Corporate Restructuring and Governance

Presented by

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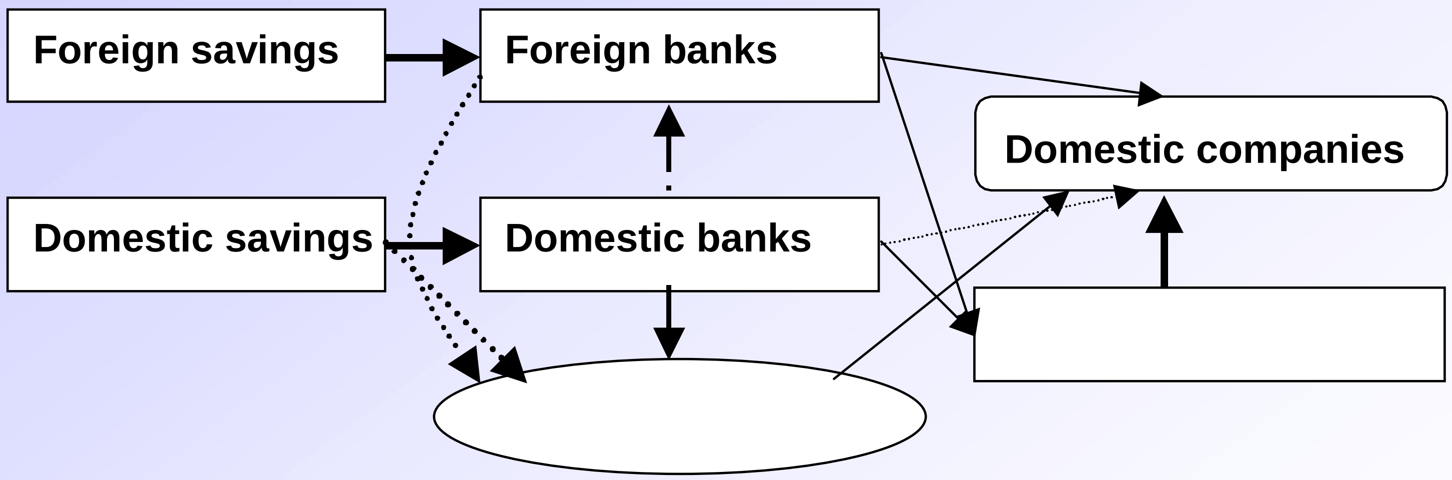
- ***Different background and structure of financial intermediation***
- ***CEE legal environment (especially corporate governance), restructuring and corporate performance***
- ***Foreign investors´ adjustment***
- ***New CEE tendencies responding to the emerging EU standards***

1.Different background and structure of financial intermediation

- CEE Features in 1H 1990´s

- Economic Transition
- High level of financial intermediation in the CR and CEE especially via banks (Bank dependent economy)
- Liberal licensing policy, weak legal system and passive bank regulation and supervision
- Emergence of Capital Markets (IPOs, coupon privatizations)

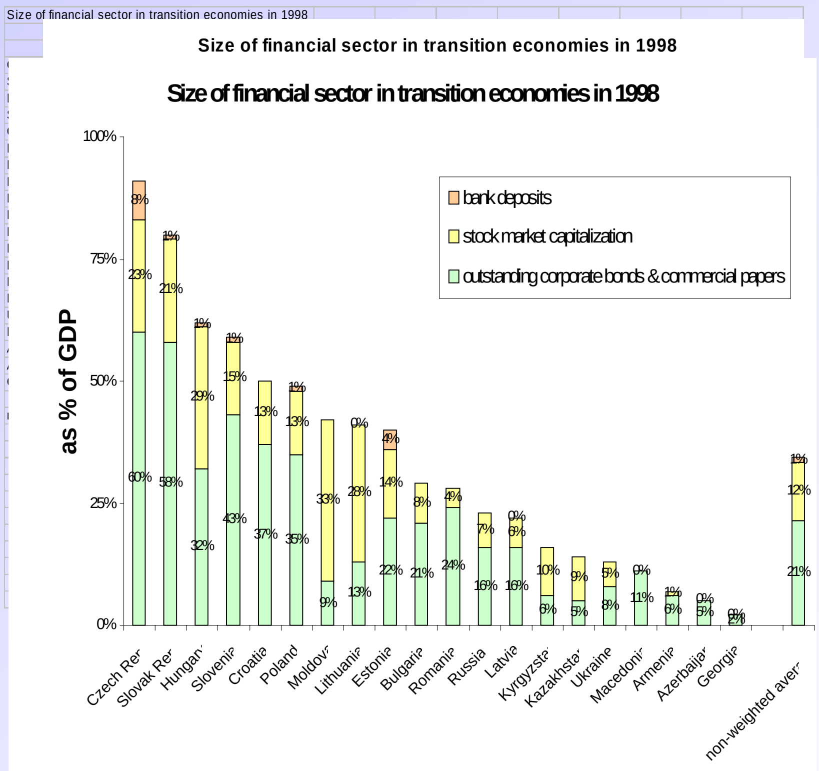
Direction of Financial Intermediation in 1992-95

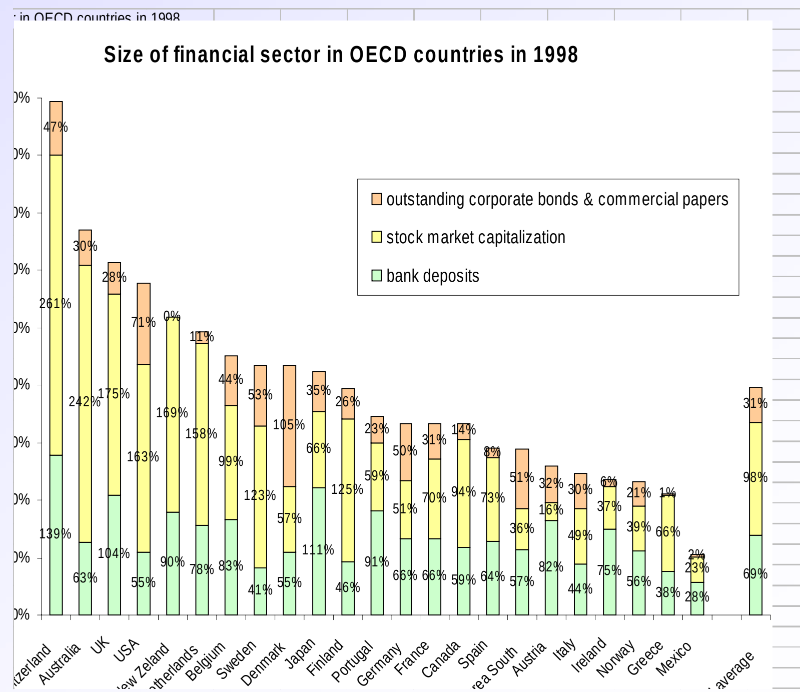


Source: Tůma (2000)

