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To: Salvator Rugamisa / Economic Advisor PM's
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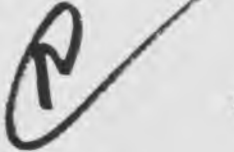
From: RHG



SOUTHERN PAPER MILLS

Introduction

1. I was involved in 1982 decision to complete not cancel SPM and have kept a worried eye on it from time to time since. Recently - when I was seeing him on other (Nishati) business, A. Boyd of CDC raised SPM in some alarm and deep concern at lack of progress and resolving problems. As AB is highly competent and a long standing, firm friend of Tanzania. I agreed to look at relevant papers from CDC and pass my comments to Dar.

2. I have now read and reflected. The situation is appalling in itself and contributes to blocking any other CDC initiatives in Tanzania by its negative 'demonstration effect.' Below are my detailed comments keyed to March 1987 CDC Report and subsequent developments. As you will note I do not necessarily agree with relative weight CDC/World Bank and all place on different points but do agree TAZARA's strangulation of SPM must be reversed (and physically can be with rational fleet management plus goodwill).

3. I am sending this memo to two addresses for specific reasons:
a. to Nd. Rugamisa because Tazara involves Zambia which is always a bore (to put it mildly) on getting action and probably requires a coordinated interministerial demarche, ultimately perhaps at political but initially at top civil servant level;
b. to PST because the export and debt service core issues are of macroeconomic concern and because CDC's contact focus is Hazina (as for that matter is mine on most topics).

Problems Threatening SPM Survival

4. SPM's survival is at risk on several fronts:

   a. TAZARA repeatedly fails to supply minimum necessary quantity of wagons (bogies);

   b. TASARA wagons and handling equipment are all wrong quality/design resulting in serious damage to paper which reduces value and threatens export saleability;

   c. A series of export marketing issues are unresolved;

   d. Certain capital investment needs are urgent for increased viability;

   e. And cannot be funded under present conditions;

   f. While the cash flow deficit is unsustainable and cannot properly be plugged by bullying NBC into providing overdraft to finance losses;

   g. So that a capital restructuring is necessary and - on the face of it - is possible without threatening cover for Hazina loan repayments.

Transport Strangulation

5. SPM in 1987 has, so far as its own operations go, been in a position to produce up to 45,00/50,000 tonnes and to sell that amount at home and abroad. But it will be lucky to reach 30,000 tonnes output and 27,500 sales. Why?
   TAZARA is not supplying bogies as needed despite clear forward requirement specifications. Near total breakdown in bogie supply took place in September/October. Earlier there had been serious problems but for a time these eased but are now at their most serious levels ever.

6. Given where SPM is, TAZARA's failure is negligence and non-cooperation. Because SPM is beyond (on Dar side) Makambako/Chita, there is no special traction power problem. Because down (to Dar) traffic is less in volume (and usually tonnage), than up (to Ndola) there should be empty backhaul cons from Ndola which commercial prudence alone would dictate supply to SPM. As SPM is a significant economic and forex unit

in Tanzania it is TAZARA:s business (as a joint T-Z venture) to go out of its way to solve it properly.

7. Not being daft or forgetful, I am well aware of the practical problems with sorting out transport issues involving Zambia. (In fact Zambia's interests would not be compromised by returning wagons carrying SPM paper to Dar - so far as Z is concerned about Tazara finance its interests would, in fact, be furthered! However, that in itself does not imply this ready cooperation will be available.) Possibly a demarche at senior level by Transport/Industry/Treasury/SPM-NDC led by PM's first to TAZARA GM and if necessary to a special TAZARA Board meeting could produce results?

8. It is all very well to say 'TAZARA is not Tanzanian' and 'CDC shouldn't judge Tanzania by TAZARA'. Indeed I did point that out to Mr. Boyd. But the facts are:
a. Tanzania is half TAZARA and surely has more leverage over it than SPM or NDC or CDC;
b. it is our paper mill that will go belly up unless TAZARA is called to order;
c. of course CDC - and not only CDC - will judge us on how we solve (or don't!) key problems of our largest single factory complex.

9. A second problem is that the wagons are the wrong size and the handling equipment (at Dar I take it) inappropriate. The result is serious damage to paper. This reduces unit value and endangers export sales even at lower price. Here, the solution is less clear - it is not TAZARA's fault its rolling stock/handling equipment does not meet unique requirements of a 2-3% user (i.e. at 70,000 tonnes input, output SPM would account for 3% of 2,500,000 tonne TAZARA total traffic - both plausible 1988/89 targets). Nor can it readily integrate a fleet of non-standard vehicles to suit SPM if these are to TAZARA capital account and have to operate Dar - Ndola - SPM - Dar.

