

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

COMPANY PROFILE – JSC “H. Z. TAGIYEV TEXTILE MILL”

June 2003

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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

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AZM	Azerbaijan Manats
USD	United States of America dollar
WIP	Work-in-Progress
Q	Quarter of the year
The Company	Joint Stock Company “H. Z. Tagiyev Textile Mill”
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 H. Z. Tagiyev Textile Mill is the oldest textile production mill built by the Azeri entrepreneur Tagiyev in 1898. After its nationalization by Soviet regime the factory was rebuilt and expanded to include three major facilities: spinning, weaving and dyeing/finishing facilities.

Previously the Company played important role in the industry by supplying numerous sewing factories and workshops with over hundred million meters of finished fabrics per year. As the orders increased, new facilities were built to expand factory's production capacity. Required growth in production resulted in increased labour resources at the Company. At its peak of production about 150 million running meters of cotton textile were produced and shipped across the former Soviet Union and to neighbouring foreign countries. At its maximum capacity the mill employed about five thousand employees to meet the orders.

After collapse of the Soviet Union the management of Tagiyev Textile Mill has tried to maintain the factory in operation and established a number of joint ventures with Turkish, Bulgarian and German partners. However, these JVs were unsuccessful and the factory ceased operations early in 2000. Due to low quality and high production costs the factory products could not compete with similar products of European and Asian manufacturers. The Company has reduced its staff down to 1,606 employees by the end of 2002, of whom 94% are on unpaid leave at the moment. The factory had no production in 2001 and 2002, but kept finished goods since 1999 with the book value of AZM 166,125K and spare parts and chemical used in the production process dated back to 1993-1994 with historical value of AZM 4,478,433K.

The Company management informs us that some of the company's assets are under arrest imposed by the court against claims from the local tax office. The total debt to the tax authorities amounts to AZM 30,438,740K or US\$6,221 K.

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 approximately 18.5 hectares and consists of three separate major facilities:

- 1) Spinning mill;
- 2) Weaving mill; and
- 3) Dyeing and finishing plant.

The new **spinning mill** was put into operation in 1976. At that time it was equipped with 30,000 rotor spinning machines. In addition to that 54 ring spinners (with 20,000 needles) were installed in 1993. The planned capacity of the spinning mill was 10,000 tons of various yarns a year. Dimensions of the reinforced concrete building of the spinning mill are 270 m x 90 m. Total area of the mill is 23,875 m². The area between columns is 18 m x 6 m and the height of the production sections is 6 m.

Other facilities of the spinning mill include:

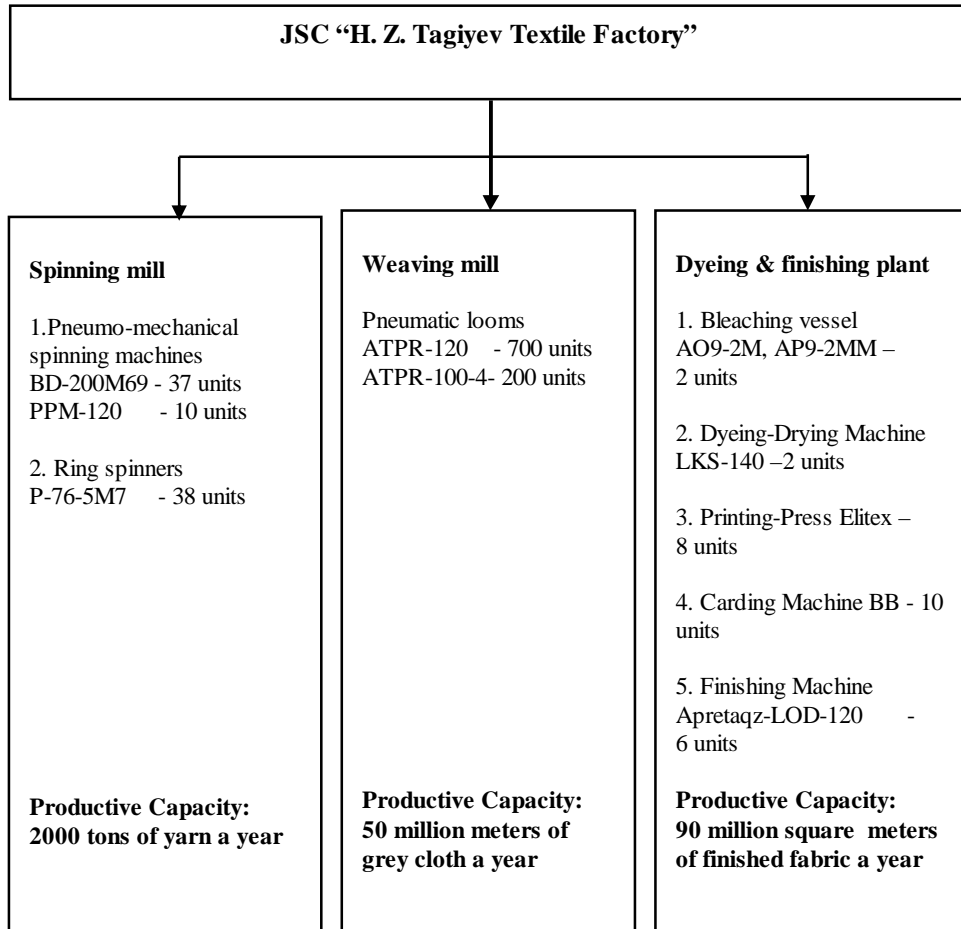
- Dwelling house (the area is 3,285 m²);
- Water pump station;
- Sewerage pump station;
- 10 water reservoirs (total capacity is 12,500 m²);
- Production laboratory.

