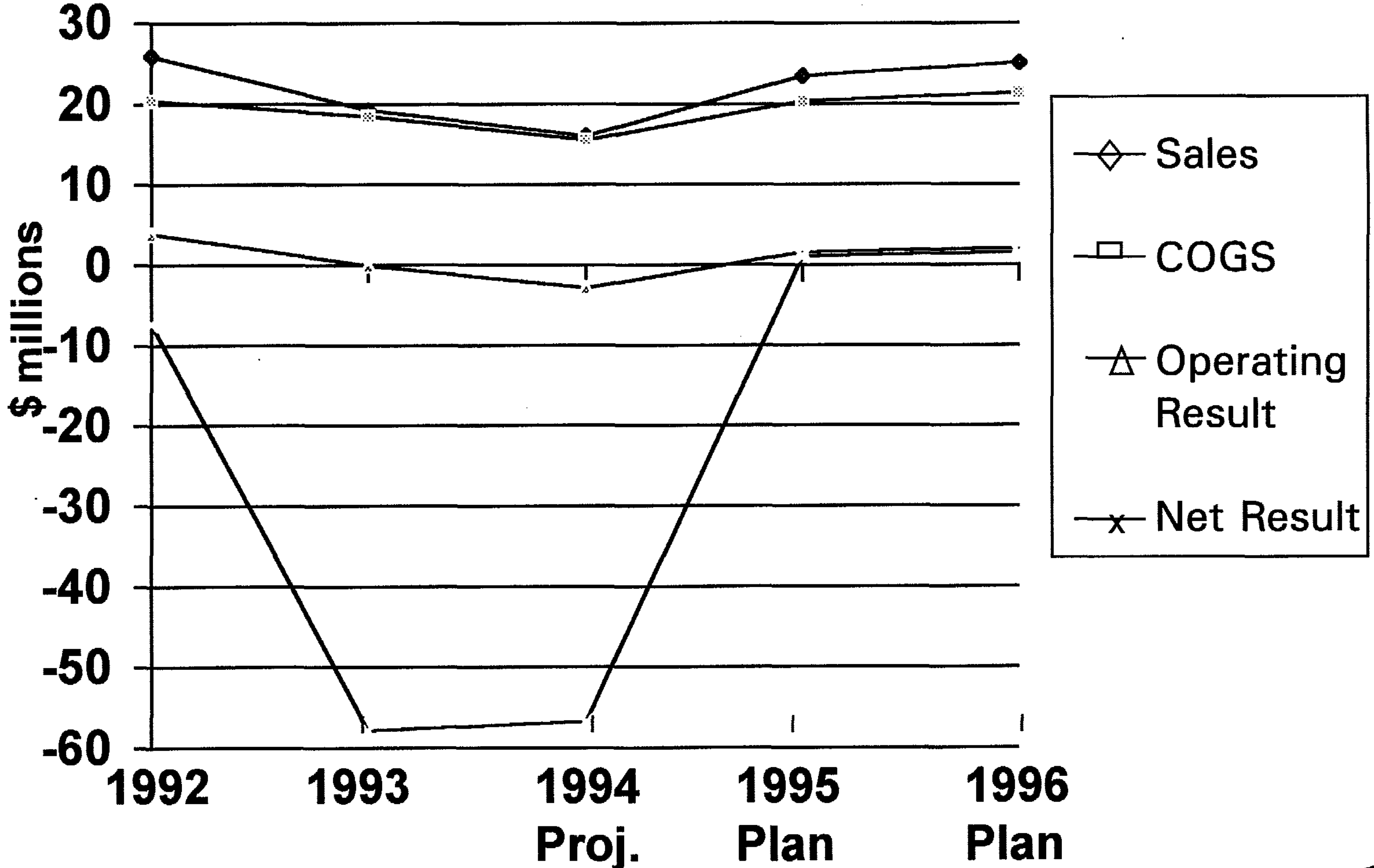
Gazela

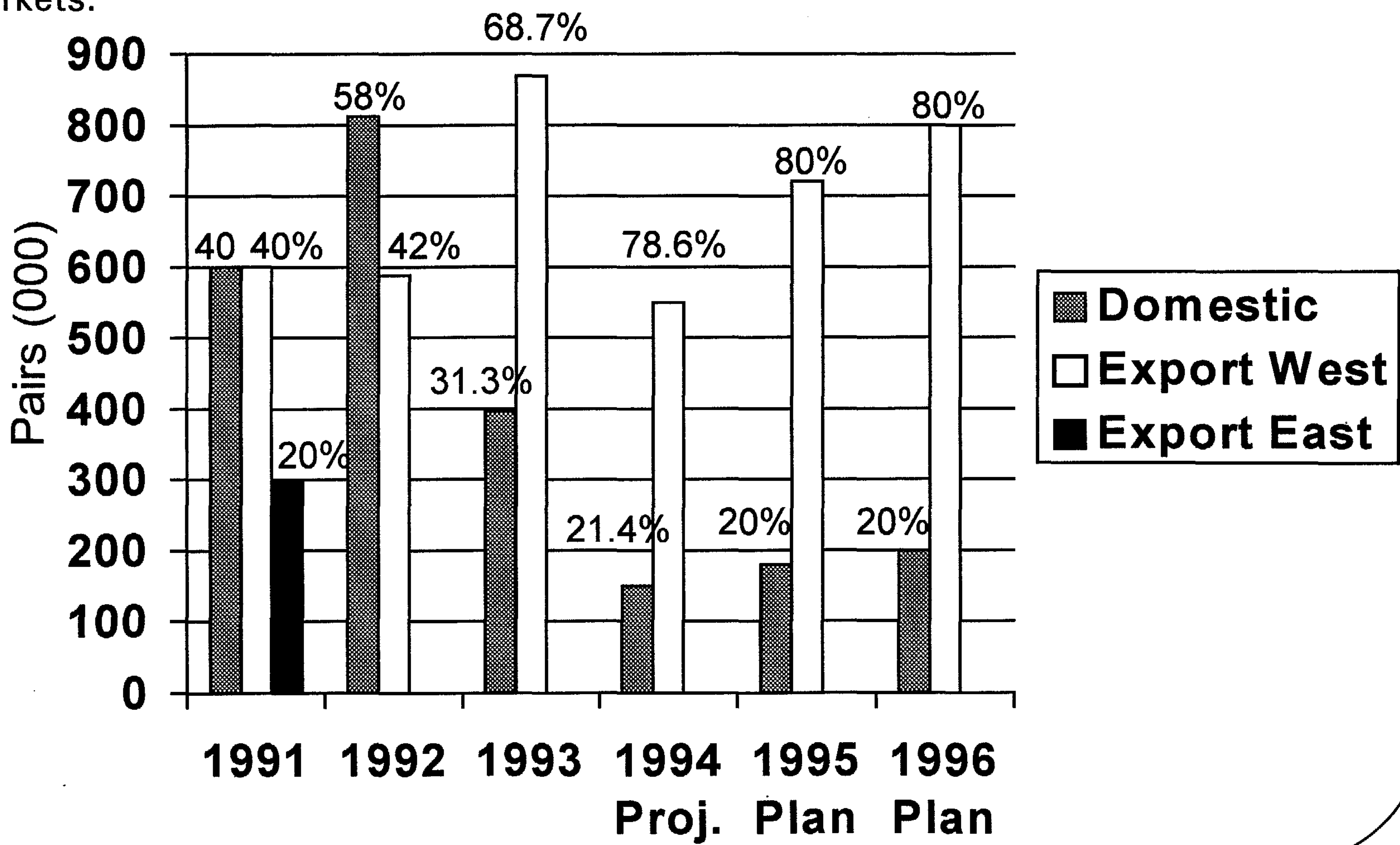
AD Gazela -- Financial Results

Projected margin improvements as a result of restructuring.



AD Gazela -- Market Contribution
Footwear

80% of the company's footwear sales are expected to be from export markets.



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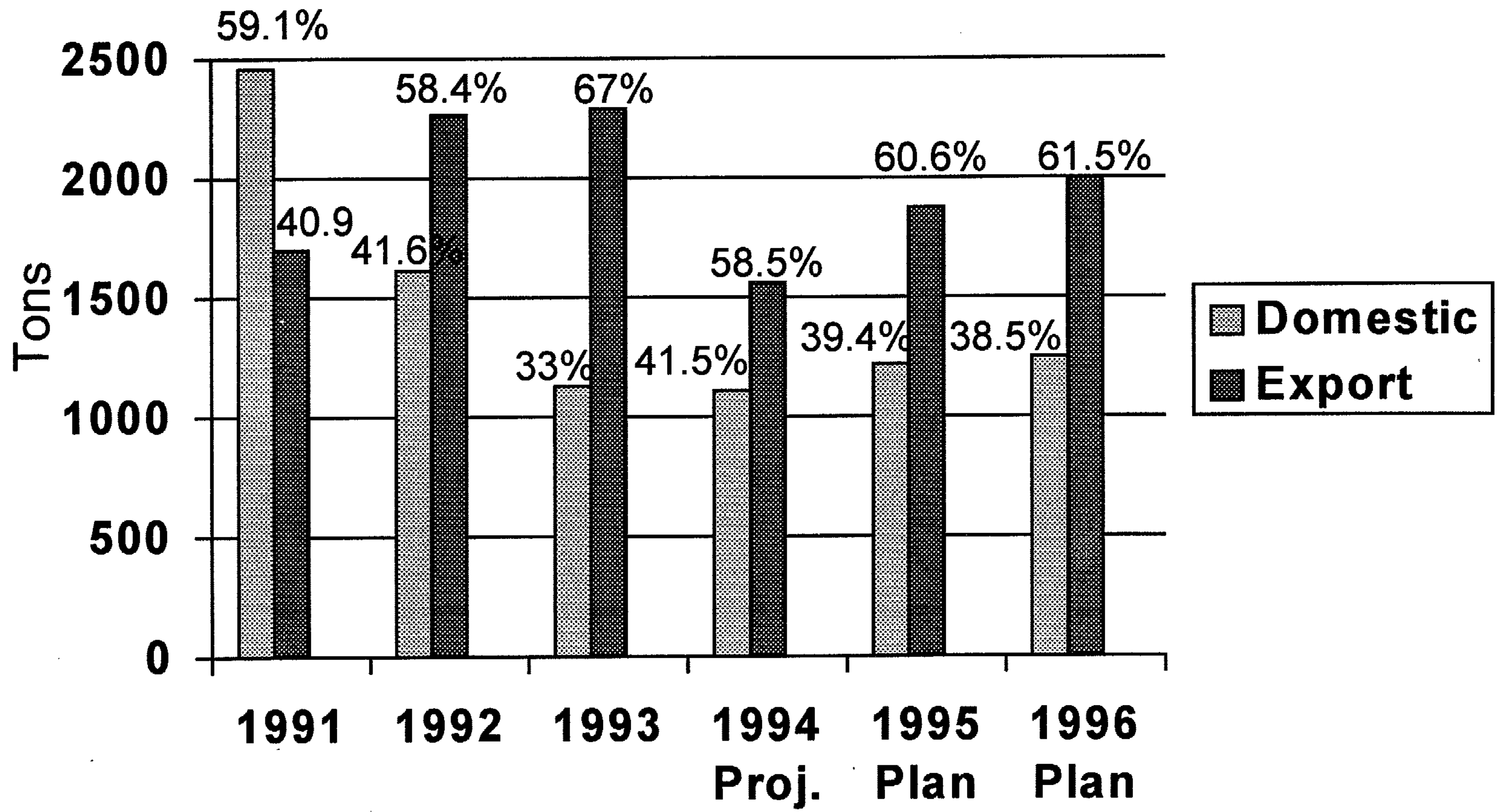
AD Gazela -- Market Contribution Rubber and Adhesive

Approximately 60% of the company's rubber and adhesive sales are expected to be from export markets.



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Gazela

AD Gazela -- Facility Capacity

Although facility utilization is increasing, it is far below acceptable levels.

Footwear (pairs)

Full Capacity	2,200,000	pair/year
1991	1,500,190	68.2%
1992	1,404,020	63.8%
1993	1,264,533	57.5%
1994 (proj.)	699,769	31.8%
1995 (proj.)	906,000	41.2%
1996 (proj.)	1,000,000	45.5%

Rubber/adhesive (tons)

Full Capacity	4,800	tons/year
1991	4,158	86.6%
1992	3,878	80.8%
1993	3,414	71.1%
1994 (proj.)	2,668	55.6%
1995 (proj.)	3,095	64.5%
1996 (proj.)	3,250	67.7%

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AD Gazela -- Projected Cash Flow 1995, 1996

Item/Period	1995 (in $'000)	1996 (in $'000)
Cashflow from operations		
Operating result	1083	2066
Depreciation	1115	1000
Sale of excess inventory	500	0
Change in A/R vs. change in A/P	(222)	500
Sub-total	**2476**	**3566**
Cashflow from financing		
Working capital loan	1827	
Interest expense	(733)	(733)
Net cashflow	**3570**	**2833**

Note: Additional $5,504,000 will be needed in 1994 to cover restart costs and severance pay ($3,216,000). For projection purposes we have assumed Gazela can obtain debt financing.

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AD Gazela -- Working Capital Requirements

	1994 projected (in $'000)	1995 plan (in $'000)	1996 plan (in $'000)
Current assets			
Cash	586	860	950
Receivables	1963	2500	2700
Finished goods	455	500	700
Raw materials	1308	1500	2000
Total	**4312**	**5360**	**6350**
Current liabilities			
Trade payables	1962	2000	2300
Other payables	257	5000	700
Accrued expenses	266	355	505
Total	**2485**	**2800**	**3500**
Net working capital	**1827**	**2505**	**2795**

New Debt Structure and Repayment Plan

- Gazela has no ability to service and repay its debt under the existing terms and conditions
- New debt or drastic modifications to the old debt should be negotiated between Gazela, bank and the Government
- Recommended new debt terms are as follows:
  - Amount of debt $7,331,000 (based on amount of cash needed to manage the current crisis, and the working capital requirements for 1995)
  - 10-year debt
  - Grace period for principal repayment 2 years
  - Interest rate 10%
  - Interest payable monthly

Gazela

Action Plan and Summary

Recommendations and the action plan focuses on restarting the company, reduced work force, generate positive cashflow, and position the company for future growth.

- Unblock the company bank account
- Size the work force to expected production levels
- Stabilize the work force
- Expand on the business plan with specific strategies and action
- Solidify current export orders
- Implement an aggressive production and quality control program
- Aggressively attack export market
- Implement technology improvements in both shoe production and rubber adhesive production
- Realignment of retail outlets

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Deloitte &
Touche

Agency of the Republic of Macedonia for the Transformation of Enterprises with Social Capital

Special Restructuring Program (SRP)

Hemteks

USAID

Sponsored by the U.S. Agency for International Development in conjunction with The World Bank

October 1994

Delivery Order No. 34

Project No. 180-0014
Contract No. EUR-0014-I-00-1056-00
Eastern European Enterprise Restructuring and Privatization Project

Deloitte Touche
Tohmatsu
International

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Table of Contents

Introduction

We have been engaged under the Macedonia Enterprises Special Restructuring Project (SRP) to:

- *Review and assess the restructuring plans prepared by Hemteks management.*
- *Evaluate the viability of Hemteks.*
- *Work with management to develop a preliminary restructuring/liquidation plan.*

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Introduction

Our definition of a viable company is a company that is reasonably expected to generate sufficient cash to cover its operating costs and to maintain its productive assets. Following World Bank guidelines, each company assessed under the SRP program is to be classified as:

- *Not viable under any realistic scenario; or,*
- *Potentially viable and competitive, but requiring a full-fledged restructuring study to eliminate long-term structural losses; or,*
- *Viable once short-term measures are adopted.*

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Introduction

Key assumptions used:

- *Hemteks will be protected from its current creditors during its restructuring period*
- *All severance costs will be funded by the Macedonian government.*

This report includes our findings and recommendations.

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Hemteks

Assessment -- Overview

Hemteks - Polyester Synthetic Fiber Producer

- *Annual Capacity: 34,000 tons*
  - → installed 1973
  - → expanded 1980

- *Employees: 761*

- *Sales:*

	1993	1994 proj.
	US$12.5 million	US$19.4million
	(at 30% capacity)	(at 45% capacity)

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Hemteks

Assessment -- Production Process

Two major raw materials:

DMT (dimethyl terephthalate) *solid*

EG (ethylene glycol) *liquid*

↓

Polymerization — *Dupont continuous process*

→ *by-product methanol MEOH*

↓

Melt spinning into fibers — *Dupont design*

↓

Mechanical drawing, crimping, cutting, bale (package) — *Dupont design*

Comments

- *Process technology*
- *Competitive with the industry*

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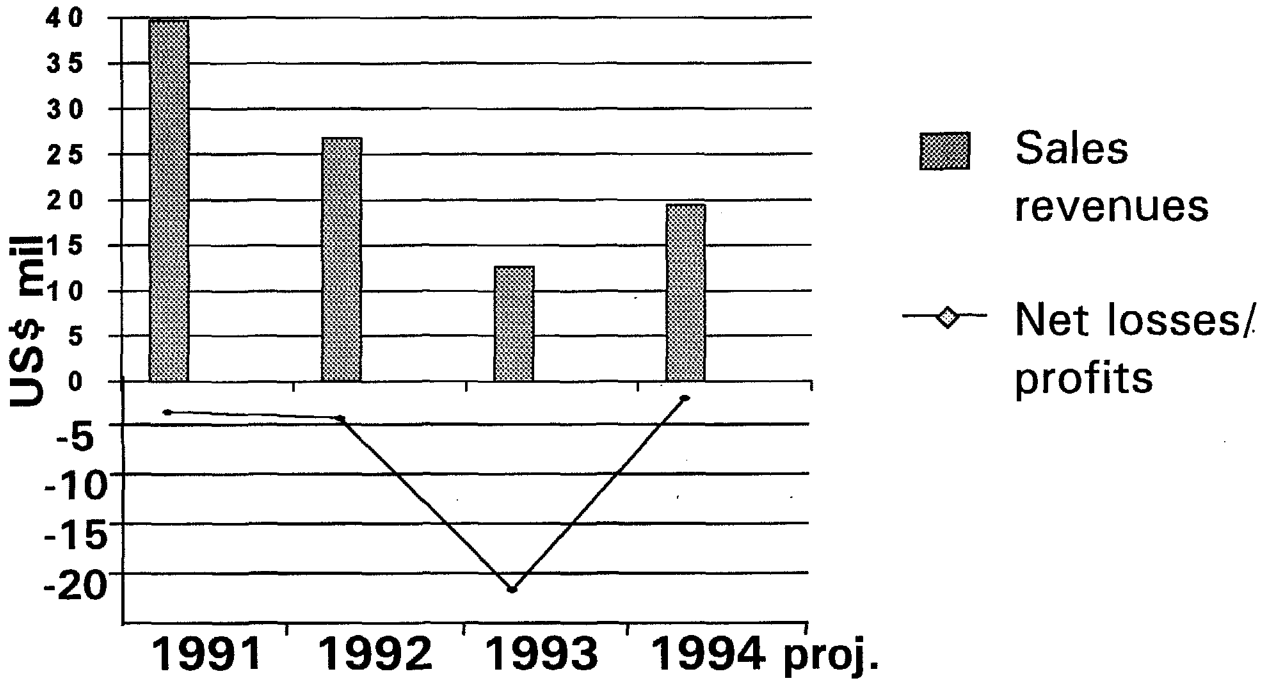
Hemteks

Assessment -- Financial Situation -- Profitability



Loss of FYR markets and decline in Macedonia economy led to a decline in sales. The huge loss in 1993 was mainly due to decline in valuation reserves adjustments (US$8 million less than in 1992) and extraordinary non-material expenses (US$6.5 million).

