

**STRATEGY PREPARATION FOR PRIVATIZATION OF
LARGE INDUSTRIAL ENTERPRISES OF AZERBAIJAN REPUBLIC
INSTITUTION BUILDING TECHNICAL ASSISTANCE, LOAN NO. 27690AZ**

COMPANY PROFILE – JSC “AZERSHIN”

June 2003

Contents


Abbreviations

1. Overview of Business and Operations

2. Reformatted Financial Statements

3. Financial Performance

4. Pricing Analysis



The content of this report is subject to and does not override the terms and conditions of our appointment as set out in the Contract of February 17, 2003.

ã Ernst & Young 2003



ABBREVIATIONS

ABBREVIATIONS

AZM	Azerbaijan Manats
USD	United States of America dollar
WIP	Work-in-Progress
Q	Quarter of the year
The Company	Joint Stock Company “Azershin”
EBITDA	Earnings before interest, tax, depreciation and amortization
K	Thousands
B/S	Balance Sheet
P&L	Profit and Loss Statement
AGAAP	Azeri Generally Acceptable Accounting Principles
FSs	Financial Statements
IAS	International Accounting Standards
GOA	Government of Azerbaijan Republic
IVS	International Valuation Standards
MED	Ministry of Economic Development of Azerbaijan Republic
MoL	Ministry of Labor of Azerbaijan Republic
SWOT	Strengths, Weaknesses, Opportunities and Threats
TOR	Terms of Reference
GBV	Gross book value
AD	Accumulated depreciation
NBV	Net book value

Overview of Business and Operations

General

JSC Azershin was put into operation in 1959, which makes it one of the oldest tyres production factories on the territory of the former Soviet Union. Previously JSC Azershin played very important role in the industry by supplying major agricultural machinery producers across former Soviet Union with tyres of different size and specifications. Orders were increasing over years stimulating expansion in the production facilities and human resources. At its peak of production more than one and a half million tyres were produced and shipped to destinations in former Soviet Union, including Russia, Ukraine, Uzbekistan, Moldova, and to foreign destinations, including Iran. At its maximum capacity JSC Azershin employed over three and a half thousand of employees to meet the orders.

Shortly after collapse of the Soviet Union production of tyres at JSC Azershin has gradually reduced and came to its complete stop in the end of 1996. Markets were lost due to disintegration of contractual relationships with the customer base, reduction in manufacturing of agricultural machinery, cessation of centralized orders, replacement of rubles with new illiquid currencies. Over two thousand employees have been terminated, the remaining employees were sent to unpaid leave. Currently, the factory is producing immaterial amounts of rubber-made industrial and consumer products employing services of some one hundred people. According to the management, current production utilizes less than one percent of total capacity of the Company and is considered as temporary solution to keep those few qualified people involved and factory operating.

Plant and equipment

Based on our discussions with the management and our own preliminary assessments, most of the equipment and facilities are obsolete and require replacement. Please refer to pictures attached to our report that have been taken during our site visits.

The production area of the Company is little over one hundred thousand square meters and it includes the following main facilities:

- main production workshop;
- engineering workshop;
- warehouse;
- compressor area; and
- repair and construction workshop

In addition to the production facilities the Company maintains on its balance sheet certain facilities of social nature. JSC Azershin used to maintain various assets of social nature on its balance sheet, including day cares, hostels and summer camps. Following Presidential decree day cares were transferred to the balance sheet of the Ministry of Education. Of five hostels, four remain on the balance sheet of the Company; they are being occupied primarily by workers and refugees. Summer camp located away from the Company is also being occupied by refugees.

Historic and current output

Historically, JSC Azershin specialized in production of tyres for agricultural machinery. JSC Azershin played very important role in supplying agricultural industry with tyres of various size and modifications. Increasing orders were part of the state program and stimulated the boost in factory capacities. According to the management, peak production was 1.5 million tyres per year. In addition to the tyres for agricultural industry, JSC Azershin produced smaller size tyres for sports motorcycles and beginning late 1990 early 1991 put into operation additional line for production of tyres for passenger cars. Approximate distribution of output for the year of 1991 follows:

1. OVERVIEW OF BUSINESS AND OPERATIONS

Table 1: 1991 output distribution (%)

Year	1991*
Agricultural	70%
Passenger	16%
Motorcycles	14%

*Source: Management of JSC Azershin.