Financial Sector Structure –
Bank dependent CEE - Czech Economies

Comparison of CEE, Czech and OECD financial institutions size in 1998





…with huge grow potential of bank disintermediation

Source: Kawalec,2000

Different background and structure of financial intermediation

- Features - 2H 1990´s

- in 1996-1999: economy problems + tight monetary policy
- Improper ***law & enforcement*** slowly improved
- Poor performance of large industrial customers
- ***Credit crunch*** and ***Institutional Adjustments***
- Establishment of ***new regulatory*** and ***institutional framework***
- ***Market clearance*** - failure of number of smaller banks
- ***Ad hoc banks´ bailouts*** by state
- ***True*** Large Banks´ ***Privatization*** with ***prior debt clean-up***
- ***Consolidation of Corporate Governance*** – Enterprises, Banks
- Post-privatization performance of the banking sector
- Orientation **towards the EU**

2. CEE legal environment (esp. corporate governance), restructuring and corporate performance

- Economic Transition
- Liberal licensing policy, weak legal system and passive bank regulation and supervision
- Privatization

The Privatization as one-off Game

Privatization and Corporate Governance
- „not only ownership matters, but institutions as well“

Privatization is an one-off process and has conflicting economic, financial and political objectives of particular interest groups (foreign vs. domestic buyers – either insiders or outsiders).
Given the unrepeatable character of privatization and incompleteness of most of contracts and of institutional framework itself, many actors in the corporate sector, not just the managers but also investment funds and asset management companies, played a one-shot game at the expense of managed companies and their own minority shareholders as well.
The rational behavior in such a game is well described by „the prisoners dilemna“ . Then to no surprise there was a temptation for a dominant short term strategy of “cheating”- i.e. exploiting any contractual incompleteness in largely unregulated environment of privatization to one´s own advantage. Such a model describes wider Eastern Europe environment (both Czech and Russian) of recent past.

CEE Corporate Governance Models

Anglo-Saxonian approach

Problems:

right to vote limited

high transastion costs

very low liquidity

Single owner

Problems:

limited information

low transparency to business partners

Stakeholder model

Limited in the CR: ex. Sale of blocking minority of local distribut. companies to municipalities

Problems:

Unefficient governance

Loss of interest

"CEEE" transition model

0 or 1 approach: large shareholder behaving as single owner

Problems:

Disadvantageous contracts

"tunnelling"

Coupon privatisation as an artificial IPO and mandatory „public tradeability of shares“

Main Results of the Voucher Privatisation:

- funds´ ownership, cross-ownership = non-transparent structure; in majority there were no strategic owners

- **without a proper institutional corporate governance framework** there was a room for tunneling and stripping valuable assets from companies – Loss of Shareholders value

- often improper management

Coupon Privatization and Imperfect Institutional Framework

Main Results :

- **No financial proceeds but temporary Political Gains due to the giving away ...but later social contract with small investors broken and Political Loss**

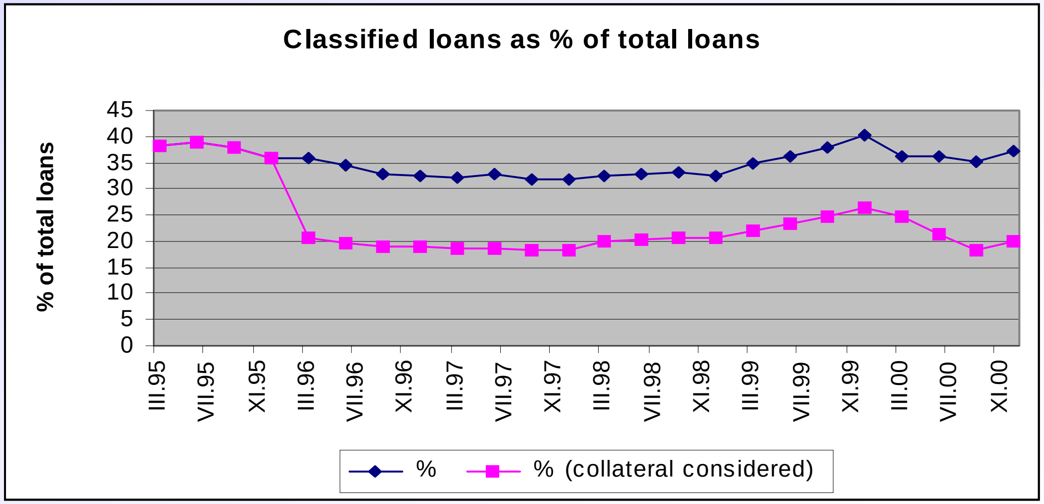
- **instead of large functioning capital market overnight high transaction costs for quasisecurities industry, non-transparent ownership structure with dominating funds´ ownership and insider trading – loss of confindence to non-bank financial sector and collective investment vehicles(CIVs) prevailing in pension, insurence and savings deposit systems in mature economis as well as loss of foreign portfolio investors** ;(blocking pension reform etc.)