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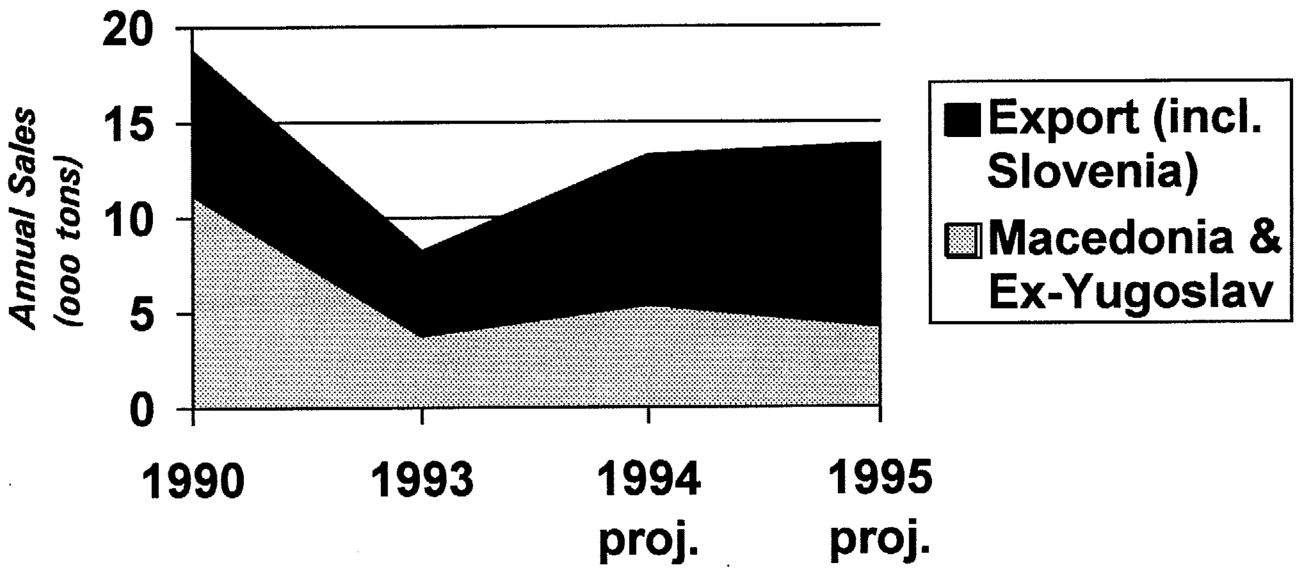
Assessment - Markets

Sales Breakdown by Markets



- *Loss of Macedonian and ex-Yugoslav markets has led management to focus on less profitable export markets.*

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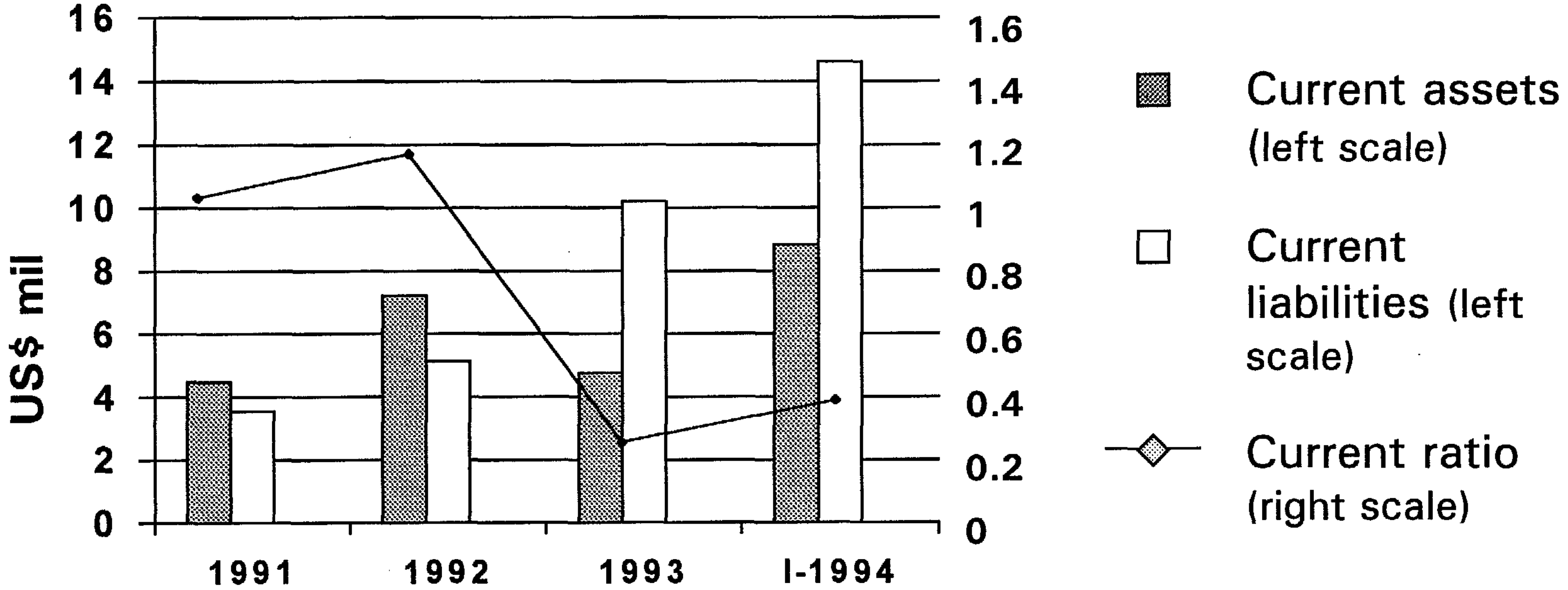
Hemteks

Assessment -- Financial Situation -- Liquidity



- *Loss of working capital has decreased Hemteks' access to raw materials and forced them into barter arrangements that are more expensive than cash purchase.*
- *Inability to pay creditors led to a cut-off by its closest Bulgarian ethylene glycol supplier.*

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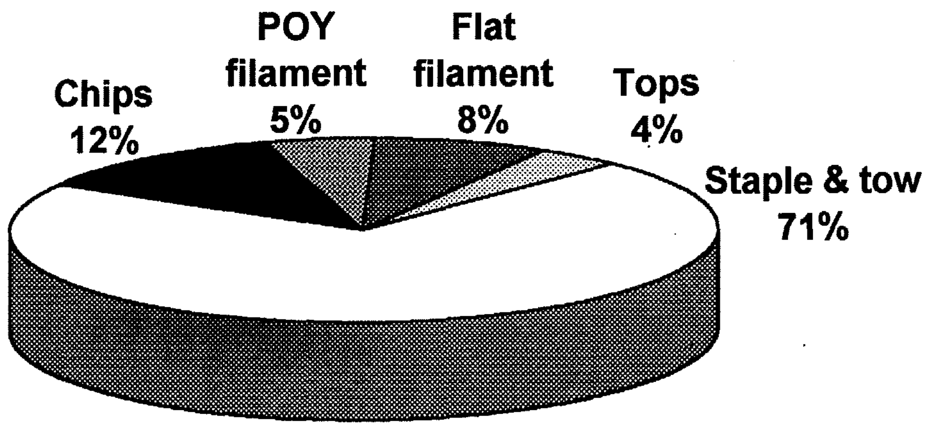
Assessment -- Products

Product mix (% of total sales: I - 1994)



- *Sales of chips and filaments are limited by capacity constraints. New investment is required to increase production.*

Hemteks

Assessment -- Products

Current Products Contribution Margins

Product	Market	Selling price	Variable cost	Contribution margin
Staple fiber	domestic and FYR	1.94	1.34	**0.60**
	export	1.36	1.34	**0.02**
Filament	domestic and FYR	3.35	1.55	**1.80**
	export	2.13	1.55	**0.58**
Fiber chips	domestic and FYR	1.61	1.32	**0.29**
Bottle chips	domestic and FYR	2.06	1.46	**0.60**

Average contribution margins ratios were 26% in 1992, 21% in 1993, and is projected at 18% in 1994. Decline is due to an increasing export sales, higher raw material and transportation costs.

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Hemteks

Assessment -- Products

Comments

- *Competitive with large European producers (selling at about same delivered price as Hoechst in Germany)*

- *Formal customer complaints*
  → only one this year

- *Returns of product*
  → none since 1990

- *Have technology in hand for full range of sophisticated products including:*
  → copolymers, hollow fibers, colored fibers, fine deniers, high quality yarns for car upholstry.

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Hemteks

Assessment -- Impact of Transportation Costs and Duty

Example: Polyester Staple Fiber

FOB Skopje	US$1.36/kg	
Shipment to Germany	US$0.23/kg	
EC Dumping Duty 15.6%		(US$0.21/kg)
EC Duty (6%)	US$0.08/kg	
Delivered price in Germany	**US$1.67/kg**	
(incl. 15.6% EC dumping duty		US$1.88/kg)

(Hoechst price FOB Germany = US$1.71/kg)

- *Without dumping duty, Hemteks is selling polyester staple fiber at approximately US$0.04/kg below its competitors.*
- *Embargo/blockade increases transportation costs by US$0.12/kg.*

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Hemteks

Assessment -- Impact of War, Embargo, and Blockade

- *10,000 tons shifted from local to export markets resulting in **US$4.5 million/year** loss of operating profit.*

- *Increased transportation cost*

Raw Materials	*US$1 million*
Finished Goods	*US$1 million*
Total transportation costs	***US$2 million/year***

- ***Total Loss: US$4.5 million + US$2 million = US$ 6.5 million/year***

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Hemteks

Assessment -- Raw Material Supply

Raw Materials	Supplier	Location	Comments
DMT	Sasa	Turkey	◆ direct producer
	Fasimex	Switzerland	◆ trading company ◆ provides stable supply (mainly from Interquiza in Spain) ◆ sell on credit ◆ charges 5.5% interest/90 days
	Jambolen	Bulgaria	◆ direct producer ◆ also a fiber producer (competitor) ◆ charge higher prices
	3 Russian suppliers	Russia	◆ direct producer ◆ have large capacity ◆ poor delivery and quality

Hemteks

Assessment -- Customer

Product	Customer	Location	End Products
Staple	Cherotan	Germany	Trading company
	Novalfa I	Italy	Garments
	ITI	Serbia	Carpets
	Filc	Slovenia	Nonwoven
	Konus-UX	Slovenia	Nonwoven
	Vinka	Macedonia	Trading company
	Danu Textile	Germany	Wool blend suits
	Sasa	Turkey	All staple products
Tops	Syntrade plus 5 others	Germany	Wool blend suits

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Hemteks

Assessment -- Customer

Product	***Customer***	***Location***	***End Products***
Filament	Struzanica Beti	Macedonia Slovenia	Trading company Texturing plus 6 others
Chips	Siminpex Progress Yugometal	Macedonia Serbia Macedonia	Trading company POY spinning Trading company
Bottle Chips	Siminpex Heba	Macedonia Slovenia	Bottles Bottles

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Hemteks

Assessment -- Customer

Product	*Customer*	*Location*	*End Products*
Waste company	Veste	Holland	Trading
Methanol	PKSCACAK	Serbia	Latex

- *Hemteks has been forced to increase sales to trading companies to finance the purchase of raw materials.*

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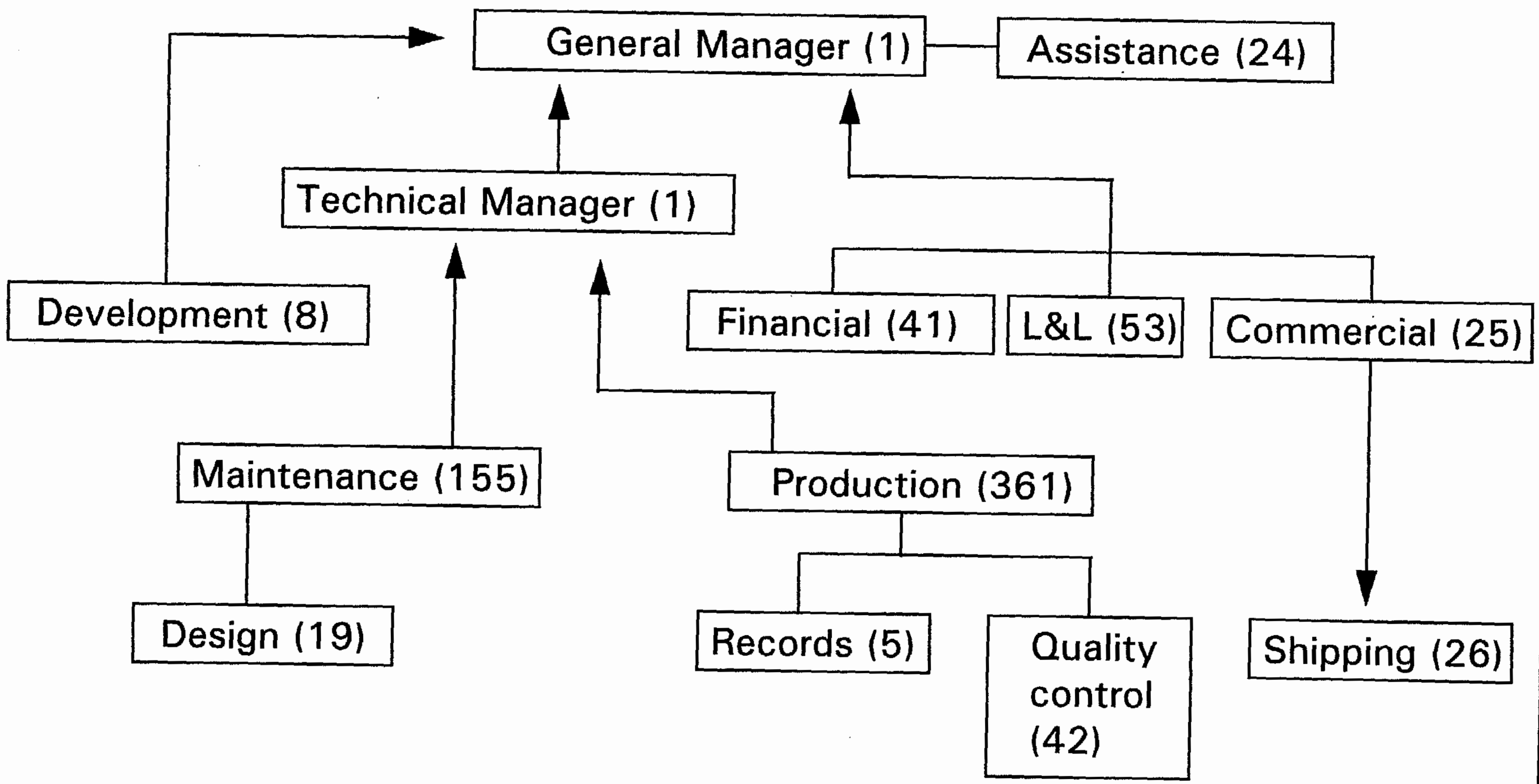
Hemteks

Assessment -- Organization



Hemteks

Assessment -- Organization

Levels of Management within Departments

General Manager

↑

Technical Manager

↑

Production Manager

↑

Chief Engineer

↑

Supervisor

↑

Shift Supervisor

↑

Facilitator

↑

Operators

6 levels

Hemteks

Assessment -- Organization

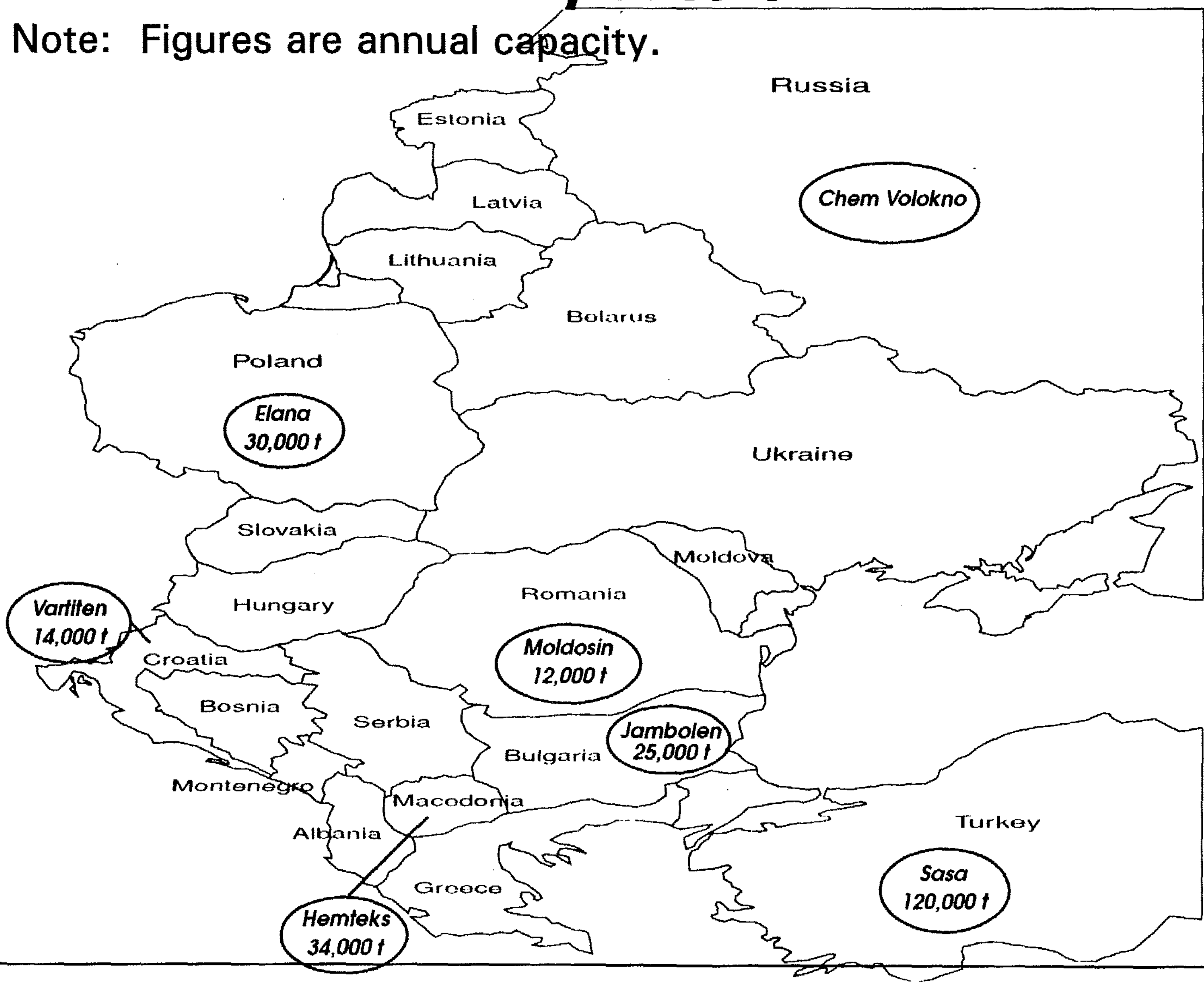
Comments

- Organized like Du Pont 20 years ago
  - ➔ too many layers of management
  - ➔ high indirect-to-direct employee ratio (1:1 versus 1:1.5 for industry average)

- Has potential to reduce work force from current 761 to 460, and management levels from 6 to 4 (management's plan is to reduce staff to 610 by the end of 1995)

Assessment -- Competitors

Note: Figures are annual capacity.



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Hemteks

Assessment -- Competitors

Company	***Location***	***Comments***
Sasa	Turkey	◆ produces DMT ◆ Du Pont process ◆ similar product line ◆ much higher capacity ◆ expanding
Jambolen	Bulgaria	◆ produces DMT ◆ similar capacity ◆ limited product line ◆ poor quality

Hemteks

Assessment -- Competitors

Company	Location	Comments
Elana	Poland	◆ produces DMT ◆ similar capacity ◆ limited product line ◆ batch polymer process
Vartilen	Croatia	◆ TPA process ◆ smaller capacity ◆ limited product line
Chem Volokno	Russia	◆ produces DMT ◆ larger capacity ◆ limited product line ◆ poor quality and delivery

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Assessment -- Competitors

Company	*Location*	*Comments*
Moldoson	Romania	◆ purchases DMT in Romania ◆ smaller capacity ◆ limited product line ◆ Toray and Barmeg machines

Assessment -- Competitors

Comments

- *Most competitors make (vs buy) DMT (investment for DMT plant at Hemteks is high - around US$90 million)*
- *Hemteks process, from DMT on, is competitive*
- *Hemteks capacity greater than all but Sasa - Sasa enjoys greater economies of scale with capacity 4 times larger than Hemteks*
- *Hemteks product line and quality equal or superior than competitors*
- *Hemteks must operate as lean as possible and provide higher value in use products to maintain competitive position opposite to Sasa or other large producers*

Hemteks

Bench Marks -- Labor Force

Labor requirements	*Industry*	*Hemteks*
Manufacturing	200	385
Power	20	28
Maintenance	70	154
Administration & support	40	194
TOTAL	330	761
Supervisory levels	4	6

Comments

- *Labor saving in the industry reflects computerization of the administrative and support functions.*
- *Hemteks will be able to operate with 460 people.*

Benchmarks -- Absenteeism

Industry	***Hemteks***
less than 1%	3%

Comments

- *Poor by industry standards but better than other east European enterprises*
- *People miss work to work on second or sideline job*

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Hemteks

Benchmarks -- Inventory

Inventory/total production capacity

Industry	*Hemteks*
10%	8%

Comments

- *Inventory is too low to meet customer demands for specific products.*

Hemteks

Benchmarks -- Cost Structure

Polyester Staple Fiber -- Cost Breakdown

	US Industry (estimate)		*Hemteks*	
	(US$/kg)	*% of total*	*(US$/kg)*	*% of total*
Variable Costs	0.9647	67%	1.3407	82%
Raw Materials	0.7915	55%	1.1083	68%
Other Materials	0.0706	5%	0.0706	4%
Utilities	0.0708	5%	0.1300	8%
Shipping	0.0318	2%	0.0318	2%
Fixed Costs	0.4805	33%	0.2991	18%
Manufacturing labor	0.1413	10%	0.1280	8%
Depreciation	0.1413	10%	0.0423	3%
Maintenance	0.0707	5%	0.0130	1%
Overhead	0.1272	9%	0.1158	7%
Total costs	**1.4452**	**100%**	**1.6398**	**100%**

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Hemteks

Benchmarks -- Cost Structure

Comments

- *High raw material costs mainly due to high transportation costs and high DMT costs due to poor bargaining position*
- *High number of people multiplied by low wages results in comparable labor costs, but undermines the competitive advantage of low labor costs*
- *Energy costs are high because of the high steam price purchased from Ohis*
- *No significant investment in plant facilities has been made in recent years, but facilities are generally well maintained*

Benchmarks -- Process Performance/ Continuity

	Industry	*Hemteks*
Yarn Breaks at Spinning (times/ton)		
Natural process breaks	0.10	0.20
Break forced by product changes	0.11	0.30
Total	0.21	0.50
Spin Pack Life	5 days	7 days
Wiping Frequency	once a day	once a day
Draw Roll Wraps	6	not recorded
Packed Yield	97%	less than 90%

Hemteks

Benchmarks -- Process Performance/ Continuity

Comments

- *Continuity and yields can be improved*
- *90% yield estimate based on break data and on-site examination*
- *Running at 50% of capacity causes low yields*
- *Doing reasonably well under current conditions*

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Hemteks

Strengths

- *Well-trained competent technical people*
  - → Trained in the US
  - → Retained by Chemtex/Du Pont to consult fiber manufacturers worldwide
- *Competitive process technology*
- *Competitive product line, quality, and value in use*
- *Capable of developing new sophisticated products*
  - → flame retardant, co-polymers, binder fibers and color seals fibers
- *Low labor costs*

Hemteks

Problems -- Operation

- *Lack of continuous supply of key raw material (DMT) resulting in:*
  - → Occasional production stoppage
  - → Plant currently running at 60% of capacity
- *All raw materials are imported with high transportation costs*
- *Manufacturing discipline not up to industry standards*
  - → Slow response to problems
  - → Poor housekeeping
  - → Lack of key process performance records
- *Low Yields*
- *High steam charge by Ohis (US$0.23/ton)*

Hemteks

Problems -- Organization

- Weak marketing capability (no marketing organization)
- General manager's resource is exhausted in operational matters such as direct selling, balancing purchase of raw materials and production, and is not available for overall strategic matters
- Excessive labor
- Excessive number of levels of supervision
- High ratio of support personnel to that of production personnel

Hemteks

Problems -- External

- *Sanction against Serbia and Greek blockade have:*
  →shrunk nearby markets
  →increased transportation costs for both products and raw materials

- *Prices of products in west European markets are lower than those in nearby markets*

- *15.6% dumping duty imposed by EC on polyester staple fiber (waived by selected customers)*

Hemteks

Turn Around Actions -- (1994-1995)

Cost Reduction

- *Improve yield (reduction of material losses) by 5% in 1995 through process improvement.*
- *Reduce labor from 761 to 610 by the end of 1995*
- *Reduce supervisory levels from 6 to 4*
- *Reduce the ratio of indirect versus direct staff from 1:1 to 1:1.4*

Hemteks

Turn Around Actions -- (1994-1995)

Revenue enhancement

- *Increase export selling prices through change of product mix by mid-1995*
- *Lease out vacant office and warehouse spaces*
  → US$195,000 annual revenue
- *Establish marketing organization*

Turn Around Actions -- (1994-1995)

Others

- *Pay off debt to key suppliers*
- *Work with the Government to lobby EC to reduce or eliminate the 15.6% EC dumping duty*

Hemteks

Turn Around Actions (1994-1995)

Sales Plan (tons)

	Jan-Aug 94	*Sep-Dec 94*	*1994 total*	*1995(projected)*
Macedonia	1529	420	1949	1260
Ex-Yugoslavia	2263	1160	3423	2947
Others (incl. Slovenia)	3674	4220	7894	9601
Total	**7,466**	**5,800**	**13,266**	**13,808**

1995 plan	**29,131**

Hemteks

Turn Around Actions (1995)

Increase Export Selling Price of Polyester Staple Through Product Mix Change

→ ***Shift to high value-added products***

Current Products	Average Price/kg	New Products	Average Price/kg	1995 proj. sales
fiberfill	US$1.36	hollow siliconized	US$1.48	4,800 tons
cotton blend		anti-pilling type		

Hemteks

Turn Around Actions (1995)

Increase Yield by 5%

- ***Process Improvement***

Actions	Expected Increase in Output
Reduce power outages	300 tons/year
Spinning - packlife increase from 5 to 14 days	50
Better control of transitions	200
Drawing - reduce can wastes, crimper wastes and wraps	132
Filament, POY and chips - increase batch polymer yields - reduce spinning breaks - reduce non-standard product	120
Total	**802 tons/year**

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Hemteks

Cash Flow Projection -- at 1994 volume

(nominal term: US$ thousand)

	1993	1994	1995	1996
Fiber sales quantity (tons)	8,204	13,266	13,809	13,809
Revenues	$12,567	$19,407	$23,096	$23,979
Operating expenses				
Variable costs	$9,954	$15,928	$18,878	$18,659
Fixed costs				
labor	$3,891	$3,638	$3,524	$3,214
others	$1,370	$1,333	$1,441	$1,477
Total	$15,215	$20,899	$23,844	$29,350
Operating cash flow	**($2,648)**	**($1,492)**	**($748)**	**$629**
Other cost requirements				
Working capital				
Repayment of Bulgarian supplier			($500)	
Severance pay			($761)	
Net cashflow	**($2,648**	**($1,492)**	**($2,009)**	**$629**

Increased revenues due to change in product mix. Decrease in cost due to reduced labor (610 employees), improved yield, and lowering of ethylane glycol purchase prices.