10. IF SPM could afford its own specialised fleet leased to TAZARA and dedicated to paper down/SPM inputs up plus inducing TAZARA to upgrade fragile cargo oriented handling equipment at Dar that would perhaps be a good solution. But SPM has not the finance, at least now now. An interim approach might be:
a. restudy loading possibilities with existing bogies/handling equipment to reduce loss (SPM - NDC - TISCO - Transport personnel);
b. consider whether flatcars with tarpaulins would be an improvement and could be made available by TAZARA for part or all of the paper (same team);
c. desk study of cost of optimal car fleet and possibility, using its backhaul for SPM inputs to lay base for SPM or TAZARA procuring such a fleet at a future date (SPM - Transport?).

Export Earnings/Sales

11. SPM was from 1982 on (when abandonment was considered seriously but continuation decided upon) been intended to export at least 30.000 tonnes of paper a year and to earn enough forex to cover all import and debt service forex requirements. Unfortunately, it appears to be an understatement to say that this decision (without which Hazina would have backed abandonment) has not been adequately articulated, prioritised or programmed. Even on present projections there remains an underlying annual forex drain of $5 to 6 million a year (versus $10 million odd plus paper inputs if the plant were abandoned). Admittedly paper prices are below 1980-82 anticipations, but they have recently improved so that a revision/improvement of export targeting and pricing to achieve Tonnes 35,000/37,500 a year and $17.5/20 million export revenue a year is a priority and not a self evidently non-feasible one. At that level by 1990 SPM would be near or at forex breakeven.

12. In 1986 export sales were apparently below the amount that could have been produced because NDC/SPM were very late (not to say lackadaisical) in securing a technical marketing partner and/or links to major paper traders. The present position is less bad but hard to evaluate:

a. TAZARA not export orders, have constrained exports, <u>but</u> whether 30,000-35,000 tonnes could have been sold abroad, if available, is less than clear;

b. damage in shipping has reduced export prices so it is hard to tell whether proper prices have or have not been negotiated for export sales (i.e. cannot compare with standard prices and have no present way to determine whether short fall is all quality/damage related or partly arises from weak selling);

c. no clear strategy as to niches in <u>market</u> (where? what kind of company?), <u>product</u> (which of SPM's possible lines should be given priority?), <u>pricing/contract</u> (i.e. spot? term? one off? continuing relationship?) seems to have been prepared and presented. (The two external marketing studies are artifactual in that they do <u>not</u> address the above very real and practical questions);

d. regional sales (SADCC/PTA) have been hampered because the BOT will not allow retention allowances on exports to be used for business travel to promote sales in those markets where SPM has some location, tariff and political advantages.

13. Action needed may include:

a. a proper export marketing study on how much, what, where, who, price/contract approach <u>independent</u> of present marketing managers;

b. on which to agree a strategy with them;

c. agreement via BET or Ministry of Industries with BOT on a draft annual travel programme for sales promotion to be financeable (i.e. forexable) out of retention allowances.

'C' is a <u>more general</u> issue than SPM. The BOT is <u>in no position</u> to handle business travel approvals for exporters. Somebody expert on export promotion (BET?) should <u>vet company proposals for year's export promotional business travel</u> and certify to BOT as acceptable for use of retention allowance forex (i.e. vet and reject, amend or approve on the basis of serious evaluation not rubber-stamp).

Asset Replacement/Supplementation/Enhancement

14. Some asset replacement is necessary - on a rising trend as plant grows older. (This is apart from replacement of assets damaged/destroyed by risks insured against discussed below under 'Other Financial'.)

15. But in addition enhancement or supplementation assets are needed:
    a. debottlenecking forestry (logging) side of operation;
    b. protecting embankment (logging) road by paving additional sections;
    c. rebalancing to meet actual local demand mix (e.g. bleached paper).

16. Beyond that <u>when</u> viability looks more assured (i.e. when <u>transport</u> blockage is cleared and one can be confident that 30,000 and more tonnes can be exported annually at plausible prices), three further needs arise:
    a. specialised rail car/handling equipment to lease to TAZARA for 'dedicated' use;
    b. debottlenecking investment to raise capacity to 75,000 tonnes (<u>if</u> that would lower average cost per tonne as appears highly probable);
    c. removing design defect gaps as to e.g. weighing equipment, heavy duty crane.

