

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

COMPANY PROFILE – JSC “BAKI CHINAR SOYUDUCHULARI”

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 “Baki Chinar Soyuduchulari”
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 Background

JSC Baki Chinar Soyuduchulari was commissioned in 1959 and for a number of years it was the second largest refrigerator plant in the former USSR. To keep up with technology advancements the Company was regularly replacing its equipment and introducing new models of refrigerators. Currently the Company is capable of producing over ten types of refrigerators with capacities varying from 160 liters to 300 liters. Main models of refrigerators are the following:

Household and commercial (glass door) models:

- Cinar-111 (300 liters);
- Cinar-7ms (280 liters);
- Cinar-427 (240 liters)
- Cinar-310

Special purpose models:

- Cinar-280
- SS-240;
- SS-500;
- Cinar-419;
- Cinar-425;

The historic maximum production capacity of the factory was 400,000 fridges a year. Up to mid 1990s the Company supplied its products both inside USSR, including Kazakhstan, Turkmenistan and many other Soviet Republics and outside the USSR to countries like Cuba, Lebanon, Pakistan, etc. The largest output was achieved in 1988 when the factory produced 350,000 fridges.

In 2000 with the initiative and support from the UN all equipment using freon-12 was replaced with the new one using freon-134. The planned maximum capacity of the new equipment is 200,000 refrigerators a year.

Disintegration of the Soviet Union and Karabakh war led to gradual setback in production with output dropping to 100,000 fridges in 1992 and 25,000 in 1994, and downtime in 1995-1996. However, the management has put a lot of efforts to rehabilitate the plant, and, installation of the new equipment in 2000 gave the Company a competitive advantage.

Plant and equipment

The overall territory of the factory is 8.6 hectares and includes 6 production areas and 3 service areas.

Six production areas are the following:

- 1 – Assembly shop;
- 2 – Machinery hall;
- 3 – Stamping-welding shop;
- 4 – Plastic molding shop;
- 5 – Painting / polymerization shop;
- 6 - Polyurethane foam shop.

Besides, the Company has three service areas including:

- 1 – Tool-room;
- 2 – Mechanical workshop;
- 3 – Electrical workshop.

Most of the equipment is up-to-date, in good condition and meets international standards. In 2000 large part of old equipment operated on freon-12 was replaced by the UN. The value of the newly installed equipment is approximately USD 2.5 million. According to the management, not more than 30% of the existing equipment may require renewal.

In addition to production areas the Company has the following facilities:

- Administrative building;
- Two transformer substations;
- Canteen;
- Heating unit;

1. OVERVIEW OF BUSINESS AND OPERATIONS

- Compressor room;
- Wearing parts warehouse;
- Chemicals warehouse;
- Oxygen storage room;
- Gas storage / metal structures warehouse;
- Noncombustible waste storage;
- Two water tanks;
- Conveyor;
- Railway branch;
- Parking lot.

During site visits it was revealed that factory buildings require repair, but the management has not yet estimated the repair costs.