- **without a proper institutional framework the corporate governance in the biased form** causes (more? than in mature markets) **huge loss of value of traded companies to the shareholders** (Black(2001) estimated for Russian large companies multiple of 2-10 mostly due to selfdealing risk subfactors such as risk of assets stripping, share transfer pricing (as there is a room for managers to loot the value of minority shareholders, siphon off the profits or tunnel)

Behaviour of Banks in mid´90s

CG failure: Violation of principles of prudential banking

- Privatisation buyouts based on bank loans
- Credit enabling ownership transfers after coupon privatization
- Instead of enforcing discipline of largest debtors and pushing towards restructuring they granted them further loans – ***provision gap***



Bank Lending Failure with Asset Bubles followed by the Poor Performance of Large Industrial Customers

Within given corporate governance model number of banks provided Privatization and Acquisition Lending to highly leveraged related conglomerates in order to create TBTF groups with soft budget constraint backed by the state. Czech Asset Bubles broke in the first 1997 recession and resulted into huge NPLs and fall of many businessmen. 71% of **related lending** in Russia was not repaid according to Laeven (2001)- result?

Possible solutions: support by the government – inefficient but keeps

-mergers with other domestic companies – a lack of domestic capital
-----reprivatisation to foreign owners – often positive results, but not always (inadequate investor, lack of knowledge of the local environment, etc.)

-bankruptcy procedure with going concern sale (to Siemens) or liquidation

In the CR, Czech Konsolidacni agency owns the majority of non-performing loans. It is preparing sales of these assets in selected

CG failure and Restructuring in mid´90s

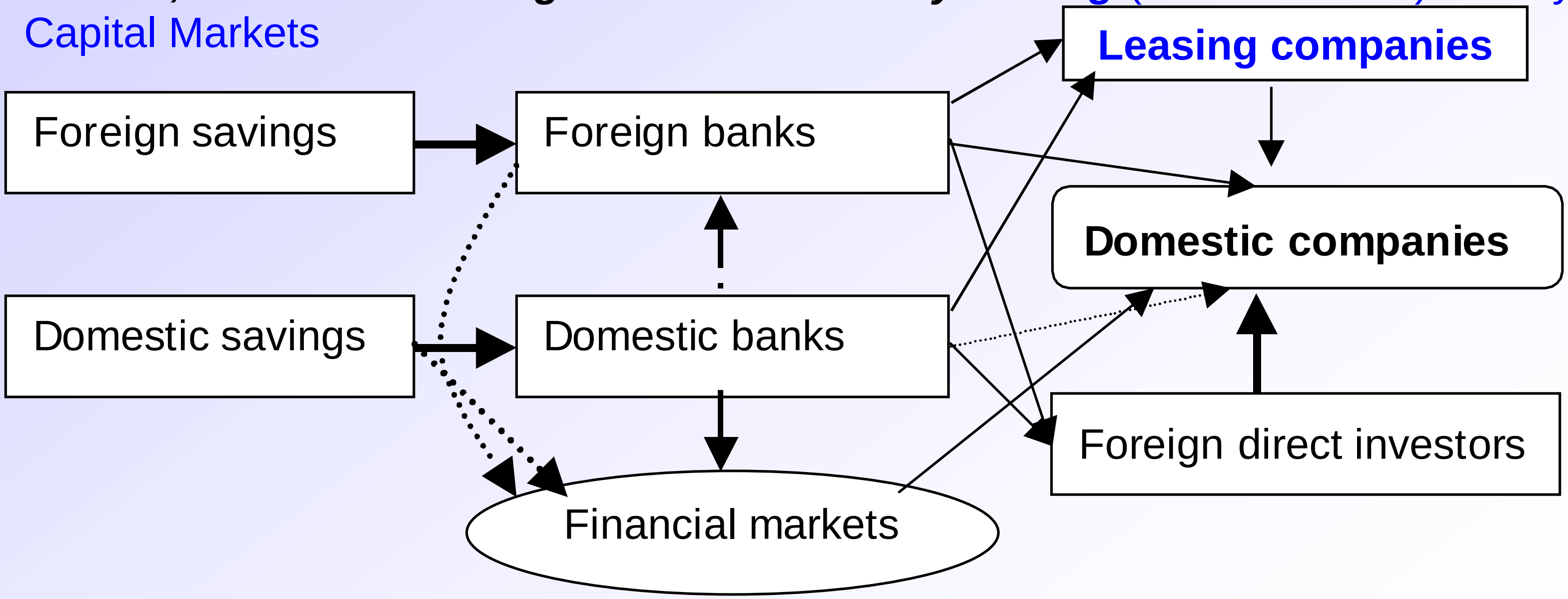
We noted above that economic relationships typically have a co-operative game or prisoner´s dilemma characteristic: full co-operation maximizes the participants´ joint pay-off in the long-term ("repeated game") but "cheating"- i.e. exploiting any contractual incompleteness to one´s own advantage, remaining the dominant strategy in one-shot game. :

- the analysis of the ownership structures and its influence on banking corporate governance failure that resulted in different restructuring profiles of particular types of companies – two speed economy:
- Given the unrepeatable character of privatization and mostly vague contracts and of institutional framework itself, many actors in the corporate sector, not just the managers but also investment funds and asset management companies, played a one-shot game at the expense of managed companies **and their own minority shareholders** as well. The dominant strategy was "**cheating"- i.e. exploiting any contractual incompleteness in largely unregulated environment to one´s own advantage connected with neglectance or adaptive restructuring.**
- Some industrial companies, mostly **foreign controlled**, have properly responded to demand and market signals (GDP growth at OECD countries generating stronger demand) properly by **deeper restructuring** – by cost adjustments (including a temporary decrease of real wages succeeded by quick wage growth after rapid productivity growth was achieved), by new products and technologies, more active marketing, etc., frameworked by a new **"contract architecture"**. They significantly increased their non-price competitiveness (e.g. VW – Škoda cars) and became the engine of **outward-looking, export led growth** stimulated by foreign demand growth. Sectors exporting market segments with higher value added (machines, equipment) sold mostly at the highly competitive OECD markets. These companies also had a lower cost of capital of those firms as they could borrow more cheaply at the international markets via their parent companies
- On the example of foreign controlled companies we illustrated the hypothesis that firms which build a reputation for ethical collaboration over a long period are able to substitute co-operative outcomes for unsatisfactory cheating ones. These relationships - the internal and external "contractual architecture" of the firm undoubtedly happened to be the source of considerable competitive advantage. Furthermore, firms which have established such a reputation have established themselves as "islands of microeconomic institutional stability" and enjoyed an advantage in attracting new trading partners - whether as customers, suppliers, or employees - precisely because the latter knew that the former can be expected to maintain their reputations.
- The foreign controlled companies seem to represent long-term standard of behaviour, with new internal and external contractual architecture, although these may in future be partially eroded in an environment with prevailing incomplete contracts used by number of participants for their individual benefit.

