

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

COMPANY PROFILE – JSC “BAKKOND”

June 2003

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The contents 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

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AZM	Azerbaijan Manats
USD	United States of America dollar
WIP	Work-in-Progress
Q	Quarter of the year
The Company	JVC “BAKKOND”
EBITDA	Earnings before interest, tax, depreciation and amortization
K	Thousands
B/S	Balance Sheet
P&L	Profit and Loss Statement
FCST	Forecast
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 Labour of Azerbaijan Republic
SWOT	Strengths, Weaknesses, Opportunities and Threats
TOR	Terms of Reference
US GAAP	US Generally Acceptable Accounting Principles
GBV	Gross book value
AD	Accumulated depreciation
NBV	Net book value

Overview of Business and Operations

General Background

Joint Stock Company “Bakkond”, set up in 2001 as the successor of the former state owned “Baki Conditioneri”, used to be the single and the largest manufacturer of household air conditioners in the former USSR.

Designed to accommodate the Japanese Hitachi technology, the production facilities, built within 2,5 years’, were put into operation in 1975 with an annual production capacity of 400,000 window-installed units of 6,000 and 10,000 Btu/hr. The production complex was intended to be the sole centre of household air conditioning in the USSR.

The full-cycle production was picking up fast growing on vast spreading demand for conditioned air supply both from the state organisations and private house holdings. The designed production capacity was as early as in 1980 paying back the investments of over \$200 million made in the project.

Since 1981 and until 1987 the company produced 430,000 units annually with around 30% of the output exported to over 60 countries across the globe. The management data says that the company’s production accounted for somewhat 40% of the total Australian market throughout the 80-s. Other import markets included Italy, China, India as well as the countries of former socialist camp – Hungary, Poland, Angola, Cuba, etc.

In the 80-s “Bakkond” was ranked the 4th largest producer of the household air conditioners in the world.

With above 50% of the components imported at the start of production, the company managed to master production of those components locally within a very limited timeframe.

Unprecedented design of the production complex allowed producing an end-user product from pure raw materials. All value-added components were produced on site.

Such an approach contributed to the enhanced profitability of production and sales, which was recorded to as high as 25-30% driven by the unsatisfied demand in the vast markets. The majority of customers though were the state organisations funded through the budget subsidies.

The company developed the service shops network that covered over 200 cities of the former Soviet Union providing the customers with the convenient and comfort maintenance and after sale support. This contributed to the “BK” brand to be the brand of choice for the majority of purchasers throughout the USSR in 80-s.

Starting its operation under the licence agreement with Hitachi providing specification for only 2 types of window installed conditioners, the company invested heavily in R&D activities which allowed to expand the product range to over 70 modifications most of which are still in-built window installation units.

By mid 90-s “Bakkond” lost most of its markets and ceased production except for making limited lots of goods on an ad hoc basis.

Plant and equipment

The state is currently seeking for an investor willing to buy the state’s shares and to invest in “Bakkond” either to develop the core business or alternative activities by utilizing the existing property, plant and equipment. These include a 34 ha plot of land in the industrial area of Baku, which houses production and office property of over 80,000 square meters. The production facilities are comprised of:

- à Assembly lines
- à Mechanical workshop

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- à Pressing and welding workshop
- à Metal smelters workshop
- à Electric motors workshop
- à Maintenance and repair workshop
- à Office, recreational and catering buildings
- à Water reservoirs
- à Compressed air station
- à Service pipes network
- à Steam generator

The Company does not currently own the land. However, under the privatisation law, the investor will have the pre-emptive right to purchase the land plot¹ or arrange for a long-term lease arrangement and make use of the company's property and other assets as per the investment programme.

Geographical Markets

For about two decades the company was delivering its products to various and vast markets across the globe especially to those where the political regimes were friendly to the Kremlin. It enjoyed the benefits of being a monopolist in Russia, other republics of the former USSR and socialist states in the Central and Eastern Europe. It also managed to expand significantly into Australian market, China and Africa.

The total of 7.5 million air conditioners were produced by Bakkond since the start of production, of which 20% were imported outside the CIS. One million units are reported to be installed within Azerbaijan.

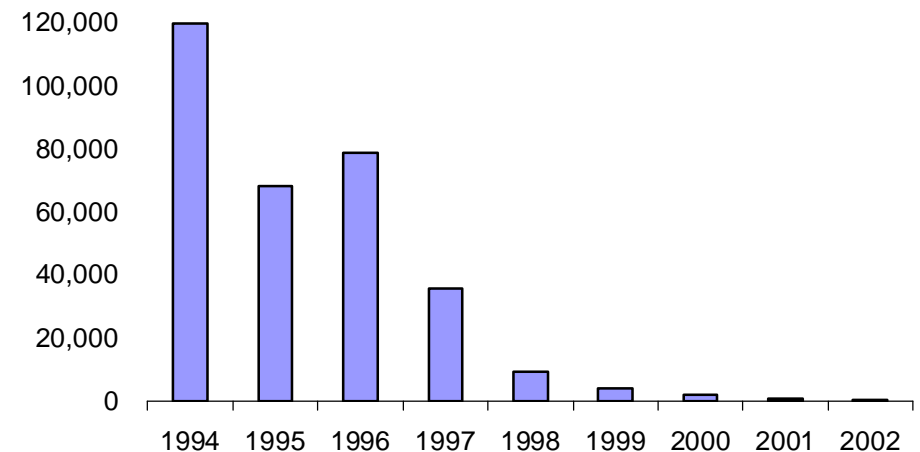
The former Soviet planned economy system allowed "Bakkond" to enjoy a number of competitive advantages over western manufacturers. Those included for instance the unattainably low production costs as the labour and raw materials were subsidised by the state budget. Also, the state offered distribution back up and guaranteed orders flow. For years this let the