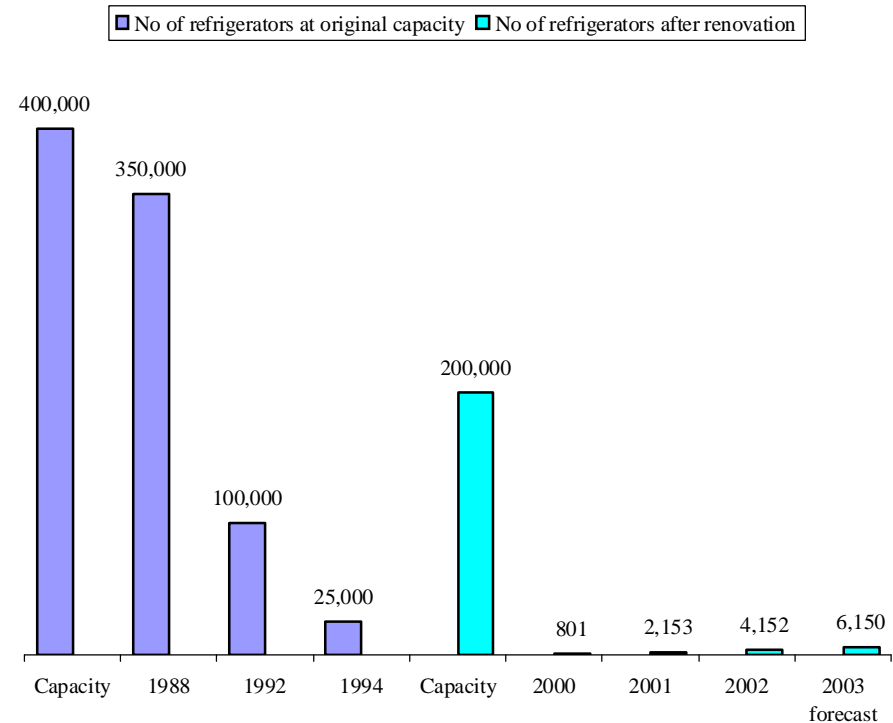
Historic and current output

The Company was put into operation in 1959 to produce at its full capacity a variety of refrigerators. The maximum historic capacity and the actual production are as follows:

Table 1: Historic and current output

Product groups	Original Capacity	1988	1992	1994	Capacity after renovation in 2000	2000	2001	2002	2003 forecast
No of refrigerators produced with original capacity	400,000	350,000	100,000	25,000	200,000	801	2,153	4,152	6,150

Graph 1: Historic and current output



The output was steadily increasing during 70s and 80s and the maximum production was achieved in 1988. Although in the former USSR placement of orders among similar enterprises was centralized, the Company has always been known for good quality of refrigerators produced and had an advantage of closer location to markets of Southern Russia, Kazakhstan, Turkmenistan, Georgia and Armenia where there were no refrigerator plants. However, after collapse of the Soviet Union relationships with customers were disintegrated and the Company had to decrease its output and completely stop the production in 1995-1996. Between 1996 and 2000 the Company has mainly performed individual orders from local customers.

1. OVERVIEW OF BUSINESS AND OPERATIONS

In 2000 the large part of the Company's equipment was replaced within the frameworks of the UNEP OzonAction Program and the 1987 Montreal Protocol and the capacity of the plant was reduced down to 200,000 units a year. Since then the Company has been steadily increasing the production output both meeting needs of the local market and obtaining orders from abroad. According to the management 50% of fridges produced in 2002 were sold at the local market while the other 50% were delivered to Kazakhstan under the contract with Kazakhstan private entity.

The breakdown of the recent production output by types of refrigerators is given in the table below.

Table 2: Output by type of model

Type of Refrigerator	Number of units		
	2000	2001	2002
Cinar-111 (300 liters)	187	521	1,464
Cinar-7ms (280 liters)	102	214	179
Cinar-427 (240 liters)	344	1,104	1,652
Cinar-280	1	10	10
SS-500	43	4	150
SS-240	95	8	
Cinar-425	16	133	297
Cinar-111 (glass door)	13	150	171
Cinar-419	-	9	1
Cinar-310 (currently Cinar-520 glass door)	-	-	228

Total	801	2,153	4,152
--------------	------------	--------------	--------------

In 2003 the management plans to exceed the 2002 output by about 50% and find more wholesale customers both in Azerbaijan and other CIS countries.

Total sales for the period from January to October 2002 amounted to AZM 2,474 million (approx. USD 507K). However, currently the Company utilizes only 2% of its planned capacity and according to the management estimates in order to achieve breakeven the Company has to sell 10,000 refrigerators a year.

Major Suppliers

A refrigerator is assembled of 168 components. Most of the raw materials and components are supplied from outside of Azerbaijan, mainly from France, Croatia, Russia, Germany and Turkey. The list of major imported components and raw materials is as follows:

- Evaporators – France;
- Polystyrene – Croatia, Turkey, Lithuania, Russia;
- Polyurethane foam – Germany, Switzerland;
- Paints – Turkey;
- Thermostats – Russia;
- Compressors – Belarus;
- Corrugated boxes (packing) – Belarus;
- Steel and copper pipes and wires – Russia.