Cash Flow Projection -- at full capacity

Hemteks

(nominal term: US$ thousand)

	1993	1994	1995	1996
Fiber sales quantity (tons)	8,204	13,266	29,131	29,131
Revenues	$12,567	$19,407	$45,674	$47,265
Operating expenses				
Variable costs	$9,954	$15,928	$39,819	$39,376
Fixed costs				
labor	$3,891	$3,638	$3,524	$3,214
others	$1,370	$1,333	$1,441	$1,477
Total	$15,215	$20,899	$44,784	$44,067
Operating cash flow	**($2,648)**	**($1,492)**	**$889**	**$3,198**
Other cost requirements				
Repayment of Bulgarian supplier			($500)	
Severance pay			($761)	
Investment in working capital			($5,100)	
Repair of equipment			($500)	
Net cashflow	**($2,648**	**($1,492)**	**($5,972)**	**$3,198**

Increased revenues due to change in product mix. Decrease in cost due to reduced labor (610 employees), improved yield, and lowering of ethylane glycol purchase prices.

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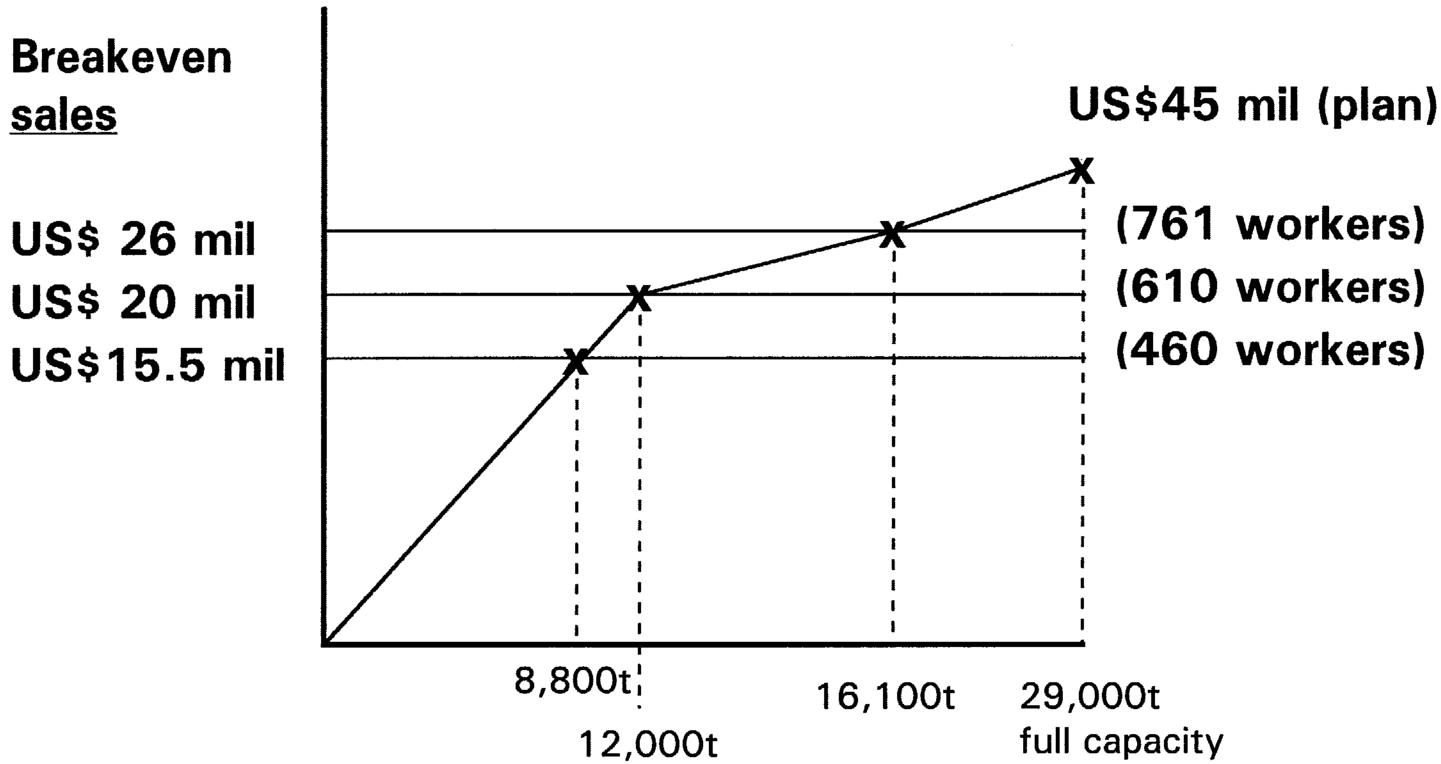
Hemteks

Breakeven Analysis



The breakeven point with 610 workers is $20 million.

Hemteks

Summary of debt outstanding (as of September 1994)

	Creditors	Amount	Interest	Comments
Short-term borrowings and accounts payable	domestic banks	US$0.4 mil	6% per month in Denars	
	domestic suppliers	US$0.7 mil	6% per month in Denars	
	Bulgarian supplier	US$0.5 mil	unavailable	Cut off supply of EG because of delayed payment.
	Other foreign suppliers	US$1.6 mil		
	TOTAL	US$3.2 mil		

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Summary of debt outstanding (as of September 1994)

	Creditors	Amount	Interest	Comments
Long-term debts	foreign	US$10 mil	4.4% (avg.)	Includes both concessional and commercial loans (frozen under the SRP)
	allocated debt	US$6 mil	unavailable	Allocated by Ohis when Hemteks separated from Ohis in 1990. May not relate to the transferred assets. Under court settlment.
	TOTAL	US$16 mil		

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Agency of the Republic of Macedonia for the Transformation of Enterprises with Social Capital

Special Restructuring Program (SRP)

Mikron

USAID

Sponsored by the U.S. Agency for International Development in conjunction with The World Bank

October 1994

Delivery Order No. 34

Project No. 180-0014
Contract No. EUR-0014-I-00-1056-00
Eastern European Enterprise Restructuring and Privatization Project

Deloitte Touche
Tohmatsu
International

MIKRON

CONTENTS

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MIKRON

INTRODUCTION

We have been engaged under the Macedonia Enterprises Special Restructuring Project (SRP) to:

- Review and assess the restructuring plans prepared by Mikron management.
- Evaluate the viability of Mikron.
- Work with management to develop a preliminary restructuring/liquidation plan.

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MIKRON

INTRODUCTION

Our definition of a viable company is a company that is reasonably expected to generate sufficient cash to cover its operating costs and to maintain its productive assets. Following World Bank guidelines, each company assessed under the SRP program is to be classified as:

- Not viable under any realistic scenario; or
- Potentially viable and competitive, but requiring a full fledged restructuring study to eliminate long-term structural losses; or
- Viable once short-term measures are adopted.

This report includes our findings and recommendations.

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MIKRON

EXECUTIVE SUMMARY

- Three primary business units
  - small electric motors
  - household appliances
  - hand-held tools

- The company has suffered from the decline in domestic and former Yugoslav markets due to embargo and blockade.

- The company is not able to replace working capital and currently must use barter to obtain raw material.

- There is increasing competition in its markets requiring the company to improve its productivity, quality and customer focus.

- The company is over staffed for the expected level of production over the next two years.

MIKRON

EXECUTIVE SUMMARY

- The company's equipment is old and in need of repair. Repair/replacement is essential if the company is to survive.

- The restructuring plan presented by the company is overly optimistic and appears difficult to achieve.

- Restructured the company could be viable. It must focus on its core business: electric motors, aggressively sell or convert existing assets and reduce its work force.

- The company must be protected from its existing creditors and given support to fund severance costs.

- In order for a restructuring plan to succeed the management group must be reinforced with technical and financial expertise.

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MIKRON

ASSESSMENT

- General Overview
- Other Measures Including :
    - Business Base
    - Financial Base
    - Financial Performance
    - Market Analysis
    - Operations
    - Organization

MIKRON

ASSESSMENT

GENERAL OVERVIEW

- A Joint Stock Company; 89% owned by its employees.

- Located in Prilep (population about 90 000) some 150 km south east of Skopje.

- Mikron employs approximately 740.

- Mikron designs, manufactures and sells small electric motors, together with a range of small household appliances and manual electric hand tools.

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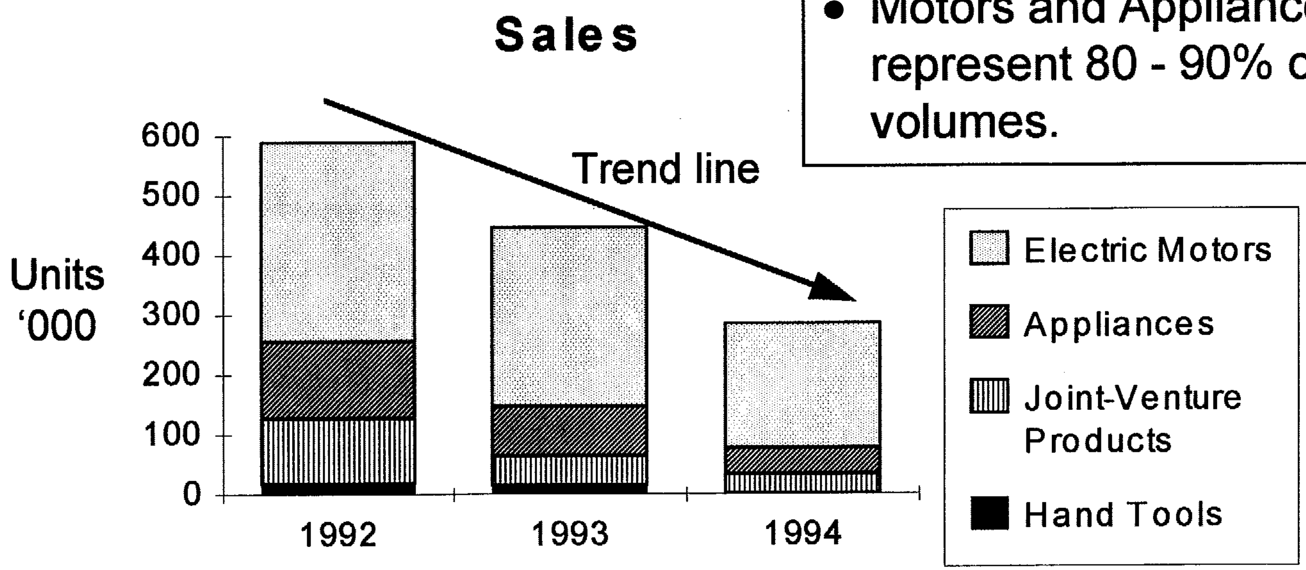
MIKRON

ASSESSMENT
BUSINESS BASE
Unit Sales

- Unit volumes have almost halved since 1992
- Motors and Appliances represent 80 - 90% of unit volumes.



Appliance sales have decreased due to competition.

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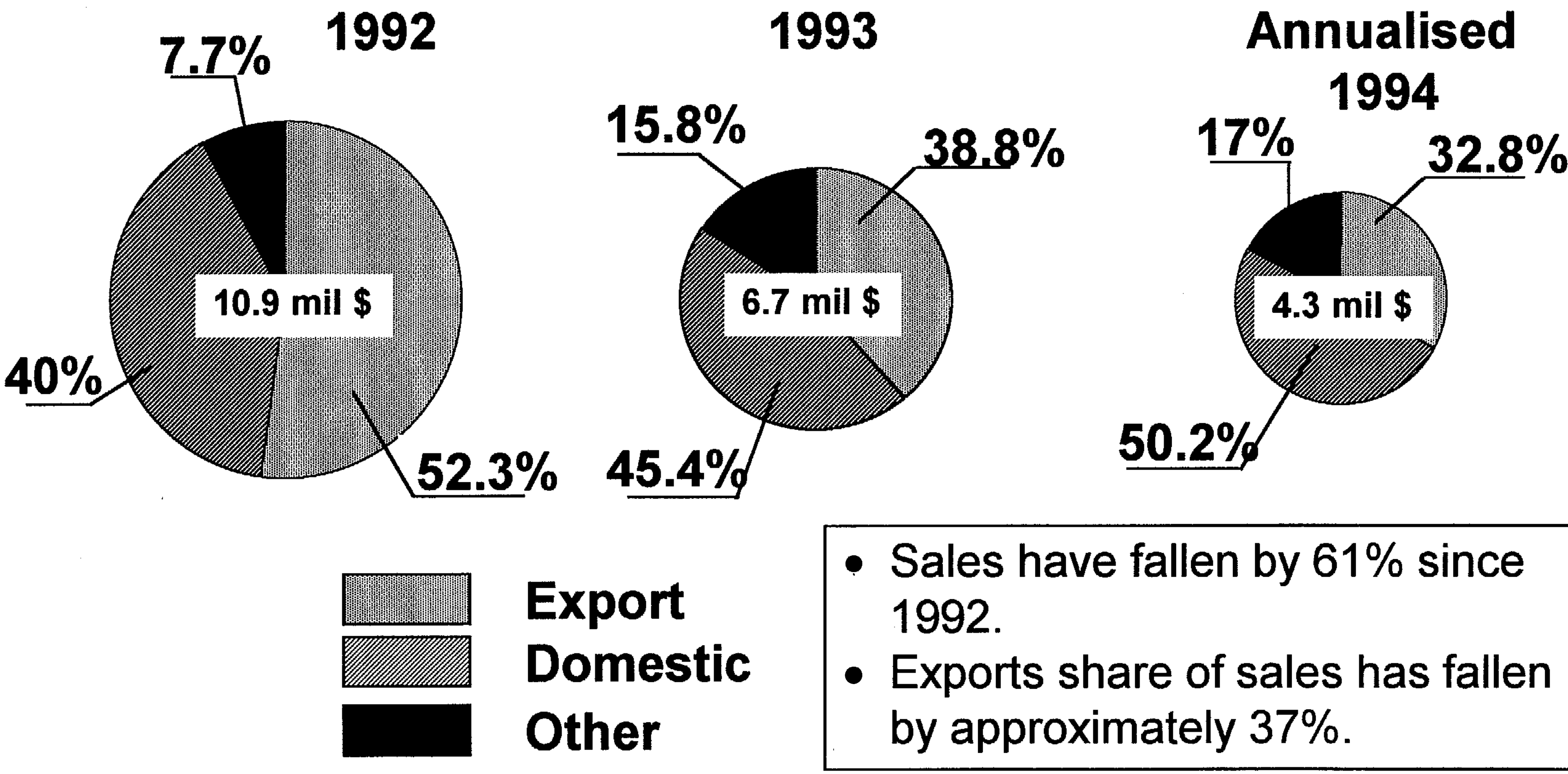
MIKRON

ASSESSMENT

BUSINESS BASE

Markets as % of total sales, Total sales relative to 1992 figures.



- Sales have fallen by 61% since 1992.
- Exports share of sales has fallen by approximately 37%.

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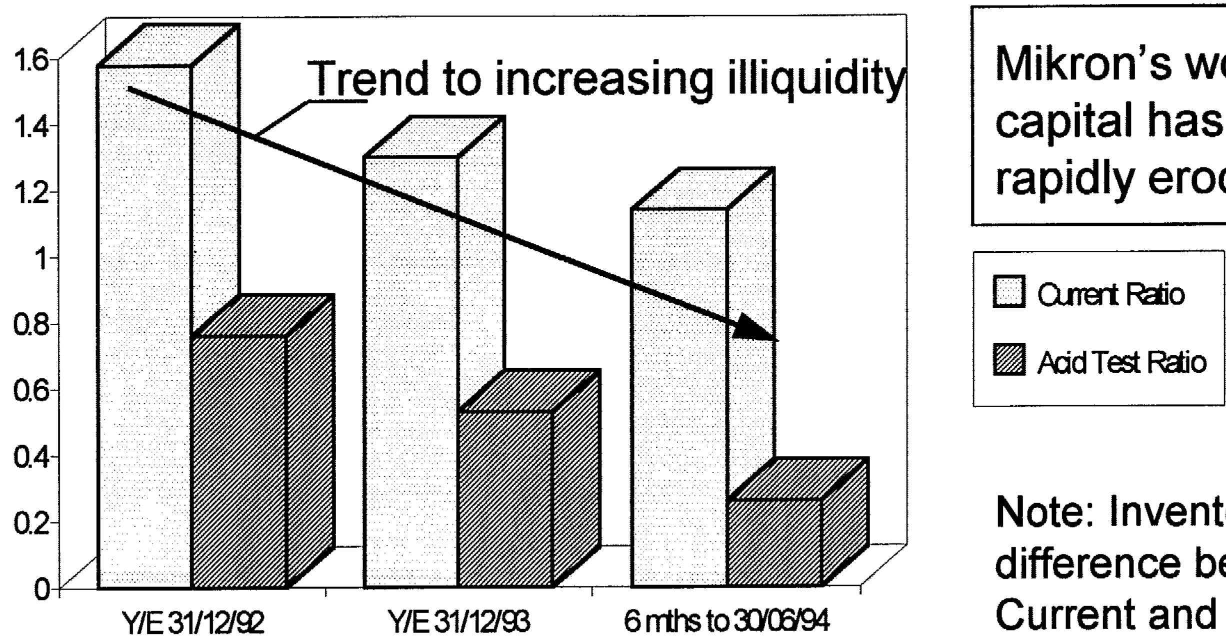
MIKRON

ASSESSMENT

FINANCIAL BASE

Liquidity Ratios



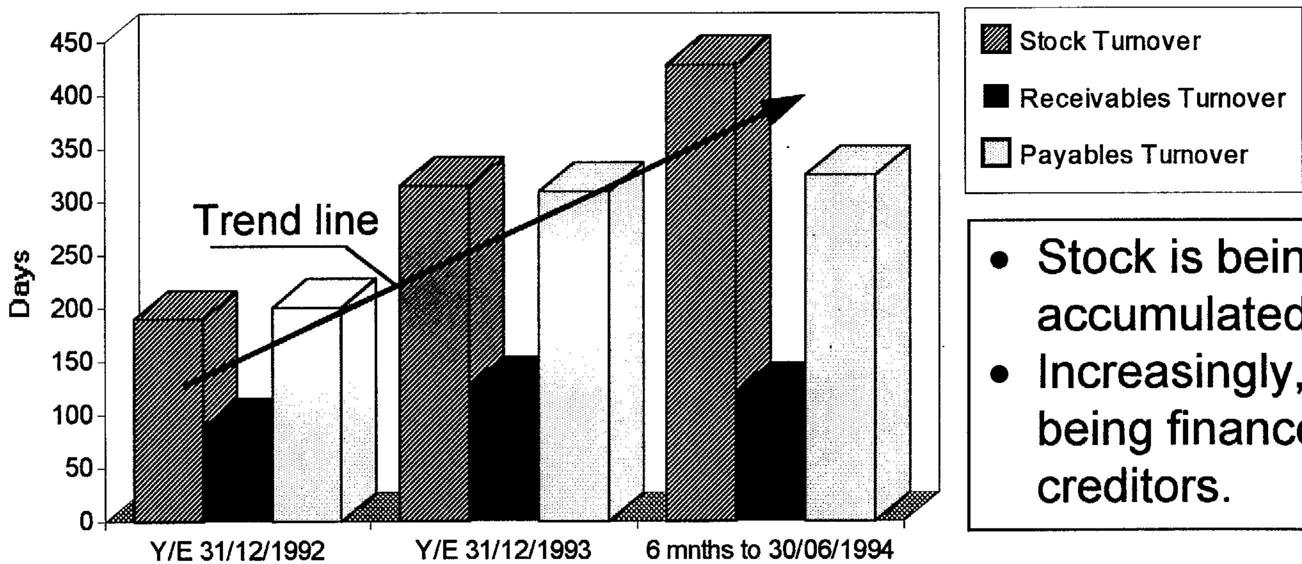
Mikron's working capital has been rapidly eroding.

Note: Inventory is the difference between Current and Acid Test Ratios.

ASSESSMENT

FINANCIAL BASE

Stock, Receivables and Payables Turnover Days



- Stock is being accumulated, not sold
- Increasingly, Mikron is being financed by its creditors.

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MIKRON

ASSESSMENT

FINANCIAL BASE

Other Relevant Facts:

- Bank Accounts are blocked by creditors claims and SOK.
- As at 30/06/94 approximately 11,000 US$ was held in cash.
- Wage arrears to employees total approximately 930,000 US$ - Equivalent to 5 months wage.