3. Credit Crunch and Institutional Adjustment of Monetary Transmission

- Large ***domestic banks*** (big 4 respectively) ***more prudential***, squeezed new credits given CNB terms

- The ***increased money supply*** in the economy was contributed both ***by the FDI inflows, activities of foreign banks*** and also ***by leasing*** (better secured) less by Capital Markets



Credit Crunch and Adjustment of Foreign Investors to weak legal Institutions

-increased money supply in the economy was caused by the ***FDI inflows*** and ***activities of foreign banks***, while abundant ***foreign portfolio investments limited***

In billion USD	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Financial and Cap. acc.	**0,0**	**3,0**	**3,4**	**8,2**	**4,3**	**1,1**	**2,9**	**3,1**	**3,8**	**4,0**	**11.0**
- direct investments	1,0	0,6	0,7	2,5	1,4	1,3	3,6	6,2	4,9	4,8	8,7
- portfolio investments	-0,03	1,6	0,9	1,4	0,7	1,1	1,1	-1,4	-1,8	0,9	-1,4
- long-term capital	0,3	0,8	1,1	3,4	3,1	0,9	-2,0	-0,7	-0,1	0	0,9
- short-term capital	-1,3	0,06	0,7	1,0	-0,9	-2,2	0,2	-1,0	0,8	-1,7	3,0

Source: Czech National Bank Monetary Reports, www.cnb.cz

2003 portfolio investments – Czech investors kept abroad (USD 11,2 bil.) by USD 5 billion more than foreign investors domestically. Only in 1Q 2003 invested abroad USD 2.1 billion (Euro 1.6 bilion) mostly in bonds, while proportion of stocks in portfolio of Czech investors further declined. **Rationale for outflow** is higher yield abroad and tendency for diversification of investments of funds, insurance companies, banks

FDI inflow- important financial channel so far

The Czech Republic has attracted one of the highest FDI inflows relative to GDP among the emerging countries in 2000-2002 with FDI exceeding 8% of GDP

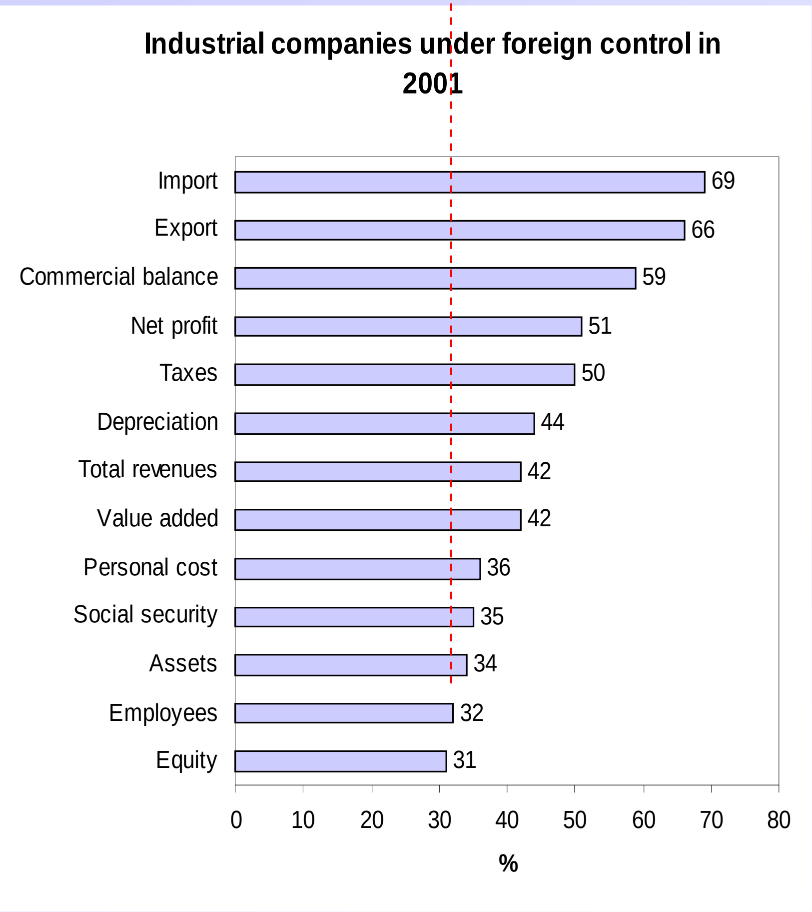
Year	FDI into CZ (USD m)	% of GDP	FDI into CEE countries per capita in USD			
			Czech	Hungary	Poland	Slovenia
1997	1 300	2,4	126	214	127	189
1998	3 718	6,0	361	202	165	125
1999	6 324	11,6	615	196	188	91
2000	4 986	9,7	484	170	233	91
2001	5 641	9,9	545	n/a	n/a	n/a
2002	Est 9305	12.2	902	n/a	n/a	n/a
1990-2002 cumulated FDI per capita			3788	3047	1178	2504

