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Handbook for Russian Financial Institutions Planning to set up Investment Subsidiaries or Investment Departments

submitted by

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I. Preface

Within the general framework of the TACIS-strategy, this guide aims at establishing a strong, coherent and sustainable position for the investment department or subsidiary of Russian regional banks with respect to the future investment business. While this guide has been developed within the framework of a Tacis funded project relating to Krasnodarbank in South-West Russia the content should be a useful guide to any financial institution intending to enter the business of investing in non-listed securities of Russian companies.

In view of the broad and complex issues associated with this demanding task, some preliminary remarks should be made at the beginning.

With the changes in economy and the economical environment that occurred during the past few years in Russia, investments have become more uncertain, yet on the other hand there is a growing potential in business development.

Due to the not yet sufficiently developed market of listed securities in most regions of Russia, this guideline concentrates on the investment business in non-listed companies. As the current situation is unique and differs significantly from Western European experience, the well-known patterns of doing business cannot be applied to it. The changing markets, possibilities in raw material supply, direct export, direct foreign competition, changes in business objectives etc. require new and tailor-made solutions. A direct application of Western European standards will lead to misinterpretation and wrong decisions.

While normally an investment decision is based on the analyses of the financial records of the previous years, the proposed way is to concentrate rather on the future business of the target companies. Due to the great variety of investment situations, one can only present an outline of the general procedures. The specific work on location, in particular that of dealing with authorities and handling legal and fiscal matters can only be taken over by experienced local staff on a case-to-case basis, and external consultants are not in the position to comment on their work.

This guideline is intended as an advisory paper on investments in unlisted companies and on monitoring an investment portfolio, once the participation has been acquired by the sponsor/ investor. This guideline will not discuss the proper selection of the various types of financing instruments as regards equity and debt financing nor address the requirements of documentation concerning the subsequent transfer in ownership. In this context, the study by ARES Associes and RINACO Plus on Emerging Market Funds in Russia, carried out in May 1995 in Moscow, may provide valuable hints.

The applied tools for the evaluation and presentation of projects to prospective investors are only propositions. However, they should cover the most essential issues. They might become subject to adjustment in accordance with the specific requirements of the Russian market. In addition, they could be partly used for monitoring an investment portfolio and, finally, planning the cash exit.

Consequently, this guideline intends to present the appropriate analytical means for the evaluation of risks. As compensation for those risks, a thoroughly prepared investment proposal is intended to demonstrate the strong potential for a positive net present value (NPV) on the money to be invested.

2. Introduction to Basic Issues of Investing in Non-Listed Companies

2.1 Compensation of Management according to Profit Contribution

This concept of compensation for management, and equally for all persons working for a company, according to their contribution to the overall economic performance of a company has not yet been accepted universally across Russia. However, it is basic to the concept of a market economy. It applies to investment companies in two respects, which are equally important. First of all, in order to retain the best persons and motivate them for high performance, any investment company should provide sufficient **monetary compensation** to its experts. If at all possible, a participation in the profits of the investment company or at least in the investments made by a specialist should be offered.

All compensation should be "above-board", meaning payments in non-monetary benefits such as the use of cars, datchas etc. should be strongly discouraged. There should be clear contractual relationships.

This applies equally well to the second aspect important to an investment company in this respect. This is the compensation paid to the managers and key persons of a company being considered for investment. Since the dedication of management to the economic performance of a company is of utmost importance, this dedication needs to be secured for at least the medium term. Participation in the equity of a company by management in addition to performance-based salaries is normally a good means. This relatively new concept should be a basic principle of investing in a non-listed company and should be put in place and enforced by the investment company before any investment is being done.

As for all other aspects concerning the relationship between a company and its investors the old truth applies that anything to be done after payment has been made will most likely not be done at all or only after many struggles.

2.2 Types of Investors

Commonly, one distinguishes between four different categories of investors:

- product and market investors
- financial investors
- investors in management or well known people
- opportunistic investors

These various categories differ in their investment objectives and behaviour.

Product and market investors aim at expanding their business by acquiring companies in various districts or countries. To be able to exist in different local markets, they usually try to get local experience on board. Often they enter into joint ventures of various kinds. The advantage for local businesses is that they gain access to foreign markets with their products and can use their local distribution network with additional products from the joint venture partner, which they usually produce under a licence agreement.

Product and market investors can sometimes be reliable business partners in a deal, because they help developing the investee's business and offer access to export markets. Product and market investors can provide substantial amounts of money, which may be needed for the modernisation of local factories. They tend to establish long-term business-oriented relationships. Their rate of return is mainly determined by an increase in business volume and share in the profit of the local company.

Financial investors, especially such with an international background, are able to provide substantial amounts of money as well. They invest exclusively in the prospects of the target company, without having any other business objective. After a certain period of time, financial investors tend to sell their investment. Their profit results from the difference between the price paid when they entered the investment and the price they get from the sale. In addition, they often receive dividends or interest payments during the investment period.

Both product and market investors and financial investors are usually very professional business partners. They examine investment opportunities thoroughly and allow sufficient time for getting through the investment process.

Investors who base their investment decision mainly on a knowledge of the people involved or on their assessment of a favourable situation usually decide very quickly. As their investment criteria are very subjective, other investors are unable to anticipate their decision. It is not uncommon that opportunistic investors try to get out of an investment business as quickly as they entered it. An opportunistic investor may prove difficult for target companies and co-investors, especially when complex decisions are to be made.

The logic of these findings implies that any investment should focus on that specific category of investors which will be most suitable for it.

It should be mentioned that domestic and foreign investors may follow different risk patterns. Especially foreign investors tend to consider the business risk higher than local investors do. Due to the fact that foreign investors can never be as familiar with local developments as domestic investors, they put more stress on the political and social environment and risks that might arise from changes in legislation, tax rules or in any kind of investment environment.

Every investor may have his own personal criteria when looking at target companies. All investors want to get their money back in time. They have to be assured that the target company will stay in business and be profitable. The main issues investors investigate before they invest will be pointed out later on in this document.

International investors need a detailed and objective description of the prospective investment, which outlines the complete process of the investment and describes the prospect of the business and the target company. A guideline on how to draw up such a description, commonly known as business plan, is given in a separate chapter.