Despite the dependence on foreign suppliers the Company is capable to offer refrigerators at competitive prices. According to the management the Company does not have any outstanding liabilities to suppliers and does not have any problems with delivery of imported materials. However, the Company does suffer from lack of working capital available for purchase of raw materials and components.

1. OVERVIEW OF BUSINESS AND OPERATIONS

Geographical Markets

Since commissioning and up to late 80s the Company supplied its products both across the former USSR, in particular to south areas of Russia, Central Asian and Caucasian republics, and outside the Soviet Union, to Cuba, Lebanon, Pakistan and etc.

After disintegration of the Soviet Union followed by the years of economic turmoil and downturn in the markets, the Company failed to maintain relationships with old customers outside Azerbaijan and survived mainly on small individual orders from local buyers.

Currently the Company owns a retail outlet situated close to the Company production facilities and sells fridges to large trading centers at the Baku Airport and near Neftchiler metro station. Besides, in 2002 the Company sold 2,000 refrigerators to Kazakhstan under the contract with Kazakh private entity, and has already renewed the contract with the same Kazakhstan customer and will supply another 2,000 fridges in 2003.

According to the management, refrigerators produced at the plant are capable to compete with similar products of other CIS manufacturers. The only weakness of the Company's products is the inner design of refrigerators. In order to bring the inner design up to modern standards the Company needs replacement of molding equipment.

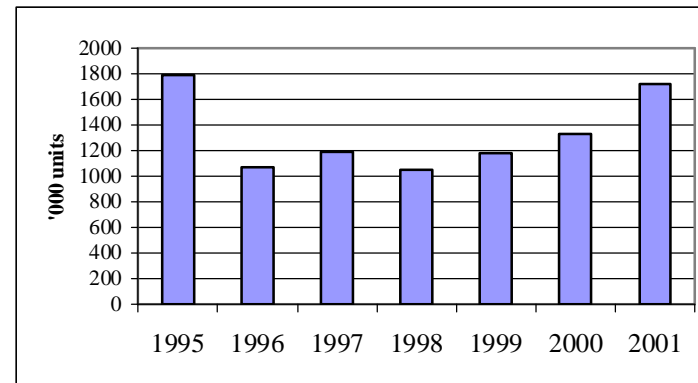
There is no consistent market data for refrigerators across all CIS countries. Thus we will estimate the CIS market based on the available production data. We will restrict our analysis to CIS markets as we believe it is unlikely that the Company will be able to sell to competitive Turkish market or relatively insulated Middle East markets.

Our estimates for the year 2001, based on production and imports data by CIS statistics, is that the market for refrigerators is around 3.4 million units with the average price of US\$210-230 per unit. This gives CIS market estimate at US\$720-800 million. The growth rate is 10-15% a year and our estimate is that

in 2002 the total CIS market was at US\$800-900 million range with approximately 3.8 million units purchased.

We estimate that Russia accounted for about 2 million refrigerators consumed, or more than 60% of total consumption. From these more than 1.7 million units were domestic production, about 20,000 imported from outside CIS and the about 260,000 units imported from CIS countries, primarily Belarus and Ukraine.

Graph 2: Russian refrigerator production

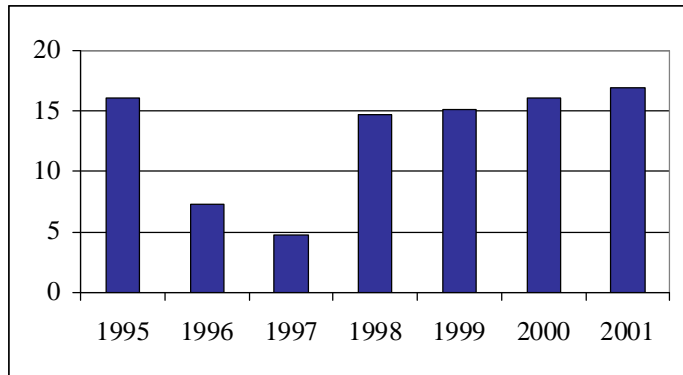


Source: Goskomstat

Domestic Azerbaijan market is quite small. According to official statistics, there were around 17,000 refrigerators bought in the country in 2001. Annual growth rate was about 6% in 1999-2001. It is not clear, however, whether official statistics correctly estimates the market.