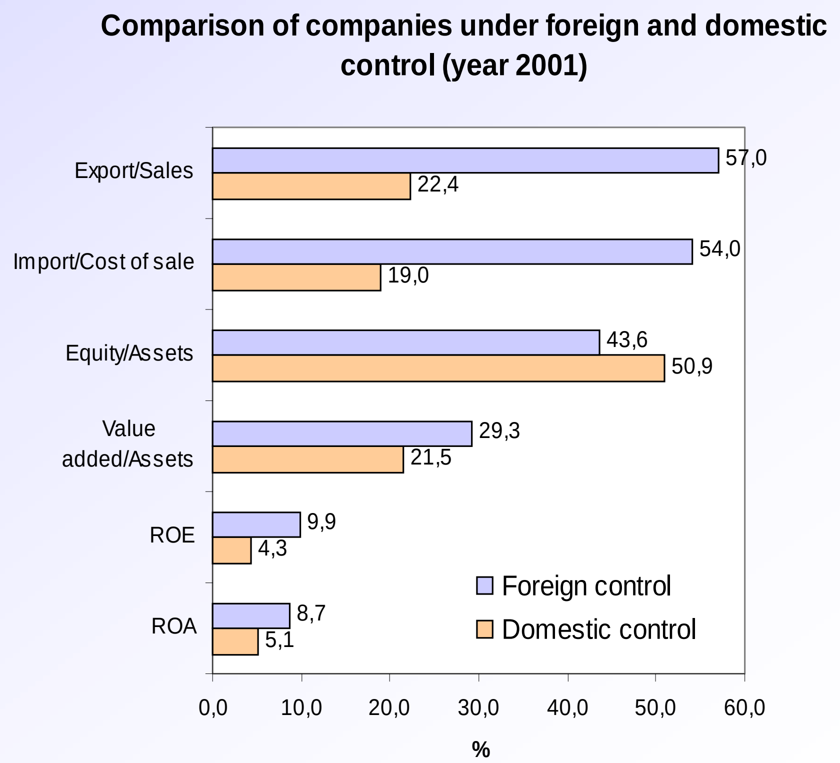
NEW CHAMPION 2003-2004 : SLOVAKIA

Source: Czech National Bank (CNB) web page (until 1997 data included FDI in equity capital, starting from 1998 data on reinvested earnings and other capital have been included in FDI flows) and WIIW Vienna for per capita comparative data estimates

CG consolidation: Czech enterprises under foreign x domestic control: performance

new contractual corporate architecture and procedures from inside subject to int. standards





Source: Neuimaier (2002)

FDI financial channel – profit reinvestment now, profit repatriation in the future?

At the end of 2002 Czech overall FDI volume of FDI (equity capital including CNB data on reinvested earnings and credit relations with foreign investors) totaled USD 36.5 billion out of which 71,6% represented accumulated equity capital, **17.3% reinvested earnings** and 11,1% other capital included into FDI flows.

Foreign controlled companies (with average profitability higher than industrial average) **financed** important part of their **development from retained earnings** (over USD 6.3 billion in just 5 years, and 2.7 billion just in 2002) **rather than paying them out through dividends**. Also other contributions to the Mejstrik(2004) confirm growing importance of retained earnings in financing companies with sufficiently high return on equity as this channel represents efficient capital reinvestment. In order to optimize weighted average cost of capital, reasonable debt instruments are, however, irreplaceable as well.

In case of the emerging countries with inherent risks of financial crises FDI liabilities seem to be safer form of financing then debt or other form of non-FDI obligation irrespective of country risk factors such as income level and degree of openess (Fernandez-Arias,Hausman(2001)), but FDI negatively modifies foreign exchange market, its volatility.

2003 – economic problems in WE markets (demand and parents) – repatriation of profits via dividends – over 0,5 bil USD – FDI inflow and ouflow getting closer and financial and capital account not exceeding sufficiently trade balance deficits . The similar processes in Hungary,…

2004 – 10 ???

Consolidation of Corporate Governance within Financial and Industrial Sector

- ***M&A with other domestic companies*** – usually ST=one-off game based on contract. incompleteness, a lack of domestic capital, unacceptable risks (IPFs)

- Better ***legislation and enforcement*** *Additional costs of bank regulation and supervision* vs. ***State subsidy***: usually moral hazard and inefficient, but large bank's pre-privatization clean-up ? *State konsolidacni agency owns the majority of non-performing loans. Sales of those assets in selected packages on the market or debt-to-equity swap*

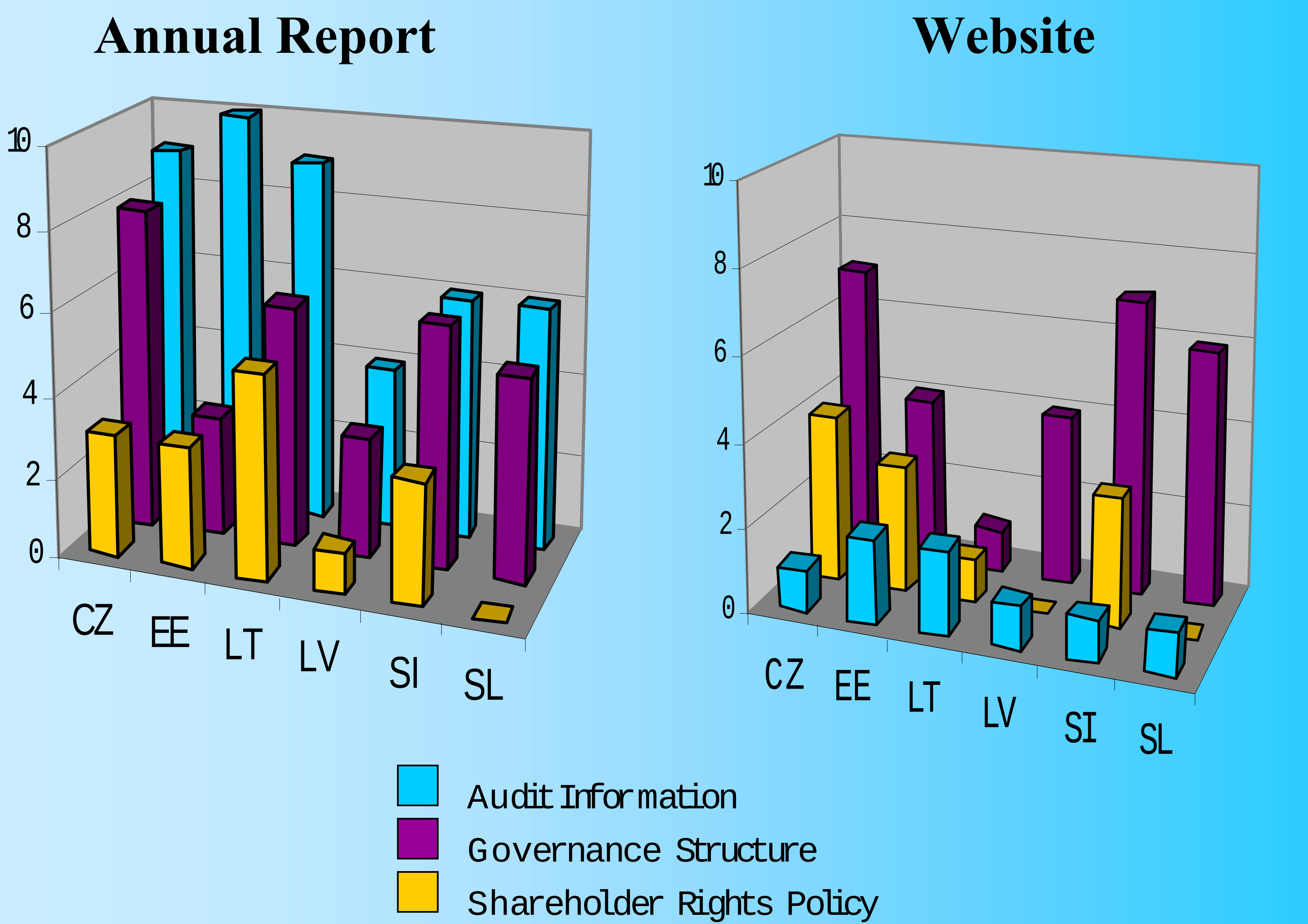
- ***Acquisition by foreign owners*** : repeated LT game - if present value of future business attractive (such as pension funds, insurance, Škoda Auto, cleaned banks) New contractual architecture from inside international corporate standards. But not always positive (inadequate investor, market change) and gradual erosion if not supported by the improvement of weak local contracts.