Financing Replacement/Supplementary Investment

17. Some capital replacement/supplementation ($3 to 4 million a year) can probably be financed from cash flow <u>if</u> transport blockage is cleared and exports sustained at 30,000 tonnes or more. But this is not enough.

18. Funds committed to SPM from foreign lenders, and not yet used, are now - for various reasons - blocked. If they could be cleared that would help on the asset replacement/supplementation side.

19. The key items seem to be CDC (£2 million), Nordic Investment Bank ($8.9 million), Kuwait Fund ($1.3 million) i.e. $13.7 million. It would be worth exploring (SPM/TDFL/Hazina):

    a. cost (arrears? guarantees? other?) of unblocking in each of the above cases;

    b. benefits beyond SPM of unblocking CDC, NIB, KF in terms of other new financing likely to result , so Hazina could determine what to do.

20. CDC needs to be cleared quite apart from SPM:

    a. it has other valuable project commitments suspended at various stages because of default;

    b. it cannot proceed with Kilamco finance until arrears are paid or at least a schedule for repaying is agreed;

    c. the total CDC cash flow to Tanzania from 'a/b' would speedily exceed the costs of clearing/partially clearing on an agreed schedule the arrears;

    d. CDC is especially useful because of its relevant technical expertise re enterprise operation (an unusual characteristic among external financing agencies) so keeping it in play is particularly valuable.

Cash Flow

21. The cash flow position of SPM is catastrophic. So is the profit and loss balance but the cash flow is more urgent and if it is corrected (other than with mirrors), then P and L would largely come right over time. The reasons have been/are/will be:

    a. inability to utilise capacity because of transport problems;

    b. low domestic/export prices;

    c. high debt service costs.

22. The first - transport - issue will be fatal to SPM unless resolved (Paras 5-7 above).

23. The domestic price problem is soluble in the sense SPM can raise prices parallel to inflation and so long as half sales

(or less) and half costs are local (i.e. not import or external debt service tied), that avoids a scissors impact. The price controlled argument seems misplaced - main paper users are not price controlled and for packaging users (e.g. TCC), who are price controlled,paper is not a significant % of total costs.

24. The export price (and perhaps quantity) problem is treated in Paras 11/13 above but its present real form is transport volume limit on amount shipped and transport damage reduction of price received.

25. Debt service is and will remain high because SPM is capital intensive by nature and has a higher than optimal capital/output ratio because of size, associated infrastructure costs and range of products produced in relatively small plant. (When in 1982 decision to complete on basis 50% or more would be exported was taken, output mix should probably have been reviewed with a view to cost saving but that is now water under the dam and over the bridge.) But the present debt/equity ratio and interest/repayment provisions appear to result in more payments to Hazina (direct lender to SPM), than it needs to make TSh equivalent servicing payments on underlying external borrowings by Hazina to finance SPM.

26. A new cash flow projection (all March 1987 ones have been overtaken by events and each left something to be desired even then) needs to be made by - say - SPM/NDC/TDFL team:

a. output targets;

b. export price projections;

c. exchange rate projections (assume say 4% a month forex price rise through 1989 and 2½% a month thereafter as a reasonable first approximation);

d. domestic inflation projection (say 25% 1988, 20% 1989, 17½% 1990, 15% 1991, 12½% 1992, 10% 1993 as first approximation);

e. domestic prices (and domestic costs) raised in line with 'd' to compute domestic sales revenue and export proceeds (and debt service plus imported operating and capital goods converted to Sh on basis of 'e') to get net operating profit (loss) and cash flow.

27. The cash flow projection needs two variants:
    a. present debt service arrangements;
    b. revision proposal below.