1. OVERVIEW OF BUSINESS AND OPERATIONS

Graph 3: Azerbaijan refrigerator consumption



Source: Azerbaijan Statistics Committee

Assuming the figure is true, refrigerator purchase was approximately 2 units per 1000 population in Azerbaijan in 2001, compared to 14 refrigerators in Russia and average 10 for the rest of CIS (excluding Azerbaijan and Russia).

Market opportunity

There is substantial discrepancy between what was produced in 2001 and what the market could consume for replacement of existing units. We have produced the following estimates for the “economic size” of the market.

Table 3: Estimates of “economic size” of the market (2007)

Units	# of house-holds, m	Rfrg/100 house-holds	Total, '000 units	Avg replacement age	Replacements, '000 units	House-hold growth rate	Additions, '000 units	“Economic Size”, '000 units
Azerbaijan	2.0	60	1,200	15.0	80	1%	7	87
Russia	50.0	80	40,000	12.5	3,200	0%	-	3,200
Kazakhstan	5.0	60	2,980	15.0	199	2%	36	234
Other CIS	37.7	50	18,833	15.0	1,256	1%	94	1,350
Total equilibrium consumption			63,013		4,734		137	4,871

Source: Ernst & Young estimates

Referring to the table above:

- We have chosen the year 2007 arbitrarily as the year when majority of Soviet-built refrigerators will go out of order and people who can afford to buy refrigerator will have to purchase one;
- Number of households – estimate based on current data for Azerbaijan, based on estimated household size and population in 2007;
- Refrigerator per 100 households is a very conservative estimate of the number of refrigerators divided by number of households. The assumption is based on penetration rate of around 55% for Azerbaijan and Kazakhstan, around 70% for Russia and around 45% for the rest of CIS (and assumption that approximately 10% of households have two refrigerators). For comparison, penetration rate for UK is 99%, for Turkey – 97%, for the US – 70%, for South Africa – 50%, for India – 10% (as of 1998 data);¹
- Total units – estimated approximate number of working refrigerators outstanding;

¹ Euromonitor, World Market for Household Appliances, October 1999

1. OVERVIEW OF BUSINESS AND OPERATIONS

- Average replacement age (cycle) – 15 years is the longest known replacement cycle (see the table below). For Russia we use 12.5 years – comparable to Brazil or Poland;

Table 4: Refrigerator replacement cycle for major national markets

Country	Years
South Korea	5.5
France	8
Canada, Israel, South Africa	10+
Germany	10.5
UK, Czech Republic, Brazil	12
Netherlands, Spain	12.5
Poland	13
US, Sweden	14
Argentina, India, Italy	15