4. New CEE tendencies responding to the emerging EU standards

- Industry Corporations mostly privatized
- Utilities privatization and liberalization speeds up
- Costs of Financial stabilization (and delayed banks´ privatization) plus Financial Restructuring of Companies for Taxpayers: E.g. Czech Fiscal innocence (since 1918 – Rasin prudential approach) will be lost – in spite of privatization proceeds consolidated public budgets debt might grow from neglectable 10% to 30% GDP just in few years partially due to transformation costs.
- CG Codes of conduct stepwise implemented – Warsaw (CG surveys – IEWS) + corporate social responsibility (pension funds)[1)]
- Transparency and Disclosure – corporate reporting improvements
- Twinning activities Corporate governance legislation – fine tuning compliance with international EU ?/UK standards
- RIA (Regulatory Impact Analysis) for new draft acts to mitigate regulatory risk

[1)] See EWMI (2004)

Survey of Reporting on CSR in CEE Countries: Corporate Governance



OECD Principles

On January 12, 2004 the OECD announced that it invites public comment on a draft of the revision of its Principles of Corporate Governance that were adopted by OECD governments in 1999.

Please visit
http://www.oecd.org/topic/0,2686,en_2649_37439_1_1_1_1_37439,00.html

The following scandals have contributed towards the need for revised principles:

Ahold (accounting irregularities)

Enron (special purpose entities)

Parmalat (offshore accounting)

Skandia (executive compensation).

New opportunities and risks and increased financial market volatility

- Comparative labor cost gradually grows but still low
- Certain FDI outflow to be compensated by portfolio investments
- Inflation/interest rates have converged to EU levels – comparable cost of capital
- Relative volatility in the EU markets and CEE markets is getting more similar (squeezing the gap)
- Paradoxically CEE´s market volatility does not decrease but EU market volatility increases

Euro, Lamfalussy report and EU Financial Services Action Plan (FSAP): Incentives to reshape the bank dependent financial intermediation towards the Anglo American structure

- The Lamfalussy Report;
- EU FSAP ,
- IMF and WB Financial Sector Assessment Program (FSAP) of the CEE countries 2000- 2003;

- Euroarea unsecured instruments highly integrated, while segmented markets for other instruments

New CEE challenges

i) Maturization of Capital Markets (IPOs, coupon privatizations):From Stocks to GDRs and (T-)Bonds for Foreign Investors to compensate repatriation of profits from FDI ?

See Mejstrik (1997,2004) for the Czech Republic and Marcincin, Beblavy (2000) resp. Marcincin (2002) for Slovakia

But we said that in case of the emerging countries with inherent risks of financial crises FDI liabilities seem to be safer form of financing then debt or other form of non-FDI obligation irrespective of country risk factors such as income level and degree of openess (Fernandez-Arias,Hausman(2001)), but FDI negatively modifies foreign exchange market, its volatility.

ii) Utilities stepwise privatized and liberalized but EU structural funds opened less available to privatized utilities but more to public sector or PPP projects (public cost/benefit accountability but political cycle with limited LT behavior of less experienced local governments. Risks: non-prudential and moral hazard)

WILL IT HELP TO FURTHER CORPORATE RESTRUCTURING ?

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Comparison of first and second tier accession countries in 2002 (1)