New premises of the **weaving mill** built of light metal structures and claydite-concrete panels were commissioned in 1986. The weaving section occupies one floor, while the stock-preparation shops are of two to four floors. The dimensions of the weaving mill building are 242 m x 90 and the total area is 25,313 m². The height of the production sections is 6 m. The weaving mill is equipped with 700 pneumatic looms of ATPR-120 brand and 200 pneumatic

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looms of ATPR-100-4 brand. The planning capacity of the weaving mill is 70 million running meters of coarse fabric a year.

Chart 1. Baku Tagiyev Textile Mill Production Facilities Layout



The **dyeing and finishing plant** consists of two sections. The first section was commissioned in 1961 and its planned productive capacity was 136.5 million meters of finished fabric a year. The second section is situated in a three-store building and was put into operation in 1991. The area of production shops in the first section is 13,000 m² while the production area of the second section is 13,500 m². The total planned productive capacity of the dyeing and finishing plant is 200 million meters of ready fabric. The plant used to produce over 50 types of fabric.

In addition to production facilities the factory has industrial wastewater treatment facilities with capacity of 5,300 m³, mechanical-repair services, construction and electrical workshop, vehicles to move between production sections, garage, railway branch and diesel locomotive.

The Company has practically been dormant since the year 2000. According to the management the main reasons of the total standstill of the Company were financial problems and expiration of operational life and further unserviceability of spinning equipment. The weaving-mill and the dyeing and finishing plant are designed to produce finished fabric with the width up to 110 cm and 105 cm.

The factory management considers that in order to resume production spinning and weaving equipment requires complete replacement while dyeing and finishing plant needs partial renewal only.

Historic and current output

While the Company was producing cotton yarn since 1898, its first finished fabric was made in 1961, when the dyeing and finishing plant was commissioned. Since then the output was growing steadily up to late 80s when it reached 120 million meter a year.

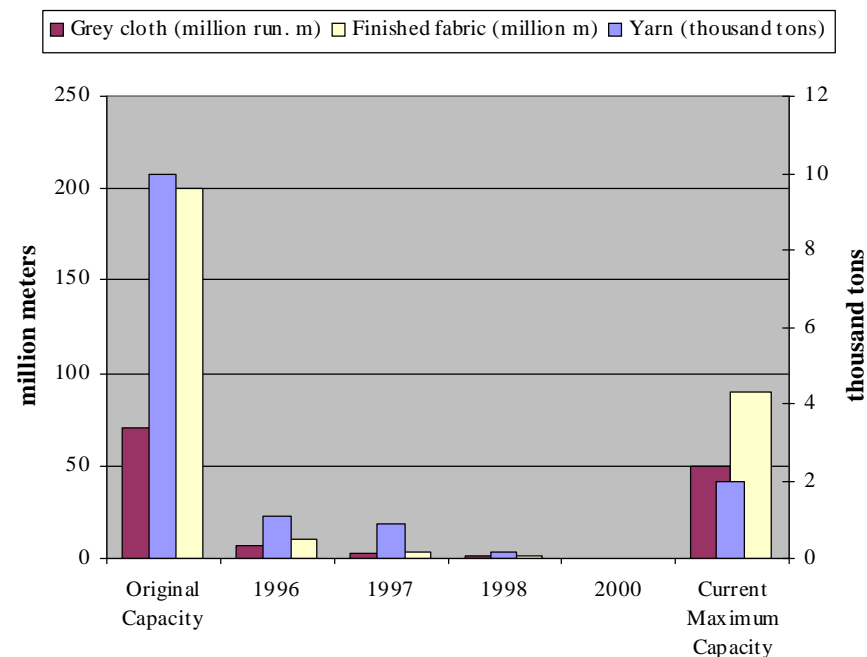
After the collapse of the Soviet Union the Company faced severe recession due to overall disintegration of supply and demand. The company lost most of the markets and customers. Lint cotton prices went up due to demand from foreign customers. According to the management estimates, in 1998 the production

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costs of the spinning mill were 18.9% higher than sales income, for the weaving mill this index was 26.7% and for the dyeing and finishing plant – 50.5%. In general the cost of manufacturing finished fabric was twice as much as its sale price.