The production technology at the Company is such that use of equipment and facilities becomes not feasible at output levels below certain volumes. After collapse of the Soviet Union and loss of traditional markets the output of the Company had gradually decreased to the levels below that level when use of production facilities and equipment is not feasible.

Currently, JSC Azershin produces various simple to produce items by utilizing less than one percent of its overall capacity. The items being produced include padding, shoe soles, automobile pads and row rubber. The output is being sold locally to private firms. In 2002 total sales amounted to 428 million mantas (approx. USD 87 thousand).

Major Suppliers

Supplies of raw materials were and continue to be predominantly from outside of Azerbaijan. According to the management of the Company, over ninety percent of components are imported from Russia, Kazakhstan and Ukraine. Current overproduction of supply materials on the territory of former Soviet Union provide tyre producers with significant negotiating power. The management, however, understands that such overproduction may lead to the economic distress and consolidations in the supply industry and market price corrections for the supplies to the tyre producers.

At its maximum production capacity, JSC Azershin used approximately 100 tonnes of raw materials per day. Currently, supplies do not exceed 250 tonnes per year.

Geographical Markets

JSC Azershin used to sell its products to manufacturers of agricultural machinery across former Soviet Union. Some of the output was sold to foreign destinations.

After disintegration of the Soviet Union followed by the years of economic turmoil and downturn in the markets, the Company failed to preserve its competitive power in hyperinflationary environment which completely diluted the working capital, led to losing the position on the market and, finally, ceasing operations.

Current market opportunity

Adverse economic conditions in the agriculture industry, spare tyre production capacities and competitive environment in the traditional markets, and negligible demand for tyres in the local agriculture industry offer little hope for the Company to regain its market shares. The management is rightfully convinced that for the Company to rebound it should look for opportunities outside of the agriculture segment of the market.

The local replacement passenger car market is the largest segment; passenger cars account for over 75% of the total park of motor vehicles in the country. We will restrict our analysis to Azerbaijan market, as we believe it is unlikely that the Company will be able to sell to highly competitive Turkish, Middle East or CIS markets.

1. OVERVIEW OF BUSINESS AND OPERATIONS

Table 2: Park of motor vehicles in Azerbaijan (units)

Year	1998	1999	2000	2001
Passenger	281,320	306,933	332,026	342,958
Busses	13,666	14,941	16,756	17,275
Trucks	79,934	69,685	78,566	77,142
Other	27,140	27,011	19,667	20,986
Total	402,060	418,570	447,015	458,361

*Source: State Statistics Committee of Azerbaijan Republic

Tyres are imported into Azerbaijan from various locations. Major supplies are from South Korea and Russia, they are firmly positioned in the low price segment (below US\$40) and together they account for over 60% of the local market. Approximately 10% of the market are cheap second hand tyres imported from Western Europe. Their share has been, however, deteriorating over the past years. The high price/quality segment (US\$40+) is represented by top players, including Goodyear, Bridgestone, Michelin, Pirelli, Sumitomo and Continental produced in Turkey, Indonesia, Malaysia, etc.

The information on sales of tyres in Azerbaijan is not readily available. We estimate that the total market is approximately 600,000-700,000 units. Our estimate is based on the assumption that consumption of tyres in Azerbaijan per motor vehicle is similar to the one in Russia, i.e. approx. 1.5 tyres/year/automobile. This gives the market estimate at US\$15-21 million with the average price of US\$25-30 per tyre.

Industry Overview

The opportunity to gain any significant share of the local market is very difficult to achieve. Competition from South Korean and Russian low price manufacturers offers little room for the Company's profit margins. There are many other companies with substantial economies of scale that would be willing to target the market.

