Privatisation and Firm Behaviour in National Transformation: the Case of Hungary

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Abstract

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This thesis is concerned with the behaviour of formerly state-owned enterprises that are subject to privatisation in the context of national transformation. In general, *this research explores conditions under which privatisation can facilitate turnaround of state-owned firms*. Specifically, it concentrates on the issue of why, contrary to theoretical propositions as well as practical expectations, privatisation has as yet resulted in only modest results in strategic restructuring of privatised firms in Hungary.

This study utilises concepts and models of economic and organisation theory. It focuses not only on ownership changes as inputs and resulting behavioural changes as outputs, but also on the process in which these changes unfold. In that, *it advances a view of privatisation that is driven by organisation theory*, to complement the dominant economic model based on the agency theory.

In-depth longitudinal case studies have been conducted to investigate whether there is a certain pattern in the privatisation process. What are the characteristics of privatisation processes of individual firms? What are the factors that control the dynamics of the process? How do process characteristics of privatisation affect turnaround? Based on the answers to these questions, an empirically grounded theory was developed for the analysis of turnaround success and failure of privatised firms.

In this theory, factors that determine turnaround include 1) the level of politicisation of the bargaining process in which the question of future ownership gets resolved, 2) the level of organisational politicking that surrounds both privatisation and strategy-making processes, 3) the effectiveness of corporate governance, and 4) the level of resource replenishment brought about by privatisation. Various combinations of these factors lead to different scenarios in which possible results are turnaround success, turnaround failure, and turnaround handicapped by either process characteristics of privatisation, or its outcome, or both.

Our results support the proposition that goal conflicts and their resolution through the use of political means make the outcome of the privatisation process difficult to predict on the basis of the rational actor model. Privatisation can be regarded as a gradually unfolding, evolutionary process. In national transformation, defective corporate governance can permit politicking to take a priority over performance. In the long-drawn-out process of privatisation, attention is diverted from efficiency. This exacerbates the firm's 'drift', which further restricts the chances of privatisation. Due to uncertainties in the privatisation process, managerial business decisions are built on vague assumptions about the likely outcome of privatisation and, if these assumptions prove false, the firm's strategy will turn out to be ineffective.

Essentially, these propositions suggest that the more procrastinated and politicised the privatisation process, the more handicapped the turnaround, which might not be offset by effective corporate governance and high levels of resource replenishment at the end of the process.

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CHAPTER ONE

1. Introduction

The research question

This thesis is concerned with the behaviour of formerly state-owned enterprises that are subject to privatisation in the context of national transformation. In general, *this research explores conditions under which privatisation can facilitate turnaround of state-owned firms*. Specifically, it concentrates on the issue of why, contrary to theoretical propositions as well as practical expectations, privatisation has as yet resulted in only modest results in strategic restructuring of privatised firms in Hungary.

Discontinuity and turbulence, commonly used terms in the strategic management literature (Ansoff, 1979; Drucker, 1980), may be the most telling words to describe the changes in Central and Eastern Europe since 1989. New states have been emerging, political and economic systems have been transforming. New priorities have been replacing old ones, interests have been overthrowing ideologies. In this context, most business organisations in Central-Eastern Europe must face challenges with no precedent whatsoever. Amongst the most substantial challenges are 'going private', that is the transfer of ownership of the firm from the collapsed socialist state to the emerging private sector, and the need for developing patterns of behaviour to cope with their dramatically altered environments.

Privatisation has been a government policy in various countries for more than a decade now. It became a major issue in the USA and the UK in the eighties (Beesley and Littlechild, 1983, 1988; Bishop and Kay, 1988; Caves, 1990; Kay, Mayer and Thompson, 1986; Marsh, 1991; Swann, 1988; Vickers and Yarrow, 1988). Then, in the second wave, privatisation of the public sector occurred around the world, including several developing countries (Cook and Kirkpatrick, 1988; El-Naggar, 1989; Glade, 1991; Ramanadham, 1989). Due to the tremendous changes that have been taking place in the countries of the collapsed communist bloc, the nineties started as the period of mass-privatisation in Central-Eastern Europe (Estrin, 1991; Lee and Nellis, 1990; Milanovic, 1990). Privatisation, as a central component of the historically unique endeavour of creating market economies region-wide on the ruins of state controlled ones, has been in the centre of government policy in some, although not all, countries in the region for the last couple of years, and is likely to remain so for several years.

In the light of this 'sweeping fashion' of privatisation, it is not surprising that it has been receiving considerable research attention. However, much of the research into privatisation has tended to be context-specific, focusing on privatisation in market economies dominated by private actors. Privatisation as it is being implemented in Central-Eastern Europe raises new problems, and poses new questions unanswered by previous research. It is not obvious, for example, what changes in firm behaviour privatisation will encourage in a different context. In an economy where most of the elements of an established market system are given, the effects of privatisation on firm behaviour can probably be anticipated with greater certainty than in an economy where all the elements of the system are in a state of flux. Although there is a recent, and burgeoning, literature on the 'transitional economies', this issue has mostly remained unexplored.

Privatisation is generally assumed to bring about stronger incentives, hence improved management and better performance. It is believed to facilitate restructuring, and encourage new, more efficient ways of doing business. As Vickers and Yarrow (1988:2) put it,

> "there are good reasons for thinking that the ownership of a firm will have significant effect on its behaviour and performance, since changes in property rights will alter the structure of incentives faced by decision makers in the firm."

Bös (1991:93) goes even further, stating that "give the bureaucrats the right incentives and they will behave as any management of a private firm." This may admittedly be "a strong, maybe even one-sided, position," a number of possible implications of the re-allocation of property rights for firm behaviour can nevertheless be, and have indeed been, hypothesised.

It is beyond the time and resource constraints of this research to address an exhaustive set of issues regarding the assumed relationship between privatisation and firm behaviour. The scope of this study is confined, for example, in terms of issues and context. *This research focuses on privatisation as affecting firm behaviour and turnaround performance in national transformation.*[1]

One would expect that as a formerly state-owned enterprise goes private, it can be no longer effective without being efficient, and consequently it will develop a pattern of behaviour better suited to the incentives that the new, private owners impose on its management. In particular, in the case of a 'troubled' firm, facing competitive pressures and losing the cushion of soft budget constraint (Kornai, 1980), this pattern of behaviour would show the characteristics of a turnaround strategy. It is this assumed relationship between privatisation and strategy that lies in the centre of the this research.

The context of the proposed research is the case of Hungary. This country had introduced some elements of a market economy with its 'stop-go' reforms since 1968. A few of the institutions of a market economy therefore had been established by the end of the 1980s, when the opportunity of the social, political and economic 'national transformation' opened. Yet, her "road to the free economy" (Kornai, 1990b) has proved to be a rocky one, where privatisation became one of the most fiercely debated issues to be solved on the way.

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[1] 'National' refers here to the various (social, political, economic) aspects of systemic changes. Instead of the commonly used 'transition' which suggests that the end-state of the change process is known, 'transformation' refers here to the evolution from one state to the other since "the future stable state of an evolving system is <u>not</u> predictable from its unstable state" (Levie, 1993:9, quoting Csányi's (1989) 'replicative' theory of biosocial evolution). For an application of the evolutionary paradigm to Central-East European transformation, see Murrell (1992).

Outline of the thesis

In this study we asked, under what conditions can privatisation facilitate turnaround of privatised state-owned firms. The brief answer to the research question is: privatisation can facilitate turnaround of state-owned firms, but it can also severely impede the successful pursuit of a turnaround strategy, depending on both process and outcome characteristics of privatisation.

In order to build a framework to study the research question, we have reviewed the relevant streams of literature that can theoretically inform such a framework (Chapter 2). This study utilises concepts and models of economic and organisation theory. It focuses not only on ownership changes as inputs and resulting behavioural changes as outputs, but also on the process in which these changes unfold. In that, it advances a view of privatisation that is driven by organisation theory to complement the dominant economic model based on the agency theory.

We have also established a few practically relevant issues on the basis of 1) an overview of the Hungarian privatisation process from the late eighties until the middle of the nineties (Chapter 3), and 2) lessons from a pilot study (section 3.6). This stage of the research process not only provided reassurance that an approach driven by organisation theory was better suited to our research than an agency theory-based approach (section 4.2), but it also contributed to the development of an initial framework.

The resulting research framework and formal propositions (sections 4.3 and 4.4) which were to guide our study suggested that turnaround attainment is influenced by an interplay of privatisation process and outcome variables, whereas strategy-making and strategy content provide the mechanism through which privatisation plays out its effect on turnaround attainment. Privatisation process, in particular, was assumed to determine strategy-making and strategy content during privatisation, and to be the driving force of a few distinct scenarios of the evolution of privatisation, strategy, and performance.

We attempted to further explore, corroborate and refine the emergent model in an empirical study that followed a multiple, replicative, longitudinal case study design (Chapter 5). In-depth longitudinal case studies were conducted to investigate whether there was a certain pattern in the privatisation process. What are the characteristics of privatisation processes of individual firms? What are the factors that control the dynamics of the process? How do process characteristics of privatisation affect turnaround? These were the questions that guided our inquiry.

Case narratives constitute the main empirical body of this research (Chapter 6). The cases were evaluated in the light of the framework to provide building blocks for theory development (section 7.2). Based on these evaluations, relationships between properties of privatisation, strategy, and performance were examined (section 7.3) and the findings were matched with our emergent theory (section 7.4). As a result of this work, an empirically grounded, 'middle range' theory (Glaser and Strauss, 1967; Strauss and Corbin, 1990) was developed that might help us better understand privatisation processes and their effect on firms' strategic behaviour and turnaround attainment in national transformation from the late communist era to (a yet unknown version of) what is generally conceived of as a capitalist system based on private property and market competition.

The resulting theory endeavours to explain and predict the differences in the performance of privatised Hungarian firms that need to achieve turnaround in the context of national transformation. We found that *turnaround attainment*, simply defined here as sustainable improved performance (see sections 2.2.2 and 4.3), is determined not only by the effectiveness of corporate governance, as the dominant, agency-theory based theory emphasises, but it is also influenced by three other fundamental factors. Thus, the conceptual elements of our theory include two properties of the privatisation process, and two properties (one of them being corporate governance) of the outcome of privatisation. Our analysis of the relationship between privatisation and turnaround through the use of case studies revealed that turnaround attainment is influenced by:

1. the level of *politicisation* of the bargaining process in which the question of future ownership gets resolved. 'Low' and 'high' politicisation denote different extents to which circumstances of political nature (or, in the most direct case, decisions made on the basis of political preferences) influence the privatisation process;

2. the intensity of *organisational politicking* that surrounds both privatisation and strategy-making processes. Politicking needs to be clearly distinguished from politicisation, and is defined here as an umbrella term that combines properties of processes within and around the organisation. For example, a case with 'high politicking' is characterised with sharp internal organisational conflicts in the privatisation process which were resolved through the use of politics, and/or evidence that the privatisation of a given firm became subject of politicking amongst players external to the given organisation;

3. the *effectiveness of corporate governance* (Monks and Minow, 1995). In this research, corporate governance is considered first of all through ownership concentration, where concentrated (private) ownership is associated with 'strong owners' and effective corporate governance, while dispersed ownership is associated with 'weak owners' and defective corporate governance;

4. the *level of resource replenishment* brought about by privatisation, that is the level of additional resources (financial and non-pecuniary alike) which may be either provided directly by the new owners (for example, increase of registered capital, or management skills), or become available to the firm from other sources due to the fact that it has been privatised (for example, tax holiday granted because of foreign ownership).

In addition, we found that the properties of the privatisation process play out their effect on turnaround attainment through strategy-making and strategy content, which are clearly distinguished in this study (see subsection 2.2.1). Each of these concepts was considered by one property. The *conciousness of strategy-making* (focused *versus* vague), and the *coping pattern of strategy content* (drift *versus* recovery) were singled out (see section 4.3).

Various combinations of these factors lead to different scenarios (labelled as 'going through', 'muddling through', and 'struggling through') in which possible results are *turnaround success*, *turnaround failure*, and *turnaround handicapped* by either process characteristics of privatisation, or its outcome, or both.

The *main relationships* are as follows:

1. Characteristics of the privatisation process, of which politicisation and politicking were explicitly considered and found to be interlinked, have an effect on properties of strategy, of which consciousness of strategy-making and coping pattern of strategy content were explicitly considered and, again, found to be interlinked. Low level of both politicisation and politicking seem to facilitate focused strategy-making and recovery, whereas high politicisation and politicking produce vague strategy-making and make the firm drift.

2. Consequently, performance of firms during the privatisation process varies between the opposites of sustained stability and decline (which may be cushioned by the 'benevolence' of the firm's environment).

3. Thus, we found that typical scenarios, as dynamic configurations of the privatisation process, strategy-making and strategy outcome, and performance during privatisation, are likely to occur in the transformation period.

4. These scenarios, coupled with different privatisation outcomes, are likely determinants of turnaround attainment of privatised firms.

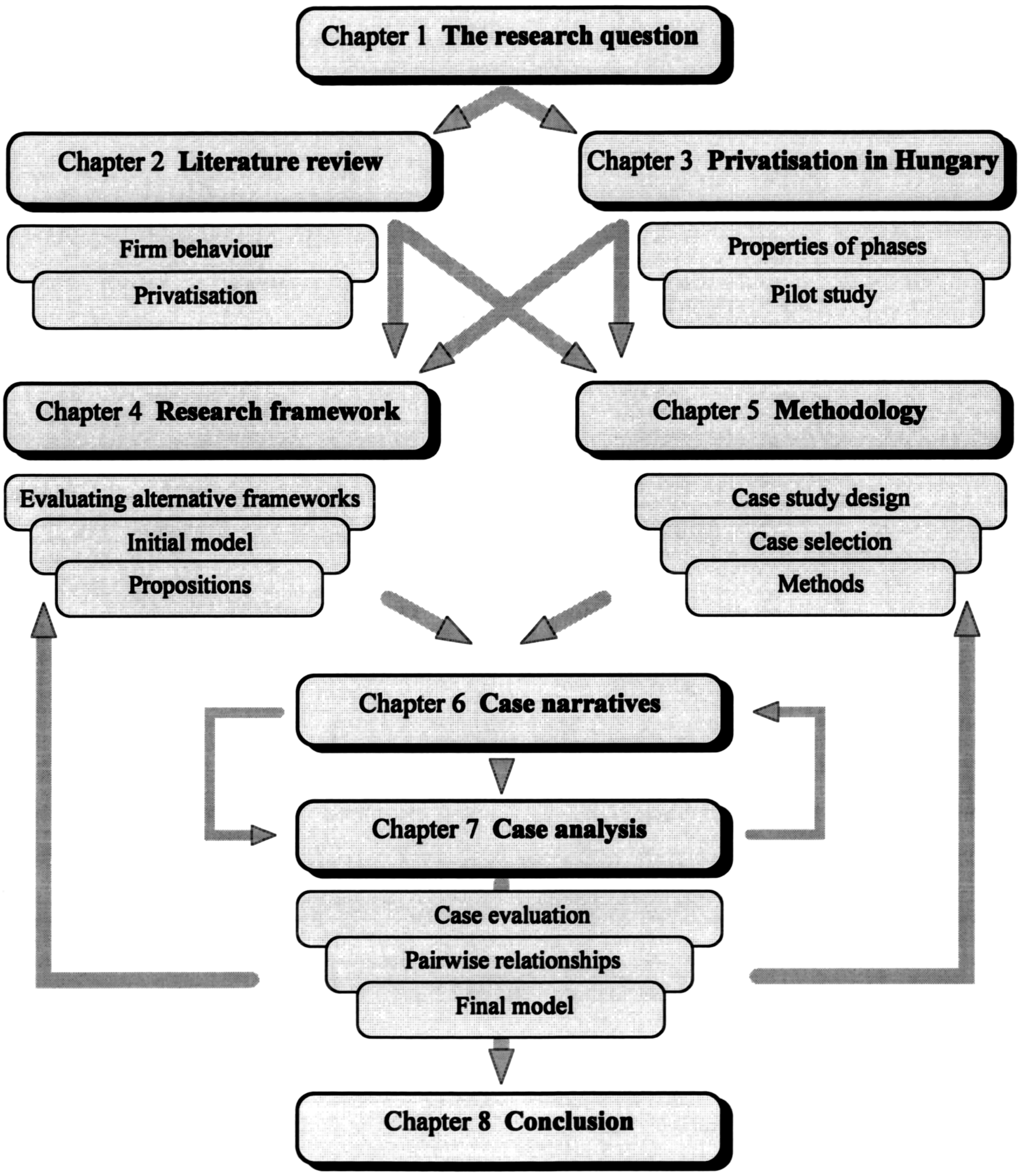
Our results support the proposition that goal conflicts and their resolution through the use of political means make the outcome of the privatisation process difficult to predict on the basis of the rational actor model. Privatisation can be regarded as a gradually unfolding, evolutionary process. In national transformation, defective corporate governance can permit politicking to take a priority over performance. In the long-drawn-out process of privatisation, attention is diverted from efficiency. This exacerbates the firm's 'drift', which further restricts the chances of privatisation. Due to uncertainties in the privatisation process, managerial business decisions are built on vague assumptions about the likely outcome of privatisation and, if these assumptions prove false, the firm's strategy will turn out to be ineffective.

Essentially, these propositions suggest that the more procrastinated and politicised the privatisation process, the more handicapped the turnaround, which might not be offset by effective corporate governance and high level of resource replenishment at the end of the process.

Chapter 8 concludes this thesis by putting the results in a broader context and offering questions for further study. Bibliography and Appendices are given.

Figure 1 (overleaf) presents an overview of the chapters and sections of this thesis, and indicates some iterations between different phases of this research process.

Figure 1 Layout of the thesis



Chapter Two

2. Review of the relevant literature

2.1 Introduction

Since the problems this research is concerned with are rather contemporary, it is not surprising that no coherent middle-range theory on how privatisation of formerly state-owned enterprises affects the behaviour patterns of these organisations in transformational economies has yet been developed. There is, however, a considerable theoretical literature on closely related issues, partly in the field of economic theory and partly in organisation theory and strategic management, from which guidelines for this study were developed.[2] In particular, there appear to be two broad fields of study one could rely upon in addressing the research question. These are:

- strategic behaviour of business organisations, and
- privatisation and its presumed effects on firm performance.

In this chapter a brief review of this literature is given with the aim of clarifying the main concepts and laying the background for the empirical work. A further objective that is hoped to be attained by the end of this chapter is an increased "theoretical sensitivity" of the researcher, as recommended Glaser and Strauss (1967) for those involved in theory development.

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[2] Drawing on concepts both from economics and organisation theory in analysing strategy issues corresponds with the contemporary development of strategy being a "meeting field" of the two disciplines. In Williamson's (1990:182) words, "Economics and organization theory ought to inform each other. Indeed, ..., that has been happening." (See also Strategic Management Journal, February 1992, Special Issue, devoted to the contribution of economics to strategy.)

2.2 A strategy view of firm behaviour

The present study is interested in changes in firm behaviour that can be attributed to changes in ownership. Moreover, these changes should constitute a coherent and consistent pattern in order to be viewed as a turnaround. Behaviour patterns of business organisations have been thoroughly discussed in the strategy literature. In fact, one of the several streams of the strategy literature defines strategy as a consistent pattern of behaviour over time. It is this meaning in which we use the term 'strategy' throughout this thesis. First, after briefly addressing the concept of strategy in general, we discuss behaviour patterns (strategy types, and turnaround strategies in particular) and the process in which they develop (strategy-making). Second, the 'strategy-view' is applied to the behaviour of state-owned enterprises operating in a non-market economy controlled by a communist political regime ('socialist firm' for short, hereinafter). Our purpose in this section is to outline a general departure point for the present study.

2.2.1 Strategy defined

In this thesis *behaviour patterns over time* are called strategies. This definition is in fact the inverted formulation of the strategy concept as it is commonly defined in the 'Mintzbergian' stream of the strategy literature, which views strategy as a consistent pattern of behaviour (cf. Mintzberg, 1978; Mintzberg and Waters, 1982; for opposing views see, for example, Leontiades, 1982). As depicted in Figure 2 (overleaf), we distinguish between

- process *versus* content ('making' *versus* outcome of processes), and
- conception *versus* action (what is intended to be done *versus* what has been done).[3]

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[3] For some of the terms used in the strategy-matrix, see Mintzberg (1978) and Mintzberg and Waters (1985), whose explicit distinctions between "intended" and "realised" as well as between "formation" and "formulation" induced this conceptual arrangement. Burgelman's work (1983a, 1983b, 1991) was also inspiring. The first version of this strategy-matrix was

Continued on next page.

Figure 2 The conceptual strategy-matrix

Strategy	**Process**	**Content**
Conception	Formulation of Intended Strategy	Intended Strategy
Action	Formation of Realised Strategy	Realised Strategy

Along the two dimensions of 'process—content' and 'conception—action', four sets of issues can be identified.

- **Formulation of Intended Strategy** refers to a process in which a conception, an idea before action, is worked out. It is this process (or often its formalised version) that tends to be called strategic planning in the literature.

- **Intended Strategy**, that is the positions to be achieved in the future and the courses of future action, is the outcome of the above process. It is the intended strategy that is often regarded as *the* strategy of an organisation.

- **Realised Strategy** denotes an *a posteriori* recognisable pattern in the course of action of an organisation (as an outcome of action of individuals in the organisation). The terms 'realised strategy', 'strategy content', or 'strategy' for

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published in Antal, Z. (1990). A similar way of arranging strategy-issues appeared in Douma and Schreuder (1992:121). Note that different sides of the strategy-matrix tend to be dealt with by authors with different background. Organisation theory, (for example, contingency theory, see Hofer, 1975; Pennings, 1992) on the process-side, and economics (for example industrial organisation, see Porter, 1980, 1985) on the content-side seem to have contributed most to the strategy-field.

short, will be used to denote this behaviour pattern of an organisation in this thesis. It is the changes in a firm's realised strategy due to privatisation that this research is concerned with.

- **Formation of Realised Strategy** ('strategy process' or 'strategy-making' for short) is the term to label the course of action itself. Chances for different members to influence the stream of action of an organisation are clearly different. Yet, especially in certain forms of organisations, it is not only the management who plays a part in shaping that stream (cf. Mintzberg, 1979). Organisational outcomes are effected by many. Therefore 'strategic management', that is the process in which the management attempts to shape realised strategy, is viewed as a subset of formation of realised strategy.

Strategy-making takes place in a complex set of external and internal factors, that are usually referred to as the *context*. It is the process of strategy-making through which context influences the behaviour pattern of an organisation, that is its strategy. For purposes of this research an approach to the concept of 'context' is needed which recognises the role of ownership, for example as transmitted via incentive systems and institutional constraints (cf. Hafsi and Thomas, 1986).

External context is usually referred to as the environment of an organisation. The dominant contingency view of strategy emphasises strategic choice, adaptation to and influence on the environment (Chakravarthy, 1982; Child, 1972; Hofer, 1975). The alternative approach of population ecology focuses on limits to strategic choice, such as organisational inertia, and thus environmental selection (Aldrich, 1979; Hannan and Freeman, 1977). In any case, the issue of relevance revolves around the relationship between organisations and environments.

Consequently, our working definition of strategy is given as *the pattern in a stream of organisational action* that reflects a certain *relationship between an organisation* *and its (broadly defined) environment* or, in other words, an organisation's *'coping pattern'*.[4] Note that this definition does not necessarily imply deliberate adaptive efforts. We also point out that the definition is formulated at a considerably high level of generalisation so that it can be applied to state-owned enterprises of non-market economies and, of course, to enterprises operating in a transformational economy.[5]

2.2.2 Strategy content and process

Strategy content: typologies and turnaround strategies

The above definition of strategy implies a structural approach, emphasising a pattern, a certain structure or configuration of behavioural variables. This is well reflected in numerous studies attempting to develop empirical taxonomies of corporate and business strategies by using factor- and cluster-analysis to 'structure' behavioural variables, to develop configurations of variables that subsequently are viewed as distinct types of strategy (Galbraith and Schendel, 1983; Hambrick, 1983a, 1983b; Hambrick and Schecter, 1983). A similar approach has often been employed in research into organisations, or 'gestalts' of organisations and environments (Miles and Snow, 1978; Miller, 1986; Mintzberg, 1979), and strategy-making (Miller and Friesen, 1984).[6]

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[4] Where a 'random' pattern does not reflect 'no relationship' or 'not having a strategy', but a "passive" (Glueck, 1972), "reactor" (Miles and Snow, 1978), "stuck in the middle" (Porter, 1980) strategy, or "adaptation by chance" (Hrebiniak and Joyce, 1985).

[5] This is in line with Ring and Perry's (1985:276) conclusion that the "application of private sector models to the public sector is problematic; ... general models of strategic management are needed." The authors also pointed out several constraints (including separation of levels and branches of government, centralised merit based personnel systems, policy ambiguity, diverse interest groups, artificial time constraints) that make the context of strategic management in the public sector markedly different from that in the private one. Many of these issues are discussed later in this thesis.

[6] Other examples for – sometimes less formalised – typologies and taxonomies, mainly of business strategies, include Ansoff (1979), Bamberger (1986), Dess and Davis (1984), Glueck (1972), Hambrick (1983c), Hambrick, MacMillan and Day (1982), Porter (1980),

Continued on next page.

Defining strategy as a behaviour pattern in the course of action of an organisation also suggests that strategy is a dynamic concept. It implies a pattern, a certain 'structure' in a sequence of events. While most of the studies relied on cross sectional analyses, taking a snapshot of the firms' strategies at one point of time, there are a few empirical studies that promisingly incorporated the dynamic nature of the strategy concept in their methodologies (see, for example, Galbraith and Schendel, 1983; Miller and Friesen, 1984; Mintzberg and Waters, 1982).

In particular, studies of *turnaround strategies* explicitly address the dynamic nature of the strategy concept since their major concern is exactly a change in the pattern over time that leads to improved and sustainable performance (Hofer, 1980; Stopford and Baden-Fuller, 1990).

Stopford and Baden-Fuller (1990:399) introduce 'rejuvenation' to denote recovery "from imminent disaster to create sustained and profitable growth" (see also Baden-Fuller and Stopford, 1992). They argue that 'turnaround management' is more concerned with efficiency and emphasises the financial dimensions, while 'rejuvenation' goes further and includes "the building of effective systems and skills needed to create sustainable growth" (Stopford and Baden-Fuller, 1990:401). Others maintain the term 'turnaround' but distinguish between 'retrenchment' and 'return-to-growth' or 'recovery' periods in the overall, multi-stage turnaround process (Robbins and Pearce, 1992; on 'stages-models' of turnaround, see also Arogyaswamy, Barker, and Yasai-Ardekani, 1995; Barker and Mone, 1994). Retrenchment may also be referred to as 'restructuring', 'downsizing', or 'corporate comeback' (Goldstein, 1988), while 'recovery' is sometimes used as a synonym for over-all turnaround or rejuvenation (Slatter, 1984). In this research the view that turnaround is a multi-stage process is accepted. 'Turnaround' and rejuvenation will be used as synonyms to denote the overall process, consisting of both *'recovery'*

White (1986), Woo and Cooper (1981). For recent discussions of methodological issues of such classifications, see Rich (1992) and Sanchez (1993).

(regaining financial stability) and *'capability enhancement'* (creating the foundation of future growth).

Much of the literature on corporate turnaround has been published in 'How to' handbooks or in a form of collected cases.[7] Notable exceptions are, for example, Hofer (1980), Hambrick and Schecter (1983), Slatter (1984), Stopford and Baden-Fuller (1990). In the typology- and taxonomy stream of research, Hofer (1980) developed a theoretical typology of business-unit level turnarounds. He described three types of strategic turnarounds (move to a larger strategic group, competing more effectively in the existing one, and move to a smaller group), and four types of non-strategic or operating turnarounds (revenue-increasing, cost-cutting, asset-reduction, combination strategies). Hofer's types were further elaborated by Slatter (1984). Hambrick and Schecter (1983) also dealt with unit-level turnaround strategies, and derived an empirical taxonomy by multivariate statistical analysis. In the case study-based stream of research, Stopford and Baden-Fuller (1990) found that in successful rejuvenation the chief executive plays an essential role by looking beyond the immediate, mostly financial, problems, triggering lasting changes in the way the firm operates, and acting as a teacher.

Strategy process: the role of rationality and power

Making the explicit distinction between intended strategy and realised strategy represents two different perspectives of looking at the notion of strategy. These perspectives can be summarised in Allison's (1971) terminology. One perspective follows the rational actor model, assuming "events as purposive choices of consistent actors" (Allison, 1971:11). The other perspective, in line with our definition of strategy, regards it as the *resultant* of action

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[7] See Davis (1988), Finkin (1987), Goldstein (1988), Goldstick (1988), Goodman (1982), Grinyer and Spender (1979), Kharbanda and Stallworthy (1985, 1987), Kibel (1982), Nelson and Clutterback (1988), Sloma (1985), Zimmerman (1991).

> "in the sense that what happens is not chosen as a solution to a problem but rather results from compromise, conflict, and confusion of officials with diverse interests and unequal influence." (Allison, 1971:162).

In other words, strategy is influenced by power in and around organisations (Mintzberg, 1983; Pfeffer, 1981). Note that this perspective does not necessarily assume functional rationality[8] at the level of the organisation. Neither does it imply that what results from conflicts and their political resolution will correspond with the preferences of any of the players in the political arena of the organisation (cf. Mintzberg, 1983).

For the purposes of this research the *power model* has been chosen (against the alternatives of the rational actor model and the bureaucratic model of decision-making)[9], for the following considerations:

- The rational actor model would assume a consistent set of preferences at the level of the organisation. The assumption could be approximated in the power model, assuming rationality at the level of individuals and the presence of certain conditions such as shared values or effective incentives and controls that ensure goal alignment. These conditions, however, are not expected to manifest in the context of national transformation.

- The subject of this research is the socialist firm before, during, and after privatisation (with most emphasis on 'during'). As illustrated later, the strategy process in this case cannot probably be described as taking place only within a given organisation. Assuming a consistent set of preferences or goals for several

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[8] 'Functional rationality' is used to denote the assumption that "decision making [is] oriented toward the improvement of efficiency or performance" (Pfeffer, 1981:14). It was Pfeffer, too, who noted: "It is also likely that theories of organization-level rationality are less applicable to public sector or nonmarket organizations, at least in the absence of strong socialization effects" (Pfeffer, 1982:134).

[9] This choice is also in line with the findings of Eisenhardt and Zbaracki (1992), whose work confirmed that organisations are political systems, and strategic decision-making is accurately described as an interweaving of boundedly rational and political processes.

organisations (including the firm and its many state superiors), however, would be contrary to evidence.

- In the strategy process, particularly in the context of this research, non-standard issues are expected to dominate. Standard operating procedures of bureaucratic organisational decision-making are hardly called for to resolve such issues.

- With the external control mechanisms and dependencies of the socialist economy eroding and finally disappearing, previous power structure is expected to de-freeze, then re-configure (one might say this is at the heart of the transformation). Before reconfiguration, however, a wide space will probably open for different interests to be manifested. As Hannan and Freeman (1984:151) put it,

  > "When members of an organization have diverse interests, organizational outcomes depend heavily on internal politics ... In such situations outcomes cannot easily be matched rationally to changing environments."[10]

  The power model can explicitly deal with conflicting preferences. This approach appears pertinent to firms operating in national transformation.

- The power model can also treat owners in an explicit way, as external influencers.

The power model in itself deals only with internal organisational processes, of which strategy, as a pattern of organisational level action, is the outcome.[11] To see whether the resultant strategy is effective ('good' or 'bad' in terms of meeting – or breaking – external constraints), a complementary theory, the resource dependence perspective of organisations (Pfeffer and Salancik, 1978) will later be employed, as a version of

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[10] Every quote is 'as is', maintaining the American spelling of and in some cases the spelling mistakes in the original source, without indicating it by '[sic.]'. Similarly, unless otherwise stated, emphasis is reproduced in the same way (boldface, italics, underlined, etc.) as in the source.

[11] In the rational actor model, this issue would be dealt with by referring to the management's deliberate choice of one of alternative (intended) strategies.

the 'power model' applicable to the relationship between organisations and external influencers.[12]

2.2.3 Behaviour patterns of state-owned enterprises

Although the main theme of this thesis is firm behaviour in national transformation in relation to privatisation, an outline of the 'point of departure' seems inevitable, since strategies are not introduced out of the blue but they are rooted in a concrete historical situation. Strategy was defined above as a behaviour pattern of an organisation, depicting a distinct relationship with its environment. This general concept is applied here to state-owned enterprises. Public enterprise economics and the resource dependence view of organisations are drawn upon.

First, strategy content is analysed in terms of orientation. Second, strategic orientation of state-owned firms is explained by contextual differences of the strategy process. Third, the effectiveness of state-oriented strategies even at the expense of efficiency is highlighted in a discussion of goal formation and external control. Throughout this section socialist (in particular, Hungarian) firms are considered, although several points may also apply to state-owned firms operating in market economies.

Strategic orientation

State-owned enterprises in general, and socialist enterprises in particular have usually been beyond the interest of Western authors in the strategy-area and organisation theory (see Carroll, Goodstein and Gyenes, 1988; Lewin, 1981; Snow, 1986). An exception is Zif (1981) who developed and tested a framework of managerial strategic behaviour in state-owned enterprises, which can be adapted to socialist

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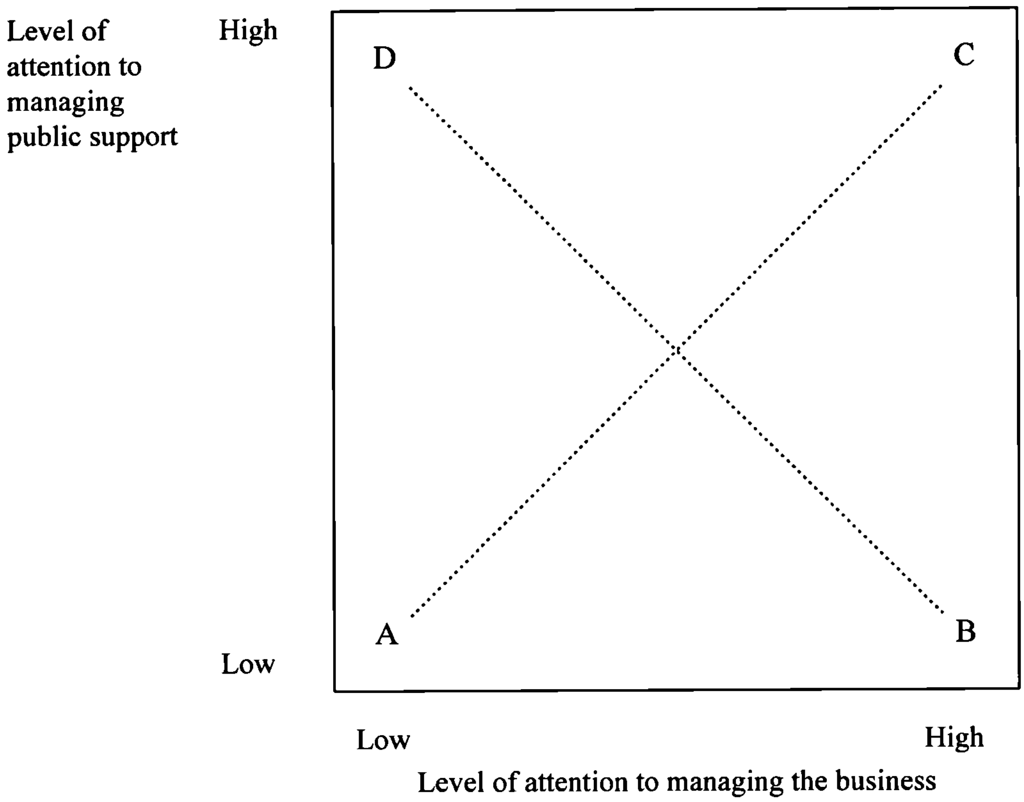
[12] In the population ecology model this issue would be dealt with by referring to environmental selection of organisations pursuing certain resultant strategies – no matter how they were arrived at in the black box of the firm.

enterprises as well. This framework is depicted in Figure 3, where the axes represent two functions of the managers of state-owned firms.

Figure 3 The space of business and political orientations



Source: Zif (1981:1327)

Following Zif's approach, we distinguish between (primarily) *state-oriented* and (primarily) *market-oriented* strategy-types. In an active state-oriented strategy (as opposed to an active business- or market-oriented strategy of a private firm in a market economy), managing the business is traded off against winning political support. This strategy seems to have been pursued by several Hungarian socialist enterprises which had received special attention by the state for some reason – for example, due to their size, that is the role they played in maintaining full employment; their proportion in hard currency export; or their contribution to any other current political and/or economic priority. At the same time, and for the same reasons, these firms had enjoyed relatively great bargaining power against the government and could gain preferential treatment in many respects.[13]

In a passive state-oriented strategy, neither political support nor the business is actively managed. This strategy type seems to have been that of the 'second ranking' large and middle size Hungarian socialist enterprises that had been weak in terms of bargaining power against the state to gain substantial preferences, but still 'important' enough not to be shut down for poor performance.

Resource dependence

As a general background, Kornai's (1992) discussion of the vertical, "paternalistic" dependence of the socialist firm is summarised in Table 1 (overleaf). This should be illustrative as to the differences between the contexts of firm behaviour in "market co-ordination" and "bureaucratic co-ordination" (Kornai, 1986, 1990a, 1992).

In the context of state ownership and bureaucratic co-ordination, the state dominates the economic payoff (Kornai and Matits, 1987, 1990) and managerial positions may often be a political patronage prize. Firm behaviour shifts accordingly. As Pfeffer and Salancik (1978: 214) put it:

> "Why do some organizations attend to the political environment and others do not? The answer is probably that the political environment is a greater source of interdependence for some organizations. ... The political system becomes relevant for the organization when the system begins to affect organizational outcomes."

Thus, *state-oriented strategies are explained within the framework of the resource dependence view* of organisations (Pfeffer and Salancik, 1978; for a theorising attempt to apply this view to the study of the behaviour of Hungarian socialist firms, see Markóczy, 1989).

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[13] In Hungary, for example, there had been some 50 so-called 'distinguished large industrial enterprises', flagships of the socialist economy. See Szalai (1989) on bargaining between large enterprises and the state in Hungary.

Table 1 The socialist firm's vertical dependence

Issue	Assessment
Entry	Bureaucracy decides on setting up new public firms, or permitting import competition or entry of private enterprise.
Exit	Winding up a firm is decided (rarely) by bureaucracy. No correlation with prior losses or insolvency.
Mergers and splits	May be initiated by firms, last word remains with bureaucracy.
Appointment of leaders of firms	Bureaucracy decides or influences decisively the nomination and selection.
Output and Input	No imposition, but 'pressures' from party and state organisations remains. Contractual disputes taken to authority, not court.
Exports/imports and Foreign exchange	Interference via export assignments, import quotas, licensing procedure, pressure.
Choice of technology and product development	Intervening via subsidy, credit facility, import license, tied to the firm's choice.
Prices	Partial deregulation. Fixed prices influence free prices. Calculation methods prescribed. Protesting pressure if price is thought 'unjustifiably high'. Highly distorted.
Wages and employment	Some state interference still present. For example, administrative ceiling, 'punishing tax' for high wage raise, informal pressure.
Taxes and subsidies	Tax system same for all in principle, easily tailor-made in practice. Extremely complex and often unpredictable. Concessions on amount and due date.
Extension of credit and loan repayment	Bureaucratic banking sector, as branch of the state. Soft budget constraint. Loan decisions are not based on economic rationality.
Investment	Partial deregulation, modest autonomy. Larger projects invariably need state funds.

Source: Based on Kornai (1992:482-486)

A basic assumption of the resource dependence model is that

> "to survive, organizations require resources. Typically, acquiring resources means the organization must interact with others who control those resources" (Pfeffer and Salancik, 1978:258).

Since critical resources are unevenly distributed among the various environmental actors, organisational behaviour will be directed to satisfying the needs of those environmental subsystems where the critical resources can be obtained from.[14] In a market economy a private enterprise can obtain its critical resources above all from markets. In a socialist economy, resources, their sources and the ways they can be obtained are 'system-specific'. Resources may include direct financial subsidies from state funds as well as 'indirect' preferential regulatory treatment in terms of prices chargeable, wages payable, tax holiday granted, permission for hard currency import, etc. In a state-controlled socialist economy – no matter if it is a classic command-economy, or a reforming one, governed via sophisticated indirect 'market-simulating' mechanisms, formal and informal 'expectations', and campaigns – the state regulatory and supervisory subsystems of the firms' environment constitute the relevant environmental sector which organisational efforts must be directed to.

In this setting, firms will accordingly develop "dominant competence" (McKelvey and Aldrich, 1983) to cope with their vertical dependence, while neglecting competence needed for managing horizontal dependencies. 'Competition' becomes the struggle for resources from the state. 'Strategic capabilities', and 'distinctive competencies' gain quite different meaning from those in the Western strategy literature which implicitly assumes market economy and private ownership. We shall return to this issue in our discussion of the Hungarian 'reforming socialist economy' later.

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[14] Following the resource based model of the firm in the strategy literature, resources are defined here broadly (cf. Barney, 1991; Conner, 1991; Wernerfelt, 1984). However, the emphasis is placed on resources that are acquired from the environment, as opposed to "organizationally generated resources" (Pfeffer and Salancik, 1978:259).

If state ownership and regulation induce an increased attention to the state in market economies, as the quoted authors assert, state orientation of the behaviour of a socialist firm is probably further intensified by the *political control* of the communist party-state.[15] Following DiMaggio and Powell (1983) who combine institutional theory[16] and resource dependence and explicitly deal with the strong state, we regard political control as one of the coercive forces through which the state creates isomorphism among organisations or, in terms of this research, similarity of the behaviour pattern they will show.[17] Similarly, in a study of 60 large Hungarian industrial firms, Máriás, Kovács, Balaton, Tari and Dobák (1981) could explain 'structural isomorphism', that is the high level of similarity of their organisational structures, with the high level of vertical dependency from the state.

Goal formation and external constraints

Public enterprise economics emphasises that the analysis of the behaviour of state-owned enterprises requires an understanding of the nature of objectives pursued by the management and the incentives and constraints it faces. Private and public firms significantly differ from both respects – therefore their strategies must also differ.

Goal formation. The positive theory of state-owned enterprises focuses on their actual behaviour (see, for example, Aharoni, 1981; Bös, 1991; Ramamurti, 1987).

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[15] 'Party-state' refers to the symbiotic relationship between the communist party and the state authorities. See Csanádi's (1987) review of economic decision-making processes in Hungary under the communist regime. See also Tsoukas (1994).

[16] For applications of institutionalism to state socialism, see Stark and Nee (1990), and Tsoukas (1994:34) who emphasised "politically-induced isomorphism" as a special feature of socialist economies.

[17] This does not mean that there is only one dominant behaviour model. In populations of firms that are less connected to the state (for example, private establishments in a so-called reform socialist country), different models may become dominant. In addition, variants of the dominant model of state orientation may arise within the population of firms that are closely connected to the state (such as large state-owned industrial enterprises), since the state is not a unitary actor but constitutes various bodies, each of which "defines its own models of organization, and competes with other authorities to have it adopted" (Carroll, Goodstein and Gyenes, 1988:238). We return to this issue later in this section.

Positive research in economics has revealed that public enterprises usually do not aim at maximising profit, not even social welfare as the normative theory suggest they should be forced to. In fact, one of the most striking difference between the goal structure of private and public firms is that in the latter case a single ultimate objective function cannot be defined. State-owned enterprises are often expected to create employment, help develop certain geographical regions, hold down prices of certain goods, earn foreign exchange, develop technologies of 'national importance', etc. These objectives are also subject to frequent changes due to modifications in the priorities and power distribution of the political leadership. In short, public enterprises seem to follow multiple and often contradictory, ill-defined or 'fuzzy' objectives emerged from a political process (see Estrin and Pérotin, 1991). In a situation like this, when it is virtually undefined what counts as good performance, it becomes extremely difficult or even impossible to effectively monitor the performance of public enterprises. Numerous and shifting targets make the term 'efficiency' blurred, prone to be subject of alternative interpretations. Governments, then, may feel necessary "to specify and monitor management's action rather than outcomes" (Estrin and Pérotin, 1991:62), but intervention into the operational activity of the firm makes the situation worse, since it may lead to passive, risk-averse and bureaucratic behaviour. As Levy (1987:93) describes the trap of a downward spiral,

> "as controllers rationally increase the extent of intervention in response to their growing perception of a gap between their goals and those of the managers, managers respond by reducing their level of effort, performance of the enterprise worsens, inducing controllers to tighten their grip even further ... until enterprise management, hopelessly enmeshed in a web of external control, begins to exhibit thoroughly passive and bureaucratic patterns of behavior."

Government intervention, even if exercised indirectly through regulations, can also be used by the management as an argument against taking responsibility for poor performance. As Kornai (1992:495) noted,

> "... the management of the firm can point out ... that they had discussed each important action they took with at least some higher party and state organizations or were specifically ordered to take that action. They can go on to plead that the losses were caused by faulty prices, the taxes or duties recently levied, the wage rises ordered by the state, and other measures taken by their superiors. Any firm on the verge of insolvency has dozens of high-ranking persons above it who possessed the

> same information as the firm's leaders, took part in taking the mistaken decision, and so have a motive for disguising the responsibility."

This suggests that strategy-making of a socialist enterprise can be conceived of as a process cutting across the blurred boundaries between the enterprise and the government,[18] and that the political relations of the management may be of utmost importance (cf. Hafsi and Thomas, 1986).

These characteristics of goal formation open a wide space for *bargaining* between the management and government. In Kornai's (1986:1700) words,

> "Bargaining goes on about all issues all the time ... and the main direction is vertical, namely bargaining between levels of hierarchy, or between bureaucracy and firm, not horizontal between seller and buyer."

In the Hungarian context in particular, the bargaining nature of the so-called reform-socialist economic mechanism also received support from Kovács (1988). In his research that was similar in its approach and methodology to Mintzberg's (1973, 1975) study of the manager's job he found that

> "The managers [of large socialist enterprises in Hungary around the mid-1980s] are aware that creating various lobbies improves the capability of firm groups to see their interests met. To move from one basket of ministerial preferences into another may bring a profit or loss of 100m, that is why managers spend considerable proportion of their time on managing external relationships. Participation in various political organisations also brings benefit, in that the manager can sit at the table where decisions are actually made ..." (Kovács, 1988:1285).

Carroll, Goodstein and Gyenes (1988:237) also emphasise: "Managing relations with the state is the highest priority of a management team in Hungary." This is what Antal, L. (1985) described in rich details and labelled "regulation bargaining"[19], as opposed to "plan bargaining" of the classic command economy.[20]

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[18] Alternatively, the whole socialist economy might be viewed as one giant multidivisional enterprise (cf. Mintzberg, 1979), appropriately re-defining the notion of boundary between state (headquarters) and firm (division).