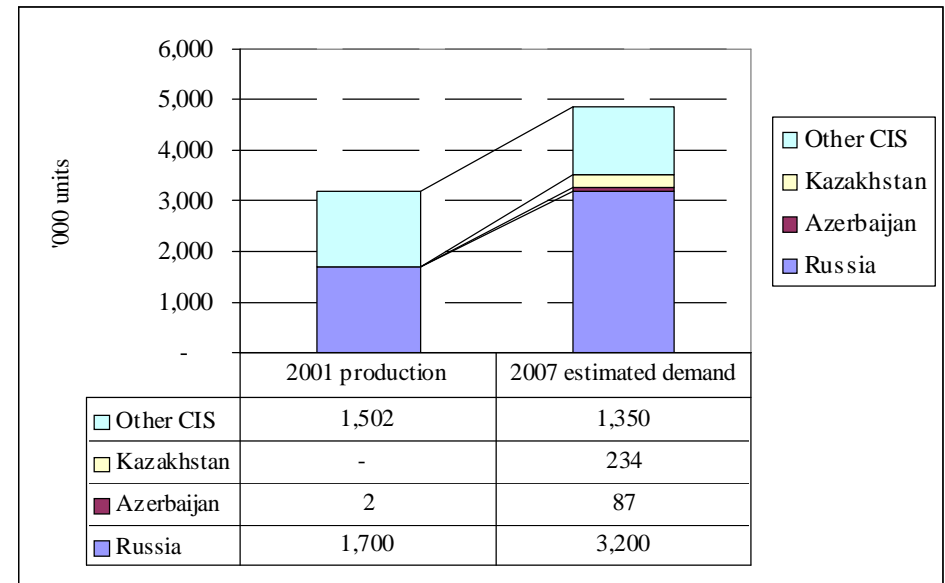
Source: Euromonitor, 1999

- Total replacements – purchases for replacement – estimated number of refrigerators outstanding divided by replacement cycle;
- Household growth rate – estimated annual addition in number of households. Russia’s population is expected to be stable or decline, Azerbaijan population may grow slightly, Kazakhstan population more quickly and other CIS population may drift up thanks to Central Asia countries primarily;
- Additions – new purchases thanks to the growth in number of households;
- “Economic size” – sum of replacements and additions.

As the chart below illustrates there exists substantial “gap” between current of CIS production and “equilibrium” level of consumption – even at its most conservative estimate. Even if official production data is underestimated there is still a room for about 40% production growth.

This gap presents potential opportunity for new entrants. Moreover, our analysis shows that the net “deficit” countries will be Russia, Azerbaijan and Kazakhstan – exactly those to which Baku Refrigerator Plant may have the best access.

Graph 4: 2001 production versus “equilibrium” economic consumption



Source: Ernst & Young estimates

Industry Overview

The presence of opportunity, of course, does not guarantee that Baku Refrigerator Plant will be able to take this opportunity. There are many CIS facilities that will target the same market. Moreover, Western companies may opt to start greenfield facilities if they find no suitable opportunity to buy existing facilities.

1. OVERVIEW OF BUSINESS AND OPERATIONS

- **Merloni/Stinol.** Merloni that acquired Stinol is currently the most visible Russian producer.
- **Nord.** This Ukrainian producer was able to sell substantial amounts to Russia and other countries as well as to domestic Ukrainian market.
- **Minsk Refrigerator Plant** retains high production level.
- **Biryusa.** Krasnoyarsk-based Biryusa is another mid-sized producer supplying primarily Siberia and Urals regions in Russia.
- **Sino,** Uzbekistan-based plant, said it was planning to re-launch production in 2003.

There are several other small and medium producers in Russia and CIS.

International market

In Attachment 1 to this report we attempted to list major known international-level producers that account for a visible share (typically either in top 5 on their regional markets or within top 20 largest international refrigerator producers or both).

Many companies listed there, especially those at the top of the list produce not only refrigerators but many other products. Some of them (like Electrolux, BSH, Whirlpool or Maytag) specialize on “white goods”. Others, like Samsung, LG or Sharp offer wider range of products, including electronics and communication equipment.

Independent specialized refrigerator producers are smaller in size – the largest have revenue of under US\$200 million. The trend on many national markets is to acquisition of large domestic brands by more diversified producer. There are clear synergies in marketing and distribution: most producers market “white goods” brand rather than “refrigerator” brand, all white goods are sold via a specialized department in electronics or household products shops – there are no specialized “refrigerator” shops. There are also certain economies of scale in production.

This means that the most credible long-term plan for the Company is to sell to some foreign company working in white goods or consumer electronics sector.

