

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

**COMPANY PROFILE –GANJA CARPETS**

**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

### *ABBREVIATIONS*

AZM	Azerbaijan Manats
USD	United States of America dollar
WIP	Work-in-Progress
Q	Quarter of the year
The Company	Ganja Carpets
EBITDA	Earnings before interest, tax, depreciation and amortization
‘000	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***

Ganja Carpets Factory was put into operation in 1964. It is located within 1.5 kilometres from the city centre and has the territory of 16.5 hectares. Taking into account of the branches which were established in 90-s the total company's territory is over 20 hectares.

In 1976 the production facilities were expanded to make the Company the third largest producer of carpets in the former USSR after Brest (Belorussia) and Ungueny (Moldova) carpet factories. There were 26 carpet factories within the boundaries of the CIS.

The third expansion phase was planned to be completed in early 90-s but never happened because of the collapse of the Soviet Union. Production premises of the 3<sup>rd</sup> phase are 25-40% complete and occupy the area of 8 hectares adjacent to the main production site.

In the past the Company was also producing blankets. The blanket unit was closed in 80-s due to obsolete state of the property and machinery. Since then the blanket production assets were abandoned. As per the management, currently part of the territory and premises are being leased to individual entrepreneurs.

Since its inception Ganja Carpets was involved in production of woollen and mixed woollen carpets and semi woollen yarn. At the peak production the company produced 21 sq.m. of carpets and 21 kg of yarns per minute. In late 80-s, 2.7 million sq.m. of carpets was produced by the Company annually. Half of the products were pure woollen with the remaining half accounting for mixed woollen goods. Most of the production was exported from Azerbaijan to the CIS countries and abroad with only 800,000 square metres supplied to the local market. The maximum headcount that the company ever employed exceeded 3,000 people. It had a group of 12 highly qualified designers who developed a comprehensive collection of carpet designs, which is considered to be one of the company's most valuable assets.

There are 127 carpet-making machines installed, which were in operation for some 25-30 years. Production machinery included equipment made in Germany, Poland and the UK. Dying and drying equipment is of Russia's origin.

On the downside it should be noted that Ganja Carpets was built in the distance from the raw material base. Over 40% of the woollen yarn was supplied from as far as Czech Republic. Synthetic yarns were supplied from Georgia, Kazakhstan and Russia.

In Soviet times one single largest customer of the company were state and municipal offices, which bought carpets as obligatory item for the office decoration. In fact, most of the production was pre-ordered leaving the minor part to be sold on the free commercial terms. Taking into account the deficit environment that was wide spread in the planned Soviet economy there was no need to develop marketing skills or techniques.

The collapse of the Soviet Union in 1991 severely affected the Company's operations. Disintegration of the Soviet states followed by the breakage of business ties and customer relations led to an abrupt spin in production. Simultaneously, local market faced a large-scale invasion of cheap, low quality carpets from the neighbouring Turkey, Iran and South Asian countries. A sharp drop in consumers' income caused by hyperinflation observed in the country in early 90-s made the cheap substitutes the products of customers' choice. The shift in consumer preferences towards imported carpets significantly eroded the Company's position on the market. The market itself shrank to a fraction of what it used to be. The collapse of the centralized supply-and-delivery system was the challenge, which the Company could not cope with. Inflated prices for the raw materials dried working capital substantially. Moreover, the Company was not able to offer new products that could compete with cheaper imports. For some time in early 90-s Ganja Carpets kept producing carpets with a density of 3 kg/sq.m whereas Turkish carpets consumed only 700 gr/sq.m. Inexperienced in competition and marketing Ganja Carpets came finally to a halt by mid-90s.

## 1. OVERVIEW OF BUSINESS AND OPERATIONS

For the 7 years the company has been operating below 1% of its peak capacity. In 2002 sporadic orders from very few customers amounted to only 6,000 sq.m. or 0.2% of the record 2.7 million posted in the 80-s. Most of the production assets remain idle and require major overhaul.

Officially the Company still employs almost 2,200 people of which as little as 65 are on the payroll list. Others are considered to be on the unpaid leave for years. There are 45 injured workers who the Company is liable to pay disability pensions. Often these payments are made in goods. Company's bank accounts are closed and a large part of the equipment is under arrest imposed by the court against claims from the local tax office.

### *Geographical Markets*

The market where Ganja Carpets currently operates is very limited and represents a fraction of the existing demand.

Below we would like to estimate the size of the local market that the Company could potentially penetrate with the right amount of investment and business strategy. Our research revealed that consumers prefer to buy carpets with size of 2mx3m. The average price for such carpets appear to be in the range of US\$250 and US\$400 dollars, or US\$40 and US\$70 dollars per square meter.