[19] Where 'regulations' in the Hungarian economic jargon mean a constantly changing, hardly predictable, complex web of parameters (i.e., financial controls, targets, quotas, etc.)

Continued on next page.

The bargaining process may result in the government being captured by the management, due to information asymmetry or the firm's superior bargaining power.[21] The fact that the state cannot be conceived of as a single principal but rather as a set of persons and organisations with their own, often divergent, objectives and capabilities to influence managers (cf. Aharoni, 1981:1342; Estrin and Pérotin, 1991:62; Kornai, 1992:487-488; Mintzberg, 1983:539; and footnote 17 on page 34 of this thesis) may also permit managers to ease away from the effects of external control by making alliances with some of the state controllers to play off others.[22] In other words, the 'fragmented' state can offer an opportunity for the organisation to turn to one state body for support if rebutted by another.

We can conclude, then, that in the context of state ownership, centralised and redistributed resources, numerous regulations, and political control, *bargaining* is likely to become *the dominant property of firm behaviour patterns.*

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set by the superior organisations in order to regulate firms in the so-called indirect mechanism of economic management. The complex system of 'regulations' also by default enabled creative accounting in order to camouflage poor performance and build up enough 'slack'.

[20] The phenomenon is not unknown in market economies; for example, see Aharoni's (1981:1342) assertion that "power relations become important variables" for managers of SOEs in bargaining; and Birnbaum's (1985) discussion on political strategies of regulated organisations.

[21] 'Capturing' of controllers by those supposedly controlled may also happen in the course of privatisation. On the British privatisation, Vickers and Yarrow (1988:428) note, that "In the process, the Government has partly been captured by the managements of the firms being sold, since their co-operation is essential for rapid privatization." Bishop and Kay (1988:23) add that "The political power of senior management comes from the practical observation that any privatization which does not enjoy their support will be at best a difficult and protracted process." The importance of the co-operation of the managements may be even higher in the case of Central Eastern Europe where the scope, size and urgency of privatisation exceed the same parameters of the British privatisation.

[22] Pfeffer and Salancik (1978:210-213), while considering the relationship between the regulated and the regulator (but without assuming public ownership), make a similar comment on the issue under discussion.

Compliance with, or orientation to the 'strong state' may not represent an *efficient* strategy; however, it may be an *effective* strategy. As Pfeffer and Salancik (1978:60) put it: "the effective organization, then, is the organization which satisfies the demands of those in its environment from whom it requires support for its continued existence". The point that is being made here is that for evaluating the appropriateness of a strategy, effectiveness instead of efficiency is the criterion to be chosen, and these two criteria had been quite independent from each other under command and reform socialist economic regimes.

External constraints. Multiplicity, internal inconsistency, political definition, and fluidity (changing nature) of objectives define a task environment in which the management has much discretion in determining what actual objectives to follow.[23] In its search of objectives it usually does not have to face the constraints that are given to its private counterpart and would align the criteria of effectiveness and efficiency. These constraints include product market competition or contestability, threat of a take-over bid or bankruptcy, managerial labour market, and effective monitoring by private shareholders.[24] For managers in socialist economies, however, none of these was present.

2.3 Existing theory on privatisation

In this section we review the second main stream of literature that is drawn upon in this study. An existing theory on the relationship between privatisation and firm behaviour is presented. Such a theory has been developed by economists in the

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[23] This corresponds to the seemingly paradox case of both high environmental determinism *and* high individual choice of strategy in which "the primary organizational task ... is to maneuver around externally imposed prescriptions and proscriptions" (Hrebiniak and Joyce, 1985:345; see also Burgelman, 1983a, 1983b, 1991; Levinthal, 1991).

[24] Examples of the relevant literature include Kornai (1980, 1986, 1990a,b) mainly on competition; Fama and Jensen (1983) and Walsh and Kosnik (1993) on the disciplinary effect of take-overs; Fama (1980) and Estrin and Pérotin (1991) on managerial labour markets. Regarding effectiveness of monitoring, see preceding discussion on goal formation and bargaining. See also section 2.3.3 in this thesis.

framework of the principal-agent model, in which changes in the 'context' due to privatisation are identified and offered as an explanation for supposed changes in the behaviour of privatised firms. The concept of privatisation is defined and the objectives that have been followed in practice in countries pursuing privatisation are discussed. Then, turning to theory, we outline the contextual changes that are introduced by privatisation and to which changes in firm behaviour are attributed.

2.3.1 Privatisation defined

Having been studied for many years, this concept still does not have a common definition.[25] Undoubtedly, it denotes a shift from the public to the private sector, but this shift can take place in various forms. What is covered from these forms by the term 'privatisation' leads to differences between authors. Confusion about this word in the post-communist countries is further exacerbated where it is often used to denote commercialisation or corporatisation, labelling a firm as privatised even if it has only been transformed into a commercial company form but still wholly owned by the state.

Broad and narrow meanings of 'privatisation' differ according to the ways through which the balance between the private and the public sectors alters. Table 2 (overleaf) summarises various policy initiatives and techniques that are often gathered under the umbrella of 'privatisation'. Swann (1988:2-3), for example, although he focuses on the transfer of public assets into private ownership, when he comes to define privatisation he regards it as an umbrella term, covering ways of

> "the introduction into the public sector, or what has previously been the public sector, of conditions which typify the private sector. ... It is therefore possible to envisage privatisation taking place even though no change in the ownership of public assets takes place. Thus public enterprise may remain in existence but may be required to adopt a more commercial approach – i.e. to behave more like a privately owned enterprise".

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[25] For the conception of the term, see Hemming and Mansoor (1988:1, footnote), and King (1987:18). On its numerous different meanings, see Thiemeyer (1986:7-10).

Table 2 A broad view of privatisation

Broad policy options	Change in the ownership of an enterprise	Liberalisation or deregulation	Private supply with government's ultimate responsibility for the supply
Techniques	• sale of equity • sale of SOE as entity • joint venture • liquidation	• allowing entry into areas previously populated only by SOEs	• franchising • contracting-out • leasing of public assets

Source: adapted from Cook and Kirkpatrick (1988:3-4)

Others, like Bös (1991) and Vickers and Yarrow (1988), use the term in a narrower sense, requiring *transfer of ownership* for the phenomenon to be called privatisation. In this research, this narrow meaning of privatisation is accepted. In our view, privatisation is about ownership.[26] It refers to the transfer of ownership from the state to private owners. In a more specific sense, it is conceived of as a transfer of ownership of a state-owned enterprise (Bös, 1991:2) where entitlements to the residual profits from operating the enterprise are devolved to the private sector (Vickers and Yarrow, 1988:7).

In this approach, privatisation and liberalisation, that is the transfer of ownership and the introduction of competitive forces to areas previously restricted to the public sector, are two distinct concepts. This distinction, however, does not mean that privatisation (or, rather, its impact on firm behaviour and performance) and liberalisation (or, rather, competition) should or even could be analysed separately (Vickers and Yarrow, 1988).

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[26] For a commonly accepted definition of ownership, see Pejovich (1990). An alternative view is put forward by Campbell and Lindberg (1990).

For understanding privatisation, a useful distinction between privatisation of supply and privatisation of ownership of capital is suggested by Blankart (1987). Milanovic (1990) also emphasises that privatisation takes place only if transfer from public to private sector results in identifiable physical persons as ultimate owners, excluding from the range of the concept the cases of state-owned holding companies or the 'cross-ownership solution' which, as we shall present later, was a popular form of several Hungarian firms in the era of the so-called 'spontaneous privatisation' in the late 1980s (see section 3.3).

Privatisation of state-owned enterprises can be partial (resulting in mixed firms with respect to ownership) or total, depending upon whether the state retains shares in the privatised company or not. It is hard to establish a measure of where a firm with private and state owners can be regarded 'genuinely' privatised. Even in cases where private owners acquired only nominal minority in a state-owned firm, they may have gained real control over the firm. Experience suggests that case-by-case study may be necessary to reach a verdict on this issue. But even if private owners have the majority, and hence probably a dominant influence on the behaviour of the (partially) privatised enterprise can be expected, the presence of the state among the owners still has to be explicitly taken into account.

In many cases actual privatisation is preceded by 'corporatisation', i.e. establishing a company with limited liability on the assets of the state-owned enterprise. Since in Hungary 'corporatisation' was sometimes labelled 'privatisation', it is important to note that in this research they are regarded as logically distinct concepts.

In Central-East European context, some authors also refer to 'hidden' or 'invisible privatisation'. According to Matolcsy (1991), 'hidden privatisation' can take place, for example, through the depreciation system, leased assets, stock option of foreign investors, and bank's mortgages on state property. On the Hungarian privatisation Canning and Hare (1994:211-212) noted that

> "The picture is further blurred by the 'invisible' privatization which has taken place alongside the 'official' privatization of state assets; by this we refer to the setting up of ostensibly new companies using the intellectual assets, markets, business contacts, and land, premises and equipment leased from the old enterprise."

By our narrow definition, we exclude these instances of divesting state assets into private hands from the concept of privatisation.

2.3.2 Why privatise?

The improvement of industrial efficiency is by far the commonest *normative* criterion against which economists judge the success of privatisation. The question whether the improvement of efficiency *should be the* top priority (if there is such) of privatisation is left to be investigated by other studies. Clearly, it *is a* priority important enough for its accomplishment to be investigated.

However, inducing a positive change in the efficiency of the privatised enterprises has not been the only *actual* aim of governments initiating privatisation policies around the world. For example, the principal (explicit as well as implicit) aims of the British privatisation programme are summarised by Vickers and Yarrow (1988:157) as follows (see also Marsh, 1991):

> (i) "improving efficiency;
>
> (ii) reducing the public sector borrowing requirement (PSBR);
>
> (iii) reducing government involvement in enterprise decision-making;
>
> (iv) easing problems of public sector pay determination;
>
> (v) widening share ownership;
>
> (vi) encouraging employee share ownership;
>
> (vii) gaining political advantage."

Experiences of privatisation programmes in less developed countries (Cook and Kirkpatrick, 1988; Ramanadham, 1989) with significant differences regarding the context of these programmes (for example, capital markets are missing or tiny) show that additional goals can also be significant. In the context of Central-Eastern Europe it should be noted, for example, that privatisation was supposed to play a significant role in the development of the capital market and strengthening the product market competition (for a review of the contextual differences of privatisation, see Estrin, 1991).

It is also important to take into consideration explicitly that privatisation in practice is not a pure economic concept but as well a political and often ideological one (cf. Bös, 1991: Chapter 1). Vickers and Yarrow's list of actual objectives of the British privatisation demonstrates that there are not only economic reasons for which governments pursue privatisation policies, and this may hold even more strongly in the post-communist countries.

2.3.3 The effects of privatisation on firm behaviour: the agency approach

Claims have been made that several positive effects of privatisation have been attained in practice (although some of these benefits may be attributed to liberalisation rather than privatisation *per se*). For example, students of British privatised enterprises, and often managers of these firms, too, note that privatisation leads to major reorientation, more business-like organisational culture, a change in the character of members of the management, less bureaucracy, more rational decision-making, rewards encouraging risk taking, structural changes of the organisation which facilitate measuring success and failure (cf. Bishop and Kay, 1988; Brunnen, 1989; King, 1987; Morley, 1986). What does economic theory tell us about the relationship between privatisation and firm behaviour?

In the economics approach to privatisation, the basic assumption is that privatisation will have privatised state-owned firms behave like any other private firm. In other words, they are expected to develop the same behaviour pattern, the same strategies that are well-known from numerous studies in various disciplines, including the whole strategy literature.

Earlier, strategy was defined as a behaviour pattern. It was also seen as an outcome of a process, called strategy formation or strategy-making. Therefore, for analysing the relationship between privatisation and strategy, the changes that privatisation will bring into effect in the context of the strategy formation process need attention. As Hammer, Hinterhuber and Lorenz (1989:24) put it,

> "The management of a state-owned company acts – just as any other company's management body – within a given set of influences. These influences change

during privatization and their effect on operational decisions and the decision making process will also alter."

The remainder of this subsection briefly reviews the contextual changes – focusing on incentives and constraints – as factors explaining the anticipated beneficial effects of privatisation. The discussion is built around the agency theory which appears to be the most frequently used approach for explaining the relationship between privatisation and firm behaviour. [27]

In economics, the context of firm behaviour is described in terms of incentives and constraints. It is expected that private sector discipline will be taken into account in every managerial decision and organisational action which leads to greater internal efficiency. In other words, privatisation alters the structure of priorities in the strategy formation process.

For understanding how priorities in managerial decision-making change due to the transfer of ownership to the private sector, the *agency theory* offers a well-developed explanation. This theory deals with a frequent situation of modern economic life, where ownership and management (decision control) are often separated (Fama and Jensen, 1983). An agency problem arises when a utility-maximising 'principal' wants to induce a utility-maximising 'agent' to act for the interest of the principal but they have different sets of objectives and information asymmetry exists. An agency relationship, as Jensen and Meckling (1976:308) put it, is

> "a contract under which one or more persons (the principal/s/) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."

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[27] From the two camps into which agency theory is split, positivist agency theory and principal-agent research (Eisenhardt, 1989a), applications of the theory to privatisation seem closer to the first one, which "focuses on the broad problem of separation of ownership and control and emphasises how managers are disciplined by incentive schemes, external labour markets and capital markets" (Nilakant and Rao, 1994:650). An alternative to agency theory is Haskel and Szymanski's (1990) 'bargaining theory of privatisation' which derives efficiency improvement from changes in labour costs that are determined in a bargaining process.

Assuming opportunistic behaviour, the argument goes, the agent may want to follow objectives – like prestige, power, growth at the expense of profit – that do not maximise those of the principal, therefore the latter has to establish incentives for the former. The assumption that the principal has all the relevant information to prescribe the behaviour of the agent is unrealistic. Since the principal is not able to collect and process all the information that would be needed in order to specify for the agent what to do under what circumstances, and he is not able to observe even the behaviour of the agent, a monitoring problem is also created. Now the principal's problem is how to design the best possible incentive scheme (contract) for the self-interested agent without full information on the environment and on the agent's behaviour, while taking monitoring costs into consideration.

One of the relationships studied with the help of this model is that of the owners as principals and managers as agents. In the light of the agency theory outlined above, "privatisation essentially represents a change in structure of the agency model" (Rees, 1988:426). The transfer of ownership from the public to the private sector brings new principals with different objectives and monitoring systems, and corresponding incentives and constraints, into the principal-agent relationship. This is the reason why the allocation of property rights does matter with respect to firm behaviour and performance.

The major contextual changes due to privatisation can be discussed under the headings of objectives and the system of incentives and constraints, are summarised in Table 3 (overleaf) and reviewed below (see Bös, 1991; Estrin and Pérotin, 1991; Vickers and Wright, 1989; Vickers and Yarrow, 1985, 1988, 1991; Yarrow, 1989).

Note, however, that not all these factors are conditional to privatisation. In particular, product market competition is often viewed as independent of the ownership arrangements, and also often considered to be more influential to firm behaviour than ownership. Regarding socialist countries, however, Kornai's view on 'strong' and 'weak' linkages between different ownership and co-ordination regimes has already been noted.

Table 3 A list of contextual changes due to privatisation

Contextual changes in owners' objectives	Contextual changes in incentives	Contextual changes in constraints imposed by
• multiplicity and fluidity decreases • profit motive	• institutional barriers to state intervention, measurability of performance • externally well-defined incentives • performance-related rewards	• financial market discipline (threat of bankruptcy and take-over) • managerial labour market discipline • product market competition

Turning to the goal formation process, multiplicity of objectives is expected to lessen as private owners are usually assumed by economic theory to have a single ultimate objective. This objective is that of the profit-maximisation which, giving the term 'performance' a specific meaning, allows adopting effective performance-related rewards schemes, thus bringing closer the interest of the management to those of the owners. Improved managerial incentives, designed to serve private owners' profit-maximising objectives, then, will result in active management, searching for opportunities to increase profits. This view is pushed further by Bös (1991:93): "give the bureaucrats the right incentives and they will behave as any management of a private firm."[28] A clear specification of profit objectives of the owners not only simplifies the objectives to be followed by the enterprise management but also allows the establishment of lasting structure of priorities, a prerequisite for any consistent and stable behaviour pattern in the long term.

Governments may retain some influence over the behaviour of formerly state-owned enterprises, nevertheless privatisation always reduces state involvement in managers' decision-making. With unambiguous responsibilities and clearer boundaries between

[28] Although Bös (1991:93) himself admits that "this is a strong, maybe even one-sided, position."

the state and the enterprise there remains less scope for bargaining and the management loses significant power to influence policy. The removal of government from business decision-making also has the advantage of shortening the decision processes (eliminating phases between the government and the management on the one hand, and having a likely positive effect on intra-firm decision-making on the other), hence decreasing bureaucracy which usually proves to be unsuitable in a turbulent business environment. Although in principle it is conceivable that the government keeps an 'arm's length' from managerial decision-making of public enterprises, practice more often than not fails to prove this principle. It is privatisation that establishes solid institutional barriers to such an intervention, ensuring managerial autonomy in business decision-making.

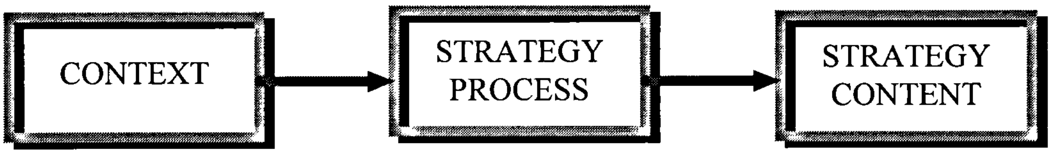
Having been privatised, firms often become players in new environments, or to reverse, new environmental subsystems become relevant to the firms. Managements of formerly state-owned enterprises must face new pressures of very different nature that they had got used to. These constraints are the product market competition (Vickers and Yarrow, 1985, 1988), the capital market discipline, i.e. the threat of take-over or bankruptcy (Aylen, 1988; Jarrell, Brickley and Netter, 1988; Jensen and Meckling, 1976; Jensen and Ruback, 1983), and the managerial market monitoring (Estrin and Pérotin, 1991; Fama, 1980). In the context of national transformation, these new constraints manifest in liberalisation of import (competition), hardening the budget constraint (bankruptcy threat), permitting investor initiated privatisation (take-over threat).

There are some conditions, however, for the assumed effects of privatisation on firm behaviour to be manifested. For example, concrete ownership arrangements (dispersed ownership, or significant share retained by the state) may impede effective monitoring. Size and structure of the business of the state-owned enterprise may hamper take-over attempts. The point has been made that "no general unambiguous prediction can be made about the effects of privatisation" (Estrin and Pérotin, 1991:70). In fact, ownership is one of a set of interrelated factors that determines managerial incentives. As Vickers and Yarrow (1988:8) emphasise, "in particular, the competitive structure of the industry in which the firm is operating and the regulatory constraints that it faces will each have significant effects on incentives. ... Moreover, the impact of changes in any one of these three sets of influences (ownership, competition, and regulation) on efficiency will, in general, be contingent upon the other two."

2.4 Conclusion

In this study, privatisation is expected to have an effect on patterns of firm behaviour. Behaviour patterns were denoted 'strategies' and shown to emerge in an internal political process, as a resultant of individual action shaped by negotiations and compromises between players of conflicting interests. The power focus for this research is formulated at the present stage only loosely: it is recognised that the inquiry should be kept open and receptive to issues of power and organisational politics. Context was said to directly influence strategy process, and through it, indirectly strategy content, as indicated in the simplified framework of Figure 4.

Figure 4 A simplified strategy-framework



Turnaround strategy was introduced above as a specific behaviour pattern, comprising activities of recovery and capability enhancement. The fact that there are almost as many different strategy typologies and turnaround stages models as authors indicates that a single 'grand map' of strategies and turnaround routes may not be drawn for the present study. These and other studies, however, may help in recognising typical patterns in the analysis of sequence of action of privatised firms and reveal the existence or absence of turnaround strategies in their behaviour, since they provide an inventory of some possible routes that a troubled socialist firm may take after, or perhaps even before, privatisation. They also call for a consideration of the extent to which chief executives can play the roles that are regarded necessary for triggering and successfully managing a turnaround. In transformation when legitimacy of the chief executives is questioned within and around the organisation, such roles can hardly be expected to be played well by them.

It was also argued that state-owned firms in socialist economies pursue state-oriented patterns of behaviour that can be exhibited in either active (influencing) or passive (adaptive) ways. In the economic sphere of activities, effectiveness of state-oriented strategies – even if inefficient – could be explained, applying the resource dependence view, by firms' paternalistic dependence upon the resource-redistribution centres of the state. In addition, the overwhelming dominance of state-oriented strategies were attributed to isomorphism created by redistribution of resources by the state as well as political control of economic activities.

On the goal formation of state-owned enterprises, multiplicity, inconsistency, 'fuzziness', 'fluidity' and political definition of goals, difficulties of monitoring both outcome and behaviour, and blurred lines of responsibility have been noted.

A number of specific features (or, more precisely, the lack) of some constraints – such as market competition, threat of take-over/bankruptcy, shareholders' monitoring – upon managers of state-owned firms have also been pointed out.

While bargaining and 'fragmented' controllers captured by those supposedly being controlled appear to have been given relatively less attention in the literature, they are consequent to the aforementioned characteristics of goal formation and constraints.

The lesson from this presentation of state-owned firm behaviour and environment in the light of our research question is formulated here as follows: any attempt that is to show the relationship between privatisation on the one hand and changes in behaviour patterns of firms due to privatisation on the other must provide an analysis of how privatisation alters goal formation and environmental constraints.

In this research the narrow definition of privatisation is accepted, reflecting our effort to keep logically distinct concepts separate. In the empirical analysis, however, a broad range of factors is to be considered (in other words, a rich description of 'context' is necessary), being aware that the impact of privatisation *per se* may not be separable from other factors. Similarly, privatisation and 'corporatisation' are treated as distinct concepts.

Studies of privatisation programmes throughout the world prior to similar initiatives in Central and Easter Europe have shown that various aims are hoped to be achieved in these programmes. In the specific context of the Hungarian privatisation, the issue of goals and objectives will be raised again in section 3.2.2. It should be noted here in advance, however, that the problem of inconsistency of goals as well as their political definition – discussed earlier with respect to the behaviour of state-owned enterprises – may well be present in the privatisation programmes, too.

In subsection 2.2.3, it has been demonstrated that state-owned (socialist) firms pursue strategies that are significantly different from those of private firms in market economies (difference in strategy content). The differences in strategic orientation were attributed to contextual factors. Characteristics of goal formation and certain forms of external control, especially vertical resource dependence from the state, were highlighted (difference in context of strategy process).

In subsection 2.3.3, a theory for explaining assumed changes in firm behaviour due to privatisation was presented. This theory, developed in the realm of economics, treats privatisation as a significant change in the principal–agent relationship in which the management of state-owned firms remains the agent but the state is replaced with private owners for the role of the principal. It was illustrated how privatisation modifies firms' context. It is expected that firms' behaviour pattern will change accordingly. The basic relationships are summarised in Figure 5 (overleaf). Consequent to the model is the assumption that firm performance will eventually improve.

Figure 5 The simplified agency-model of privatisation and firm behaviour

CHANGE IN PRINCIPAL: FROM STATE TO PRIVATE → CHANGES IN CONTEXT: INCENTIVES, CONSTRAINTS → IMPROVED MANAGERIAL DECISION-MAKING

When applied to privatisation in Central-East European context, some of the underlying assumptions of the agency approach to privatisation as it has been developed in Western context require careful consideration. The assumptions we consider here pertain to initial ownership rights and institutional stability.

Initial de facto property rights are often blurred in Hungary (and, for example, in Poland, too), a fact mainly resulted from economic reform efforts in the mid-1980s (see subsection 3.2.1). A similar situation was reported even in Russia by Schleifer and Vishny (1992:2): "many 'stakeholders' have existing ownership rights, in the sense of being able to effectively exercise control over assets." In Hungary, from government agencies to managers, from the Enterprise Council to local municipalities many actors had acquired some element of property rights (Sajó, 1990). Under the system, and ideology, of 'self-governance' (for a recent summary, see Kornai, 1992, Chapter 20), managers, while demanding 'greater autonomy in taking economic decisions', fought for part of the right to control the firm, and were successful in getting a share of the property rights.

Institutional stability appears to be one of the major assumptions held by the agency approach to privatisation. Central-Eastern Europe represents a considerably different context. It is a region emerging from almost half a century of state control, where an effective capital market is missing; the evaluation of the firms lacks the information that are present in a developed market economy; managements as well as employees of firms had long been cushioned from effects of inefficiency; the size, scope, and speed of privatisation exceed any previous experience; enforcing private sector discipline may seriously threaten social stability; and the economic transformation takes place in a politically overheated environment.

An example of the issue at hand is that of the disciplinary effect of emerging managerial labour market. Parallel to propositions by Fama (1980), and Estrin and Pérotin (1991) one could hypothesise in line with the underlying assumptions of the agency approach that an emerging management market (or anticipation about the development of an effective management market) common to the private and still state-owned but eventually to be privatised sectors in the transformation period might play such a role in Central-Eastern Europe. If, however, one considers that it takes a long time for a new institutional arrangement to emerge and become effective, the hypothesis will probably have to be moderated, by taking into account how privatisation, or the so-called 'system transformation' in general, is carried out. If there are no other types of effective control on managements to squeeze out resources from the firms to establish their own private business (i.e. to change their status from managers to owners in the course of privatisation), then, assuming opportunistic behaviour, disciplinary power of the emerging management market will be severely limited. To simplify, managers of state-owned firms will hardly bother with being head-hunted by emerging private firms if they have the opportunity, in the process of system transition, to become 'head-hunters' (as owner-managers) themselves.

Similarly, while privatisation may decrease information asymmetry between agents and principals as the latter change from a divided group of bureaucrats to private stockholders with essentially the same shared objective, to assume the same relationship to bear out during the transformation period would be to neglect the rather unsteady nature of institutional arrangements. One must also consider the rudimentary nature of market institutions, such as the stock exchange, that enhance the opportunity of private owners to be well-informed. Therefore, during the transformation period, when the firm is still in state ownership, information asymmetry may even increase as the existing, often informal and political, information channels break up without being replaced with effective new ones.

CHAPTER THREE

3. Privatisation – The case of Hungary

3.1 Introduction

This section provides an overview of the Hungarian privatisation from about 1987 until 1994. It is not intended to give a complete account of the process to date (for reviews, see references below in this chapter). Our purpose is, first, to offer a guide for understanding the cases (which themselves present much of the details about 'context') that follow in Chapter 6, by introducing the main players, reviewing the rules and outlining the results to date. Second, this section contributes to an emergent framework of the empirical study, by establishing a few main characteristics of the Hungarian privatisation process.

We begin, in section 3.2, with a summary of economic reforms in the last twenty years of the communist regime and a brief review of political developments in its last few years. This background section is followed in section 3.3 by a more detailed discussion of the so-called 'spontaneous privatisation' that was taking place from about 1987, until the freely elected government took control of the privatisation process in 1990. In section 3.4, we discuss two main phases of privatisation policy in Hungary between 1990-1994, the first being characterised with emphasis on centralisation and revenues to the state, whereas the second phase witnessed the use of decentralised and 'populist' methods. Section 3.5 concludes this overview by highlighting a few major issues. Added to these issues are the main conclusions of a pilot study, briefly reported in section 3.6.

3.2 Antecedents to privatisation

3.2.1 Reforming the Hungarian economy[29]

First debates on reforming the classic Soviet-type command economy began in Hungary as early as the early fifties. Yet, Kornai's (1957) seminal work "On the over-centralisation of economic administration" was in practice followed by a centralisation campaign in the early sixties that created large vertical conglomerates by merging in many instances a whole industry into a single trust.

It was only in 1968 when significant reforms were introduced with the 'New Economic Mechanism', which attempted to increase enterprise autonomy, market co-ordination, and the profit motive. Many of the central controls were kept in place, however, and around 1972 a new 're-centralisation' took place, cutting back firms' short-lived rights to make quasi-autonomous business decisions. Investment and consumption boom, financed from borrowed Western funds, coupled with overwhelming Soviet- and CMEA-orientation[30] of foreign trade, led to a serious crisis of balance of payments by the end of the seventies. Restrictive measures on the one hand, and decentralising reforms on the other, including breaking up some of the industry-wide trusts created twenty years earlier, were effected to revitalise the economy to no avail.

In 1984, state-owned enterprises were in principle given considerable autonomy with the introduction of the so-called 'self-governed forms of state-owned enterprises'. In about 70 per cent of the industrial firms (representing about 50 per cent in terms of output, although with significant variations in different sectors), Enterprise Councils became the top decision-making bodies with the right of hiring and firing the general

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[29] For reviews of the Hungarian economic reforms, see Antal, L., Bokros, Csillag, Lengyel and Matolcsy (1987), Hare and Révész (1992), Jeffries (1993), Kerpel and Young (1988), Kornai (1986), Mattheisen (1991), and many of the references in subsequent sections of this chapter.

[30] CMEA (often called COMECON): trade block of former communist countries.

manager, making "strategic" decisions such as ones on merger and de-merger, etc. Enterprise Councils were made up of workers' delegates (50 per cent of the seats), managers (33 per cent), the ministry's representative (1 person), the rest being appointed by the general director. Although the composition of the councils *per se* may suggest otherwise, effective decision-making power was assumed by the management, with the councils acting either simply as a rubber-stamp on managerial decisions, or represented a body to reach a compromise with by way of accommodating workers' interest in wages. In other, normally smaller firms, the role of the 'self-governing body' was played by the General Assembly of Employees, while public utilities, mines, and some other, generally large and for some reason distinguished firms were kept under direct state (ministerial) control.

The basic idea of the Hungarian economic reforms had always been to increase enterprises' decision-making autonomy. In this regard Hare (1991:195) points out that "there is much stronger continuity in the Hungarian reforms than one can find elsewhere in the region" or, as another observer notes, "economic agents in Poland and Hungary have a familiarity with the institutions and functions of market economies lacking in other countries" (Crane, 1991:318). As Antal, L. (1985) aptly pointed out, however, these reforms had only transformed the economy into one which was still centralised, although administered by the centre using indirect controls and regulations instead of direct commands.

The importance of the Hungarian socialist state for organisational outcomes is illustrated in Kornai and Matits' (1987, 1990) study on redistribution of firms' profits by the state. The main results (based on a census of all Hungarian industrial firms, not on a sample) are shown in Table 4 (overleaf).

Table 4 Levelling of profits in Hungary

Transition **From original profitability**	**To final profitability**			
	Loss maker	Low profitability	Medium profitability	High profitability
Loss maker	0.233	0.500	0.122	0.145
Low profitability	0.038	0.853	0.103	0.006
Medium profitability	0.000	0.734	0.206	0.060
High profitability	0.008	0.394	0.505	0.083

Note: The transition from "original" to "final" profitability means the transition from the pre-tax and pre-subsidy position to the post-tax and post-subsidy position. Firms are classified in four categories: "loss making" means profitability less than -2%; "low profitability" is between -2% and +6%; "medium profitability" is between +6% and +20%; and "high profitability" is more than 20%. The figures refer to the proportion of firms in any given original profitability class that became members of a given final profitability class as a result of fiscal redistribution.

Source: Kornai (1992:492), also published in Kornai (1986:1697), based on Kornai and Matits (1987, 1990)

Data in Table 4 clearly indicate that organisations with poor performance had been bailed out with resources taken from organisations with high performance, suggesting that obtaining a tax concession, a firm- or industry-specific subsidy (especially if the industry, as is often the case, comprises only one or a very few firms) from the state officials may have been just as an effective strategy as cost-cutting, product differentiation, etc. In addition to the ways in which a firm could increase its chance to move upwards to a better final profitability position through fiscal redistribution, bargaining over output and input prices and other tactics could also improve original profitability.

The middle of the eighties saw an unsuccessful attempt made by the communist party-state centre to boost economic growth which resulted in an even more serious balance of payment crisis. More substantial reforms followed, including a two-tier bank system, a taxation system which resembled Western counterparts, and a bankruptcy law, just to name a few. Many of these reforms were effected in the run-up period to the political turnaround (which seemed inevitable to many) but still devised and brought about by communist governments.

For our purposes, the most important legislation enacted in this period are the ones which most directly affected ownership, namely the Company Act of 1988, the so-called Transformation Act of 1989, and the Foreign Investment Act of 1988. Thus, by the end of the eighties, a reasonably well developed legislative framework for privatisation in Hungary was already in place, which many consider "a central reason for the substantial success of Hungary's privatization to date" (Boone, 1994:238). On the other hand, the process of gradually increasing 'enterprise autonomy', which culminated in these Acts, eventually resulted in blurred ownership rights, shared between various bodies of the state and enterprise managers. (For an analysis of property rights in Hungary under the communist regime, see Sajó, 1990, and Szakadát, 1993.)

The early legislation may have also had dubious effects, and resulted in abuses on the part of enterprise managers. From a review of possible motives behind 'spontaneous privatisation' in the next section, it is apparent that managers engaged in this process for a variety of reasons. The question arises: in cases where they did abuse their position, what made it possible for them to do so? We conclude this section with a note on corporate governance, to illuminate a structural characteristic of the Hungarian economy that had resulted from the process of earlier reforms.

By the end of the eighties, many of the constraints that had fulfilled the functions of corporate governance in the communist regime had eroded, partly because of more or less continuous reforms increasing managers' decision-making autonomy or independence from the economic centre, partly due to a depletion of resources that this centre could redistribute, and finally due to political changes that had seriously curtailed the communist party-hierarchy's ability (and perhaps intent) to keep managers under control. We should note that almost a year before the elections, opposition had already gained seats in the parliament. In September 1989 an agreement had been reached on holding multi-party elections. Therefore, the incumbent government's legitimacy had been eroding.

Sárközy's (Hungarian edition, 1993:139-140; English edition, 1994:143)[31] admittedly "rather simplified and exaggerated" example appears a telling characterisation of changes in corporate governance by 1989:

> "ever since 1967 an enterprise manager could theoretically sell a large proportion of enterprise assets, deposit the funds on a savings account and live on the interests with his secretary. This was not really prohibited by the rules. Yet, enterprise managers did not often engage in such activities because there were the county and enterprise party committees, branch and enterprise trade unions, and the ministry, and within the enterprise there were the chief of personnel, the security guard [two positions often filled by former employees of the Ministry of Home Affairs, thus prime candidates for being suspected as informers] as well as a wide range of informers from the III/III and III/IV departments [of the Ministry of Home Affairs], as the logic of a communist-minded state apparatus would require. This network, however, had dissipated by the summer of 1989, the comrades fled wherever they could, re-trained themselves and burned their earlier papers."

3.2.2 Political events in Hungary, 1987-1990

In order to provide a background for the discussion of the so-called 'spontaneous' privatisation in Hungary between 1987–1990, political and some economic developments during this period are listed in Table 5.

Table 5 Political developments in Hungary, 1987–1990

Date	Event
1987	
January	Miklós Németh is appointed Head of the Economic Policy Department of the Central Committee of the Hungarian Socialist Workers' Party (HSWP, the communist party)
June	Miklós Németh is elected to member, and secretary, of HSWP Central Committee Károly Grósz is elected Prime Minister
July	Financial institutions, the Chamber of Commerce and the Ministry of Finance prepare a joint plan to develop security market

[31] Quote from the English edition, but corrected on the basis of the Hungarian one.

Date	Event
1988	
January	Hungarian citizens are allowed to obtain 'world passport' and to travel freely to any country without further permission Personal Income Tax and (a VAT-like) General Tax on Turnover are introduced
May	The first union that is independent from the HSWP-related National Association of Unions is established Károly Grósz Prime Minister is elected General Secretary of HSWP; János Kádár takes the newly created position of President; Miklós Németh, Rezsõ Nyers and Imre Pozsgay are elected members of the Political Committee The Association of Young Democrats is established
June	A demonstration is held on the anniversary of the execution of Imre Nagy, Prime Minister of Hungary during the revolution in 1956; the police interferes
July	Imre Pozsgay is appointed Minister of the State
September	After a year of existence as a loosely organised group of intellectuals, the Hungarian Democratic Forum, as an independent social organisation, is established; later turned into a formal political party
October	A number of large state-owned enterprises are transformed into companies on the basis of loopholes in existing legislation Independent representatives (members of the Parliament who do not belong to any parties, at this time 24% of all the MP's) wish to create a parliamentary faction
November	On 7th November, paid holiday due to the anniversary of the Soviet Communist Revolution of 1917, about 100,000 Hungarians travel to Austria for one day only and spend 0.5 bn schilling on goods ranging from refrigerator to perfume Association of Free Democrats is established Miklós Németh replaces Károly Grósz as Prime Minister; Rezsõ Nyers is appointed Minister of the State; the introduction of a "limited" multi-party system (that would grant 51% of the seats to the HSWP while the rest would be contested) is proposed on the sitting of the House
1989	
January	The Company Act comes into force Imre Pozsgay openly judges 1956 (until then officially considered a counter-revolution) a "people rising"; two weeks later the HSWP's Central Committee deems Pozsgay's public announcement premature and unfortunate

Date	Event
	Withdrawal of (some) Soviet armed forces is announced (the agreement between Hungary and the Soviet Union on total withdrawal of Soviet troops is to be signed in March 1990)
February	The HSWP's Central Committee announces that "political pluralism can be realised in a multi-party system" (which was earlier accepted only as a "solution possible in principle") A wave of resignations, started in Autumn 1988 and caused by "proposals on lack of confidence," reaches its peak with the resignation of the Chairman of the House
March	Eight organisations establishes the Opposition Round Table
April	A new HSWP Political Committee is elected, only two of the earlier members remained
May	On the basis of the decision made by the Political Committee in February, the removal of the so-called iron curtain between Austria and Hungary started 49.65% of the shares in Tungsram Rt. is sold for US$100m to a Western bank consortium led by Girozentrale; the agreement stipulates that the shares can be re-sold after three years only; Hungarian Credit Bank buys back the shares in November and sells 50% + 1 share to General Electric for US$150m; the price difference was evenly split between the two banks János Kádár, communist leader since 1957, is relieved of his position as President with reference to a report on his health The HSWP's "Reform Circles" demand that the party change its name and introduce substantial reforms The Transformation Act is passed
June	Following two months of discussions behind the scenes, political negotiations started between the HSWP, the Opposition Round Table and seven other social organisations Imre Nagy (with many others) is re-buried on the day he was executed three decades earlier; some 300,000 people are present A four-strong HSWP Presidium, including Grósz, Németh, Pozsgay and Nyers, is established
July	János Kádár dies; on the same day the formal legal process of the political rehabilitation of Imre Nagy and his associates ends, the Supreme Court declares earlier judgements unlawful A scandal is prompted by the HSWP's attempt to create companies and transfer properties currently in its use to these companies The HDF gets all four seats in the Parliament in by-elections

Date	Event
September	The Hungarian government opens the Western border to East-Germans; in the following five weeks about 110,000 East-Germans move to West-Germany via Hungary
	The HSWP and the opposition (excluding the Free Democrats and the Young Democrats) sign an agreement on the political transformation
October	The Hungarian Socialist Party is established as a "socialist, social democratic" successor of the HSWP; later a new, communist, HSWP is established The Hungarian Republic is proclaimed (without 'People's' in her name)
December	The Council of Ministers (Cabinet) approves the bills on the protection of state assets, and on the establishment of a State Property Fund (later to be established as the State Property Agency)
1990	
March	First round of general elections (65% of the electorate votes)
April	Second round of general elections (45% of the electorate votes); out of 386 seats in the Parliament, Hungarian Democratic Forum: 165, Alliance of Free Democrats: 94, Smallholders' Party: 44, Hungarian Socialist Party 33, Association of Young Democrats: 22, Christian Democrats: 21 Pact between HDF and AFD is signed, allowing smoother operations of the legislation
May	The Government led by Miklós Németh submits its resignation and remains as 'interim' József Antall is elected Prime Minister; presents the Programme of National Renewal; the new Cabinet is introduced
September	First round of local elections (with the participation of 40% of the electorate)
October	Second round of local elections (33% turnout); independent candidates (many of whom were previous Chairpersons of former Soviet-type local councils) achieve overwhelming victory; in larger towns, AFD wins most seats 'Taxi-blockade': taxi-drivers, supported by the AFD, paralyse traffic throughout the country for three days, protesting against raise of petrol price

3.3 'Spontaneous' privatisation at the end of the 1980s

'Spontaneous privatisation' is probably the most misleading label on what was taking place in Hungary in the late eighties with respect to ownership changes. It was neither privatisation, at least in the strict sense of the word, nor spontaneous. Yet, no thorough analysis of the Hungarian privatisation could possibly avoid a discussion of the phenomenon that has come to be known as 'spontaneous privatisation'.[32]

The term 'spontaneous privatisation' is usually employed to denote a process which started in about 1987 when, first only a few, SOE managements discovered legal loopholes allowing the creation of subsidiaries capitalised with a proportion of assets of the state-owned enterprise. As it has been noted, the functions of corporate governance at this time were divided between several state-agents, leaving many quasi-ownership entitlements to the discretion of the firms' self-governing bodies.

On the one hand, 'spontaneous privatisation' cannot be regarded as privatisation in the strict sense of the word since the state enterprises holding majority in the subsidiary companies still remained in state ownership. Minority owners were many times other state enterprises and state-owned banks. Nevertheless, in the system of ill-defined ownership rights at the time, top managers of these holding enterprises could indeed assume quasi-ownership entitlements and play the roles of owners with respect to the management of the companies they created.

On the other hand, while 'spontaneous' privatisation may seem unintended from the standpoint of the state, it was clearly a deliberate action on the part of the managers.

As far as the state is concerned, state organs could, and indeed did actively influence the process in general (Voszka, 1993), even if not on a case-by-case basis that was to become the main approach to privatisation in Hungary. Amongst its means to

[32] For a more detailed analysis of 'spontaneous privatisation', see Canning and Hare (1994), Matolcsy (1991), Sárközy (1993), an Voszka (1993), which were the primary sources for this section.

encourage 'spontaneous privatisation' were the increasing pressure on enterprises with tight credit and reduced subsidies, the tax concessions granted to every new company (later limited only to joint ventures with foreign capital), and the abolition of strict wage controls for companies, but not for SOEs. A ministry representative always attended meetings of enterprise councils, therefore enterprise plans on (partial) transformation could not be kept concealed. In many cases, concealment was not even the intention of managers, since they often voluntarily consulted with state administration, whose attitude "seems to have been one of benign neglect," as Canning and Hare (1994:213, end-note 13) put it.

According to Voszka's (1993:99) observation, actors of 'spontaneous privatisation' did not "consistently followed particular aims, but rather ... fluctuated among them." According to various reports (see, for example, the case collection in Antal, I., 1989; a case study analysis in Branyiczki, Bakacsi, and Pearce, 1992, and further analyses by close observers such as Matolcsy, 1991; Sárközy, 1993; Voszka, 1993)[33], motives of state enterprises were manifold, but it seems convenient to sort them into five categories. These are: easing financial pressure, pursuing independence from the state, reducing uncertainty, resolving organisational conflict, and acquiring personal wealth. While these objectives appear to have been present at the same time within the same enterprise, it is possible to treat them separately for analytical purposes.

Easing financial pressure: Large firms in poor financial condition, such as Medicor and Ganz Danubius, rushed to exploit the newly discovered opportunity since it allowed them to forerun the new Company Act whose drafts they had found more severe than the old trade law (Sárközy, 1993). There seems to be a widely held view that 'spontaneous privatisation' was a response of very different enterprises to

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[33] Matolcsy was then a researcher and consultant to firms, one of the designers of the 'companisation'-solution (creating spin-off companies with leaving all the liabilities with the state-owned headquarters; cf. Matolcsy, 1990), later an official in the freely-elected government for a short period; Sárközy, a professor of law, himself was the 'father of the Company Act'; Voszka has been one of the few researchers with a consistent programme of research into, and having access to a wide range of sources about, privatisation.

common problems, of which the most important was their severely deteriorated financial position. High level of indebtedness, coupled with a loss of markets, called for immediate action. Converting some of the assets of the state enterprise could contribute to alleviate the problem in several ways. First, the companies could be established virtually debt-free, thus opening new credit possibilities, with all liabilities kept with the state-owned 'holding' company which could go bankrupt without risking the existence of the companies. Between 1988 and 1991, every newly founded company, including those created with state assets, enjoyed substantial reduction in profit tax for a period of three years. Creative accounting also helped. Fixed assets could be re-evaluated when contributing them in-kind to the company; obsolete stock could be written off. By creating many subsidiaries, relationships with banks could be optimised since the new companies most often belonged to different banks. Often, banks were also willing to convert a part of the debts to equity. Finally, in the case of outside investor(s), new capital could also be brought in.

Reducing uncertainty: When some of the stock of the new company was subscribed to by the founder's business partners, including most importantly banks but also suppliers and buyers, these partners became more closely tied to a network whose members could count upon mutual favours, such as price bargains or commercial credit. Mutual favour very often meant subscription to stock in companies founded by partners, thus resulting in a web of cross-ownership. As pointed out by Matolcsy (1991:182), for example, investments were made on the basis of reciprocity and courtesy rather than pure financial rationality. With subscribing to even if a small proportion of stock in the new companies, suppliers and buyers indicated their good will, complied with the request of the management that wished to have rather many than a few shareholders. Managers had interest in dispersed ownership not only because of the standard argument that typically relates it to less effective monitoring of managerial action, but also because dispersed ownership *amongst business partners* was expected to reduce uncertainty. In this sense, 'spontaneous privatisation' was seen by some as a process of converting network-capital into physical (financial) capital in order to shield against uncertainty, thus reinforcing network relations (cf. analyses by Czakó and Sík, 1995; Stark, 1990, 1994a,b).[34]

Resolving organisation conflict: Breaking up the state enterprise into several independent companies was also a way to reach a compromise between headquarters (often located in the capital) and discontented plant managers (often in the countryside). The latter could thus take advantage of new career routes that were created by the establishment of companies, enjoy greater decision-making autonomy regarding the operations of their units, and probably enhance their prestige in the local community. The former, on the other hand, could retain strategic decision-making rights over the individual companies, and continue to exercise the function of internal resource allocation, now reinforced by ownership ties instead of former administrative links between headquarters and subsidiaries. For the headquarters, 'letting the plants go' by way of converting them into companies was also a way of preventing them from going entirely independent by initiating with the state supervisory body their separation from the large state enterprise, and re-establishment as an independent firm. Thus, the establishment of companies and converting the headquarters into an 'empty shell' served the interests of the top manager (general director) by preserving his or her position, those of the staff of the headquarters by maintaining, albeit in a re-organised structure, internal resource allocation, and those of the plant managers by increasing their decision-making powers.