Overall Conclusion:

- Mikron is insolvent on a cash basis.
- With the possible exception of stock it has no readily available liquid resources.

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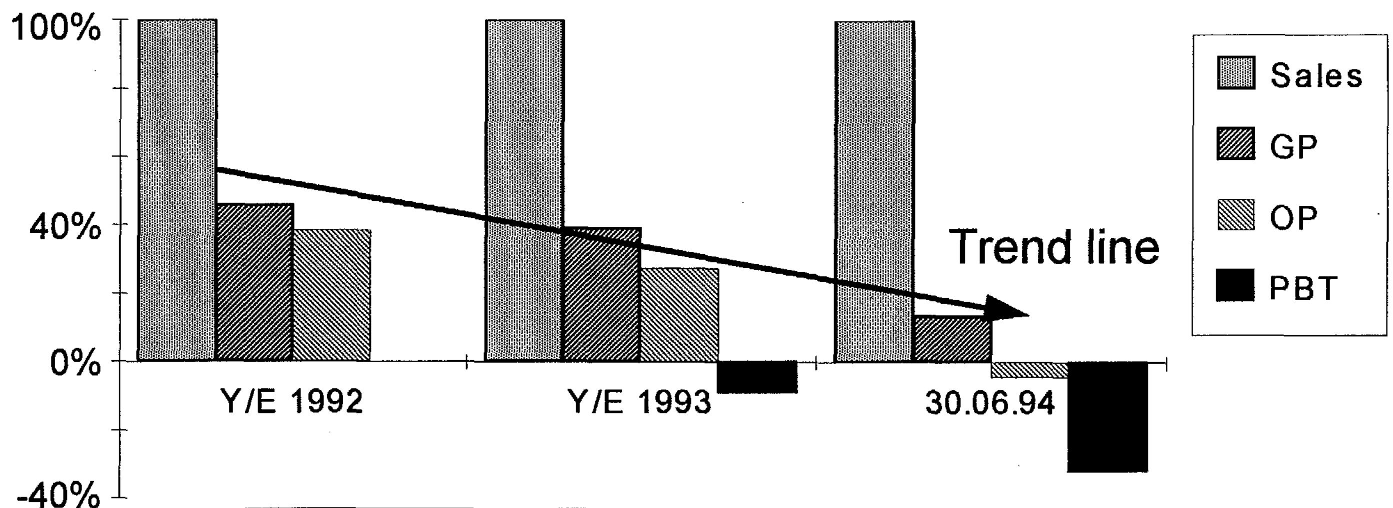
MIKRON

ASSESSMENT

FINANCIAL PERFORMANCE

Summarized Margins (as % of sales)



- Margins have decreased largely due to Mikron's inability to cut its wage bill.
- Mikron must cut costs if it is to survive.

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MIKRON

ASSESSMENT

MARKET ANALYSIS

Overview of Mikron's Products:

- Diverse range covering electric motors, small household appliances, personal care products, and hand power tools
- Electric motors represent the core business skills and expertise of Mikron
  - Universal single-phase commutator and synchronous motors
  - AC and DC from 0.5W up to 1400W
- No clear product strategy for household appliances
- Designs generally inferior to competing products from W. Europe
- Hand power tools restricted to electric chain saws and angle grinders

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ASSESSMENT

MIKRON

MARKET ANALYSIS

Mikron's Products: Electric Motors

- Mikron's range of motors covers more than 20 basic models, most offering alternative specifications (e.g. different stack heights or speeds)
- End use applications range from hair dryers and sewing machines to washing machine drain pumps and railway braking systems
- Although design modifications are made to meet specific customer requirements, the designs are quite old and were first introduced between 1975 and 1987
- Although Mikron quotes its production capacity at 1,500,000 motors pa, production volumes have averaged only 300,000 pa since 1992. During this period only 6 types of motor have been manufactured in quantities greater than 30,000 pa

MIKRON

ASSESSMENT

MARKET ANALYSIS

Fractional HP Electric Motors

- Leading competitors are mainly European-based companies having a strong sales & service network and close proximity to their customers' culture & needs
- Competition is intense because the market is mature and has excess capacity
- With more "standardised" products price is becoming the key differentiating issue
- The DC 50-250W segment is the fastest growing segment in the European fractional horsepower market
- Universal motor segment dominated by the vertically integrated domestic appliance manufacturers

Source: Frost & Sullivan, 9/94

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MIKRON

ASSESSMENT

MARKET ANALYSIS

Small Household Appliances

- Intense competition and overcapacity across all segments of the market
- W. European markets close to saturation - replacement sales predominate, except in "unified" Germany and Spain
- In E. Europe a shortage of hard currency leads to requirements for barter trade
- Imports from Hong Kong, Singapore and E. Europe (e.g. CZ) compete with superior W. European products

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ASSESSMENT

MARKET ANALYSIS

Opportunities in Western Europe:

Functional HP Electric Motors

- Increased use of fractional hp motors in Motor Cars and in the Packaging Industry
- Focus on niche market sectors

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MIKRON

ASSESSMENT

MARKET ANALYSIS

Customer Opinions of Mikron:

- Summary of opinions expressed by one of Mikron's major customers:
  - Products (Electric Motors)
    - » Reliability/Quality - Fair
    - » Design/Specs./Price - Good
  - Sales Support - Poor/Fair
  - R&D - Poor
  - Delivery Performance - Poor/Fair
  - Production (Planning & Inventory Management) - Very Poor

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MIKRON

ASSESSMENT

OPERATIONS

Site and Facilities:

- 40,000m^2 site with 19,000 m^2 available for expansion
- Site is generally in poor condition (broken windows, leaking pipes etc.) and is untidy (both production areas and stores)
- Out of a covered floor area of 13,000m^2 only 6,000m^2 is currently used for production approximately 30% of the materials storage (4000 m^2)

MIKRON

ASSESSMENT

OPERATIONS

Production Equipment:

- High proportion of old and worn-out machines and tooling (50% over 15 years old) contribute to poor quality and low productivity
- Insufficient funds set aside for "professional" maintenance of machines and tooling contributes to poor quality and excessive machine downtime
- Several key machines urgently require overhaul or replacement (e.g. Idra Die Casting M/c and Schuler Presses) to maintain production

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MIKRON

ASSESSMENT

OPERATIONS

Production Planning and Control:

Basic principles are being followed, but

- Inventory control is poor (e.g. excess stocks yet material shortages; inaccurate stock records)
- Production is based on Economic Batch Quantities leading to very high levels of Work in Process not matched by customer orders
- Mikron is making “for stock” rather than “to order” in order to keep workers busy (see next slide). (Inventory turns are now less than 1 per year against an industry norm of 5-10)

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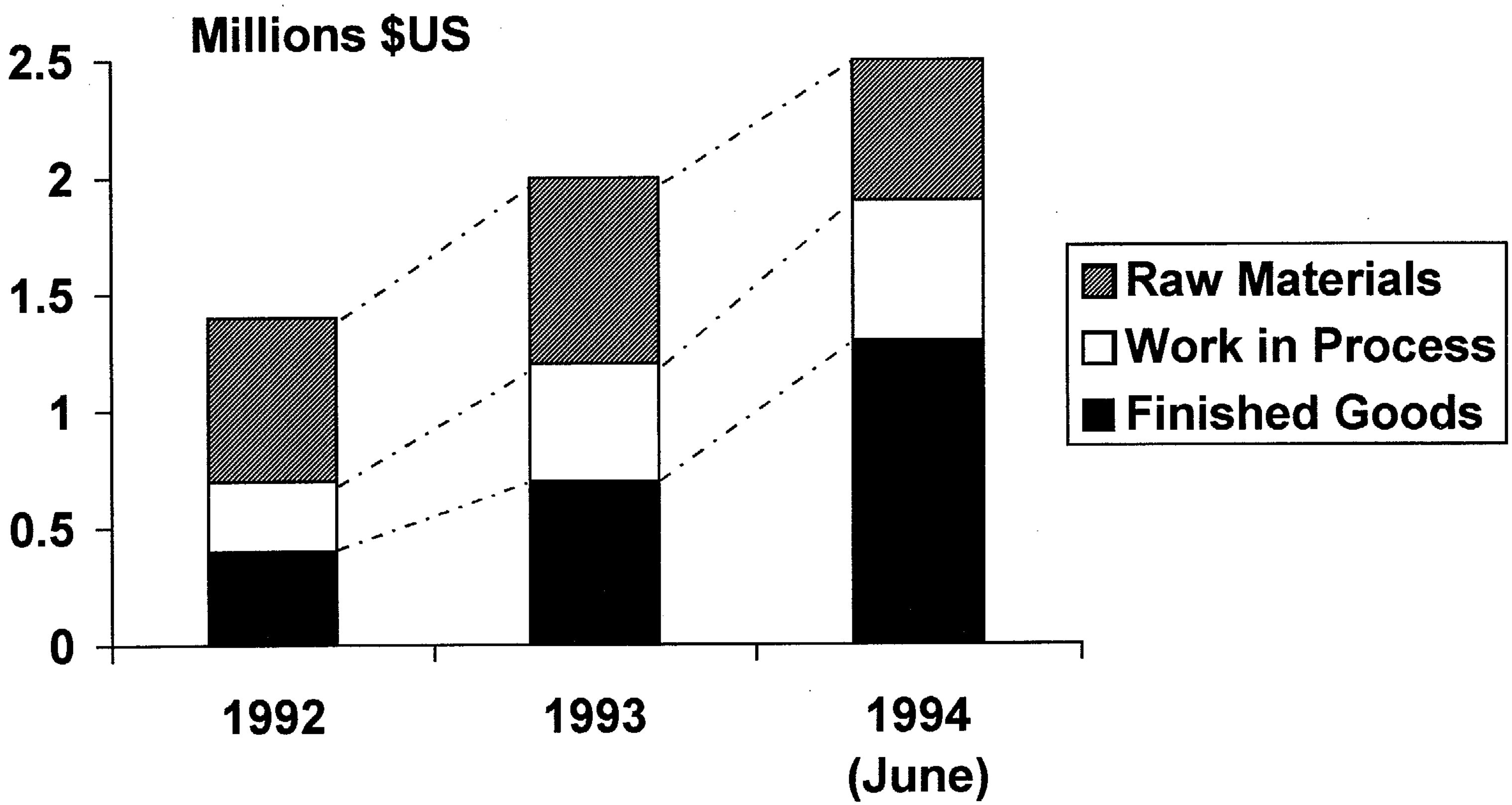
MIKRON

ASSESSMENT

OPERATIONS

Inventory Levels



MIKRON

ASSESSMENT

OPERATIONS

Quality:

- Rework levels are far too high to be competitive (20+% on electric motors - needs to be <5%)
- Scrap levels too high (2.4% by value - needs to be <1%)
- Statistical Process Control (SPC) is planned but not used at present
- Outmoded “Inspection” techniques need to be replaced by a Total Quality Management approach with the emphasis on the elimination of waste

RS

MIKRON

ASSESSMENT

OPERATIONS

Product Costs:

- Material costs are abnormally high (typically 70% of total costs) because:
  - Most key raw materials are imported
  - Barter adds considerably to the cost (see next slide)
- Direct labour costs appear low (10-15%) due to the low wage rates ($140 per month), but working methods and productivity are poor and there is considerable rework (20%+)
- Tooling and quality costs are understated (e.g. 1% wastage allowance is factored into product costs compared with actual scrap rate of 2.4%)

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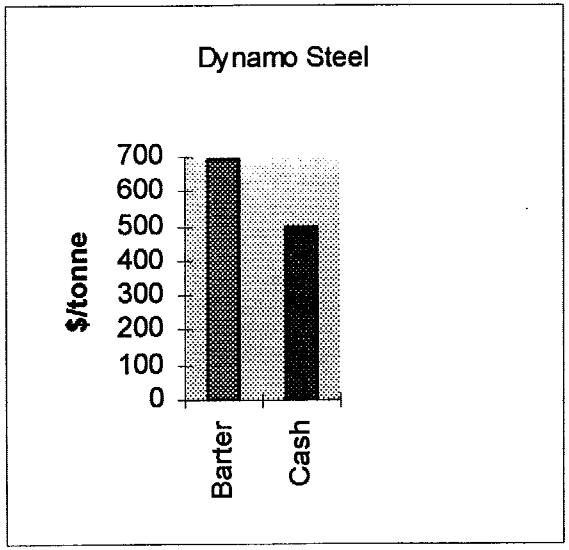
MIKRON

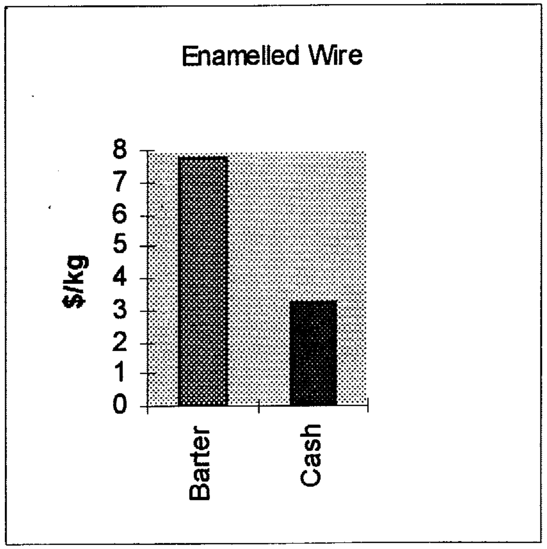
ASSESSMENT

OPERATIONS

Product Costs:

- Material costs are abnormally high because:
  - Most key raw materials are imported at a premium
  - Barter adds considerably to the cost as illustrated below





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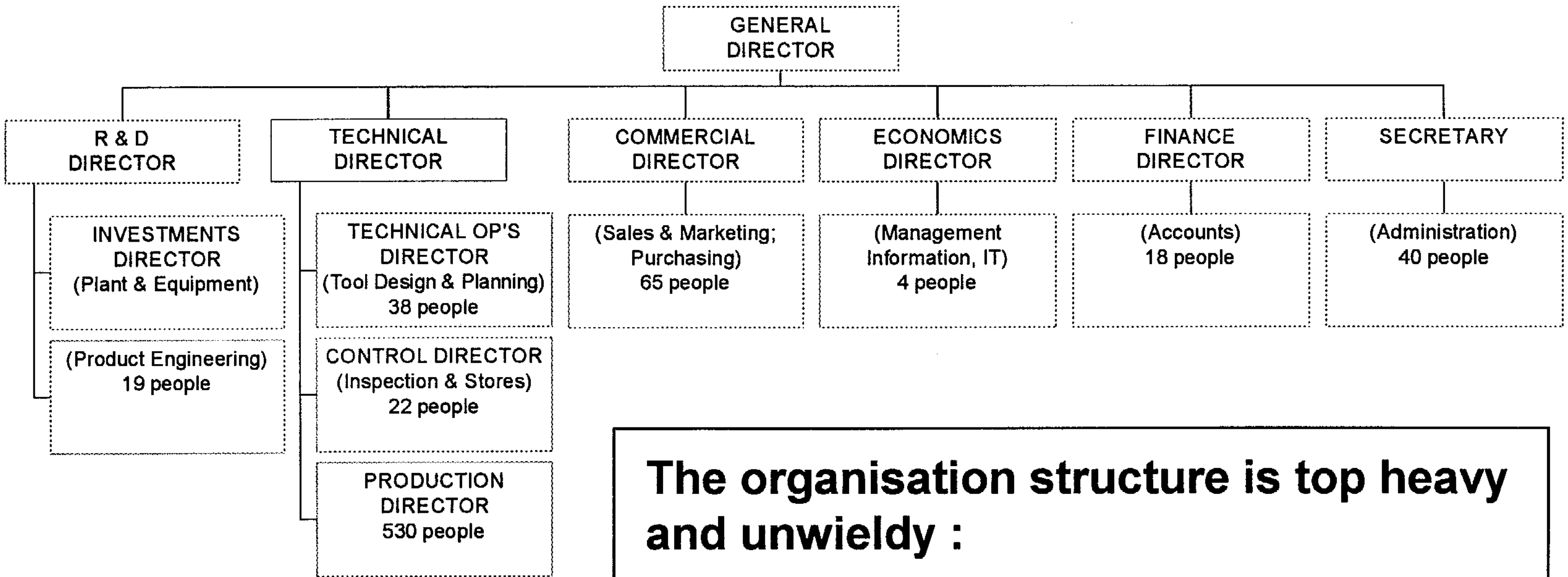
MIKRON

ASSESSMENT

ORGANISATION

Current Structure



The organisation structure is top heavy and unwieldy :

11 Directors, 6 of whom report directly to the General Director

MIKRON

ASSESSMENT

ORGANISATION

- Functional responsibilities are confused and show some conflicts (e.g. Inspection and Production both report to the same Director)
- Based on the current order situation current staffing levels are too high (543 surplus out of 743; 319 according to Mikron's own calculations)
- "Indirect-to-Direct" employee ratios are out of proportion - 519 Directs and 224 Staff/Indirects (ratio should be at least 3:1)

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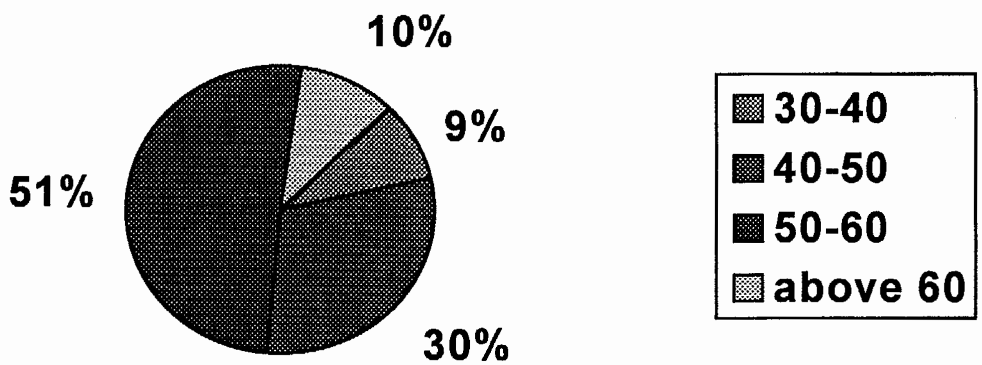
ASSESSMENT

STRUCTURE OF PERSONNEL BY AGE



81% of the personnel are in the 40 to 60 age groups

Only 10% are in the 30 to 40 age group

There are no employees under 30 years of age

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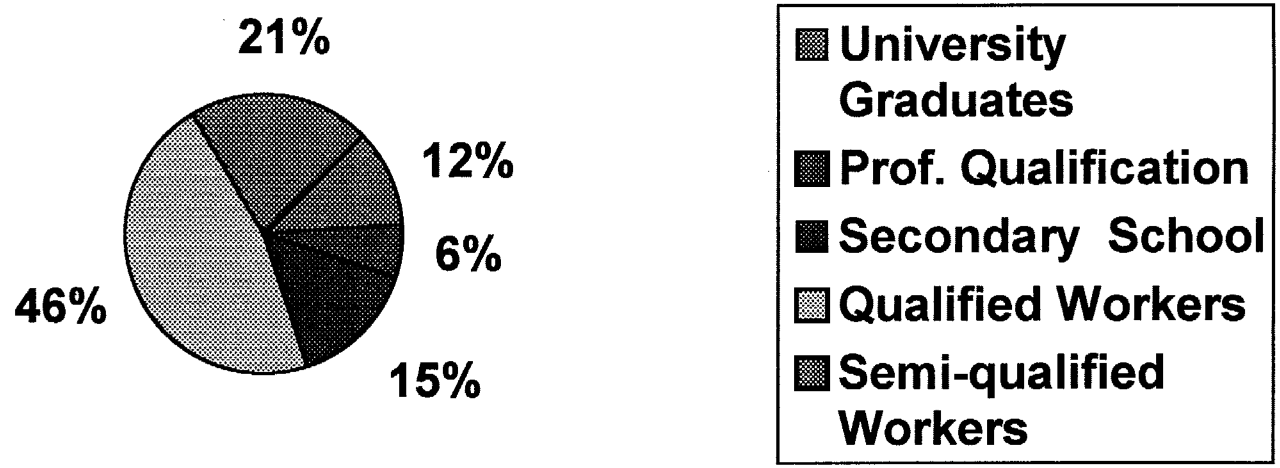
MIKRON

ASSESSMENT

STRUCTURE OF PERSONNEL BY QUALIFICATION



61%Of Employees Have Not Completed High School

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MIKRON

RECOMMENDATIONS

This section includes our restructuring recommendations. Our recommendations are summarised under the following headings:

- → Markets and Products
- → Financial Base
- → Financial Performance
- → Operations
- → Organization
- → Required Support

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MIKRON

RECOMMENDATIONS

MARKETS AND PRODUCTS

Electric Motors:

- Focus on electric motors, Mikron's core business.
- Focus on the hard currency export markets it knows best. It should try to sell only its key profitable products and seek to secure long term high volume contracts.
- New products should only be developed on the back of longterm contracts, adequately costed and with finance secured.

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MIKRON

RECOMMENDATIONS

MARKETS AND PRODUCTS

Household Appliances:

- Cease production of household appliances. Mikron's products are uncompetitive in terms of price and brand quality.
- Clear away existing stocks by way of an aggressive sales campaign.

MIKRON

RECOMMENDATIONS

MARKETS AND PRODUCTS

Retail Shops:

- Use the existing shop network as part of a strategy to dispose of surplus finished goods stock.
- Thereafter the shops should be closed down and marketing efforts made to sell through established retailers.

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MIKRON

RECOMMENDATIONS

MARKET AND PRODUCTS

- Strengthen marketing, sales and customer service functions
- Carry out a quick assessment of existing customers' needs to identify immediate sales opportunities
- Undertake a more comprehensive review of market opportunities covering at least E. & W. European markets, analysing competitors' strengths & weaknesses and identifying potential new customers

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RECOMMENDATIONS

FINANCIAL BASE

- Aggressively convert existing assets into cash.
- Drastically reduce manning levels from 743 to 200.