In addition to that, the factory equipment was getting obsolete and the Company suffered from the lack of working capital required for replacement of equipment. Cheaper goods from Turkey, Europe and Asia flooded Azerbaijan thus leaving the Company little chances to rebound.

Production	Initial Capacity	1996	1997	1998	2000	Current Maximum Capacity
Yarn (thousand tons)	10	1.11	0.9	0.18	0	2
Grey cloth (million run. m)	70	6.08	2.08	1.17	0	50
Finished fabric (million m)	200	9.84	3.68	1.04	0	90



Picture 2. Output by major groups of production

Major Suppliers

The raw material for the spinning-mill was the lint cotton received from south regions of Azerbaijan. The major suppliers of the lint cotton included:

- Saridjalar ginnery;
- Kurdamir ginnery;
- Laki ginnery;
- Legpromservice;
- Imishli ginnery;
- Salyan ginnery;
- Salyan industrial complex;
- Sabirabad ginnery.

About 9% of the lint cotton was imported.

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Cotton yarn produced at the spinning-mill of the Baku Tagiyev Textile Mill was delivered to the weaving mill, where grey cloth is manufactured. At the peak of production output 30-35% of the grey cloth processes at the dyeing and finishing plant was made at Baku Mill while the remaining 65-70% were delivered from Gandja and Mingichevir Textile Factories. At present both of these factories no longer to send their grey cloth for dyeing and finishing to the Company.

Geographical Markets

Before collapse of the Soviet Union 70% of the Company products were exported to other Soviet republics.

In 1996-1998 when the factory was still operating, products were sold to the Azerbaijan Ministry of Light Industry, the Ministry of Engineering Industry and the Ministry of Social Security. In addition to that certain amounts of products were supplied to various commercial enterprises based on barter arrangements or on account of loans repayment and were given to employees instead of salary payments.

Currently the management considers that if the factory equipment is replaced the Company would be able to satisfy local demand in bed linen, and produce military uniform based on orders from the Azerbaijan Ministry of Defence. However, the management has not provided any formal estimates of this proposal.

It should be taken into account that there are two more large textile mills in Azerbaijan, one is located in Ganja and the second one is in Mingichevir. All three Azerbaijan textile mills are in approximately similar situation, i.e. require replacement of obsolete equipment and renovation of other production facilities.

The statistical information on cotton fabrics market in Azerbaijan is very limited. Based on our observations, the retail market for textile and knitted

goods is dominated by imports from Middle East, Indonesia, China, etc. goods.

Historically the textiles and textile products sector was a labour-intensive industry. Therefore the general trend in textile industry was relocation of production to low-cost countries. This is particularly relevant to apparel industry while textile industries the developed countries focus more on home furnishing and industrial textiles. Another global trend in textiles is moving manufacturing into countries close to home markets, that is US textile capital flows into Mexico and Caribbean countries, while European textile and apparel producers relocate their manufacturing facilities in Eastern Europe and North Africa. This allows textile companies to reduce delivery times and to help strengthen ties to their apparel manufacturing customers.

Taking into account low labour costs in Azerbaijan, availability of locally grown cotton and proximity of Baku Tagiyev Textile Plant to the seaport and the railway there is an opportunity of restarting textile production but at a smaller scale.

Despite the low cost of labor in Azerbaijan the Company products will hardly be able to compete with cheaper imports from Turkey, Iran, China, etc. Price is the most important factor given the weak purchasing power of the domestic consumer. (According to Azerbaijan State Statistical Committee textile fabrics and knitwear constituted 3.35% of the retail trade in 2001. Also, based on the World Bank data 68% of Azerbaijani population lived below the poverty line in 2001). Eastern European countries have been facing similar problems after collapse of the Soviet Union, but have experienced growth of their textiles production between 1995 and 2000. Currently the textiles industries in all Eastern European countries are export oriented, even in Slovenia where wages level is relatively high, 71% of textiles and 55% of clothing production is being exported. The growth of the textile industry took place in the Eastern Europe due to proximity to the EU and cost advantage, which steadily deteriorates with increase in wages. Outward processing (OP) was very popular in Eastern Europe as a form of international co-operation on a contractual basis between independent firms from different countries. The contractor exports mainly semi-processed goods (fabric, cuttings or semi-finished garments) to the