2.3 Investment Situations

The most likely investment situations may be

- A Spin-off out of an conglomerate
- Entry into new markets (product-wise or geographical)
- Modernisation and reorganisation of production and logistics
- Acquisition of a suitable company to achieve critical mass for market penetration

This - somewhat incomplete - catalogue of investment situations indicates that the future situation of the target company will always be different from its current situation. It is irrelevant to focus on historic data. Instead, investors should build scenarios of future market prospects. A restructuring becomes necessary to allow the management and shareholders to meet their objectives. In addition to the changes in the company's business there may well be a change relating to the management and a joining of new shareholders.

Companies which have a sufficient amount of money at their disposal will be better able to take advantage of market chances better than other companies that have to arrange their financing first.

2.4 Size of Investments

The size of investments will differ from company to company. International investors tend to prefer investments in amounts exceeding 500.000 US-Dollar. Some refuse to invest less than 1.000.000 US-Dollar. The investigation of investments is time-consuming and expensive. If an investment is too limited, the work necessary for assessment will not be balanced by the prospective return.

The size of an investment will be defined by

- the requirements of the company;
- the work necessary for evaluation in relation to the prospective return of the investment;
- the degree of risk in relation to the prospective return
- the potential of the investor.

2.5 Financial Criteria of Investments and Investment Risk

Apart from the statements made above, the possibility of terminating the investment and withdrawing the money from the investment at the end of the prospective investment period must be stated clearly.

The next very important criterion is the prospective rate of return. It is unlikely that investors invest in companies when they have the possibility to get higher returns for the same risks in alternative investments.

The different categories of investment risks are as follows:

- Loss of all the money invested
- Loss of part of the investment
- Necessity to invest more money than the investor originally intended
- Receiving a lower return or receiving the money later than expected

2.6 Minimum Rate of Return

Investors try to compensate for the expected risks and therefore base all decisions on risk-adjusted returns derived from investment in so called non- risky investments.

Risk-adjusted return means that investors are fully aware that one or more investments in their portfolio will fail. The remaining profitable investments have to balance the risk and lead to an overall return that has to be higher than any so-called non-risk or guaranteed investment. One has to bear in mind that, in times of high inflation rates, any investment will always constitute a special situation.

In order to operate successfully within such an environment, each investment decision is governed by the underlying aim of earning the maximum return with respect to a given risk or of looking for an investment with the lowest risk patterns at a given rate of return.

In practice, this means that any assessment of an investment project has to concentrate primarily on the evaluation of the manifold risks and possibilities of balancing them.

In times of high inflation rates and uncertainty of a currency's future, investors tend to shorten the investment periods. The rate of the prospective return will rise enormously. In investments under stable currency and interest rate conditions, return will be increased at rates between 12% to 25 % per year. During times of inflation with rates well above 50%, the returns have to be defined on a short-term basis.

2.7 Duration of Investments

Despite the fact that high inflation rates don't allow long-term planning, investments need time to develop. If a company raises money to invest in new equipment, it may easily take 2 to 3 years until one sees an improvement in economics. Any investment in new products or markets will take 2 to 5 years to create additional value for shareholders.

Another item that currently leads to longer investment periods is the fact that stock exchanges, which are the ideal instrument to sell investments to other investors at market price, still have to be developed further and become more efficient.

2.8 How to look at Target Companies

The first and foremost criterion for investors to look at is the capability of the target company's management. Its management must be capable, experienced and flexible enough to react to the market requirements in order to ensure the prosperous development of the target company. The company and management must be of good reputation, and the contacts to relevant authorities, companies and banks should be well-established.

The management must be able to draw up a business plan and prove that it is fully aware of the development of the company and the market.

Other criteria deal with the position of the target company in the market and its importance for the country. Big and locally important companies might receive more assistance and help from authorities and banks than other companies.

The various steps of examining companies are set out in chapter 3.1 "The General Idea of a Business Plan"

2.9 How to determine a Company's Value

The crucial question for the success and the financial performance of an investment is the overall return in relation to the money invested. The main criterion to determine the performance of an investment is the difference between entry and exit price.

It is obvious that the problem of proper evaluation has to be dealt with twice, at the start of an investment and at exit.

If an investor pays a entry price that is too high, it will be extremely difficult to perform sufficiently. The same effect occurs when the exit price is too low.

As methods of evaluating companies that are based on historical performance are obsolete in the current situation, it is necessary to focus on the future development of the company. In spite of the fact that this method is the most difficult to adhere to, it is the only appropriate way of assessment.

Again, we refer to the business plan, which has to describe the business and the possible future development.

A crucial element of the business plan is the five year plan of the company's prospective economical development.

On the basis of the prospective profit and loss statement and the plan for capital expenditure future cash flows can be estimated. To determine a company's value, investors discount future prospective cash flows. The rate of discount normally varies between 12% and 25% per year. The cash flow of the last year of the planning period will be discounted at the following formula:

Value = cash flow/(discount rate/100)

The result is the so-called terminal value, which has to be discounted by the number of years making up the planning period and added to the sum of discounted cash flows of every year of the planning period.

The following simple example illustrates this method of evaluation (a more realistic example is shown in the appendix):

Year	**1**	**2**	**3**	**4**	**5**
Discount Rate	**20%**	**20%**	**20%**	**20%**	**20%**
Cash Flow	**1000**	**1000**	**1000**	**1000**	**1000**
Discounted Cash Flow	**833**	**694**	**579**	**482**	**402**
Cumulative discounted Cash Flow	**833**	**1527**	**2106**	**2588**	**2990**

Assumed terminal value at the end of year 5: 5000;
discounted terminal value using 20 % rate: 2009

Value of the company before debt is the sum of the discounted cash flows:
= Cumulated discounted cash flow + discounted terminal value

4999 (2990 + 2009)

Any interest-bearing debt needs to be subtracted to arrive at the value of the company's equity.

A question frequently asked is whether the company’s assets, especially the land, buildings, machines, equipment etc. should be the deciding factor of company's value. It is certainly not! If one buys all these assets, one still doesn’t have the company's real ability to create future cash flows.

The cash flow is internationally agreed as the basis of a company’s evaluation. If a company has valuable assets which it doesn’t need for the production process, e.g. land which can be used for other purposes and has a certain market value, this value has to be added to the addition of discounted cash flows.

For any investor it is a crucial question which tax the company or the investor himself has to pay. Cash flows and values from idle assets are understood as net values (after tax).

An example of a company evaluation is shown in Appendix B.