Pursuing independence from the state: 'Spontaneous privatisation' was also a defensive manoeuvre motivated by desire for protection against state intervention. As the establishment of companies prevented plants from initiating independence, it also made it more difficult for state bodies to separate them from the state enterprise for any reason, for example in efforts to break up monopolies, or to sell units to

[34] In the context of market economies, a similar argument is presented by Schoorman, Bazerman and Atkin (1981) and others who considered interlocking directorates as a strategy for reducing environmental uncertainty. For a challenging view, see Zajac (1988).

investors, since a company could not be drawn under direct state supervision (ministerial control).

Acquiring personal wealth: Another group of motives behind 'spontaneous privatisation' was of course simple vested interest. The establishment of companies brought about new sources of personal wealth: the new companies had boards of directors and supervisory boards to which managers of the headquarters as well as those of co-owners could delegate their representatives. More importantly, managers could obtain, even if minor, ownership in the companies, thus diverting state assets not only to their own control but often at least partial ownership.

The 1988 Act on Business Societies, Associations, Companies and Ventures (Company Act for short hereinafter) came into force in January 1989. The Company Act provided the managers with a firm legal basis for continuing 'spontaneous privatisation' by formally entrusting the Enterprise Councils of self-governed state enterprises to establish a new corporate entity on the basis of the assets of the state enterprise. As Earle, Frydman and Rapaczynski (1993:5) pointed out, "this law was the first opening for a conversion of property-like entitlements, acquired by managers and other insiders during the post-1968 reform period, into formal ownership rights."

There is also anecdotal evidence on siphoning out resources through commercial contracts from state enterprises to private companies established following the Company Act (for example by granting a small private company exclusive rights to trade the state enterprise's products as a commission merchant).

The Act No. XXIV of 1988 on Foreign Investments also came into force in January 1989, allowing foreign investors to set up a business in Hungary without any special permission (except for banking and financial services) and to repatriate their profits. Foreign ownership of land still remained subject to restrictions. Joint ventures with at least 30% foreign ownership and meeting a couple of other requirements were entitled to significant tax privileges (in some cases an absolute tax exemption for five years and further allowances afterwards, again for five years).

With the Company Act and the Foreign Investment Act, it became possible for self-governed state enterprises to transfer state property into joint ventures with foreign co-owner whose mere presence was a further safeguard against state intervention. We should also note the January 1989 amendment to the Company Act which granted tax concessions for joint ventures with foreign capital of a mere HUF 5m or more.[35]

The Act No. XIII of 1989 on the Transformation of State Enterprises regulated 'corporatisation', or transformation as it is referred to in Hungary. A state enterprise could transform either to a limited liability or a joint stock company under the law. Whereas the use of the provisions of the Company Act resulted in only partial conversion of state assets into corporate forms, the Transformation Act regulated the conversion of the whole state enterprise. The successor company of a state enterprise converted according to the Transformation Act also inherited the predecessor's liabilities. On the other hand, this act opened news ways of appropriation by enterprise insiders who became entitled to acquire 20% of the shares of their firm at a discount of up to 90%. A powerful incentive existed therefore to undervalue the assets of the state enterprise to be transformed in a period when state control of this 'corporatisation' did not prevail. In addition, as Frydman, Rapaczynski, Earle *et al.* (1993:142) remarked,

> "the payment for the insiders' shares is said to have been made out of a special bonus voted for the insiders by the (insider-dominated) enterprise council immediately before transformation."

The Transformation Act stipulated that 80% of the proceeds from the sale of shares in a transformed firm go to the state property management organisation (not established yet), while 20% be transferred back to the firm itself as capital reserve, from which issuing of employee shares (as prescribed in the Company Act) could be financed.

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[35] Note that in the late eighties, according to a few well-publicised cases, top managers of state enterprises drew large bonuses in the range of HUF millions per year.

A self-governing state enterprise that had transferred more than 50% of its assets at book value into companies was required to wholly transform within two years. In exceptional cases, it was made legally possible to draw a self-governing state enterprise (but not companies) under direct state (ministerial) control.

On the extent of 'spontaneous' privatisation we can only have estimates. Csanádi (1991) analysed balance sheet data of about 60 state enterprises that were the first to found companies with their assets. This seems only significant if we consider that most of these firms were certainly large ones, representing a greater proportion of state assets than this number would suggest. Mizsei, Móra and Csáki (1994:45), on the other hand, asserted that

> "the extent of the transformation during the socialist period was exaggerated. Rough estimates indicate that less than 1.5 percent of industry moved into foreign hands. As of 1989 about 11 percent of state assets were transformed into corporate structures."

Unfortunately, the authors do not reveal what sectors of industry they considered in their estimate. A similar figure is reported in Gatsios (1992). Riecke and Antal, L. (1993:119) do not even mention spontaneous privatisation but they assert that the privatisation "process achieved a level worth mentioning only in 1991".[36] Voszka (1993:96), on the other hand, maintained that "by that time [when the SPA was established] several hundred deals ... had been completed in the process of 'spontaneous privatization'." In most cases, only a minor part of state assets was contributed in-kind to the companies, in several dozen other cases, however,

> "large state enterprises founded individual companies with each of their factories, plants, and even administrative departments. The former enterprise center was left only with the function of asset management" (Voszka, 1993:97).

[36] However, as one of our case studies revealed, one of these authors was actively involved in spontaneous privatisation as a high level government officer in the last communist government whose favour was sought by a potential investor.

3.4 Phases of privatisation policy, 1990–1994

The Hungarian privatisation policy between 1990–1994 is usually considered to consist of two main phases (see, for example, Canning and Hare, 1994; Csillag, 1994). The first phase started with the state's attempt to put a stop on the abuses of 'spontaneous privatisation', which culminated in a 'centralised' and 'revenue-centred' policy. The second phase was that of changing priorities on both counts, and giving way to a more decentralised and politically motivated approach.

3.4.1 Centralised privatisation for cash

Privatisation monitored by the state

After the elections in May 1990, the new centre-right government led by the late dr. József Antall, was supported by a three-party coalition including the Hungarian Democratic Forum (HDF), the Smallholder Party and the Christian Democratic Party, altogether controlling about 58 percent of the seats in the one-chamber parliament.

The declared privatisation policy of the government could be discerned from the HDF's "Programme of National Rejuvenation".[37] It ruled out cross-ownership and give-away methods, and indicated an intent to service foreign debts from privatisation revenues. The exclusion of the 'cross-ownership solution' followed from the new government's critique of the abuses in the course of 'spontaneous' privatisation and its apparent conflict with the management of state-owned enterprises. Regarding debt service from privatisation revenues, which was a policy in line with expectations of international financial institutions, it is very important to note that Hungary's hard currency debt per capita was by far the highest in the region. At a time when the government wanted to attract foreign capital, it was not

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[37] And from several statements that appeared in the press, particularly a list of 'theses' published in August 1990 in 'Figyelõ' weekly.

considered a viable option to cease due payments and, thus, to send a perhaps deterring signal to foreign investors who might feel their investments insecure in a country that stops servicing its debts. Such a decisions would have also had detrimental effects on the relationship with international financial institutions, particularly the International Monetary Fund, whose credit policy towards the country was also a factor considered by investors.

The Antall-government declared that it wanted to reduce the share of state-owned assets in the so-called 'competitive sector' to about 50 per cent by the end of its term in 1994, and to develop the institutional framework of a market economy. It envisaged a privatisation process which was to be rapid in order to achieve the above said quantitative objective, and 'transparent' so that transactions could be justified to the public and accusations of 'squandering state property' could be fended off.

Following public outcry over the abuses of 'spontaneous privatisation', ownership rights of the state were attempted to be reinforced with the creation of the State Property Agency in March 1990 by the Act No. VII of 1990 on the State Property Agency and on the Management of State Property in State Enterprises. Other relevant legislation included the Act No. VIII of 1990 on the Protection of State Property Entrusted to State Enterprises, the Act No. LXXIV of 1990 on Privatisation of Properties of the State in the Retail Trade, Catering, and Consumption Services (the 'Pre-Privatisation Act' which targeted mainly small business), and the Property Policy Guidelines on the priorities of privatisation and on the use of the proceeds from it. The Temporary Property Policy Guidelines placed the reduction of state debts on top of the priority list, which also included transparency and objective asset valuation. The SPA staff was encouraged to achieve the highest price by incentives tied to revenues from transactions.

Note that the first Property Policy Guidelines were passed by the Parliament as Temporary in March 1990, to be renewed in October for 1991, yet it remained in force until the end of 1992 by way of extension. In October 1991, however, the legislature decided against the proposal of the government to extend the Guidelines again, and deferred this matter until the discussion of a new package of privatisation law scheduled for the first months of 1992. Thus, for a period of several months there were no valid Property Policy Guidelines, which put the SPA being *de facto* policy maker, regardless of the fact that even in this period policy making by the SPA was certainly influenced by the same political and economic considerations that shaped the Property Policy Guidelines.

Although the State Property agency was created as some sort of a government bureau, it was headed by a Board of Directors consisting of eleven members, that initially represented the parliamentary parties. The SPA was first charged with the supervision of the process of transformation and privatisation. With respect to those firms already transformed into companies, it held the shares not sold yet, and it also personified the state as owner for firms still in a state enterprise status. Over these firms the SPA exercised the functions of corporate governance, most importantly by appointing or approving (if proposed by others, including state organs and the firm itself) members of the Board of Directors and Supervisory Board, by confirming – or replacing – management, and by approving decisions involving the divestment of state property of significant value.

In the first few months of its operation, the SPA struggled with having only a small staff[38], and had to establish its position not only as the organisation personifying the state as owner with respect to state enterprises, but also vis-à-vis other state bodies.

With the legislation of 1990, rules of a state-controlled but essentially decentralised privatisation were laid out, in which the primary initiative rested with the managers, and the state, as personified by the SPA, was to oversee the process and make sure that the relevant law was adhered to. This short period did not produce spectacular results in terms of proportion of state assets already sold, since the SPA's main concern at the time was to take control of the process and to develop its own organisation.

[38] While throughout its operation it was struggling with an extremely high fluctuation of its staff who were often recruited by consulting and investment businesses.

Centrally managed sale of state property

From the end of the Summer 1990, state-controlled decentralised privatisation was gradually replaced with a state-governed, centralised approach. The government attempted to centralise decision-making power on transformation and privatisation of state enterprises.

After a few months during which the SPA was operating under the supervision of the Parliament, it was drawn under the government's control (with an amendment to the law on the SPA, enacted in July 1990), and its first managing director, appointed before the elections, was also replaced, signalling the government's intent to exercise tighter control over the privatisation process. The possibility of appealing against the decisions of the SPA in court was revoked. While the SPA's Board of Directors originally consisted of representatives of the main political parties (including the opposition) as well as seven government organs, party representatives were gradually replaced. The eleven members of the Board were appointed for five years, and could be dismissed, by the Prime Minister. According to the law the Board had final, 'undivided' (that is, between its members) responsibility to make decisions, and it could delegate its authority to the Management Committee in cases not exceeding certain limits in terms of value and number of employees concerned. On certain issues, the SPA's managing director and the directors (and later the newly created Privatisation Branch Committee that acted as a preliminary filter before issues were submitted to the Management Committee and the Board) could make decisions.

Parallel to the increase in the SPA's authority, the government also attempted to curtail state enterprise managers' acquired powers with a decree (No. 20/1990. [VIII.3]) on re-elections of enterprise councils. Motivated by experiences of 'spontaneous privatisation' as well as political considerations, the government ordered the enterprise councils to be re-elected until 15 September 1990, and the renewed enterprise councils were required to re-elect the general director with a two thirds majority within 15 days. That the government's decree directed clearly against the managers was apparent, since in most of the enterprises, enterprise councils had just been renewed after fulfilling their 5 year mandate (as specified in the 1984 legislation). In the summer, however, only slightly modified enterprise councils were elected, which relieved only a few, either clearly incompetent or retirement-aged, top managers of their position. The secret ballots held in September had similar results. According to Matolcsy (1991:92) and Sárközy (1994:154-155), contrary to the expectations of many politicians, apart from just a few dozens of cases the enterprise councils were re-elected with no substantial change in their membership, and the existing general directors came out of this challenge re-confirmed in their positions. Another government decree (No. 7/1990 [VII.17]) that may illustrate the government's anti-management position curtailed the possibility for state enterprise managers to hold positions in management bodies of companies.

Also in Autumn 1990 the governing coalition, whose popularity had been declining since the elections almost throughout its term, failed dramatically at the local elections where not only the opposition but also former local council leaders now entering elections as independent candidates collected most of the votes. Since municipalities were entitled to shares in privatised companies according to the value of land in use of the firm relative to its total asset value, one could expect that politics would play a role in debates between municipalities and the privatisation agency on the exact share to be allotted.

This was the general climate when the SPA launched its central privatisation programmes.[39]

Pre-Privatisation: This programme, on the basis of the Pre-Privatisation Act passed in September 1990, targeted small shops in the retail, catering, and consumer services sectors. The programme was expected to proceed fast enough to justify its name, but it "soon submerged in administrative problems and political conflict" (Canning and Hare, 1994:194). Many of the shops and retails outlets belonged to large state

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[39] For a review of the legislation and various privatisation programmes, see Price Waterhouse (1993). General reviews in English are also given in Gabor (1994), Mellár (1992), Mihályi (1992), Tárkány-Szûcs (1994).

enterprises that acted as a 'middleman' and were threatened in their existence by the programme which intended to privatise individual shops by open auctions. These enterprises could be expected to proceed with auctioning their shops with little interest. This programme, also called 'small privatisation' in other Central East European countries, is not a subject of our study (for details, see Earle, Frydman, Rapaczynski and Turkewitz, 1994). Note, however, that outlets belonging to a chain of stores were excluded from Pre-Privatisation. Some 'middleman' enterprises could argue that their shops actually constituted a chain, thus exempting themselves from the programme and placing their transformation and privatisation under procedures of 'large privatisation'.

'Active' privatisation programmes: Canning and Hare (1994), and Frydman *et al.* (1993) provide a thorough overview of these programmes. The First Privatisation Programme was launched in September 1990 and involved 20 large enterprises believed to be sold quickly on the basis of their relatively favourable economic conditions and earlier discussions with potential investors. Note that enterprises were sometimes requested by the SPA to participate in the First Privatisation Programme, while in other cases the firms themselves asked the SPA for allowing their entry into the programme (see case study evidence in Branyiczki, Bakacsi and Pearce, 1992).

The Second Privatisation Programme aimed at 'empty shells' that had transferred more than 51 per cent of their assets to companies or joint ventures. Other 'active' programmes targeted special sectors, such as 'historic vineyards', the construction industry, and those severely hit by the collapse of Soviet and CMEA-markets.

Investor initiated programme: In an attempt to speed up privatisation, the SPA introduced the 'investor initiated programme' in February 1991. Outside investors could submit proposals to the SPA for partial or full acquisition of state enterprises. Typically, the SPA announced an open call for bids to obtain competitive proposals in the spirit of state-revenue maximisation.

Asset Protection Procedure: Following provisions of the Act on the Protection of State-owned Assets of 1990, state-owned enterprises were obliged to seek the SPA's approval in cases when the value of state assets sold without involving transformation of the whole enterprise itself exceeded a certain limit. These assets could be the enterprise's own nursery school or even a whole production plant. In some cases, for example when a subsidiary or a plant of state-owned enterprise is contributed in kind to a joint venture, a transaction under the asset protection procedure may result in the establishment of a new company.

Supplementary Methods: Combined with the aforementioned programmes, some additional methods of divesting state assets were also in use. Property transfers to the church, Social Security Funds, and other beneficiaries are beyond the scope of our study. Here we emphasise only two groups that were active in acquisition of shares: the employees and the local governments.

Employees had two preferential ways of acquiring shares. They could purchase 'employee shares', tradable only amongst employees and pensioners of a given firm, issued to the extent of 10 per cent of the firm's registered capital, at 90% discount covered from the firm's capital reserve (created from 20 per cent of the privatisation proceeds that the privatised firm was entitled to, while 80 per cent was the net revenue of the SPA). Managers and workers could also acquire common shares at a discount, in the SPA's practice at 50 per cent of par value. Total allowances which employees were entitled to had a ceiling in terms of percentage of the firm's asset value or its wage level.

Municipalities were also beneficiaries of share transfers from the SPA upon transformation, according to the value of land where the self-governing firm and its plants, shops etc. are located. However, before September 1991, when state enterprises under direct state (ministerial) control were transformed into a company form, municipalities were not granted any shares.

The various programmes of centrally selecting and privatising packages of firms were generally perceived as failures, and in many cases indeed did not bring the expected results due to various reasons. Delays were caused by claims of municipalities, the time required to select outside consulting and investment firms from several hundred applicants, and the time required by those selected to proceed with their complex task.

The introduction of investor initiated privatisation also failed to accelerate the process as it turned out that foreign investors were rather unwilling to enter competition by submitting proposals for tenders. Among the reasons for this reluctance one might assume their realisation that as the state-owned enterprise's market share was eroding, there was less need for a potential investor to team up with the firm to be privatised. Instead, greenfield investment and developing an own distribution network may have become preferred alternatives. In addition, the deteriorating financial position of many state-owned companies may have suggested that investors could acquire necessary assets more cheaply in a liquidation sale, with the additional advantage of bypassing the SPA's bureaucracy and dealing directly with commercial banks (as recommended by Price Waterhouse, see Frydman *et al.*, 1993:117).

Perhaps the most important cause, however, was the SPA's high asking price for the firms involved. Many observers attribute this for

> "the political sensitivity of privatization in the aftermath of the controversy over 'spontaneous' privatization and to the fear of accusations of 'selling off the family silver'" (Canning and Hare, 1994:188).

The same argument, coupled with the SPA staff's incentive being tied to sales revenue, is presented by Frydman *et al.* (1993:134). These authors also noted that even under the SPA's monitoring, 'spontaneous' privatisation continued, albeit in a modified form in which

> "managers still initiate most transactions, often after negotiating contracts with outside investors, and then bargain with the SPA over their approval" (Frydman *et al.*, 1993:133).

As Voszka (1993:103) put it,

> "Ironically, the primary concern of enterprise managers is to identify the SPA officials who regulate the firm's transformation, to discover his or her knowledge, goals, and interests, and to work out appropriate arguments and bargaining strategies to realize the enterprise's particular aims. ... all elements of transformation and privatization (form, schedule, selection of owners and managers) may be part of a

> bargain. ... Centralization on the governmental level actually strengthens the bargaining position of the enterprises."

Thus, just as the 'spontaneous' label did not fit, the 'centralised' period was not exactly what its label would suggest either.

In this period, emphasis seems to have been more on 'corporatisation' than genuine privatisation. According to Frydman *et al.* (1993:143-144), the SPA strongly supported the controlled corporatisation process as a 'prelude to privatisation'. In principle, the enterprise councils had the right to decide upon transformation, but these decisions were subject to the SPA's approval or possible veto. The small proportion of transformations rejected by the SPA (see Table 6 on page 82) indicates that in most cases the SPA

> "adopted the policy of bargaining with the enterprises rather than simply vetoing their proposals ... in all the more significant cases, several rounds of bargaining and negotiations among the SPA, the enterprise, and outside investors are the rule before the final approval is issued." (Frydman *et al.*, 1993:144).

One possible reason, as suggested by these authors, for which the SPA may have preferred transformation prior to sale is that it may have attempted to take control of the process and forestall deals pre-arranged by managers and investors. In a transformation process prior to privatisation the SPA could obtain information, influence asset valuation, etc. Thus, it may become more difficult for insiders to evade supervision and make deals with investors in return of maintaining management control.

Under pressure of continuous criticism for being slow, bureaucratic, and unsuccessful in accelerating and properly controlling the privatisation process, the SPA introduced some elements of a decentralised approach to privatisation. This is from where the end of the first and the beginning of the second phase of the Hungarian privatisation policy is usually considered.

3.4.2 Decentralisation and politicisation

From the second half of 1991 and particularly in 1992 the Hungarian privatisation policy took a turn. Two major trends were characteristic of this policy shift. First, direct state (SPA) control over privatisation was relaxed. Second, privatisation became more and more influenced by the intent to enhance the opportunities of domestic investors and employees to participate in the privatisation process.

Self-privatisation

Due to the perceived failure of centralised programmes, and because of the realisation that even in the first phase enterprise initiative had played an important role, 'self-privatisation' was introduced in the middle of 1991. The SPA invited proposals from consulting firms which then could effectively play the role of the SPA on the basis of a 'framework contract' that specified the basic rules. The SPA's direct involvement was reduced to intervening only if the law was not adhered to. First, state enterprises with less than 300 employees and a turnover of less than HUF 300m per year were included in this programme. In the second round, launched in May 1992, the ceiling was lifted to 1000 employees and HUF 1 bn turnover.

Since most of the enterprises included in this programme do not meet our selection criteria for case studies (see section 5.3 later), we refer the reader interested in details to Canning and Hare (1994:192-194). It is important to note, however, that the introduction of 'self-privatisation' was a departure from the first principle of previous policy, that is centralisation. Speed, even if only concerning a certain group of enterprises, took priority over control. In effect, we can consider 'self-privatisation' a special case of enterprise initiated, or 'spontaneous', privatisation.[40] As Matolcsy (1991) noted, enterprise initiatives that had been suspended for a while during the government's efforts to centralise the privatisation process were revived around Spring 1991, when it became apparent that the new government could not proceed with privatisation without relying upon them. For a certain group of firms, by Summer 1991, 'spontaneous privatisation' was dead, but it revived soon in disguise, as 'market (self-)privatisation.'

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[40] Note that the SPA terminated self-privatisation at the end of 1993.

"Populist" privatisation

The introduction of self-privatisation was followed by two main changes that made the year 1992 a milestone in the Hungarian privatisation policy. These changes indicate that the second principle that had governed privatisation policy to date, that is maximisation of revenues, lost its overwhelming importance and gave way to other considerations.

1. The legislation and institutions of privatisation and state asset management changed. In January 1992, a minister without portfolio in charge of privatisation (privatisation minister for short) had been appointed, whose "Strategy for breakthrough in privatisation" laid out new priorities for the Hungarian privatisation. A new package of privatisation law was enacted. The institutional framework that provided support for privatisation was further developing (credit schemes, Guarantee Fund, etc.). In October 1992 the State Asset Management Company (SAMCo) was established under the rationale of separating privatisation and long-term management of state assets.[41] Even the formal organisational rules of conduct of the SPA, having been in existence for two years, were eventually prepared.

2. Possibilities for domestic investors to finance acquisitions of state property were expanded. Interest rate on the so-called '*Existence-loans*', launched in March 1991 specifically for encouraging domestic investors, were decreased from 75 to 60 per cent of the central bank's base rate, and the ceiling on the amount one could borrow was abolished.

The first *compensation notes* appeared on the market in early 1992, and started trading on the stock exchange a few months later. As we have already noted, the new

[41] SAMCo and its firms are outside the scope of our study since we are interested in privatisation rather than management of assets in long-term state ownership. For a review of the debate surrounding its establishment, and an analysis of its operations, see Canning and Hare (1994:203-207), and Voszka (1995). Note, however, that the establishment of SAMCo curtailed the powers of the SPA over state assets.

government rejected in-kind restitution. Instead, owners (or their direct heirs) whose property had been confiscated by the communist state and those who had suffered injustice for political reasons were given compensation notes up to HUF 5m. The notes were tradable on the stock exchange[42], bore an annual interest of 17 per cent, and could be used to acquire state property, including housing and land, or to obtain fixed life-annuity. In cases when stock offered for sale in tender calls could be paid for in compensation notes, the SPA accepted them at 'nominal value', that is at face value increased with accumulated fixed rate interests. A lively secondary market also developed, due in part to the continuously decreasing quotations on the stock exchange, which in turn was attributed by many to lack of sufficient supply of state property to be bought in exchange for compensation notes. The Ministry of Finance originally estimated that claims would be submitted to the National Office for Compensation and Settlement of Damages in the amount of about HUF 60 bn. Eventually, the number of claims submitted under various Compensation Acts ran into more than two million, and the total (face) value of compensation notes issued reached HUF 132 bn (HUF 220 bn at 'nominal value')[43], raising a substantial demand for state property.

Introduction of other methods that gave priority to domestic investors with limited resources soon followed. For cases when two calls for bids were unsuccessful, *privatisation by leasing* was made possible. *Payment in instalments* on terms and conditions not worse than those of an Existence-loan became accepted. Also in this line of measures was the *Small Investors' Share Purchasing Programme*, a scheme allowing citizens to purchase stock in privatised state-owned companies up to a limit of HUF 100 thousand on credit, that was under consideration for a long time and eventually introduced, involving only two firms, only a couple of months before the end of the government's term in 1994.

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[42] Note that the compensation notes were quoted at a steadily decreasing price (January 1993: 80%, January 1994: 620%, January 1995: 40%; Source: 'Figyelõ' business weekly, 17 August 1995, p.24.)

[43] Source: Privinfo, 1995, 4(15):37

A new scheme for employee ownership was also introduced. Added to earlier possibilities for acquisition by employees – employee shares and preferential purchase of common shares, as specified by provisions in the original Company Act and the Property Policy Guidelines, supplemented from late 1991 with priority to be given to competitive employee bids, other conditions being equal –, the Act on *Employee Partial Ownership Programme* was passed in June 1992.[44]

3.4.3 Some caveats: privatisation policy in the light of data

Table 6 (overleaf) presents the number of complete transformations of state enterprises initiated, or in case of enterprise initiative, approved or rejected by the SPA, as well as the value of assets involved (at book value and revised value as reappraised and approved upon transformation). Table 7 (on page 83) gives similar data on the so-called 'asset protection transactions', that is on divestitures of assets of state enterprises without involving the transformation of the state-owned enterprise itself.[45] Finally, Table 8 (on page 84) shows revenues of the state from privatisation between 1990–1994.

[44] Often referred to as MRP (Hungarian abbreviation), or ESOP, following common usage in the West; ESOP hereinafter.

[45] Both tables cover only 1990–1992 since data for later years were available only in incompatible format. It may be indicative that the kind of data published in 'Privinfo', the primary source of privatisation data, tended to change parallel to the shift of the declared policy. After 1992, separate tables and charts were prepared on "techniques encouraging domestic investors".

Table 6 Transformations and asset value involved, 1990–1992

(by initiation, in HUF billion, increment in period and cumulative over time)

	1990	1991		1992	
		increment	cumulative	increment	cumulative
Self-privatisation					
Number of transformations	0	20	20	237	257
Book value of assets	0	1.15	1.15	27.35	28.50
Revised value of assets	0	1.56	1.56	24.74	26.30
Management and/or investor initiated					
Number of transformations	27	153	180	116	296
Book value of assets	26.19	167.30	193.49	216.51	410.00
Revised value of assets	41.47	240.01	281.48	129.66	*411.14
State initiated					
Number of transformations	0	18	18	31	49
Book value of assets	0	150.43	150.43	215.57	366.00
Revised value of assets	0	182.16	182.16	744.84	927.00
Total approved					
Number of transformations	27	191	218	384	**602
Book value of assets	26.19	318.88	345.07	459.43	***804.50
Revised value of assets	41.47	423.73	465.20	899.24	1364.44
Rejected					
Number of transformations****	8	3	11	4	15
Book value of assets	3.99	1.05	5.04	1.95	6.99

* Not given in source. Calculated from available data.

** According to a later issue of the same source, 690; calculated sum is shown.

*** In source, given as 645.54; calculated sum is shown.

**** Without those rejected earlier but approved or in progress since then.

Source: adapted from Privinfo, Vol.1. No.1. p.5.; Vol.1. No.10. p.17., Vol.2. No.3. p.24., Vol.2. No.12. p.18., and own calculations.

Table 7 Asset protection transactions and asset value involved, 1990–1992

(in HUF billion, increment in period and cumulative over time)

	1990	1991		1992	
		increment	cumulative	increment	cumulative
Establishments of companies					
Number of transactions	46	80	126	46	172
Book value of assets	11.50	9.84	21.34	1.86	23.20
Revised value of assets	19.45	17.85	37.30	7.50	44.80
... with domestic partner					
Number of transactions	18	52	70	29	99
Book value of assets	1.51	2.22	3.73	1.57	5.30
Revised value of assets	2.07	7.03	9.10	4.30	13.40
... with foreign partner					
Number of transactions	28	28	56	17	73
Book value of assets	9.99	7.62	17.61	0.29	17.90
Revised value of assets	17.38	10.82	28.20	3.20	31.40
Rejected					
Number of transactions	12	3	15	2	17
Book value of assets	0.49	0.22	0.71	0.33	1.04
Asset sales related to establishment of companies					
Number of transformation	0	17	17	0	17
Book value of assets	0	5.17	5.17	0	5.17
Revised value of assets	0	7.00	7.00	0	7.00
Approved other transactions (sale of individual assets, etc.)					
Number of transformation	38	169	207	244	451
Book value of assets	1.86	6.73	8.59	5.80	14.39
Revised value of assets	3.96	13.15	17.11	12.24	29.35
Rejected other transactions					
Number of transformation	11	5	16	3	19
Book value of assets	0.92	0.94	1.86	88.94	90.80

Source: adapted from Privinfo, Vol.1. No.1. pp.5-6., Vol.1. No.10. p.18., Vol.1. No.13. p.29., Vol.2. No.3. p.24., Vol.2. No.12. p.19.

Table 8 Revenues of the state from sale of state property by the SPA

(HUF billion, per year)

Form of payment	1990*	1991	1992	1993	1994
HUF cash	0.14	4.82	17.51	15.30	14.10
Foreign currency cash	0.53	24.61	40.98	25.50	6.10
Total cash	0.67	29.43	58.49	40.80	20.20
Loans**	–	1.01	9.07	21.70	30.23
Compensation notes	–	0.00	2.52	16.90	44.88
Dividend, rent and others	–	0.94	4.74	2.40	1.96
Total non-cash	–	1.95	16.33	41.00	76.07
Total revenues	0.67	31.38	74.82	81.8	97.27

* Since March 1990, when the SPA came into operation.
** Mainly Existence-loans. From 1994, payments in instalments are also included.

Source: adapted from various issues of Privinfo (Vol.1. No.1. p.6., Vol.1. No.10. p.18., Vol.1. No. 13. p.30., Vol.2. No.3. p.24., Vol.3. No.5 p.34., Vol.3. No.13. p.36-37., Vol.4. No.6. p. 25., Vol.4. No.9. p.6-8.)

The data presented in these tables may hide important details; yet, a number of conclusions can be drawn.

Table 6 indicates that even in the first phase of privatisation policy, said to have been characterised with centralisation, the initiative mostly came from the management, at least in terms of the number of transformations. In terms of asset value involved, however, the state continued to dominate the initiation of transformations, even if we assume that all asset protection transactions shown in Table 7 were initiated by the management. The data also indicate a shift to self-privatisation, again in terms of the number of transactions.

However, both Table 6 and Table 7 show significant difference between the book value of assets involved in transformations and asset protection transactions and their revised value as reappraised and approved by the SPA at the time of the transaction.

We may reasonably assume (as our case studies will indeed show in Chapter 6) that in the absence of appropriate capital market institutions, reappraised asset values result from a bargaining process. The right of final approval rests with the SPA which, instead of rejecting a transformation initiated by the management at the outset, may prefer to attempt to exercise control in the course of this bargaining process. Thus, the distinction (originally devised by the SPA) between state initiated and management initiated processes might be less relevant than the fact that who has control over the evolving process, to what extent, and by what means that control is exercised. An empirically founded answer to these questions may reveal some continuity behind the seemingly distinct phases.

Data on the SPA's revenues in Table 8 evince that the percentage of cash revenues relative to the value of compensation notes accepted for acquiring state property dramatically decreased[46]. Amongst the possible reasons for the policy shift that is evidenced by the data, political considerations (winning the electorate's favour, offering concessions to various political groups) are usually considered to be of significant importance. Hence, most observers agree that the year 1992 divided privatisation policy in Hungary into two markedly different phases, where the second phase is seen as typically "political" (Csillag, 1994), or "populist" (Canning and Hare, 1994). As Canning and Hare point out, however, the departure from the revenue-centred approach may also be attributed to the possible lack of sufficient interest from foreign investors who may have already acquired most of the firms for which they were willing to pay cash. Yet, *privatisare necesse est*, and the noted shift may have also served the purpose of keeping the privatisation process going.

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[46] A similar trend appears from data on sales by SAMCo, which collected HUF 7.69 billion in cash and HUF 19.33 billion in compensation notes in 1994. However, in 1993 one major transaction conducted by SAMCo, the sale of 30 per cent of the shares in the telecommunications company, brought in about HUF 85 billion cash in hard currency (half of the amount in form of capital increase, one third to SAMCo, the rest to the ministry for concession rights). For source of these data, see notes under Table 8.

3.5 Conclusion

We end this section by highlighting major issues. Four questions are singled out: the legacy of the past, bargaining and politics in the privatisation process, the role of insiders and networks, and the effect of the use of 'cheap money'. The implications of these issues for our study are formulated here only vaguely in that the empirical inquiry must be kept open and receptive to them, thus supplementing "theoretical sensitivity" (recommended for researchers engaged in theory development by Glaser and Strauss, 1967) with 'practical sensitivity'.

Legacy of the past

It is important to realise that privatisation in Hungary was not introduced out of the blue but in a specific social, political and economic situation, and it is this concrete historical 'context' and not an abstract discussion of social justice or economic rationality that determines many aspects of the process. In accordance with this view, several authors interested in privatisation in Hungary have pointed out that policy options had been considerably restricted by the time the freely elected government took control in the summer 1990 (see, for example, Canning and Hare, 1994; Earle, Frydman and Rapaczynski, 1993).

We briefly recapitulate here the preconditions to privatisation – factors that appear to determine many features of the declared, and actually followed, privatisation policy of the government – by grouping them in three categories. These are: economic conditions, political considerations, and property rights/corporate governance.

Economic conditions: consideration of mass-privatisation by free distribution was precluded by the highest foreign (hard currency) debts in per capita terms in the region, combined with apparent pressure by international financial organisations, most notably the International Monetary Fund, and the government's firm commitment to repaying all due debts in an era of recession, decreasing Gross Domestic Product and exports. The question whether to sell or give away state property did not actually mean real options. The debate on full in-kind 'reprivatisation' (restitution), that is the transfer of state assets to their former owners, also seems to have been 'resolved' by the pressing need to generate income from privatisation.

Political considerations: Privatisation to insiders was unacceptable for the new coalition. The common view held by many amongst its ranks that state enterprise managers were members of the old *nomenclature* who should not be allowed to convert their managerial powers into those of owners, and the public outcry over the abuses during 'spontaneous privatisation' made it impossible to adopt such an approach. However, even if full reprivatisation was rejected, some sort of compensation of former owners clearly followed from the political values held by the coalition, which considered it a priority to create a wide 'middle-class' and cultivated good relations with Christian churches that claimed their confiscated property back.

Property rights and corporate governance: we have already noted that earlier reforms, aimed at increasing enterprise autonomy, had resulted in blurred property rights. Managers had assumed quasi-ownership entitlements, leaving the state in a relatively weak position. Thus, although the government was firmly against insider privatisation, managers were bound to play an important role due to the 'property-rights legacy' and lack of effective corporate governance.

Bargaining and politics

Bargaining: The gradual and evolutionary nature of the Hungarian reforms has been noted. Mizsei (1993:133) attributes Hungary's "*relatively* well-structured political party system with a workable set of political (constitutional, electoral, and parliamentary) rules" to the "organic political transformation" and "deeply rooted pragmatism." Canning and Hare (1994:177) mention "the evolutionary approach and the legacy of earlier reforms which have marked Hungary's economic transition in general" and are "clearly evident also in the process of privatization." They also point out Hungary's being unique in its pragmatism in terms of the great

> "variety of models and approaches which have been developed to cover almost every eventuality, and in the high degree of apparent responsiveness and flexibility on the part of the government and its agencies when one set of measures or

particular privatization programmes have failed to produce the expected results" (Canning and Hare, 1994:177)

However, what appears gradualism and pragmatism may have been only a continuation of the bargaining system that had characterised Hungary for decades and gained increasing importance since the 1968-reforms. Following reforms, bargaining upon state directives, production plans and alike had been replaced by bargaining on regulatory controls, prices, wages etc. At about the end of the communist regime, and even more apparently after the political turnaround in 1990, players and their relative bargaining power did change, of course, just as the stake of the bargaining did, but the bargaining nature of the allocation processes remained and may have had an important effect on the outcome of these processes.[47] Canning and Hare (1994:178) assert that in the course of trial and error in Hungary's privatisation, "there can be no doubt that political bargaining and compromise have played their part." The possibility of bargaining in East-European privatisation was also pointed out by Stark (1991). This should come as no surprise. As Rausser and Simon (1992:247) argue, "In a world in which economic rights are ill defined, a bargaining problem naturally arises."

A similar position is taken by others who have pointed out Hungary's, again unique,

> "reliance on a case-by-case approach to the privatisation of property ... [T]he predominant pattern has remained the treatment of each transaction on its own terms rather than adoption of a set of strict rules applied to all of them ... [M]anagers have in practice continued to predominate in initiating and determining the process, albeit with the necessity to bargain with the SPA over the outcome ... [T]he failure of the SPA's attempts to centralize and accelerate the process through the so-called 'active privatization' has further reinforced the power of the managers" (Frydman *et al.*, 1993:130).

To simplify, from lack of rules, bargaining follows. More precisely, there are rules and policies for the Hungarian privatisation but they

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[47] See, for example, debates on ESOP, whose popularity was heightened with various incentives motivated by political considerations, *versus* in many cases its expected detrimental effects to the long-term viability of the firm privatised by this method.

"must be understood as functioning only as a framework within which bargaining among individual actors takes place. Laws describe possibilities without placing many rigid constraints on outcomes, which depend more importantly on the circumstances and the relative bargaining power of the actors in particular cases" (Frydman *et al.*, 1993:131).

Urbán (1993:108) also asserted[48] that there was always room for bargaining under the rules since "the legal framework is applied in the case of each enterprise by different actors, and, as a consequence, almost every case is different."

One could infer from these positions that drawing general lessons about the Hungarian privatisation is next to impossible. Indeed, Frydman *et al.* (1993) conclude that this case-by-case, bargaining approach makes it extremely difficult to generalise about the Hungarian privatisation. In our view, instead, what appears from our review in this chapter is that precisely this *is* the generalisable pattern that characterises the process[49], whose effect on the outcome of the process should be made subject to inquiry. Privatisation policy in Hungary may seem hectic if one focuses on the wide range of techniques used in the process; yet, by focusing on preferences granted to different groups of possible owners, markedly different phases could be discerned, in which otherwise excluded groups were allowed to enter the bargaining process. Furthermore, by noting underlying mechanisms of conflict resolution, bargaining and politics appear to have been remarkably continuing characteristics, regardless of the phases (which themselves seem to have been induced in part by political considerations). In simplifying words: policy may change, bargaining remains.

Politics: The role that politics can play in privatisation has been studied from various angles. One possibility is to look at the legislature's politically motivated decisions that have consequences on general privatisation policy, the subject of the study by

[48] Presumably on the basis of his experience as a member of parliament for the Association of Young Democrats (in opposition), who also served on the SPA's Board of Directors for some time.

[49] That is, the process of privatisation, the level to which the generalisation is made.

Urbán (1993). Considering political objectives of privatisation, Brabant (1992:158) singles out strengthening of democracy and social stability, restriction of the role of the state, and breaking of the politically appointed managerial structures. Estrin (1994) emphasises securing of the irreversibility of the reform process, and directs focus on how different privatisation policies separate losers and winners. Batt (1994) appears to be more interested in general issues of political legitimacy. Others discuss the political economy of privatisation, placing special emphasis on political considerations surrounding debates on, implementation of, and obstacles to privatisation policies (see Rausser and Simon, 1992; Schipke, 1994; Winiecki, 1992). In a speech on the political aspects of privatisation, Stone (1994) went further when he defined privatisation as "being in essence a transfer of power," and "a political act".

What is common in most of these treatments of our subject is that they realise that policy choices on various issues related to privatisation are choices that affect re-distribution of wealth and, eventually, power.

The Hungarian privatisation seems to have been inextricably interwoven with politics. We have noted political considerations as factors affecting the government's declared privatisation policy in 1990. They also appear to have played a role in subsequent practice of the Hungarian privatisation as indicated by our review of particularly the second, 'populist' phase, when decisions motivated at least in part by political considerations determined to a great extent who were allowed to the bargaining table, by increasing one's ability to enter bargaining even if one's initial bargaining power stemming from one's economic resources was weak.

While the effect of politics on general privatisation policy choices has been discussed in the literature, its significance for the process and outcome of privatisation of individual firms appears to have been ignored by scholars, although anecdotal evidence on the practice of Hungarian privatisation suggests that bargaining and the play of political forces can be expected to take place at the level of individual firms, too.

Insiders and networks

Insiders' role in the Hungarian privatisation process appears prominent. It was apparently decisive in the era of 'spontaneous' privatisation. Insiders' influence seems to have remained relevant even in the so-called 'centralised' phase of privatisation policy.

The ability of insiders to influence privatisation seems to be rooted above all in quasi-ownership entitlements acquired during earlier reforms. However, it is reinforced by a number of other reasons including, for example, an obvious information asymmetry which creates an enormous monitoring problem and renders corporate governance ineffective. Second, there is a trade-off between transparency and other considerations (such as speed), and it is transparency that appears to have lost priority in the Hungarian privatisation process. Third, the bargaining nature of the process may create more latitude for managerial influence.

As we have seen, insiders were successful in creating a web of cross-ownership, thus strengthening a network based on mutual favours as well as business relationships. As Canning and Hare (1994:211) pointed out, cross-ownership further developed even after the era of 'spontaneous' privatisation, in part due to widespread debt-equity swaps which in turn could be attributed to strict bankruptcy legislation since 1992.

The importance of network- or relational capital in the Hungarian transition has been emphasised by Matolcsy (1991) who argued that mutual favours had no longer been directed only at consumption in order to obtain scarce goods, but also, and more importantly, at accumulation of physical capital. Networks comprise both insiders (e.g., managers) and outsiders (e.g., officials of party- and state bureaucracies). The argument that emphasises the role of networks and network-capital in Hungary before and, increasingly, after the political turnaround is presented in full by Stark (1990, 1994a,b) and Czakó and Sík (1995), who follow Bourdieu-esque traditions of sociology (cf. Bourdieu, 1978) and utilise Granovetter's (1985) theory of embeddedness of economic behaviour. However, they focus on small entrepreneurs rather than large enterprises. The role that networks play in the privatisation process therefore remains to be subject of further study.

The effect of 'cheap money'

Regardless of the motives behind the policy shift in 1992, with the appearance of various forms of preferential payment two types of currency became accepted in privatisation deals: 'real money' and 'cheap money', the latter including soft loans, compensation notes and instalment payment. The implications of the two currencies are important.

First, an investment offer financed from an E-loan was worth only about half of an up-front cash bid, considering the state subsidy provided with an E-loan (bearing an interest of 7% compared to a standard commercial loan bearing 25–30% interest). Also note that only 2–15 per cent "own capital" was required to take an E-loan with 2 years forbearance and 8 years loan period.

Second, a similar argument applies to the compensation note. On the one hand, its value was continuously decreasing and in 1993, for example, it was traded at the stock exchange at about half of its face value. On the other hand, the SPA was required to accept compensation notes at their nominal value, calculated as their face value plus accumulated interest (fixed 17% per year). Thus, one who could use compensation notes could offer roughly three times higher purchase price than a cash paying bidder. In other words, one could offer to pay 300 per cent of the par value of the shares to be acquired and be a sure winner against another whose offered price would be only at par value, but to be paid in cash only.

Third, in some cases several options – such as compensation notes and paying in instalments, not to mention various incentives for employee ownership – could be used in combination, further increasing the gap between 'real money' and 'cheap money'.

Thus, in cases where payments were allowed to be made in 'cheap money', those who were entitled to take advantage of its use could artificially increase their bidding power. It may appear that this group first of all includes resource deficient, mainly domestic, would-be owners such as employees and original recipients of compensation notes, in accordance with the declared policy shift as laid out in the government's "Strategy for breakthrough in privatisation." However, before prematurely jumping to the conclusion that from 1992 resourceful (mainly foreign but also a few domestic) cash bidders were necessarily bound to lose in bidding contests, two caveats have to be made.

First, note that it was the SPA's authority to decide upon the structure of different forms of payments acceptable in a bidding process. One could assume that permitted forms of payments might be determined in the tender announcements in accordance to the seller's preference with respect to the eventual winner.

Second, often 'cash bidders', domestic and foreign alike, might be able to find ways of going around their being excluded from the use of 'cheap money'. This was the case when the SPA accepted compensation notes from anyone, and not only from those who had received them as subjects of economic or political reprimands under the communist regime. 'Cash bidders' might also be able to make an agreement with those entitled to various price concessions to acquire shares from them subsequent to privatisation and share the benefits of state subsidies.

3.6 Lessons from pilot study

Before a research framework to be formally developed for empirical investigation, a pilot study was conducted. The main results are briefly summarised here only to indicate issues that shaped our framework. More details of these cases will follow in subsequent chapters.

The pilot study included in-depth longitudinal case studies that covered privatisation processes of two manufacturing firms until the Summer of 1993. Note, however, that both cases were still incomplete at the time of the pilot study. In one case, privatisation had already been concluded, but it was clear, and indeed planned by relevant actors, that further changes in ownership was going to occur soon. In the second case, privatisation was just about to be completed. While these pilot cases were informative regarding firm behaviour during the privatisation process, they did not allow the investigation of changes in behaviour and performance due to having been privatised.

The main purpose of the pilot study was to gain first-hand, factual knowledge of firm-level behaviour during the transformation period. Answers were sought to three general questions:

- What are the characteristics of privatisation processes of individual firms?
- What are the factors that control the dynamics of the processes?
- How do process characteristics affect the outcome of privatisations?

Through these general questions, the relevance of some issues that had emerged from the literature review was to be established. These issues, considered to be tentative until their relevance is either confirmed or disproved by the pilot study, can be summarised in the form of a research question as follows:

Do politics and bargaining in and around the firm play an important role in the process of privatisation; if so, why; and what are the consequences?

Only the main lessons are presented below to the extent necessary to indicate how they shaped the emergent model. Selection criteria applied in choosing the cases, case narratives of the two pilot cases with follow-up periods as well as four more cases, and intra- and cross-case analyses are presented in subsequent chapters.

The two pilot cases seemed to support the following statements:

- Privatisation should probably seen as an evolutionary process which unfolds in a sequence of numerous little steps as time passes by, as opposed to one that follows a sequence of 'planning, then implementing' as seen from the perspective of the rational actor model.