MIKRON

RECOMMENDATIONS

FINANCIAL BASE: Realisation of Existing Assets

	US$ 000's	% Realisation
Realisation of Current Assets:		
Bank and Cash	11	
Bills Receivable	27	95%
Net Trade Receivable	580	70%
Payments in Advance	9	90%
Short Term Lendings	312	70%
Other Short Term Receivables	6	70%
Finished Goods	392	50%
Stock in Shops	302	60%
Surplus long-term assets	500	*
TOTAL REALISATION	**2,019**	

* estimated by Mikron

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MIKRON

RECOMMENDATIONS

FINANCIAL BASE: Realisation of Existing Assets

Financial Performance (1994 Sales)

	1992	1993	1994	1995
Revenues	10,900	6,700	4,300	4,300
Variable costs	6,540	5,025	3,225	2,795
Fixed costs				
Labor	1,248	1,248	1,248	336
Other	1,000	1,000	1,000	1,000
Total fixed	2,248	2,248	2,248	1,336
Total costs	8,788	7,273	5,473	4,131
Net cash from operations	2,112	-573	-1,173	169
Other sources/uses				
Sale of surplus assets			400	
Realisation current assets			1,119	500
EC Phare			1,000	
Equipment replacement			-1,000	
Working capital			-346	-669
Net	**2,112**	**-573**	**0**	**0**

Improvement in 1995 is due to reduced labor and the decrease in raw material prices due to the ability to pay cash rather than barter.

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MIKRON

RECOMMENDATIONS

OPERATIONS

Production Equipment:

- Focus on ensuring production reliability and quality from existing processes and equipment
- Approximately $1 million is needed to repair/replace old and worn out production equipment
- Conduct capability studies **immediately** on key items of production equipment to:
  - highlight (and quantify) problem processes
  - prioritise areas needing attention
  - develop maintenance and/or replacement action plans

MIKRON

RECOMMENDATIONS

OPERATIONS

Quality:

- Start immediate training of all employees in waste reduction and Total Quality Management
- Introduce SPC and "self inspection" techniques
- Bring Health & Safety up to W. European standards (e.g. eye protection; machine guards; footwear; lighting)
- Tidy up all parts of the factory, particularly the Stores and Production areas

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MIKRON

RECOMMENDATIONS

ORGANISATION

- Mikron's overriding priority must be to establish financial viability with a greatly reduced workforce (i.e. total of 200 employees)
- No re-expansion should be considered until a viable and stable financial performance has been achieved
- Mikron needs to strengthen marketing research, sales, customer relations function.
- With a reduced workforce it will be necessary to simplify the organisation structure and re-assign responsibilities (see next slide)

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MIKRON

RECOMMENDATIONS

ORGANISATION

Revised Structure and Responsibilities

- GENERAL MANAGER
  - ENGINEERING
    - Plant & Equipment
    - Product Design
    - Quality Management
  - MANUFACTURING
    - Production Engineering
    - Production Planning
    - Production
  - SALES & MKTG.
    - Market Research
    - Sales & Marketing
    - Customer Relations
  - FINANCE & ADMIN.
    - Purchasing, Stock Control
    - Accounts, Costing
    - Personnel
    - Management Information

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MIKRON

RECOMMENDATIONS

REQUIRED SUPPORT

Estimated liability as of 30 June 1994:

	US $ 000's
• Employees	
• Arrears of wages	929
• Severance pay	2,359 (12 months)
• Trade creditors	1,808
• Other creditors	214
• Bank creditors	981
TOTAL	**6,291**

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MIKRON

REQUIRED SUPPORT

SOCIAL IMPLICATIONS OF REDUNDANCY IN PRILEP

- Over 500 Employees are expected to be made redundant according to both the D&T model and Mikron's own numbers (Prilep's population is 80,000 approx.)
- Over 50% of redundancies are likely to be in the 50 to 65 year old range
- Direct labour will typically have experience in the machining/ metalworking sector and are unlikely to find suitable alternative employment in Prilep which matches their skills
- Indirect labour although more flexible will be significantly reduced

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MIKRON

CONCLUSION

- Mikron faces significant challeges

- The company could be viable if it moves aggressively to reduce its costs and improve quality and customer focus. It must:
    - focus on electric motors
    - reduce its work force to approximately 200 from its current level of 743
    - aggressively market its existing stock and surplus assets
    - repair or replace failing equipment
    - strengthen its marketing and customer relations

- In order for a restructuring plan to succeed the management group must be reinforced with technical and financial expertise.

- The company will need support during the restructuring process
    - protection from existing creditors
    - funds to repair and replace failing equipment
    - funds to cover severance pay

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Agency of the Republic of Macedonia for the Transformation of Enterprises with Social Capital

Special Restructuring Program (SRP)

Tresca

USAID

Sponsored by the U.S. Agency for International Development in conjunction with The World Bank

October 1994

Delivery Order No. 34

Project No. 180-0014
Contract No. EUR-0014-I-00-1056-00
Eastern European Enterprise Restructuring and Privatization Project

Deloitte Touche
Tohmatsu
International

Introduction

We have been engaged under the Macedonia Restructuring Project to:

- Review and assess the restructuring plans prepared by Tresca management
- Evaluate the viability of Tresca
- Work with management to develop a preliminary restructuring/liquidation plan

Our definition of a viable company is a company that is reasonably expected to generate sufficient cash to cover its operating costs and to maintain its productive assets. Following World Bank guidelines, each company assessed under the SRP program is to be classified as:

- Not viable under any realistic scenario, or
- Potentially viable and competitive, but requiring a full fledged restructuring study to eliminate long-term structural losses, or
- Viable once short-term measures are adopted

This report includes our findings and recommendations

Tresca

Assessment of the company
General company information

- Company has been founded in 1924
- 25,000 sqm production facilities on 63,000 sqm property close to the centre of Skopje
- Originally designed to provide the entire market of former Yugoslavia with furniture
- Production of case furniture, upholstered furniture, prefabricated houses, trailers and plastic goods. Provision of transport services
- Divisional organisation structure, including three Ltd.s, dealing with catering and tourism, disabled people and purchasing
- 1,126 employees plus 180 employees in Ltd.s

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Tresca

Assessment of the company
Benchmarks (case furniture industry)

Benchmark	Western Europe	Eastern Europe	Tresca 1993	% of WE*	% of EE**
Turnover / Employee (000.US$)	155	30	10	6	33
Turnover / Production Worker (000.US$)	195	45	14	7	31
Employees Production : Administration / Supervision	4:1	2.5:1	3:1		
Sales / Sqm. Production Facilit. (US$)	1,800	400	250	14	63
Investment / Sales (%)	3	5	0		
Capacity Utilization (%)	>90	40-80	20	22	25-50
Market Segments per company (No.)	1	3	10		

* Western Europe
** Eastern Europe

Current productivity is well below Western and Eastern European standards due to low sales revenues and high employment levels.

Tresca

Assessment of the company
Benchmarks (upholstered furniture industry)

Benchmark	Western Europe	Eastern Europe	Tresca 1993	% of WE*	% of EE**
Turnover / Employee (000.US$)	93	48	20	22	42
Turnover / Production Worker (000.US$)	140	59	26	19	44
Employees Production : Administration / Supervision	4:1	3:1	3:1		
Sales / Sqm. Production Facilit. (US$)	3,000	800	1,330	44	166
Investment / Sales (%)	1.5	3	0		
Capacity Utilization (%)	>90	60-90	45	50	50-75
Market Segments per company (No.)	2	3	10		

* Western Europe
** Eastern Europe

Current productivity is well below Western and Eastern European standards due to low sales revenues and high employment levels.

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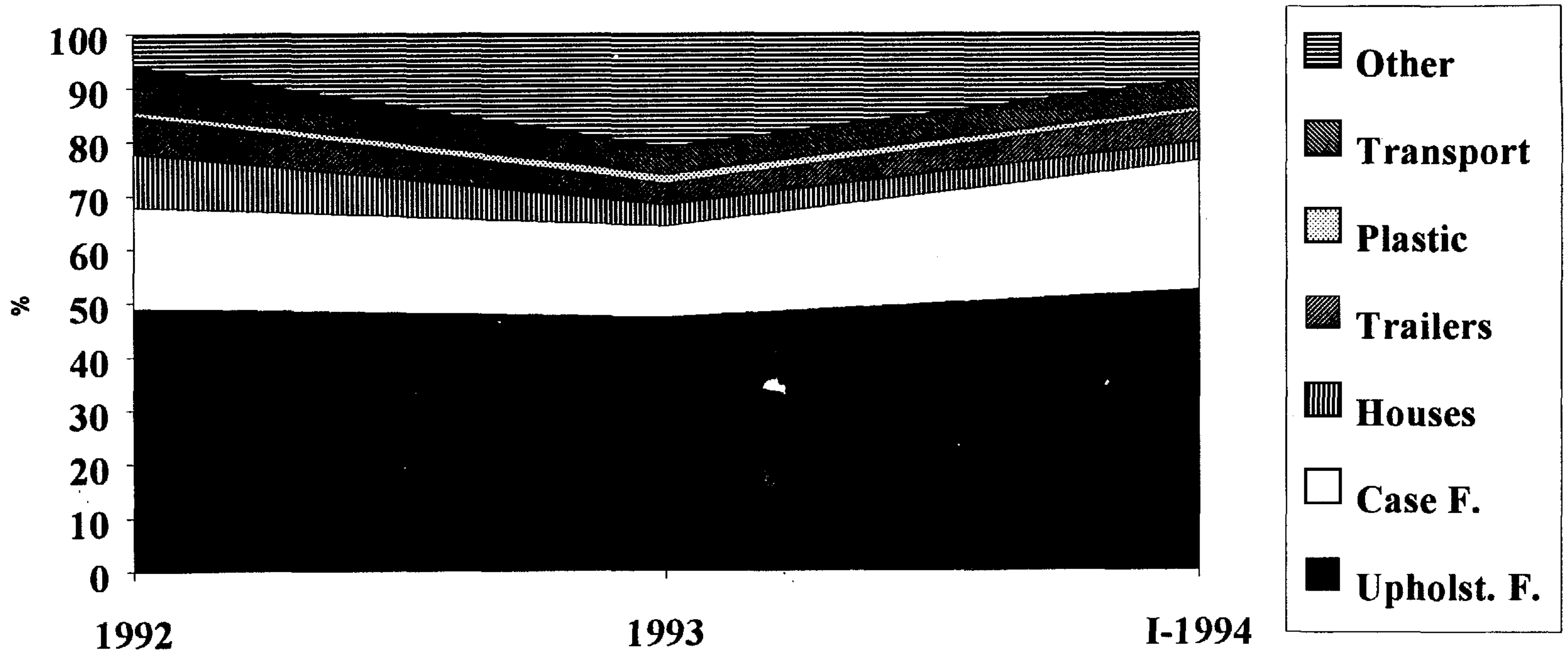
Tresca

Assessment of the company
Product line overview

Allocation of total Revenues



Upholstered furniture and case furniture are major sources of revenue.

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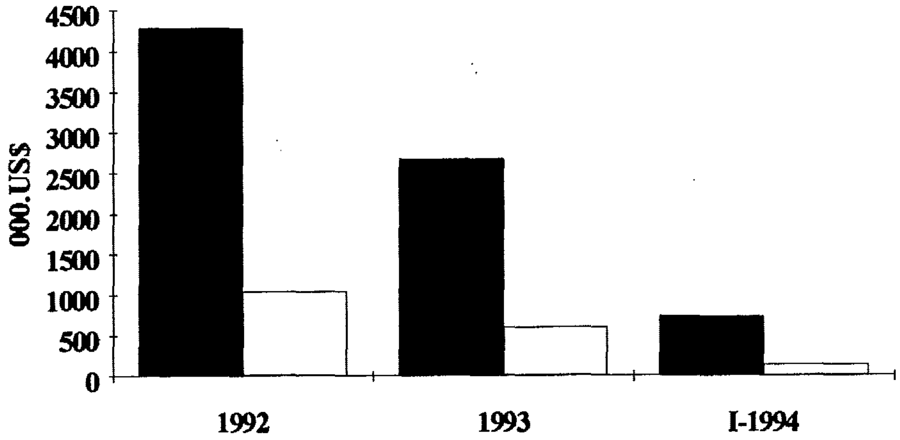
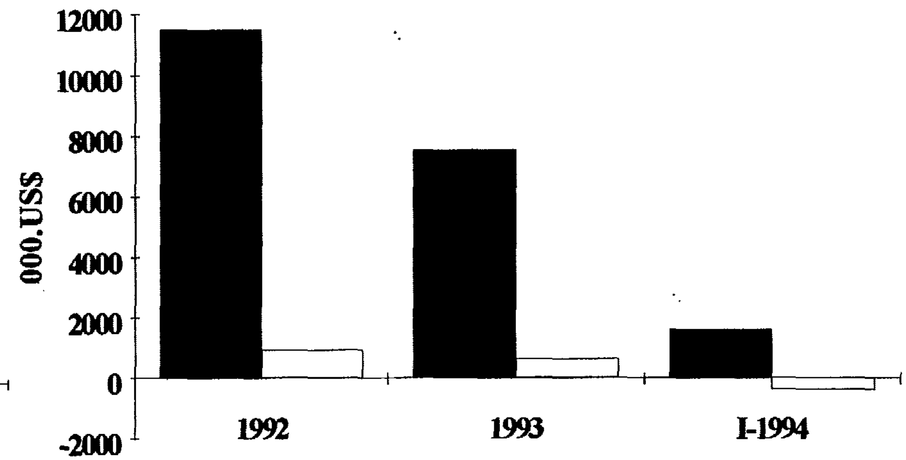
Assessment of the company
Product line overview - Summary

Tresca

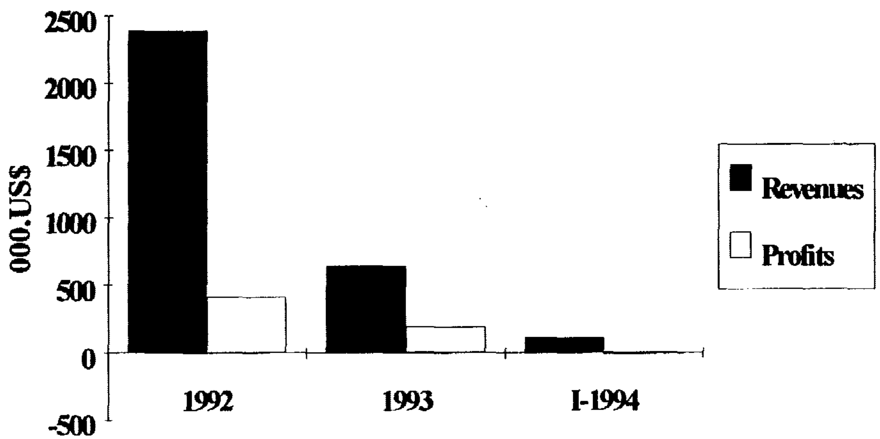
Case Furniture Division



Upholstered Furniture Division



Prefabricated Houses Division



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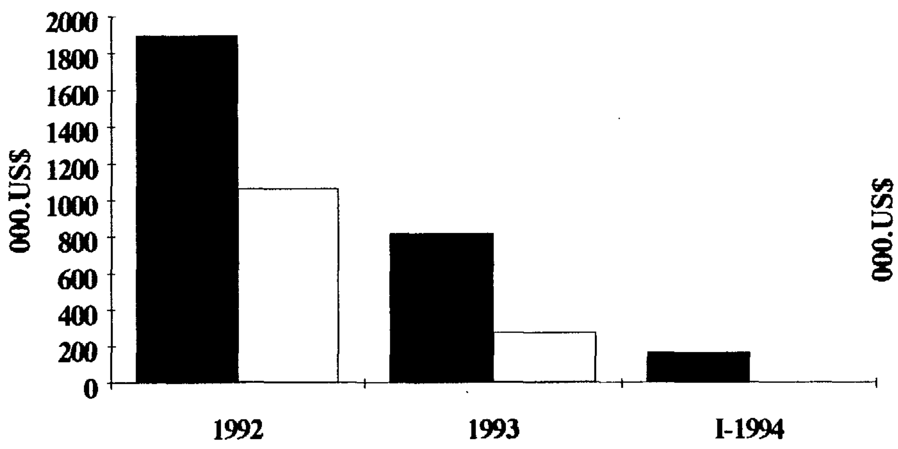
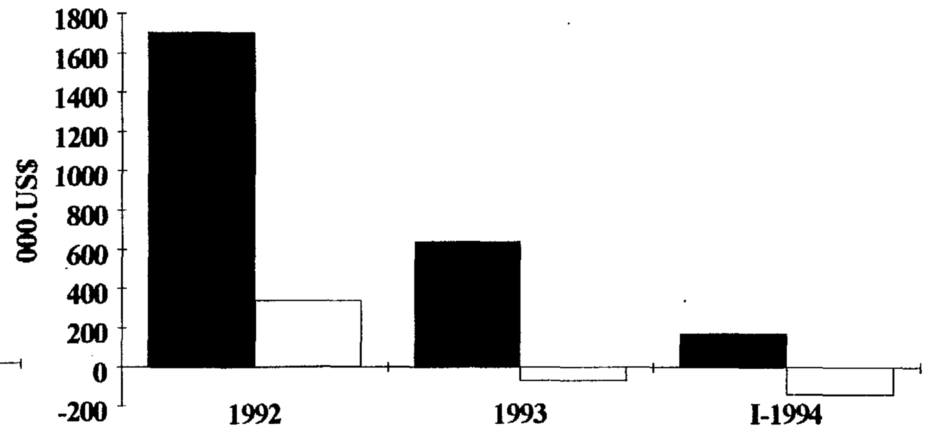
Tresca

Assessment of the company
Product line overview - Summary

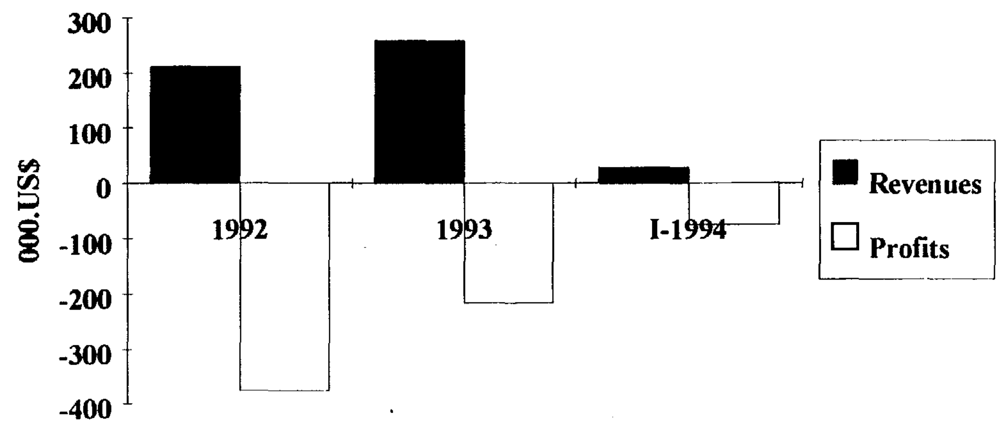
Transport Division



Trailers Division



Plastic Division



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Tresca

Assessment of the company
Product line overview - Case furniture

- Production of wallunits and kitchens in different colours
- Designs are not up to date
- The current utilization of the capacity (15,000 wall units / year) is appr. 20%
- The manufacturing employs traditional techniques of case furniture manufacturing, the process flow is unsufficient, the production facilities are in a bad condition and order, environmental pollution is evident
- The equipment is old but sufficient for current products
- The raw material is not equivalent to Western quality standards but at least as expensive, lack of working capital is the major issue
- The division employs 141 skilled workers, 51 unskilled workers and 84 employees in administrative functions (total 276)

in 000.US$

Year	Material	Labour	Other*	Total Cost	Revenues	Net	%
1992	1,628	369	1,240	3,237	4,279	1,042	24
1993	1,032	430	611	2,073	2,671	598	22
I/1994	283	156	159	598	733	135	18

Important source of revenue (24%), not competitive on Western markets without heavy investments to update technology, new designs required for existing markets in the short term, competitive on domestic market.

*excludes financial costs

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Tresca

Assessment of the company
Product line overview - Upholstered furniture

- Production of fabric and leather upholstered furniture
- Poor fabrics
- The current utilization of the capacity (25,000 sets/year) is appr. 40 %
- The manufacturing process employs traditional techniques, the potential productivity is equivalent to Eastern European standards (overstaffed)
- The equipment is old but sufficient for current products, increase of capacity does not require major investments (sewing machines and cutting tables)
- The raw material is not equivalent to Western quality standards but at least as expensive, the lack of working capital and the procurement of foam (since own production burned down) are the major issues
- The division employs 177 skilled workers, 109 unskilled workers and 95 employees in administrative functions (total 381)

in 000.US$

Year	Material	Labour	Other*	Total Cost	Revenues	Net	%
1992	7,490	680	1,750	9,926	11,512	1,586	8
1993	4,746	776	1,045	2,073	7,564	997	8.5
I/1994	1,150	263	441	1,854	1,604	(250)	(25)

Generates 52 % of total revenues, competitive on Western markets but disadvantage of location in comparison with direct competitors, lack of working capital, poor fabrics and requirement for in-house foam production

*excludes depreciation

Tresca

Assessment of the company
Product line overview - Prefabricated houses

- Production of prefabricated wooden houses
- Designs sufficient for current markets
- Low level of standardization due to response to customer requirements
- The manufacturing process employs traditional carpentry techniques, the productivity is below Eastern European standards due to lack of working capital (low volumes)
- The current utilization of the capacity (12,000 sqm/year) is appr. 40%
- The equipment is old but sufficient for current manufacturing, increase of capacity does not require major investments (turn key projects would require substantially more know-how, project management, contractual and legal skills)
- The division employs 29 skilled workers, 21 unskilled workers and 30 employees in administrative functions (total 80)

in 000 US$

Year	Material	Labour	Other*	Total Cost	Revenues	Profit/Loss	%
1992	714	218	1,045	1,977	2,389	412	17
1993	168	65	214	447	639	192	30
I/1994	30	58	36	124	108	(16)	(15)

Moderate source of revenues (4%), not competitive on Western markets, high risk in providing turn-key projects, opportunities in former Yugoslavia if war ends.

*excludes financial costs

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Tresca

Assessment of the company
Product line overview - Trailers

- Production of trailers and caravans (metal and plastic constructions)
- Designs are probably sufficient for Eastern European and Balkan markets
- The current utilization of the capacity (2,800 units/year) is appr. 20 %
- The manufacturing process employs traditional techniques, level of automation is low
- The equipment is old but sufficient for current products, increase of capacity does not require major investments
- The lack of working capital, the procurement of raw material and the seasonality of the sales are the major issues
- It has been decided by the Tresca management not to continue this business line in the future
- The division employs 89 skilled workers, 46 unskilled workers and 60 employees in administrative functions (total 195)

in 000 US$

Year	Material	Labour	Other*	Total Cost	Revenues	Profit/Loss	%
1992	696	425	243	1,364	1,705	341	20
1993	230	295	189	714	641	(73)	(11)
I/1994	127	133	54	314	170	(144)	(85)

Provides about 5%of total income, decision to close the division has been made.

