

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

COMPANY PROFILE – JSC “MINGICHEVIR 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 “Mingichevir 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 Background

JSC Mingichevir Textile Mill is the largest yarn and textile production mill in Azerbaijan. It used to employ over five thousand workers to supply textile mills inside and outside of Azerbaijan with knitting and weaving yarn and gray cloth for their further processing into various finished fabrics. The factory was built during late 50s. Its first output was produced in 1960. Main reasons behind building the factory in Mingechevir were ample human resources, availability of power supply and proximity to cotton ginneries.

The Company had two production specialties, (1) production of weaving and knitting yarn and (2) weaving of gray cloth and was designed to be capable of producing annually 8 thousand tons of yarn and 32 million running meters of gray textiles, respectively. In late 70s the maximum production capacity was increased to 13 thousand tons of yarn and 65 million running meters of textiles.

The Company used to meet the entire demand of the local market for knitting yarn. In addition, over 20 percent of the output was supplied to the republics of the Soviet Union, Poland, East Germany, Austria and North Korea. The Company did not have its own dyeing and finishing facilities, weaving yarn was processed into gray cloth and was supplied mainly to Tagiyev Textile Mill for dyeing and finishing.

After collapse of the central system of orders and disintegration of relations with traditional suppliers and customers the Company faced difficulties with finding the markets. Rapid drop in orders and gradual reduction of production put the Company in severe distress. Up until recent times the Company was practically dormant. Recent initiatives of the management led to revival of limited production at the Company.

Plant and equipment

The Company occupies some 14 hectares of land and includes the following main production facilities:

1. Administrative building;
2. Spinning mill
 - a. preparation workshop;
 - b. carding workshop;
 - c. spinning workshop;
3. Weaving mill
 - a. preparation workshop;
 - b. beaming workshop;
 - c. sizing workshop; and
 - d. weaving workshop
4. Warehouse of finished goods;
5. Storage of raw materials;
6. Heating facilities;
7. Storage of spare parts; and
8. Repair shop

Facilities are in poor condition and require repair. Deteriorated air conditioning system negatively affects quality of the output.

Majority of the equipment was imported from Russia and allows for two methods of weaving: ring-spinning and compressed air methods. Following is the list of main equipment used by the Company:

Compressed air spinners:

BD-200-M (69 units)

PPM-120-A-1-M (107 units)

Ring spinners:

R-66-5M7 and 5M4 (90 units)

All spinners are over 20 years old and according to the management over 60% require replacement. The remaining may be refurbished and used to produce technologically old quality products.

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Weaving machines:

ATPR-100-4 (668 units)

ATPR-120-4 (378 units)

STB-180 (90 units)

According to the management, only some 30% of weavers can be refurbished and used, the remaining requires replacement.

Carding machines:

TB-3 and 16 (283 units)

Carding machines are over 30 years old and in poor condition. Management believes that over 250 units require replacement.

Other types of equipment in smaller quantities exist at the Company. The average age of equipment used at the Company exceeds 20 years, most of it is technologically outdated and capable of producing low-grade yarn and fabrics. According to the management approximately 60% of all equipment requires replacement. Currently, only 3% of the existing equipment is being used in production.

Historic and current output

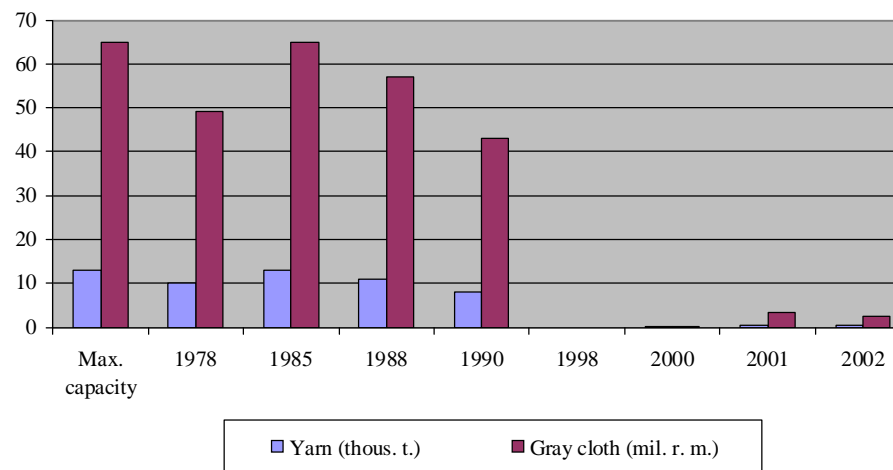
The Company produced its first yarn in 1960. Since then the output was growing steadily over years and reached its maximum capacity in 1985.

After collapse of the Soviet Union the Company faced severe recession due to overall disintegration of supply and demand. Increase in raw material prices coupled with sharp drop in demand eroded working capital and drained liquidity from the business. The company lost most of the markets and customers. Cheaper finished goods from Turkey, Turkmenistan, Uzbekistan and China flooded Azerbaijan thus leaving the Company little chance to rebound.

Picture 1. Output by major groups of production

	Max. capacity	1978	1985	1988	1990	1998	2000	2001	2002
Yarn (thous. t.)	13	10	13	11	8	0	0.14	0.6	0.4
Gray cloth (mil. r. m.)	65	49	65	57	43	0	0.2	3.4	2.5

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Gray cloth (mil. r. m.)	65	49	65	57	43	0	0.2	3.4	2.5



Currently, the Company operates at its minimum capacity. Average annual output is 400 tones of yarn and 3 million running meters of gray fabrics. In 2003 the management signed an agreement with local commercial company to rent its facilities and equipment in return for coverage of the Company's running costs, including electricity, water, phone and security expenses.