- The chain of preceding events restricts the range of possible later choices not only for the decision-maker but also for other players.

- Privatisation processes do not necessarily follow a predictable route; despite apparent commitments at a point, the events may often take an unexpected direction. Participation of players with conflicting interests makes the flow and final outcome of privatisation processes difficult to predict on the basis of the rational actor model.

- In the course of privatisation, interests and motivations of players do change with time. 'Preferences' should not probably be treated as chiselled in stone.

- Supposedly unified interest groups (e.g., state, management, foreign investors) may be internally divided to the extreme; they cannot be – as they often are – viewed as homogeneous. Temporary alliances, probably on individual level, may cut across these groups.

- Managers do not see themselves rendered to be passive subjects to privatisation; instead, within the boundary that the firm will eventually be privatised in any case, they use various tactics to influence the process and its final outcome. In this sense, privatisation itself is a strategy variable at the management's level (as opposed to government or agency levels). Management does have strategic choices to influence privatisation.

- Privatisation goals appear central in managerial decision-making. On the one hand, privatisation *per se* is a central issue, requiring much of managerial time and attention. On the other hand, possible decisions on almost every aspect of organisational life are filtered through assumptions on their likely effect on achievement of goals that are related to privatisation. In cases when privatisation goals and business goals seem to be in conflict, the former often take priority over the latter.

- Due to uncertainties in the privatisation process, business decisions are built on vague assumptions about privatisation's likely outcome, and if these assumptions prove false, the firm's strategy will turn out to be ineffective.

- In the process of privatisation, internal organisational conflicts are often attempted to be resolved by way of politics, and may give rise to extreme strife. Theories of power, and 'power games' in particular, may prove to be useful in analysing privatisation as organisational change (sometimes upheaval).

- In the context of national transformation, defective corporate governance can permit organisational politicking to take a priority over performance. In the long-drawn-out process of privatisation, this diverts attention from efficiency and exacerbates the firm's 'drift', which further restricts the chances of privatisation.

In sum, in terms of our research question, "Do politics and bargaining in and around the firm play an important role in the process of privatisation; if so, why; and what are the consequences?," the pilot cases clearly indicated that politics and bargaining are essential features of individual privatisation cases, most importantly because of ineffective corporate governance, and with the likely result of performance loss. This result calls for a research framework that explicitly takes these factors into account.

CHAPTER FOUR

4. Research framework and propositions

4.1 Introduction

In the preceding chapters four foundations, two theoretical and two practical, were laid down for building our initial research framework. These are:

- a discussion of state-owned firm behaviour as seen from a strategy perspective (see 2.2),
- a review of the existing theory on privatisation (see 2.3),
- issues derived from a review of privatisation policy and practice in Hungary (see 3.5), and
- issues that emerged from a pilot study (see 3.6).

On the basis of these foundations, a tentative model of privatisation and firm behaviour in national transformation began to emerge which seems markedly different from that suggested by the agency approach as applied to privatisation in the West. The emergent model rests on:

- *a political view of firm behaviour:* patterns of firm behaviour (strategy content) emerge in a political process (strategy making) as a result of individual action shaped by negotiations and compromises between players of conflicting interests; factors that make up the 'context' (including, but not restricted to, incentives and constraints) indirectly influence patterns of firm behaviour through the process of strategy making,
- *a strategy-view of behaviour of socialist firms:* strategies of state-owned firms operating under a regime of communist political power and bureaucratic co-ordination of economy are different from those of private firms operating under a

regime of capitalism and market co-ordination; behaviour patterns of state-owned firms are state-oriented due to their political and resource dependence from centres of political control and economic redistribution; consequent to specific features of goal formation and lack of constraints, bargaining with redistribution centres takes priority over market performance and separates effectiveness from efficiency.

- *an existing theory of the relationship between privatisation and firm behaviour:* changes in patterns of firm behaviour are eventually expected to result from changes in goal formation and from more effective incentives and constraints brought about by replacing the state with private owners as the principal; in the case of a 'troubled' firm, privatisation is expected to bring about a specific type of behaviour that can be labelled as 'turnaround strategy', comprising activities of recovery and skill-building.

Section 4.2 highlights differences between two alternative approaches (driven by agency theory *versus* organisation theory) to studying the relationship between privatisation and firm behaviour. In section 4.3 our research framework is presented, while section 4.4 summarises propositions in a more formal way, thus providing 'signposts' for a theoretically informed case analysis.

4.2 Alternative approaches

In this subsection differences between two possible approaches, one based on agency theory, the other driven by organisation theory, are highlighted.

Economic perspectives, notably industrial organisation and transaction cost economics have brought clear benefits to the study of organisations.[50] Recently, privatisation has become an issue where the contribution of economics is remarkable.

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[50] See, for example, Porter's (1980) work on competitive strategy, and Williamson's (1975, 1990) work on organisational structure.

In fact, representatives of no other discipline than economics have as yet shown the greatest interest in the study of privatisation. In this interest, agency theory has received wide acceptance. In essence, the agency approach to privatisation asserts that, following privatisation, consequent to a number of changes in the 'context', managerial decision-making (and, ultimately, firm performance through behaviour patterns better suited to the altered environment) will improve. The question arises: is this theory appropriate in Central-East European, and particularly the Hungarian context, when one is interested in changes of firm behaviour due to ownership changes? In other words, does this approach provide an appropriate framework for the study of our research question?

While the agency approach provides important insights into the likely changes in firm behaviour due to privatisation, and aptly re-establishes self-interest and opportunism in organisational studies in contexts where goal conflicts are substantial (see Eisenhardt, 1989a), as in owners–management relationships, we argue below that the study of privatisation can gain substantially from an organisation theory-driven approach. Some problems of the application of the agency approach to privatisation in Eastern Europe were noted in subsection 2.4. Further weaknesses of the agency approach are discussed here, building the argument around problems arising when agency theory is applied to studies of organisations in general, and in particular when the agency approach is employed in studies of privatisation when the unit of analysis is the organisation.

For studying organisations in general, agency theory appears to have some limitations. By opening up the black box of the firm and putting the managers into the centre, agency theory makes a substantial step towards understanding the behaviour of the firm. By focusing on the relationship between senior managers and owners, however, it tends to ignore the existence of complex relationships within the organisation and tends to restrict the notion of the environment to the incentives and constraints originated from the owners' objectives. In other words, agency theorists recognise goal conflict in the relationship between owners and management, but tend to focus on single principal – single agent relationships and disregard goal conflict in intra-organisational relationships, among the multiple agents.[51] This is probably because in agency theory the attention is focused outside the firm, and the organisation is seen as "a unit subsumed under the regulatory forces of the market," which serves primarily the interest of the investors (shareholders), while an organisation theory-driven approach would see the market as "a challenge faced, and to be overcome, by the company and its people" (Hirsch, Friedman and Koza, 1990:94; see also Eisenhardt, 1989a). As to the difference between the two approaches, their view of the take-over – which is in fact one of the possible angles from which privatisation can be looked at – may be illustrative.

> "Economic analysis is identified with the market and the interests of investors, while behavioral analysis is identified with the firm and its managers. ... Economists generally favor takeover, as a means to discipline managers and spur efficiency. As long as the stock goes up, utility is maximized, and the world is better off. Behavioral analysts, though, point out that psychological contracts are being broken, that talented managers will early-on seek new employment, and morale crashes ... . How to clean up the ensuing mess is of concern to those with a behavioral approach..." (Hirsch *et al.*, 1990:94).

Furthermore, agency theory, although it rejects the classical model of the firm, still seems to apply the classical model of the 'economic man'. It is not the task of this work to solve the old problem of "whether it is the personality that is decisive, as reflected in one's utility function, or the economic environment, as reflected in the incentive schemes" (Bös, 1991:50). However, both our review of privatisation in Hungary (in section 3) and the lessons of the pilot study (in subsection 3.6) suggest that understanding the effects of privatisation on the strategies or behaviour patterns of enterprises in Central-Eastern Europe may well require a framework that combines these seemingly contradictory approaches, takes into account internal organisational processes that work against the assumption of rationality at the level of the

[51] Interestingly, even in the relationship between owners and managers, or more precisely in the field of corporate governance challenges, politics appear to replace take-overs (which is a central component of the agency theory-based approach); see Pound (1992).

organisation, and enlarges the concept of external environment including incentives as well as a range of other factors in an explicit way. Such a framework can be developed from the perspective of organisation theory.

The agency approach appears to assume a great deal of rationality at the level of the organisation. In agency theory, management's interests are aligned with those of owners, their "goal conflicts are resolved through alignment of goals through the use of incentives" (Eisenhardt, 1988:492, see also Eisenhardt, 1989a). Regarding intra-organisational relationships, we have already argued in favour of a political model of decision-making where goal conflicts are resolved through the use of power mechanisms – bargaining, negotiation, and coalitions. In order to supplement the argument presented in section 2.2, we draw on Hafsi and Thomas' (1986) framework of strategic decision processes. In their model, contextual variables (of structural and motivational nature, leadership characteristics, organisational culture, environmental and institutional constraints) can be specified in either precise or vague terms. The coalition, on the other hand, can be either divided, "with several groups of relatively equal power competing for domination," or united, "with a clearly dominant set of groups that agree on a basic programme or modus operandi" (Hafsi and Thomas, 1986:221). The strategic decision process, then, is labelled "Partisan" where the context is vague and the coalition is divided — a plausible assumption on the context of strategy-making in national transformation. In the "Partisan" process,

> "groups' rationality and interests are expected to prevail over all other considerations (including the organization's global interests)", and "The dominant rationality is an individual or group-centred rationality" (Hafsi and Thomas, 1986:222,239).

A similar 'message' is offered by Pennings (1992:299) who assumes that the political model of decision-making as described by Allison (1971) "fits a more fluid, changing and volatile setting, in which individuals are jockeying for optimal positions to protect their self interest, to acquire power and hold onto it." Both Hafsi and Thomas', and Pennings' insights may prove to be useful when analysing behaviour in national transformation.

For studying privatisation when the unit of analysis is the organisation, it seems problematic that cause and effect in the relationship of privatisation and strategy appears unidirectional from an agency-theory perspective. In the long term and on aggregate, this may be an appropriate simplification. In the short term and at the level of individual organisations, however, the relationship may be more complex. For example, it is not always obvious whether a privatised firm performs better than non-privatised firms because it was privatised, or it was privatised first because it had better prospects to perform well.

Agency theory seems to focus on corporate governance at the expense of explicit attention devoted to the importance of resources, skills and capabilities for a successful turnaround. An approach driven by organisation theory (and that part of the strategy literature which has sprung from organisation theory as opposed to the strategy-camp populated by economists and scholars of industrial organisation) would suggest that effective corporate governance in itself may indeed facilitate strategic turnaround, but only to the extent it provides adequate resource base and helps replace old dominant competence of privatised firms with new ones which increase their survival ability in the dramatically altered environment. In the terminology of organisational learning, one might formulate the assumption in terms of privatisation's contribution to organisational oblivion as well as to organisational learning. If, for some reason, privatisation fails to overcome inertial forces, to break the 'competence trap', and to support the development of new, appropriate skills and capabilities, it may even reduce the survival ability of the privatised firm.

Agency theory, as applied to privatisation, appears to employ an underlying logic of comparing the distinct states of 'before privatisation' and 'after privatisation', while ignoring what is happening in between, as if privatisation were not a process but a one-moment event whose presumed effects are immediate. The question arises: is Central-European transformation happening overnight, playing out the presumed effect of privatisation on firm behaviour in a short period, and if not, what are the implications? On the contrary: the process appears to be long, which may have significant effect on the outcome. While the agency approach aptly directs attention to the importance of external economic incentives and constraints, i.e. selective forces that will inevitably reign in the long term, an organisation theory-driven approach could highlight the role and importance of 'voice', adaptation, influence tactics, and politics during the process of privatisation.

Similarly, in terms of an input-process-output model (Van de Ven and Huber, 1990), the agency approach seems to focus on the input and outcome of organisational change. Applied to the problem under study, the input (independent variable) would be the change in ownership (along with changes in incentives and constraints), and the output (dependent variable) would be some observed change in firm (or managerial decision-making) behaviour (or directly firm performance). The explanation would then require a 'variance' theory, and statistical analysis of variations in some outcome criteria, taking the traditional form of 'an increase in X is related to an increase in Y', but it would not capture the dynamic aspects of the process of privatisation (cf. Monge, 1990:413).

A review of the literature on privatisation in Hungary and lessons from case studies suggest that issues emerging in the transformation and privatisation process are important.[52] We are not only interested in input and output, but also in the process in which changes of firm behaviour unfold. This interest requires a 'process theory', explaining the sequence of discrete events based on a historical narrative (Abbott, 1990; Van de Ven and Huber, 1990).

The two approaches should be seen as complementary and mutually reinforcing. 'Process theory' can provide an explanation of 'why' and 'how' questions, but

> "To do so requires opening the proverbial 'black box' between inputs and outcomes, and to take process seriously by examining temporal sequences of events."

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[52] In this, a "European" (as opposed to U.S.) perspective is taken which treats organizations in "a much more context-specific, historical view. Organizations are much more clearly related to the broader social issues of power and politics in the society ..." (Pfeffer, 1981:15).

On the other hand,

> "just as change is only perceptible relative to a state of constancy, an appreciation of a temporal sequence requires understanding the starting conditions and ending results. In short, answers to both questions are needed to appreciate the inputs, processes, and outcomes of organizational changes being studied" (Van de Ven and Huber, 1990:214, 215).

This study takes a micro-perspective by placing organisations in the centre, regarding process, power, and politics as important, and viewing the privatisation process as organisational change (sometimes 'upheaval'). In this sense this research is a study of organisational change. The process of privatisation (in addition to its outcome) may have a significant effect on the success of a privatised firm's turnaround strategy. Reformulating the research question, we may ask, "What are the factors that prevent Hungarian firms from attaining the expected benefits of privatisation in the economics literature, at least in the short term?," and see whether the difference between successful and unsuccessful, or not attempted, turnaround strategies of privatised firms can be partly attributed to differences in the way they have been privatised.

The range of possible strategies that are implicitly considered in the agency approach seems to be limited. The variety of behaviour patterns that is sufficient to describe firms operating in established institutional systems presents an inappropriate framework to analyse strategy content during the transformation period. It was argued in section 2.2.3 that, in general, as long as the state has resources to distribute and re-distribute, a state-oriented strategy, which seeks to establish strong linkages with the state's redistributing centres, can be effective. When resources are drying up, new strategies are needed. The emerging patterns of behaviour followed by many state-owned enterprises in the late 1980s and early 1990s, however, will not necessarily be genuine market-oriented competitive strategies. An example may be the "asset subtracting" strategies reported by Török (1992). Matolcsy also warned that in the state sector, "a slow self-divestment is occurring through continuous living through of assets," and noted that asset sales seemed to reflect "a corporate policy of overt living through of assets" (Matolcsy, 1991:45,202) instead of an organised divestment. He claimed that a number of state-owned firms were trying to finance survival without significant restructuring efforts by selling valuable properties.

In national transformation, ineffective corporate governance structures may result in 'perverse' strategies. A warning has been made by Estrin, Gelb, and Singh (1991; see also Mayhew and Seabright, 1992):

> "it is weaknesses in ownership arrangements and corporate governance that permit the emergence (or persistence) of rent seeking" and "the impact [of privatization] on management in any given firm will, of course, depend on the structure of corporate governance that evolves in the course of reform" (Estrin, Gelb, and Singh (1991:2,9).

In a similar vein Kornai (1990b) calls for a strong government during transition. He considers successful managers of state-owned firms as highly esteemed officials (as opposed to businessmen), who are part of the bureaucracy, and should be treated accordingly: with a strong hand. That is why, at the time of the so-called spontaneous privatisation, Kornai demanded not to give unrestricted power to managers of state-owned firms.

Some major differences between alternative approaches are summarised in Table 9 (overleaf).

In sum, a research framework based solely on the agency approach to privatisation seems inappropriate for studying the relationship between privatisation and firm behaviour at the level of the organisation in a Central-East European context during the transformation period. Yet, one should not be over-critical, but realise that the approaches compared above are not rival theories. They are in fact complementary in that agency theory provides a general formal theory to explain long-term effects at an aggregate level, whereas the alternative approach as outlined above attempts to deal with phenomena at the level of the firm in a shorter time span in order to yield a middle-range theory whose validity is confined by time and space conditions.

Table 9 Approaches to investigate privatisation and firm behaviour

Economic (agency) theory framework	**Organisation (power) theory framework**
Privatisation seen as	
stable start- end end-states (state-owned versus privatised)	organisational change process
Pattern of firm behaviour (strategy) seen as	
determined by rational managerial decisions	'resultant' pattern of behaviour, shaped by political resolution of conflicts
Context seen as	
incentives and constraints management has to align with context	a range of external and internal factors management can influence context
Assumed relationship between behaviour and privatisation	
once privatised, profit-seeking behaviour	in the course of privatisation, 'perverse' patterns of behaviour are possible We don't know ⇨ descriptive cases are an appropriate research tool
Research interest	
focus on two discrete 'equilibrium states' interested in (variance between) behaviour before and after the transfer of ownership	focus on 'disequilibrium process' also interested in behaviour in the course of transfer of ownership

However, what the agency approach can do for a study based on the outlined alternative is significant. On the one hand, as far as the assumed relationship between the main categories is concerned, it can serve as a 'benchmark', reminding us of the eventual economic purpose of privatisation. On the other hand, regarding the variables to be included in the framework, it directs attention to the importance of the concrete ownership arrangements and the effectiveness of corporate governance that evolve in the course of privatisation. Viewing from this perspective, the present research attempts to explore the benefits of mutual reinforcement and complementarity that can be gained from a two-lensed approach – that of economics and organisation theory – in the study of privatisation.[53]

4.3 Research framework

A research framework in this context means a set of 'variables', stated in the form of categories or concepts, and their assumed relationships, stated in the form of exploratory research questions and propositions, that are expected to produce a predicted outcome. Concepts are conceptual labels on discrete events or instances of an observed phenomenon; properties are attributes or characteristics of a concept; and dimensions are locations of properties along a continuum (see Strauss and Corbin, 1990).

On the basis of the conclusions drawn from our literature review and pilot study, a small initial set of concepts were derived as shown in Table 10 (overleaf). The assumed relationships between these concepts are depicted in our process-framework of privatisation, firm behaviour, and turnaround attainment in Figure 6 (on page 109).

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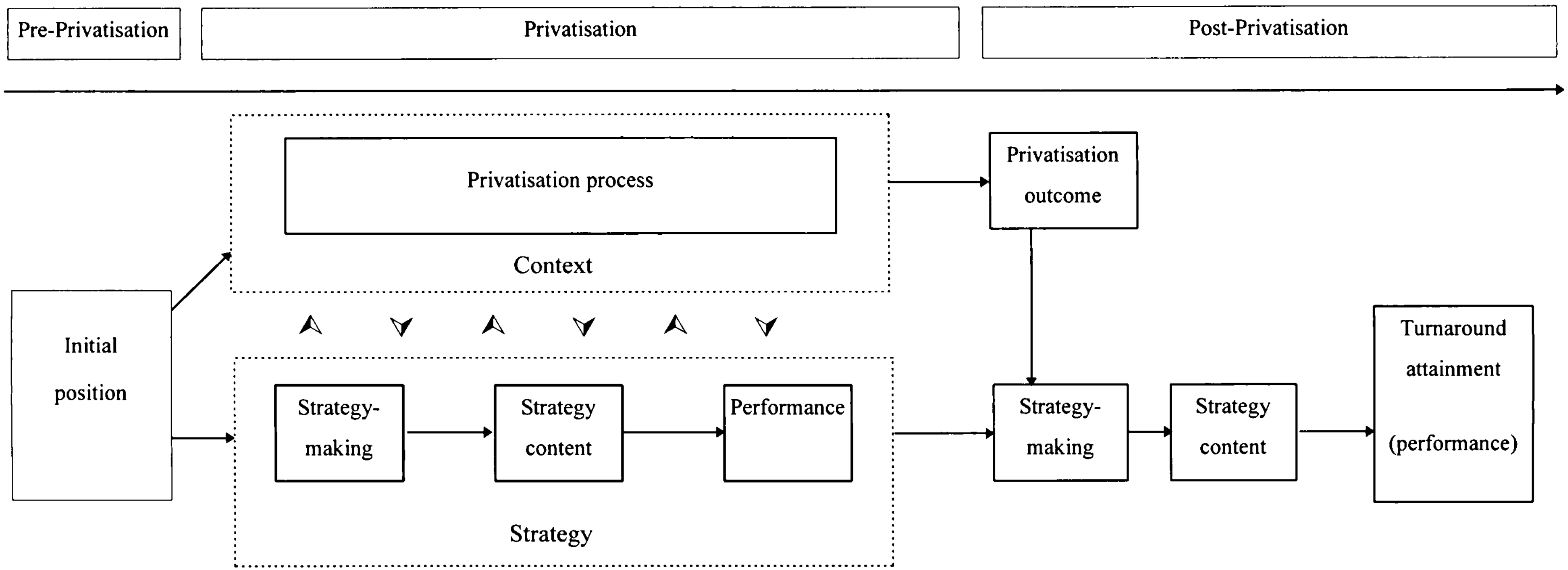
[53] For a classic example of multiple paradigm research, see Allison (1971); in the field of organisation studies, a recent example is Hassard (1991).

Table 10 Relevant concepts, properties and dimensions for initial framework

Category/concept	**Property**	**Dimension**
Dependent variable		
Performance	Turnaround attainment	success *versus* failure
Independent variable		
Privatisation process	Politicisation	low *versus* high
	Organisational politicking	low *versus* high
Privatisation outcome	Governance effectiveness	effective *versus* defective
	Resource replenishment	low *versus* high
Mediating variable		
Strategy process	Consciousness	focused *versus* vague
Strategy content	Coping pattern	turnaround *versus* drift

Figure 6 Privatisation, behaviour, and turnaround attainment: process-framework



Our 'dependent variable' is a variant of firm performance. Considering that this research is attempting to learn about a strictly defined population of firms that, due to their poor initial (pre-privatisation) position, needed major changes, performance is specified as *'turnaround attainment'*, which is defined by the dimension of which 'turnaround success' and 'turnaround failure' are the opposing extremes.

The 'independent variables' include features of privatisation process and privatisation outcome. In this research the process and the outcome of privatisation are distinguished as two separate concepts. Privatisation process is defined as the flow or sequence of events (decisions and action) that are taken to influence issues of future ownership. Turning points in this sequence are of special importance, and defined as barometric events that cause the process to move forward (that lead to a changed situation). Privatisation outcome denotes ownership arrangements and consequences that result from the privatisation process.

The outcome of privatisation is considered from two aspects. First, *'governance effectiveness'* is considered through ownership concentration, where concentrated (private) ownership is associated with 'strong owners' and effective corporate governance, while dispersed ownership is associated with 'weak owners' and defective corporate governance. Second, *'resource replenishment'*, that is the level of additional resources brought in by privatisation (either directly by the new owners or from other sources that became available to the firm due to having been privatised), is taken into account.

Two properties of the privatisation process are singled out in the initial framework on the basis of theoretical discussion and pilot case study evidence. *'Politicisation'* denotes the extent to which circumstances of political nature (or, in the most direct case, decisions made on the basis of political preferences) influence the privatisation process. This property is again 'dimensionalised' between 'high' and 'low' levels. In a case with high politicisation we should find evidence that political preferences had a significant effect on the privatisation process, probably initiating a turning point in the flow of events. For low politicisation, where turning points are caused by genuine economic factors only, we should observe the lack of the effect of political preferences, or even resistance of decision-makers to political influence. *'Organisational politicking'* is an umbrella term that combines properties of processes within and around the organisation. In this research we are interested in the intensity of politicking, and dimensionalise this concept accordingly between the opposing extremes of 'low' and 'high'. In the case of 'high politicking', we should observe 1) sharp internal organisational conflicts in the privatisation process which were resolved through the use of politics, and/or 2) evidence that the privatisation of a given firm became subject of politicking amongst players external to the given organisation.

The basic assumption of our framework is that turnaround attainment is dependent both on the privatisation process and its outcome. In the model shown in Figure 6, this basic insight is developed a little further by providing a possible mechanism through which the assumed effect of the independent variables on the dependent one is played out. This mechanism is the firm's strategy-making process and its outcome, strategy content, which are regarded here as 'mediating variables' for their role in linking the independent and dependent variables.[54]

In the initial framework, *'consciousness'* is the only property of the 'strategy process' (or strategy-making) concept that is explicitly considered. It refers to the extent to which the dominant coalition of an organisation perceives the turnaround situation as such, and deliberately attempts to cope with it. Simply put, the issue this property looks at is whether those capable to influence firm behaviour are aware of the difficulties and want to do something about it. This definition is reflected by the way this property is 'dimensionalised'. 'Focused' strategy process denotes awareness of the turnaround situation, recognition of the need of a turnaround, and a concerted effort to implement such a strategy. 'Vague' strategy process, conversely, signifies lack of awareness and effort.

[54] This conceptualisation is similar to Miller, Dröge and Toulouse's (1988) work who considered strategy process and content as mediators between organisational context and structure.

Strategy content is specified as the coping pattern of an organisation; that is the pattern of its behaviour vis-à-vis environmental challenges. *'Coping pattern'* is labelled 'turnaround' if activities of recovery and capability enhancement are carried out, and 'drift' if no consistent pattern of activities aiming at recovery and capability enhancement is revealed.

In this framework, the privatisation process affects turnaround attainment in two indirect ways. First, it may result in a privatisation outcome that is either favourable or unfavourable to turnaround attainment by providing resources either sufficient or insufficient to realise such a strategy, and/or by implementing either effective or defective corporate governance. Second, process characteristics of privatisation are assumed to have an effect on strategy-making which, then, may produce strategy content that is either favourable or unfavourable to turnaround attainment. Interaction between players is assumed in the framework to take place in inter- and intra-organisational bargaining. It is in this sense that our framework can be considered as a bargaining model of privatisation.

This framework is further specified in the next subsection where a few propositions are formulated.

4.4 Propositions

Propositions that suggest hypothesised relationships between various concepts in the framework are presented here in the form of likely scenarios of privatisation and strategy that may lead to turnaround success or failure. Although the basic idea behind these propositions could be formulated in standard terms of variance-theory (such as "The more politicisation and politicking in the privatisation process, the more vague the strategy making, the more drifting the strategy, and the less chance for turnaround attainment"), possible scenarios are hypothesised instead in order to emphasise temporal dynamics and, even in terminology, to safe-guard against premature hypothesis-testing.

According to the exploratory nature of this research, these propositions are formulated in order to facilitate the 'discovery' of emerging issues rather than to 'test' them as in statistical analysis. Following qualitative research traditions and recommendations (in particular, see the literature on grounded theory), propositions should be seen as tentative that can be reformulated as the research proceeds, rather than fixed ones that may or may not be falsified. However, the explicit formulation of propositions that can serve as signposts to facilitate systematic and disciplined case analysis is considered important.

Propositions on how the privatisation process and outcome, through strategy making and strategy content, affect turnaround attainment are summarised in Figure 7 (overleaf). In this 'Conditional Matrix' a set of conditions results from juxtaposing the concepts that qualify the process and outcome of privatisation. Within this set of conditions, certain hypothesised relationships are expected to bear out.

Essentially, these propositions suggest that procrastinated and politicised privatisation processes are less successful from the perspective of the firm involved. Furthermore, the less additional resources are brought in and the less effective is the corporate governance resulted from privatisation, the less chance there is left for a firm to achieve a successful turnaround.

Figure 7 Possible turnaround scenarios by privatisation process and outcome

Process \ Outcome	1. effective corporate governance high resource replenishment	2. effective corporate governance low resource replenishment	3. defective corporate governance high resource replenishment	4. defective corporate governance low resource replenishment
1. low politicisation low politicking	1.1 successful turnaround			1.4 handicapped turnaround (by outcome)
2. high politicisation low politicking				
3. low politicisation high politicking				
4. high politicisation high politicking	4.1 handicapped turnaround (by process)			4.4 turnaround failure

The conditional matrix yields 16 scenarios for turnaround to succeed or fail. For purposes of illustration, the four extreme scenarios are described in some detail below.

Scenario 1.1: *Low politicisation and low politicking of the privatisation process, effective governance and high resource replenishment after privatisation, turnaround success.*

In this scenario, the ailing firm is acquired by a resourceful (most often strategic, as opposed to financial) investor in a calm process. The expected result is turnaround success. The low politicisation and low politicking of the privatisation process allow focused strategy making during the privatisation process. The management is aware of the firm's difficulties and, in the absence of politicking, exerts collective effort to remedy the situation. In the absence of adequate resources, it focuses on recovery and, at the same time, facilitates privatisation on the basis of expected strategic benefits, from which it hopes to gain resources for building new capabilities. In fact, in this scenario turnaround begins (in its first, recovery, phase) even before privatisation ends.

At the end of the privatisation process, the new private owners who acquire majority indeed bring in fresh capital, management skills, technology, access to market channels, and thus the firm can enjoy the benefits of high resource replenishment coupled with effective governance. Recovery can now be followed by the second phase of a turnaround strategy, capability enhancement and skill building.

It is this scenario that appears most often in everyday expectations. Furthermore, this scenario seems to fit best with the agency approach to privatisation. In fact, a study which compares firms at two distant points of time, before and after privatisation, may well conclude that this is the only scenario, given that the dates of observation are distant enough to let failure cases either disappear from the population due to selective forces or turn into success in subsequent take-overs. A study that takes a process view and 'accompanies' firms through their privatisation history should, however, reveal other possible scenarios.

Scenario 4.1: *Highly politicised privatisation process with intensive politicking, effective governance and high resource replenishment after privatisation, turnaround handicapped by outcome.*

The firm is initially in a difficult position and, therefore, in need of a turnaround strategy and adequate resources. Eventually, privatisation brings about both. However, in this scenario privatisation politicisation and politicking makes the process procrastinated and becomes a political arena in which conflicts and their political resolution are dominant.

This results in significant delays in making necessary responses to environmental changes in a period when quick action should be made to stop further deterioration of the firm's position.[55] Chances of focused strategy making are limited due to the organisation being torn apart by internal politicking. Management feels paralysed by uncertainties that surround politicised privatisation, thus strategy making becomes subordinated to privatisation. Management may even view the privatisation process as an opportunity to obtain personal benefits (not necessarily by acquiring ownership) and not as an opportunity to enhance organisational capabilities, in which case business decisions are made by constantly considering their likely effect on the attainment of personal or group interests in privatisation.

As a consequence, the firm is drifting, its position is further deteriorating. Once the firm is privatised, turnaround may still happen but is expected to be seriously 'handicapped by process'. Due to losses in the course of privatisation, relatively higher level of resource replenishment (including the replacement of the top management) may be necessary for a turnaround to be successfully implemented.

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[55] Compare with Eisenhardt and Bourgeois (1988:737) who found that "politics within top management teams" in high-velocity environments "are associated with poor firm performance."

Scenario 1.4: *Low politicisation and low politicking of privatisation process, defective corporate governance and low resource replenishment after privatisation, turnaround handicapped by outcome.*

As in Scenario 4.1, the expected result here is again 'handicapped turnaround'. In this case, however, turnaround success is jeopardised by the outcome of privatisation. The transfer of ownership occurs in a 'smooth' process. Focused strategy making is not hindered by organisational politicking, and attempts may be made to achieve recovery. Privatisation, however, results in the firm being acquired by private owners who are resource deficient to facilitate capability enhancement and weak to exercise effective governance at a time when management may prefer 'organisational peace' to making hard decisions for recovery. The firm may still try to pursue a turnaround strategy, but its implementation will be at an obvious disadvantage.

Scenario 4.4: *Politicised privatisation process with intensive politicking, defective corporate governance and low resource replenishment after privatisation, turnaround failure.*

In this scenario, the firm is again one which badly needs turnaround strategy. For that, it also needs resources and a determined management to take those often tough measures that are necessary for keeping the firm afloat. Instead, what the firm gets at the end of a long-drawn-out and highly politicised privatisation process are weak owners with no resources. By this time, the firm's position will probably be even more severe due to a high level of uncertainty and fierce politicking in the privatisation process. The expected outcome is, first, turnaround failure and, second, a possible subsequent take-over.

Other hypothetical scenarios shown in the table but not describe above are expected to result in turnaround partially handicapped by both process and outcome.

CHAPTER FIVE

5. Methodology

5.1 Introduction

This chapter is about methodological choices, or "judgment calls" (McGrath, Martin and Kulka, 1982), that have been made in this research, and about the way these choices have been arrived at. In section 5.2 the selection of the research design for the present study is briefly drawn up. Section 5.3 provides details on the criteria used to define the target population of firms and on the process of selecting individual cases. Section 5.4 reviews the sources and methods used in data collection, and the case analysis methods employed.

5.2 Case study design

As the appropriate methodology for the study, the use of multiple, replicative, longitudinal case studies on a small sample of privatised firms was selected in order to build a middle-range theory around the research question.[56] The case study design fits the dynamic and causal nature of the issues concerned (cf. section 4.2 of this thesis). Instead of revealing static relationships, it promises to yield an explanation of the dynamics of how the relationships work. Based on 'stories' or 'narratives' of the unfolding events, the case study design can suit the interest in the existence of sequence patterns, their causes, and their resulting consequences.

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[56] Another research design that has been considered is the development of comparative cross sectional taxonomies of privatisation and strategy, both empirically derived by making use of statistical analysis on a large sample of privatised firms. If some *ex ante* hypothetical relationships between configurations of privatisation and strategy types on the one hand and performance on the other were found, the research question would be answered. This well-established design, although seemingly suitable for the way our propositions have been structured, was eventually rejected due to several shortcomings that the case study design was able to overcome (see the remainder of this section).

The case study design also fits the situation of no testable theory, without pushing the researcher into premature hypothesis-testing. It is applicable to the situation of the small, yet very heterogeneous population of privatised firms, which would render any effort to derive taxonomies statistically prone to failure. As Walton (1973:175) pointed out, the virtues of a comparative case study design[57] are that

> "it provides detail and depth, thus maximizing the validity of the results ... [T]hese results provide a rich fund of material for generating theory ... [and] information for subsequent synthesis."

It relies on theoretical sampling, starting with a partial framework (or, in the case of pure grounded theory-building, with no framework at all) and developing the sample and the emergent theory in tandem (Glaser and Strauss, 1967). It also allows a focus on change processes within the broad social, economic, and political context (Easterby-Smith, Thorpe and Lowe, 1991; Gill and Johnson, 1991). This contextual approach is particularly needed in process studies. As Pettigrew (1990:268) argues, "theoretically sound and practically useful research on change should explore the contexts, content, and process of change together with their interconnections through time." In short, it fits Marshall and Rossman's (1989:21) description of what they call "real research" which "is often confusing, messy, intensely frustrating, and fundamentally non-linear".

Discussing the applicability of case studies for research purposes, Yin asserts:

> "In general, case studies are the preferred strategy when 'how' and 'why' questions are being posed, when the investigator has little control over the events, and when the focus is on a contemporary phenomenon within some real-life context", and
>
> "a case study is an empirical inquiry that:
>
> - investigates a contemporary phenomenon within its real-life context; when
> - the boundaries between phenomenon and context are not clearly evident; and
> - in which multiple sources of evidence are used" (Yin, 1984:13,23).

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[57] On the comparative method in general, see numerous papers in Comparative Political Studies, particularly Volume 8, Number 2, including Campbell (1975), Lijphart (1975), Meckstroth (1975), and Teune (1975).

While this design apparently fits our research theme, it is not without major problems. Dealing with time, selection of sites, choices about data collection, confidentiality, handling the inherent complexity of the 'stories', the required labour intensity, the often 'slippery' qualitative data, and generalisability (external validity) are amongst the most frequently mentioned difficulties (see, for example, Leonard-Barton, 1990; Pettigrew, 1990; Van de Ven and Huber, 1990; Yin, 1984).

While these problems are acknowledged (and have indeed been experienced in this research, too), scholars dealing with change processes have developed some guidelines and procedures for conducting rigorous case study research.[58] Yin's (1984) pre-specified procedures or "tactics" for satisfying various validity criteria in case study research, and Eisenhardt's (1989b) recommended activities in the process of building theory from case study research[59] seem particularly useful as a guide to make case study research a more rigorous way of scientific inquiry as judged against four common criteria.[60] These "tactics" and "activities" are depicted in Table 11 (overleaf) and Table 12 (on page 122), indicating those which were most attentively followed in this research.

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[58] See, for example, papers in Organization Science, Vol. 1. Nos. 3 and 4, devoted to longitudinal field research methods, and Miles and Huberman's (1994) sourcebook of displays and other techniques.

[59] However, note that Eisenhardt's (1989b) original attempt to increase the rigour of case study research was criticised by Dyer and Wilkins who called for "Better stories, not better constructs ...", describing her approach as "paradoxical" in that it included features of a hypothesis-testing research, contrary to its aim of facilitating theory generation. Her focus on constructs while losing sight of context was particularly noted. In her response, Eisenhardt argued in favour of rigour and multiple-case comparative logic of replication (see Dyer, Wilkins and Eisenhardt, 1991).

[60] On criteria for evaluating organisational theories, see also Bacharach (1989).

Table 11 Case study tactics for four design tests

Test	Case-Study Tactic	Phase of Research in Which Tactic Occurs
Construct validity	• use multiple sources of evidence* • establish chain of evidence* • have key informants review draft case study report	• data collection • data collection • composition
Internal validity	• do pattern matching* • do explanation-building* • do time-series analysis	• data analysis • data analysis • data analysis
External validity	• use replications logic in multiple-case studies*	• research design
Reliability	• use case study protocol* • develop case study data base*	• data collection • data collection

Source: Yin (1984:36)

Note: * marks tactics that were most adhered to in this research.

Table 12 Process of building theory from case study research

Step	Activity	Reason
Getting Started	Definition of research question*	Focuses efforts
	Possibly a priori constructs*	Provides better grounding of construct measures
	Neither theory nor hypotheses*	Retains theoretical flexibility
Selecting Cases	Specified population*	Constrains extraneous variation and sharpens external validity
	Theoretical, not random, sampling*	Focuses efforts on theoretically useful cases — i.e., those that replicate or extend theory by filling conceptual categories
Crafting Instruments and Protocols	Multiple data collection methods*	Strengthens grounding of theory by triangulation of evidence
	Multiple investigators	Fosters divergent perspectives and strengthens grounding
Entering the Field	Overlap data collection and analysis, including field notes*	Speeds analyses and reveals helpful adjustments to data collection
	Flexible and opportunistic data collection methods*	Allows investigators to take advantage of emergent themes and unique case features
Analyzing Data	Within-case analysis*	Gains familiarity with data and preliminary theory generation
	Cross-case pattern search* using divergent techniques	Forces investigators to look beyond initial impressions and see evidence thru multiple lenses
Shaping Hypotheses	Iterative tabulation of evidence for each construct	Sharpens construct definition, validity, and measurability
	Replication, not sampling, logic across cases*	Confirms, extends, and sharpens theory
	Search evidence for "why" behind relationships*	Builds internal validity
Enfolding Literature	Comparison with conflicting literature	Builds internal validity, raises theoretical level, and sharpens construct definitions
	Comparison with similar literature	Sharpens generalizability, improves construct definition, and raises theoretical level
Reaching Closure	Theoretical saturation when possible	Ends process when marginal improvement becomes small

Source: Eisenhardt (1989b:533)

Note: * marks recommendations that were most adhered to in this research.

5.3 Case selection

This section first deals with issues of defining the population of firms targeted by this study. Next, some further criteria applied in the selection of the pilot cases are presented. Then, the subsequent sampling process is described. Finally, issues of access, confidentiality and anonymity are discussed.

Target population

Privately established firms, and those state-owned enterprises in which significant state ownership was intended to be maintained in the long term were obviously excluded from this study.

The target population of firms was confined by using pre-established criteria that clearly followed from our research question: "Under what conditions can privatisation facilitate turnaround of formerly state-owned firms?", or in a reformulation, "Can the difference between successful and unsuccessful (or not attempted) turnaround strategies of privatised socialist firms be partly attributed to differences in the way they have been privatised?" In addition, we attempted to define a segmented population in order to control for variables (as in an experimental design) that might have an effect on turnaround success. The criteria used, their definition as a requirement that firms must meet to be selected, and examples of sectors excluded from this study as a result of applying the criteria are given in Table 13 (overleaf).

Table 13 The definition of the target population

Criteria and Definition	**Examples of *excluded* sectors**
Criteria related to privatisation	
Ownership commonalities Firms must have common initial ownership arrangements and be subject to a common privatisation legislative framework.	Agriculture (state farms and co-ops); firms initially owned by local municipalities (soviet-type "councils"); small service; firms involved in "self-privatisation"
Lack of specialities in privatisation process There must be no peculiar features in the privatisation process that might dominate strategy during privatisation and subsequent performance.	Foreign trade firms (they were deprived of their only main asset, headquarters building, by the SPA); firms that are known to be scandalous privatisation cases (with the exception of FB1, see below)
Criteria related to strategy	
Market conditions Firms must face competition.	Natural monopolies, public utilities (but firms initially in a monopolistic position due to administrative protection are included)
Organisational status Firms must be independent going concerns with a history of pre-, during, and post-privatisation.	Divisions and holding centres (but spin-offs created from legally independent subsidiaries are included)
Criteria related to performance	
Initial market and/or financial position Firms must enter the transformation period facing serious challenges (needing strategic turnaround).	Firms that are likely to successfully compete without strategic turnaround
Strategic viability Firms cannot be *ab ovo* expected to be bound to fail due to industry effect.	Notoriously loss-making industries such as heavy metallurgy and mining
Lack of state dependency The state must not play a decisive role with respect to firms' business success/failure.	All firms involved in the so-called consolidation programme (bail-out by the state); a further 13 large firms bailed out by the state under a special programme

Note that a number of sectors were excluded by more than one criterion. Also note that the application of these criteria also relatively clearly define the target population in terms of firm size and industry, providing a group of middle-size and large (but not 'giant' to Hungarian standards) state-owned firms with a number of employees in the range of some 300–2000 people, and an asset value of about HUF 0.5–3.0 bn, that operate in consumer goods manufacturing industries. In the consumer goods sectors, known cases also indicated variety (for example in terms of final owners) necessary for comparisons. In addition, within this sector there are relatively populated industries.

In sum, these criteria seem to specify middle-size and large consumer goods manufacturing firms as the target population. It is this group of firms to which the results of this research are hoped to be generalisable.

Criteria for pilot cases

Before the pilot studies, a list of already or soon to be privatised firms was obtained from the SPA. On the basis of data provided in this list and additional public information systematically collected from the Hungarian press, a short-list of about a dozen candidates was prepared. For choosing two firms as subjects of pilot study from the short-list, a couple of further special considerations guided case selection.

It was an objective to find a firm that was known to have been subject to a 'complex' or problematic privatisation process. With this criterion, we followed recommendations of the literature on case study research (see section 5.2 for references) to utilise extreme cases in order to reveal unexpected features of the phenomena under study. A firm in the food and beverage industry was a known example. Its privatisation process had already been concluded by the time of preparing the pilot case which also made it possible to follow up the case into its post-privatisation stage. A firm producing personal products, on the other hand, had not been sold by then, providing an opportunity to follow the unfolding events of privatisation in real-time. Also note that at about the time we prepared the pilot study on this firm, its privatisation was publicly considered as an exemplary one, promising a possibility to learn from a comparison of extremes.

A natural consideration was the progress of privatisation, that is firms, to be selected for the pilot study, had to belong to sectors where privatisation had significantly proceeded, or could reasonably be expected to proceed considerably within the time limits of the study.

Finally, selection was also influenced by access. The privatisation deal of a third firm that was also targeted as a possible candidate for pilot study was subject to litigation by losing bidders. Although a very informative conversation was conducted with the General Director of the firm, he and the Director of Legal Affairs of the SPA appeared reluctant to co-operate. In the other two cases, the support of both the management and the SPA could be obtained. Thus, these two consumer goods firms were chosen for pilot studies (referred to as Food and Beverage 1 and Personal Products 2 in Chapter 6 and onwards).

Theoretical sampling

The subsequent sampling process followed recommendations on "theoretical sampling" (Glaser and Strauss, 1967; Parkhe, 1993; Strauss and Corbin, 1990; Yin, 1984). In theoretical sampling, each case must be carefully selected for purposes of either literal replication (predicting results similar to the preceding cases) or theoretical replication (predicting contrary results but for predictable reasons). As Glaser and Strauss (1967:47) put it, "The basic question in theoretical sampling ... is: *what* groups or subgroups does one turn to *next* in data collection? And for *what* theoretical purpose?" A recent example of theoretical sampling in action is the work of Parkhe (1993), who followed the lead of Glaser and Strauss (1967) and Yin (1984) when outlining a normative programme for theory development in international joint ventures, comprising a single-case study on multiple sources, and literal and theoretical replication through multiple case studies. Note that an *a priori* set of selection criteria is not required by, and in fact contrary to the logic of, theoretical sampling; yet, for a pilot study, as we have presented above, it seems necessary to lay down a few signposts that can guide initial case selection.

In accordance with the exploratory nature of this research, sampling, analysis and theory building are interwoven processes. Data collection and parallel data analysis feed into an emergent theory which in turn orients further efforts of data collection. This process implies constant comparisons between cases that have already been analysed and those yet to collect information about, making sure that variance in the dependent variable, the *sine qua non* of all comparative studies, will be present. The emergent theory controls the process of data collection, hence the name, 'theoretical sampling'. Its dominant logic, as in experimental designs, is replication, rather than 'sampling' as in survey, or variance analysis in general.

In this research, we could only approximate this ideal procedure of selecting cases one by one as the emergent theory suggests. On the basis of the emergent theory based on the two pilot cases, six further cases were selected. First, possible case subjects were selected from an updated version of the aforementioned SPA-list of privatised enterprises. Second, a short-list of ten firms was prepared on the basis of information gathered from our own vast archive of press-clippings. This information was used to judge if certain firms were acceptable by the criteria presented in Table 13. Firms on which cases had already been prepared by or on behalf of the Institute for Privatisation Studies (a semi-independent research organisation often commissioned by the SPA) were also excluded, since we believed that following such an earlier research inquiry our investigation might be unwelcome, if not rejected altogether. Finally, this short-list was finalised, and reduced to six firms, with the help of a former high-ranking SPA-officer who, due to his position, was familiar with most of the cases handled by the SPA. His assistance helped us determine if necessary variance amongst cases could be expected.