company operate above the designed capacity without paying attention to or investing in developing marketing capabilities, new product development or production facilities upgrade.

Low product price and maintenance costs coupled with the state distribution support and protectionism against the imports paved Bakkond's air conditioners an easy-to-go way into the markets across 60 countries worldwide.

However, the collapse of the Soviet Union followed by the lengthy and painful process of transition to the market economy had a non-healing impact to the company's market position. The inflated prices for the raw materials, disintegration of business ties and consequently the disruption of supply and distribution resulted in an abrupt spin of the output volumes and a severe drain on cash flows. Within the first five years of 1990-s production fell by over 80% and kept declining thereafter sharply to stabilise at 1,000-1,500 units per annum in the past three years. The graph below illustrates the production data provided by the company's management.

"Bakkond" output dynamics (in units)



¹ Except for foreign investors who are restricted to buy land in Azerbaijan

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“Bakkond” used to generate a significant portion of its revenues and profits from servicing and maintenance activities via a network of repair shops and service centres in hundreds locations in Russia and CIS countries. The company, however, lost control over its service and maintenance network over a decade ago. Since then “Bakkond” has not received any significant orders for spare parts or professional services neither from outside Azerbaijan nor from the local market.

The modern market trends show that the split and floor-based air conditioners enjoy greater and growing popularity among the consumers as compared to window installed ACs (WIAC).

Current Market Opportunities

On the other hand, less expensive WIACs remain competitive on the markets with low disposable income of population such as Azerbaijan. The management assesses the total annual capacity of Azerbaijan market for household air conditioners at 12,000 units with the WIAC’s share to be 35-37%. This however, includes WIACs with airflow parameters that exceed those of “Bakkond” products. There is a window of opportunity for “Bakkond” though to increase its market share in Azerbaijan provided there will be financing available to increase production up to 2,500 – 3,000 units per annum which should cut the cost of production and make the price more attractive to the potential buyers. This opportunity though is only short-term and should be used to enter the market segments where the growth is sustainable in the longer term, i.e. split and floor based types of air conditioners. The most viable option for this strategy would be assembling of the imported SKD components under “Bakkond” brand.

Industry Overview

As per the management data the global market for household air conditioners is seen growing at a pace of 5% per annum in the foreseeable future. Some regional markets demonstrate even higher growth in demand for household air conditioners such as China, Russia and many CIS countries. This makes the

industry very competitive and requires the technology innovations, exterior design improvement and expanded functionality of the device to be the key factors to allow products to compete successfully on the market.

Competition in the industry in the past decade has led to a significant advancement in consumer quality and affordability of household air conditioning appliances.

The world’s leading manufacturers of air conditioners built their success on new production technologies that incorporate sophisticated supply and delivery logistic systems. This allows to arrange production within the growing market, to cut transportation costs and import duties and, finally, to offer better prices.

Privatization developments

In 2001 the company underwent the first privatisation phase. “Bakkond” was turned into a joint stock company with as much as 15% of the shares offered to the company’s employees to purchase. Out of this amount only slightly above 30%, or 5.54% of the total company’s shares, were paid for by 1,317 employees with the privatisation coupons. The remaining 9.46% of the shares were added to the state’s stake, which now accounts for slightly above 94%.

From our interviews with the management, we learnt that some several years ago the company was approached by a strategic investor, an American manufacturer of air conditioners, who explored an opportunity of setting up a joint venture with “Bakkond”. The negotiations although ended with no results.

Talks with Toshiba Corporation regarding the establishment of the SKD-based production of modern types of Toshiba air conditioners were no success either as the parties failed to find a compromise solution on the joint marketing and sales strategy.

Negotiations with a number of other potential strategic investors/partners failed to develop further after the state’s refusal to provide the investors with the state guarantees to mitigate the investment risks.

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For the privatisation of the Company to be successful, a number of restructuring and value enhancement measures need to be taken by the Government. These include restructuring and revaluation of the Company's assets and liabilities, application of tax exemptions, provision of financial support, etc.

Management plans

The company has developed a business plan for the period of 2003- 2005 aiming at boosting production to 20,000 WIACs and SKD split-type devices in the next three years.