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subcontractor, who refines, assembles or finishes the product, which is then re-imported to the contractor's country. In Slovenia the downward trend in the textiles industry has already started and expected to continue as labor costs are too high for OP contracts. Slovenian company Prevent, today Europe's largest producer of car-seat covers supplying Volkswagen, Renault, Ford, Peugeot, BMW and Citroen has shifted parts of its production to cheaper sites in Bosnia, Croatia and Moldova. It is expected that even Romania with extremely low wage level (4% of the Austrian wage level) may lose OP contracts soon and OP contracts will be shifted to countries like Russia, Belarus and the Ukraine.

Table 2: Gross National Income per capita

Country	2001 GNI per capita (Atlas method)
Turkey	\$2,530
Russia	\$1,750
Romania	\$1,720
Iran	\$1,670
Bulgaria	\$1,630
Belarus	\$1,350
China	\$1,129.3
Ukraine	\$710
Azerbaijan	\$660
India	\$470
Moldova	\$400
Bangladesh	\$380

Source: <http://www.worldbank.org/data/countrydata/countrydata.html>

Table 2 shows that the level of the Gross National Income per capita in Azerbaijan is between GNI in Ukraine and India, but 1.7 times higher than that in Moldova.

Considering the experience of the Eastern European countries the labour costs may stay at low level at least for another five to ten years. At the same time

with rising incomes the domestic consumptions of textiles in Azerbaijan will grow as well.

Industry Overview

The survey of the textiles sector of the Central and Eastern European countries (CEEC), which are comparable with Azerbaijan in terms of the population size, income level and overall political and economical environment, reveals that the textiles industry takes a relatively small size in production (only 6%-8% in Bulgaria and Romania) but plays a major role in employment (Romania – 21%, Bulgaria – 23%) and in exports in less advanced countries (Romania – 37%, Bulgaria – 29%). In this case the term 'textiles sector' is not limited to production of cotton yarn and fabrics and includes preparation and spinning of textile fibres, various textile weaving, manufacturing of made-up textile articles, knitted and crocheted fabrics and articles, various wearing apparel and dressing and dyeing of fur.

The sector benefits from lower wages and unit labor costs as compared to Western European countries and also from outward processing agreements. However, investment and especially foreign direct investment is small and productivity levels are low. Due to weak domestic consumption and rising competition from cheap imports the overall performance of the sector is negative. In *Bulgaria* and *Romania* the outward processing still plays an important role, while in *Slovakia* the textiles industry was hit hardest of all countries in the region, productivity declined significantly and unit labour costs increased and are relatively high now. *Hungary* and *Poland* were the only two countries where the sector showed a recovery, possibly due to the better performance of the domestic economy.

Textile production in the CEEC takes place mostly in small and medium-sized enterprises (SMEs). For instance, the textiles sector of Bulgaria, the country with the population around 7,600,000 people, comprises some 3000 enterprises, of which only ten companies employ over 1,000 people. These large companies are involved mainly in woollen-type or cotton-type weaving, fibres spinning, yarn/fabric production and manufacturing of outdoor/underwear. Main foreign investors in the Bulgarian textiles industry include Marland International Ltd.

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(Ireland), Maser (Turkey), Miroglio (Italy) and Salvadori (Italy) and, in the clothing industry, Hainer & Peter Roesler (Germany), Rollmann (Germany) and Brandex.

The overview of cotton fabric production shows that even in the USA the majority of the cotton fabric manufacturers are smaller firms with 250 employees or less. Besides, many of these companies are diversified, producing cotton and synthetic broad-woven and knit fabrics.

Based on the example of the CEEC and given low labour costs, availability of local raw cotton and proximity to the EU countries, Azerbaijan currently has an opportunity to develop textiles industry through outward processing agreements.

Demand in cotton fabrics/ products even in the USA and other developed countries has been decreasing worldwide since mid 1990s and is forecast to continue losing ground to cheaper synthetic fabrics, particularly micro-fibre and polyester materials.

	1996	2001	2006
US Resident Population (mil persons)	269.4	284.8	301.1
US Demand in Broadwoven Cotton Fabric (mil square meters)	5059	3957	3678
US Demand per person	18.8	13.9	12.2
Azerbaijan Population (mil persons)	n/a	7.8	7.95
Estimated Azerbaijan Demand in Broadwoven Cotton Fabric (mil square meter) based on US Demand per person	n/a	108	97

Table 3

There is no data available regarding the demand in cotton fabric in Azerbaijan therefore we used the US demand per person figures to estimate current and projected future demand in cotton fabric in Azerbaijan.