3. Various Steps in the Investment Process

3.1 The General Idea of a The Business Plan

In the current situation in Russia every company has to be regarded in the same way as one looks at a start-up that has to build up its business from scratch.

In this context, the products and the markets of the company are of primary concern. The decisive questions are:

- Can enough products be sold at a sufficiently high price in the relevant market?
- Are there any local, countrywide or foreign competitors who will be able to enter the markets with similar, cheaper or better designed products ?
- Can the current customer base be maintained ?
- Will the company be able to manufacture at market price and guarantee the necessary quality standards?
- Is the company able to handle logistics in a proper way ? Is transport available at a reasonable price?
- Are the company's customers able and willing to pay their bills ?
- Can money be blocked by any kind of authority such as customs, tax authority ?
- Is the company in the position to produce higher number of pieces at the same or better quality and the same or reduced costs per unit?
- Can the production process be interrupted or disturbed by outside entities such as power supply, chemical additives etc. ?
- Are there any signs indicating that the production process will be more efficient in the future?
- Will the company in future get raw materials, parts, energy at the same price-level as it gets them now ? Are these items generally available ?
- Can the management be considered as being able to handle crises, or has the management team at least reached an unanimous agreement on how to run the company ?
- Is the local environment friendly to the company?

Each of the aforementioned items can be broken down into extensive questionnaires. It is wise to deal with all these questions. If there is any doubt whether the company is in the position or prepared to deal with the challenges of markets, an in-depth investigation has to be to considered. The minimum requirement with respect to the management is that it can present an action plan on how its position is to be improved.

The management has to have a strong influence on the way in which the business plan is set up. The business plan should give proof of the management's concurrence with the statements and figures presented therein.

The next list of important questions deals with the liabilities which have to be taken into account. There are liabilities which have to be mentioned in the accounts of company:

- Liabilities to suppliers of goods, parts, energy, transport etc.
- Liabilities to suppliers of machinery, trucks, construction work
- Bank debts
- Unpaid customs and taxes
- Back wages

Apart from these and other liabilities which are usually mentioned in the company's books, there is a long list of other possible liabilities.

For example, there can be liabilities arising from

- Obligations to deliver goods at too low prices
- Obligations to pay for hospitals, kindergarten etc.
- Obligations to pay for newly built roads, equipment for power supply
- Licenses of any kind
- Pension plans
- Guarantees
- Environmental damages
- Other obligations caused by the former company structure
- Are there any claims by authorities dealing with the company's site; should the company be relocated within the few next years; are investments to be made to improve the security of old- fashioned plants or installations etc.

All these items have to be carefully investigated. It has been shown that hidden liabilities can lead to much higher investments or even to a failure of the investments.

It has to be pointed out again that the above mentioned items are not a full questionnaire, but they should lead to a way of looking professionally at target companies. A guide on how to prepare a proper business plan is shown in Chapter 5.

3.2 Due diligence

After studying the business plan and following discussions with the management and other investors, professional investors start the process of due diligence. **Due Diligence means the verification of the statements made in the business plan**. Investors or their advisors will check market prospects as well as the economical and financial condition as stated in the business plan and accounts.

It is essential to look carefully at the calculations of the different products. The company has to prove that it will be able to manufacture goods at prices which will be marketable. During due diligence it has to be shown that all costs are properly calculated with respect to their real volume. Sometimes companies calculate costs and prices for high volumes, but unfortunately they can sell only small quantities. This will undoubtedly lead to substantial losses.

If a company projects a sharp increase in sales, it has to be proven that the company will be able to manufacture these goods with its machinery, while maintaining proper quality and timely delivery.

There must be an understanding of the production process. Diagrams help to explain the passage of the goods through the manufacturing process. Bottle necks can be identified. If a company plans a change in its product portfolio, it might be helpful to look at the machine capacity and the time which is needed for the different production processes. For example, if a company that manufactures eye-lenses plans to substitute one lens by a new one and the production of the new lens takes 2 minutes more per lens, this means that the production of 50000 pieces requires 1.667 hours more. This in turn could easily make an additional machine necessary.

If a company has foreign sales, it is important to know if the company can immediately dispose of income in foreign currency.

3.3 Deal structure

After general negotiations and due diligence regarding the structure of capital, the input has to be discussed. There are manifold instruments to inject money into a company. Apart from the participation in share capital, loans can be granted. Loans can bear fixed or floating interest or any combination hereof. Even a participation of loans in profit is possible. Loans might be converted into equity some time later, whereat the rate of conversion has to be defined. The structure will be defined by:

- the requirements of the company
- a mix of different risks and returns for investors
- the tax structure
- the legal environment.

Furthermore one should clearly state:

- the remuneration and participation of the management
- the participation of the employees.

The structure can balance the diverging interests of the company and its investors with respect to the economic terms of transaction.

The structure has to take the current and, if it can be predicted, the future tax situation into account. For many investments it is crucial to save taxes and create a high net cash flow that can be used for further investments and for expanding the business.

Taxes have a strong impact on the return. Is it more sensible for investor to receive dividends or interest payments ? Is capital gain tax free ?

It is necessary to have a clear picture of the various shareholder's rights which are linked to different levels of stake in companies. Again, everything needs to be determined by a concise contract accepted by all concerned parties. This obviously needs to be completed before closing and disbursement of the funds.

3.4 Legal Prerequisites and Closing

All relevant legal agreements will be examined and discussed by investors and their lawyers. The shareholder agreement and all other agreements that deal with the relation between company and shareholders have to be agreed. Even the management contracts could be analysed in detail. Every investor will know which decisions can be made by the management and which decisions have to be subject to a shareholders' meeting. It is common practice that all decisions which involve outflow of money above a certain amount as well as any change in capital has to be agreed by a majority of the shareholders. Lawyers can provide a long list of cases where an agreement is necessary.

Furthermore all contractual rights and obligations of the company have to be defined in the contract between investor and company.

3.5 Monitoring the Investment

Every investor likes getting current and updated information on the situation of the company. This means that the company has to provide a monthly report on the situation of the company. The monthly report should contain:

- A profit and loss statement
- Comments on substantial items
- Liquidity status
- Statements on important events and developments
- A detailed explanation of deviations from budgeted figures

The monthly profit and loss statement normally shows the figures taken from the accounts. It is not supervised by any accountant or advisor. It is very common to show the figures for the month, the cumulated figures for the year and the comparable figures of last year.

The liquidity status shows the prospective in- and outflow of money in the company's accounts during the next month.