One of the six firms chosen had to be dropped when, following our choice, the firm became the beneficiary of a state rescue package and its privatisation was postponed. On another firm, we prepared a case study in Hungarian (as in all but two other cases, for the purpose of communicating with the managements), but then decided to leave it out from the sample for several reasons. First, due to lack of more information, this case study covered only two years, not permitting a relatively complete account of the privatisation process. Second, this firm became the subject of an investigation carried out by the SPA's internal Investigation Office, due to some alleged procedural mistakes in the privatisation process, and because of the appointment of a former SPA-employee for the position of managing director of this firm, who then was interested in a management buy-out. We believed that a research inquiry could be mistaken by possible informants as a disguised element of the said investigation, reducing the possibility of preparing a true and fair account of the events. Third, and most importantly, many of the apparent features of this firm's privatisation process seemed to simply 'imitate' characteristics known from other cases, without adding to the emergent theory, implying that "conceptual saturation" (Strauss and Corbin, 1990) may have been reached. The number of the case studies was kept relatively low not only because 'conceptual saturation' appeared to emerge but also because an optimal trade-off between width and depth was sought. After the pilot studies revealed a quite different story from what had been expected, a choice was made in favour of depth; we considered it very important to gain as detailed and complete a picture as possible of what was actually going on in the privatisation processes.

In sum, the first two pilot cases were followed by four more cases, selected not one by one but at about the same time. This approach was also made necessary by uncertainties surrounding our access opportunities. After the general elections, on the eve of moving the SPA and SAMCo together as a preparation for their eventual integration in 1995, not only people but also archive files were to be moved, implying that personal contacts labouriously built up would soon evaporate and documents would not be accessible for a long period. Two backers of this researcher were also expected to leave the privatisation agencies.

Access, confidentiality, and anonymity

Throughout this research, issues of access, confidentiality and anonymity required careful attention. Once the cases had been selected, we employed a range of tactics to enlist support from all possible informants, interviewees and document keepers alike. These tactics, actually used in combination as some of them opened the way to the use of others, included the following:

- Letter of reference from supervisor, reference to academic background[61], and old school-ties[62] were used to obtain commission letters from the SPA for the pilot cases.

- Letter of reference from a publisher with an attached copy of the manuscript of this researcher's paper on privatisation (Antal, Z., 1994), letter of recommendation from a former SPA-executive, and a presentation of our research were used to obtain commission letters for further cases.

- Commission letters from the SPA, reference to academic background, assurance of confidentiality and anonymity and, in the follow-up stage of one case, a family tie[63] were used to enlist support of private owners and/or top management of firms involved.

It was clear that no thorough cases could be prepared without the support of the State Property Agency. First, the SPA had a vast amount of documents on each case that were nowhere else available. Second, the SPA also had documents that could only have been collected from numerous and diverse sources. Third, even if the SPA did not retain majority in a firm, its commission letters were expected to 'oil the wheels' at the firms concerned on the assumption that managers would be less reluctant to disclose information if this researcher's in-depth familiarity with their cases (made possible by the SPA assignments) were indicated.

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[61] At the time, this researcher was an assistant professor of management at the Budapest University of Economic Sciences which was believed to increase his credibility.

[62] One of the the SPA-executives had once taught the author for three semesters; another had been a study group mate for two semesters. After the initial contact, only the first connection was relied upon.

[63] In one case, the subject of our case study was acquired, during a follow-up phase, by a group of investors, renowned for being closed to any outside inquiry. One of the owners who also acted as CEO of the acquired firm at the time had been a former colleague of this researcher's wife. After this fact resurfaced in an introductory meeting, the initial rejection turned into full support admittedly only because of "assumed trust" based on this link.

This researcher was advised to channel his work through the Institute for Privatisation Studies (IPS) which regularly produced case studies for the SPA. Thus, all the cases selected for this study were formally covered by commission letters, signed by the managing director of the State Property Agency, for the author to prepare case studies for the IPS on behalf and for the benefit of the SPA. The official assignment allowed us to request documents related to the cases and to conduct interviews with the SPA-staff. Communication with the SPA-staff was further facilitated by the fact that this researcher was provided a temporary office and often could be seen in the building (with due observation of the apparent dress code), which may have lent him a look of 'one of us'. The commission letters also made it possible to approach the firms still run by SPA-appointed management at the time of the initial contact with a look of having authorisation.

All those involved – the SPA, the IPS and the firms themselves – were aware of, and agreed to, the final utilisation of the cases for the purposes of the research presented in this thesis. While the commission letters provided authorisation to prepare case studies, and for that purpose, to have access to confidential information, both the SPA and the firms required due observation of confidentiality and anonymity. Therefore, we followed a protocol to disguise the organisations and persons appearing in the case studies, as summarised in Table 14.

Table 14 Tactics used for disguising case subjects

Tactic	Used for disguising
Aggregation	Industries
Changing nationality	Foreign organisations and persons
Using pseudonyms	Organisations (firms and institutions) Persons
Rounding Expressing value in relation to another value Multiplying values by a constant	Quantitative data
Lack of specification	Exact date of occurrence of events

In disguising industries, the level of industry specification was raised, making sure that the main structural characteristics of the given industry remained unchanged. Subjects of the cases and other organisations as well as persons were disguised by an 'expressive pseudonym', allowing an overall impression of their qualities. The nationality of the actors involved were also changed in some cases.

Quantitative data were disguised in one of three ways. When it seemed sufficient, for example with the number of employees, simple rounding was used. In some cases, a value was expressed in relation to another value (for example, cash bid as a percentage of par value of the stock). Finally, where specific values were given, they were multiplied by a constant (a number between 0.8 and 1.2), thus preserving the correct ratio of values.

In order to disguise the exact date of occurrence of events, only month and year are indicated in the case studies. Events within a month are listed in chronological order. This tactic ensures that the length of periods between discrete events is unchanged, and permits micro-level events to be linked to trends in a broader context.

5.4 Data collection and case analysis

Information for the cases were collected from three main types of sources: documents, interviews, and press reports.

Documents at the SPA, held by central and departmental archives and by case officer(s), were of great variety. Some documents, relating to the same case, often had to be obtained from more than one case officer, and sometimes from more than one directorate of the SPA. Cardboard boxes and folders full of documents without any apparent filing system were browsed through. Apparently more important parts of documents were not noted but read aloud and recorded for making a transcript in the evenings. This 'repetitive noting technique' helped us increase sensitivity to relevant issues. In order to keep track of the vast amount of documents on each case (from 0.5 to 2.5 meter paperstack per firm), and to organise our notes and transcripts, a simple filing method was developed around subjects, dates and sources. To indicate the range of documents studied, examples are listed below:

- Documents relating to investment tenders: Information Memorandum, call for bid announcements, bids submitted, minutes taken at meetings of tender evaluation committees;
- Documents relating to executive appointments: job tender announcements, applications, appointments, bonus descriptions, evaluations;
- Advisors' applications submitted to the SPA, reports, analyses and sales recommendations prepared by privatisation advisors;
- Briefs and proposals prepared by SPA staff for SPA decision-making bodies (Privatisation Branch Committee, Management Meeting, Board of Directors);
- SPA internal memoranda,
- SPA Board minutes and resolutions, minutes of Management Meetings;
- Share sale contracts, syndicate agreements;
- Company Deed of Foundation, Articles of Association;
- Proposals from management to Enterprise Council, minutes of Enterprise Council meetings, documents prepared for and minutes taken on company board meetings and shareholders' meetings;
- Correspondence between parties involved in the process of privatisation (SPA, management, union, consultant, potential investor, government bodies, lawyers, party politicians, ministers and state secretaries, banks, local government, taxation office, etc.);
- Personal remarks on post-it notes.

Note that the documents held by the SPA actually constituted of a very wide range of sources of information. It should also be noted that we often had the opportunity to peruse different draft versions of the same document which permitted the tracking of changes in viewpoints and positions. We could also compare representations of the same event by different persons. Finally, the margin notes and remarks made on these documents while they were being circulated in the SPA proved to be a useful source of information, too.

Other documents were provided by the firms themselves, including minutes of executive meetings, financial reports, organigrams, plans, budgets, etc.

The next main source of information was the interviews conducted with SPA staff members, owners, executives and in some cases other employees of the firms concerned, and other key informants such as consultants involved in privatisation. Interviews were arranged after the author had obtained familiarity with the cases from press reports and the documents held in the SPA.

Interviews usually started with some initial time spent to build trust, to communicate interest in the firm and commitment to a thorough case study, and to give interviewees assurance of confidentiality. The interviews followed a semi-structured format, suitable for interviewing élite (Marshall and Rossman, 1989:94). For each interviewee, a contact summary sheet (see Miles and Huberman, 1994:51-53) was developed. It included a 'tailor-made' list of issues, taken from a general list of questions, and modified according to the interviewee's position, known or presumed part he or she had played in the privatisation process, and occasionally, what had been said by other interviewees in preceding discussions. This list was used in a free manner as unexpected but interesting details arose.

In case of some 'critical interviews', conducted with executives who were known to have played an important part in the events, after some initial time for building trust, interviewees were asked about the use of a tape-recorder, which was purposefully kept in sight from the beginning.

Typically, the more ambiguous issues were revealed in the course of document analysis and the more details required further clarification, the more interviews were conducted in relation to a particular case. Furthermore, in the cases that we considered exemplary in the light of the emergent theory ('prototypical' cases in the sense that they appeared to fit neatly to the whole theoretical framework), attempts were made to hold discussions with a diverse range of interviewees. A smaller set of interviews was deemed sufficient in other cases, which served the purpose of concept development, or validating a particular relationship rather than corroborating the whole framework. In some cases, self-appointed interviewees who wanted to have their opinion heard were also included with the only purpose of signalling the researcher's genuine commitment to a thorough understanding of local details. Thus, at two firms the number of interviewees reached more than a dozen, including owners, executives, middle managers in headquarters, plant managers, union leaders, ESOP trustees, and a driver (the latter chosen deliberately). However, in two other cases that appeared unambiguous on the basis of available documents and a discussion with the SPA administrator, only a few key informants were interviewed mainly for the purpose of validating a draft case study. Finally, interviews were also a matter of personal collaboration with the researcher.

The third source of information was a systematically collected set of press reports on the firms involved and their industries. Some of the cases received considerable attention and publicity. Press reports were also used to 'clue up' about the firms before conducting the interviews, and to establish issues that would need special attention or clarification during the discussions. This type of source of information included:

- articles and reports available in English in Financial Times and via Reuters News Service;

- the complete series of Privinfo, a Hungarian bi-weekly specialised in privatisation, officially supported by the SPA;

- press-clippings of thousands of articles related to privatisation that had appeared since 1989 in 'HVG' and 'Figyelõ' (two economic weeklies) and in three of the Hungarian dailies with national coverage;

- a selection of articles from local papers and company newsletters.

Based on these sources of information, detailed chronological case histories were prepared. Subsequent analysis was carried out at two levels: within each case, and across all the cases.

Following Miles and Huberman's (1994:10) definition, analysis is viewed in this research as "consisting of three concurrent flows of activity: data reduction, data display, and conclusion drawing/verification." For intra-case analysis, displays and networks (see Miles and Huberman, 1994) were used

- to reduce, simplify and abstract raw data in a process of identifying relevant information[64], and

- to display information in a way conducive to

- drawing and verifying conclusions in the light of our emergent framework.

In Chapter 6, the results of intra-case analyses are summarised in lists of critical events. These lists represent a modified version of Miles and Huberman's (1994) critical incident chart in that we have also incorporated notes and comments that provide background information and explanation. While these lists may seem

[64] For this purpose the use of computer-aided content analysis (Miles and Huberman, 1994; Weber, 1990) was contemplated, and subsequently rejected. First, it seems most suitable for developing a 'pure' grounded theory where the theory is built on (and locked in) the data with no prior theorising. However, while there has been no developed theory on our research question, there was considerable scope for *a priori* theorising to guide our research. In addition, there were several practical reasons against the use of this method, the two most important being the impossibility of digitising the vast amount of text within our time and resource constraints, and the coding problems stemming from the fact that much of the 'raw data' in text form were in Hungarian.

lengthy, note that they have been derived from thousands of pages of raw text data, through a focused case chronology of about 100-200 pages per case.

Further results of intra-case analysis, namely the analysis of each case in the light of our research framework, appear in comparative tables in section 7.2. These tables arrange the cases according to their qualitative scores, as judged by this researcher, on the dimensions of the conceptual properties. Qualitative judgements are tightly linked to information provided in the cases.

For cross-case analysis, the case survey method (Larsson, 1993; McPhee, 1990), that is a quantitative analysis of information from a large number of cases, was considered inappropriate partly because of the same problems that excluded the use of large sample-based taxonomy-design (see section 5.2). In addition, the use of case studies prepared by other researchers was precluded by the fact that we could locate only one (from about 70) that was prepared on a firm meeting our criteria (see Table 13) *and* provided sufficient detail for a meaningful comparison. Instead, we followed the underlying logic of pattern matching that compares an empirically based pattern with a predicted one on the basis of different aspects of the phenomena concerned (see Campbell, 1966; Parkhe, 1993; Strauss and Corbin, 1990; Yin, 1984). While promising attempts have been made recently to develop a formal protocol for quantitative pattern matching (Larsson, 1993; Levie, 1995; Vagneur, 1995) this route was not taken in this research. Conclusions were instead corroborated by matching patterns observed in the cases with our theoretical propositions in a qualitative way. In this sense, this research remains a pure qualitative study in that it does not employ quantitative methods of data analysis, although it makes use of quantitative data.

CHAPTER SIX

6. Case narratives

6.1 Introduction

In sections 6.2 to 6.7, six cases are presented. Each case begins with a brief introduction of the firm (the 'stage') and the actors (the 'players'), followed by a narrative of the privatisation process (the 'play').

Actors are identified by 'Expressive Pseudonyms'. Those who appear in all or most of the cases are listed in Table 15 (overleaf0. The reader may also wish to consult the Appendix that presents a summary of style convention followed, special terms, abbreviations and acronyms. Note especially that actors, persons and organisations alike, are usually given pseudonyms according to their titles, ranks or positions (such as General Director, Second Administrator, or State Commissioner), or a characteristic feature (such as Mighty Multinational, Large Licensor Company, or Expatriate Investor).[65]

For the purposes of the thesis, a chronological format of the presentation of the privatisation processes was chosen because it "focuses directly on the major strength of case studies ... that case studies allow an investigator to trace events over time" (Yin, 1984:113). The time-ordered flow of events is summarised in 'Lists of critical events', adapted from Miles and Huberman's (1994) 'Critical Incident Chart'.[66] The critical event lists take a standardised style. They present the main events before, during, and after privatisation. Phases of the process are distinguished and labelled

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[65] These pseudonyms, of both persons and organisations, are used as proper names (as opposed to common nouns), that is *without a preceding definite article* throughout the text.

[66] In terms of content it approximates what Abbot (1992) calls a 'plot' – the events arranged in a loose causal order. Since the 'plot' unfolds over time, the chronological presentation is maintained here.

according to their main theme. Events are detailed, substantiated with quotes[67], explained and/or put in context in a distinctive text format. Unless stated otherwise, sources of quotes are normally the last explicitly mentioned document (such as a letter, a memorandum or a brief, without specifically indicating) or retrospective interviews (indicated by giving pseudonym of the interviewee).

Table 15 Actors appearing in all or most of the cases

Name (acronym, if any)	Note
Insiders	
The firm, the company	the firm concerned, unless identified by pseudonym
General Director	the chief executive of the firm concerned
Deputy general director (in charge of ...)	one of the deputies of the chief executive (in charge of a specific field such as production, sales, finance, etc.)
Enterprise Council; and its Chairman	self-governing body of the firm while it is still a state-owned enterprise before 'transformation'; chief of this body
Board of Directors and Supervisory Board	governing bodies of the firm concerned after 'transformation'
ESOP	the 'Employee Share Ownership Programme' organisation or its organising committee
ESOP Leader	chief of the Trustees
ESOP Trustee(s)	member(s) of the ESOP organising committee, or leaders of the ESOP organisation itself (once it is established)
Local Union Leader	Chief of local labour union
The State	
State Property Agency (SPA)	in existence from March 1990

[67] Quotes from interviews conducted in Hungarian and from written sources produced only in Hungarian are presented in the author's translation. Quotes were translated in an effort to induce the least possible distortion; instead of an 'interpretative' approach, literal translation was hoped to serve this purpose at the expense of smooth reading, except for a few cases (for example, figurative expressions, 'bureaucratic' Hungarian).

Name (acronym, if any)	Note
Responsible Politician	a political appointee (at least to some extent) who is likely to transmit political considerations: any of the minister in charge of privatisation or the chairman of the SPA's Board of Directors or a distinguished member of this board
SPA Board of Directors	top decision-making body of SPA; members are appointed by Prime Minister
SPA Management Meeting	second-level decision-making body; includes SPA leaders and directors
Privatisation Branch Committee	third-level decision-making body; includes SPA officers and representatives of other organisations (e.g. Ministry)
SPA Leader	any of the managing director and his deputies
SPA Director SPA Deputy Director SPA Administrator	officials of various rank, *directly* dealing with the case concerned; numbered or otherwise indicated if they succeed each other (for example, First Administrator, or New Deputy Director)
Other SPA officials	as introduced in the cases, usually support-staff (legal experts, auditors)
Ministry	the ministry which the firm concerned belongs to
Ministry Officials	any civil servant within Ministry, with the rank of a State Secretary, Deputy State Secretary or Head of Department
Competition Office	oversees adherence to rules of fair competition
Outsiders	
Bank	'the' Bank (with initial always capitalised) is the main bank of the firm concerned; usually the largest creditor; may also be provider of an Existence-loan for management/employee acquisition
Advisor	advisor to the State Property Agency
Consultant	advisor to the management and/or the ESOP organisation of the firm concerned; may also advise investor
Auditor	auditor of the firm concerned
Also appearing	
investors (who may become bidders), banks, various domestic and foreign institutions, party politicians, nation-wide union leaders, lawyers etc. as introduced in the cases	

Note: When it is important to distinguish between two actors with the same pseudonym (for example, two Responsible Politicians), it will be indicated in the text.

Foreign actors normally stated values in terms of US dollars (US$), British pounds (GBP), or Deutsche Marks (DM), whereas data on Hungarian firms and values given by domestic actors were usually in Hungarian Forints (HUF). To ease comparison, all values are given in Hungarian currency, calculated with exchange rates shown in Table 16.

Table 16 Exchange rates on the last day of the year, 1989–1994

(medium rate in forint terms, for one unit, unless otherwise indicated)

Currency	1989	1990	1991	1992	1993	1994
US Dollar (US$)	62.54	61.45	75.62	83.97	100.70	110.69
Deutsche Mark (DEM)	36.87	40.47	49.83	51.96	58.06	71.47
British Pound (GBP)	100.23	116.58	141.48	127.03	148.90	173.11

Source: Annual report 1994. Hungarian National Bank, Annex B/III/2

6.2 Struggling through – Food & Beverage 1

6.2.1 Introduction

'Food and Beverage 1' (FB1) operated in a certain branch of the food and beverage industry comprising a handful of major suppliers. When its privatisation process began, FB1 was the third largest firm with a market share of about 13% while its largest competitor had more than 30% and the smallest about 4%. With a net asset value of HUF 0.9 bn and some 1100 employees in 1989, FB1 was a middle-size firm in the Hungarian industry, yet a very important local employer and, due to its business domain, a significant taxpayer in a mid-size town.

Prices were fully liberalised in 1989. Demand had risen until 1991, but turned into a sharp decline in 1993. Demand was seasonal with a summer peak. For FB1, seasonality was amplified by its dependence on tourism.

All producers had license agreements with Western firms. In FB1's case, brands produced under a license agreement accounted for about 33% and 40% of the total sales and operating profits in 1989, respectively. Four competitors, including the second largest, had already been privatised by 1991, with foreign companies holding majority stakes in each.

Table 17 Main actors in FB1 case in order of appearance

Name (acronym, if any)	Note
Insiders	
Enterprise Council Chairman	also Deputy general director in charge of economic matters, a locksmith by profession
Discontented Middle Managers	led by Head of production and Head of capital expenditure; another core member was to become Independent Union Leader
New Managing Director	Head of production after taking over as General Director
Independent Union	company union
The State	
Cabinet Office	included representatives of ministries and other state organs before the elections in 1990
Outsiders	
Licensor	a foreign firm whose brand was produced by FB1 under a license agreement; later one of the bidders
Expatriate Investor	a potential acquiror who was born in Hungary but grew up and became a business man abroad
Consortium	consisted of three foreign firms, including Licensor; bid
Major European Company (MEC)	a potential investor
Another Major European Company (AMEC)	another potential investor
International Financial Institution (IFI)	might team up with a strategic investor to invest in FB1
Atlantic Major Company (AMC)	another potential investor
Small European Company (SEC)	succeeded Licensor when it took away its brands

Name (acronym, if any)	Note
Domestic Investment Firm (DIF)	owner of FB1 for a short period
Major International Company (MIC)	the eventual owner (third after the SPA)

Note: for a list of actors appearing in all or most of the cases, see Table 15.

6.2.2 Case narrative

Table 18 Event history – critical incidents in FB1's privatisation

Date/Period	Description of Event
	'Spontaneous' start-up
1987	License agreement of 1984 is extended; the idea of a joint venture with Licensor emerges; Licensor provides FB1 with equipment that is later to be acknowledged as a non-pecuniary contribution to a prospective joint venture
March 1989	Enterprise Council authorises General Director to discuss joint venture with Licensor
April 1989	Talks between General Director and Licensor
Summer 1989	Asset valuation, commissioned by Licensor, is carried out
July 1989	Letter of intent from an Expatriate Investor, meetings with government officials
	Competing offers
November 1989	Expatriate Investor submits offer to government for 100% acquisition General Director and Licensor draw up plans for joint venture Expatriate Investor presents two alternatives
Licensor's offer: FB1 is valued HUF 1.379 bn Equity raising by HUF 745 m, thus acquiring 35% in the enlarged company Equipment provided under the license agreement is valued HUF 248m (a few years later FB1 will acquire it for HUF 39m), cash contribution is thus HUF 497 m	Expatriate Investor's offers: First alternative: purchases 100% of FB1's assets as valued by expert firm Second alternative: equity raising in the amount equal to FB1's asset value, thus acquiring 50% of the enlarged company Revised offer: only 1st alternative offer is maintained As specified in December 1989: assumes debts of HUF 900m and pays HUF 830m cash

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">The choice</td></tr>
<tr><td>December 1989</td><td>Enterprise Council meeting first votes against Licensor, then chooses Expatriate Investor's second alternative</td></tr>
<tr><td colspan="2">The meeting was presided over by Enterprise Council Chairman. Six issues had been discussed before General Director presented the asset valuation and the talks he had had with possible investors. In his comments he favoured Expatriate Investor's offer. He appealed for the members "good decision," adding that "it is a difficult decision but I can state in my full responsibility that this management is not committed to anyone, only to the Enterprise Council, and to all the employees of the firm. The management has done everything in its capacity in order to ensure the cleanness and irreproachability of the preparations for the decision."

At the end of the discussion the report about the asset valuation was put to a vote and the Enterprise Council accepted it. Then the Chairman ordered a one hour break. After the break the members of the Enterprise Council were asked to choose between the Licensor and the Expatriate Investor. Once the Licensor's offer was rejected, the choice was reduced to one of the Expatriate Investor's alternatives.

The minutes of the meeting were certified only three months later, with an amendment. One of the two certifiers complained that he had asked Enterprise Council Chairman for the tapes taken at the meeting but he had not received them. He recollected that an expected loss of HUF 281m had been mentioned at the meeting by the Enterprise Council Chairman and this did not appear in the minutes. On the contrary, in the minutes one can see a reference made to a possible profit range of HUF 100–135m.</td></tr>
<tr><td></td><td>Expatriate Investor is pleased to learn about Enterprise Council's decision, but 36 hours later ...

in a fax he asks FB1 to agree to the first alternative instead</td></tr>
<tr><td colspan="2">"I undertook the second alternative of the economic renewal [of FB1] with the intention that in the long term ... I would buy up [all] the shares ... Now, that I started arranging matters, I see that the present legislation makes it very circuitous to establish the joint stock company. The proposal included in the first alternative seems much simpler, according to which [my company] buys 100% of the valued and audited assets of FB1. Since the final outcome is the same, I am asking the Honorable Enterprise Council – if there is no legal barrier to this and they agree with me – to consider and accept the first alternative." That is, with the same amount the investor would be the single owner (instead of holding 50%).</td></tr>
<tr><td></td><td>A day later, Enterprise Council extraordinary meeting changes previous resolution and agrees to first alternative</td></tr>
<tr><td colspan="2">This meeting was drawn together at unlawfully short notice (min. eight days required). The minutes of this meeting did not go into detail; it simply stated the resolution. One interviewee believed that the Enterprise Council members "did not know what it voted for," "they could not differentiate between the alternatives." The heads of the Production Department and the Capital Expenditure Department were not members of the Enterprise Council, although these were usually considered 'strong positions' in the Hungarian industry in general and in the food and beverage industry in particular.</td></tr>
<tr><td colspan="2">The authorities' commitment</td></tr>
<tr><td></td><td>High level government officials commit to Expatriate Investor's offer</td></tr>
</table>

Date/Period	Description of Event
Cabinet Office Leader assured Expatriate Investor in a letter that he would initiate and promote the deal to be implemented as soon as possible, and that after the decisions by the Government and the Parliament, he would "intercede with the responsible ministers in order that the necessary permissions be issued out of turn." An assistant minister informed his colleague that his ministry had accepted the Enterprise Council's (modified) resolution. As the "quickest and least difficult" way of getting the transaction done, he proposed FB1 be drawn under ministerial control (which required Parliament decree), turned into a ltd. with the state as the sole owner, and then sold to Expatriate Investor. A proposal prepared for the Cabinet argued that FB1's economic situation was deteriorating; however, there was foreign interest in investment, so in the interest of the firm's development it was reasonable to draw it under ministerial control and then sell it.	
The time of discontent – the 'young Turks game'	
"It was a period of big fights, internal contentions, ... external supports [viz. lobbying]." (Independent Union Leader)	
January 1990	FB1's (internal) legal counsellor's letter to General Director and Enterprise Council Chairman argues against ministerial control
"It is against our intentions, against our autonomy. ... the Ministry [then] can sell the firm to anyone at its own discretion, and the collective ... will have no right to have a word about it!" He argued that the firm's plan for the next year projected [considerable] profits, therefore 'deteriorating financial position' was not a valid justification to draw the firm under direct state control.	
	Last Enterprise Council meeting had no quorum
It was again convened at unlawfully short notice. When asked whether the presumed loss mentioned at earlier Enterprise Council sittings or the profit prospects mentioned by the legal counsellor in his letter were the truth, General Director answered, according to the detailed minutes: "We must wait until the end of the Parliament's present sitting. If an unfavourable decision were made, I can take measures against it." When pressed about what he could do, given the present legislation, he stated, "the negotiations I have had to date and my personality are the guarantees that I have always represented and will represent the interest of FB1's working collective."	
'Young Turks' enter	
A middle manager (later to become Independent Union Leader), about 1990: "The management did not give much attention to the firm, because everybody was engaged in these internal problems. ... It could be felt that the managerial energy [was devoted] to something else [than business]. ... The management have no longer dealt with the firm; [they were only interested in] keeping the deal alive and in saving their positions ... The whole affair led to a clash. ... This was a very baleful, stormy period."	
	A group of middle managers' letter to an MP argues against deal with Expatriate Investor and FB1's being drawn under direct ministerial control, and attacks General Director
Arguments included: assets of FB1 had been undervalued; Expatriate Investor's financial background was questionable; FB1 would achieve profit in 1990; the sale would solve the problem of "some missing stock" ; 1990 was the year of re-election of the increasingly unpopular General Director, and the sale would secure his position for the next 5 years. The group started a fight against what they saw as fraud and dark prospects for FB1. They believed that a fulfilment of all the promises made by the prospective acquiror, coupled with his need to tap FB1's cash flow in order to repay debts, would suck out resources and lead to an eventual collapse.	

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">Seeking support with modest success</td></tr>
<tr><td>January – April 1990</td><td>Middle managers seek support from ‘outside influencers’</td></tr>
<tr><td colspan="2">Further letters were sent to another MP, county chief police commissioner, county public prosecutor, Ministry, State Audit Office, SPA. (Throughout the year, many more letters followed.) A press campaign began. An independent union was established by middle managers; workers soon join in increasing numbers. Heated public demonstration was held on main square of town. A speaker cited “one of the top managers” who one day earlier, in the county’s local press, called the commencing resistance a “conceptual manifestation stemming from resentment, increasing desire for power, weakness of mind and character.” The speaker noted, “we regret that the management of the firm so appraised the responsibility felt for the factory by [the group of middle managers]. Those who squander the factory should not cover themselves by referring to responsibility.”</td></tr>
<tr><td>February 1990</td><td>Five members of Enterprise Council enter an action in court, requesting Enterprise Council’s resolution be judged null and void; “management deliberately misled the Council”

Appeal made to Ministry to stay the sale, signed by 20 middle managers and dozens of workers

FB1 is drawn under ministerial control by Parliament

Authorities’ earlier commitment is cemented</td></tr>
<tr><td colspan="2">Minister issued letter of intent to Expatriate Investor, promised that a closed call for bids would be announced and Expatriate Investor would be granted first refusal right; assured that the SPA, once it came into operation, would regard the outcome of the negotiations with the Ministry as binding.</td></tr>
<tr><td>March 1990</td><td>SPA comes into operation

Enlarging group of middle managers protest at the SPA</td></tr>
<tr><td colspan="2">“We object the 100% sale because we do not see guarantees that our firm will directly gain from the deal [and] because the ... management reached the resolution concerned by misleading the Enterprise Council members.”</td></tr>
<tr><td></td><td>Small group of employees’ letter (allegedly encouraged by General Director) to the Ministry supports the deal and attacks middle managers

Debate between SPA and Ministry on authority</td></tr>
<tr><td colspan="2">The Cabinet Office and Ministry argued that Expatriate Investor’s offer was the best possible; Ministry favoured closed (invitational) tender. SPA suggested open call for bids, “according to the rules, contrary to prior government-level (or seemingly government-level) commitments,” and stated, “It is the SPA’s right to make a decision.”</td></tr>
<tr><td></td><td>Ministry orders an investigation of “various abuses” at FB1

Expatriate Investor meets about 400 workers, outlines bright future; Head of Production starts an argument

SPA Leader seeks support from an MP</td></tr>
<tr><td>April 1990</td><td>Open call for bids is advertised, somewhat in concealment

Expatriate Investor protests against open tender call</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>Protesting letters from middle managers and employees to various state officials; SPA Leader assures them he will not agree to a deal if they oppose

Only two bids are submitted: Licensor and Expatriate Investor confirm earlier offers. Ministry proposes Expatriate Investor be given an option “which would not harm the interest of anyone.”</td></tr>
<tr><td colspan="2">Ministry official’s arguments included: Licensor wished to acquire 35%, while Expatriate Investor sought 100%; Expatriate Investor’s offer was higher by X million, and wanted to keep the profit in the country, he wanted to modernise, did not plan lay-offs; the sale had unanimously been initiated by the Enterprise Council and was supported by the majority of the employees; a letter of intent had already been issued to Expatriate Investor, and the transaction had been approved by another ministry; only a few employees had objected from personal motives, hindering progress by swaying public opinion in an undesirable way.

Note that 100% sale is preferred on its own right to an acquisition of 35%; and that the price difference between the two offers, as presented by the Ministry official, results from directly comparing differently structured deals. Expatriate Investor’s offer was indeed higher by X million than the sum Licensor had valued FB1. However, Licensor’s valuation pertained to FB1’s current assets, while its offer included a capital raising and thus acquiring 35% interest in (original value + additional equity). In fact, in relative terms Licensor valued FB1 significantly higher than Expatriate Investor, and was prepared to pay a better relative price even for a minority stake. Yet, the presentation of the offers as laid down in the Ministry official’s arguments suggested quite the opposite, and these arguments were repeated several times in various documents. Also note that some arguments could also be said about Licensor’s offer.</td></tr>
<tr><td>May 1990</td><td>SPA Leader visits FB1, announces decision “pro-sale”

SPA Leader’s brief to Prime Minister and letter to designated Prime Minister presents Expatriate Investor’s offer as by far the most favourable

SPA Leader assures Expatriate Investor in a hand-written letter</td></tr>
<tr><td colspan="2">“Dear [first name] I am writing to you personally ... I managed to contact [Prime Minister and designated Prime Minister] and I assure you your option is firm and will be honoured.”</td></tr>
<tr><td colspan="2">The option period</td></tr>
<tr><td></td><td>Expatriate Investor is given option for 6 months; asks management to refrain from major decisions; gets involved in decision-making at FB1</td></tr>
<tr><td colspan="2">He mediated a purchase of imported used equipment. This deal was presented to SPA by General Director as exceptionally favourable. Later the purchase was attacked by middle managers as a waste of money on junk.</td></tr>
<tr><td></td><td>Middle managers’ letter to another MP attacks General Director, Expatriate Investor, SPA Leader</td></tr>
<tr><td colspan="2">Expatriate Investor conducts “most of his negotiations in week-ends, or after working hours, at the General Director’s apartment or his [wine] cellar. ... It seems the point in all this was only that the transaction could be managed still by the old government.”</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>June 1990 and onward</td><td>Some letters present Expatriate Investor as a resourceful investor. Expatriate Investor seeks money and bank guarantees.</td></tr>
<tr><td colspan="2">Expatriate Investor wanted to take a loan to be taken from a foreign bank. Since foreign banks could not register mortgage on Hungarian property, "a Hungarian bank is necessary, which gets the mortgage, and if I go bankrupt, it swallows FB1, and repays the money to the [foreign] bank." (Press interviewee with Expatriate Investor.) That is, in case of bankruptcy, he would lose only the assets he would acquire from a loan that was to be obtained by mortgaging the very same assets.</td></tr>
<tr><td>July – August 1990</td><td>Licensor, apparently treating Expatriate Investor as effective owner, wishes good luck in his "fight with bureaucracy."

Independent Union's membership exceeds that of old one</td></tr>
<tr><td colspan="2">It was founded by 85 members, although only some 40 turned up on the founding meeting. "45 did not dare to come," said its Leader. "On the next day we were up to 200, then the union grew up to 400 members in a few moments, exceeded the number of the [the old] union, and eventually stabilised at 6–700 members."</td></tr>
<tr><td></td><td>New leaders are appointed at Ministry and SPA

Tax Office launches investigation

Ministry (triggered by objections raised by representatives of the largest governing party, whom had been contacted by the middle managers) raises concerns about deal with Expatriate Investor

SPA Leader and Ministry official decide to wait</td></tr>
<tr><td colspan="2">SPA Leader's letter: "It would not be advisable, in the interest of good foreign reflection of the Hungarian economic conduct," to initiate the sale of FB1 again, i.e. to withdraw Expatriate Investor's option.</td></tr>
<tr><td>September 1990</td><td>FB1 is transformed into ltd.; SPA is the sole owner; a protesting middle manager gets a seat on Supervisory Board</td></tr>
<tr><td colspan="2">Note that timing was of essence here. Due to seasonality, FB1's operating profits were at peak when the transformation occurred. According to the law, FB1 had to pay tax after its peak-level profits as of the day of transformation.

Later it turned out that the outstanding results of the Summer season were considerably lower when matched with liabilities. An interviewee "Expatriate Investor did everything he could to hide the profits," so that "there be no cash," but "a huge stock accumulated," and "they did not pay tax, so tax arrears accumulated," "the way of selling [our products] was also rather a waste than a sale, since receivables increased but less payment was made, and it is still [in 1993] irrecoverable."

It is understood that General Director himself put forward the proposal of the middle manager to be elected. This move was later described by the person concerned as an attempt to satisfy the quarrelsome, which itself was said to be only one part of an "if you cannot beat them, try to enlist them" tactic.</td></tr>
<tr><td>October 1990</td><td>Tax Office investigation reveals arrears

SPA's draft contract is prepared, asking for a price higher than in the option to acknowledge seasonal profits and a proper asset valuation. Expatriate Investor protests.</td></tr>
<tr><td>November 1990</td><td>Sale contract between SPA and Expatriate Investor signed on option-terms. Payment due within 25 days.</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">'Who is going to pay for it, anyway?'</td></tr>
<tr><td>December 1990</td><td>Expatriate Investor fails to pay; misses extended deadline, too; gets final notice from SPA

Middle managers increase pressure on SPA; Vice mayor joins supporters; Independent Union Leader threatens SPA with strike</td></tr>
<tr><td colspan="2">"The control over [this] privatisation has fallen out of your hands. You are driven by the events, or the buyer's behaviour. ... We are asking you, how long can it be going on like this? How longer will you stand it and how longer do you think that the employees can bear the feeling of being in uncertainty and having been swindled? We state that we shift all responsibility upon you for the present ineffective privatisation ... You should have employed sanctions against the [top] management long ago ... We announce that due to the harm to the employees that has already occurred because of your deferring activity, we – depending on your answer! – hold out the prospect of STRIKE." Some parts of this letter became public in the press, which might be viewed as an additional pressure on the SPA.</td></tr>
<tr><td colspan="2">End-game</td></tr>
<tr><td>January 1991</td><td>Expatriate Investor misses last deadline. SPA abandons contract, plans a tender for consultants and a call for bids

SPA Leader attends workers' assembly, informs of abandonment of contract with Expatriate Investor

Expatriate Investor asks SPA Leader for more time in a letter</td></tr>
<tr><td colspan="2">"... [T]reat this as a personal letter from me to you. I do not mean that it is confidential, necessarily, because I want to make certain submissions to you about the FB1 project which I hope will become an official part of your file. ... The last thing I want to do really is rely on legal remedies I am supposed to have. ... I have come to appreciate your abilities and the grasp you have of complicated situations and the high standard at which you operate to protect the interests you represent. Similarly, I hope you have a reasonable estimation of my standards and what I have to offer." This letter was soon followed by another one to Responsible Politician.</td></tr>
<tr><td></td><td>Independent Union's letter (with hundreds of signatures) requests appointment of new General Director

A Deputy general director (described as mentor of two core leaders of middle managers) joins those discontented and signs a letter (with about 40 managers and 700 workers) that demands immediate dismissal of General Director; otherwise strike

General Director's allegedly self-interested contract with a business partner is attacked

General Director obtains supportive letters from customers, and attempts to cover an unfavourable purchase of used equipment (mediated by Expatriate Investor) with an expert's technical opinion

SPA suspends General Director, appoints 'mentor-deputy' to be acting general director

General Director is said to move documents in cardboard boxes out of the firm; safety measures are introduced by acting general</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>director; SPA is urged to fire General Director

General Director defends himself in a report prepared for SPA

'Counter-reports' are prepared</td></tr>
<tr><td colspan="2">Middle Manager on Supervisory Board and Independent Union Leader prepared (apparently harmonised) reports, describing General Director as "old fashioned, building on his network, keeping everybody around him in a state of being intimidated, following only his self-interest." Traditional union leader also acknowledged, "the trust in General Director has crumbled"</td></tr>
<tr><td></td><td>General Director goes on sick leave, and is allowed to take early retirement after recovery

Expatriate Investor reiterates his request for extension of deadline; claims that SPA Leader is under pressure of FB1's 'troublemakers'; seeks Ambassador's support who meets SPA Leader; sends letter to Foreign Minister; and one more letter to SPA Leader; accuses middle managers of colluding with Licensor</td></tr>
<tr><td colspan="2">He claimed that he could not take a loan because he had become a victim of protesting activists who had approached the managers of the local office of the Hungarian bank involved and asked them not to provide a guarantee.

At the meeting of the Ambassador and SPA Leader, the latter took Expatriate Investor's earlier 'quasi-personal' letter with "indecent haste," as Expatriate Investor wrote in one of his appealing letters later.

Expatriate Investor to SPA: "I have been purposefully prevented to complete my financial obligations by elements in FB1 ... I could not understand before why this group of people were so much against me purchasing FB1. I could understand that perhaps they had some grieviances against General Director. ... I now have been informed by a most reliable source that this group of people have a secret agreement with [Licensor] that if they get rid of General Director and stop the sale to me their position ... will be secure and they will receive a considerable amount of money. ... How could I know that there would be such a conspiracy against me."</td></tr>
<tr><td></td><td>SPA Board of Directors reviews the case, does not change its position</td></tr>
<tr><td>January-February 1991</td><td>When learning about failure of deal with Expatriate Investor, possible investors, including Licensor, express interest in acquisition

A number of press articles, taking position on both sides</td></tr>
<tr><td colspan="2">The case as reflected in the press at the time:

An article on middle-managers: "ambitious self-appointed executive-candidates," "court revolution" by "the authentic representatives of the 'people' with the help of intimidated [by them] workers." It was also reported that "Mr. Expatriate Investor has just returned [from abroad] with the necessary money," suggesting that he would be ready to pay in cash in any moment. In fact, Expatriate Investor asked for extension until the end of March.

Other titles: "Mr. Expatriate Investor was cornered with impossible deadlines." He "has fully drunk the poison cup, which had been mixed for him by 'bartenders' heated by adverse political and personal ambitions." Expatriate Investor was reported to say he was "a political football."

Another article presented the opposite story; General Director "used every opportunity to make Mr.</td></tr>
</table>

Date/Period	Description of Event
Expatriate Investor popular for the employees. It is said that the [Enterprise Council's] members had been worked on well in advance."	
February 1991	A letter to the Finance Minister: Expatriate Investor is "a swindler with a gift of the gab but with no money"; the letter prompts inter-office correspondence within government; sender and his address turn out to be non-existent Expatriate Investor appeals to Prime Minister in a letter, also published as paid advertisement, repeats arguments (including alleged secret agreement with Licensor) Job tender for position of General Director; three applicants (two outsiders); Head of production receives support from within the firm; SPA appoints him (from this point, becomes New Managing Director) SPA Board hears Expatriate Investor's case once more
March 1991	SPA Board's final resolution rejects reconsideration of Expatriate Investor's case; open tender with the assistance of external Advisor is prescribed New Managing Director completely reshuffles management; some middle managers are promoted License agreement is extended and amended; sets high annual sales target to FB1
Time is passing by	
April 1991	Advisor is selected; contract is signed only in June
September 1991	Valuation report prepared
November 1991	Advisor's Sales Recommendations prepared SPA Board decides upon structure of deal: injection of fresh capital and employee ownership of 12% to be undertaken
The deal is slowly being concluded	
December 1991	Several possible investors seem interested FB1 is converted into joint stock company, SPA owns all but one share, New Managing Director owns one share
February 1992	Advisor invites bids from 17 companies
According to an interviewee, some of those who turned up at this stage seemed to be seeking only market information and data on FB1 as a competitor of theirs (as opposed to being driven by a genuine investment interest). FB1's bitter experience was said to have been that one of the early inquirers, who did not submit a bid later, could easily run away with a new part of FB1's distribution channel, simply by outbidding FB1 with a bit of a tip.	

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">So much for competitive bidding</td></tr>
<tr><td></td><td>Only one offer, from Consortium, including Licensor
SPA rejects offer due to insufficient cash proceeds and conditions, but talks begin</td></tr>
<tr><td colspan="2">The offer: HUF 295m for all shares, capital raising of HUF 1,886m, 12% of shares offered to workers; offer is conditional on substantial debt and tax arrears forgiveness</td></tr>
<tr><td>March 1992</td><td>According to Advisor, FB1's bank creditors are getting nervous about FB1's deteriorating financial position
FB1's Supervisory Board requests crisis plan from management
SPA emphasises strategic prospects; Consortium emphasises current difficulties</td></tr>
<tr><td colspan="2">Change of tide</td></tr>
<tr><td>April 1992</td><td>FB1's management and employees initiate a buy-out</td></tr>
<tr><td colspan="2">A 'sleeping' ltd. (established by three then middle, now top, managers in late 1991 in order to take advantage of tax concessions available until the end of the year) was renamed, recapitalised by all participating managers and employees (about 420 people) and used as a vehicle in the buy-out transaction; FB1's directors and board members controlled about 30% interest in the vehicle, the rest being widely spread.
Note that at about this time general privatisation policy shifted (see section 3.4) which may have signalled to FB1's management and employees what the priorities were 'to be referred to'. Management and employees' proposal to SPA emphasised the importance of "the emergence of a group of Hungarian owners that is inevitable from the point of view of the country's stabilisation," adding that "in our view this solution could also be welcomed politically, since it satisfies the legitimate need that a middle class emerges on business foundations which can be a leverage to the economy."
An interviewee: "We looked after what changes of legislation were in the pipeline, figured a 'philosophy' suitable to them, that why could not a middle class with ambition but no money get a share from the cake of ownership ... [and] we were lobbying for the issue." Before and after submitting their offer, they tried to enlist various organisations and individuals. Even if they did not manage, "at least we knew where to improve the offer." The idea of a "pure management buy-out," however, had been dropped, because they believed that it would not have much chance due to lack of finance and appropriate political receptiveness. "The press would have jumped on us immediately, that the previous managers wanted to squander it, now the new ones want to steal it for themselves."</td></tr>
<tr><td>May 1992</td><td>Management rejects external analyst's opinion that FB1's poor condition is due to the present poor financial control; "WE SHALL NOT TAKE RESPONSIBILITY for the previous management's mistakes"
Revised buy-out offer is submitted; FB1's major Bank supports buy-out</td></tr>
<tr><td colspan="2">HUF 337m for all shares, financed from own sources (HUF 39 m), E-loan (HUF 168 m) and standard bank credit (HUF 130 m); all debts of FB1 assumed; it was intended to draw in external capital of HUF 900m after the acquisition</td></tr>
</table>

Date/Period	Description of Event
	Consortium revises offer; still conditional (on debt-equity swap by Bank) New interests are expressed: domestic group is considered dubious by SPA and resource deficient by Advisor; foreign company needs more time to make an offer
June 1992	Bank gives promissory note for buy-out Licensor is said to have deterred potential bidders and to have exploited its strong position to the full
Due to the amendment of the license agreement in March 1991, Licensor was believed to have a right to terminate the agreement in case of an unfavourable privatisation outcome. Advisor's report: "Licensor's Consortium has delayed discussions, presumably in the belief that its hand will get stronger as the company's financial position deteriorates further. Indeed, Licensor has implied in discussions that it would probably be able to acquire FB1 more cheaply in a liquidation sale."	
July 1992	FB1's General Meeting: maintaining liquidity should take priority over preserving production volume, market share and employment A local consortium is interested but believed to have no finance Major European Company (MEC, already having an acquisition in Hungary and planning to combine it with FB1) is interested but needs more time to submit formal offer Advisor acknowledges that management and employees are preferred by SPA, but proposes different deal financial structure, and favours equity raising to be managed by SPA instead of attempted by management and employees after privatisation
Sold, but ...	
	80% of shares are sold to management and employees for HUF 270 m; all debts are assumed; no conditions
September 1992	Call for bids for the remaining 20% of shares to be sold in exchange of compensation notes
October 1992	SPA accepts only offer, from management and employees
Price: C-coupons of a total nominal value of HUF 67m (then accepted by SPA at 120.7% of the face value; thus, total face value HUF 56 m; C-coupons then traded below face value). Note: privatisation in this way brought no new resources, no tax concession.	
During the year 1992	Conversion of commercial depots into limited liability companies
In search of an investor	
November 1992	FB1 sends out Investment Memorandum, seeking foreign investors to take minority position

<table>
<tr><th>Date/Period</th><th colspan="2">Description of Event</th></tr>
<tr><td></td><td colspan="2">MEC makes an offer
AMEC makes an offer</td></tr>
<tr><td colspan="2">MEC, as in letter of intent: HUF 2,357m capital raising, thus acquiring 48% of shares in the enlarged company
After some revisions, "Specified offer": 51.6% of existing shares for HUF 1,037 m, capital raising HUF 1,745 m, thus acquiring 76% interest</td><td>AMEC: capital raising HUF 900m for 35% interest; HUF 1,167m (of which HUF 584m equity) capital expenditure in 3 years</td></tr>
<tr><td colspan="3">Going for the big win</td></tr>
<tr><td>December 1992 - February 1993</td><td colspan="2">Negotiations between management and MEC, and AMEC
Negotiations between management and AMEC</td></tr>
<tr><td colspan="3">Management attempted to avoid becoming subordinated to MEC's other Hungarian acquisition (larger than FB1), and to achieve higher price. From management's letter to MEC: "If your market strategy is based on these two [firms] what will be the planned volume of ... production at [this firm]?" From a negotiation plan prepared prior to the management's discussions with MEC: "FB1 should operate as an independent company, should not be merged with [MEC's other acquisition]." "We must get exclusive rights to trade [MEC's leading brand] on the Hungarian market."
MEC pointed out that FB1's actual position was worse than presented in Investment Memorandum.</td></tr>
<tr><td>December 1992</td><td colspan="2">Management and employees assembly (practically, a shareholders' meeting) votes for MEC offer</td></tr>
<tr><td colspan="3">New Managing Director stated: "what the SPA could not achieve, the management ... could achieve in 2 months." Two weeks later, at the following assembly: "in spite of our greatest efforts, we could not achieve the investment of foreign capital in our Company in minority," adding that "it is certain that no matter who will come [as an investor], it will bring change, and it will for sure leave the agreement with Licensor [intact], even more, [the agreement] will be extended."</td></tr>
<tr><td>January 1993</td><td colspan="2">Office of Economic Competition seems to have no objection to MEC's acquisition of FB1
AMEC improves offer</td></tr>
<tr><td>January 1993</td><td colspan="2">Management and employees assembly changes earlier decision, now favours AMEC
Discussions with MEC are delayed, management fails to submit files to Competition Office; MEC urges management to submit files
MEC's Board approves deal but on worse terms and conditions than discussed</td></tr>
<tr><td colspan="3">As approved by MEC's Board: HUF 660m for 76% of existing shares (HUF 377m to repay management and employees' debt, HUF 283m net cash position), and capital raising HUF 1,745m</td></tr>
<tr><td>February – March 1993</td><td colspan="2">MEC conducts due diligence; revises offer, requesting a large sum and management and employees' remaining shares to be put on an escrow account by management and employees to safeguard against hidden liabilities
Versions of Preliminary Agreement with AMEC are prepared</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">AMEC would acquire 75% stake: equity raising HUF 1,360m, primarily to repay debts, and acquisition of existing shares for HUF 1,109m (reduced if audited asset value was less than expected). Bad relationship between AMEC and Licensor in their home country cast shadow on negotiations.</td></tr>
<tr><td>March 1993</td><td>Idea of investment by IFI emerges</td></tr>
<tr><td>April 1993</td><td>Management rejects MEC's conditions

MEC once more clarifies offer; relationship terminated by management</td></tr>
<tr><td colspan="2">MEC's last offer: acquires 76%, pays HUF 1,020 and assumes debts of HUF 1485, plus pays management and employees HUF 282; before the deal, management and employees put HUF 56m in an escrow account, and they put into escrow all remaining shares for 18 months (or more) as a guarantee.

