

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

COMPANY PROFILE – JV “BAKMIL”

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	JV “BAKMIL”
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

Azerbaijan-Italian Joint Venture “Bakmil” was established to be one of the largest producers of universal commutator type electric motors in Azerbaijan and CIS.

The Company was set up in 1988 by the state owned “Baki Kondesioni” producer of air-conditioners, and the Italian “Merloni Progetti”, a consulting and design subsidiary of the Europe’s leading manufacturer of household equipment “Merloni Elettrodomestici”.

The equity capital structure of “Bakmil” is as follows:

State (via “Baki Kondesioni”)	-	69.9%
“Merloni Progetti”	-	30.1%

The Company’s production facilities were designed to manufacture a wide range of electric motors of various application and a number of household appliances including the following products:

- Mixers
- Coffee grinders
- Kitchen processors;
- Meat mincers
- Hand dryers
- Ice cracking machines, etc.

The maximum production capacity of the equipment allows for manufacturing 1,5 million units of electric motors and 700 thousand units of household appliances:

The Company began operational on 15 October 1991 after the completion of the green-field construction of the production property, installation and commissioning of the equipment, which includes European and Russian made machines, automated assembly lines, presses, plastic mill, foundry plastic machine, non-ferrous metal smelter and casting line as well as other service and storage infrastructure. (See Plant & Equipment section for more detail)

The Company’s property is located on a land plot of 24,000 sq.m. adjacent to “Baki Kondesioni” territory and in about 7 kilometres from the harbour and railroad. The property includes:

- production and storage building having the total area of 11,500 sq.m. of which 10,000 sq.m. is usable space,
- six-storied administrative building of 4,300 sq.m. accommodating the Company’s management, accounting, commercial and other units and test laboratories.

As per management discussion the total project costs were in excess of USD 35 million and were financed both from the Shareholders’ funds (USD 9 million) contributed to the charter capital at inception and commercial loans received from a group of European banks (ECU 24 million) against the guarantees issued by the former Ministry of Economy of the USSR. A loan of USD 15 million was used to finance the purchase of the local equipment, cost of erecting the buildings and also to cover the working capital needs.

Plant and Equipment

The Company’s main production area consists of four workshops, namely

1. mechanic workshop
2. workshop for plastic goods and ferrous casting
3. workshop for assembling of engines and devices
4. instrumental workshop

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Mechanic workshop is comprised of Pressing, Turnery, Polishing and Welding work units each specialising in preparation and processing metal parts of a motor. This workshop operates as an integrated full cycle mechanism designed to produce pre-fabricated parts from raw metal plates.

Turnery work unit is equipped with the following machines most of which are above 10 years old.

Unit of equipment (made in)	No of Units
Turnery p/a IMIODA (Russia)	19
Turnery p/a IBII6II (Ukraine)	6
Turnery p/a AWA (Poland)	4
Turnery automatic LA-155F30c CPU (Russia)	2
Turnery automatic CPU 16B16TC1 (Russia)	2
Turnery automatic CPU 16A20F3639 (Russia)	1

The pressing work unit is equipped with primarily German made equipment of the similar age and is engaged in production of various parts used in assembly of an electric motor as well as a household device.

Unit of equipment	No of Units
Automatic press PAZS-80,3	2
Curvilinear press KD2126	2
Press Kd2 128 K	1
Press body AKD -2126-07	1
Press body. KD2328	1
Press body AKKD-2128-07	1
Press body KD2324	4

Press body KD2326	1
Press body. KD10t	2
Automatic press «Bihler»	1
Press machine «Furh»	1

Polishing& milling work unit includes the following machines manufactured in Sweden and other European countries in early 90-s

Unit of equipment	No of Units
Non-cent. polishing machine ZE184	2
Non-cent polishing and cutting machine 727PMB	2
Semi-automatic profile-rolling A9521	1
Semi-automatic profile-rolling A9518A	1
Semi-automatic profile-rolling «Thommen» 500-109	1
Universal milling machine 6T80	1
Toothed-milling machine «Mikron»	1
Universal milling machine 67K25PR	1

There are also two welding machines MT 1928 in Welding work unit which as per management discussion are in a very satisfactory state. It should be noted that despite the fact that the above enlisted equipment is approaching its useful life limits most of the units were underutilized in the past several years and thus require minimal investments for extending their functional capacity. The management believes that as much as USD 5,000 is needed to make all units up and running.