In November of each year, the company has to submit the budgets for the following year to the investors. Budgets include

- profit and loss statement plan for the following year
- balance sheet plan for the following year
- cash-flow-statement plan for the following year
- capital investments plan for the following year.

with detailed comments explaining the individual figures, e.g. the turnover will be commented on separately for every group of products, according to volume and prices.

Receiving meaningful and timely information is, however, only the passive part of monitoring an investment portfolio. In the case of a significant equity stake held by the investment company there will be the need (and, if everything has been done correctly, the right) to exert positive influence on the company. This can be done, for example, through participation and voting rights in a supervisory board or the right to have to be consulted before important decisions are being made.

Investors therefore often request that the company establishes a supervisory board. All reports will be addressed to the supervisory board. All decisions on which investors have to agree will be made there.

3.6 Co-operation between Investors

When two or more investors invest in a company, they normally agree on a contract which pools their interest. Investors with different time frames for investment or different interests in the company will cause difficulties. Investors should team up and agree on one investor as lead investor. The agreement should deal with following items:

how long should the investment be effective
(minimum investment time)
which exit should be chosen
pre-emption rights of investors
mechanisms to deal with difficult situations during
investment period

Investors should take care that they act with one vote and one voice vis à vis the company.

3.7 The Exit

To achieve a sufficient return it will be necessary for the investors to have the possibility to sell their shares at an attractive price. Ideally, the exit follows a stock exchange introduction of the company's shares. The price of listed shares is equal to the market price or evaluation of company. If there is no chance to get a listing at local or any other stock exchange, the shares can be bought back by the company itself - if it is legal to do so - or by other shareholders. Other possibilities may be selling to another company or to others investors.

4. Issues when Setting up an Investment

4.1 Business Opportunities

When a financial institution enters the investment business, it intends to advise:

domestic investors,
foreign investors,
companies which look for funds and investors.

Furthermore, some banks intend to act as investors on their own behalf or by order of clients.

Krasnodarbank, for example, is in the position to enter the business in an aggressive way. Western European investors are highly interested in investments in Russian companies. It is extremely difficult to get money for a so called blind fund which has nothing to show except for the mere intention to invest money. It is much easier to prepare a memorandum which

shows 5 to 10 well worked out investment opportunities. Capital investors are much more prepared to invest in something they can ”touch” than in any other business opportunity.

Basically, such a fund can be listed at a Russian or Western European stock exchange and managed under a management contract by the investment company. A listing helps to attract investors.

4.2 Typical Structure of Investment Department

Propositions dealing with direct investments in non-quoted companies are one of the most complex duties of any financial institution. Every institution, whether it is a bank or an independent unit, has to build up sufficient, well-trained and experienced staff. The number of people depends on the prospective number of deals per year. It can be assumed that the consumption of a deal takes about six months. A team of three experienced investment professionals may be able to work on three deals at the same time.

This results is a maximum of six deals per year and team. Experience shows that only a certain percentage of the deals materialises. If every third deal is closed, two deals per team and year mean that the team is successful.

With some deals the monitoring of investments will be time-consuming and additional staff will be required.

Investments in trouble are extremely time consuming. Only the most experienced staff should deal with these situations.

If more teams are in operation, they can specialise on different business sectors and build up additional expertise.

The team that runs a managed investment fund should consist of five to six members and appropriate support staff.

4.3 Remuneration

The client who asks for a service, regardless whether he is an investor or a company, normally has to pay the financial institution for its services. Remuneration can be agreed upon as:

- time based fee,
- success fee in % of investment,
- any combination thereof.

Success fees normally are more attractive, but they are based on the assumption that the deals will be closed. The amount of the success fees depends on the volume of the deals. In Western Europe it is quite common to charge:

- 5% for investments up to US $ 1 Million.
- 4% for volumes between US $ 1 Million and US $ 3 Million
- 3% for volumes between US $ 3 Million and US $ 5 Million.

Success fees are negotiable and any kind of agreement is possible.

Fees for managed investment funds could be:

- management fee: 2% of volume
- success fee: 20% of difference between the money invested at the beginning and the money investors receive at the end of the day.

4.4 Budget of the Department

The budget should cover:

- Number of people, Remuneration,
- Rent
- Communication costs
- Travel expenses
- Legal and tax Advise
- General administration expenses and office equipment.

5. Steps in the Preparation of Investment Memoranda and Typical Content

This section specifically refers to an "Investment Memorandum" rather than a "Business Plan" even though the two, if well done, are essentially the same. Within the context of Russia a business plan, as referred to by Western consultants, it is often a rather simple document serving a different purpose and target audience. The document to be developed within a serious investment company needs to be much more elaborate and the investigations have to be thorough and provide reliable and complete information.

5.1 Outline Structure

The outline should highlight the ability of the management, its competencies and its knowledge of the product market. With respect to their expected decision, investors seem to give priority to the qualitative aspect. If they are satisfied with the concept, they will proceed to examine the figures. The contents of the business plan are described in a separate chapter.

There are three investment criteria that ought to be looked at:

- management team
- management competencies,
- strategic-competitive/ financial.

In principle, this guideline will be based on the above concept. It will contain the following issues:

- Executive Summary
- Proposal
- Company Description
- Management Competencies
- Products and Services
- Target Markets
- Market Strategy, Strategy for Growth
- Financials - actual/forecast.

The guideline addresses the basic information required and describes its use under each heading. A SWOT analysis (short for: strengths, weaknesses, opportunities, threats) completes the process.

Initially it is recommended to elaborate the first few propositions with the assistance of an experienced investment consultant..

5.2. Executive Summary

Formally, the executive summary is a brief presentation - usually one page - of the contents of the project proposal, i.e., it can only be written once the full version of the business plan is completed. It tends towards the more qualitative aspects of the proposal. At the outset it should clearly state to whom it will be addressed and that the proposal is nothing else but a business plan.

By fulfilling this objective it gives the potential investors an overview of the business and the investment proposal. It should (1) express the reasons why the proposal is so attractive and (2) communicate the belief that the objectives of the business plan are well founded and achievable.

The summary represents a powerful sales document and must not be underestimated, especially in those situations where additional funding has to be secured. The typical financial investors look at the attractions first and, if they meet their expectations, they will be encouraged to study the entire plan.