28. There may be a bridging finance need. However, that cannot be determined until debt restructuring is agreed. Further until a cash flow projection that really does turn positive by 1993 including 1993 principle repayments (and that can begin to be believed attainable) is arrived at/agreed upon there can by definition be no bridging finance because no shore for bridge to reach will have been identified. To the extent operating and asset replacement/improvement cash flow is O.K and debt service is not fully covered, the logical lender is Hazina i.e. SPM pays over debt service and draws bridging loan e.g. 3 to 7 years at 15% from Hazina for amount not met from cash flow:
    a. it does not pay to close SPM under those circumstances;
    b. loan is to cover a loss;
    c. Hazina for IMF purposes deducts net loans from expenditure;
    d. the cross transaction give a clearer picture of reality than allowing arrears or using NBC advances to hide the cash flow loss

Refinancing/Financial Restructuring

29. NBC should not raise the overdraft limit until a plausible financial and cash flow restructuring is complete unless Hazina or an NDC unit with positive cash flow gives an unconditional guarantee. NBC is not a source of cover for operating losses with no foreseeable ceiling at the end. To make it so (as NMC and other Board cases show) is a route to tears not solutions and merely makes NBC unviable without solving non-viability of problem enterprise. (Here, I disagree with SPM and CDC - NBC should not be forced to provide commercially non-viable overdrafts/advances).

30. The debt/equity ratio can afford room for endless argument and some very odd propositions like 5% (real negative 15% to 20%!) interest rates. I think it might be prudent to cut the Gordian

Knot with a clean piece of rough and ready surgery. It needs to meet two basic conditions:

a. SPM pays Hazina shilling equivalent of Hazina's servicing of external debt incurred for SPM;

b. SPM is able either by revaluing/depreciating assets or by taking exchange loss on principal repayments as a cost before taxable income to avoid paying tax on flows which are in fact loan servicing costs raised by devaluation.

31. The first condition can be met by creating a loan (debenture) from Hazina to SPM:

a. 5 years grace (88-92)

b. 15 years repayment (93-2007)

c. denominated either in USA $ (if all underlying loans for SPM serviced by Hazina are in $) or the Tanzania currency basket (if mix of underlying loan currencies);

d. paid by SPM at current shilling equivalent;

e. at 15% interest (not excessive on a long term loan assuming we can get inflation driven down to 15% after 1990);

f. with loan amount such that at 15% interest and lagged repayment of principal Hazina receives its shilling debt service equivalent with at most small shortfall 88-92 and larger surplus thereafter.

This is viable in that it meets Hazina need to recover debt service (thus avoiding need to foreclose on SMP and appoint a receiver and manager!) but also in that SPM's export sales prices rise in Sh value parallel with exchange rate alterations. Domestic sales prices do not rise that fast if - as intended - Tanzania inflation is beaten down and SPM prices rise by about the local inflation average. But with 50% plus export sales there is no inherent problem servicing the rising shilling equivalent of $/basket denominated debt to Hazina.

32. The second condition turns an interpretation of Income Tax law.

a. revaluation of assets does not per se give rise to a tax liability. But nor does it allow increased depreciation allowable for tax purposes;

b. increased shilling interest paid as a result of devaluation is an expense allowable against income for tax purposes;

c. loss on increased shilling cost of repaying foreign currency loans is a borderline case. It has on occasion been allowed as expense (when paid) before computing taxable income and at times disallowed. The problem is as to whether such losses are trading or capital losses since former are allowable against current income and second only against capital gains.

33. A common sense solution (probably compatible with the present act but could take an amendment to make this certain) would be:
a. to allow capital loss on all external liability rise in shilling cost with devaluation;
b. to allow 'a' to be offset against an equal capital gain from revaluing fixed assets and (imported) inventories by the same amount;
c. and to allow revalued figure as base for depreciation allowable against tax (fixed assets) or for cost of sales (inventories).
This is not a tax fiddle; the only allowable additional offsets are those which cancel the increase in Shilling level of external liabilities.

34. If Hazina and AG's have not the personnel to draft '33' possibly the Counsellor at Brussels Embassy (ex CPD B. A. Rahim) could be borrowed or a week or three to help out. Note Para 15 is a general solution not just an SPM one.

Other Financial

35. That the SPM insurance with NIC is apparently denominated in TSh and not reinsured externally poses very real problems other than (indeed greater than) violation of loan covenants:
a. Tsh amount needs to be raised at each devaluation for real cover (i.e. ability to replace/repair from proceeds) to remain unimpaired;
b. unless NIC reinsures at least on catastrophe basis (e.g. loss in one year of over $2.5 million) the risk to NIC is too great relative to its total portfolio and the TSh would not serve to repair/rebuild SPM because to do that takes forex.