Plastic goods and casting workshop includes the following pieces of equipment allowing to produce various plastic details, i.e. bodies, caps, etc. which are used in assembling household appliances:

Equipment unit	No of Units
Thermo-layer DE 3130 125Z1-Korea	1
DE3132-250Z1 city of Hmelnyzk	2

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DE3132-20Z1	1
DE3330-125 city of Hmelnyzk	3
TAM -250 г. city of Tiraspol	1
3M 88MK3-c HSONG	1
D3132-250 city of Odessa	2
KM150-600, Germany	1
KM210-600, Germany	1
Automatic Thermo-layer battenfel, Germany	1
KM350-1420, Germany	1
ANKER, Germany	1
D3136, г. city of Odessa	1
A711 A08	2
A711H08	2
A711A08M	1
Melting and distributing est. 250	4
Carving-cutter machine 2054m	6
Hydraulic press P6320B	2

As per management opinion, an investment of USD 5,200 is needed to complete all necessary repair and maintenance work to make the work unit fully functional.

Instrumental workshop provides repair and maintenance services to the key production workshops and is equipped with the following machinery:

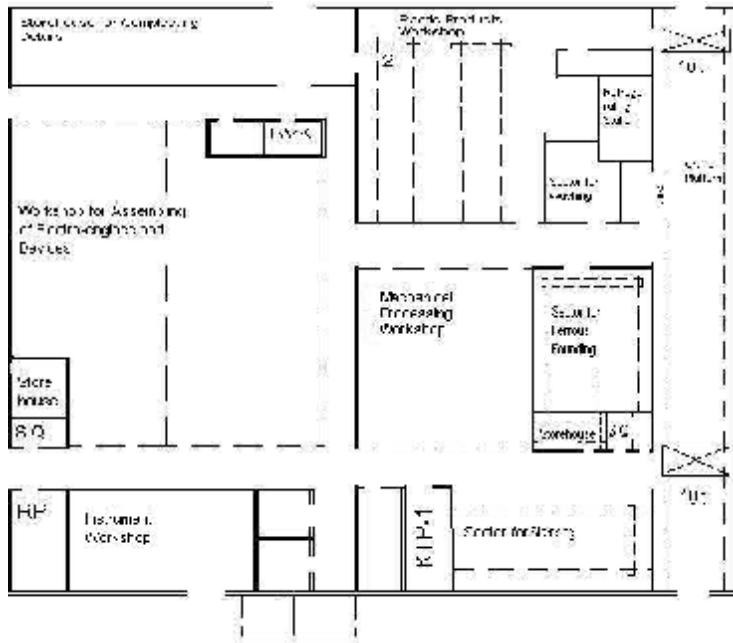
Name and mark of equipment	Units
Universal milling machine κ 67κ25PR	1
Milling machine 6T82-milling machine 1	1
Milling machine 6Д81S	1
Turnery machine 16D25	2
Turnery machine IT-1T	1
Round-milling machine 3U12YB610	1
Round milling machine 3U10	1
Turnery machine 16C05A810	1

Profile-milling machine 3951VF1U	1
Coordination-fixing machine 2431SF10	1
Coordination-milling machine 32T133SF10	1
Milling machine with 4PU 6220VF2	1
Machine for flat milling 3L722VD	1
Machine for flat milling 3D711VF11	3
Grinding machine 3E642	1
Grinding machine 3E642EE	1
Radial-drilling machine 2A554	1
Drilling machine 2C132	1
Cutting machine 8725	1
Milling machine 3K634	1
Cutting machine IB6118	1

As per management estimate an investment of approximately USD 8,000 is needed to get the equipment in the instrument workshop functioning.

The general layout of the above described production shops and work shops and work units is presented on the Graph below.

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Geographical Markets

From the very start the Company's core market was Russia and other former Soviet republics that suffered shortages in supply of electric motors and household appliances in early 90-s.