*excludes financial costs

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Tresca

Assessment of the company
Product line overview - Plastics

- Production of a wide range of plastic and plexiglass products for different uses
- Low volumes, single parts and small series
- Production facilities are poor, safety is neglected
- Contribution to total revenues is insignificant
- No viable concept for the future
- The division employs 6 skilled workers, 11 unskilled workers and 10 employees in administrative functions (total 27)

in 000.US$

Year	Material	Labour	Other*	Total Cost	Revenues	Profit/Loss	%
1992	220	57	311	588	211	(377)	(179)
1993	128	53	294	425	258	(217)	(84)
I/1994	7	19	79	105	29	(76)	(265)

Contribution to total revenues is insignificant (1%), the cost structure is instabil, no concept for the future, permanent loss maker, not worth the required management attention

*excludes financial costs

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Tresca

Assessment of the company
Product line overview - Transport

- Provision of transport services to other divisions and to external parties
- Division has about 40 trucks and various other vehicles
- Most trucks are very old, use 40 ltrs. of petrol for 100km and need regular repair and maintainance
- The current utilization of the truck fleet is well below capacity
- Trucks could not be used to deliver to Western Europe, even if they could take the direct route (transport cost are too high)
- Repair and maintainance cause severe environmental pollution
- Accounting principles are complex, no clear allocation of costs and revenues
- The division employs 45 skilled workers, 14 unskilled workers and 25 employees in administrative functions (total 84)

in 000.US$

Year	Material	Labour	Other*	Total Cost	Revenues	Profit/Loss	%
1992	179	215	440	834	1,896	1,062	56
1993	79	208	257	544	819	275	34
I/1994	17	77	71	165	165	0	0

Division provides 5% of total revenues, relevant services to most of the other divisions, trucks are not appropriate for long distance transport, Transport Division should remain to provide services to the other divisions and actively market services outside the company.

*excludes financial costs

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Assessment of the company Environment & Safety

- The energy supply causes air pollution considerably above Western European standards (carbon monoxide, carbon dioxide, dust)
- Compounds are not treated carefully, soil pollution is obvious
- Safety is well below Western and Eastern European standards
  - No safety shoes (sandals etc.)
  - No mirrows on corners to support fork-lift drivers
  - Low automation of safety devices

The company needs an environmental and safety review to identify the most urgent problems and to specify action steps

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Assessment of the company
Other problems

- A marketing function is not existent for any division:
  - no reliable market data available
  - no marketing strategy
  - the pricing could be more agressive to obtain a bigger market share
- No sales representatives for case and upholstered furniture in order to:
  - present products to retailers
  - help retailers with the layout of their showrooms
  - provide retailers with sales support material
- Lack of working capital prevents the company from:
  - buying raw material at market prices (20-30% premium)
  - paying creditors
  - producing at demand levels (only 30% of orders are accepted)

Assessment of the company

Operating results for six months ended June 30, 1994

in 000.US$

Item	Case fur.	Uph. fur.	Houses	Trailers	Plastics	Transport	Adm/Sal	Total
Revenues	733	1,604	108	170	29	165	275	3,084
Cost o.g.s.	505	1,589	107	274	48	120		2,643
Indirect c.	56	265	9	11	7	23	682	1,053
Deprec.	37	145	8	29	50	22	24	315
Interest							3,763	3,763
Net P&L	**135**	**(395)**	**(16)**	**(144)**	**(76)**	**0**	**(4,194)**	**(4,690)**

Decrease in sales, due to lack of working capital and increase in interest expense gave rise to the overall net loss experienced during the first half of 1994.

Without the interest expense, the loss for the first half of 1994 would have been US$ 930,000, although all fixed and variable cost have been accounted for and the number of employees is at a very high level.

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Assessment of the company
Current financial status - Liquidity

000.US$ at the end of each period

Item	1992	1993	I-1994
Liquid assets			
Cash	31	125	148
Accounts receivable	1,769	2,166	3,325
Total liquid assets	1,800	2,291	3,473
Current Liabilities			
Accounts payable	2,111	1,906	3,682
Wages payable	243	336	1,041
Loans and accrued interest	1,209	3,299	7,026
Total current liabilities	3,563	5,541	11,749
Deficiency in liquidity	**(1,763)**	**(3,250)**	**(8,276)**

Decreases in sales over the past two years, recurring operating losses, and poor collections on accounts from customers have resulted in a lack of cash for paying suppliers, employees, and bank creditors

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Assessment of the company
Current financial status - Working capital

The cash conversion cycle (CCC)

	currently (6-94)	1993	objective 1995
Inventory days	134	57	50
Debtor days	160	45	70
Creditor days	-122	-55	-70
Cash conv. cycle	172 days	47 days	50 days
No. of CCC/Year	2.1	7.8	7.3
Working capital required to support US$15 m sales*:			
	US$7,142,857	**US$1,923,076**	**US$2,054,794**

Working capital excluding short-term investments and loans (000.US$)

start of period	2,366	1,777
average	2,016	2,072
end of period	1,665	2,366

During I-1994 , the receivables increased by 53%, the payables increased by 131%, the inventory increased by 18%. The required working capital to support the 1993 level of sales would be US$ 7 million because of poor cash management

*Assumption: Cost = Revenues (no leverage)

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Assessment of the company
Current financial status - Working capital (cont.)

- The current working capital of US$ 1,665,000:
  - **receivables of US$ 3,324,000**, which are only to 20-30% paid in cash (after 160 days), which increases the cash conversion cycle considerably, the remaining 70-80% are paid with goods and materials of minor quality
  - **inventory of US$ 1,992,000**, which is overvalued, out of date, produced for insolvent customers or consists of semifinished goods which cannot be completed because of the shortage of cash
  - **payables of US$ 3,800,000**,which cannot be paid because
    - the cash shortage of the company and
    - the shortage of goods which would be accepted by the creditors instead of cash
  - **cash of US$ 147,000**

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Assessment of the company
Current financial status - Summary

- Revenues have decreased from around US$ 23 million in 1992 to around US$ 3million for the first half of 1994
- Insufficient cash flow (barter trade, long cash conversion cycle) has resulted in delays of payments to suppliers and has resulted in the inability to get material needed for production
- Wages earned since April 1994 have not been paid to employees
- Overall economic conditions make it more difficult to collect cash from customers for goods sold

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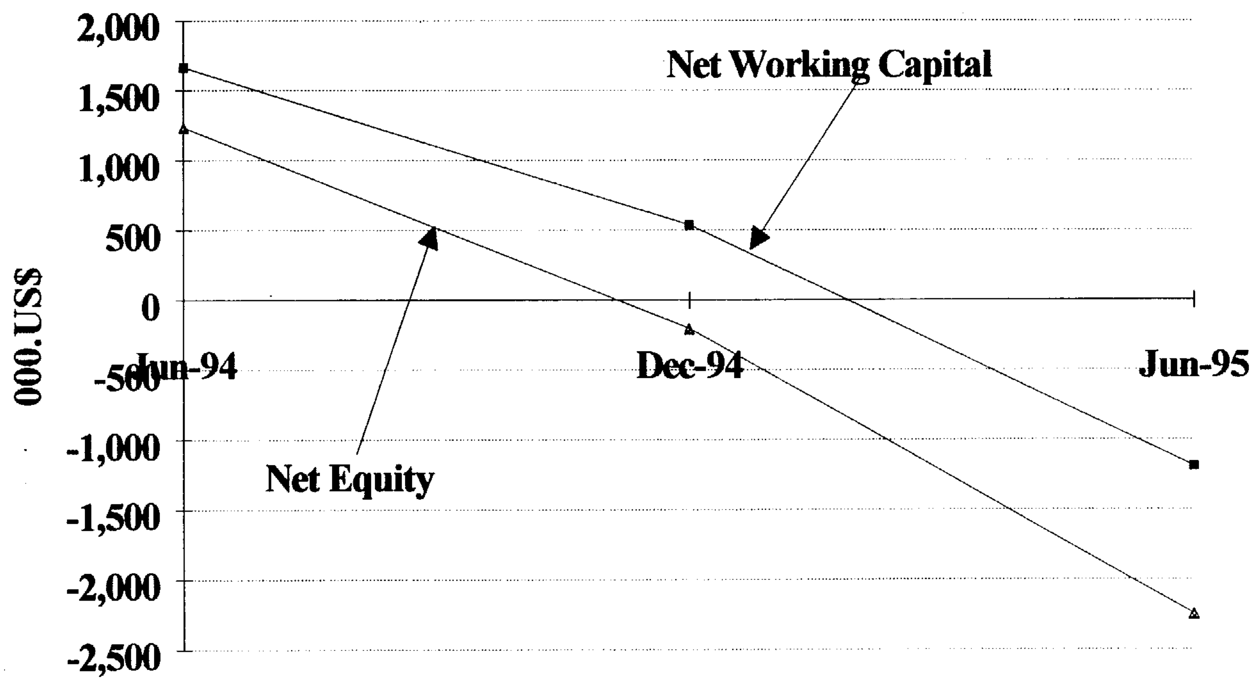
Assessment of the company
Financial forecast - Summary

Net working capital (excluding bank debt and accrued interest) and net equity of the company are expected to change as follows:



It appears likely that operations would cease during I-95 (unless external cash is provided) due to the total inability to buy raw materials and pay employees (strikes)

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Tresca

Assessment of the company
Financial forecast - Profit & loss account

in 000.US$

Year	Item	Case fur.	Uph. fur.	Houses	Trailer	Plastic	Transp.	Adm./Sal.	Total
II-1994	Revenues	681	1,490	100	158	27	153	0	2,609
	Cost o.g.s.	576	1,590	117	302	40	107	0	2,732
	Indirect cost	56	261	8	12	7	39	617*	1,003
	Depreciation	37	145	8	29	50	22	24	315
	Net profit/loss	**12**	**(509)**	**(33)**	**(185)**	**(70)**	**(15)**	**(641)**	**(1,441)**
I-1995	Revenues	504	1,102	74	117	20	113	0	1,930
	Cost o.g.s.	555	1,551	112	298	36	102	0	2,654
	Indirect cost	56	264	9	11	7	39	617*	1,003
	Depreciation	37	145	8	29	50	22	24	315
	Net profit/loss	**(144)**	**(858)**	**(55)**	**(221)**	**(73)**	**(50)**	**(641)**	**(2,042)**

Without significant changes to the company, losses will grow. Operating results based on current conditions have only been forecast for one year, since operation beyond this point is unlikely without change.

*excludes interest on bank loans

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Assessment of the company Financial forecast - Cash flow

- The losses projected indicate that the liquidity position will grow worse

- Without protection the company would fall more behind in payments to suppliers and employees as working capital is used to fund the operating loss

- The company would not be able to make any debt repayments or capital expenditures due to lack of cash

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Restructuring strategies

- Separate the viable part of the business from the remaining business units, activities, employees and financial burden, by:
  - consequently close down non-viable business lines
  - keep only those employees needed for short/medium term operations (including related accrued wages)
  - discharge other employees without taking over related liabilities
  - pay 10% interest on all fresh loans obtained, repay all new loans received in the short/medium term
  - withhold payment on existing debt (principal and interest) until financial health is restored

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Restructuring assumptions

- **The 1993 level of activities for the remaining business lines can be achieved in 1995 through the provision of sufficient working capital (market study required)**
- **A short term loan for the installation and the working capital for the newly purchased foam machine is available, foam can be sold to external customers in a quantity well below the expectations of Tresca management**
- **The cash conversion cycle can be reduced to 50 days**
- The company continues the production of case furniture, upholstered furniture, prefabricated houses and the transport services, other activities are terminated
- Current markets respond to improved design, reduced prices and more aggressive marketing with reasonable increases of demand (market study required)
- Reasonable increases of productivity can be achieved through higher volumes and workforce adjustments
- The prices of raw material remain the same although Tresca management expects at least a 20% reduction if working capital is available, other costs as in 1993/94
- No changes in the political environment of neighbouring countries, no access to Western European markets, current markets can be served

Realistic/pessimistic approach, well below expectations of the TRESCA management.

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Tresca

The working capital issue

- In order to produce the 1993 level of sales, the company would need additional working capital of US$ 2,000,000
- To avoid the continuation of cash shortage after cash injection, the company has to reduce its cash conversion cycle to 50 days by:
  - increasing the number of customers who pay in cash after maximum 70 days on average (selective selling)
  - selecting barter trade customers who trade more useful goods at a realistic value
  - negotiate discounts for immediate payments to creditors (if not possible, agree at least on 70 days payment terms)
  - increase the turnover of inventory by completing caravansand trailers

Fresh working capital and improved cash management are essential preconditions for restructuring to be effective.

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Tresca

Summary of recommendations

in 000.US$

Recommendation	Cash Effect 1994	I-1995	95/96	Total
Reduce prices according to market study(cases, uph.)		275	1,324	1,599
Install and operate existing foam machine		-239	1,649	1,410
Push inventory sales		250	750	1,000
Improve cash management		150	150	300
Produce caravans from available material		160	100	260
Complete small trailers from available material		70	50	120
Reduce level of external services bought	10	60	180	250
Improve standardization of best sellers of pref. houses		15	85	100
Other recommendations (following slide)	-97	-305	-65	-467
Total cash effect	-87	436	4,223	4,572

Positive effect on cash flow after 1994

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Tresca

Summary of other recommendations

in 000.US$

Recommendation	Cash Effect 1994	I-1995	95/96	Total
Clean up plant, repair pipes and buildings, paint buildings		-225	-70	**-295**
Get control over environmental pollution	-30	-20		**-50**
Raise safety levels	-15	-10		**-25**
Perform study in existing markets (cases, uph.f., houses)	-15			**-15**
Close Trailers and Plastics Division		(see redundancy cost)		
Deploy surplus workforce		(see redundancy cost)		
Improve marketing/train salesforce (case, uph., houses)	-15	-15	-45	**-75**
Design flexible wall-unit programm for case furniture		-15		**-15**
Sell surplus assets when possible		40	20	**60**
Let surplus buildings to other companies		10	60	**70**
Increase utilization of truck fleet	3	10	30	**43**
Train remaining workforce and management	-15	-30	-30	**-75**
Improve operations, administration and control	-10	-30	-30	**-70**
Establish profit center organization		-20		**-20**
Total	**-97**	**-305**	**-65**	**-467**

Implementation of other recommendations is necessary for continuation of operations in the future.

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Tresca

Recommendations for immediate action (1994)

in 000.US$

Recommendation	add. Cash-out	add. Cash-in
Get control over environmental pollution (investigation)	30	
Raise safety levels	15	
Perform study in existing markets (case, upholstered, houses)	15	
Improve marketing and train salesforce (case, upholstered, houses)	15	
Improve selection of fabrics for upholstered furniture		
Improve standardization of best sellers of prefabricated houses		
Stop production of other houses		
Improve cash management		
Push inventory sales		
Sell surplus assets when possible		
Deploy surplus workforce	(see redundancy cost)	
Reduce level of external services bought	-10	
Increase utilization of truck fleet	7	10
Train remaining workforce and management	15	
Improve operations, administration and control	10	

Tresca

Recommendations for short term action (I. 1995)

in 000.US$

Recommendation	add. Cash-out.	add. Cash-in
Reduce prices according to market study (case f., upholstered f.)	748	1,023
Install and operate existing foam machine	764	525
Push inventory sales (cont.)		250
Improve cash management (cont.)		150
Produce caravans from available material	40	200
Complete small trailers from available material	10	80
Clean up plant, repair pipes and buildings, paint buildings	240	15
Get control over environmental pollution (cont.)	20	
Raise safety levels (cont.)	10	
Close Trailers and Plastics Division	(see redundancy cost)	
Improve marketing and train salesforce (case, uph., houses)(cont.)	15	
Design flexible wall-unit program for case furniture	15	
Improve standardization of best sellers of pref. houses (cont.)	17	32
Sell surplus assets when possible (cont.)		40
Let surplus buildings to other companies		10
Reduce level of external services bought (cont.)	-60	
Increase utilization of truck fleet (cont.)	20	30
Train remaining workforce and management (cont.)	30	
Improve operations, administration and control (cont.)	30	
Establish profit center organization	20	

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Recommendations for medium term action (II. 1995-1996)

in 000.US$

Recommendation	add. Cash-out.	add. Cash-in
Reduce prices according to market study (cases, uph.)(cont.)	3,537	4,861
Install and operate existing foam machine (cont.)	276	1,925
Push inventory sales (cont.)		750
Improve cash management (cont.)		150
Produce caravans from available material (cont.)		100
Complete small trailers from available material(cont.)		50
Improve standardization of best sellers of pref. houses (cont.)	91	176
Clean up plant, repair pipes and buildings, paint buildings (cont.)	80	10
Improve marketing and train salesforce (case, uph., houses)(cont.)	45	
Sell surplus assets when possible (cont.)		20
Let surplus buildings to other companies(cont.)		60
Reduce level of external services bought (cont.)	-180	
Increase utilization of truck fleet (cont.)	60	90
Train remaining workforce and management (cont.)	30	
Improve operations, administration and control (cont.)	30	

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Tresca

Assumptions on productivity and sales increases

Productivity per employee in 000.US$ per year

Product Group	**West.Eur.'93**	**1994**	**I-95**	**II-95**	**I-96**	**II-96**
Case furniture	**155**	**30**	**40**	**47**	**55**	**63**
% of Western Europe	100	20	25	30	35	40
Upholstered f.*	**93**	**55**	**55**	**60**	**65**	**70**
% of Western Europe	100	60	60	65	70	75
Pref. houses*	**80**	**48**	**48**	**52**	**56**	**60**
% of Western Europe	100	60	60	65	70	75
Sales increases based on 1993 sales						
Case furniture (new program)		0%	20%	25%	30%	40%
Upholstered f. (better fabrics)		0%	20%	25%	30%	40%
Pref. houses (standardization)		0%	10%	15%	20%	20%

Reasonable increases of productivity caused by reduction of workforce and improved operations. Sales increases caused by availability of working capital, reduced prices, improvements for individual product groups and a more sophisticated marketing approach for all product groups.

*comparably low value added

Tresca

Social implications

- The objective is to keep as many employees as possible, but to secure the long term viability and competitiveness of the company
- The company pays the salaries from earlier periods of the people who are kept, as soon as possible, but within the next two years
- Out of the total employees needed under the productivity assumptions,
  - **20% should work full time**
  - **80% should work part time**, starting in November 1994 with 50% employment, which is flexible with regards to sales revenues, employees might be exchanged among divisions

Function	Case F.	Upholst F.	Houses	Transport	Adm/Sales	Total
Administration						
– Full time	1	1	1	1	15	19
– Part time	1	2	0	6	44	53
Production (incl. supervisors)						
– Full time	8	24	1	7	0	40
– Part time	67	196	15	52	0	330
Total						
– Full time	9	25	2	8	15	59
– Part time	68	198	15	58	44	383

Part time	**Nov.94**	**I-95**	**II-95**	**I-96**	**II-96**
average % of part time worked	50%	63%	60.3%	54.7%	50.9%

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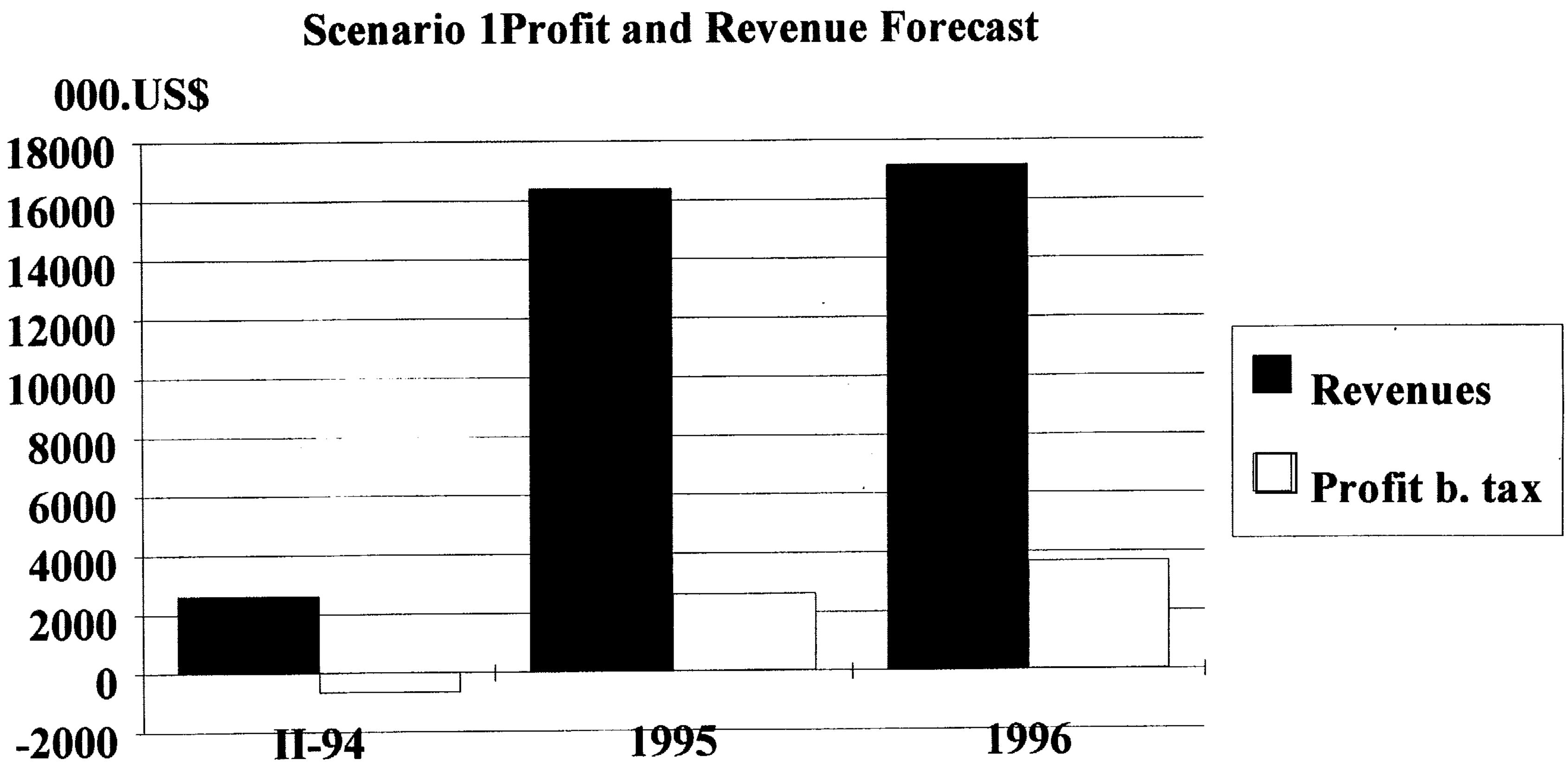
Financial forecast - Profit & loss account



Shows a profit in 1995 and stable conditions for the future

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Tresca

Financial forecast - Profit & loss account

in 000.US$

Year	Item	Case fur.	Uph. fur.	Houses	Trailer	Plastic	Transp.	Adm./Sal.	Total
	Revenues	681	1,490	100	158	27	163	0	2,619
	Cost o.g.s.	444	1,369	64	134	22	99	0	2,132
II-1994	Indirect cost	93	409	17	40	57	66	484	1,166
	Profit b. tax	**144**	**(288)**	**19**	**(16)**	**(52)**	**(2)**	**(484)**	**(679)**
	Profit a. tax	**144**	**(288)**	**19**	**(16)**	**(52)**	**(2)**	**(484)**	**(679)**
	Revenues	3,122	10,615	719	430	0	879	30	16,395
	Cost o.g.s.	2,072	7,530	369	366	0	360	0	10,697
1995	Indirect cost	203	918	96	0	0	170	1,703	3,090
	Profit b. tax	**1,447**	**2,167**	**254**	**64**	**0**	**349**	**(1,673)**	**2,610**
	Profit a. tax	**1,012**	**1,517**	**177**	**45**	**0**	**244**	**(1,171)**	**1,824**
	Revenues	3,755	11,711	767	0	0	879	40	17,152
	Cost o.g.s.	2,065	8,183	393	0	0	377	0	11,018
1996	Indirect cost	188	918	76	0	0	170	1,099	2,451
	Profit b. tax	**1,502**	**2,610**	**298**	**0**	**0**	**332**	**(1,059)**	**3,683**
	Profit a. tax	**1,051**	**1,827**	**208**	**0**	**0**	**232**	**(741)**	**2,577**

The company becomes profitable in 1995. After restructuring Tresca should be able to breakeven at approximately $7,500,000.

