

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

**COMPANY PROFILE – JSC “GANJA 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.*

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## ABBREVIATIONS

### *ABBREVIATIONS*

AZM	Azerbaijan Manats
USD	United States of America dollar
WIP	Work-in-Progress
Q	Quarter of the year
The Company	JSC “Ganja Textile Mill”
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**

JSC “Ganja Textile Mill” was put into operation in 1927. It is located within 1 kilometre distance from the city centre and has the territory of 13.7 hectares. Over decades Ganja Textile was one of the largest producers of cotton yarn and raw cotton fabrics in the former USSR with production capacity of 6 million running meters of fabrics and 600 tons of cotton yarn per annum.

The company was the core supplier of raw cotton fabrics to Baku Tagiev Textile Mill, which had the capability for their further processing into finished goods.

Ganja Textile was at its peak of production throughout 80-s when 200-220 thousand running meters of cotton fabrics were produced daily. At those times the company employed 5,000 people and exported its products to Central and Eastern Europe as well as to Finland and Korea.

Since inception the Company underwent very few upgrade and modernisations. New storage, administrative and auxiliary buildings were erected in mid 70-s. In early 80-s some production equipment, primarily weaving looms and spinning frames, was replaced with new and more productive machines. According to the management the main production premises are fully depreciated.

### ***Plant and equipment***

There are over 1,500 pieces of machinery, which allow for the full-cycle production of cotton yarn and fabrics. All of the equipment is of Russia’s origin. Machinery’s age varies somewhat between 20 to 40 years. As per management less than 50% of the production equipment is operational or require minor repair. Majority of the equipment requires replacement. The

production technology is very much outdated and is only capable to produce low quality and low value-added products.

Major production units include:

1. Spinning mill
  - a) preparation workshop
  - b) carding workshop
  - c) spinning workshop
2. Weaving mill
  - a) preparation workshop
  - b) beaming workshop
  - c) sizing and weaving workshop

### ***Historic and current output***

After collapse of the Soviet Union Ganja Textile faced severe recession due to overall disintegration of supply-and-delivery chains. 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 and of higher quality goods from Turkey, South East Asia and China flooded Azerbaijan and CIS markets thus leaving Ganja Textile little chances to rebound.

In the past several years the Company operates at below 10% of the production capacity. In 2002 only 500 thousand running meters of rough cotton fabrics used by cotton farms as packaging material were produced. But even such orders from cotton farms are irregular and show no sign of growth in either volume or money terms.

In the past 3 years the Company’s payroll list included on average 70 people with over 1,500 of other headcount staff registered as being on the unpaid leave. The Company’s liability for the wage arrears currently amounts to USD 70,000.

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The management confirmed that there are number of litigations under way between the company and employees regarding repayment of wage arrears and other compensations, which include disability pensions and benefits due to 23 disabled workers registered on the company's headcount list.

With no evidence or details provided the management revealed that some of the company's assets are under arrest imposed by the court against claims from the local tax office. Those assets however could not be sold due to the lack of liquidity on the market. However, this contingent liability remain outstanding.

### *Geographical Markets*

The only market where Ganja Textile currently operates is limited to several local cotton farms, which order rough cotton fabric to package the cotton. The market therefore is highly seasonal and to a large extent is barter based.

Given the availability of raw materials and human resources there is very little hope that the company will be able to enter other market niches or other regional markets in the foreseeable future without substantial investments in working capital, marketing and product quality upgrade.

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 in 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 transportation routes there is an opportunity of restarting textile production but at a smaller scale.

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 charge 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 loose 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

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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

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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 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

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*

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 will require replacement of most 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.

The management did not provide us with the estimated investment requirements for bringing the Company to the standards capable of regaining the markets. A thorough analysis of the potential market is required to estimate such capital requirements of the Company.

### *Privatization developments*

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Ganja Textile underwent its first privatisation phase when 15% of common stock was offered to the employees. As per the management, very few shares were bought in exchange for privatisation vouchers. Currently less than 1% of shares are owned by individuals. As we were not provided by the company's Charter or other relevant documents, the exact number of private shareholders is unknown.

As per the management information a number of industry investors from Russia and Pakistan visited the company several years ago. After inspecting the site and production facilities the investors withdrew with no further talks or discussions continued.

The management interpretation of the investors' position was that the equipment installed couldn't be used to produce sellable goods and the replacement and renovation costs appeared to high to yield acceptable returns.

### *Management plans*

No traces of business or development plans were found by or disclosed to us. The company operates on an ad hoc basis as and when orders come from cotton farms or elsewhere through General Director efforts.

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

Based on our interviews, the management and organizational structure of the company includes:

1. General Director
2. Chief Accountant
3. Heads of production units

The General Director appears to be the only and sole body that oversees the Company's operating activities and strategic development. As per our understanding the major objective of the General Director is to preserve the production assets from stealing.

We received no evidence of the existence of the Board of Directors or Shareholders' Committee or any other corporate structures that exercise management functions.

There are 70 people currently working in the company of which production staff accounts for 50%. The other half is administration, security and other service staff. In 2002 the total payroll expense was around USD 17,000.

**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.**