Management Plans and Investment Estimates

The company has both working capital and long-term investment capital requirements. In order to raise competitive capacity of the products the Company has to replace remaining old equipment and refurbish plant premises. According to the management less than 30% of existing equipment requires replacement and the urgent investments in equipment and refurbishment constitute USD 1,5 million. Short-term working capital investments are also estimated at the amount of USD 1.5 million.

The management assured us that the Company had two scenarios of the two-year business plan, one was for the total amount of USD 3 million and another – for USD 6 million, but due to technical problems with computers they were not able to present these plans to us. Our understanding is that the Company has not developed long-term investment plans through the year 2008. We believe, however, that these plans are of little value and actual investment amounts and production configuration would be determined by the plans of the would-be investor in the company.

Privatization developments

During interviews the management revealed that in 1998-1999 representatives of Korean and German manufacturers visited the Company and expressed an interest in establishing a joint-venture with Baku Refrigerator Plant. However, these were just short discussions that were not continued. After that the Company has not received any offers from investors.

The management believes that the plant may be of interest to investors since most of the equipment is up-to-date and minimal investments are required to make the Company refrigerators fully competitive against similar products of CIS manufacturers.

1. OVERVIEW OF BUSINESS AND OPERATIONS

According to the law on privatization, employees are allowed to buy out 15% of shares at discounted price, however, only 5.27% were acquired by the existing and former employees of the Company. Large portion of the allotted shares has not been purchased, probably, because the Company resumed its operation three years ago only and most of employees are still on unpaid leave.

Organizational Structure, Management and Labour

At the period of high production output the Company hired 3,000 employees. Since early 90s over 70% of employees left the Company. Besides, only 23% of staff registered in the Company's records does actually come to work at the plant. The below given table demonstrates sliding dynamics in the labor force of the Company:

Table 5: Average number of employees and payroll

Year	1980s	2001	2002	2003
No. of employees as per records	3,000	1156	996	867
No. of employees actually working, including	n/a	185	202	196
Workers	n/a	117	133	141
Administrative personnel	n/a	68	69	55
Average salary ('000 AZM)	n/a	n/a	215	258

According to the management, the long downtime when salaries were not paid, low pay and harsh working conditions have been the reasons for employees to look for opportunities outside the Company.

Currently, average monthly salary at the Company is AZM 258K (approx. USD53). For the last two years the Company pays employees' salaries regularly and does not have any outstanding debts on salary payments at the moment.

The Company maintains records of 23 former employees who were injured at work and therefore eligible for compensation by the Company at the rate of AZM 353K (approx. USD 70) a month. The Company makes these payments regularly and does not have any outstanding debts to disabled employees.

Trade Union is not active at the Company.

SWOT Analysis

Strengths

- Growing production volume and sales although from low base;
- Equipment is relatively new and well functioning;
- Production could be boosted with relatively low investment;
- § Established relationships with suppliers of raw materials and components;
- § Availability of qualified labour;
- § Three-year warranty on products and availability of warranty service and post-warranty repair services;
- § Flexibility to consumer demand.

Weaknesses

- Insufficient working capital
- Lost all key markets, including even domestic market. Lack of proper distribution network
- CHINAR is a little-known brand. "Made in Azerbaijan" will not be considered advantage by Russian or CIS distributors
- § Buildings and premises require renovation.

Opportunities

- Azerbaijan market is likely to grow extremely fast in the next five years
- CIS refrigerator market is expanding, in particular Russia and Kazakhstan could present good opportunities

1. OVERVIEW OF BUSINESS AND OPERATIONS

- Consumer credit development in Russia and Kazakhstan may further help sales
- Foreign white goods and consumer electronics manufacturers are increasingly interested in CIS market.
- Foreign manufacturers may seek domestic assembly.
- Limited number of alternative production sites in CIS
- Visible success stories in refrigerator/white goods production in CIS: Nord, Stinol, Atlant.

Threats

- Competition from other CIS producers/sites on CIS markets;
- Competition from greenfield (newly constructed) production sites in CIS;
- Potential protective measures from major potential foreign markets Russia or Kazakhstan.

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.