In addition, under the joint-venture agreement "Merloni Progetti" claimed to buy and sell into European markets around 35% of the Company's output. Export revenues were supposed to be used to repay loans received from European banks.

Company's secondary target markets included Iran and Turkey.

After the disintegration of the USSR followed by the years of economic turmoil and downturn in all former Soviet states' 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.

In the past three years the Company receives sporadic and very limited orders for some products. The table below provides a comparison of the best year's operating results vs. the past three years' figures.

(in units)

Products	1993 best year	2000	2001	2002
Mixer	207 206	-	367	145
Mincing-machine	91 515	-	87	1 000
Coffee-grinder	620	-	13	178
Electrical engines	173 737	36 000	934	66

Industry Overview

The manufacturing of household appliances and electric motors in Azerbaijan is currently in a deep decline caused by

- à disintegration of the business ties and confidence between the producers and suppliers followed by the collapse of the Soviet planned economy
- à sharp increase in raw materials prices coupled with a deep drop in consumer purchasing power driven by hyperinflation and devaluation of local currencies
- à plunging margins eroded the ability of local goods to resist the massive invasion of the cheap imports on the CIS markets
- à inadequate abilities, skills and knowledge of the local management to run the business in the free market environment

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Currently, there are two major producers of household appliances in Azerbaijan, Bakmil and Bytmash. The latter is in fact Bakmil's core client for electric motors.

Both companies did extremely well in early 90-s growing their sales and profits by untapping the demand for the products which were not available on the markets during Soviet times. Affordable prices and modern design made the products great success.

In terms of electric motors production Bakmil is the single largest manufacturer within the boundaries of the former USSR. There is a dozen of smaller producers, located primarily in Russia, of which many are military and defence companies that produce household appliances as a by-side products.

It should be noted though that starting from the second half of the 90-s the industry is being dominated by imported goods manufactured in China and South East Asia. This was due to a number of factors which were beyond the local manufactures control such as:

- à hyperinflation that drove raw materials prices sky high,
- à weak and unstable legislative environment, that provided little if any protection of local producers against imports at dumping prices
- à local currencies devaluation
- à low contractual discipline between counter parties
- à lack of affordable financing resources
- à remote raw materials base

Among the subjective factors that contributed to the current Bakmil's position are:

- à inability of the management to run the business under stress
- à reactive rather than pro-active approach to planning counter actions aimed to reducing the negative impact of the hostile environment
- à poor marketing skills

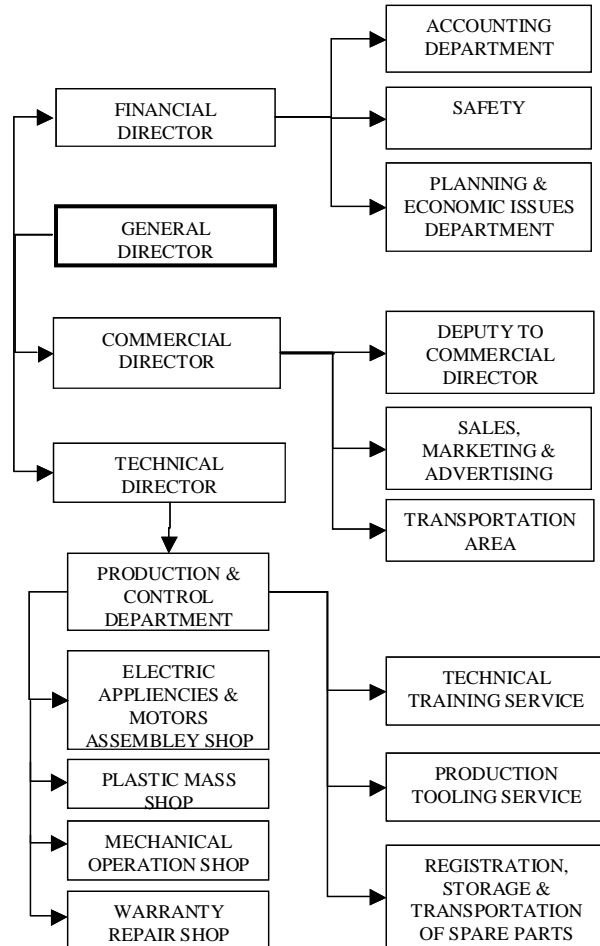
Privatization developments

Based on interviews with managers, we were unable to determine whether any interest was expressed by potential buyers/investors regarding buying of or investing in Bakmil over the past several years.