	Area	Population	GDP in purchasing power standards			GDP percent growth	Inflation rate	Unemployment rate	Current account
Country	1000 km2	Million inhabitants	Billion EUR P.P.S.	EUR/inhab. P.P.S.	EUR/inhab. percent EU average	Percent	Year on year	Percent active population	Balance percent G.D.P.
Bulgaria	111.0	7.9	47.4	5,900.0	25	4.8	5.8	18.1	-4.7
Cyprus	9.0	0.8	14.0	17,400.0	72	2.2	2.8	3.8	-5.3
Czech Republic	**79.0**	**10.2**	**146.9**	**14,400.0**	**60**	**2.0**	**1.4**	**7.3**	**-6.3**
Estonia	45.0	1.4	13.5	10,000.0	42	6.0	3.6	9.1	-12.3
Hungary	93.0	10.2	138.2	13,600.0	57	3.3	5.2	5.6	-4.0
Latvia	65.0	2.4	19.9	8,500.0	35	6.1	2.0	12.8	-7.7
Lithuania	65.0	3.5	34.3	9,400.0	39	6.7	0.4	13.1	-5.3
Malta	0.3	0.4	4.6	11,700.0	55	1.2	2.2	7.4	-3.9
Poland	313.0	38.2	363.0	9,500.0	39	1.6	1.9	19.9	-3.6
Romania	238.0	21.8	128.9	5,900.0	25	4.9	22.5	7.0	-3.4
Slovakia	49.0	5.4	61.3	11,400.0	47	4.4	3.3	18.6	-8.2
Slovenia	20.0	2.0	35.3	17,700.0	74	3.2	7.5	6.0	1.7
Turkey	775.0	69.6	382.9	5,500.0	23	7.8	45.0	10.4	-0.8
EU 15	3,234.0	378.4	9,166.5	24,010.0					
Acceeding 10	739.0	74.3	831.0	11,150.0					
EU 25	3,973.0	452.7	9,997.5	21,910.0					

Note: Malta GDP figures are for 1999, EU 25 per capita PPS is an approximation based on EU 15
Source: EUROSTAT, "Continuing enlargement: Strategy Paper and Report of the European Commission on the progress towards EU accession" (October 2003), p.42

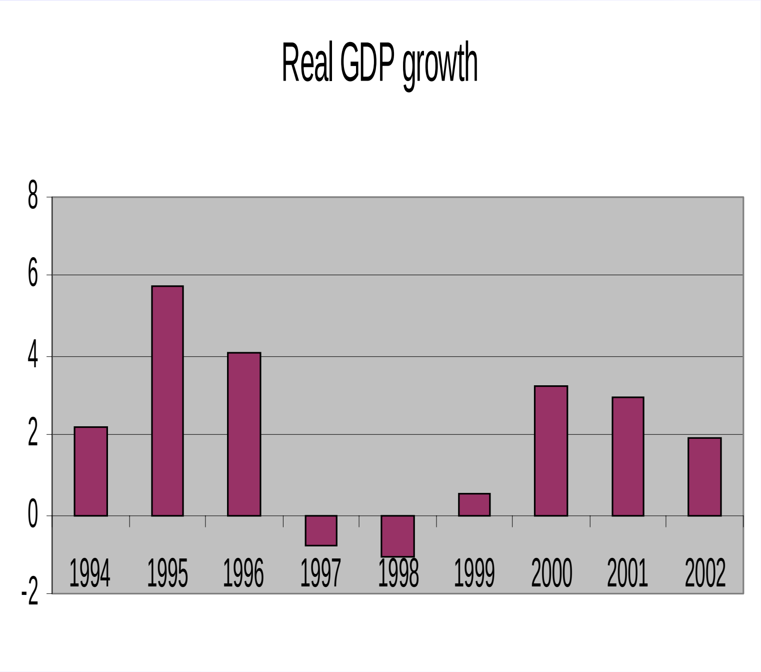
Comparison of first and second tier accession countries in 2002 (2)

Country	Foreign direct investment Net inflow in percent of GDP	Foreign direct investment EUR per capita	General government budget Balance in percent of GDP	Share of agriculture Percent of gross added value	External trade Exports percent of imports	External trade Exports to EU, percent of total exports	External trade Imports from EU, percent of total imports	External trade Balance with EU, in EUR mil
Bulgaria	3.9	273	-0.6	12.5	78.2	55.6	50.2	606
Cyprus	4.3	N/A	-3.5	4.3	12.5	48.0	55.8	2,173
Czech Republic	**13.4**	**2,289**	**-3.9**	**3.7**	**94.4**	**68.4**	**60.2**	**1,673**
Estonia	4.4	2,092	1.3	5.4	71.6	68.0	57.9	847
Hungary	1.8	N/A	-9.2	4.3	91.4	75.1	56.3	-68
Latvia	4.6	978	-3.0	4.7	56.4	60.4	53.0	620
Lithuania	5.3	723	-2.0	7.1	71.0	48.4	44.5	1,290
Malta	8.8	6,418	-6.2	2.8	74.1	46.6	67.0	1,575
Poland	2.2	963	-4.1	3.1	74.4	68.7	61.7	9,165
Romania	2.9	252	-2.2	13.0	77.6	67.1	58.4	1,003
Slovakia	17.0	903	-7.2	4.5	87.1	60.5	50.3	-982
Slovenia	8.3	1,543	-2.6	3.3	94.7	59.4	68.0	1,806
Turkey	0.6	296	-10.0	11.5	69.1	51.5	45.5	2,178

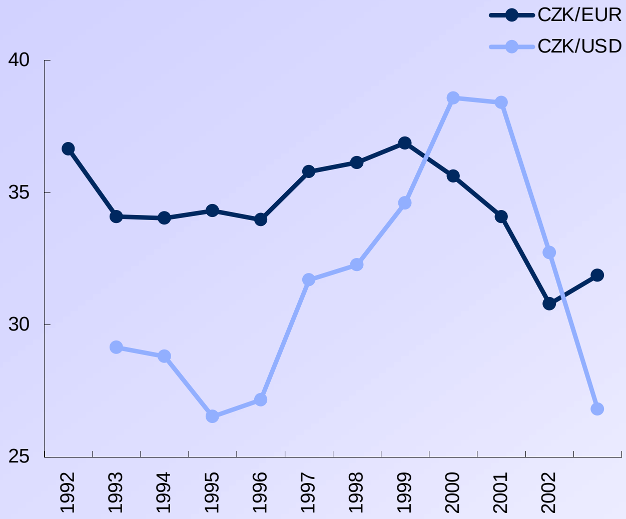
Note: Malta GDP figures are for 1999, EU 25 per capita PPS is an approximation based on EU 15