36. Is it really the case that NIC has not reinsured on catastrophic loss basis? (It did up to 1982 reinsure for catastrophic loss.) That is terribly dangerous on e.g. ATC aircraft, TIPER, textile mills as a group, breweries as a group, cement plants as a group, TFC and Tanga jetty, Dar Harbour as well as SPM. If NIC does reinsure then lesser problem of sorting out keeping constant $ cover (presumably reinsurance is in $) to insured and - subject to BOT/Hazina approval - paying out on major losses in forex tied to rehabilitation imports. As SPM had an explosion in 1986 (related to chlorine; damage contained) and is a volatile chemical using technology, a catastrophic loss is not so remote a possibility as to be overlooked.

Conclusion

37. Southern Paper Mill, Tanzania's largest industrial project ($281.4 million capital cost plus about $100 million related forestry and other infrastructure i.e. Sh 2,800 million odd) is in imminent danger of terminal collapse.

38. The macro economic costs of such an outcome would be very severe (loss of $15 to 20 million gross export earnings; $10 million a year external debt service on dead assets, loss of a district's economic heart; need to finance $10 million a year more paper imports; write off of $54 million odd Tanzanian resources invested.) Further the morale and credibility damage to the whole public enterprise sector and public economic policy spectrum would reach far wider.

39. Perhaps we should have cancelled SPM in 1982 review and writte of $50-75 million spent or committed beyond recall as of then. Perhaps I was wrong in arguing we could make a go of it as 50/50 domestic/export market plant. It is too late to regret 1982 - the task is salvaging 1988 and after.

40. SPM is capable of producing 60,000 tonnes by 1988/89 in practice as well as on nameplate specifications. The expatriate and Tanzanian production team is competent. At th

level of output with say 22,500 tonnes local and 37,500 tonnes export sales SPM could have a positive cash flow and profit and loss position. (So far at that goes 1982 decision to go ahead was sound.) Thus the situation is salvageable.

41. The immediate constraint throttling SPM is TAZARA. It does not provide needed, pre-scheduled bogies so production/sales cannot meet target levels for reasons totally beyond SPM's control. Transport/Hazina/PM's need to have a demarche with TAZARA to break this bottleneck (which almost certainly is soluble technically if TAZARA really tries).

42. The next constraint is ensuring adequate export sales and prices. Here situation has moved from disastrous (1986) to perhaps passable but obscure. A clearer study in strategy, niches, paper prices is needed. So is a viable allowance for regional sales promotion travel. BOT cannot be expected to vet these (for SPM or generally) - a procedure for annual allocation vetted by (say) BET on behalf of BOT is needed.

43. Replacement - complementary capital investment is needed beyond what can be covered from cash flow. To get it financed we need to unblock frozen commitments (NIB, KF, CDC) if cost of doing so is bearable. Unblocking CDC is important because arrears unresolved there also block several other projects and will block Kilamco so cash flow net gains from unblocking should be substantial.

44. NBC overdraft should not be used to paper over losses. If somebody must loan to SPM it should be Hazina at 15% in back to back transactions with SPM debt service payments.

45. While 41 (transport) is the immediate priority and assuring ourselves export strategy/actual selling is in hand is second, capital restructuring is urgent to avert cash flow quagmire. It should be practical to achieve a) TSh plan to Hazina roughly parallel to TSh equivalent of its debt service on loans raised for SPM and b) to allow SPM to take all debt service costs

(including devaluation increases of principal) as costs deductable before taxable income arises.

46. A loan denominated in $ (payable at current exchange rate at time of each payment in TSh), 5 years grace and 15 repayment, at 15% interest (assuming we plan to drive inflation down to 10 to 15% by 1990), of an amount which yields TSh to Hazina roughly equal to debt service in its SPM loans would meet first condition.

47. Allowing SPM to take capital losses on devaluation rise in TSh payable on principal (interest is allowable) on loan at '46' and offset these against asset revaluations (capital gains) which would then be allowable against taxable income (no depreciation on fixed assets or cost of sales on inventories) would meet second condition. This is probably lawful under present act, but an amendment to make that certain is desirable to cover all external loan cases not just SPM.

48. These suggestions are detailed in main text together with certain important, but slightly less crucial, issues (e.g. damage to paper from wrong bogies and lack of catastrophic loss reinsurance in forex to allow making good severe damage if it were to occur).

49. I feel SPM is being allowed to drift and now needs priority attention. It can be saved and is worth saving.

- RHG
Sometime EA/T
25-XI-87
Falmer

(Report cited is Report On Mission To Assess Current Operating Position And Future Viability, March 1987, issued by CDC, U.K)