5.3. The Proposal including ROI

From the very beginning, the reader of the business plan should clearly understand its purpose. It should be stated, therefore, whether it has been written in order to raise additional funds, to finance working capital requirements, or to receive long term funds and/or equity capital. This section should allow the reader to determine the amount and type of funding like equity participation, long term loans, private placements, time loans and overdrafts or internal dotation of funds that are being sought, the purpose and, if possible, the most suitable method of raising the money. This section refers especially to the attached financial planning documents and cash-flow projections. If the establishment of a corporate investment unit or a separate investment company is being envisaged, the same procedure applies.

The wording should be short and reflect the project sponsor's objective(s) accurately to allow the reader to determine precisely what he is looking for. Half a page may suit that requirement.

The proposed return on investment (ROI) to the investment company or the outside investor should be clearly stated.

5.4. Description of the Company/ Organisation

The executive summary has created sufficient interest that the reader wants to learn more about the company. He is ready for a thorough study of the proposal. It should provide key information on when the business started and how it has progressed since then. This section should at least contain the following information:

- description of business (products, activities, services, research and development)
- key personnel such as managers, directors, researchers
- financial history of the company and cost structure
- current financial arrangements
- principal legal engagements like joint ventures, co-operative agreements etc. supply contracts
- production and office facilities, technologies used, material supply situation, logistics, capacity constraints etc.)
- subsidiaries, ventures, other dependencies.

In order to facilitate the analysis, ready-made questionnaires should be used. These worksheets could be structured according to the attached examples (Appendix E). They are intended to help elaborating the main characteristics and, as a side effect, are regarded as an excellent training tool. In the case of an entirely new business or a new form of organisation the description should mainly focus on the factors that have led to the demand for a new product/ service and on how the new venture will meet that need.

5.5 Management Skills and Competencies

Investors, in particular bankers, present their arguments according to certain priorities and follow these in their decision making process. In their opinion, the quality of the management is the most important factor, followed by product and service. The market and its growth potential rank third, whereas profitability comes in fourth. In accordance with this order of significance, the business plan should focus preferably on the management's ability to run the business successfully. In principle, the quality of the management is an undefinable combination of technical expertise, management skills and the competencies as displayed. Its track record is the best indication that it may handle the future aspects of the business.

Most appropriately this section starts with the display of the organisational chart. The chart should give an overview of the key executives of the company and should list their main responsibilities. For this purpose, an abbreviated version may be sufficient.

In order to evaluate the key peoples' potential, brief curricula vitae (3 to 5 lines) are to be included for each of them. In the comments section, the plan should point out special strengths

and qualifications. It should also clearly elaborate the individuals' competence and his potential. Key elements of the employment contracts are to be incorporated.

A well-prepared plan also addresses possible gaps in the skills that are either missing completely or are only weakly represented in the company. The plan should clearly point out those gaps and present suggestions on how to fill them in.

A crucial factor for the company's success is the individuals' commitment to their work. Consequently, the business plan should give insights into the company's scheme of profit-related remuneration for key executives. If not already established, the plan should indicate when it will be introduced and what shall be the core parameters. A kind of bonus and/or share option system for key personnel is considered mandatory in the business world of today. Some of the key individuals may already have a personal financial investment in the company. Readers will appreciate this as a significant indicator of the dedication and a particular motivation for the future.

Although the business plan should be as short as possible and concentrate on key characteristics, the organisational chart, the CVs of the key executives, the employment contracts and information on the remuneration scheme have to be supplemented by detailed documentation.

5.6 Competitive Analysis (SWOT)

The SWOT pattern is internationally used to give an overview about the situation of the company in their market. SWOT stands for:

- Strengths
- Weaknesses
- Opportunities
- Threats.

Every item important to the business of the company should indicate the position of the company versus its competitors. If a company, as is not to be avoided, has weaknesses it should be pointed out which measures the management plans to undertake to overcome those weaknesses. A "quick and dirty" example on how to conduct a SWOT analysis is given in Appendix B.

5.6.1 Products and Services

The general description of the business is followed by a detailed analysis of the products and services and the reasons why these activities have been successful/less successful. This section has to focus on the essential characteristics that have made the company unique. It should include information on the means of production and the means by which the service will be provided. Appendix E will provide some guidance for the collection of detailed information. Prospects, photographs, blueprints, models et cetera could furthermore help to generate the desired impression and should be added as documents.

The wording should be such that the reader(s) can easily understand or even visualise the output and can get an idea of the technological advantages without particular technological knowledge.

In essence the section should comment on the following issues:

- product, product range activities and services provided
- product and marketing strategy
- technological and competitive strengths
- research and development
- manufacturing and logistics
- supply of materials
- workforce
- logistics
- land and buildings (availability, quality, additions)
- any other item essential for an understanding of the company.

5.6.2 Market Characteristics

The description of the target market is of crucial importance to the development of the sales plan. It should be well-presented. The intention is to demonstrate that there is a demand for the products/services at attractive prices and to explain the forces that drive the market.

The overall assessment should lead to an unbiased judgement regarding the expected size of the potential market, its projected growth and the share that could be gained. It should be objective and give only little room for enthusiasm. Readers should have the impression that the plan is both realistic and trustworthy.

It is to be expected that the development of such a plan that meets these high standards necessitates the involvement of external experts in the collection of data and the assistance of advisors in its evaluation. Surveys, statistical data and the results of market research are the most frequently used instruments in this context. In the eyes of prospective investors, the utilisation of those instruments underlines the professionalism and objective attitude behind the work.

The plan should start with the macro-economic assessment of the size of the market, the boundaries of which should be clearly defined. The work concerns the definition of the geographical coverage of the goods/services offered, the quantitative and qualitative aspects of the current demand, segmented into categories of buyers, the volume of the disposable funds

of prospective buyers, legal limitations, the structure of the market and the behaviour of market participants as regards competition, entrance and substitution. In short, it should exploit and present the market forces at work.

Within the parameters of the macro-economic settings, the historical and actual role of the company has to be elaborated. The past and actual share in the market should be explained on the basis of statistics. Graphics are considered to be the most impressive vehicles to illustrate the development to date. Primarily they are to be used to show correlations, tendencies and dependencies of the company's achievements within its market. A thorough analysis will lay the ground for the decision on future market activities and strategical changes of the company. The latter aspect will be handled under the heading "Marketing Strategy."