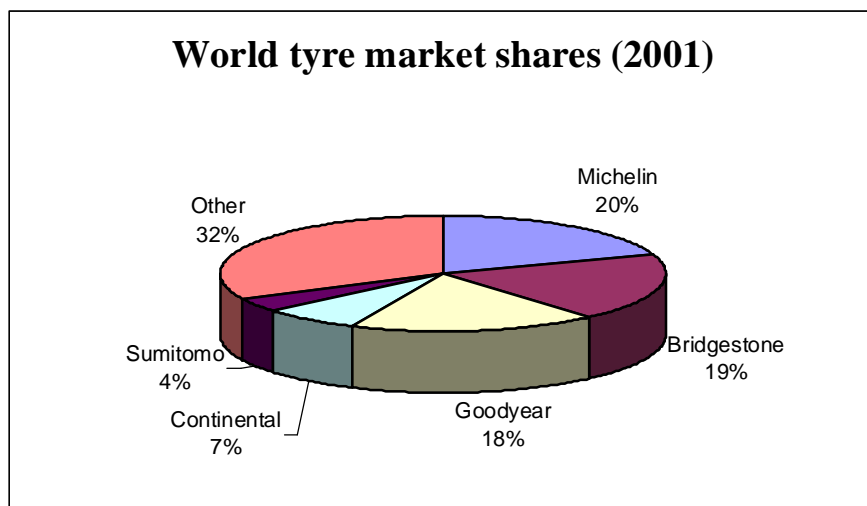
- **Russia.** There are thirteen separate tyre plants in Russia which are expected to gain competitive advantage through consolidations and vertical integration;
- **Turkey.** Facing fierce competition from low cost manufacturers at home, Turkey-based producers (Brisa Bridgestone, Goodyear, Petlas) have to look for the opportunities outside of their local market.
- **South Korea.** Korean producers (e.g. Kumho) emerge as strong competition in the low price segment of the market.

World's top five tyre manufacturers, including Michelin, Bridgestone, Goodyear, Continental and Sumitomo have presence across Eastern and Central Europe with plans to expand to Russia, home to the largest consumer base in the CIS. While in the early 90es majors entered these markets through joint ventures and acquisitions of brown fields, current trend on the national markets is to build new plants.

The world's largest tyre producers (Goodyear from the US, Bridgestone from Japan and Michelin from France) moved into Eastern Europe, drawn by low labour costs (important, because of higher labour intensity), by the geographical closeness to newly established car manufacturers and by a potentially growing number of customers. Foreign investors concentrated on the production of cheap tyres in order to fend off price competition from Asia and Latin America. The most important target was Poland, with its largest and most dynamic car market in Central and Eastern Europe. Countries of smaller population and markets, such as Bulgaria (population of 8.2 mil. in 2000) and Hungary (10 mil.) were not able to attract foreign investment in the tyre industry. However, Slovakia (5.4 mil.) and Slovenia (2 mil.) have been able to attract Continental and Goodyear to produce tyres at cheaper cost than at their western plants.

1. OVERVIEW OF BUSINESS AND OPERATIONS

Graph 1: Top five tyre manufacturers



Source: "Tire Business," Bloomberg Financial Markets, Michelin and Deutsche Bank

Investment requirements

It is clear that the Company requires replacement of most of its equipment and significant repair works of the production facilities. The existing equipment has not been maintained for many years and it is technologically outdated. The management of the Company believes, however, that some major elements of the existing equipment may be refurbished at minimum cost and used for production.

Based on our discussions with the management, the Company investment requirements may be as low as 100 thousand to launch the small size production facilities and up to 50 million to clean up the territory and replace outdated equipment.

Privatization developments

According to the law on privatisation, employees are allowed to buy out 15% of shares at discounted price, however, only 3% have been acquired by the

existing and former employees of the Company. Such trend is common among other state-owned enterprises undergoing through privatisation.

As for the remaining state-owned shares in the Company, the management believes the most appropriate method would be the one that would require the acquiring party to meet specific investment targets leading to rehabilitation of the Company and recreation of work places. Prior to its privatisation the Company requires significant restructuring, including removal of excessive, non-core and social nature assets, restructuring and transfer of debts off the Company's balance, etc. The management believes that minor investments are required. Support of the Government, tax exemptions, and temporary protection against imports are, however, important prerequisites of investor interest in acquiring the Company.