The plan calls for attracting a bank loan in the amount of \$2.9 million and at a cost of 7% per annum. The loan is planned to be used to cover:

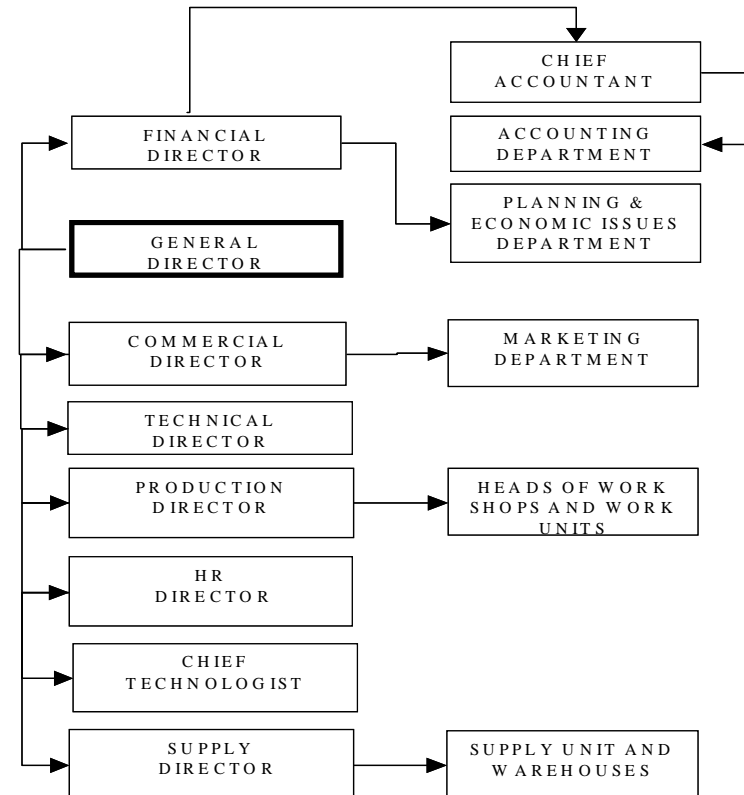
1. production launch costs
2. purchase of SKD components
3. marketing and promotion expenses

Under the production and sales plan the borrowed funds will allow producing 10,000 WIACs and 4,000 split-systems in the first year and as many as 20,000 WIACs and 20,000 split systems during the third year of the project.

Taken into account that no calculations regarding costs of production, working capital needs, profits and cash flows were provided to us, we are not able to comment on the viability of the management's plans. It should therefore be noted that such calculations are to be produced, discussed and assessed by an investor or an independent consultant base on the reliable and adequate market information that is missing in the business plan.

Organizational Structure, Management and Personnel

The organizational structure of the Company is as follows:



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At the peak production the Company used to employ around 7,500 labour, managerial and administrative staff. It currently employs 1,200 people, of which only 250-300 is on the payroll list. Others are on non-paid leave for years.

Summary SWOT Analysis

Strengths

The strengths or advantages that “Bakkond” has over other investment opportunities related to the production of the air conditioners are limited to:

1. availability of qualified labour
2. existing products
3. lower start up costs
4. shorter time to production
5. additional cash flow from assets disposal

These appear to be the main factors that could leverage an investment in “Bakkond”. From this perspective teaming up with a foreign manufacturer of air conditioners or components may be considered as a viable privatisation strategy.

The listed strengths though do not seem strong enough to factor those in the market premium for an asset. Taking into account that the cost of establishment of SKD assembly production are fairly low and the requirements for labour qualification are considerably lower than in full-cycle production the leverage effect that the said strengths can produce may not be material.

Weaknesses

The quality of the company’s assets both in terms of physical size and the state of property and hardware is “Bakkond”’s weakest point seen through the eyes of a strategic investor.

It comes clear that the designed capacity of “Bakkond” by far exceeds the current and future demand in Azerbaijan and on the neighbouring markets and thus is not needed. A smaller-scale production of WIACs, leave alone assembling split-systems from SKD components does not require that much brick and mortar and hardware which might cost a fortune to maintain or to get rid of. Unless there is more clarity on timing, costs or additional revenue from the excessive assets disposal, investor’s interest towards this opportunity is unlikely to be inspired.

Opportunities

In the current competitive environment the short-term opportunities for “Bakkond” as a manufacturer of air conditioners are limited unless the state is planning to impose protective measures against the competing products imported from outside Azerbaijan.

The longer-term prospects are linked primarily to the position of management and the state to preserve or not the company’s product specialisation. From this point of view it should be noted that:

1. there is no clear evidence of “Bakkond” products can compete successfully in the WIAC niche in Azerbaijan or neighbouring markets in the future which casts doubts on the company’s growth strategy;
2. the technology which the company uses to produce the products is outdated and needs large-scale investments to upgrade and comply with modern standards and requirements
3. the aging processes in the idle equipment undermine the company’s core strength that is the opportunity to resume production at low costs

Threats

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The key threats to “Bakkond” in its current situation refer primarily to the opportunities that yet remain open to the company. In the first place these include a possibility of either green or brown field projects developments by foreign manufacturers of air conditioning appliances at other premises in Azerbaijan or neighbouring countries.

Others threats include delays in getting approvals/permits from the state authorities with regard to the disposal of assets which do not add value to the target investors.

Ability of the management to attract and develop the alternative businesses, which could accelerate their growth through investment in “Bakkond” assets.

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.