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Tresca

Financial forecast - Cash flow

in 000.US$

Item	I-95	II-95	I-96	II-96
Sources of cash				
Operations	**1,713**	**1,963**	**1,845**	**1,734**
Borrowings	3,000[1]	0	0	0
Sale of assets	40	20	0	0
Uses of cash				
Debt principal payments	0	(1,000)[2]	(500)[3]	(500)[3]
Debt interest payments	(150)[4]	(150)[4]	(100)[4]	(75)[4]
Capital expenditure	(700)	0	0	0
Prior wages for employees	(177)	(177)	(177)	(177)
Increase in working capital*	(3,726)	(656)	(1,068)	(500)
Cash surplus / (deficit)	**0**	**0**	**0**	**482**

1 Foam machine, buildings, environment, working capital

2 Foam machine, buildings, environment

3 Working capital

4 10 % on all loans

The company can generate sufficient cash to expand the business, to repay all fresh loans by the end of 1997, to pay 10% interest on all loans, and to pay prior salaries to employees kept.

*required for expansion of the business

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Tresca

External support

- Complete moratorium on existing bank debt US$ 7,030,245 and interest liabilities US$ 3,762,843 **(per end of June 1994)**
- Protection for liabilities associated with surplus labour (payments of US$ 700,000, severance payments of US$ 575,000 and salaries from earlier periods US$ 700,000)
- Support sales of assets >DM50,000 (legal restrictions)
- Short-term loan of US$ 700,000 to install and operate the foam machine (I-95)
- US$ 300,000 short-term loans to allow implementation of other recommendations (I-95)
- US$ 2,000,000 long-term loans to furnish company with working capital (I-95)

The total external assistance for future operations is US$ 3,000,000.

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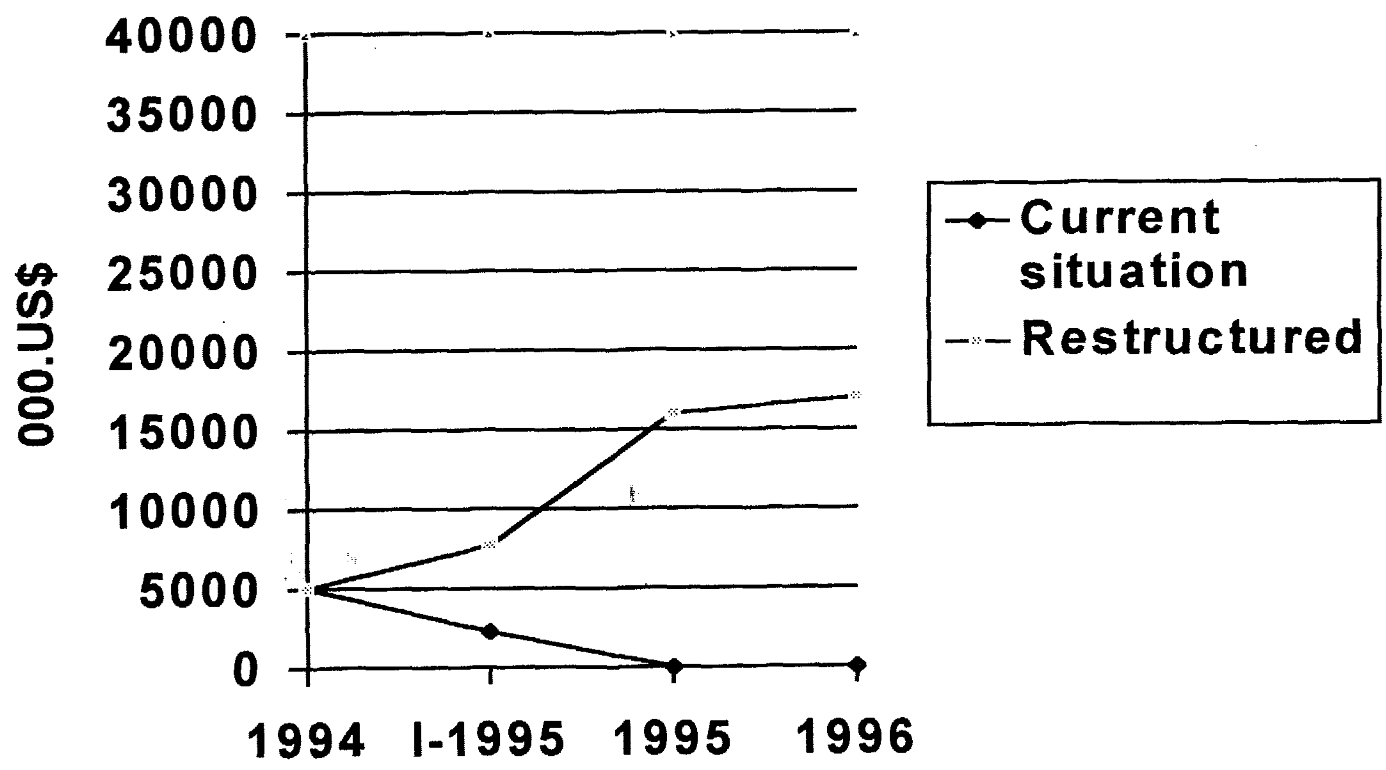
Restructuring results summary
Sales revenues



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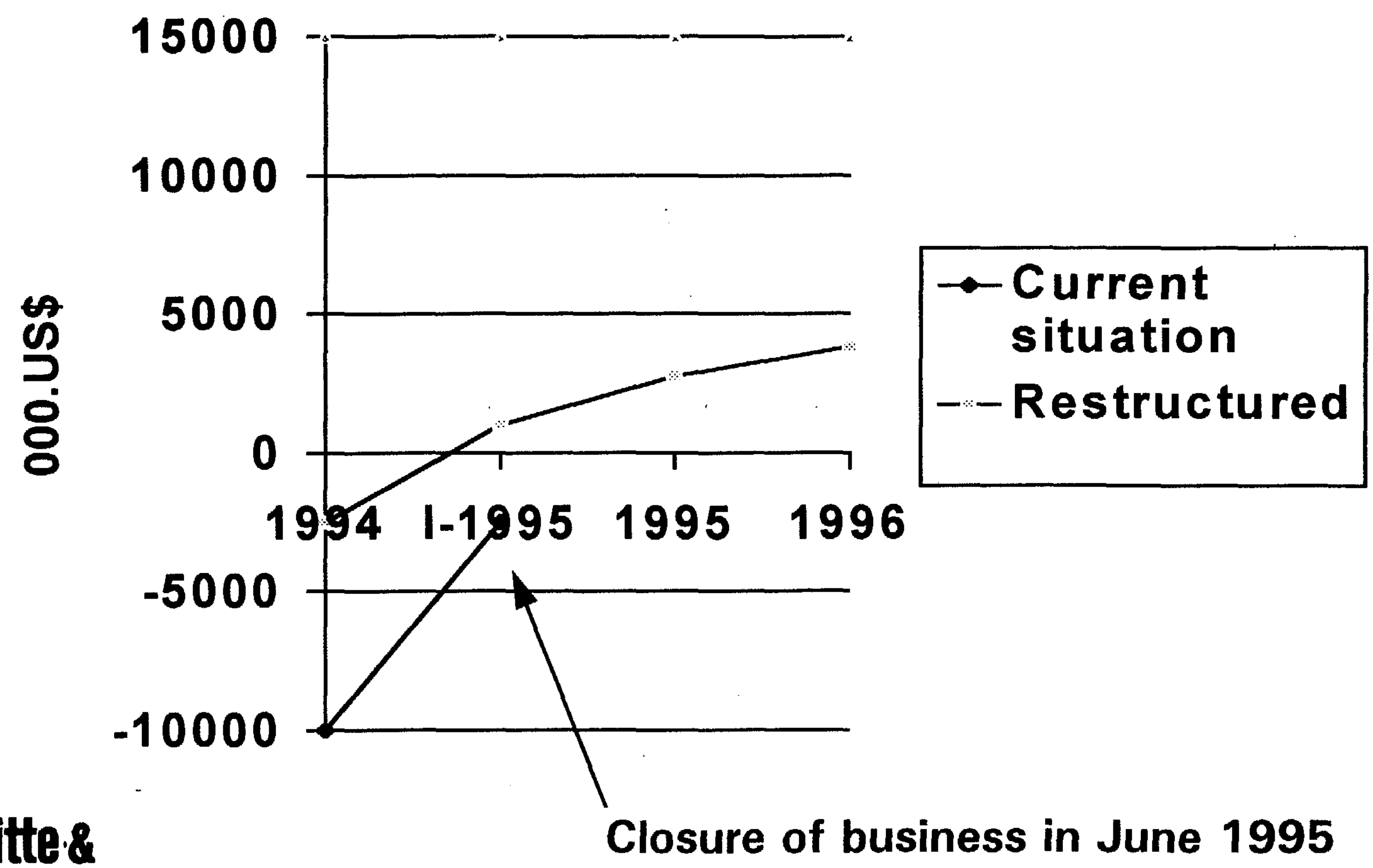
Tresca

Summary of alternatives
Profit & loss account



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Issues for implementation

- We do not believe that current management can implement the recommendations needed to reach the required productivity and sales level. We recommend that the company be provided with a part-time "shadow manager" to assist them.
- The required reduction of the workforce will have major effects on the **social situation of the concerned people**. The payment of salaries from earlier periods, severance payments and redundancy payments would help them to bridge the probably medium to long term unemployment period.

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Future Possibilities

- Our restructuring recommendations are based on the continuation of war, embargo and blockade. Should these conditions change, Tresca should have enormous earnings potential.
- Our analyses indicate that with the tecnical assistance and $700,000 of additonal short-term loans to purchase new trucks, Tresca's sales could grow to $42,000,000 by 1996. Employment would also increase from 442 (59 full-time/383 part-time) to 610 full-time employees.
- A corridor through former Yugoslavia is available after **July 1995** and provides access to Western European markets (to be used for the export of upholstered furniture to Germany, Austria, Switzerland, Italy and France); and the countries of former Yugoslavia can be provided with furniture and prefabricated houses after **January 1996**, but demand is well below the expectations of Tresca management.

Realistic/pessimistic approach , well below expectations of Tresca management

Summary

- Tresca is not viable in its current shape and under management's existing plan for the future
- Tresca would be viable if:
  - the markets react as expected (market study)
  - it concentrates on the viable business lines
  - reduces the workforce as recommended
  - it receives fresh capital as suggested and improves its cash management
  - it does not have to carry its current financial liabilities and the liabilities associated with surplus employees
- Restructured Tresca should have enormous potential should embargo and/or blockade end.

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Agency of the Republic of Macedonia for the Transformation of Enterprises with Social Capital

Special Restructuring Program (SRP)

Zelezarnica

USAID

Sponsored by the U.S. Agency for International Development in conjunction with The World Bank

October 1994

Delivery Order No. 34

Project No. 180-0014
Contract No. EUR-0014-I-00-1056-00
Eastern European Enterprise Restructuring and Privatization Project

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INTRODUCTION

We have been engaged under the Macedonia Enterprise Restructuring Project to:

- Review and assess the restructuring plans prepared by Rudnici i Zelezarnica "Skopje"
- Evaluate the viability of Rudnici i Zelezarnica "Skopje"
- Work with management to develop a preliminary restructuring/liquidation plan

Our definition of a viable company is a company that is reasonably expected to generate sufficient cash to cover its operating costs and maintain its productive assets. Following the World Bank guidelines, each company assessed under the SRP program is to be classified as:

- Not viable under any realistic scenario; or,
- Potentially vialbe and competitive, but requiring a full fledged restructuring study to eliminate long-term structural losses; or,
- Viable once short term measure are adopted

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BACKGROUND & ASSESSMENT

"Skopje" Iron & Steel Works established as a greenfield site which started production in 1967

Iron Making

- ❒ Designed to use local ore processed into iron using 5 direct reduction furnaces using lignite (from Serbia) and electricity as fuel
- ❒ Included associated ore mines (3) and ore preparation plant
    - ◆ "Spun off" as separate companies in 1991
- ❒ Direct reduction furnaces closed in 1991:
    - ◆ Uneconomic process compared to blast furnances
    - ◆ Unreliable supplies of lignite from Serbia
    - ◆ Poor quality of Macedonian iron ore deposits
    - ◆ Environmentally dirty process
- ❒ Molten iron was processed into steel using a converter (LDAC)
    - ◆ Closed since 1992
- ❒ Currently revamping 2 furnaces to produce Ferro Alloys

BACKGROUND & ASSESSMENT

Steel Making

- LDAC 100 tonne converter and associated 1,250 tonne mixer
  - Installed in 1967
  - Cannot work without molten iron
- 55 MVA electric arc furnace installed in 1975
  - Ugraded in 1989 with computer controls
  - 130 tonnes but limited to 100 tonnes due to crane limitations
  - Annual capacity is 300,000 tonnes
- Satisfactory scrap bay and associated cranes
- No secondary steel making limiting both output and quality

Zelezarnica

BACKGROUND & ASSESSMENT

Continuous Casting

- Russian built three strand with 10 meter radius curved mould machines with argon shrouding and submerged pour
  - No computer controls
  - No flame scarfing for surface quality
  - Annual capacity of 700,000 tonnes
  - Yield attainment is 1.7% below western standards
  - Expensive to maintain

Hot Strip Mill

- Six stand finishing with single reversing rougher
  - Installed in 1967
  - Annual capacity of 800,000 tonnes
  - 1.4 meter width
  - Under powered unit (17MW) with no hot boxes
  - Declining useabilty
  - Limited capacity for thin strip production - cannot service automotive, tin plate or white goods markets

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BACKGROUND & ASSESSMENT

Cold Strip Mill

- Five stand Siemag Cockerill with computer controls
  - Installed in 1972
  - Variety of associated mill
    - Galvanizing Line - Closed since 1992
    - Painting Coating Line- Closed since 1989
    - Strip processing
  - Annual capacity of 450,000 tonnes
  - Limited capacity for thin strip production - cannot service automotive, tin plate or white goods markets

Plate Mill

- 4 High reversing mill by Davy
  - Installed in 1967
  - Annual capacity of 340,000 tonnes
  - Restricted by finishing processes
    - Under capacity
    - No stocking
    - No small plate preparation
  - Reasonble rolling facility in need of a furnace upgrade

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BACKGROUND & ASSESSMENT

Markets

- No sector of the company has a strong local or "home" market
  - Designed to supply former Yugoslavia Republic
  - No specialist finishing function

- It is unlikely that the former Yugoslavia Republic will provide adequate markets in the future
  - Rebuilding war torn economies will take time
  - Republics will build links with alternative suppliers with the ability to offer better quality and service

- New sales must come from bulk orders on the international market
  - Characterized by low prices
  - Significant bulk contracts required to obtain adequate utilization levels
  - Inability to acess cheap raw materials and power place firm at a disadvantage against other bulk suppliers

- Access to international markets is expensive and difficult
  - High transport charges due to distances from ports and continued Greek embargo and UN sanctions against Serbia

BACKGROUND & ASSESSMENT

Raw Materials

- The plant is critically short of scrap
  - Macedonia currently produces only 2,500 tonnes per month (3,500 tonnes at "normal" economic activity)
  - Represents approximately 16% of electric arc furnace's capacity
  - Likely that other former Yugoslav Republics will direct their scrap to their own domestic steel industries

- Must import scrap through purchase or barter arrangements
  - Purchased scrap currently at a premium ($115 to $140 per tonne)
  - Currently unable to purchase scrap due to lack of working capital
  - Transport adds an additional $33 per tonne from Bulgaria or $22 per tonne from Thessalonika
  - Barter deals structured to obtain process scrap due to lack of working capital
  - Select analysis indicates that barter deals are uneconomic (see page 8)

- Slab supplies are currently available from Ukraine @ $180 to $200 per tonne
  - Quality below world standards
  - Long term availability at this cost is unpredictable

- Adequate hot band supplies for cold mill may be available at $265 per tonne; long-term contracts must be negotiated

Zelezarnica

BACKGROUND & ASSESSMENT

Barter Transaction Analysis

Select analysis of barter transactions designed to obtain raw materials reveal that they are uneconomical

Contract			**Kloeckner**			**Zaporozje**
Material			H.R.Plate			C.R.Sheet
Slab Tonnage			20,000			153,000
Delivered Tonnage			13,333			87,000
Skopje Rolls			$943,600			$19,453,681
Skopje Brings Slab			$559,410			$4,681,800
Skopje Despatches Plate/Sheet			$407,330			$2,657,850
Bank Charges			$19,000			$145,350
Skopje Costs			$1,929,340			$26,938,681
	Tonnes	Value		Tonnes	Value	
SkopjeSells Scale			9,000			68,850
Skopje Sells	2,350	$400	$940,000	48,778	$403	$19,657,534
	1,021	$420	$428,820			
	696	$350	$243,600			
Skopje Revenue			$1,621,420			$19,726,384
Skopje loss			**$307,920**			**$7,212,297**

BACKGROUND & ASSESSMENT

Power

- Electricity currently priced at 2.6 to 3.0 cents per Kwh, production cost of Macedonian electricity estimated at 5.5 cents per Kwh
- Off peak usage would limit operating period reducing output resulting in higher refractory and power costs per tonne
- Unused combined heat, steam and power station located on site
  - Generating capacity of 27.5 MW
  - Unused since 1982
  - Proposal to revamp unit into combined heat and power station buring natural gas (c.f. heavy fuel oil)
  - Capital investment estimated at $8 million
  - Separate assessment required to determine viability

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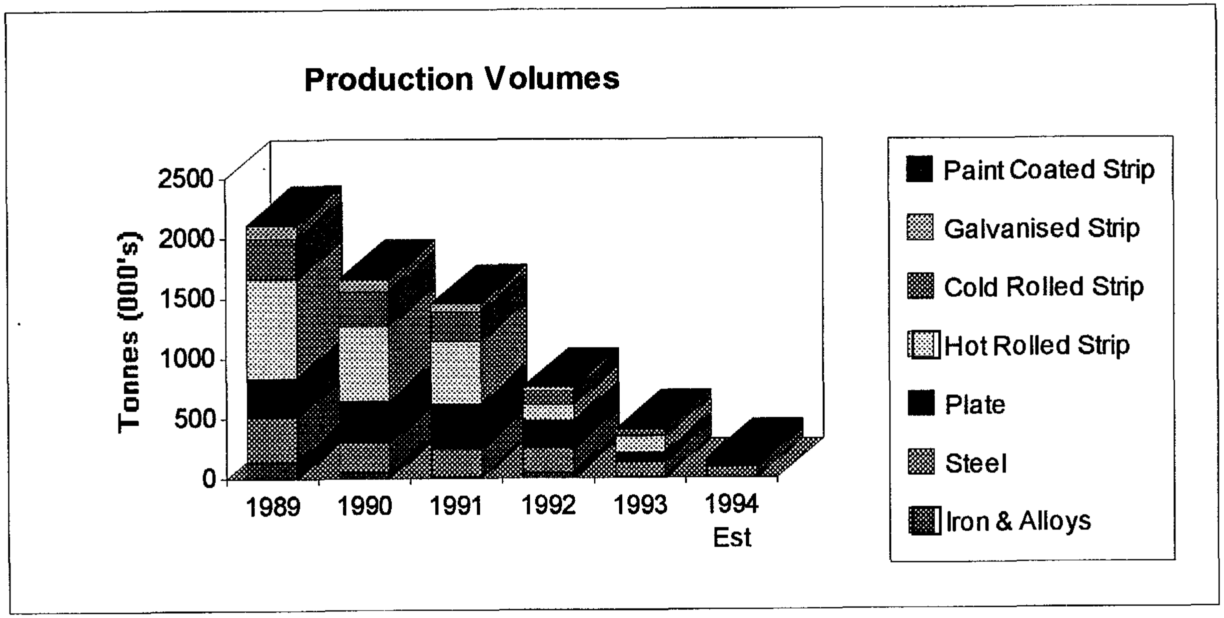
BACKGROUND & ASSESSMENT

Production Volumes

- All products have experienced sharp declines in volume since 1989
    - Iron making, galvanizing and painting closed for one or more years
    - Steel making @ 30% of capacity
    - Plate mill @ 19% of capacity
    - Hot rolled strip @ 1% of capacity