According to Table 3 the estimated current domestic demand in cotton fabric is slightly higher than existing maximum production capacity of the Company. Taking into account that the above estimates are made based on the demand per person in the USA where purchasing power of resident population is much higher, it is clear that the real demand in cotton fabric is significantly lower than the above estimates.

Thus the Company's recovery depends on profitability of arranging outward processing at the Company's facilities and suitability of its buildings and structures for installation of up-to-date equipment. Investors may find it more cost effective to build completely new facilities. Besides they may rather prefer to diversify production than to focus on cotton products only.

In terms of labour costs the Ukraine and Moldova are the strong competitors for Azerbaijan. Besides, they are located closer to the EU countries and have the advantages of shorter delivery time and lower transportation costs. Thus, unless the forecast growth of wages in Azerbaijan for the next five-ten years is lower than for the Ukraine and Moldova it is unlikely that Azerbaijan will be attractive for outward processing.

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 is obsolete and technologically outdated.

The Company does not have any formal business plan and the last time investments requirement were estimated in 1999 when Pakistani businessmen proposed to set up a small textile production enterprise using the Company's facilities. The Pakistani project required US\$18 million in investments and expected to produce 15.6 million meters of grey cloth.

To be able to regain lost traditional markets, the Company will have to improve quality of its products (a bigger product range, accurate colour spectrum, accurate observance of delivery deadlines and so on). Improvement of quality

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will require replacement of its outdated equipment with modern and technologically advanced equipment capable of mixing natural fibers with synthetic fibers and producing fabrics of quality comparable to fashionable fabrics from Europe and Asia at lower cost.

Privatization developments

According the law on privatisation, employees are allowed to buy out 15% of shares at discounted price, however, only 2% 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. Support of the Government and temporary protection against imports are, however, important prerequisites of investor interest in acquiring the Company.

Organizational Structure, Management and Labour

Despite the efforts of the management to keep the factory operating the Company had to gradually cut its productive output due to lack of demand in its products and subsequently shed over sixty percent of its labour force since collapse of the Soviet Union.

The following table demonstrates sliding dynamics in the labour resources of the Company:

Year	1995	1996	1998	2000	2001	2002
Total no. of employees (including on unpaid leave), of whom	4,465	3979	2747	1952	1892	1606
Workers	3499	3086	2118	1767	1764	1515
Administrative personnel	966	893	629	185	128	91
On payroll, including	n/a	n/a	n/a	227	186	128
Workers	n/a	n/a	n/a	128	119	79
Administrative personnel	n/a	n/a	n/a	99	67	49
Average salary ('000 AZM)	117	152	103	238	133	103

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

According to the management, the Company pays salaries to the payroll employees on time. Currently, average monthly salary at the Company is AZM103,000 (approx. USD20). 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.

Baku Tagiyev Textile Factory maintains records of 73 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 9.5 million to such individuals. However, the Company does not pay these obligatory payments.

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The company's liability for the employees compensation currently amounts to USD 645,000.

Trade Union is not active at the Company.

SWOT Analysis

Strengths

The management considers the following as the strengths of the Company:

- Concentration of all production process at the factory, which allows to manufacture finished fabric from raw cotton.
- Infrastructure, proximity to suppliers of raw materials, power and water supply, seaport, railway and airport.
- Availability of cheap labor resources.

Weaknesses

- Obsolete equipment that is able to manufacture low quality products only.
- Small domestic market, historic production capacity of the Company is significantly higher than domestic market requirements.
- The Government does not provide sufficient support for recovery of the Company through tax holidays and protectionism against imports;
- New technologies and equipment are required to produce fabric of reasonable quality;

Opportunities

- Restructuring and downsizing of the Company to produce smaller volumes of output.
- Due to proximity to ginneries and availability of cheap labor, foreign garment manufacturers may be interested to use the factory as a supplier of cheap cotton fabric.
- Given the central location of the site the land plot can carry some value for housing or commercial construction. The valuation is yet to

be performed on the analysis of the existing demand and include costs to investor related to the site cleaning.

Threats

- Reducing number of qualified employees. Replacement of equipment will require labor training.
- State authorities may not give approvals/permits from the state authorities with regard to the disposal/lease of assets, which are not perceived as adding value under the restructuring plan.
- Market for the used machinery or commercial space may be too soft to generate funds needed for restructuring purposes.

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.