We have been told, with no evidence provided though, about some unspecified tenants who rent storage space in the Company's main production building. Management discussion on whether this type of activity could be further developed showed limited interest in finding ways to increase utilisation of assets.

Organizational Structure, Management and Personnel

The organizational structure of the Company is as follows:



The Company used to employ over 800 labour, managerial and administrative staff. It currently employs 145 people of which more than a half is on the non-paid leave for years.

The management structure of the Company includes:

1. Executive Board
2. Directorate
3. General Director

Executive Board is comprised of four members and is in fact the supreme body of the Company. Currently it includes:

1. President of “Baki Kondesioni” (Chairman of the Board)
2. General Director of “Baki Kondesioni”
3. Representative of “Merloni Progetti” (Vice Chairman of the Board)
4. General Director of “Bakmil”

The Board is empowered to take decisions on every aspect and issue related to the Company’s operations. The Board nominates the Directorate and the General Director of the Company. A number of issues require a unanimous voting by the Board. These include but are not limited to:

- à Making changes to the Company’s Charter
- à Approval of the following year’s budget
- à Increase or decrease of the Charter capital
- à Determine the scope of the General Director’s prerogatives
- à Nomination / replacement of Directorate members
- à Approval of borrowings
- à Liquidation / Reorganisation of the Company

Directorate is responsible for day-to-day management of the Company. The number of the Directorate’s members is determined by the Board for the term of 3 years. Directorate is managed by the General Director who has the right to

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represent the Company and conclude transactions required to maintain the Company's continuous operations within the limits set forth by the Board.

It should be noted, that Charter of the Company has not been revised after its adoption on 25 May, 1988. Therefore, a number of Articles are perceived to contradict with the current legislation of Azerbaijan and are to be brought in compliance with the governing law. We are not providing recommendations regarding this issue as this was beyond our scope of work.

Summary SWOT Analysis

Strengths

The company does not appear to have any significant strengths related to the production of the core products. Regaining former market position looks unattainable without massive investments in marketing, distribution and R&D work.

However, given the quality of the equipment and property, teaming up with the Russian manufacturers of similar product looks a viable option to resume production.

Weaknesses

The current poor financial standpoint represents the key weakness of Bakmil that is likely to persist without capital injections. Taking into account the unaffordable cost of borrowed funds that are currently available in Azerbaijan the option for the search of capital is limited primarily to equity investors.

The Company has paid little attention to new products development in the past several years. Although technical characteristics of the devices are claimed to be superior to the imported analogues manufactured in China and South East, the exterior design looks very much outdated and does not comply with modern customers' requirements.

Opportunities

Bakmil's opportunities as a manufacturer of electric motors and household devices appear to be limited provided that:

1. there is no evidence of a possible upsurge in demand for household appliances in Azerbaijan in the near future on which the Company could build its growth strategy;
2. competitive advantages of the products with regard to their price-to-quality characteristics are not evident and clearly conveyed to the market which will hamper successful launch of new products to allow for a breakthrough on the market
3. the speedy aging of the idle equipment reduces the window of opportunity to resume production at low costs

The Company should explore an opportunity to sell its motors to producers in Russia (or Uzbekistan or Turkey, or Iran) in a more active manner provided there is enough confidence that competitive prices, guaranteed volumes, higher quality and timely delivery can be offered.

Another opportunity to be investigated is switching from the core to another business activity by using the leverage of the quality assets available, namely property and equipment. These other activities may include property management/development business, i.e. leasing out production and commercial space or turning the Company's property into a logistics service centre.

Threats

The threats that Bakmil is to keep facing challenges include the enhancing obsolescence of the idle equipment that will significantly reduce the opportunity for assets disposal. Also, taking into account the oversupply of idle commercial and production space within the area, the chances of Bakmil's to become the leasees' best choice are very much uncertain and tend to reduce if action are not taken within the next 6-12 months.

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.