Major Suppliers

Before collapse of the Soviet Union the Company used to purchase short-staple cotton from local ginneries and import long-staple cotton from Central Asia. Currently, all cotton is being purchased locally from privately held ginneries in Ali Bayramli, Saatli, Neftchali, etc. The pricing is regulated by the central exchange. The price fluctuated between \$800 and \$1,000 per tone.

Geographical Markets

The Company supplied most of its output to Tagiyev Textile Mill for processing into finished products. In addition, approximately 20% of the output was

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exported to various countries, including Ukraine, Poland, Baltic countries, North Korea, etc.

After collapse of the Soviet Union and opening of the local market for imports of cheaper and higher quality finished fabrics and clothes put most of the local garment workshops out of business. These workshops were the major buyers of gray and processed fabrics from the local textile mills, including the Company, Tagiyev Textile and Ganja Textile mills.

Over the last few years the management has been able to identify demand of the market for gray cloth. According to the management there is a significant layer of population with low income and not able to afford finished textiles. This group of consumers has to opt for a cheaper alternative, gray fabrics, which is being used for various household purposes. The management estimates the local market to be able to absorb annually 10 million running meters of gray fabric of which 3 million are being supplied by the Company. The rest of the market is supplied by imports from Turkmenistan and Uzbekistan. The management is, however, concerned that local producers such as the Company are in disadvantage compared to importers as they have to charge value added tax on top of their sales price. Importers are exempt from such tax payments and, therefore, able to offer their textiles at lower price.

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.

Even in the low price market segment local products face tough competition from cheap imports from Central Asia. Competitive advantage of imports is often due to their exemption and non-payment of import duties. Local producers are, however, required to change taxes (e.g. VAT) to final consumers and thus making their products less competitive. Stronger competitive edge of the imported goods is also due to technological superiority, which translates into a higher quality product from both base material, finishing, colour pattern and design point of view. Often local

products lose their customer because of low volumes and poor market penetration as the result of working capital constraints.

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 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 loose 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

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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. (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

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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' 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

After many years of under-investment the Company is in need of urgent investments in the fixed and working capital. The amount of investment is obviously dependent on the proposed and justifiable business strategy of the Company. The management strongly believes that the Company should be re-started at some lower capacity, as it is well positioned to regain local market, has access to raw materials, labor and power resources. The proposed capacity of the Company is dependent on the market environment and state support.

According to the management estimates, the Company requires overall investment of some 400 thousand dollars to relocate one hundred weavers in a separate seven thousand square meters area within the Company's premises, install dyeing and finishing equipment and hire services of some 100 workers. Within such smaller and compact production, the Company would be able to produce up to 3.5 million running meters of finished textiles per year.

Privatization developments

The management has expressed its interest to continue its involvement with the Company and its potential privatization. The management estimates the value of the Company not to exceed 500 thousand dollars.

According to the law on privatization, employees are allowed to buy out 15% of shares at discounted price, however, less than 1% was acquired by the existing and former employees of the Company. The management explains this is due to lack of adequate corporate governance, disbelieve that the Company could be profitable and pay dividends to the shareholders.

According to the management there was no active interest of local and foreign investors in the past to acquire the Company. The Company was put for sale through the investment contest. Some Turkish investors have visited the Company in the past. However, no interest was expressed to acquire the

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Company with the investment commitments required by the terms of the contest.

The management is skeptical about the opportunities of attracting private investor to the Company without support of the Government, protection of the local market from cheap subsidized imports.

Management and Labor

While gradually reducing its output to becoming practically dormant the Company shed almost all of its over five thousand employees since collapse of the Soviet Union and is currently employing services of 256 management and work labor. The following table demonstrates sliding dynamics in the labor force of the Company:

Year	1985	1990	1995	2000	2002
No. of employees, including	4,780	4,024	5,203	1,962	1,395
Unpaid leave	n/a	n/a	n/a	1,837	1,139
Average salary ('000 AZM)	n/a	n/a	n/a	119	198

According to the management, low pay, systematic non-payments of salaries 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 all active employees on time. Over half a billion AZM are, however, outstanding for prior years.

Trade Union

Trade Union is not active at the Company.

SWOT Analysis

Strengths

- Ability to refocus to different types of output;
- Proximity to ginneries (Evlakh, Agdar, Lakin);
- The only producer of knitting yarn in Azerbaijan capable of meeting the demands of the local market;
- Cheap and ample labor resources;
- Ability to produce cloth of up to 1.7 meters wide.
- Proximity to power and water resources;
- Infrastructure, access to railroad transportation routes.

Weaknesses

- Local market is insignificant (according to the management, up to 10 million running meters of gray cloth per year);
- Lack of protection/coordination function from the Government, low public awareness of bad quality imports;
- Cheap imports of textiles due to their synthetic content, lower costs of production and protective measures by their respective governments;
- Dependent on Tagiyev and Sheki dying and finishing capacities as do not have its own.
- Old and technologically outdated equipment;
- Production facilities (as per management, over 60% of all facilities) require significant repair works and investment;
- Lack of coordinating authority able to protect and promote local industries.

Opportunities

- The opportunity exists to regain a share of the local market. Need to define local market demand and generate demand for the Company's products;
- Impose restrictions on inferior quality imports by imposing customs duties;

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- Taking into consideration current state of the equipment and facilities the Company has capability to produce at half of its maximum capacity;
- In late 80es initiated construction of the dyeing and finishing workshops, however in early 90es the construction was interrupted. The management believes that there is still an opportunity to finish the construction of the facilities.

Threats

- Growing competition around the world and economies of scale on the part of Asian textile and finished clothes manufacturers threaten the Company not to be able to gain the competitive advantage;
- The size of the potential market and individual segments within the market may not be sufficient to restart the Company, unless the capacity is significantly reduced.

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.