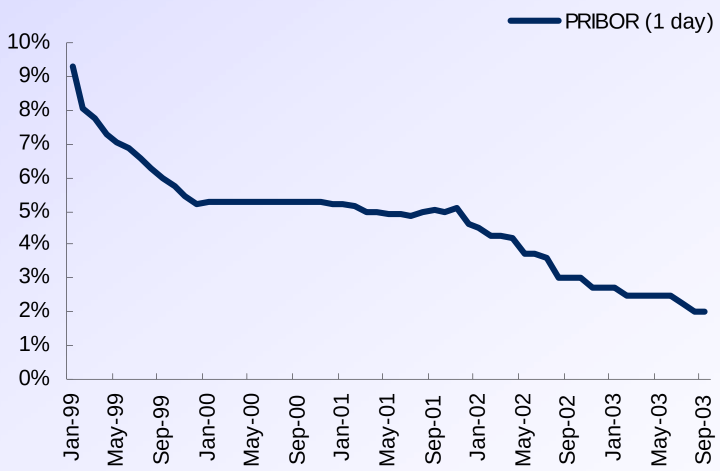
Source: EUROSTAT, "Continuing enlargement: Strategy Paper and Report of the European Commission on the progress towards EU accession" (October 2003), p.42

Macro- environment for corporate development – Inflation and GDP



Macro- environment for corporate development – Exchange rate and 1-day PRIBOR



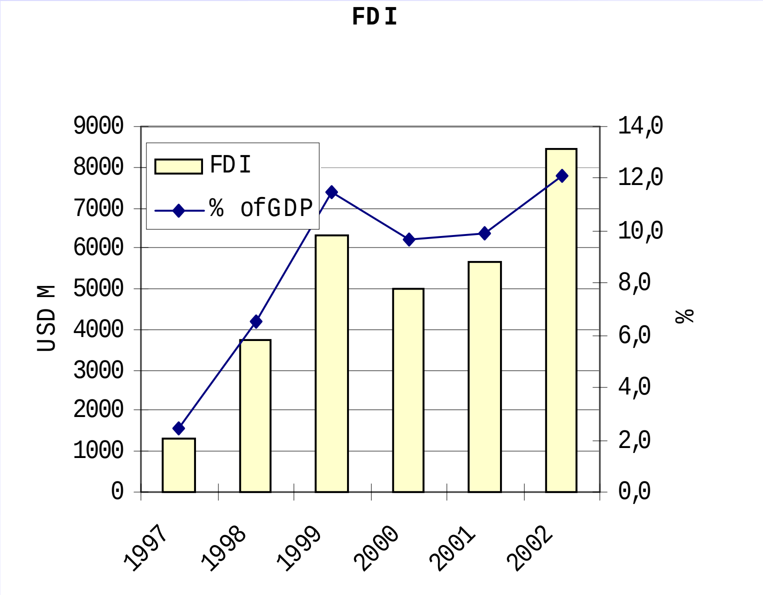


Source: Czech Statistical Office and CNB

Note: Annual data up to 2002, November 22, 2003 for 2003. CZK/EUR rates for period 1992 – 1998 were simulated on a trade-weighted basis

Capital Markets and Privatization?

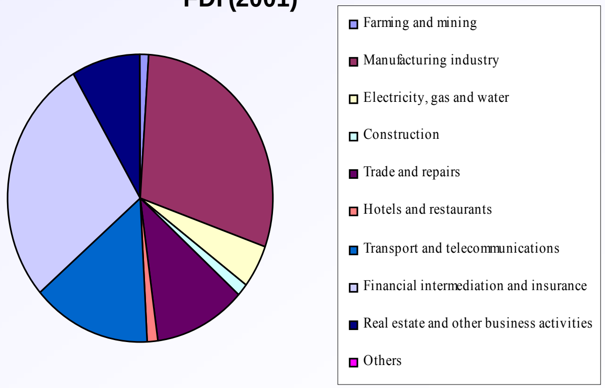
– Privatization mostly by strategic sales given the sentiments of financial markets and type of assets
– GDR program ? Another Bordsodchems ?



Privatisation program

Name	Sector	Equity in bln CZK	Stake for sale	Exp. closing
CEZ	Energy	114	68%	2004-2005
6+2 EDC	Utility	45	50%	2004-2005
CT	Telecom	98	51%	2003-4
Transgas	Utility	40	97%	sold to RWE 12/2001
8 GDC	Utility	20	50%	sold to RWE 12/2001
Unipetrol	Chemical	27	60%	2003-2004
KB	Banking	19	60%	sold to SoGe 11/01
Cra	Telcom	11	51%	sold to Bivideon in 10/01
CKD DS in bancruptcy	Transport systems	1	100%	quasiprivatization - Siemens 12/01

FDI (2001)



Economical environment

- The huge fiscal deficit represents currently one of the most significant economical problems in the country. It was partially driven by the bank restructuring costs in 2000, but it remained at similar level in 2001 and 2002 (public budget deficit in 2002: -5.1% of GDP). Public budgets consolidated debt grew from 13% in 1998 up to 20.3% of GDP in 2002. When all obligations of Czech consolidation agency are included 28% for 2002 and autonomous growth up to 45% in 2006.
- The trade deficit for 2002 and 2001 decreased slightly in comparison to the year 2000 (CZK 71 bn in 2002, 120,8 in 2000). It was positively influenced by the development of exchange rates.
- Rapidly increasing foreign direct investments (FDI) due to the strengthening of the institutions of market economy and due to the accelerated privatization projects launched.
- Structural reforms should continue, including privatization and transformation of the social security and pension systems – see draft of MoF (2002).
- Economic growth is largely export-led.

Key figures				
Indicators	**1999**	**2000**	**2001**	**2002**
Inflation in % , annual average	2,1	3,9	4,7	1,8
GDP growth in %	0,5	3,2	3,0	1,9
CA balance in % of GDP	-2,7	-5,3	-4,6	-4,6
Ext. indebtedness in % of GDP	43,1	41,2	36,5	34
Exchange rate CZK/EUR	36,88	35,61	34,08	30,82

**Source: Czech Statistical Office, Mimistry of Finance*

Souvereign ratings		
Agencies	**Foreign currency [1]**	**local curren.**
Moody's	A1	A1
Standard & Poors	A-	A+
Fitch Ibca	A-	A

1: Long-term, foreign currency rating
Sources: Moody's, Standar&Poors, Fitch Ibca