Based on the data published by the State Statistical Committee of Azerbaijan, the estimated number of carpets purchased in 2001 is as follows:

**Table 1: Estimated market of wool and synthetic carpets in Azerbaijan.**

Azerbaijan total retail turnover, 2001 (billion AZM)	11,877.4
Carpets as a % of turnover	0.14%
Total value of carpets purchased in 2001 (million. AZM)	16,628.4
Total value of carpets purchased in 2001 (thousand USD)	3,580.6

According to the above estimates it appears that the local consumers spend annually some US\$3.6 million on carpets. In square meters the annual consumption of carpets ranges between 50 and 90 thousand. We believe that

the statistical data supplied by the State Statistical Committee on the share of carpets in the total retail turnover is understated, as according to the management of the Company in late 80ies the domestic market absorbed some 800 square meters of carpets produced by the Company on an annual basis. Nevertheless, the estimated size of the domestic market is 10 times higher than the current output of the Company and 10 times lower than the historic demand supplied by the Company.

Therefore, given the local availability of the raw materials and cheap laborur resources, we believe that the opportunity exists for the Company to restart its operations but at some smaller scale of production. However, substantial investments in working capital, marketing and product quality upgrade are required to restore the production and be able to regain the lost markets.

### *Industry Overview*

Ganja Carpets is the only large size industrial company in Azerbaijan specialized in production of household and office carpets.

Based on our observation of the retail market for household and office carpets the market is largely dominated by carpets manufactured in Turkey and Iran.

Local products are primarily hand made carpets, which target tourists and are sold in souvenir shops and street markets.

It should also be taken into account that in many former traditional markets of the CIS there is a distinct shift in customer preferences away from the carpets and towards carpet mats. Thus in order to increase its market opportunities the Company may have to diversify the range of its end products.

### *Privatization developments*

As per the management information there were a number of industry investors who visited the Company in recent years. Unfortunately, none of the investors have demonstrated their strong interest in acquiring the Company. The major

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reason as per management opinion was the size of the production facilities and the poor state of the equipment installed.

In early 2003 the Company entered into a lease agreement with a Turkish entrepreneur who is ready to invest in the carpet production workshop in the backyard of the Company's main site. Under the lease terms two of the former storage buildings will be converted into production units with 10 carpet making machines leased from the Company. The leased machines have never been in use since early 90-s after they were delivered on site to replace the old and outdated equipment.

### **Organizational Structure, Management and Personnel**

The Company key management is represented in Appendix 2.

### **Summary SWOT Analysis**

#### *Strengths*

Amid availability of raw materials and cheap labour resources, the Company is positioned to regain a share of its lost domestic market that could support the longer term ambition to penetrate traditional CIS markets. Significant state support, availability of raw materials at competitive prices (e.g. wool and synthetics), downsizing of the plant to a smaller scale and cost effective production capacities, investments in the modern equipment are some of the major factors that would facilitate the restart of the Company.

In its current state Ganja Carpets' strengths are rather limited due to depleted assets, uncompetitive technology, poor market position and financial insolvency.

Given the central location of the site the land plot can carry some value for housing or commercial construction especially the land plot where the new production facilities were supposed to be erected.

Presence of the investor is another company's strength, which needs to be properly used in order to produce any benefits to the Company. Sale and lease back arrangement with the investor should be explored and developed.

#### *Weaknesses*

Apart from the outstanding financial liabilities currently borne by the Company, lack of liquidity and poor market position, the quality of production premises and equipment represents the major weakness, which can substantially discount the value of this opportunity for a strategic investor.

Unless properly restructured a sale of the company to a strategic investor looks unrealisable.

The Company will have to compete with cheap imports by foreign suppliers that often have greater competitive advantage over the Company due to their access to the larger consumer markets and consequent benefits of "economies of scale" (e.g. Russia, Turkey, Iran), protection mechanisms established by their respective Governments, access to cheap raw materials, available resources for quality improvements and research and development.

#### *Opportunities*

The short-term opportunity available to the Company is linked to the ability to collect cash from the disposal or lease of the excessive, idle or depleted assets. The funds then can be used to upgrade production of a product, which will have the best market opportunities.

Idle production premises can be used to develop alternative business opportunities based on the market/industry research. Existing service infrastructure, buildings and location may have a higher value for investors from other industries than carpets manufacturing.



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### *Threats*

The major threat to the Company is the inability to get 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.

Another threat comes from the market for the used machinery or commercial space. The market may not exist or 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.**