According to the management a number of foreign investors have expressed their initial interest in the past in the Company. These include Turkish producers Lassa and Petlas, Japanese Mitsubishi, Russian Sibur and Titanik.

Organizational Structure, Management and Labour

While gradually reducing its output to becoming practically inoperative the Company shed over ninety five percent of its labour force since collapse of the Soviet Union and is currently employing services of some one hundred employees among which some sixty are being involved in filling sporadic orders for simple to produce consumer and industrial products. The remaining are being employed at premises of social nature, including hostels and summer camps. The following table demonstrates sliding dynamics in the labour resources of the Company:

Year	1991	2000	2001	2002
Total (including on unpaid leave)	3,000*	1,045	929	872
On payroll	3,000*	300	230	107

* approximate numbers provided by JSC Azershin Human Resource Dept.

According to the management, low pay and harsh working conditions have been the reasons for employees to look for opportunities outside the Company.

1. OVERVIEW OF BUSINESS AND OPERATIONS

According to the management, the Company pays salaries to the payroll employees on time. Currently, average monthly salary at the Company is AZM 200,000 (approx. USD40). Payments are, however, outstanding to certain groups of former employees, including the ones on unpaid leave and those who have been injured at the Company (please see additional discussion below).

The organization structure that was presented to us by the management of the Company represents a historic depiction of the management system that used to be in place at the Company but is currently not of meaningful substance.

JSC Azershin maintains records of 134 former employees who were injured at work and therefore eligible for regular compensation by the Company. As per management, the Azeri law requires monthly payments of AZM 353,000 (approximately USD 70) to such individuals. The Company, however, pays only a fraction of such obligatory payments.

Trade Union is not active at the Company.

SWOT Analysis

Strengths

The management considers the following as strengths of the Company:

- The Company is the only tyres production factory in the Caucasus and is positioned to penetrate local market and the markets of neighboring countries.
- Overproduction of supplies in the region provide opportunities for low cost supplies.
- In addition to low cost supplies, cheap labor resources may put the Company in a competitive advantage.
- The Company is conveniently located in the industrial part of Baku and has an access to major infrastructure.

Weaknesses

- The domestic tyres market is relatively small to penetrate and may prove to be not sufficient to support the restart of the Company. Historic production capacity of the Company is significantly higher than domestic market requirements;
- The Government does not extend sufficient support for recovery of the Company through tax holidays and protectionism against imports;
- New technologies and equipment are required to produce tyres of reasonable quality;
- Production of tyres involves processes which are dangerous and harmful for health of employees. Early retirement and special food treatment are required with use of existing old technologies.
- Most raw materials must be imported from abroad, as they are not available in Azerbaijan.

Opportunities

- Tyres production industry is a growing industry across CIS.
- The management of the Company believes that a number of opportunities exist for gradual recovery of the Company. First is restructuring and downsizing of the Company to produce smaller volumes of output and focusing on retreading segment. The management estimates less than 100 thousand dollars would be required to implement this short-term alternative;
- The Company requires minimum state support to be able to bid for the lucrative contracts in the oil and gas industry. The management has brought construction of the oil pipelines as an example of such supply opportunities for the Company;
- Management sees the Company as an effective competitor in supplying tyres for regular and heavy load vehicles.

1. OVERVIEW OF BUSINESS AND OPERATIONS

Threats

- Existence of world major tyre producers in neighbouring Turkey and their entrance in CIS markets (e.g. Russia) threatens to put Azershin in an increasing competitive environment.
- Reducing number of qualified employees. Tyres production is a complex industry that requires specific qualification workers.
- The management estimates the threat of mandatory payments to injured individuals exceeding AZM15 mil. as minimal.
- According to the management, Government sets unrealistic valuation targets for the Company sale through privatization.

**Additional information and data including Reformatted Financial Statements and Financial Performance materials are available upon request.
When writing to AIPAF please provide a short background on your company activities and plans about the project.**