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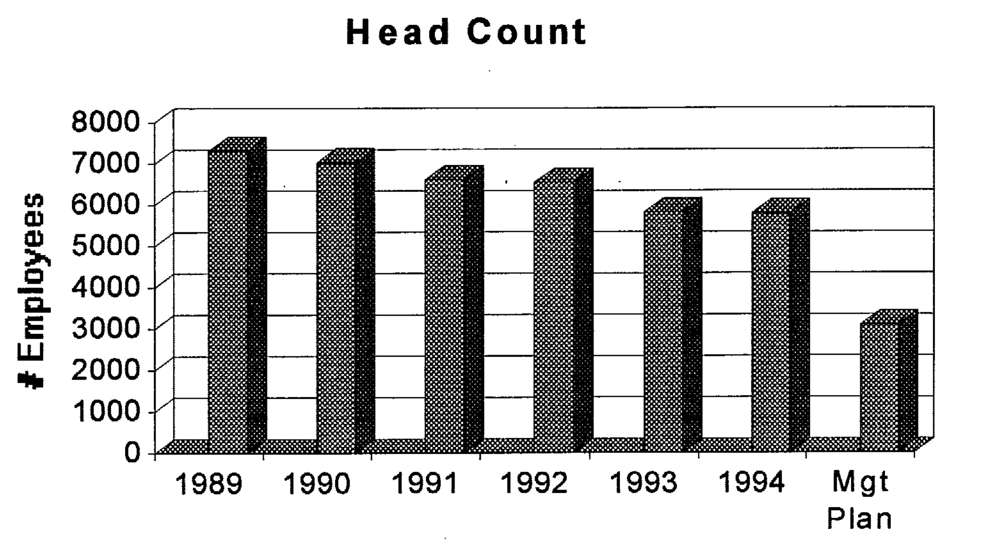
BACKGROUND & ASSESSMENT

Manning

- Steel works has reduced headcount from 7,310 to 5,783 or 21% since 1989
- Management's plan calls for additional reduction to 3,080 employees
- After additional reductions, operations we believe that are still overmanned by approximately 30% on average



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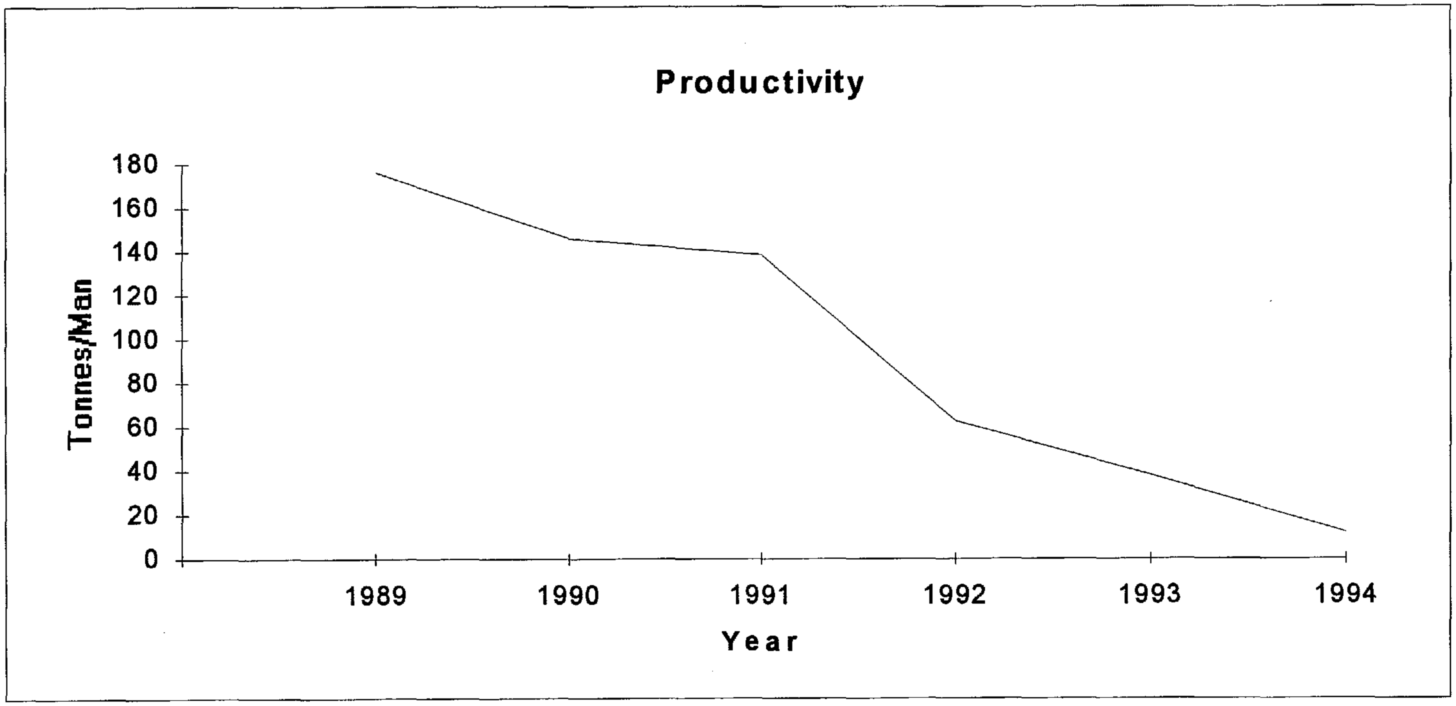
BACKGROUND & ASSESSMENT

Productivity

- Headcount reductions have lagged behind decreases in volume resulting in a significant declines in productivity. 1994 productivity is forecast at only 12 tonnes per man



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BACKGROUND & ASSESSMENT

Current Financial Status

- Critical and deteriorating working capital position. Skopje unable to fund ongoing operations and meet creditor obligations
- Incurring substantial losses at an increasing rate
- Significant excess assets at current production volumes

	Dec-92	Dec-93	Jun-94	Industry Median
Profitability				
Profit After Tax	-25.8%	-32.0%	-63.3%	2.9%
Interest Coverage	(2.1)	(0.3)	(0.5)	3.5
Returns				
Return on Assets	-15.0%	-21.0%	-22.6%	4.0%
Return on Equity	-22.5%	-27.5%	-26.6%	11.8%
Liquidity				
Current Ratio	0.8	0.6	0.5	1.8
Work Capital to Sales	-14.5%	-25.1%	-105.4%	10.1%
Utilization				
Fixed Asset Turnover	0.9	0.9	0.4	8.5

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BACKGROUND & ASSESSMENT

Current Financial Status

- Negative working capital of $36.2 million
- Interest arrears of $10.9 million in spite of Paris and Zurich rescheduling agreement

Working Capital and Debt as of June 30, 1994 (000's $) @ 40 Denars per US Dollar	
Current Assets	
Cash	$527.6
Net Accounts Receivable	$14,826.4
Inventories	$17,061.7
Other Current Assets	$1,489.2
Total Current Assets	$33,904.9
Current Liabilities	
Accounts Payable	$27,398.1
Short Term Debt	$14,596.6
Other Current Liabilities	$28,233.0
Total Current Liabilities	$70,227.7
WC Deficit	($36,322.8)
Debt & Accrued Interest	
Short Term Debt	$14,596.6
Long Term Debt	$3,034.2
Total Debt	$17,630.8
Accrued Interest-A/P	$6,235.2
Accrued Interest-Debt	$4,629.1
Total Accrued Interest Expense	$10,864.3

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BACKGROUND & ASSESSMENT

Subsidiary Companies

- The steel works has a 100% interest in 18 subsidiary companies
  - Subsidiaries "spun off" from steel works over last two to four years
  - Include mines, refractory production, nail and screw production, spare part production and other ancilliary services
  - Combined revenues of US $12.7 million in the 1st six months of 1994
  - Accounted for 31% of consolidated revenues in 1st six months of 1994
  - Employ 2,903 workers or 33% of the consolidated companies total workforce
  - Nine subsidiaries posted statutory profits in 1993
  - Only two show a statutory profit for the first six months of 1994
    - Health station
    - Scrap collection and processing

We have not assessed the viability of the subsidiary companies.

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RESTRUCTURING ANALYSIS

Introduction

To assess potential viability Skopje was divided into four distinct business units

- ❐ Ferro Alloy Production
- ❐ Melting plant, concast plant and plate mill
- ❐ Hot Strip Mill
- ❐ Cold Mill including Galvanizing, Cold Rolling and Strip Coating

Separate Business Unit pre tax profit and loss analyses were prepared.

RESTRUCTURING ANALYSIS

Assumptions

- Calculations prepared using:
  - Sales at management's "normal year"
  - Sales at 50% of management's "normal year," and sales at 30% of management's "normal year" ("normal year" assumes end to the embargo and blockade)
- Hire rolling sales:
  - 33.3% of plate mill sales
  - 72.5% of hot strip mill sales
  - 61.7% of cold mill sales
  - 48.9% of galvaniser sales
- Electricity at 2.49 cents per Kwh., 3.5 cents per Kwh, and 5.5 cents per Kwh
- Scrap at $115 per tonne and supplied slab at $180 per tonne
- Average gross salary of $285 per month
- Management's attainable manning levels reduced by 30% (from current level of 5,783 to 2,156)

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RESTRUCTURING ANALYSIS

Melting

- Reflects one existing contract
- Ferro alloy process requires large quantities of power. Contract only covers electricty costs up to 2.6 cents per Kwh
- Current contract is almost breakeven with electricity costs of $0.0249 per kwh. There are significant losses at realistic energy costs
- Zelezarnica should renegotiate electricity cost reimbursement clause of contract or failing to do that cancel the contract and close down the unit

Melting	Annual (current contract)
Sales (tonnes)	70,000
Revenues	$3,710
EBIT	
$0.0249 Kwh	($351)
$0.0350 Kwh	($2,467)
$0.0550 Kwh	($7,172)

$$ in thousands

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RESTRUCTURING ANALYSIS

Steel, Slab & Plate Plant

- Plant will only breakeven at full capacity and lowest energy costs
- Plate mill is critically dependent on imported slab. The high cost of transport makes Skopje vulnerable to competition.
- Losses increase rapidly at lower sales volumes and more realistic energy costs
- Significant capital expenditures need to meet international standards of quality, yield and output

Steel, slab & plate	1994 Annualized	30% Mgmt Normal Yr.	50% Mgmt Normal Yr.	Mgmt Normal Yr.
Sales (tonnes)	65,059	108,000	180,000	360,000
Revenues		$31,324	$50,766	$104,414
EBIT				
$0.0249 Kwh		($5,004)	($3,578)	($14)
$0.0350 Kwh		($5,471)	($4,356)	($1,570)
$0.0550 Kwh		($6,395)	($5,897)	($4,651)

$$ in thousands

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RESTRUCTURING ANALYSIS

Hot Strip Mill

- Hot Strip Mill will only breakeven at approximately 400,000 tonnes
- Higly dependent on obtaining slab at reasonable prices
- Significant capital expenditures are required to upgrade quality of product

Hot Strip Mill	1994 Annualized	30% Mgmt Normal Yr.	50% Mgm Normal Yr.	Mgmt Normal Yr.
Sales (tonnes)	10,000	120,000	200,000	400,000
Revenues		$11,161	$50,766	$37,202
EBIT				
$0.0249 Kwh		($643)	($261)	$693
$0.0350 Kwh		($680)	($323)	$568
$0.0550 Kwh		($754)	($446)	$323

$$ in thousands

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RESTRUCTURING ANALYSIS

Cold Mill

- Cold Mill will breakeven at approximately 153,000 tonnes
- Minimal investment is required to maintain plant in operating condition
- Requirement for Cold Mill products could pick up as economy improves and war/embargo ends
- Viability depends on obtaining consistent supplies of hot band

Cold Mill	1994 Annualized	30% Mgmt Normal Yr.	50% Mgm Normal Yr.	Mgmt Normal Yr.
Sales (tonnes)	3,195	75,000	125,000	250,000
Revenues		$30,460	$50,766	$101,532
EBIT				
$0.0249 Kwh		($3,874)	($1,368)	$4,895
$0.0350 Kwh		($4,070)	($1,694)	$4,242
$0.0550 Kwh		($4,457)	($2,340)	$2,950

$$ in thousands

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RECOMMENDATIONS

- Establish a Plant Demolition and Scrap Task Force under the direction of a senior manager
  - Demolish surplus plant, buildings and equipment (e.g iron kilns, sinter plant)
  - Prepare demolished scrap for Electric Arc Furnance

- Undertake immediate and drastic redundancy program - at least 3,750 jobs in short term
  - Retain/train redundancy counsellors
  - Initiate discussions with government concerning financing/payment of approximately $24.2 million in back salary and initial redunancy costs

- Renegotiate or terminate Ferro Alloy contract
  - Objective - Obtain reimbursement for actual production cost of electricity feasibility of the power stations future

- Close down Electric Arc Furnace after processing demolished scrap
  - Uneconomic operation due to high cost of imported scrap and transport
  - Significant investment required to meet international standards of yield and quality unsupportable even at increased output levels

- Operate plate mill for three more months despite nonviability
  - Pursue possible sale to a trading partner who has expressed interest
  - Maintaining plant in operational considition could improve chance of sale
  - Close plant after three months if no progress

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RECOMMENDATIONS

- Close down Hot Strip Mill and pursue sale possibilities

- Retain experienced and reputable Agents and International Valuation Experts to advise on which plants have resale possibilities and their values
  - "Rough Estimate"- Hot Strip Mill might be sold to China for approximately $1.7 million
  - "Rough Estimate" Cold Mill might be sold to China or India for $750 thousand

- Operate Cold Mill on a stand alone basis
  - Success of operation dependent on obtaining reliable source of hot band
  - Initiate immediate negotations with Zaporozje (Ukraine) for long term sourcing hot band
  - Reassess viability after six months
    - Hot band sourcing
    - Markets for Cold Mill products
    - Ability to compete against other Cold Mills given high transport costs
  - Pursue opportunities to sell Cold Mill in parellel with continued operation

- Establish a separate holding company (New Co.) which will have the assets and liabilities of the 18 subsidiaries transfered to its control
  - Prepare separate restructuring plans
  - Privatize as rapidly as possible
  - Assume responsibility for assessing

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EXTERNAL SUPPORT

Skopje will need the following external support:

- Protection from existing creditors (June 30 W/C deficit -- $36.5 million)
- Funds for unpaid back salaries ($13.4 million)
- Funds to pay redundancy costs (projected: $10.8 million)
- Additional transition funds during demolition, sale period

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Macedonia Special Restructuring Project

Discussion Outline

- ***Review of Presentations***
- ***Personal Observations***
- ***Opportunity***
- ***Work Plan***

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Review of Presentations -Conclusions

- Potentially viable enterprises: TRESCA, GAZELA, HEMTEKS, MIKRON (weakest).
- ZELEZARNICA most parts not viable at realistic slab and energy costs. Cold Mill is potentially viable but enterprise must secure long term hot band supplies; which is probably not possible.
- Significant labor shedding required.
- Working capital infusions, creditor protection and severance cost funds required.

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Review of Presentations - Conclusions

($$ 000s)	GAZELA	HEMTEKS	MIKRON	TRESCA	ZELEZARNICA	Total
Labor Reduction	1031	151	540	684	3627	6033
Severance Costs	3216	761	2359	1975	10800	19111
Working Capital Required	3720	1248	0	3000		7968
Capital Investment	200		1000			1200
Total Capital Required	7136	2009	3359	4975	10800	28279
Creditor Protection	96721	1800	3932	9850	87859	~~112303~~

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Review of Presentations - Government participation

- Very limited government involvement, no apparent decision- makers attended

  - *TRESCA -- one person (economics ministry)*

  - *MIKRON -- two people (economics, Deputy Ministry representative)*

  - *GAZELA -- five people (economics, chamber of commerce, labor, Deputy Ministry representative)*

  - *ZELEZARNICA -- three people (Deputy Ministry representative, chamber of commerce, labor)*

  - *HEMTEKS -- two people (labor economics)*

Review of Presentations - Government participation

- Government participants seemed to have limited understanding of what was going to happen next

  "Government will review presentations and decide."

- Companies were quite frustrated with the lack of government participation
  - *Need protection from creditors, release of blocked funds, assistance shedding labor and working capital*
  - *Management is focusing on immediate needs*
  - *SRP plan appeared to have been poorly communicated to SRP participants*
  - *Some companies apparently did not know about debt moratorium*

    How long it is to last
    What debt will it cover
    What happens after the moratorium ends

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Review of Presentations - Acceptance of our work

- I believe that our presentations were well received.
  - *Government representatives seem very appreciative of the work we had done and appeared to understand our conclusions and the reasons for them.*
  - *Company representatives supported our conclusions for the most part*
    - ◊ Usually only disagreeing with the number of employees to be shed
    - ◊ Steel company management appeared to be putting up "token" resistance, arguing about the availability of Ukrainian slab and inexpensive energy.

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Review of Presentations- Concerns expressed during the presentations

- Companies saw many regulations impeding success
  - *DM 50,000 asset sale limitation*
    "Need government approval and proceeds go to the government"
  - *Inability to sell vacant land in cities (evidently government owns land in cities but not in countryside and business can only sell rights to use building on city land)*
  - *Most problems will not surface until implementation attempted*
- Role of SOK
  - *Needs to support restructuring*
  - *Need to free blocked funds*

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Review of Presentations - Concerns expressed during the presentations

- Management's freedom to act
  - *Management elected by worker councils*
  - *Decisions can be over ruled by board dominated by worker council*

    "They can reverse our decision to fire a specific employee"

    "The government must pass a law protecting for three years"

- Politically sensitive issue of labor shedding
  - *Company management understands the need to reduce labor, but feels that it can not go it alone.*

      "How do we convince the employees that it is in their interest to reduce costs?"

      "How do we convince redundant employee-shareholders that the value of their investment in the company will increase if company productivity improves?"

      "We don't have any examples to point to."

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Review of Presentations -Concerns expressed during the presentations

- Capital required

  "Where will the money come from?"
  "What has to be done to get it?"
  "Will it come in time? We have working capital needs now"

- Technical assistance

  - *Most of our companies acknowledged need for technical (principally marketing and modern "methods" knowledge) and financial expertise. Even the Steel company suggested that help may be needed to sell assets.*

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Personal Observations

- Momentum seems to be flagging
    - *Could just be election distraction*
    - *No one seems to understand what happens next.*
- Need an overall, cohesive plan of action or "road map"
    - *So that everyone is working towards a common goal.*
        - ◊ Companies
        - ◊ Government
        - ◊ Funding agencies
    - *Companies need to know what is expected of them, when and what they can expect in return.*

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Personal Observations

- Plan
  - *What is needed, such as*:
    - ◊ Rules for shedding labor
      - Criteria for deciding who goes, who stays
      - What benefits do they get
      - Length of notice period (the current law apparently requires six months)
      - Are the rules enterprise specific or industry specific

        Petroleum industry has evidently worked out industry-wide criteria for deciding who goes

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Personal Observations

- Plan (continued)

  - *Rules/organizations for reviewing management decisions or replacing management.*

    ◊ With additional capital and good management many of these enterprises can be saved

    ◊ Three of the four possible survivors from our lot will probably die without technical assistance.

    ◊ Management needs freedom to act
    What regulatory changes are needed?

    ◊ Who can replace management, if it is not doing a good job?

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Personal Observations

- Plan (continued)
  - *Rules to work out existing SRP enterprise debt*
    - ◊ Who decides how much they can afford?
      What percentage of future cash flow must be reserved for existing debt obligations?
    - ◊ Who legitimizes the companies release from existing debt that cannot be repaid?
    - ◊ Who decides what they are given in return?
      Equity position?
      Company board representation?

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Personal Observations

- Plan (continued)
  - *Priorities and task relationships -- what must be done first before we something else?*
    - ◊ Technical assistance and new capital should come after labor shedding has been worked out
  - *What is going to happen when?*
  - *Who is going to do it?*
    - ◊ Who provides assistance to the companies, for how long, how frequently?
    - ◊ Who advises the government, creditor committees?

Personal Observations

- Plan (continued)
  - *Who is going to fund it?*
    - ◊ Severance payments
    - ◊ Payments to redundant employees during severance period
    - ◊ Working capital
    - ◊ Technical assistance

Personal Observations

- Need to give management authority to act
  - *Need protection from worker councils*
  - *Technical assistance will not be effective unless management or a creditor board can make authoritative decisions*
- Need working capital
  - *Little domestic capital to purchase assets in liquidation.*
  - *SRP companies have bled to the point that working capital is needed to keep them going*
  - *Funds from asset sales and funds freed as the result of creditor protection and cost reductions are not enough in most cases.*

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Opportunity

- Create a fund to provide working capital or to replace working capital loans from the government
  - *Possibly using seed money from EBRD or IFC*
  - *Open to all*
    - ◊ Macedonians
    - ◊ Foreigners
  - *Provide debt or equity capital*

Opportunity

- By offering to provide capital, FUND could require company or governmental action

  - *Labor shedding*
  - *Board position for Fund and possibly other creditor representative*
  - *Acceptance of technical assistance by management*
  - *Quick removal of other impediments to restructuring and privatization*
  - *Regulation granting priority claim to Fund investment*
  - *Regulation allowing Fund or creditor committee to select/replace management (eliminating worker council influence)*
  - *Standard prospectus information*
  - *Standard financial reports, including accounting policies*
  - *Etc.*

Opportunity

- Professional management of the FUND, including a free hand to choose investments and methods of investing would possibly lead to:

    - *A belief by the populace that the FUND is a good investment, possibly repatriating Macedonian funds currently abroad.*

    - *An informed populace by publishing reasons for accepting or rejecting investments.*

    - *An informed populace by publishing financial information on companies that the FUND has invested in.*

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Opportunity

- Technical assistance could be provided to companies to prepare company plans, prospectuses, convert financial statements; or to train Macedonians to do so

- Problems:

    - *Length of time required to develop the FUND, possibly 12 months, and time needed to remove impediments to FUND investments*

        ◊ Companies working capital needs are more immediate
        Government could provide short-term funds

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Opportunity

- Problems (continued):

    - Fund could replace government short-term money

        ◊ Might encourage rapid action to insure FUND will invest when formed.

  - *Possible desire of the Government to control FUND*

    - Limiting effectiveness.
    - Raising risk, reducing inflow of capital.

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Work Plan

- Prepare a “high-level” plan or “road map” including:
  - *Discussion of lessons learned*
    - ◊ From SRP work so far.
    - ◊ Implementation problems encountered in other Central/Eastern countries.
  - *Sets out*
    - ◊ What needs to be done (i.e. create creditor committees, pass regulations granting new bankruptcy capital first claim, etc.)
    - ◊ Priorities and task relationships
    - ◊ Possible schedule

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Work Plan

- Present action needs to Macedonian Government

- Work with the Macedonian Government and lenders to develop detailed plan that covers all the main restructuring issues, including:

  - *Implementation plan*

  - *Responsible parties*

  - *Funding sources*

- Work with EBRD and other capital sources to create a FUND.