Management's letter to MEC: "We have already expressed ... that the ... guarantee system [is] unacceptable for us ... as the enforcement of these depends only on your consideration in your clear majority position. Your [proposal in this respect] met ... a flat refusal at the meeting of our major shareholders. We cannot imagine that the members' meeting of [the vehicle organisation] would make the decision to accept the business with such terms and conditions ..."

Note that MEC's proposal was rejected by 'major shareholders' (in the vehicle organisation and, thus, in FB1), that is FB1's management.</td></tr>
<tr><td></td><td>MEC attempts to revive discussion to no avail

AMEC realises that Managing Director's one share prevents it from having 75% + 1 vote; debate starts with management who wants to keep 25% + 1 vote

Preliminary agreement with AMEC is signed (giving AMEC 75%+2 shares)

Management accepts mediating service of a consulting firm</td></tr>
<tr><td colspan="2">On the basis of circumstantial evidence, the management may have attempted to personally gain from the transaction in this way, believing that a deal with AMEC would be struck soon.</td></tr>
<tr><td colspan="2" align="center">Trying alone</td></tr>
<tr><td></td><td>Postponement of share sale and equity raising</td></tr>
<tr><td colspan="2">They hoped that at the end of the summer season they might have a better position to negotiate, or even an opportunity to "stand on our own feet." For the sake of safety, search for financial investors was to be continued; management was given flexible authorisation to negotiate 'the best possible' deal with any suitable investor.</td></tr>
<tr><td></td><td>IFI delegation visits FB1</td></tr>
<tr><td colspan="2" align="center">Tightening control by Bank</td></tr>
<tr><td>June 1993</td><td>Bank gets more position on FB1's Boards; FB1 has to accept, since "we are at the Bank's mercy"; New Managing Director is optimistic about sales prospects

IFI attempts to win over Licensor as strategic investor, or if not interested, to have the licensing agreement extended; these plans fall through later</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>Auditor, commissioned by AMEC, reports smaller value than expected</td></tr>
<tr><td>July 1993</td><td>Two day meeting of AMEC, management, FB1's Consultant, vehicle organisation representatives, Bank, Auditor</td></tr>
<tr><td colspan="2">From the minutes:

"AMEC: ... We wanted to sign the [final] agreement with FB1 today, but the auditor's report ... shows that [FB1's asset value is much lower than it was presented in the Information Memorandum of November 1992].

Management: ... if AMEC takes the auditor's report as 'gospel', then we would like to finish the talks. If you thoroughly scrutinised the auditor's report, you could find contradictions.

AMEC: It is not only the FB1's assets that must be taken into account, but its profit and loss statement as well. ... there is no profit. Sales are decreasing, expenses increasing, profitability of FB1 is further deteriorating."

Management: [when FB1 Ltd. was converted into a joint stock company] our objective was to arrive at the lowest possible value [in the asset valuation], since we were the buyers of the enterprise. [Note that management and employees formally filed their bid for FB1 only several months after the conversion.]

Auditor: Auditing of FB1 was the most messy I have ever done. Import[ed products] – according to [FB1's] data – are sold at a loss.

Consultant: Import products have never been sold at a loss.

FB1: Why did you document such silly things, Mr. [Auditor]?

Auditor: I asked you for the documents twice, yet I have not got them.

AMEC: Where does Mr. [Auditor] get the idea that FB1 is ripe for liquidation?

Auditor: Indicative are the financial structure, decline in sales, ..., frequent conversions and extensions of guaranteed loans. ... In my opinion, it is doubtful that FB1, without a foreign partner, will remain in business in the medium term.

Bank: I issue a written statement that, if the shares are sold to AMEC, then the stock ... will be entirely unencumbered. Our Bank at the same time issues a statement which shows the existing loans and we testify that we shall prolong them until 31 December 1993." The said statements were issued that day.</td></tr>
<tr><td></td><td>Scheduled date of signing Main Agreement is extended twice; management urges AMEC to strike a deal quickly

Licensor revokes license agreement with FB1, management believes because of their talks with AMEC; soon Licensor takes license to MEC's Hungarian acquisition

AMEC withdraws from prospective deal</td></tr>
<tr><td colspan="2">Final hope</td></tr>
<tr><td></td><td>Talks with AMC begin</td></tr>
<tr><td>Summer 1993</td><td>Directors of vehicle (including Independent Union Leader) criticise FB1's management in two letters which remain unanswered; FB1's top management is said to "have become alienated" from others</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>August 1993</td><td>FB1's sales are only 60% of same period last year; market decline is 'only' 20% on average; Bank urges firm measures, and indicates its tolerance is limited: "FB1 [should] make every necessary step without delay and with appropriate firmness, as happens at competitors already acquired by foreign companies."

AMEC confirms withdrawal, denies that the reason is Licensor's revoking of the license agreement, rejects the idea of a license agreement with FB1; makes a conditional offer for 100%, would pay HUF 1,750 m, but debts in part to be repaid from collected receivables, in part to be forgiven by creditors; offer is left unanswered by management until November

AMC's preliminary offer, subject to due diligence: equity raising HUF 620m, loan HUF 170m at 7% interest, loan HUF 1,000m at 17% to repay debts (currently bearing 27% interest), mortgage on all fixed and large part of current assets, both loans may be converted to equity; thus acquires 50%+1 share plus further 25% when loans are converted to equity

AMC's revised offer: HUF 679m equity raising, HUF 113m loan, conversion rules different</td></tr>
<tr><td colspan="2">AMC's consultant assured FB1's management that his client did not want to take advantage of FB1's being pressed by time to find a foreign investor so that it could become entitled to tax concessions.</td></tr>
<tr><td>September 1993</td><td>Privatisation of two firms still in state ownership (including the largest competitor and FB1's most direct competitor) is soon concluded; to be sold to foreign firms

License agreement with SEC; conditions are admittedly worse than FB1 had with Licensor

Some cost-cutting measures are introduced

Management visits AMC</td></tr>
<tr><td colspan="2">A top manager's report on the visit "... we can carry out the investment programme with any of the potential partners only if we provide the appropriate information, do not contradict our earlier statements, and frankly disclose the changes in expected figures."</td></tr>
<tr><td></td><td>AMC starts due diligence

Bank presents ultimatum to management: unless certain conditions (regarding sales volume, capital raising successfully concluded) are met; it will take over the shares at an "acceptable price"</td></tr>
<tr><td>October 1993</td><td>AMC's due diligence report shows serious problems; AMC withdraws.</td></tr>
<tr><td colspan="2">AMC Consultant's eight page letter pointed out: technological waste, quality problems, environmental pollution, and more: "Your capital spending budget as presented to us is inadequate," substantially higher investment is necessary. FB1's accounting records "are in a very poor shape. Management is not provided with the type of information needed to make intelligent and informed decisions. ... [you]</td></tr>
</table>

Date/Period	Description of Event
thought that the Company had made [X] million profit for the eight months ended August 31, 1993. A more careful examination of the books and records indicates that this figure was before accruals. Had these accruals been properly made, the statements would have shown [-1.44*X] loss. ... [H]ad you just ... followed what the Law requires in Hungary you would have arrived at a ... loss. ... Licensor's people, we understand, are already visiting [FB1's distributors] ... in order to convince them to join the new licensee's camp. There is a danger that you may lose to [MEC's Hungarian acquisition to which Licensor took his brands] as many as 1/3 of [your distributors] ... It seems that you have lost control over your [depots] and this is costing you sales. In this context, we have noted that your reasoning for organizing the depots the way you indicated to us when we first met (i.e. to ensure that there are no bad debts) did not work out at all. ...[T]here are disclosed and undisclosed tax problems that may affect your relationship with [Tax Office] and which may result in substantial fines. ... FB1's volume is seriously down – by 41%, to be precise ... [You] never expected to come under intense attack from foreign multinationals in the Hungarian food and beverage industry and [were] totally unprepared to defend [yourself], besides which, [you] did not have the financial means to do so either. ... Market surveys are not conducted with any accuracy or regularity and the information reaching management cannot be relied upon. The cost of each product is not known. ... FB1's management is very good at making [their products], but less good at understanding the market in which it is selling it. FB1 should, as I write these lines, be visiting [distributors] and introducing a new brand to them. Unfortunately, the Company has neither the resources nor the ability to do so. ... The facts, as they exist now, diverge greatly from what was represented to AMC in the month of August. AMC realises that the reason for this is more FB1's management's inability to develop information quickly rather than because of any attempt on management's part to distort the facts."	
	AMC's consultant outlines a Contingency Plan for possible co-operation with between AMC and FB1 so that FB1 can become entitled to tax concessions due to foreign ownership; IFI was also planned to join Managing Director re-contacts MEC; it refuses Repayment of part of management and employees' debt to Bank is planed to be covered from FB1's sources Quarrel between FB1's Managing Director and Independent Union Leader at management and employees assembly
From the minutes: Independent Union Leader: "no matter if we are talking about it or not, but at least we must admit to ourselves, FB1 is in a very difficult situation." Former Head of capital expenditure, now Deputy of New Managing Director: "It seems that it is not possible to find a serious partner for capital investment ... He guarantees ... that they will not make an unfavourable deal. However, due to the fact that the negotiations are still going on, he cannot say any more." An argument develops on why top management did not seek help from others. New Managing Director states one has to do one's job; those who want more involvement should focus on implementation.	
November 1993	Attempts to renew relationship with AMEC, under pressure due to having to strike a deal before end of year in order to be entitled to tax concessions; AMEC rejects once and for all AMC's Contingency Plan falls through

Date/Period	Description of Event
	Take-over
November 1993	Bank does not tolerate more delay in stemming the losses and objects to drawing on FB1's resources to pay back management and employees' debt. At management and employees assembly FB1's top management announces that shares have to be sold to DIF DIF acquires shares for HUF 80 m, all debts of both the firm and its owners (management and employees) are assumed
DIF was brought in by Bank. Terms and conditions were dictated, otherwise Bank would discontinue loans to FB1. New Managing Director: "We have no choice." The offer means doubling personal investments in a year (much less than some other offers would have granted). DIF is said to want to restructure and sell FB1 soon. Some argument arises, top management gets accused of mismanaging the search of investors, and neglecting running the business. Another line of quarrel develops between production and sales. A member of the once protesting middle managers, still a middle manager: "We made a big fuss three years ago but the team has entirely fallen apart by now. There should have been team-work in the running of the FB1, but unfortunately there was no sign of it."	
December 1993	FB1 is taken over by DIF, then in two weeks ... sells enough shares to a foreign (offshore) financial investor for FB1 to become entitled to tax concessions; shares can be bought back any time at same price
January – June 1994	DIF drastically restructures FB1; former top management is kept at second level positions; some others are fired; tight financial control, sales of assets, complete renewal of managerial information system; DIF and Bank renegotiate arrears with Tax Office; Bank converts some debt to equity, short term loan to middle term loan
May 1994	Information Memorandum is prepared by consulting firm
	FB1 is sold again
Summer 1994	DIF sells FB1 to MIC which already had a large acquisition in Hungary but never formally bid for FB1; price is unknown; the two acquisitions combined create the largest player in the industry
December 1994	News about drastic lay-offs as well as capital expenditure at FB1

6.3 Family silver somewhat tarnished – Precious Trading

6.3.1 Introduction

'Precious Trading' (PT) was a retail chain operator with 120 shops around the country, and employed about 650 people in late-1990. By 1992 the number of employees decreased to about 460, partly due to the divestment of some shops (see below), and partly due to the decrease in central administration as part of a streamlining effort (from 120 to about 70).

Until the early 1970s, PT enjoyed a monopoly position. A few small firms were established later, mainly in the countryside, without really challenging PT. In 1988 the firm still dominated the market. From 1988, trading constraints were gradually relaxed; by the end of 1989, domestic trade was fully liberalised. Several hundred retailers entered the market. In addition, the 'black market' (with an estimated market share of 30%) and, due to liberalised hard currency allotments, 'tourist imports' hit the firm. "The monopoly situation collapsed in a minute," said an interviewee, although as a chain, PT still remained the largest firm. Even in 1990, it could claim about 40% market share. At this time PT developed a wholesale business. Foreign trade, at least in one of PT's two main businesses, was entirely liberalised in 1989. In this business, PT's product mix mainly consisted of cheap Eastern brands, and its stock was losing value every time a new competitor offering attractive Western brands entered the market. PT then placed an emphasis on keeping a wide range of high quality goods in its shops, which increased its reliance on short term credit to finance the stock.

In 1990, its 'own capital' totalled HUF 0.9 bn. The firm made after-tax profit of HUF 66m and 43m on sales of HUF 5.84 bn and 3.82 bn in 1990 and 1991 respectively. Its short term liabilities increased by 50% over these two years and by 1992 they reached the level of its 'own capital'. At the same time the firm's market share reached its nadir with about 25–30%.

PT was run by General Director who graduated in 1976 in economics and was appointed in 1990 after a job tender. His Deputy in charge of economic matters, who was to become ESOP Leader, came from a bank where he had specialised in privatisation matters. He joined PT after the beginning of the privatisation process, essentially for the purpose of managing it. The deputy in charge of trade had earlier spent several years at the Ministry which the firm belonged to. The management saw its task as pursuing a turnaround strategy, "preparing for getting out of the crisis" that it faced due to increasing competition and shrinking domestic demand.

Table 19 Main actors in PT case in order of appearance

Name (acronym, if any)	Note
Insiders	
New Managing Director	ESOP Leader (also Deputy general director in charge of economic matters) who takes over the position of General Director after the third tender (referred to as ESOP Leader until then)
The State	
Co-ordination Consultation Committee (CCC)	consisted of representatives of various state bodies, was headed by a Ministry State Secretary, dealt with matters of pre-privatisation within the SPA
Outsiders	
French Trader and Partners (FTP)	potential acquiror in the first tender
American Department Store Operator (ADO)	another potential acquiror in the first tender
Expander	fast-growing domestic firm led by Empire Builder, backed by considerable foreign capital (see also case on PP2)
Italian Manufacturer Firm (IMF)	bid in the second tender
Middle East Company (MEC)	potential acquiror in the second tender
CEIG Leader; CEIG Partner	American investor, chief of Central European Investment Group; and his partner, former vice president of an American investment house
Consortium	led by CEIG, bid in the third tender

Note: for a list of actors appearing in all or most of the cases, see Table 15.

6.3.2 Case narrative

Table 20 Event history – critical incidents in PT's privatisation

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">The management's initiative: the first investment tender</td></tr>
<tr><td>1990</td><td>Management formulates turnaround objectives</td></tr>
<tr><td colspan="2">Broadening the business domain by establishing manufacturing capacity, shifting emphasis towards foreign trade; in the long term, turning into a trading house.
Modernisation of the retail chain by developing unified corporate image, introducing up-to-date information system.
Developing sales methods by adjusting product range to increasingly differentiated demand, increasing advertising efforts, introducing sales from catalogue, enlarging agent network, etc.
Employment: streamlining central administration, education (e.g. languages).</td></tr>
<tr><td>March 1990</td><td>Enterprise Council authorises management to initiate transformation and privatisation</td></tr>
<tr><td>August 1990</td><td>Management invites investment bids from foreign partners, and advertises open tender
Management submits transformation plan to SPA</td></tr>
<tr><td colspan="2">The management intended to implement considerable changes in PT's operations and organisation. They estimated that about HUF 550–750m would be needed in order to ensure long term stability and carry out the intended business strategy. They longed for an investor who would increase capital, thus acquiring at least 35% shareholdings, who would not repatriate profits, who would provide long term professional partnership, whose contribution would be cash in hard currency and in-kind contribution of technology (i.e. not merchandise and 'know-how'), who would secure export markets, and who would actively promote developing the company into a trading house acting as a European distributor. These requirements then appeared in an investment tender.</td></tr>
<tr><td>September 1990</td><td>PT's Consultant informs SPA of offers received; two firms are interested
Pre-Privatisation Act passes; PT is considered to be subject to this Act, putting the existence of the firm at risk</td></tr>
<tr><td>October 1990</td><td>As required by Pre-Privatisation Act, PT specifies 50 shops for auctioning; management requests SPA to be allowed to transform while keeping the remaining 70 outlets</td></tr>
<tr><td>November 1990</td><td>SPA's CCC accepts PT's requests to transform with 60 shops retained</td></tr>
<tr><td colspan="2">Note that the proportion of shops to be auctioned was a result of negotiations with a Ministry State Secretary (head of CCC). Management sought to convince him that PT's shops represent an integrated chain and thus should not be subjected to the Pre-Privatisation Act. In these talks it must have helped that an executive had worked for the Ministry. Management also attempted to convince the SPA that the proceeds from selling PT as one entity would be higher than what it could raise from auctioning shops individually. As several other firms in the same situation at the time, PT could only achieve a</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">compromise.

Auctioning of the selected 50 shops was then executed. Without following this line of the story, we should note that PT gave every support to the managers and employees of these shops so that they could acquire the outlets. In return, these shops were then supplied by PT (as wholesaler) under long-term contracts.</td></tr>
<tr><td>December 1990</td><td>SPA Director authorises management "to negotiate conditions of privatisation," but "final agreement must be confirmed [viz. approved] by SPA."

Management informs those interested of changes in assets due to Pre-Privatisation Act (loss of 50 shops)</td></tr>
<tr><td>December 1990 – January 1991</td><td>Interests confirmed: FTP plans major restructuring; ADO takes long term view</td></tr>
<tr><td colspan="2">FTP noted it had restructured itself recently and gained experiences; wanted full management control regardless of minority ownership; did not specify either the proportion it would acquire, or the amount to be paid; investment would mainly be in the form of know-how and non-pecuniary contribution.

ADO: "it would clearly be our intention to be patient with regard to building a profitable business"; expert firms were selected to conduct audit/valuation and to evaluate specific real estate holdings – whether owned or leased – of PT; ADO wanted "to move at deliberate speed in the next several weeks to identify outstanding issues, and put together an itinerary of our next visit ..."</td></tr>
<tr><td>January 1991</td><td>Offers are evaluated; ADO is ranked first, FTP second</td></tr>
<tr><td colspan="2">General Director and his two deputies, Chairman of Enterprise Council and Consultant regarded FTP's offer as low commitment; emphasis on drastic restructuring was a black mark; it was objected that PT would be subordinated; FTP's business plan was regarded contrary to PT's own business plan.

ADO's offer was well-received; it did not want to terminate PT's independence and to immediately repatriate profits; ADO's considerable size and capabilities were appreciated; it was noted that ADO had no other interests in Europe.</td></tr>
<tr><td></td><td>Management asks SPA to approve ranking and to permit asset valuation; General Director estimates asset value at HUF 900m

SPA approves all, holds right to determine price and to approve buyer; tender will have to be called "regarding the issue of the price"</td></tr>
<tr><td>April 1991</td><td>ADO withdraws</td></tr>
<tr><td colspan="2">According to the management, ADO went through a downsizing programme and completely gave up its intent to expand in Central-Eastern Europe.</td></tr>
<tr><td></td><td>PT appoints Hungarian firm to conduct asset valuation, appoints new Consultant</td></tr>
<tr><td>May 1991</td><td>Management submits transformation concept</td></tr>
<tr><td colspan="2">The firm, including the chain of 70 retail shops, would transform into joint stock company limited by shares (note that the management emphasised again that it wanted to keep these shops, since at this time there was still a danger of further 'being truncated'); Preferably foreign strategic, capital should be injected by increasing equity; Some existing shares would also be sold to foreign investor(s), and to employees (with discount and with preferential terms of payment); Depending on profitability,</td></tr>
</table>

Date/Period	Description of Event
flotation.	
An investor was hoped to make an investment of at least HUF 1.120 bn in order to get majority. Requirements to be met by the investor included at least partial re-investment of profits, securing export markets, commitment to capital expenditure programmes, support of partial employee ownership.	
	'Intermezzo' – an impatient potential buyer
FTP "sent a rather impatient letter," attempting to speed up the process. It then visited PT and SPA, outlined its offer, now indicating price and possible ownership split, and specifying various conditions. FTP's offer was far from the requirements of the firm, and even farther from that of the SPA, although SPA's requirements were not formally specified at the time. FTP urged SPA to speed up asset valuation and, on that basis, specify in writing the expected price. FTP indicated it would withdraw if an agreement could not be reached soon. They referred to their similar discussions in one of the neighbouring countries, and to PT's rapidly worsening market position.	
June 1990	SPA approves Transformation Concept on conditions
51% interest may be acquired by 'professional' investor(s) who may be chosen via 'closed' (invitational) tender; 40% (or more) of the total investment must be paid for SPA-shares, the rest may be equity raising; capital reserve may be used for issuing employee shares of HUF 90m, at 10% of par, employees may buy ordinary shares up to HUF 110m, at a price the external investor will pay (also at a discount). PT appears to have waived the 20% of the proceeds from the share sale which it would be entitled to (according to Transformation Act). According to an interviewee, this gesture was to make sure that, in return, the SPA would approve transformation "one-to-one," without cutting off further shops.	
Second privatisation tender	
July – August 1991	Invitation is sent to 11 potential foreign bidders; deadline is August, then extended to September upon investors' request; invitation is sent to three more firms who turned to SPA directly in the meantime; management wishes to close this tender quickly and successfully
One of the new interested investors was Expander, a fast growing, diversified Hungarian firm with interests in retail, too. A large proportion of Expander's shares were owned by foreign investors, partly due to a successful private placement in the USA. It was controlled by a Hungarian investor, Empire Builder, who returned to Hungary from the USA and was building a most successful business empire.	
September 1991	Three bids: IMF is disqualified; remains MEC and FTP; FTP claims to have acquired rights; no bid from Expander
IMF was rejected due to lack of formal requirements MEC's offer: acquisition of SPA shares HUF 374m, equity increase of HUF 562m, both are to be adjusted (reduced by minimum 20%, see below). Obtained interest in PT: 55.53% Reasoning: MEC was willing "to value PT according to its assets and liabilities (no reputation or goodwill shall be taken in account)," instead of basing valuation on future cash flow, on the condition that every item would be reappraised. "If the new value assigned to an item is less than the value set forth in the Appraisal in the Tender, the new value will apply. However, if the new value of an item is greater than the value in the said Appraisal, the value in the Appraisal will apply." MEC also proposed that the new appraisal value company should be multiplied by 79.68% (the ratio of the value MEC placed on PT and PT's asset value as given in Tender) "and the amount of the Investment (562m Forint) and the amount of the Acquisition (374m Forint) will be adjusted accordingly." That is,	

Date/Period	Description of Event
even if the new asset valuation (by MEC's rules) confirms the previous one, the actually paid amounts would be HUF 447m and HUF 299 m. MEC counted on various incentives and guarantees from the government. Conditions included: "The proceeds ... will be used, in part, to repay ... loans ...; until the self supply of [a newly set up factory], MEC will be the main supplier of ... to PT... and will also be responsible for the purchasing of all the other merchandise sold by PT" "SPA will cause [municipalities] to undertake not to raise the rental payments for the properties that are leased by PT in excess of what is customary for similar properties, and in any event, the rental payments shall not exceed fifty percent of the increase in the consumer price index from the beginning of the year in question." IWP's offer: Acquisition of SPA shares HUF 99 m, equity increase HUF 148 m. Obtained interest in PT: 51%. Reasoning: "if we act quickly, the good name of PT can be saved and remain a trustworthy, important company in Hungary. Yet, in order to fulfil such high expectations, we need to have all possibilities and rights of decisions." Investments would be made in "machines for production unit for [auxiliaries], computers, other products." IPW's conditions included: FTP must have right to "Review and, if so desired, cancel existing agreements with suppliers, customers or other partners. ... Act as purchasing agent for PT for all kind of products provided the cost of goods is the same or lower as actually paid. Act as selling agent for PT for all kind of products to be exported from Hungary provided the price paid corresponds to a fair market value." FTP proposed "a flat sum of HUF 42m as a one-time penalty" on top of refund of any amount already invested and of expenses, if one or several requirements would not be strictly fulfilled. In FTP's bidding document the cover page was followed by an insert: "This paper shall serve as an offer to your tender dated June [in fact, July] 1991 from FTP. However, we inform you that the preparation, contents and procedure of said tender is violating prior agreements between [PT's Consultant in 1990] and the Consortium and should therefore be voided. We reserve all legal steps in this matter."	
	MEC's offer is ranked first; General Director asks SPA to authorise management to conduct negotiations, and to re-consider the possibility of issuing new employee shares, since "the firm has waived its entitlement to the 20% of the proceeds from the sale of state-owned shares"
An evaluation committee (management, Enterprise Council, Labour Union, Consultant) considered "the offer of MEC the only one meeting the requirements of the Call for Tender both on the basis of the professional concepts [i.e. business plan] and the proposed sale price. ... [T]he firm regards the tender successful and suggests entering into negotiations with MEC." FTP's low-price proposal and claim to have acquired rights was not welcomed.	
	SPA and Consultant prepare draft replies to bidders in accordance with evaluation (tender is successful)
October 1991	SPA declares tender unsuccessful, but sees possibility of negotiations with MEC and IMF; IMF gets forgotten when notifying letters are sent out

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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">That is, the tender that had been considered successful by the firm was now declared unsuccessful by the SPA probably to make it possible to enter into free negotiations without having to follow the binding rules of the tendering process.</td></tr>
<tr><td colspan="2">Free negotiations</td></tr>
<tr><td>October 1991</td><td>SPA – MEC talks</td></tr>
<tr><td colspan="2">MEC maintained the offer; SPA could not provide guarantees beyond its authority. MEC considered it indispensable that PT's assets be re-appraised item by item by a renowned firm, and SPA should accept the results of such an asset reappraisal whatever it would be, as well as MEC's conditions tied to the result of the reappraisal. SPA rejected to accept the results in advance. Later, MEC demanded that "at the very least, the government must provide a refund of the tax in respect of monitored sales to tourists."</td></tr>
<tr><td>November 1991</td><td>Management and SPA propose compromise</td></tr>
<tr><td colspan="2">"The SPA is willing to accept in advance the final results of an asset valuation made by an internationally recognized appraising firm, provided, of course, that MEC will act in the same way." One of 'Big Six' accounting firms was proposed. Furthermore, "the SPA is not willing to accept your proposal as to multiplying the new appraisal value by the ration of approx. 80% and adjusting the amount of the investment and that of the acquisition accordingly. ... the SPA is not ready to grant MEC the right of option with the terms and conditions as proposed by MEC. ... any change in tax laws or foreign currency laws is beyond the powers of the SPA."</td></tr>
<tr><td>December 1991</td><td>MEC withdraws from further negotiations</td></tr>
<tr><td colspan="2">According to SPA, MEC had "exaggerated claim for guarantees," although "the offered price was close to our prior expectations." A PT-executive explained, "MEC found out the conditions [within which PT was operating]; they could not understand how the firm was still in business."</td></tr>
<tr><td colspan="2">Transformation and offer off-tender</td></tr>
<tr><td>October –
December 1991</td><td>Preparations for transformation: stock-taking, updating asset valuation, preparing Transformation Plan, etc.</td></tr>
<tr><td colspan="2">SPA started preparations while it was still holding discussions with MEC. Management advocated transformation, too. Focusing on transformation also meant that the relative importance and urgency of 'genuine' privatisation decreased. This may have come to the benefit of the management by keeping privatisation in suspense until favourable opportunities of managerial and employee ownership (already in the pipeline) opened.</td></tr>
<tr><td></td><td>Reconciliations with Ministry, union, municipalities

Bank (main creditor of PT) is willing to consider acquisition of some shares

Enterprise Council approves Transformation Plan: planned date of transformation 31 December 1991; management and employees aspire to manage the SPA-stock in the "transitional period until the sale of the state-owned shares" and want first refusal right to be granted</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>January 1992</td><td>New potential investor appears: CEIG and its partners would acquire shares between 51% and 82%, “assuming that the management of PT will support this effort”</td></tr>
<tr><td colspan="2">CEIG Leader and CEIG Partner were backed by “a number of leading strategic principals ... in the United States and Western Europe.” CEIG Leader wrote they were “most impressed by the present management of PT” and their investment group was “particularly excited about the growth potential for this company,” adding that their interest was strongly based on two factors: “first, the present management led by General Director must commit to continue their effective leadership. Second, this purchase must be concluded on a rapid basis in no later than 60 days.” As a starting point of negotiations about price, the amount of PT’s share capital and capital reserve was considered.</td></tr>
<tr><td></td><td>Management asks SPA Leader to approve appointment of CEIG as PT’s privatisation advisor</td></tr>
<tr><td colspan="2">The fax was sent from CEIG. CEIG’s earlier achievements in attracting foreign capital into Expander were emphasised. The possibility of creating “at least 120 new jobs” was anticipated. A speedy privatisation process was urged.</td></tr>
<tr><td></td><td>SPA Board approves transformation</td></tr>
<tr><td colspan="2">Share capital HUF 810 m, capital reserve HUF 94 m; “the buyer must be chosen in an open tender. If there is interest, all the state-owned shares can be sold ...”; in case of unsuccessful tender, “the firm must be given into asset management by way of an open tender” which was requested by, and would probably create an opportunity for the management; PT can keep rest of its shops; PT Board members are approved

From the resolution: “issuance of employee shares can take place in accordance with the Transformation Act,” that is, employee shares of can be issued against 20% of the proceeds from the sale of state-owned shares (which the firm once waived). The resolution did not explicitly mention the firm’s other proposal regarding the sale of SPA-shares to employees at a discount but referred to the “highest permissible amount and form,” which can be understood that the discount provided by the Transformation Act would exhaust the permissible limit.

Since CEIG wished to acquire more than 51% of the shares, it was necessary to remove the ceiling up to which stock could be sold to foreign investor as specified earlier (see June 1991; note that then a closed tender was allowed. The qualifying adjective ‘closed’ was deleted from the photocopy attached to the SPA-brief of January 1992).

The SPA Board nominated only four members of PT’s Board of Directors; the fifth member (a ministry official in the original plans) was to be appointed later. While at the subject of PT’s executives, the SPA Board stated as an “issue of principles” that “participation of civil servants in Boards of Directors of [state-owned] companies is undesirable, since this would mean an unjustified maintenance of direct influence over the state-owned sector, and may lead to incompatibility.” Before the end of the month, an MP of a governing party was appointed to the fifth seat on PT’s Board. According to an interviewee, another member of the Board was a friend of a minister, and yet another belonged to the “inner circle” of a high level politician.</td></tr>
<tr><td></td><td>SPA Director notifies management of resolution, and specifies it</td></tr>
<tr><td colspan="2">He specified the Board’s resolution on employee ownership by presenting two channels for acquiring ownership: under the Transformation Act, new employee shares could be issued (HUF 90m), plus “in connection with the privatisation of the company, a stock of HUF 112m at nominal value can be sold to employees of the company at 50% of the price the external investor paid” (cf. June 1991). Note that this was the SPA Director’s own interpretation of the resolution. This interpretation was later codified in PT’s Deed of Foundation.</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>February 1992</td><td>PT Company's Deed of Foundation and Articles of Association are prepared (retrospectively)
Discussions between SPA and CEIG</td></tr>
<tr><td colspan="2">In a subsequent letter, CEIG Leader stated that "the management of PT has indicated strong support for this effort." Subject to no more than 90 days due diligence, CEIG was "prepared to make an offer on behalf of an investor group to acquire controlling interest of the company." CEIG Leader and CEIG Partner were by then joined by another Hungarian expatriate investor who returned from abroad. The identity of "a number of leading strategic principals" remained undisclosed. CEIG Leader now added his "extensive experience in the ... retail, wholesale and manufacturing business," as President of a large "multi-store national ... retail chain with operations in" five states of the USA. CEIG Leader still was "most impressed by the present management," and "particularly excited about the growth potential for this company." The possibility of creating "more than 200 new jobs in Hungary during the next three years" was mentioned. CEIG asked SPA for preferential treatment; CEIG had "little interest in pursuing this matter if this effort must once again be subject to a long and drawn out tender and bid process. While we certainly appreciate and respect the rules and procedures that a public agency such as the State Property Agency must follow, we feel justified in asking for special consideration for several reasons."</td></tr>
<tr><td>March 1992</td><td>SPA invites CEIG to bid</td></tr>
<tr><td colspan="2">"Despite your advantageous proposal, we cannot ignore the State Property Agency's decision regarding the transformation of PT, namely that the shares ... can be sold only through an open tender process".</td></tr>
<tr><td colspan="2">Third investment tender</td></tr>
<tr><td>Early 1992</td><td>PT streamlines its organisation</td></tr>
<tr><td colspan="2">One layer in the hierarchy was eliminated, a unit was established specifically to deal with the shops, the marketing and finance functions were strengthened. Later in 1992 PT started slowly to regain some of its lost market share. Yet, after decades of profitable operations, PT ended 1992 with a loss. Not only competition, but the new Accounting Act also had a part in it. Earlier, PT could earlier book profit by simply moving stock between its wholesale warehouse and retail chain, no matter if the goods were actually sold. "We could make profit as we wished," said an interviewee. From 1992, profit could be booked only after actually sold goods. Under previous rules PT could have shown HUF 88m higher profit in 1992. Its profit was also reduced due to devaluation of dead stock at the time of transformation.</td></tr>
<tr><td>March 1992</td><td>Call for bids from advisors to SPA</td></tr>
<tr><td>April 1992</td><td>Advisor selected</td></tr>
<tr><td colspan="2">A medium size Hungarian bank, in which CEIG Leader's family had 12% interest, also applied, allegedly on request of PT's management. According to ESOP Leader, the bank's reference to PT's request was only an attempt of CEIG Leader to improve his position. Yet, General Director alone may have made such a request.</td></tr>
<tr><td>May 1992</td><td>SPA and Advisor concludes contract
Information Memorandum and Call for Investment Tender are completed</td></tr>
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Date/Period	Description of Event
June 1992	Tender is advertised
86% of SPA-shares is offered for sale (84% of all registered shares); 80% of total investment is to be spent on acquiring existing shares, 20% on equity raising; bids "able to identify with and support the goals and objectives laid down in [PT's] transformation plan and long-term strategic plans would be preferred"	
July 1992	ESOP Organising Committee is established
80% of the employees supported the organising committee to be brought into being (the minimum level of support required by the law was 40%). The organising committee included two deputies of General Director and a head of department who was the union secretary, too.	
September 1992	Tender opening: bids from CEIG and partners (the Consortium), and from PT's ESOP teamed up with Bank (ESOP–Bank)
In the meantime, CEIG changed its name and an American government fund became one of its shareholders (but sold its interest later, under pressure by Congress). The Consortium included the American retail firm where CEIG Leader claimed to have been president. This firm was now represented by CEIG Leader's father, who was also CEO of an American corporation, involved in retailing similar goods as PT. The Consortium did not offer a specific amount to be spent on either the equity raising or the acquisition of SPA-shares. For the transfer of all the shares in PT which was now described by the bidders (earlier excited about growth potential) as "potentially viable," the SPA would get 25% of PT's profits after tax for 5 years, and the total amount of after-tax profits from the sale of the current inventory of PT. A joint venture with PT and the company run by CEIG Leader's father was planned. It was noted that since receiving the Call for Tender, they had held several discussions with PT's management. They had assured the management that a significant employee ownership would be supported. PT's management, however, had informed them of their competing bid. The Consortium stated that "the interests of the SPA, PT, and both of the bidders would be best served if the future company was jointly owned and run by the two bidding groups." The management and the employees, however, teamed up with another partner. ESOP–Bank's offer offered 75% (almost 100% if PT's good-will was valued at zero) of par value for a stock of HUF 590m, and equity increase in the amount of HUF 90m, paid for by Bank. 20% of the stock to be acquired would be bought by the Bank for HUF 88m in cash, and 80% would be acquired by ESOP from an E-loan, provided by the Bank. The employees also laid claim to a further stock of 112m at a discount. For the rest of the SPA-shares the bidders wanted to get an option for three years. Flotation on the stock exchange was anticipated in middle term, probably in 1995. Note the explanation provided by company interviewees (including ESOP Leader) on how they teamed up with Bank: by this time, the firm had already had experiences with possible investors. Some were manufacturing firms, trying to find distribution opportunities. They thought it would be a "suicide to base our future mainly on products of only one manufacturer when the market needs variety." They saw examples to such a "suicide" in other Hungarian retail businesses. Others were considered as "speculators, interested only in the shops, and it was clear they would sell the chain one by one as ice-cream parlours or something." Therefore, they had given up their original intention to find a foreign strategic investor. They organised the ESOP, with the support of an SPA Board member who supplied them with information on expected changes in legislation. It was regarded important to conclude privatisation quickly, because "by 1992 the competition reached peak level, which required all efforts, and not a torn, ragged and divided firm. [We] could not afford it that half of the management was privatising and tendering, instead of actual work [viz. doing business], when a strategy should have been formulated." According to some, PT "could have reached profit even in 1992, new Accounting Act regardless, if we could have concentrated our forces better." The ESOP alone, certainly without resources, had no chance to win since an equity increase was required in the tender. It was the management who included this requirement 'two tenders earlier' so that PT's financial difficulties could be alleviated. Now they needed a partner who was able to meet this	

Date/Period	Description of Event
requirement. Bank seemed an ideal co-owner, since it thus would commit itself to financing PT, and the promissory note (a necessary requirement for ESOP to bid) would also be granted.	
	Evaluation of the offers
Advisor and an appointed expert regarded 75–78% of the nominal value as a reasonable price. Evaluating the Consortium's bid they pointed out that, taking a yearly after tax profit of HUF 65m (that was forecast for 1992 in PT's plans) and receiving its 25% for 5 years, the SPA would get a total of 81m. According to the evaluators, "if this sum was increased by 50% due to the assumed positive effect of the investors on the performance of the enterprise, yet only HUF 121m would be paid to the SPA." The SPA would get almost nothing from the sale of the current stock, since "according to the Consortium as well as the management, the merchandise stock is over-valued, and in part can be regarded dead stock". From the ESOP–Bank deal the SPA would get an immediate income of HUF 442m, and another 90m would be paid on equity raising. According to the evaluators, there was no risk in accepting this offer, since a promissory note had been provided by the Bank. Note that the evaluators did not take notice of the Bank's condition that made the final decision upon the E-loan subject to the result of due diligence. This evaluation was later concurred by an SPA brief prepared for the Board; likewise, the evaluation that considered 75–78% a reasonable price was approved by the SPA's internal Asset Appraisal Office.	
	CEIG Leader 'substantiates' the offer
He sent a letter to almost everyone at the SPA whom he thought to have something to do with the PT-privatisation. Most of the recipients promptly forwarded the letter to the one directorate which was in fact in charge. The bid was attached to each copy of the letter. CEIG Leader noted that to their knowledge two bids had been received following the call, theirs and an ESOP-offer. In the last paragraph of their offer they had expressed their hope that their bid would receive confidential treatment "according to normal professional norms," nevertheless CEIG Leader appeared to be quite well-informed of the ESOP–Bank-offer even before official announcement about the results of the tender. His estimation of numerical data included in the ESOP–Bank bid with considerable accuracy is worth noting. "According to the ESOP-offer, PT will have to undertake a new, enormous tax-burden of about HUF 450m in order to finance the purchase of the SPA-stock. For a company which has a debt of already HUF 560m, this additional debtor responsibility would be paralysing." He added that "as experienced investment bankers we believe it would be irresponsible to put further debts on PT, a company which has already severely indebted, because this would undoubtedly lead to bankruptcy." "[A]s a result of an irresponsible loan-taking it is said in the ESOP-offer that they would pay about HUF 450m to the SPA. This cash to be paid to the SPA makes the ESOP-offer appear illusorily more advantageous, because the debt to be serviced means the collapse of the firm ... since finance is provided by a state-owned bank, this only means that the money wanders from one pocket of the state to the other, while getting lost in the process." CEIG Leader brought up the previous unsuccessful tenders and, referring to a possible attempt to bring in external capital in the future he stated that "furthermore, [CEIG], which was as successful as possible in bringing in external capital in Hungarian companies can assure you that there will be no passive [viz., non-strategic] investor who would be willing to invest in PT." It remains an unanswered question whether this statement should be regarded as a forecast made on the basis of professional considerations, or as a 'warning' from bankers having wide spread network in the world of investors. The idea of co-operation between the two bidding groups was again raised which would give employees a stake of 34%. CEIG Leader's arguments also included that "the proposed ESOP would be such a mistake that would discredit the whole ESOP-programme and retard the development of employee ownership in Hungary." Some arguments referred to PT's internal relations. "We are almost sure that if the employees of PT were aware of the measures we propose, they would join us in full conviction. ... Yet, it seems as if the management did not allow it. ... [W]e can only say that the ESOP-offer on the part of the management is an irresponsible and manipulative attempt to use the	

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<tr><td colspan="2">ESOP-programme to preserve their privileges even at the price of bringing the company into bankruptcy and thus plunging the employees into unemployment."

According to a PT-executive, in September 1992 CEIG Leader initiated a meeting with the ESOP representatives and attempted to obtain information on their bid. He wanted to impel them ("with every means," "by intimidating the management") to either withdraw the bid or to submit a joint offer.</td></tr>
<tr><td></td><td>General Director reminds SPA that SPA has approved to give the company back 20% of the proceeds from the sale of the shares</td></tr>
<tr><td colspan="2">This issue was still disputed between the company and the SPA. According to previous documents the company had already waived the 20%, but later the SPA had indeed agreed to give it back.</td></tr>
<tr><td></td><td>ESOP Leader 'substantiates' offer</td></tr>
<tr><td colspan="2">The content of CEIG Leader's letter did not remain unknown to ESOP Leader, who (with General Director's consent) also sent letters to members of the SPA Board. "[T]the [Existence]-loan will be taken out by the ESOP-organisation, not the company ..., thus indebtedness of PT will not increase, its credit-worthiness will not decrease. (If the ESOP organisation cannot service the debt, the shares in PT Co. will be transferred to the ownership of Bank.)," as if this was a reply to the points in CEIG Leader's letter. Note that the ESOP organisation obviously wanted to pay back the debts from PT's future profits.

As CEIG Leader's, this letter too brought up a 'political' argument in that "the firm would remain in dominantly indigenous ownership" and "carrying out the already formulated strategy coupled with domestic ownership would also reduce prices" and "increase employment (by establishing manufacturing capacity)."