5.6.3 Customers

This section should be devoted to the company's current as well as prospective customer base. Its purpose is to convey to the reader who the customers are, what their financial means are and what kind of marketing strategy is followed. It should end with a clear statement on the competitive advantage the company may have over its major challengers. A complete list of customers including prospects must be added as document.

5.6.4 Marketing Strategy

With the knowledge of the forces that drive the market and the company's potential to serve it, the ground is prepared for the presentation of a well-founded marketing strategy. This strategy aims at several directions, but ultimately it aims at expanding the room for manoeuvre as regards the company's independent price policy. Advertisements, image campaigns, sales promotion and product diversification are to be considered as key elements to push the sales volume. The plan should already provide examples of the first measures to be taken. Potential investors will be very interested to read this section.

5.7 Plan for the Future

At this section the proposed strategy for further growth and profitability needs to be described. All assumptions and inter-dependencies as well as the likelihood of certain critical events actually occuring will be included.

In order to give substance to the sales forecast leading to the financial projections, the presentation of the formal sales plan becomes necessary at this stage. The sales plan itself consists of two subplans: (1) sales and margins plan, (2) overheads plan.

5.7.1 Sales and Margins Plan

The approach to the sales and margins plan starts with (a) considerations on future activities whose outcome are (b) sales figures after (c) costs over a defined time horizon (3 to 5 years) and ends with the presentation of the operating plan.

The planning process commences with the formulation of the best estimate of sales. Material requirements, production optimising, labour requirements, financial needs et cetera are subordinate and based on this estimate. Once the forecast is given, the management can calculate the profit and loss, the future balance sheet(s) and the cash-flow projections of the company.

In the course of this process, the management must handle the surrounding uncertainties. It has to present realistic assumptions on how to quantify the manifold risks. This condition demands a sales plan where each activity is broken down to the core factors affecting it. The management must then evaluate their contribution to the overall outcome and decide on what would be the most likely scenario to adopt.

5.7.1.1. Range of Activities

The agreement on the margins plan requires the determination of products, line of products or range of activities. This is an essential task, as products overlap in terms of manufacturing, facilities used, buyer markets and raw material. The most suitable approach is to distinguish product or product areas based on customer markets and to subordinate the manufacturing process, the financing et cetera to match this condition. If the plan is going to be generated for a new venture, customer requirements should aim at product differentiation.

To allow for a more accurate forecast of cost and earnings, the number of products/ activities should be kept low. This exercise forces the management to concentrate on products, on customer segmentation and on the production process. Thus it highlights the particular strengths and weaknesses. Professional advice from outside the company is sometimes required.

5.7.1.2. Sales Forecast

The identification of the range of activities should be followed by a reasonable assessment of the sales volume and sales prices. The forecast of the volume may be based on quantity, weight, time or any other criteria. Multiplying the quantity times the average price generates the basic estimate. It can be used as baseline to predict the dimensions of variations in both factors, e.g. the price elasticity. For example, a 10% price discount could result in a 20% increase of sales. But does the overall effect on the company's return before tax yield such a price reduction compared to the original volume and original price? This question can only be answered at a later stage, when costs are introduced.

Basically, the separation of volume and price is more understandable and facilitates the evaluation of the effects of changing them. In other words, it explains their elasticities. It also helps to assess the effects of deviations from the plan when new business opportunities are

introduced or the market conditions do not allow the achievement of the planned forecast. It therefore becomes a useful tool for monitoring the ongoing business.

In principle, the applied procedure serves three objectives: (1) the evaluation of margins resulting from increases or decreases of sales volumes and price changes respectively, (2) to monitor the level of stock holdings in raw material, prefabricated goods, merchandise and goods ready for sale, and (3) the creation of a simple table to assess the cost of sales.

5.7.1.3. Forecast of Cost of Sales

Any costs that affect the sales directly must be identified and are to be included in the calculation. Consequently the calculation comprises purchase costs, distribution costs, salaries of the sales team, advertising costs et cetera.

In a first step the costs have to be identified according to type and grouped into workable categories. Costs may rise or fall with the production cycle or in relation to the sales volume. Examples for this fact are raw material and labour costs. They could be fixed like management salaries, car rents, leases. They may be variable in relation to the production output, but not to the sales volume and vice versa. While sales commissions, rebates and distribution costs vary with sales, they do not alter with the production output. There are costs that change indirectly, but not in a one to one ratio like raw material which is bought in large quantities like screws and nuts with substantial rebates but used in manufacturing for several products.

The allocation of costs can cause the management many problems. However, the advice that costs should be allocated where the manager can control them best indicates how companies may solve the problem. Principally it is preferable to forecast and monitor variable costs accurately, but to predict fixed costs as well as to control them separately.

5.7.1.4. The Operating Plan

The merger of the cost forecast into the sales forecast creates the operating or margins plan. This plan is not generated by simply adding the figures of two separately maintained plans but also by testing the underlying assumptions. The tool used for that purpose is called sensitivity analysis or contingency planning. The analysis should help to understand (1) how much can be gained or lost from either over- or under-optimistic forecasts, (2) how the business can best be operated in the future, (3) what are the products to lean on, (4) what is the pricing optimum, and (5) how the company should react when market conditions change and the level of expected margin(s) in certain segments seems impossible to realise.

The analysis starts with estimates on the margins (sales and costs) for each activity, if different sales volumes are envisaged. The variations could range from the worst to the best possible scenario. Within those parameters, the effects of a sales increase by say 5%, 10 %, and 15% or of a sales decrease by similar ratios are to be plotted under the assumption that the level of distribution costs shall remain fixed. The forecast should be generated on a monthly basis for three consecutive years at least.

An explanatory model for a sales and margins sensitivity analysis could be developed as follows:

Scenario	Sales	Margins (30%)	Overheads	Pre-tax profits
	(Year ending December 31, 1996, in million rubles)			
Best 15 % above target	11,500	3,450	2,600	850
7,5 % above Target	10,750	3,225	2,550	675
Target	10,000	3,000	2,500	500
5 % below target	9,500	2,850	2,450	400
10 % below target	9,000	2,700	2,400	300
20 % below target	8,000	2,400	2,350	50
Worst 25 % below target	7,500	2,250	2,300	(50)

5.7.2. The Overheads Plan

A certain set of cost categories is not included in the forecast of the operating plan. These are called overheads and are not directly related to the sales of goods or the provision of services. They can be summed up and categorised as follows:

Personnel costs: pensions, social insurances, housing allowances, other benefits;

- Additional operating costs: telephone, light, heating, general insurances, cars, cleaning;
- Finance costs: interest on overdrafts and loans, leasing instalments, fees;
- Sales and marketing costs: advertising, exhibitions, business promotion, salaries and wages of the sales team;
- Equipment costs: maintenance, repairs, depreciations;
- Research and development salaries, equipment and other costs that would disappear if the R&D programme was stopped;
- Start-up costs: rents, legal fees, premises, insurance and repairs of premises.

Here, too, a sensitivity analysis is required. It can provide valuable hints as to the development of the overall costs in comparison to total revenues. Ultimately, it emphasises those overheads (1) that are necessary and/or on which the business depends and (2) that are too low or too high in the forecast.

5.8 Strategy for Growth

At this stage of the business plan, the reader will have gained an insight into the products and services offered, how the company has developed to date, its financial situation, the key personnel's capabilities and potential and its current financial/ economic outlook. Now the work must focus increasingly on the selling aspect of the plan. Potential investors will be interested to learn about the management's endeavours to lead the company towards a bright and profitable industrial future. --Examples of the range of strategy-oriented topics are to be presented in detail. In this context, the plan may address the following subjects:

- growth potential of the business
- plans for expansion
- planned increase of profitability
- planned additions to products and services offered
- mergers and acquisitions of other companies, partnerships, joint ventures
- plans to expand the capital base
- synergies (vertical, horizontal, conglomerate).

The business plan should only select those issues that are deemed necessary to reach the desired effect. The text could ideally start with the description of the growth potential and the management's future policy. This procedure generates a clear understanding of how the management wishes the business to develop, and potential investors will be able to see what role they can play. This section should furthermore provide a likely response to the investor's most crucial question concerning the ability to realise the investment. He wants to know how, when and by what means he can reasonably plan the cash exit. For example, the company may decide to go public after five years and to place the shares in the market, or to re-purchase the shares after three years. In the case of a joint venture or co-investment, the business plan should give careful consideration to the nature of the potential investor's own business and present possible synergies.

5.9. Financial Forecast

The most tangible result of the planning process is the financial forecast describing the company's strategy by means of pro-forma balance sheets, income statements and cash-flow projections. The plan establishes the financial objectives and is considered as a benchmark for evaluating the subsequent performance. It combines the effects of the totality of the company's individual investments as well as finance decisions, and already contains alternative strategies to be employed in the event of unfavourable surprises. The presentation of a clear and logical financial plan allows prospective investors to assess the expected rate of return. It provides a means to differentiate between various investment opportunities and their effects on the company's profitability, liquidity, capitalisation, market penetration etc.

The development of the formal plan requires, among other things certain assumptions on sales and services, on prices, on costs, on financing, on taxation and the capital structure. Most of those assumptions are derived from former operating experiences and/or other market information. It is quite understandable that the assumptions must be realistic and plausible. The most appropriate approach for a going company seems to lean on average key figures of the past 3 to 5 years and correlate them to the overall performance of the economy. In this context, the Gross National Product (GNP), Export-/ Import Statistics, Tax Revenues, Money Supply Figures, Inflation Rate, and Industrial Indices could present excellent guidelines for forecasting the general outlook for the company. Statistical background figures shall be given either by the State/ Central Bank or international agencies/ banks like OECD, IMF, EBRD. Bank practice has shown that pro-formas can be derived from the projection of eight figures :

- sales or expected rate of increase of sales
- consumption/ supply of raw material/ merchandise
- personnel expenses or percentage of personnel expenses vs. operating income
- de-/ increase of fixed assets
- annual depreciation
- raising and/or repayment of loans and equity
- withdrawal of funds for taxes
- other withdrawals.

The application of the more simple procedure will not replace the forecast of every individual item. But it can well serve as a vantage point when the economy has not yet stabilised and allows for large deviations that especially characterise emerging markets. An explanatory model for a sales and margins sensitivity analysis could be developed as follows:

To avoid any excess documentation, a reasonable compromise must be found between the figures and ratios to be presented in the plan and those to be documented in the appendices.

Examples of the pro-formas can be found in Appendix B, Evaluation of a Company. They can easily be computerised and thus help to accelerate the forecasting process as well as to perform any sensitivity analysis.

The time frame the spread sheets should cover depends on the purpose of the business plan. A minimum of three years, but ideally 5 years, are advisable. As regards the discount of the cash-flow projection, the net present value (NPV) calculation might be added on demand.

Where the inflation rate surpasses normal levels (> 5%), the figures must be indexed.

Appendix A

Example of a SWOT Analysis

Strenghts and Weaknesses Profile
Comparions with
strongest competitor

* Company reported
\+ Company compared

Rating **Bad** **Good**

- Product quality
- Orientation towards customer demands
- Service quality
- Acceptance
- Cooperation with distributors
- Ability to deliver
- Distribution/marketing concept
- Price level
- Management qualification
- Employees' qualification
- Employees' motivation
- Technological standard of production
- Cost situation
- Possibility of subcontracting
- Location

Commentary

Appendix B

Example of Financial Analysis - Company Evaluation

The following example is based on the free cash flow method. This method shows the cash return on invested capital very clearly. Other than most traditional methods, it not only considers the fixed capital invested in a business, but also the working capital requirements.

Obviously, any evaluation is only as valuable as the underlying assumptions. To start with, the turnover and the development of units and prices have to be estimated. Page 1 of the example shows the sales forecast of the four products which Company XXX produces. Sales of trading goods and spare parts are shown as well. Total sales are calculated by adding the volume of the different product groups.

Page 2 shows us - in a simplified manner - assumptions on material costs, personnel costs, other operating costs, tax rate and required capital expenditure.

The profit and loss statement on page 3 is a results of the assumptions. Only depreciation, which has an influence on the calculation of taxes is put in as a constant. Of course depreciation is a function of capital expenditure.

Since depreciation is a non cash-out item in the profit and loss account, it has to be added to the net operating profit in order to arrive at the free cash flow. Capital expenditure has then to be added, and the change in working capital, which can be positive or negative, has to be considered as well.

The yearly cash flow then has to be discounted. Discount factors are usually the costs of capital including an adequate risk premium.

At the end of the planning period which is mostly 5 years, the company's operations will continue. It is common sense to take the last year of the planning period as an ongoing basis. This terminal value is calculated as a perpetual rent and will be discounted by 5 years.