The understanding and mutual support that seemed to have characterised the relationship between the management and CEIG had apparently turned into confrontation by this time. A partial explanation could be that even in early 1992, the relationship was only seemingly cloudless. First, it was only General Director who had had discussions with CEIG. Second, CEIG was supported by the management as an advisor and mediator (in these roles, CEIG was successful, as Expander's example showed), but not as a possible owner.</td></tr>
<tr><td></td><td>Brief prepared for Responsible Politician suggests ESOP–Bank to be the winner</td></tr>
<tr><td>October 1992</td><td>SPA Board "declares the joint bid of ESOP–Bank the winner," no bid was declared second; SPA management is authorised to make an agreement with the winners on certain conditions</td></tr>
<tr><td colspan="2">"1) a stock of HUF 590m may be sold; 2) equity raising must be carried out in the value of HUF 90m, to be paid up in cash, within 60 days after signing the agreement; 3) the smaller shops, up to 25% of the total [i.e. 20 outlets], must be taken out of the chain and sold separately under the rules of Pre-Privatisation Act; 4) an option may be granted for the remaining stock only at a price of 100% of the nominal value." Note that the resolution included a condition that had not appeared in earlier documents (the 'Third Point" hereinafter). Ordering to sell the shops at auctions meant depriving PT of some of its assets as they existed when the tender was announced.</td></tr>
<tr><td>November 1992</td><td>SPA approves the establishment of PT's ESOP Organisation</td></tr>
<tr><td colspan="2">Until now, an ESOP Organising Committee acted on behalf of the ESOP-participants.</td></tr>
<tr><td></td><td>Agreement between SPA and ESOP–Bank is prepared; Third Point is debated</td></tr>
<tr><td colspan="2">SPA included the Third Point in its draft agreement to be made with ESOP–Bank, prescribing that 25% of shops be sold, and their asset value be deducted from PT's capital reserve. ESOP considered</td></tr>
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<tr><td colspan="2">the Third Point "contrary to the conditions as specified both in the Call for Tender and in the bidding proposal ... as well as the tendering rules. In the view of our legal experts, the agreement, including the conditions of the Call and the Proposal, should be considered being 'en force' by" the Board's resolution which had declared the bid the winner." SPA's revised draft then specified that "the smaller shops up to 25% of the total" (emphasis added) were to be sold; there was no explicit reference as to what would happen with the income from the shop sale.</td></tr>
<tr><td>December 1992</td><td>Third ESOP Trustee suggests compromise</td></tr>
<tr><td colspan="2">She was the third member of the Organising Committee besides the two deputy General Directors who had usually signed correspondence with the SPA. She suggested, as a compromise, that the shop sale be carried out by PT "under its own name and for its own good".</td></tr>
<tr><td></td><td>SPA Administrator supports ESOP-compromise; SPA Leader approves it</td></tr>
<tr><td colspan="2">Administrator's memorandum: "I assume that the Board's resolution was mainly motivated by [the intent] to increase the privatisation supply and not the proceeds to the state, therefore I suggest that leaving the income from selling shops (mainly leaseholds) with the company be approved since in any case the decrease of the retail chain weakens the business plan prepared to service the debt to which the Bank made out the guarantee. And this would make even concluding the agreement questionable."

As interviewees explained the compromise, the SPA staff saw that the Board's resolution was "not entirely lawful, but it was binding and had to be executed." On the other hand, PT's management did not need "spotlight, which we would have certainly attracted" if it had insisted on keeping every shop.

SPA Leader accepted Administrator's proposal on the same day, thus seemingly removing the last obstacle from concluding an agreement with the tender winners.</td></tr>
<tr><td colspan="2">It takes two</td></tr>
<tr><td></td><td>Bank proposes Syndicate Agreement with ESOP; wants ESOP to vote with Bank, more influence on PT, compensation for ESOP's taking out resources from PT</td></tr>
<tr><td colspan="2">The relationship between Bank and ESOP was twofold: that of creditor and debtor, and that of partners in investment and future ownership of PT. In addition, Bank was the main creditor of the company itself. Accordingly, for providing the E-loan and for the investment by the Bank, a Credit Contract (with related Security Contract and Guarantee Contract), and a Syndicate Agreement were to be made between the parties. The Security Contract was to state that ESOP would put its shares under Bank's charge until the E-loan was repaid; the Guarantee Contract was to provide guarantee by PT for ESOP's debt. The Syndicate Agreement was to settle some issues regarding the partners' relative positions and voting behaviour as co-owners of PT.

Bank, amongst other claims, wanted a call option from the third year for a stock of HUF 112m at 50% of par value as a compensation because ESOP intended to use 20% of PT's pre-tax profits to repay its debts (to Bank), thus withdrawing the source of dividends from the co-owner. Another claim stated that, in case the SPA deprived PT of the proceeds from the sale of the shops, the "Bank as a financial investor will suffer," therefore "the ESOP should take an obligation that it will give the Bank free of charge a stock equal to 60% of the amount deprived [by the SPA]." Bank emphasised that it wished to sign the share sale agreement with the SPA, and the other contracts with ESOP at the same time, in one act.</td></tr>
<tr><td></td><td>ESOP objects to Bank's claims</td></tr>
<tr><td colspan="2">Some of Bank's claims were against the ESOP Act; the preferential ESOP-income of 20% of the Company's pre-tax profits (allowed by the ESOP Act) had been an integral part of the ESOP feasibility study which the Bank had then approved without condition; ESOP as a co-owner would just as suffer from consequences of Third Point as Bank. Both the Bank and the ESOP seemed to</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">regard the asset deprivation as a possibility, although SPA Leader had already approved to leave the proceeds from the shop sale with the Company. Presumably, those concerned had not been notified yet.</td></tr>
<tr><td></td><td>ESOP proposes compromise</td></tr>
<tr><td colspan="2">Concessions were made regarding, for example, how to regulate the exclusive decision rights of the General Meeting of Shareholders, and the Board-positions demanded by the Bank.</td></tr>
<tr><td></td><td>Agreement with SPA suffers delay, SPA Administrator urges Bank</td></tr>
<tr><td colspan="2">“Since the beginning of December 1992, a draft contract acceptable to all parties has been at hand. According to the SPA’s procedural regulations, we should have concluded the share sale contract in 30 days from the acceptance of the bid ... We do not understand what is hindering the signing of the contract on your part, especially as you had already harmonised the conditions with the ESOP Organising Committee for preparing and submitting the joint bid since it had served as the basis for you to provide the guarantee.”

ESOP Leader and other interviewees explained later that Bank had granted its support at the time of the tender on the basis of their earlier relationship, without giving much thought to the matter. It was Bank’s first transaction of this kind, and the Existence-loan was apparently considered by Bank’s executives as a way through which the National Bank provided credit for ESOP organisations.</td></tr>
<tr><td></td><td>Bank says it can sign agreement only in January 1993</td></tr>
<tr><td colspan="2">“The reason for the delay is that the business terms between the two owners must be reconciled with the ESOP-members.” The necessity of this reconciliation was explained by Bank in part with the debated Third Point.</td></tr>
<tr><td>January 1993</td><td>SPA Director urges Bank</td></tr>
<tr><td colspan="2">“[In early December] we already discussed and agreed upon all the terms.” Director objected to the Bank’s reference to the necessity of reconciliation of business terms “that should have already been sorted out for submitting the joint bid, and to the Third Point ... which we have already set straight in the contract to be made.” “If the contract is not signed [in a week], then we will be forced to submit the issue of PT’s privatisation before the SPA’s Board again.”</td></tr>
<tr><td></td><td>Following promising negotiations, Bank and ESOP Leader’s joint request for extension of deadline until end of January; SPA accepts</td></tr>
<tr><td>February 1993</td><td>Bank and ESOP confirms they have “basically agreed” on the Syndicate Agreement, but “unforeseeable, technical” problems arose</td></tr>
<tr><td colspan="2">Under the law, the agreement with the Bank “may come into force only with the approval of the ESOP Assembly, and signing the share sale contract [with the SPA] can happen only after that.”

The Syndicate Agreement was indeed coming into shape. A recent draft included the ESOP’s voting in accordance with the Bank and established 79% voting rights for the Bank.</td></tr>
<tr><td></td><td>ESOP informs SPA that they are ready to sign all contracts, proposes early March for signing ceremony</td></tr>
<tr><td>March 1993</td><td>ESOP Leader explains further delay; asks for extension</td></tr>
<tr><td colspan="2">Final approval of the E-loan by Bank suffered delay “because the Bank’s President and CEO had taken ill,” but “the Bank has confirmed that [the loan] will be approved in” a few days.</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>Bank sends ESOP written draft contracts the first time</td></tr>
<tr><td colspan="2">The drafts, at least in the ESOP's opinion, included "new elements" and "obligations that are contrary to the ESOP Act."</td></tr>
<tr><td></td><td>SPA Administrator explains delay to SPA Leader; considers replacement of Bank</td></tr>
<tr><td colspan="2">From an SPA-brief: "they could not yet agree due to [Bank's] exaggerated conditions. ... If an agreement was not reached by the end of March 1993, then I would consider the option of submitting the matter before the Board again, so that the ESOP Organisation be provided an opportunity and 2–3 months time to [find] a new ... bank."</td></tr>
<tr><td></td><td>ESOP prepares "temporary regulations of share distribution"</td></tr>
<tr><td colspan="2">Once ESOP shares (representing 25.1% of share capital) are unencumbered, they can be distributed amongst members. Planned distribution rules would result in top management (3 persons) holding 9.14%, all management (10 persons) 16%. ESOP Assembly voted for developing new rules later.</td></tr>
<tr><td></td><td>ESOP and Bank are still negotiating

PT and ESOP offer compromise, and indicates possible termination of business between PT and Bank; Bank is willing "to finance the Company's operations for a year, but only if an agreement ... were reached," holding the right to terminate relationship with PT any time</td></tr>
<tr><td colspan="2">PT's guarantee for ESOP's debts is granted, Bank's conditions on the mortgage and on financing the Company's operations are rejected; mortgage could be accepted in return of a credit limit contract on HUF 400m per year for the period of the E-loan. General Director stated that in case of accepting their proposals, PT would favour the Bank in using financial services in the future; if the Bank did not "confirm its intention with the Company" [in two days], then he could not "see an opportunity of a successful and long-term co-operation between PT Co. and the Bank." PT is understood to have been an important account for the bank, in part due to the high proportion of tax in its turnover which meant a steady cash flow through the Bank. At the same time ESOP Leader sent draft Security Contract with substantial concessions to Bank as final compromise, stating "if you cannot accept it, we shall consider it so that you do not provide the E-loan and thus you do not fulfil your obligation taken in our joint bid."</td></tr>
<tr><td></td><td>General Director visits Responsible Politician

ESOP Leader requests SPA to approve more time and another bank if Bank does not accept ESOP's last compromise

SPA has had enough; considers dropping Bank as buyer</td></tr>
<tr><td colspan="2">Third ESOP Trustee stated that there was still no agreement, since the Bank "demanded so high level of security in its proposed draft credit contract which PT Co. and the ESOP Organisation, even by yielding the highest possible concessions, could accept only in parts."

SPA Leader's a hand-written note: "let's create an 'E' loan construction [viz. scheme] for the ESOP!"

As ESOP Leader explained later, they considered Bank's requirements as "one-sided blackmail" at the time; now the management is more appreciative of the Bank's priorities. Later the relationship between ESOP and Bank improved; although there were other issues of misunderstanding (for an example, see below, on management issues), a "normal co-operation developed" slowly.</td></tr>
<tr><td></td><td>Third ESOP Trustee says agreement is close; ESOP appears to give in; Trustee asks SPA for urgent meeting</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">“The principal terms of the agreement between ESOP and Bank were cleared up on 31 March. Now technical and less important details are being discussed. ... the share sale contract can be signed in a week.” “Although the positions have considerably come closer, ESOP and the Company could not have their – we think, rightful – way in many points.”</td></tr>
<tr><td>April 1993</td><td>PT-case is included in a routine State Audit Office-investigation

Share Sale Agreement with SPA is eventually signed (25% of shops must be sold, but proceeds from sale remains with the company)</td></tr>
<tr><td colspan="2">Change in top management</td></tr>
<tr><td>May 1993</td><td>A clause to the Agreement sets effective date a month later

New SPA Administrator is assigned to PT-case

ESOP Assembly approves contracts with SPA and Bank; approves PT Boards’ reports; rejects PT’s business plan for 1993; votes for changes in PT’s management</td></tr>
<tr><td colspan="2">The “Report on the activity of the Board of Directors,” signed by General Director, proposed an outsider, ESOP Leader and General Director for the Board (further two members could be nominated by Bank and SPA). On the spot, the outsider was removed from the list of nominees, and five others were added. The voting eventually resulted in ESOP Leader collecting overwhelming support, while the members of the ESOP Organisation practically relieved General Director of his position, although it could officially be effected only on PT’s AGM. Due to the delay in signing the share sale contract with the SPA, however, the share price had not been paid yet, therefore the shares had not been endorsed to the new owners. Consequently, ESOP was not in a position to vote on the AGM.</td></tr>
<tr><td></td><td>Bank suggests SPA should vote on the AGM with the full stock; if SPA did not attend the AGM, there would be no quorum, AGM would have to be reconvened in 15 days, which would allow for sorting out ownership rights

SPA does not attend Annual General Meeting</td></tr>
<tr><td colspan="2">The SPA then argued that the person in charge had not been received the invitation to the AGM. In the meantime, the SPA had seen one of its reorganisations, the PT-case had been taken over by another directorate, and the invitation to the AGM must have been mislaid somewhere. General Director sent the invitation again and other documents one day before the AGM, but there was obviously not enough time left for the SPA to prepare. In addition, New Administrator considered the information provided on the fourth point on the AGM’s agenda – “election of executives of the Company” – insufficient.

At about this time a hand-written note (made presumably by New Administrator when taking over the case from the previous one) remarked: “Bank wanted to pillage the ESOP.”</td></tr>
<tr><td>June 1993</td><td>Signing ceremony eventually takes place

Third ESOP Trustee suggests quick endorsement of shares so that ESOP can vote on AGM; also asks SPA for meeting</td></tr>
<tr><td colspan="2">According to the company bylaws, election of the executives was an issue requiring a qualified majority voting (75%). Third ESOP Trustee argued that the SPA with its remaining stake could have a decisive influence on the voting, and requested that SPA support the ESOP’s position. “[A]ccording to professional opinions and press articles, PT’s privatisation has been considered exemplary – first of all due to the SPA’s behaviour with which it was unconditionally supporting, in accordance with the</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">actual government policy, the employee ownership concept. So that the final completion of this privatisation be considered in a similar way, the ESOP still needs such a support from the SPA. ... [A]s it can be seen from the attached minutes [of the ESOP's Assembly], not a general management crisis, but a shaken trust in the present General Director" was the case. "The most important reason for withdrawing trust is that the ESOP members considered the current business policy as being the main cause of decreasing sales. Besides, the General Director's lifestyle and leadership style was regarded unacceptable for the ESOP members. Every participant in the ESOP has acknowledged that carrying out the ESOP programme requires sacrifice from everyone ... [T]hey also expect the company's management to be their partners in undertaking this sacrifice. Considering that earlier the SPA assured the ESOP of its support for carrying out the ESOP programme, and that solving the present situation which endangers the implementation of this program as well as avoiding a possible negative stir in the press are vitally necessary, we are asking for your help so that on the [reconvened] AGM of the Company [in June] the owners can decide by taking into account the interests of the majority owner." In the light of details this researcher has not been authorised to share in any form, the aforementioned argument on the General Director's lifestyle (supported from company resources) and leadership style appears to be a benevolent understatement.</td></tr>
<tr><td></td><td>New Administrator proposes how the SPA should vote</td></tr>
<tr><td colspan="2">"Stemming from the tension between Bank and PT ESOP, it would be practical not to get involved in debate on personal matters." According to an interviewee, the Bank intended to "cement General Director in his position," regardless of the will of the ESOP members. New Administrator suggested that the SPA should abstain from voting on each point on the agenda.</td></tr>
<tr><td></td><td>ESOP and Bank make payments for shares

SPA shares are endorsed to ESOP and Bank

Reconvened AGM: General Director is relieved, ESOP Leader is elected New Managing Director, Bank gains veto power in major issues by increasing the level of 'qualified majority vote' from 75% to 79% so the Bank's 23.1% (after the equity raising) will be enough</td></tr>
<tr><td colspan="2">On the AGM, ESOP controlled 42000 votes, SPA 19500, Bank 10500. General Director proposed Bank's representative for acting Chairperson of the AGM, rejected by ESOP and SPA. Then Third ESOP Trustee was elected unanimously.

New Administrator announced she would abstain from voting on each point. Bank's representative wondered what the SPA's abstaining would mean. New Administrator repeated "it means that [the SPA] will abstain from voting in each point." Thus, the number of exercised votes decreased to 52500. Practically, what it actually meant was that SPA granted qualified majority for the ESOP in terms of the exercised votes. Decisions taken on the ESOP assembly could thus be effected.

As an interviewee put it, "we put a full stop at the end of a process, everyone calmed down, everyone was doing his/her job."</td></tr>
<tr><td>July 1993</td><td>SPA transfers 20% of the proceeds from share sale back to PT

Management continues "streamlining" and starts new projects of modernisation</td></tr>
<tr><td colspan="2">Major projects that started around Summer 1992 included: development of a computerised managerial information system, shop refurbishment programme, "front-line education" for shop staff, improving PT-image, sale campaigns.</td></tr>
<tr><td>October 1993</td><td>Share capital is increased by HUF 90m (subscribed by Bank); interest of shares held by Bank is specified at 18% in 1993 and</td></tr>
</table>

Date/Period	Description of Event
	1994, then 15% until all ESOP debts are repaid
November 1993	Management reports to SPA on sale of shops
A few shops had already been sold, others were advertised.	
February 1994	Third SPA Administrator takes over the case
May – June 1994	Socialist Party is expected to win general elections SPA prepares detailed privatisation review for acting Prime Minister (and, eventually, for the new government) Some issues are settled
By this time, employee shares had not been issued yet. The amount of HUF 90m (from which employee shares could be financed) was instead used by the company to ease financial strain. Since there was no deadline specified in the Agreement in this respect, it was left to the management to decide when it would issue employee shares. In May 1994, New Managing Director was holding discussions ("was wrestling," in his words) with the SPA about the acquisition of shares in the amount of HUF 112m by the employees at a discount. Progress seemed to be blocked by political uncertainty in which "the SPA was not really operational." In June, however, PT was commissioned by SPA to sell this stock to employees on behalf of SPA. As to the sale of 25% of its shops (20 outlets), 10 had been sold by this time. Just before the SPA closed its review for the acting Prime Minister, New Managing Director could have this result accepted by SPA as "fulfilment of obligations under the agreement" (without having to sell other 10 shops). In addition, even the sale of some of the 10 shops sold were carried out in a way that did not seriously impair PT's chain. The last outstanding issue in June 1994 was that of the option of the buyers to acquire the remaining SPA-shares at par before the end of 1995. There was only one hand-written note available on this issue, made by an SPA staff member who assumed that the management would want to carry out a "pure MBO" and request Bank to give up its option. New Managing Director did not confirm this assumption.	
Summer 1994	PT continues restructuring and modernisation projects
PT's executives characterised these projects as "relatively risky," "strained," adding that "there are really no resources to finance" them. Some relief that Bank increased equity, and SPA transferred back 20% of sale price. Management attempted to have debt maturity rescheduled; its request was under consideration in Summer. Flotation, planned by ESOP and Bank at the time of the bidding, seems unlikely in the near future.	

6.4 Squeeze play – Food & Beverage 2

6.4.1 Introduction

'Food & Beverage 2' (FB2) was operating in a specific branch of the food and beverage industry and had only one site. When the industry-wide trust was disbanded in 1988, FB2 became an independent state-owned enterprise under direct ministerial control (i.e. there was no Enterprise Council). With about 550 employees and asset value of about HUF 1.1 bn in 1991, it produced semi-processed food, but also carried out commissioned warehousing of meat for meat-processing firms. On sales of HUF 1.1 bn, it made profits of HUF 84m in 1991. About half of its production was exported, mainly to Western countries. On the Hungarian market it had a 14% market share in its main product line. More than 80% of its products had been produced for more than 20 years. From the early 1990s, FB2 had to face decreasing domestic demand and growing competition. A sensitive point of the operations was the commissioned warehousing, a highly profitable activity but dependent on the international meat market and the state of the livestock. The firm was run by a General Director, appointed in 1985 at the age of 39, confirmed in his position since then several times. He chose the other members of the management team.

Table 21 Main actors in FB2 case in order of appearance

Name (acronym, if any)	Note
Outsiders	
Swiss Firm (SF)	a bidder
Mighty Multinational (MM)	a bidder and eventual owner of FB2

Note: for a list of actors appearing in all or most of the cases, see Table 15.

6.4.2 Case narrative

Table 22 Event history – critical incidents in FB2's privatisation

Date/Period	Description of Event
The management's initiative	
1990	Asset valuation is carried out Preparatory discussions with Ministry, SPA, domestic business partners and foreign potential investors
October 1991	Management informs workers of preparations Management submits transformation plan to SPA; asset valuation is updated, then revised
Updated asset value was HUF 1.26 bn; FB2's so-called 'own capital' was given as HUF 966m. Planned date of transformation was 1 January 1992. The management planned to transform the firm into a joint stock company with shareholders	

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">including the SPA and its business partners. “There were examples that served as a pattern, but the Ministry drastically objected to cross-ownership,” explained General Director. Transformation was planned to be followed by a sale of shares to and a capital increase by foreigners who would eventually hold 30–40% interest. Financial investors were preferred to ‘strategic’ ones, admittedly because they were thought to have no intention “to influence the company’s economic activity.” The management held firm views as to what they wanted to do with the foreign investors’ money. General Director stated at a workers assembly that “we shall use the capital provided by the foreigners to pay back short term loans, to modernise and enlarge storing facilities, and to improve technology.” “When most of the country’s enterprises are becoming joint ventures of mixed [domestic and foreign] ownership..., if we stay out from this process, that would necessarily lead to loss of markets.”</td></tr>
<tr><td>November 1991 – February 1992</td><td>Discussions with SPA, Ministry</td></tr>
<tr><td colspan="2">The idea of domestic business partners as shareholders was dropped; instead, SPA would have 96.3% interest and municipality 3.7%. General Director: “The concept changed several times ... often according to political interests. It was a rhapsodic, erratic period. The concept was often determined by local [viz. parochial] interests.”</td></tr>
<tr><td>March 1992</td><td>Ministry’s gives opinion on FB2’s transformation plan

SPA’s Human Policy Directorate proposes smaller Board with outsiders</td></tr>
<tr><td colspan="2">Ministry referred to “reconciliations in the meantime,” i.e. FB2 was convinced to drop domestic business partners from the list of would-be shareholders; in the Ministry’s view, “thus, contrary to the original [plans] the owners of the new company will be the SPA and the municipality, and in this way there is no longer a danger of disputable cross-ownership between firms with the same scope of business.” On the issue of “real privatisation” in the second step, the ministry supported 40% foreign interest “only if the rest of the state-owned shares can indeed be sold to domestic owners. Besides employee ownership this can be achieved by shares–compensation notes swap, and farmers’ ownership.” The Ministry also suggested that a high proportion of the shares should be sold in return of compensation notes and that maximum legally possible discount should be granted to the employees in order to create an indigenous “owners class”, and that “in order to strengthen [export] market positions ... strategic investors should be preferred to financial ones, contrary to the firm’s proposal.”

The SPA’s Human Policy Directorate suggested that instead of the proposed six members of the Board of Directors that would have included the top management, there should be only three Board members, with two external members, one of whom being the Chairman.</td></tr>
<tr><td>May 1992</td><td>SPA Administrator suggests an investment tender to be handled by the firm; proposed date of transformation 31 March 1992</td></tr>
<tr><td colspan="2">FB2’s ‘own capital’ was proposed to be divided between registered capital and capital reserve in about 3:1 ratio; following privatisation, employee shares were planned to be issued to the extent of HUF 72m (10% of the registered capital, discount to be given in accordance with the provisions of the Property Policy Guidelines).</td></tr>
<tr><td>June 1992</td><td>SPA Board resolution: transformation is approved as proposed; employee shares can be issued only subsequent to privatisation; 20% of SPA-shares are to be reserved for later sale in exchange for compensation notes as specified by the provisions of the Compensation Act, the rest can be offered for sale

Hungarian subsidiary of Foreign Bank complains at SPA that General Director is not co-operative</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">Foreign Bank claimed it could introduce a strategic investor; requested SPA to suspend proceedings with FB2's privatisation for three months while they prepare an offer; asked SPA to help obtain information from management; urged SPA to declare its position because "our commissioner is becoming downhearted." Two weeks later Foreign Bank again urged the SPA, this time at top SPA-level.

General Director suspected that the prospective buyers were after only information about FB2 since they had already made an acquisition and were competitors.</td></tr>
<tr><td></td><td>SPA informs Foreign Bank that it certainly cannot delay the process for months and grant exclusive rights to Foreign Bank for mediating between SPA and a potential investor</td></tr>
<tr><td>July 1992</td><td>FB2's first General Meeting of Shareholders</td></tr>
<tr><td colspan="2">First Tender</td></tr>
<tr><td>Summer 1992</td><td>Tender for consultants</td></tr>
<tr><td colspan="2">19 consulting firms were invited to bid, 10 submitted an offer. FB2's top management and its Board of Directors evaluated the offers. General Director argued that the offers were quite similar, and the decision could only be made on the basis of trust. It must have certainly helped that one bidder had been working with the company on the introduction of the TQM-concept (total quality management). It was considered an important factor that the consultant should "be able to carry out the privatisation by considering the management's concept," and "the other important factor was the readiness to co-operate."</td></tr>
<tr><td>September 1992</td><td>Advisor selected

Supervisory Board's first meeting: "the Board wishes to help the Company in its difficult situation"</td></tr>
<tr><td>October 1992</td><td>SPA Management Meeting discusses selection of advisor; eventually approves it</td></tr>
<tr><td>November 1992</td><td>SPA changes draft tender announcement to emphasise that bids from employees enjoying discount opportunities will be treated as equal to bids of "external, or capital-strong investors"; also insists on keeping the opportunity of a two-step tender procedure

Call for bids advertised

Supervisory Board reviews FB2's situation</td></tr>
<tr><td colspan="2">The company's financial position was said to be "balanced," with no delays in payments. In the second and third quarters of the year, however, losses of HUF 3m were made, casting doubt on the possibility of achieving planned pre-tax profits of HUF 17m for the year. The management regarded the accomplishment of the target as top priority, not only because of the bank's judgement but also because of the upcoming privatisation. They had introduced measures to improve the situation by restricting purchasing (only if approved by top management), monitoring revenues and costs item by item every week, and preparing weekly cash flow reports. Co-operation between marketing and production functions was improved. "The tough cost-cutting measures have already started to bring results." Yet, the decline of the meat industry due to losing its Eastern export markets had caused severe problems to the firm. In terms of volume, this business reduced to 15% of what it was in the previous year. "This had been ... an extremely profitable [business]. Now it got stopped. We must prepare for survival." In addition, "the Western export markets got blocked to such an extent that could not be expected at the beginning of the year." This situation was certainly mirrored in the</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">increased stock of finished products. To alleviate the difficulties, the management had launched sales promotion and cost cutting programmes which was “unusual, different form previous practice.” Buyers were monitored by making use of a computer programme, and they were not serviced until outstanding payments were settled. The proportion of sales for upfront cash in total sales increased. Maintenance works were delayed. In the series of cost cutting measures the management also attempted to reduce social benefits.</td></tr>
<tr><td>December 1992</td><td>ESOP Organising Committee is interested in acquiring 52% of shares</td></tr>
<tr><td colspan="2">They calculated that the company would be profitable even after meeting obligations for the ESOP. They promised to prepare the ESOP Feasibility Study and submit a bid by 31 March 1993, and asked the SPA to consider their intent to bid later when evaluating bids submitted to the tender.</td></tr>
<tr><td>January 1993</td><td>Tender opening: only the ESOP interest is entered in the minutes</td></tr>
<tr><td colspan="2">Consultant had directly invited several firms to bid yet there was no interest (Foreign Bank did not reply). SPA approved a second call for tender but asked Advisor for a detailed report of the causes of lack of interest. Advisor pointed out that the time period available to prepare bids had probably been too short, general considerations of country risk might have played a role, and investors who had already known the firm might have been deterred from bidding by the need to make large investments to update the company’s technology to modern Western standards.

General Director, in an interview: “There had been seriously interested firms when we had had discussions, but they withdrew.” “The firm can be presented so that they do not want to buy it. [A French company] was an example, they wanted big downsizing.”</td></tr>
<tr><td>February 1993</td><td>Supervisory Board reviews FB2’s situation</td></tr>
<tr><td colspan="2">Profit from the commissioned warehousing business in 1992 totalled only HUF 48m while it reached HUF 173m in the preceding year. A successful campaign towards the end of 1992 to sell products from stock at reduced price helped to realise profits, although less than planned.

General Director informed the Board that SPA supported the ESOP-concept, and mentioned that they had asked four consulting firms to submit offers to assist in preparing the ESOP’s bid. They wished to acquire 51% of the shares but also wanted to have a 30% foreign interest in the company. However, in the business plan for 1993 that was prepared a few weeks later, only a minority position of the ESOP was envisaged.</td></tr>
<tr><td colspan="2" align="center">Second Tender</td></tr>
<tr><td>February 1993</td><td>Second call for tender is advertised</td></tr>
<tr><td>March 1993</td><td>SPA, General Directors and Chairpersons of all the firms in the industry discuss how to speed up privatisation</td></tr>
<tr><td colspan="2">General Director: “The Ministry encouraged [ESOP], but the SPA drastically stopped it. The SPA [applied different principles to different companies in the industry], but specifically FB2 was threatened that they would sell it to the Social Security Fund ... which is bad because it not a future-oriented owner, it doesn’t solve the problems. Of course it was only spoken. I did not particularly support the ESOP, there would not have been enough [money] left for repaying the debts and for necessary developments. ... At other firms they view it in a different way. ... [It is important] who has how many years left [until retirement, viz. one can gain a lot before retirement and then leave the firm to its fate]. Or they must have someone to sell it to.” On the fact that the planned proportion of shares the employees would acquire changed a few times, General Director remarked: “The SPA said, ‘we approve it if it’s such and such’, then we went back with a revised plan, but the SPA also changed [its view], people changed there, too. Then, at the end ... they rejected [significant employee ownership] because they considered [the firm] ‘sellable’.”</td></tr>
</table>

Date/Period	Description of Event
	The SPA's invitation letter also asked General Director to report in writing about his official trips to foreign countries in 1992, and planned trips in the first half of 1993.
	General Director to SPA: we believe the best solution would be foreign strategic investor's majority and capital increase; in addition, ESOP and other ways of employee ownership, too
April 1993	Tender opening: no bid submitted, interests expressed by SF and MM are entered in the minutes
	SF announced a non-binding interest and required one or two months to prepare a bid; intended to establish a store chain in Southern Hungary, of which FB2 could be a supplier. MM first indicated interest in late March after a visit to FB2; asked the SPA to keep the tender for FB2 open "for an additional eight weeks, which gives us the opportunity to investigate other factories". In another fax, 20 minutes before the tender opening, MM announced that on the basis of its investigations FB2 seemed the best acquisition target in the Hungarian semi-processed food industry, and asked the SPA to extend the deadline to submit a formal bid with two months. MM indicated that it wanted to acquire 100% of the shares and that the SPA should convince the minority owner municipality to sell its shares.
	Offers and negotiations off-tender
April – May 1993	General Director's and Boards' reports on FB2's economic situation
	Due to new, active marketing methods, domestic sales had increased but commissioned warehousing had drastically declined, which reduced the profits by HUF 112m from 1991 to 1992. (In this extremely profitable business, FB2 made HUF 168m profit on revenues of HUF 227m in 1991, whereas only HUF 56m profit on HUF 74m revenues in 1992.) The devaluation of the pound had also hit the company ... In export markets competition had intensified due to low cost producers. FB2 had been working on launching new products. The management had succeeded on reducing interest payments with better credit policy, but the firm's indebtedness, partly inherited when the trust was disbanded and FB2 became an independent firm, remained a serious burden. The company's pre-tax profits in 1992 were HUF 10m (only for the period after transformation; for the whole year pre-tax profits reached HUF 41m). The actual difference between the company's overall profits in 1991 and 1992 was only HUF 28m, that is the company had succeeded to compensate for HUF 85m of the HUF 112m that would also have been realised if commissioned warehousing had reached the same level as in 1991. Cash flow was said to have been very well managed. Organisational changes had also been made. Personnel of a whole department, dealing with agricultural producers, had been replaced. A new export department had been established. The ISO 9000 quality standards were being introduced at that time and their audit was scheduled for early June.
	SF and MM visit FB2; MM requests deadline to be extended until end of May
	MM's letter started (just as its earlier letters) with emphasising how important company the potential acquiror was: "MM is one of the largest world-wide companies in consumer goods with a leading position in [various segments of food industry]. In 1992 the total turnover of MM world-wide was [US$ several billions] with a profit after tax of [US$ a couple of billions], providing very strong financial resources. MM has already a strong presence in Hungary ... Following [this] acquisition, we plan to invest some HUF 350–450m within FB2 in order to upgrade [it] to MM quality requirements. We would manage the acquired company as a division of MM Hungary ... We have ambitious plans to grow in the semi-processed foods market in Hungary by increasing the availability of high quality products. On export we intend to develop volumes by taking full advantages of the demand of other MM companies in Europe, which are already sourcing from Central Europe. ... MM would open its technologies and know-how in the technical and marketing areas in order to make the acquired

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">company an efficient, modern and profitable company. Should we make an offer for the FB2 Company, such offer would be subject to: satisfactory due diligence ...; ... full access ... to the company's premises and records; the acquisition of 100% of the shares of FB2 Company," etc.</td></tr>
<tr><td></td><td>SPA wants a binding offer from MM

Supervisory Board meeting; General Director: "if there is no 100% acquisition, we [ESOP] would like to acquire 25–30%," "in a very unfavourable environment [our] main objectives are to ensure the viability of the company and to facilitate privatisation"

AGM: "we have accomplished our main objectives, the company is profitable and financially stable"; AGM approves reports, no dividend is distributed; profit is to be spent on new equipment.

SPA Director outlines alternatives for FB2: a new tender or waiting for MM's offer or leasing

SPA Leader suggests investigating the possibility of leasing, but "it won't be finished in 8 weeks in any case; if MM comes in the meantime, let's give it [to them]".</td></tr>
<tr><td colspan="2">After two unsuccessful tenders, the law allowed for privatisation by leasing, in which management had earlier expressed its willingness in case there was no other solution.</td></tr>
<tr><td></td><td>MM wants the deadline extended until 20 June</td></tr>
<tr><td>June 1993</td><td>Employees' attempt to secure the benefits they were entitled to under the law</td></tr>
<tr><td colspan="2">Local Union Leader's letter to SPA Leader recalled that according to SPA's June 1992 decision, a discount of HUF 72m was to be granted to the employees and employee shares could be issued only after the privatisation; pointed out that the privatisation process had advanced considerably; "to sum up the wish of the employees we declare that we intend to take the opportunity" of buying these shares at 90% discount.</td></tr>
<tr><td></td><td>MM's first, non-binding offer for 100% of shares</td></tr>
<tr><td colspan="2">Note that MM again introduced itself in considerable length, emphasising not only its mighty size and resourcefulness but also its already considerable importance in foreign direct investment and employment in Hungary.

Main points of the offer: MM valued the firm at HUF 674m; debts HUF 352m to be deducted. Thus, cash price was HUF 322m, for 100% of shares, but any losses that may have occurred in the working capital value between 31 December 1992 and the date of transfer were to be deducted. Planned investment was in the range of HUF 550–600m. "The transfer of know-how and the use of MM Trade Marks will be subject of separate service agreements." MM would source locally and "intends to boost FB2's existing exports ... thus increasing export of Hungarian Semi-processed food products and improve the country trade balance." The company was planned to be run "mainly with local management supported by a few MM expatriates to transfer know-how and management skills." "Substantial retraining" of the workforce was considered necessary. The offer also stated that "MM will cooperate with agro-suppliers to develop together a better raw material base."

"Outline of basic Conditions of the contract of purchase: ... SPA must ... must guarantee that the 3,7% shares held by local municipalities will be transferred to MM ... Obsolete stocks and stocks sold at less than inventory price [and] uncollected debtors will give rise to a reduction of the price. ... No major decisions concerning [FB2's] business shall be taken without the prior consent of MM as from</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">20th June 1993. ... All guarantees given by FB2 to third parties ... must be withdrawn or undertaken by the SPA. ... All payments to be made to non working (at the date of transfer) employees covered by a legal status (e.g. maternity leave), ... bonuses to be paid to employees of FB2 in relation to the achievement of the privatisation of the company ... as well as bonuses related to the achievement of the planned profit target on a prorata temporis basis [are for the SPA's account.] ... It is assumed that following an environmental audit all the identifiable costs and investments which are to be incurred are for the account of the seller ... The seller will guarantee that no penalties and/or increase of levies will be charged to FB2 for environmental matters within the next five years. If shares have later to be sold to employees, the difference between the price of their shares and the value of their shares is for the SPA's account. However, MM would like to avoid the employees shares scheme or any other third party shareholding and remain 100% shareholder. FB2 must be granted a full (100%) tax holiday for a period of 5 years ... and a partial tax holiday (60%) for the following 5 years. Export subsidies at a rate of 25% of export revenues must be guaranteed to FB2 for a period of at least 5 years ... Part of the purchase price will be retained for a period not exceeding two years as further security for the performance of the obligations of the seller. ..." On the Hungarian translation copy of the offer document, several "No!" remarks on these conditions can be seen in the margin. SPA Leader's margin note to his colleagues: "Talk to them and let's privatise it."</td></tr>
<tr><td></td><td>Meeting between SPA and MM results in revised, "final offer" for 100% of shares</td></tr>
<tr><td colspan="2">FB2 was now valued at HUF 722m (from 674), less debts results in HUF 370m (from 322). In the conditions, FB2's guarantee for International Bank was named as an example of liabilities to be withdrawn or undertaken by the SPA. In addition, "part of the purchase price (10%) will be retained for a period not exceeding 6 months after completion as further security for the performance of the obligations of the seller, until a review of the fulfilment of the guarantees given by the SPA."</td></tr>
<tr><td>July 1993</td><td>MM's offer is evaluated</td></tr>
<tr><td colspan="2">The SPA legal department suggested that the contract should include MM's guarantees for the investment, increase in exports, maintaining current level of employment and providing necessary retraining, and that FB2 would not revoke its contracts with its current suppliers for at least a year. Certain conditions were rejected, partly because the SPA had no authority to grant them and partly because they were considered exaggerated.</td></tr>
<tr><td></td><td>Upon SPA's request, General Director provides information for SPA's negotiation with MM; SPA presents its position to MM</td></tr>
<tr><td colspan="2">The management also informed the SPA that the municipality seemed willing to sell its shares at the purchase price as negotiated with MM. Debts totalled HUF 260m. Liabilities included FB2's guarantee of HUF 150m for a loan taken by Foreign Trade Company from International Bank. (FB2 inherited this liability from the times when it was part of an industry-wide trust.)</td></tr>
<tr><td>August 1993</td><td>MM acknowledges some of SPA's proposals</td></tr>
<tr><td colspan="2">"During our meeting you have made some remarks ... [W]e understand that to fulfil some of our conditions is not under the authority of the SPA and we recognise it. Therefore with regard to the subsidy level during the next five years, the employees shares scheme and the tax holiday ... we confirm that MM will stick to the prescriptions of the laws prevailing in Hungary. ... The compensation notes scheme is a different issue. We would like to see in advance the preference list and ask you to implement the compensation notes programme of FB2 as quickly as possible."</td></tr>
<tr><td></td><td>Draft share purchase agreement is prepared by MM</td></tr>
<tr><td colspan="2">MM considered a quick deal very important so that FB2 Company could be entitled to tax holiday (automatically granted to firms with at least 30% foreign ownership until the end of the year).</td></tr>
<tr><td></td><td>SPA brief outlines alternatives, points out MM's strong position</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">"The offer and the attached draft agreement include elements that are partly unacceptable and partly require further negotiations. ... The bidder, having had excellent information, formulated its terms and conditions when he had already been aware of the failure of the two tenders." The brief outlined two alternatives: accepting the offer with conditions more favourable to the SPA (for example, requiring the buyer to pay at least 80% of the nominal value of the shares; 25% + 1 vote to be sold to agricultural producers in exchange for compensation notes; etc.), or rejecting the bid (and to offer the shares to small investors and agricultural producers). The brief formulated the first one in a decision proposal. In a later draft it was also proposed that after concluding a contract with MM a press release should be made in which the SPA would state "what a national interest it is to attract a major multinational company to the industry."</td></tr>
<tr><td></td><td>Ministry objects to sale of all shares to MM and wants better conditions</td></tr>
<tr><td colspan="2">"We strongly recommend that shares representing 25%+1 vote, under the provisions of the Property Policy Guidelines, be warranted to producers, and that shares be sold at a discount to employees." The Ministry firmly objected that the draft terms and conditions kept only the buyer's interests in view, requested guarantees for everything but provided no guarantee for the buyer's undertaking, not to mention that some of MM's requests were contradictory to the Property Policy Guidelines, or could not be satisfied by the SPA due to lack of authority. "If the purchase price were to be reduced by the Company's liabilities as ... requested ... then it may happen that the SPA will have to make a financial sacrifice in order to strike a deal. ... In our view, whatever advantage it may bring in the future to have MM in the Hungarian semi-processed food industry, this offer includes unacceptable conditions. ... Products of the Hungarian semi-processed food industry are marketable at home and abroad as well, they have good long term prospects. It is unacceptable that a foreign party one-sidedly dictates the terms and conditions, even if it is the internationally respected MM company." Finally, the Ministry suggested that in case negotiations with MM failed, a new call for tender should be announced.

General Director: "Ministry objected to foreigners; [it] was afraid of monopoly. They wanted to protect the farmers. They [later] switched to the foreigners due to budgetary pressure."</td></tr>
<tr><td></td><td>SPA Board resolution requires further negotiations</td></tr>
<tr><td colspan="2">SPA wanted to achieve the following position: 71.24% of the registered capital to be sold for at least 80% of the nominal value; employee shares with discount to be issued by capital raising; capital investment to be carried out within two years; shares representing 25% + 1 vote to be sold to agricultural producers in exchange of compensation notes (MM could have an option to the unsubscribed shares). It was also decided that these target conditions could only be modified by the Board of Directors. The Board's resolution prescribed that after the conclusion of the contract it was to be emphasised in a press release that "it is national interest to draw a multinational into this industry."</td></tr>
<tr><td></td><td>Ministry objects</td></tr>
<tr><td colspan="2">Deputy State Secretary pointed out he had personally requested that FB2's privatisation not be discussed at the SPA Board meeting because he could not attend. He stated that the Board had disregarded his request, discussed the case, and made a decision which was against the Ministry's position. In a new tender he wished to achieve that 50%+1 vote be offered for sale, a further 25%+1 vote be offered to agricultural producers, and the SPA Board's earlier provision regarding the extent of employee ownership be enforced. "Considering that the ministry's opinion was left with no representation in my absence, and the decision was thus made, I insist that this fact and our expressed objection be entered as a clause in the minutes of the meeting," which was duly done afterwards. SPA Leader then requested Director to conduct negotiations with MM in accordance to the Ministry's position and bring back the issue before the SPA Board in case such negotiations failed to result in agreement.

General Director: "If they [MM] say they want 100%, it is in vain that Ministry Deputy State Secretary wants 25% + 1 vote for the producers, it depends on both sides. It wasn't serious."</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>September 1993</td><td>SPA and MM meeting results in revised, “final and definitive” offer for at least 75%+1 vote</td></tr>
<tr><td colspan="2">MM wanted full control, with at least 75%+1 shares, after sales of shares to employees and farmers, and first refusal right regarding all shares not purchased by the farmers against compensation notes, and shares sold by any other shareholders (municipality, employees) at any time. For 100% ownership, MM offered a maximum of HUF 432m. “In order to meet the request of the Board of Directors of the SPA, there will be a share capital increase of HUF 80m in favour of the employees.” The SPA should compensate MM for the shares sold to employees at a discounted price.</td></tr>
<tr><td></td><td>SPA evaluates offer</td></tr>
<tr><td colspan="2">SPA Administrator recalled that the Board’s resolution had required the buyer to pay 80% of par whereas MM now offered 60%. He referred to the obligation to present the case, with the Ministry’s opinion, before the Board again (at this point a margin-note was made, “Is the Ministry thwarting it?”), and argued that “in my view we should accept MM’s offer since it is in our interest to attract them into the industry.” He also noted that in the case of two other firms in the same industry the SPA could achieve price levels of 50% and 85% of the nominal value of the shares which made MM’s offer of 60% in cash look acceptable.</td></tr>
<tr><td></td><td>SPA requires Ministry’s position on revised offer</td></tr>
<tr><td colspan="2">“The SPA does not wish, and it is not in the SPA’s interest either, to take a position contrary to that of the Ministry, the decision with respect to FB2’s privatisation is not final and definitive,” but if MM’s offer was rejected, then “how FB2’s privatisation should happen while keeping it viable and safeguarding the value of the state’s shareholding.”</td></tr>
<tr><td>October 1993</td><td>Ministry is still not happy</td></tr>
<tr><td colspan="2">When the SPA’s Board approved FB2’s transformation, it prescribed, in accordance with the Compensation Act, 20% of the shares to be reserved for the farmers. Ministry Head of department “still consider[ed] it necessary to entirely adhere to the law.” Also in the SPA’s resolution it had been prescribed that discount had to be granted for employee ownership to the extent of 10% of the registered capital. MM’s offer included “a share capital increase of HUF 80m in favour of the employees” which was 8m higher than the sum granted by the SPA. MM wanted compensation for selling shares to the employees at a discount which would result in a transaction at 48% of par. “60% means a sale by far below the real value, a sale at 48% means disregarding reality.” In fact, due to further price adjustments, even this 48% might decrease. “MM’s offer [is] unacceptable, at such a price we do not recommend the sale,” concluded Ministry Head of department.</td></tr>
<tr><td></td><td>SPA brief summarises situation</td></tr>
<tr><td colspan="2">MM made an offer for 83.3% of the registered capital, whereas the SPA Board resolution prescribed the sale of 71.2%. MM thus wanted to ensure that it would have 75%+1 vote even after issuing the employee shares. Thus the SPA can offer “only a stock of [11.6%] to the agricultural producers,” contrary to the 20% prescribed by SPA Board. MM offered 60% of the nominal value of the shares which was less than required by the SPA Board (80%) but more than MM’s previous offer (51.4%). “The offerer made it clear that this was his last and definitive offer; he does not wish to make any other major modifications.”</td></tr>
<tr><td>November 1993</td><td>SPA Management Meeting discusses the offer; shares originally intended to be sold to agricultural producers are now offered for sale; MM is asked to revise offer accordingly

MM submits revised offer for 96.3% of shares and puts pressure at high level</td></tr>
</table>

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">The SPA argued later that "farmers' ownership could not be realised because they had the right to bid in the first two tenders, but they didn't. ... The SPA Board ..., considering the 11.6% to farmers, offered [this stock to MM] at the negotiated price. Thus the farmers can count on a sure, solvent owner [of FB2], and buyer [of their agricultural products]." The ambiguous wording makes it possible to speculate that the Board's consideration of the "11.6% to farmers" actually meant the following: since MM's offer left only 11.6% of the registered shares available to be offered to farmers (who would pay with compensation notes), we might as well give this stock to MM, who pays in cash.