The sum of the discounted free cash flows of the planning period and the terminal value form the enterprise value of the company. This enterprise value includes all interest bearing debt. If the balance sheet of Company XXX shows bank debt of 10 million and a debenture of 5 million, the purchase price would be determined as enterprise value of 38 million minus 15 million, i.e. 24 million.

Appendix C

Questionnaire - Market Attractiveness

Market attractiveness

Criteria	Bad	Medium	Good
I. Quantitative market elements			
- Market growth			
- Size of market			
- Dependence on economic development			
II. Market quality			
- Profitability (returns) of business			
- Buyers' bargaining power and attitude towards buying			
- Flexibility of price policy			
- Technological standards			
- Potential for innovation			
- Protection of technological know-how			
- Threat from alternative products (substitutes)			
III. Supply of energy and raw material			
- Price fluctuation for raw material			
- Availability of alternative raw materials and energy supplies			
- Number and structure of potential suppliers			
IV. Environmental conditions			
- Threat from environmental restrictions			
V. Miscellaneous			

Commentary

Appendix D

Questionnaire "Business Plan"

1. General Description of the Company

Company name & initial/brand

Address

Main Activities (brief comments on product(s) and/or product lines, volume, value, past performance, degree of integration, level of bought-in merchandise and/or prefabricated goods, range of diversification, leadership and competencies, opportunities/risks et al.)

Other Activities

Legal Status & Year of Incorporation
(If available, copy of the Licence, the Registration and the Company's Charter and by-laws)

Type and Year of Privatisation

Percentage of Ownership/ Shareholders (grouped into Categories Directors, Employees, Other(s)

Location of Facilities (office, production, branches - List of all facilities required.)

Subsidiaries, Joint Ventures, Cooperative Arrangements
List of main sub's and joint ventures required. The list shall contain: name of company, activity, set-up date, share, other shareholders, additional comments.

Contingent Commitments and Guaranties (given and received)

Questionnaire "Business Plan"

2. Organisation and People

Organisational Structure (if available, the organisational chart should be added, if not, details on the structure must be given in order to design the chart)

Key People like Directors, Senior Managers, Researchers (name, title, responsibility and year of assignment, year of joining the company)

Comments on the Strengths and Weaknesses of the Management

Features of the Employment Contracts for Key Individuals

Remuneration and Bonus Schemes

Staff Development (number, structure, salaries, social benefits, productivity per person etc.)

Skills/ Qualification of the Workforce

Training

Labour Laws (affecting hiring, dismissal and disposition of people)

General Comments (quality, preparedness to accept changes, potential etc.)

Questionnaire "Business Plan"

3. Supply and Logistics

Development over the past 3-5 years

Main Supplier(s) (name - grouped in accordance with the corresponding product/ activity - seize, sales volume, market share)

Strengths and Weaknesses

Development of the Terms and Prices

Barter Deals (key elements, statistics on sales and prices)

Logistic of Sales and Purchases

Development of Stocks

a) Raw Material

b) Prefabricated Goods

c) Finished Goods

d) Merchandise

To avoid any excess documentation, a reasonable compromise must be found between the figures and ratios to be presented in the plan and those to be documented in the appendices.

An examples of the company valuation has been shown in Appendix C. This can easily be computerised and thus helps to accelerate the forecasting process as well as to perform any sensitivity analysis.

The time frame the spread sheets should cover depends on the purpose of the business plan. A minimum of three years, but ideally five years are advisable. As regards the discount of the cash-flow projection, the net present value (NPV) calculation might be added on demand.

Where the inflation rate surpasses normal levels (> 5%), the figures must be indexed.

Questionnaire "Business Plan"

4. Macro-economics

Development over the past 3-5 years

Main Markets (quantitative estimates on each product, product line, activity etc. on volumes, values, past development, outlook). Surveys are to be directed towards:

a) Local Market

b) Regional Market

c) National Market

d) Exports

Comments on the Structure of the Market and its Segments, its Trend, its Price Elasticity and on Competition including factors inducing adjustments and changes

a) Structure (oligopolistic, monopolistic patterns as regards both seller and buyers)

b) Trends and Substitutions

c) Price Elasticities (reaction to changes of prices and volume)

d) Competition (new entries, expansion of existing producers, disappearance of old market participants)

Questionnaire "Business Plan"

5. Activity Characteristics

Sales Figures of each Activity and Market Segment (list of all products, reasonable grouping sales statistics

Main Competitors (name, size, trends, market share, competition on local, regional, national, and export markets)

Strengths and Weaknesses

Output and Capacity Utilisation

Production Process and Productivity (list new installations, equipment, facilities etc.)

Research & Product Development (actual status, launch of new products and their expected contribution to sales, budgets over the last 3 years, people and their qualification, new ideas)

Development of Manufacturing Costs/Productivity (per person over a period of minimum 3 years)

Patents, Licences (main characteristics, contribution to sales and income)

Quality/ Training

Questionnaire "Business Plan"

6. Planned Investments/Capital expenditures

Main and Secondary Objective(s) (commercial, industrial, financial)

Type (product improvement, diversification, new demand, new segment, quality improvement, capacity enlargement, energy saving, ecological aspects)

Input (material, human resources, engineering, training)

Output/ Products/ Services

Time-schedule

Total amount(s)

Profitability, Cost Structure, Ratios

Amortisation

Budget (structure, terms and conditions, short-term liquidity plan, cash-flow projections for each project)

History (3 years) of Recent Types of Capital Expenditures (replacements, new technology, capacity extension, environment)

Additional comments

Questionnaire "Business Plan"

7. Financials

List of All Fixed Assets (installation year, book value, current net value)

Summary of All Tangible Assets (entry, gross book value)

Company's Balance Sheets (min. 3 years) including audit reports

Company's income statements (min. 3. years) containing the following items:

sales and revenues
other income (rents, discounts,
interest, subsidies)
tax returns
extraordinary income
income before company tax

raw material
energy
labour costs
depreciation
overhead expenses + direct taxes
financial expenses
direct taxes

Cash-Flow Analysis, Analysis of Sources and Application of Funds

Dividends and Dividend Policy

Financing Agreements with All Lenders and Rent Contracts

Minutes of Management, Shareholder and Staff Meetings

Financial Forecast (methods, pro-formas of balance sheets and income statements, liquidity plan for up to one year, development of key ratios on liquidity, leverage, earnings and taxes, cash-flow projections)