MM urged the conclusion of the agreement on a meeting with and in a letter to the Minister (emphases in original):

"We want to acquire FB2 .... We see Semi-processed food as a natural complement to [other division]. ... We plan to develop FB2 both on the domestic market and abroad. In Hungary, we will offer consumers a large portfolio of quality and value-for-money products, under [our brand name]. To boost export, we intend to supply more of the demand from MM companies in Western Europe. ... [W]e are committed to invest HUF 575 m. ... [W]e will build strong links with the farmers supplying the factory, by sharing know-how and expanding the business. ... We valued FB2 assuming we will qualify for the 10 years tax reduction granted to foreign investment. ... Timing is critical ... The deal with SPA must therefore be concluded before the year-end. ... The price we offered values the business fairly and I have no authority to increase it further."</td></tr>
<tr><td></td><td>SPA Board accepts offer on conditions; negotiations follow</td></tr>
<tr><td colspan="2">The SPA Board prescribed that all the SPA shareholding (including the stock originally reserved for farmers) can be sold to MM at 60% of par; employee ownership was to be ensured to the extent of 10% of the enlarged registered capital; the buyer was to undertake a capital investment of HUF 575m within two years. In the minutes taken at the Board meeting, Ministry apparently "agreed to the [SPA] Management's proposal. In the discussion of the Board [a member of the Board] objected that MM took an unfair advantage of its favourable bargaining." According to SPA-practice, the final agreement was to be concluded within 30 days after the Board's decision.</td></tr>
<tr><td></td><td>Upon SPA's request, MM submits draft final agreement</td></tr>
<tr><td colspan="2">It specified some previous conditions and included some new elements: an amount to be withheld to cover possible reduction of the purchasing price; indemnification under various accounts to be limited in 25% of the purchase price (instead of a smaller extent as the SPA wanted); capital investment to be undertaken by the company (FB2) and not MM; release of FB2 from a guarantee given to International Bank for Foreign Trade Company (to be assumed by the SPA); English to be the language of the contract.</td></tr>
<tr><td>December 1993</td><td>A (supposedly last) all-day-long meeting to finalise agreement; some issues are still debated; MM wants one more meeting with a higher ranking SPA executive</td></tr>
<tr><td colspan="2">SPA-brief: "Representatives of the buyer have been negotiating (for half a year by now) with the benefit of knowing that there has been no bidder in the privatisation tender of FB2, they will get FB2 in one way or another in any case, [and] they will oblige the seller in various ways, perhaps by way of legal action, to pay indemnification to the extent of a large proportion of the paid-in purchase price. The best example of [MM's behaviour] is that [as prescribed by an SPA Board resolution] employee shares ... will be issued by using the capital reserve to increase the registered capital. Employees can acquire these [shares] at 10% of par. [MM] will buy back the shares at nominal value, having the sum of the 90%-discount ... paid by the seller. Of course this happens only if the employees use their opportunities, but the buyer insists on a guarantee in this regard to be included in the contract (a separate guarantee)." The brief pointed out that the worst possible scenario (if MM claimed all guarantees, price adjustments and indemnification) would "warrant a net income of HUF 67–73m to the SPA, which is 12% of the nominal value."</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>MM asks SPA Administrator to settle the issue of the Bank-guarantee as soon as possible; Administrator gets excited</td></tr>
<tr><td colspan="2">A margin note “Once again a provocation” on MM’s fax indicates the quality of the relationship between the parties, as does Administrator’s reply: “I cannot construe [your request] in possession of our agreement, therefore I shall submit the content of the fax, the circumstances hindering the conclusion of the contract, to the SPA Management Meeting. I shift responsibility for your unusual action and all its detrimental consequences onto personally you.” He immediately prepared a brief for the Management Meeting on this matter.

In the afternoon MM’s counsel wrote back to Administrator and apologised for the delay in sending the latest version of the agreement which was said to have been caused by a total computer network breakdown. As to Administrator’s reaction to MM’s fax, the counsel assumed a “fatal misunderstanding” and made it clear that MM had only tried to ask for Administrator’s assistance in solving the problem of the guarantee, but had no intention to delay the conclusion of the contract.</td></tr>
<tr><td></td><td>International Bank releases FB2 from guarantee (SPA assumed it)</td></tr>
<tr><td colspan="2">Had Administrator waited only a few hours with sending MM his excited reaction and preparing a brief for the SPA Management Meeting on problems jeopardising the scheduled Closing Date, he could have saved himself some work. Now he had to prepare an addendum on the most recent developments.</td></tr>
<tr><td></td><td>MM assures SPA that “we will attend the signature ceremony”

SPA’s legal department misses some documents</td></tr>
<tr><td colspan="2">On the eve of the signature ceremony a representative of the SPA’s legal department made some comments on MM’s last version of the agreement. She criticised the buyer’s one-sidedly favourable position and the lack of some documents (various addenda, declarations of the company’s executives, etc.) “that are indispensable for the SPA to responsibly sign the contract.” Considering all these, she refused to initial the contract. Yet, ...</td></tr>
<tr><td></td><td>Contract is signed; MM immediately issues press release and sends letter to FB2’s business partners</td></tr>
<tr><td colspan="2">Thus, MM acquired all the SPA shares (96% of registered capital) for HUF 418 m, subject to subsequent adjustments. MM was to be compensated for discounted employee shares: “the Allowance must be repaid by the SPA to the Purchaser within 60 days after the issuance of the Employee Shares.” Regarding investments, MM “guaranteed] that within 2 years .... <u>up to</u> HUF 575m capital investment <u>will be made</u> at FB2 [emphasis added].” The transfer of know-how and the use of trade marks were subject to a separate agreement.

Note that the terms and conditions included in the contract differed from what had been approved by the SPA Board. The main differences were: 10% of the purchase price was withheld to cover subsequent adjustments of the purchase price; the SPA undertook to compensate MM in the amount of HUF 72m for the discounted issuance of the employee shares; the SPA Board’s resolution had not prescribed a limit to the indemnification, whereas the agreement set a ceiling of 20% of the purchase price; the SPA assumed the company’s guarantee in the amount of HUF 168m. There is no evidence that would show an expressed acceptance of these conditions by the SPA’s management or any of its members, although the SPA Board’s resolution in November required any changes in approved conditions to be brought before the Board again.</td></tr>
<tr><td colspan="2">Outstanding issues</td></tr>
<tr><td>December 1993</td><td>Payment is made; shares are endorsed</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>February 1994</td><td>New Boards are elected at EGM; increase of registered capital by HUF 80m by issuing employee shares against capital reserve</td></tr>
<tr><td>April 1994</td><td>MM informs SPA that employee shares have been issued (as contracted) and this was registered by the Court in early April; therefore MM claims its money from SPA</td></tr>
<tr><td colspan="2">From MM's letter: "According to the Share Purchase Agreement ... [the SPA] must repay the company within 60 days after the issuance of the employee shares, 90% of the nominal value of the respective employee shares."</td></tr>
<tr><td></td><td>SPA Director "cannot construe [MM's] request"</td></tr>
<tr><td colspan="2">SPA Director raised objections to MM's claim to a compensation. He argued that MM had not provided evidence of meeting its contractual obligations before it could claim any compensation, and asked MM to "let me have detailed information in order to close this issue as soon as possible."</td></tr>
<tr><td>June 1994</td><td>SPA again rejects compensation for employee shares</td></tr>
<tr><td colspan="2">MM must have urged the SPA, at a higher level, in one more letter (unavailable to us), since SPA Leader made reference to such a letter in his writing to MM in June. "I have no knowledge of the issuance of the shares ... [Y]ou only informed us on the subscription to the shares. The prerequisite of the employee share issuance by way of capital raising is the increase of the capital, and its registration with the court. Employee shares can be issued after the court registration, thus we can settle the issue in 60 days after the receipt of a certification [of a court ruling on subscription to capital increase]." On the basis of available information, however, it seems MM did actually inform the SPA in a letter in April of the issuance of the shares and the relevant court registration. Yet, the SPA had not repaid the allowance for months.</td></tr>
<tr><td></td><td>International Auditor's report is done</td></tr>
<tr><td colspan="2">It stated that the Balance sheet as at 31/12/93 should be corrected by HUF 93m.</td></tr>
<tr><td>July 1994</td><td>MM and SPA discuss compensation and Auditor's report
MM submits claim for price adjustment</td></tr>
<tr><td colspan="2">On the basis of International Auditor's report, MM put forward a claim for HUF 93m, due the decrease in FB2's audited asset value from end of 1992 to end of 1993. In the same letter MM stated, "The employees shares scheme has already been finalised at the full satisfaction of the employees. We have already implemented quality improvement programmes in co-operation with our agricultural partners and our relationships are excellent ... The investments ... already started ... The launch of a new high quality product range will be made in Autumn in Hungary and the FB2 products are developing well on international markets."</td></tr>
<tr><td></td><td>SPA pays MM compensation for employee share discounts</td></tr>
<tr><td>August 1994</td><td>Legal study on FB2's privatisation is prepared; employee shares are believed to have been bought up by MM, "contrary to the spirit of the agreement"</td></tr>
<tr><td colspan="2">General Director: "MM bought all the employee shares, they were not actually issued [viz. printed]; workers got a cash amount equal to net wages of six months. MM also bought up the municipality's shares, now it's 100% theirs." The legal study also raised concerns with respect to MM's obligation to carry out a capital expenditure programme. However, General Director said: "From this September [of 1995, later than undertaken] MM will start a capital expenditure programme of HUF 1.685 bn [as opposed to the HUF 574m undertaken] ... Now there are resources to substitute the commissioned warehousing business and to concentrate on the core business."</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>September 1994</td><td>(New) SPA Director attempts to sort out outstanding issues</td></tr>
<tr><td colspan="2">He pointed out some errors and missing formalities in the Auditor's report, and asked MM to specify its claims and reveal its position whether in its understanding the 20% ceiling upon indemnification included both price adjustment and various guarantees, since only the recently submitted claim exceeded this ceiling.</td></tr>
<tr><td>End of Summer 1995</td><td>General Director is about to leave the company; makes general comments</td></tr>
<tr><td colspan="2">General Director was going to leave FB2, apparently because he saw no future career opportunities in running a unit which was under tight control and "needed only a shopfloor manager." Yet, "this is a successful privatisation. I mean if MM is here, it's barometric [viz. indicates that the country is a safe place to invest in]. This is an acknowledgement. Foreign capital comes in, but it buys Hungarian crops. MM has a good relationship with the producers, at some places it advances half of the production costs. It brings its culture, etc. and thinks in long-term. ... We can be proud of [this privatisation]. Labour decreased significantly, but it can grow later. ... The price is what has been negotiated. It was not important for the firm. ... I do not know what I would do in another way. I acted upon conviction. My colleagues sometimes said I was too virtuous. I think I facilitated a good privatisation. It's not much of a consolation in the short term for those made redundant, but it created a 'perspective' [viz. good future prospects]. As soon as market opportunities improve – you see, this market is very much dependent on general standard of living – the firm will be doing very well."

In reply to a specific question about politics surrounding privatisation, General Director remarked: "No, there was no politics. There are charismatic party leaders in [the region where FB2 is located] but regional politics could be kept away."</td></tr>
</table>

6.5 Brown and rough(-and-tumble) – Personal Products 1

6.5.1 Introduction

'Personal Products 1' (PP1) became part of an industry-wide trust in the early 1960s. It was turned into a 'subsidiary with legal personality' from July 1991. PP1 was one of the largest units of the trust, with more than 1000 employees and about HUF 1.685 bn net book value of assets, although it dwarfed in comparison with the trust's two largest companies. PP1 Subsidiary's main business was personal (mainly hygienic) products. On sales of HUF 3.82 bn, it made profit before tax of about HUF 0.56 bn in 1991. PP1's products were mainly sold in Hungary where they had a high market share, ranging from 30% to 80% in the firm's main product lines, even if the products were somewhat brown and rough. Although domestic competitors were only two (one belonging to the same trust, the other having small production capacity), PP1 faced increasing import competition from white and soft products of better quality. Imports had already been fully liberalised. The Hungarian personal products industry, contrary to that of neighbouring countries, was not protected by tariffs and duties.

Table 23 Main actors in PP1 case in order of appearance

Name (acronym, if any)	Note
	Insiders
(PP1's) Director	Chief executive of PP1
ESOP I Leader	Leader of one of the rival ESOPs
ESOP II Leader	Leader of the other ESOP, supported by PP1's Director
	Outsiders
Trust	the nation-wide state-owned enterprise of which PP1 was a subsidiary with legal personality; 'Trust' is often used by actors to refer to the headquarters only
General Director	Trust's chief executive
State Commissioner	appointed by SPA to be Trust's chief executive after General Director's early retirement; previously a deputy of General Director
Central ESOP Preparatory Committee (CPC)	created by Trust's management to deal with ESOP-issues; negotiated with ESOP leaders of various units
Other Personal Products (OPP)	a subsidiary of Trust (like PP1) which wanted to become independent (like PP1)
Another Personal Products (APP)	another subsidiary of Trust; subject of alleged misdeed of Trust's management; eventually acquired by Spanish Industrialist and merged with PP1
Small Personal Products (SPP)	another unit within Trust; also subject of alleged misdeed of Trust's management
Second Largest Personal Products (SLPP)	a modern unit within Trust; contributed by Trust's headquarters to a joint venture with a foreign company; its production was soon halted; years later was subject of a liquidation sale
Governing Party Politician	was lobbying for ESOP
Foreign Holding (FH)	ESOP teamed up with this allegedly Swiss firm; they form ESOP–FH consortium
Spanish Industrialist	eventual owner of PP1

Name (acronym, if any)	Note
Spanish Industrialist and Bank (SIB)	a temporal consortium of Spanish Industrialist and a Hungarian bank
Domestic Investment Group (DIG)	of five Hungarians; bid for PP1
Large Atlantic Company (LAC)	bid for PP1
Disqualified Domestic Consortium (DDC)	missed the deadline by seven minutes
Tiny Foreign Company	was supposed to prove professional capabilities of Foreign Holding
Small Service Firm (SSF)	a business partner of PP1; misdeed was suspected

Note: for a list of actors appearing in all or most of the cases, see Table 15.

6.5.2 Case narrative

Table 24 Event history – Critical incidents in PP1' privatisation

Date/Period	Description of Event
Prelude: Towards breaking up Trust	
by 1990	Trust already established a few companies with foreign co-owners, by contributing its subsidiaries in-kind to joint ventures
Spontaneous start-up	
April 1992	First draft of Trust's Transformation Plan is submitted, following discussions with and instructions from SPA Trust's Enterprise Council authorises General Director to initiate transformation
May 1992	General Director submits Transformation Plan to SPA
At this time, Trust was operating as a group consisting of several companies (out of which some were established as joint ventures with foreign firms) and subsidiaries (legally independent units). Since more than 50% of the firm's assets had already been represented in company form, Trust was required by law to transform by the end of 1992. Based on the sector's capital and R&D intensity and "international experience," Trust's management proposed that the group should not be broken up. It planned a holding structure with headquarters carrying out asset management function over the companies. Note that Trust was heavily indebted. Planned date of transformation was July 1992.	
June 1992	PP1's employees raise voice
Vice President of PP1's local Workers' Council complained at General Director and SPA that he had been informed only from the papers of the fact that Trust had submitted a transformation plan; asked for information so that they could "in time use the employees' right to formulate an opinion." A week	

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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">later he requested that the SPA find a solution that would protect employment.</td></tr>
<tr><td>July 1992</td><td>PP1's independence from Trust and an ESOP are initiated: ESOP Leader requests SPA to "deprive Trust of the assets of PP1 Subsidiary ... so that on the basis of these assets a company can be established and in this company an ESOP programme can be launched..."</td></tr>
<tr><td colspan="2">ESOP Leader started his career at PP1 as a mechanic. He studied part-time for his engineering diploma and graduated in 1978. "I belonged to the manager reserves of the large firm [i.e. Trust's headquarters]." In 1979, however, he had a work accident which resulted in partial paralysis of his right arm. He then studied for a second diploma. In the early nineties, he was head of technical development, although the number of employees in his department was one. In his letter to SPA he argued, "it has been for years a determined demand of PP1's employees to be separated and to operate as an independent company. This effort has so far been made hopeless by the rigid opposition of Trust's management."

At about this time another subsidiary of Trust (Other Personal Products, OPP) made a similar move, in order to achieve independence from Trust and to implement ESOP.</td></tr>
<tr><td></td><td>Workers' open forum with the participation of Ministry, National Association of Workers' Councils, 'Taking-Part' Foundation (a pro-ESOP organisation led by one of the SPA Board's members), where Trust's General Director and PP1's Director "promised to support the ESOP Organising Committee's work" (quote from a letter of ESOP Leader to SPA)</td></tr>
<tr><td colspan="2">Rivalry and politics</td></tr>
<tr><td>July – August 1992</td><td>A rival ESOP is launched (ESOP II; ESOP mentioned above now becomes ESOP I)</td></tr>
<tr><td>August 1992</td><td>The two ESOP Organising Committees submit a memorandum to Trust's Enterprise Council</td></tr>
<tr><td colspan="2">"It is our basic and shared objective that the subsidiary, following transformation, continue its operation as a joint stock company limited by shares ... and a stock representing at least 45% of the registered capital be acquired by the employees" in the form of employee shares with 90% allowance to be granted by the SPA. For the 10% to be paid for, the ESOP Organising Committees planned to take an 'Existence-loan' for a period of 10 years. However, they outlined two alternative routes to achieve employee ownership. In the first way the parent company, before its own transformation, would transform the subsidiary into a company, and with the SPA's consent it would enter into agreements necessary to realise the above mentioned objectives. In case this proposal was rejected by either Trust's Enterprise Council or the SPA, the memorandum stated that "in the process of the parent company's transformation the subsidiary's employees want to use their right granted by the ESOP Act that the SPA, at the time of the parent company's transformation, deprive it of [the subsidiary's] assets and transform [the subsidiary] into a company by granting the employees an opportunity to acquire shareholding" to the same extent as in the first alternative.</td></tr>
<tr><td></td><td>ESOP I Leader seeks support from MP</td></tr>
<tr><td colspan="2">ESOP I Leader prepared "Possible alternatives to transform and privatise PP1" for the purpose of informing the MP. He attacked Trust which "before the system change [i.e. the political turnaround in Hungary] was in a monopoly position due to its state-owned large enterprise status. It wants to keep this centralised ... position –this is vital for its further existence" since if Trust was dismantled, there would be no subsidiaries to direct from the top. If the SPA accepted Trust's proposal, it would in</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">ESOP I Leader's view provide headquarters with an opportunity "to continue its operations, just like in the earlier, socialist, megalomaniac industry structure," acting under a different name but enjoying the same rights with which "it contributed to the crisis of the sector." On the other hand, acceptance of their, i.e. the ESOP's, proposal would "impede power-saving," that is it would prevent managers appointed in the communist era from transforming their base of power to better fit to new institutions and organisational forms. ESOP I Leader asked the MP for his support so that the SPA "1. deprive Trust of PP1 subsidiary's assets, 2. temporarily draw the subsidiary under direct state control (by appointing a state enterprise commissioner), 3. on the basis of these assets establish a single-person company [with the state as the only shareholder] in order to attain partial employee ownership there, 4. directly supervise and manage – in accordance with national and local interest – the introduction of foreign capital".

To put the events in historical context, note that about a year earlier the same argument was presented in a 'public notice' sent to the SPA on "squandering Trust's [APP] subsidiary." Trust's headquarters was said to have attempted to sell APP at any price "only in order to keep their individual positions on the top of an asset management holding." It is a fact that at that time headquarters wanted to transform APP subsidiary into a "self-accounting internal unit" (a legally non-independent form), "so that [Trust as a state-owned enterprise] can keep in its books those receivables, liabilities and stocks that could be contributed [to a joint venture] on unfavourable conditions, in the interest of avoiding their re-valuation losses." (Quote is from a resolution made by Trust's Enterprise Council.) The ownership split of the planned joint venture would have been Trust holding 40% and the foreign investor 60%. That is, Trust's headquarters attempted to accumulate all the losses and contribute APP's assets to a joint-venture clean of all debts and liabilities. The deal fell through later; APP was eventually acquired by the same investor who bought PP1.

Trust's Enterprise Council passed the same resolution regarding SLPP subsidiary. In that case the ownership split was to be 49% and 51% for Trust and the foreign owner respectively. This deal was eventually struck. A few months after the establishment of the joint venture, SLPP's modern machines were stopped, production was 'suspended' and a long battle began between the SPA and the foreign investor whose other companies were said to have been hit by recession.

In another case Trust intended to strike a deal with a foreign firm in 1991 on the basis of its SPP subsidiary. The planned deal was characterised by an SPA-director at the time as follows (emphasis in original): "1. Essentially, Trust would transfer [Hungarian word can also be interpreted as 'give away'] controlling rights and 100% of the assets [of the subsidiary concerned] without [receiving] money. 2. [The foreign firm's] commitment is minimal. ... All the risks are taken by the Hungarian side!"</td></tr>
<tr><td></td><td>ESOP I Leader complains that management does not provide information and money for preparing an ESOP Feasibility Study</td></tr>
<tr><td colspan="2">He also referred to his earlier letter in which "I asked the SPA to deprive Trust of the subsidiary's assets and transform it into an independent company, then privatise it by partly providing employees with shareholding and partly, via tender, involving mainly foreign but also domestic suppliers and buyers." The self-quoted letter did not make reference to any would-be owners other than employees.</td></tr>
<tr><td></td><td>A consultant's preliminary study concludes ESOP would be feasible on conditions</td></tr>
<tr><td colspan="2">ESOP seemed feasible if there was a tax shield to be granted to PP1 (for example, due to foreign interest), and 13–15% return on sales could be achieved. The subsidiary's management regarded a higher profitability necessary for PP1 to be able to finance its operations while covering the ESOP's debts.</td></tr>
<tr><td></td><td>MP asks Responsible Politician for urgent help in PP1's case "before things completely get muddled up."</td></tr>
<tr><td colspan="2">"On the initiative of the Workers' Council ... an ESOP was established at PP1. Their efforts have in</td></tr>
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<tr><td colspan="2">every possible way been thwarted," wrote the MP and attached documents that he had received from ESOP I Leader. Responsible Politician passed it on to SPA deputy leader with a hand-written note: "Let's create an opportunity for them!"

Some time later Responsible Politician also received a letter from OPP, where an Independent Workers' Council had been established. Parallel to the developments at PP1, a similar story was unfolding at OPP.</td></tr>
<tr><td>Autumn 1992</td><td>SPA attempts to find solution to double problem</td></tr>
<tr><td colspan="2">SPA faced two problems: how to transform and privatise Trust while taking into consideration the attempt of some of the subsidiary's employees to become independent, and how to handle the rivalry between the two ESOP Organisation Committees. As to the first problem, in the beginning the SPA Administrator's position was that there should be no delay in the transformation of the whole Trust, and the SPA should solve PP1's problem afterwards. As to the second problem, the memorandum of the two ESOP Organising Committees to Trust's Enterprise Council may not have made it clear how big the difference between the plans of the two Committees was. The first Committee, backed by 25% of the employees, insisted on becoming independent of the parent company before transformation and privatisation took place. The second Committee enjoyed support of 45% of the employees and the subsidiary's management, and planned to achieve employee ownership while remaining part of the Trust. SPA attempted in vain to reconcile the two ESOP Organising Committees, whose rivalry "even raised anger."</td></tr>
<tr><td>September 1992</td><td>ESOP I Leader meets Responsible Politician; in a subsequent letter he repeats arguments and requests Responsible Politician's support; now also mentions need of foreign capital; complains that Trust's and PP1's management do not give documents for preparing detailed Feasibility Study

Trust establishes Central ESOP Preparatory Committee (CPC); Trust's Enterprise Council does not discuss memorandum of PP1's ESOPs; CPC and ESOPs have discussions</td></tr>
<tr><td colspan="2">Because the Enterprise Council members received the memorandum only one day before their sitting, it passed a resolution that it "supports employee ownership to the legally possible extent in every unit of the Trust group," but it could not responsibly discuss the proposal because it had not had the minimum required preparation period of 8 days. Thus the discussion of the memorandum was postponed. The newly created CPC's position was that employee ownership was acceptable to the financially feasible extent (less than claimed by ESOPs); Trust "would re-invest [in PP1] dividends it is entitled to in every year, subject to evaluation of the company's [subsidiary's] capital requirements," which evaluation would certainly be made by headquarters. CPC objected to the demand that the transformation of the parent company could only happen after PP1 subsidiary was already privatised. CPC promised to make a detailed business plan available to the ESOP Organising Committees in a few weeks so that they use it in preparing a Feasibility Study. According to CPC's report to the SPA, only ESOP II Organising Committee accepted CPC's position. ESOP I Leader practically refused to acknowledge the authority of CPC in a matter that had been addressed to Trust's Enterprise Council.</td></tr>
<tr><td></td><td>Ministry listens to Trust</td></tr>
<tr><td colspan="2">Deputy State Secretary wrote to SPA Leader: "I have been informed by Trust's management ... that the SPA requires a proposal on the firm's transformation that includes the alternative of decentralisation [viz. breaking up Trust]. We agree .. that it must be examined ... [but] <u>this should not delay the firm's transformation programme that has been harmonised with the Ministry.</u> The firm has considerable and to date successfully managed debts. In the coming weeks renewal of credit agreements inevitable for maintaining its viability is due, which is seriously jeopardised by any further delay in the transformation. ... The firm's decentralisation and the implementation of an ESOP</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">at [various subsidiaries] are also possible after [Trust's] transformation. On these [issues] there have been successful discussions between the employees and managements of these units and the central management".</td></tr>
<tr><td></td><td>Responsible Politician pushes 'decentralisation'</td></tr>
<tr><td colspan="2">There was pressure from two (and soon three) of the subsidiaries, and there were indeed problems in the relationship between the SPA and the foreign co-owner of other Hungarian personal products companies. Responsible Politician's margin note on a letter he had received from OPP and passed on to SPA Leader made it clear that "decentralisation is to be discussed." Another note on an attached slip was absolutely unambiguous: "Mr. [SPA Leader], Trust has to be decentralised!! The daughters [viz. subsidiaries] have to be let go independent! They [must] receive positive reply!" A few days later Responsible Politician noted again in a margin note: "Trust [must] be drawn under direct state control, and let us break it up by appointing a commissioner!" SPA Leader requested Administrator to prepare a proposal for the SPA Board according to this instruction.</td></tr>
<tr><td></td><td>SPA Leader requests Director "to immediately commission an expert for preparing a decentralisation concept in 2–3 weeks," adding that "[OPP] must be sent a positive reply. Copy [must be given] to Responsible Politician."

SPA assures PP1's and OPP's ESOP leaders that nothing has been decided yet and their interest is being considered</td></tr>
<tr><td colspan="2">SPA's main problem was whether to transform Trust and then turn the 'renegade' subsidiaries into independent companies, or to establish independent companies from the subsidiaries and then transform and privatise the rest of the group. The second alternative, preferred by ESOP and Workers' Council-leaders of the subsidiaries, would lead to a delay in the transformation of the group.</td></tr>
<tr><td></td><td>MP gets satisfactory reply</td></tr>
<tr><td colspan="2">In response to his letter to Responsible Politician, MP was informed that "preliminary studies show that the best possible solution seems to be letting the subsidiaries ... go before the parent's transformation." Whether it would be a feasible solution was subject to further studies.</td></tr>
<tr><td></td><td>Subsidiary managements declare faith</td></tr>
<tr><td colspan="2">Leaders of Trust's subsidiaries, including PP1's Director, sent to SPA a declaration, stating that the they wanted to transform their subsidiaries into company from 1 January 1993 within Trust (i.e. within a holding company to be established from Trust's headquarters). They also urged the SPA to proceed quickly with their case since "Viability of the units is jeopardised by dragging on of the transitional state." The directors unanimously suggested that Trust and its OPP subsidiary should be transformed at the same time, as from 1 July 1992 (retrospectively). PP1 was not singled out.</td></tr>
<tr><td>October 1992</td><td>Trust's management suggests that Trust's Enterprise Council should vote according to CPC's position

ESOP I Leader corrects Deputy State Secretary</td></tr>
<tr><td colspan="2">"Contrary to the statement of Trust, there has been no successful discussion with our ESOP Organising Committee, although you have been informed so by Deputy State Secretary in his letter ... which was worded on the basis of information provided by Trust's management. ... Trust wants to divide employees, we do not get information on financial issues, and despite our written request we have not to date received data and documents necessary to prepare the ESOP Feasibility Study."

From this time, when OPP's similar efforts were made public in the press, ESOP I Leader often referred to OPP, thus indicating that PP1 was not the only one who was rocking the boat.</td></tr>
<tr><td></td><td>Director and ESOP II Leader present their view to SPA Leader</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">“In order to provide complete information, we consider it necessary that the SPA get to know the proposal of the management and the ESOP II Organising Committee representing 45% of the employees.” The attached “Proposal on the transformation of Trust’s PP1 Subsidiary” suggested ‘ESOP within Trust’ with the following ownership split: Trust or its successor 71–51%, employees (employee shares + ESOP) 25–45%, municipality 4%. This proposal was signed by the subsidiary’s director, Leader of ESOP II Organising Committee, two functional directors, and several middle managers.

In order to make sure that employee ownership would be achieved after transformation, the management planned to introduce “internal convertible employee bonds” in the amount of HUF 112m. The bonds would be sold to employees at 10% of their nominal value, and they could be converted into employee shares after the subsidiary’s transformation. The SPA later did not approve this since “there are opportunities of employee ownership at great discount after transformation.”</td></tr>
<tr><td></td><td>SPA prepares ‘decentralised privatisation’</td></tr>
<tr><td colspan="2">A proposal to the Board of Directors was being prepared to draw Trust under direct state control under the leadership of State Commissioner who was already selected.</td></tr>
<tr><td>November 1992</td><td>Ministry gives in</td></tr>
<tr><td colspan="2">Ministry Head of department wrote to SPA Leader: “following several requests made by Trust’s PP1 Subsidiary (its ESOP I Organising Committee), we considered the firm’s transformation once more and concluded that it is necessary to change the position we have had till now.” The Ministry had had discussions with the ESOP Organising Committees and the subsidiaries’ managements, and found that “they want to gain independence” and the subsidiaries’ economic situation “is not without problems, but manageable.” He suggested that the subsidiaries should be independently transformed into companies parallel to (but not, as demanded by ESOP I Leader, prior to) Trust’s transformation.

This letter was followed in early December (prior to an SPA Board meeting) by another one signed by Deputy State Secretary, who now favoured Trust’s “privatisation by decentralisation.” He listed the arguments of Trust’s headquarters against decentralisation, and immediately fended off these arguments in a four page long letter (plus appendix) that seems to have been drafted for him at PP1.</td></tr>
<tr><td>December 1992</td><td>SPA’s Board resolution: Trust is to be drawn under direct state control as from tomorrow; top management is replaced and given the task to draw up a “crisis plan” and a transformation and privatisation plan in 30 days</td></tr>
<tr><td colspan="2">General Director’s work was duly acknowledged; nevertheless he was relieved of his position and soon retired. State Commissioner, who had already been selected before the SPA Board made its formal decision, was appointed as from 1 January. He was also required to examine whether there had been abuse of state-owned property in the process of establishing joint ventures on the basis of Trust’s assets.</td></tr>
<tr><td>March 1993</td><td>Responsible Politician replies to Governing Party Politician</td></tr>
<tr><td colspan="2">Governing Party Politician’s letter is not available, but its content may be deduced from the reply. Responsible Politician assured Governing Party Politician that “I support the concept of decentralised privatisation ... and ... employee ownership by means possible under the law, and I have reminded the SPA of this task.” On PP1’s specific case Responsible Politician stated, “I consider it most important to carry out an ESOP programme.”</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">Transformation</td></tr>
<tr><td>March 1993</td><td>State Commissioner submits to SPA transformation plan for PP1 subsidiary</td></tr>
<tr><td colspan="2">The plan combined capital injection and employee ownership by “subscription to employee shares or perhaps some other privatisation technique,” which elsewhere was specified as an ESOP with the maximum possible discount. Planned transformation date was 1 April 1993. PP1’s “own capital” was proposed to be divided to registered capital of HUF 1.163 bn and capital reserve of HUF 0.516 bn.

A separate section dealt with the opportunities of employee ownership. Also attached was an “Employment and social plan” which envisaged keeping the job of every employee, 25% increase in wages plus a so-called ‘13th month salary’, and continuing operations of ‘social assets’. Later the leaders of the local union and the workers’ council recorded in writing that they agreed to the proposed forms of employee ownership “on the condition that various forms of acquiring ownership by employees taken together should make it possible for the employees to acquire majority interest”.</td></tr>
<tr><td></td><td>SPA Board resolution: crisis management and privatisation proposal for Trust is approved</td></tr>
<tr><td colspan="2">“Writing off of Trust’s long term state loan must be requested from the Government, or the Parliament. The Board approves that HUF 1.572 bn out of privatisation proceeds be used to service [Trust’s] debts. ... Trust’s subsidiaries and self-accounting units be transformed into companies as from 1 April 1993; ... the Board authorises ... the commissioner ... [to] announce public call for bids.” Trust was also to be transformed soon, and at the end of the privatisation process it was to be wound up.</td></tr>
<tr><td>April 1993</td><td>PP1 is transformed into joint stock company, wholly owned by Trust (still state-owned); PP1’s Director is confirmed in her position until end of first fiscal year (May 1994)

PP1’s Workers’ meeting is attended by SPA Deputy Director</td></tr>
<tr><td colspan="2">United Play of Politics</td></tr>
<tr><td>May 1993</td><td>ESOP I and ESOP II merge (ESOP I Leader now becomes ESOP Leader)

Local Party Politician’s interference is rejected by SPA Leader</td></tr>
<tr><td colspan="2">Only the reply is available. “We read your letter to the SPA ... with astonishment ... [I]t is the State Property Agency’s ... duty to transform enterprises. This Act exactly specifies what obligations of conciliation the SPA has. These obligations of conciliation does not include political parties or regional organs of parties.” The rest of SPA Leader’s letter sheds light on a growing conflict within PP1’s organisation. “At the time of appointing the company’s managing director, we did not see any reason for replacing the existing [Director]. To our best knowledge the subsidiary has been successfully operating under her management, its first quarter ended with profits. The management has not taken any illegal or unethical measures. ... At the workers’ assembly [in April 1993] ... employees were given information ... [and SPA Deputy Director] also announced the SPA Board’s position of principle that a leader of an ESOP Organising Committee cannot hold top management position.”

Apparently there had been attempts to replace PP1’s existing top management. Behind these attempts we may assume ESOP I Leader. This assumption gains more evidence later.</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>June 1993</td><td>SPA Board approves privatisation plan for Trust's companies</td></tr>
<tr><td colspan="2">SPA was ready to accommodate bids from ESOP organisations. A public call for tender was to offer 51% of shares in PP1, allowing bidders to use E-loan and compensation notes.</td></tr>
<tr><td></td><td>United ESOP leaders, teamed up with one of the functional directors, present conflict within the firm and outline 'ESOP–MBO–Foreigner' plan to Another Responsible Politician</td></tr>
<tr><td colspan="2">The ownership split would be worked out by a consulting firm. "The contract with the consulting firm has to be approved and signed by the SPA, since the employees cannot bear the costs of this."

"Privatisation of Trust has been unsuccessful to date ... The management [of Trust] that brought this about was given an opportunity to implement a decision that is completely contrary to its proposal ... Complete settlement of the internal tension within the factory would be needed so that common interest dominate in the preparation of the ESOP–MBO offer. ... Intimidating [us] by making references to the banks has been a means used by Director ... [Cf. the ESOP Organisation cannot take a loan if Director refuses to allow the bank to register mortgage on the firm's property.] In case of a [public call for tender] the director and her circle may submit a proposal on a completely different privatisation solution, or may organise an investment consortium. By knowing the employees' offer she can take an unfair advantage. ... [S]he has hitherto monopolised discussions with [state agencies, consulting firms and banks], and excluded employees from the processes. ... [I]t can be presumed that such conditions will be proposed that are unfavourable to employee acquisition, for example prescription of bid bond ... [The management of Trust and PP1's Director] were only pretending co-operation, but they were in every possible way delaying, bargaining and impeding, and they deprived the ESOP Organising Committee and the management at PP1 of the possibility of not only getting but also of providing information [viz. they prevented us from having our voice heard]."</td></tr>
<tr><td></td><td>SPA Deputy Director fends off ESOP's proposal</td></tr>
<tr><td colspan="2">In a memorandum to Another Responsible Politician and SPA Leader, Deputy Director presented his opinion: "The ESOP Organisation's proposal ... is all too messy and unacceptable to the SPA ... It is a statement with no foundation whatsoever that the conditions of the privatisation are determined by Trust, or perhaps the leader of the transformed subsidiary. This is the right of the SPA's Board of Directors, with the assistance of our directorate ... I am getting the impression that the ESOP Organising Committee does not have firm plans regarding the company's privatisation, except for one thing, namely that the existing director has to be replaced, and a person suitable to them has to be appointed."</td></tr>
<tr><td></td><td>SPA's Advisor is appointed

ESOP appoints new Consultant</td></tr>
<tr><td colspan="2">Consultant's assignment was "to harmonise a Management Buy-Out with an ESOP-acquisition." Consultant was also assigned to "harmonise the outside investor's acquisition intent with the ESOP."</td></tr>
<tr><td>July 1993</td><td>ESOP teams up with a possible investor, Foreign Holding (FH)

Consultant prepares ESOP Feasibility Study

Another Responsible Politician requires a reply to be sent to ESOP "on the basis of which the conflict cannot be intensified"; Deputy Director drafts reply</td></tr>
<tr><td colspan="2">"The internal conflict you mentioned in your letter is felt by the State Property Agency, too. The implementation of the privatisation as soon as possible will hopefully bring a solution to this tension. Until then, I suggest that you reach a consensus. In the absence of this I see the realisation of employee ownership in any form jeopardised."</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>ESOP Leader assures Another Responsible Politician that ESOP will keep the rules, and explains why they want majority stake</td></tr>
<tr><td colspan="2">“For us ... it is a great honour that You, besides Your diverse duties of utmost importance, are dealing with the transformation and privatisation of PP1 in details on its merits. With high esteem we thank You for your efforts and assure you that ... we operate by strictly adhering to the law so that the State Property Agency can make an optimal decision ... We too consider the introduction of such a foreign investor desirable who undertakes to ensure the long term interests of PP1, that is, who will carry out major capital investment in order to improve our competitiveness and to ensure efficient employment of the present work force, and is in possession of the necessary capital and capability to enlarge our markets. The purpose that is served by our declared intention to acquire the majority of the existing shares in the company is to achieve that the foreign investor’s possible capital increase be large enough to carry out the inevitable and urgent developments.”</td></tr>
<tr><td colspan="2">Sale of majority stock</td></tr>
<tr><td>August 1993</td><td>Cover page story in English-language paper considers PP1 “one of SPA’s few remaining diamonds in the rough,” due to its high market share; but it’s ripe for major upgrade

Advisor expects relatively easy privatisation and at least ten bids; a later bidder says “the whole factory really is not much, but the local market is a big attraction”</td></tr>
<tr><td colspan="2">“Unlike other state-owned monopolies or near monopolies that have rapidly lost market share over the past three years to foreign competition, PP1’s market share is not expected to change. ... Imports are not likely to increase because of anticipated local production of the higher quality product, which will be significantly less expensive to produce and deliver. For the same reason, greenfield projects are not expected following the sale of PP1 to a Western company.”</td></tr>
<tr><td colspan="2">First round of tender</td></tr>
<tr><td></td><td>Call for bids for 51% of shares</td></tr>
<tr><td colspan="2">Deputy Director updated Another Responsible Politician that “in the first round bidders will be pre-qualified mainly on the basis of their business plans ... then we shall ask them for their price offer. ... The ESOP Organisation have had discussions with several foreign investors in order to submit a consortium offer. ... they signed an agreement on establishing a consortium with” a foreign partner.</td></tr>
<tr><td></td><td>SPA Leader updates Nation-wide Union Leader</td></tr>
<tr><td>September 1993</td><td>Trust’s State Commissioner forms opinion on PP1 ESOP Feasibility Study</td></tr>
<tr><td colspan="2">From this written source the content of the Study can also be inferred to. State Commissioned accepted every conditions that were normally parts of ESOP-deals, but objected to ‘over-capitalising’ the ESOP organisation. “In the Feasibility Study [it is proposed that] prior to the actual take-over, PP1 should transfer for good HUF 62m ... to the ESOP Organisation, and give an additional sum of HUF 8m from its pre-tax profits. Basically, this transfer would be the ESOP members’ own contribution [a requirement for taking an E-loan].”</td></tr>
<tr><td></td><td>Responsible Politician reminds SPA “PP1’s privatisation must be given topmost attention” and wants to be “continuously kept informed”

Tender opening: five bids received, +one submitted late</td></tr>
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Date/Period	Description of Event

Spanish Industrialist + Hungarian Bank (SIB)

Spanish Industrialist was acknowledged in the industry, being a principal owner, chairman and CEO of companies in two countries. Also had interests in shipping, real estate, trading. He would acquire 30% and Hungarian Bank would acquire 21% of the shares. They did not bid for the stock reserved for employee ownership but indicated willingness to acquire shares that employees might sell later.

Spanish Industrialist individually

Same as above.

Large Atlantic Company (LAC)

LAC was a member of a family-controlled group with long traditions in the this industry. It had interests in numerous countries, and projected major restructuring and capital investment for PP1.

Domestic Investment Group (DIG)

rejected

ESOP + Foreign Holding (ESOP–FH)

rejected

Disqualified Domestic Consortium (DDC)

disqualified

October 1992	Evaluation of bids

The Evaluation Committee consisted of representatives of SPA, Advisor and Trust. Bids from SIB, Spanish Industrialist, and LAC were regarded acceptable in terms of formal requirements and content. In other cases there were more important issues than the business merits of the bids.

DDC: According to the minutes of the tender opening, the bid was received seven minutes past 12.00, the official deadline. It is understood that DDC also included some of the members of the company's existing management.

DIG: It included a software engineer, a pharmacist, an economist currently working for a casino as marketing manager, and two lawyers. They were called to provide references in the personal products industry. DIG issued a declaration in which it referred to three industry experts who wanted to remain anonymous until the second round. The SPA considered a hostile take-over possible; a margin note made on a brief instructed Administrator that "the Board of Directors must be told [viz., it must not be included in the written proposal] on what considerations the assumption of a hostile take-over was based."

ESOP–FH: Foreign Holding, allegedly a Swiss firm, attached a Liberian registration abstract. The four persons acting as representatives of FH gave Tiny Foreign Company (TFC) as site of business reference. SPA: "it was a small enterprise employing 36 employees altogether, completely unknown in international business." A consortium agreement, drawing up the mutual obligations of the partners, was also missing from the bidding documents, contrary to tender requirements. The Evaluation Committee did not consider this bid valid, adding that it was also poor on professional merits.

However, the Evaluation Committee also suggested that "in order to promote employee ownership, the SPA's Board of Directors should pass a resolution that employees, in an ESOP programme, can have a shareholding in the company to the extent of 20%, out of the 49% not offered for sale in the present tender." This recommendation implied not only that the employees would not be excluded from the acquisition because of having teamed up with a partner of questionable background but also that they would not have to compete with any other bidder. Also note that this proposal suggested that offering 20% of the shares for sale was a solution that would most likely satisfy the ESOP, although it was probably clear to everyone that the ESOP leaders had been seeking a larger interest. This recommendation, thus, limited the interest that the ESOP could, at least in principle, acquire.

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>SPA Board resolution declares first round successful, disqualifies DDC and ESOP–FH, does not invite DIG to second round; authorises SPA-directorate to initiate discussions with ESOP on the sale of 20% of the shares at a price equal to what the winner of the present tender was to pay</td></tr>
<tr><td>October – November 1993</td><td>'Epilogue' to the first round</td></tr>
<tr><td colspan="2">DDC objected to having been disqualified, arguing in letters to SPA Leader and Responsible Politicians that they had submitted the bid just in time but by the time the receipt confirmation slip was filled in, it was already three minutes past noon. Upon request by SPA, Advisor asserted that DDC's dispatcher arrived late, adding that "In a moment after the dispatcher left our office [representatives of ESOP–FH who had just submitted their bid], set foot in the secretariat" and called Advisor's attention to the clock. SPA eventually concluded that DDC's claims were simply not true and rejected DDC's protest.

ESOP–FH considered legal action. A lawyer and SPA exchanged letters. SPA requested ESOP's position whether the lawyer indeed represented ESOP or acted only on behalf of FH. It was made clear that such a declaration from the ESOP was necessary to the SPA "for further administration of the sale of 20% of the shares to the ESOP Organisation," implying that the 'wrong' answer may lead to withdrawal of the SPA's offer.

At the time of these debates, Another Responsible Politician received some documents from an anonymous sender via fax. In a letter dated May 1993 a foreign investment trust certified, with an illegible signature but without the name being typed underneath, that it held "in excess of [HUF 1.7 bn] of the investors funds available for investment in this company at investors sole discretion." A London Post Office Box and phone number were given. Another document, without date, was meant to certify on behalf of an Italian company that Tiny Foreign Company "is a major [personal products] producer in [the Middle East]. We know this company for several years and have learned that it is a dynamic and serious company. .... well-known for its reliability and strong marketing expertise." The third document was a on LAC, presenting a dark picture on LAC Group's financial state and a struggle in the LAC family. It seems reasonable to assume that deliverance of these documents in early November probably served the purpose of strengthening FH's position while attempting to discredit LAC before the SPA.</td></tr>
<tr><td>November 1993</td><td>Interlude: PP1's contract with SSF is revoked

Contract with ESOP's Consultant is to be revised

ESOP once more seeks Responsible Politician's and SPA Leader's support</td></tr>
<tr><td colspan="2">The contract with SSF was concluded in December 1992 when PP1 was still a subsidiary of Trust. It gave SSF an exclusive right "to co-ordinate and manage" PP1's foreign trade activity, including both exports and imports, for 5 years. For its services, SSF was entitled to a fee and, in case of specific transactions, 2–3% of the transaction value.

SPA requested Director to revise the contract with Consultant because of unjustified elements of its fee structure.

Following the SPA Board's decision, ESOP Leader and, on behalf of the MBO-group, one of PP1's functional directors sought Responsible Politician's help. They referred to his earlier supporting letter, stated that 20% of the shares was not enough to attain their objectives, and asked him for his personal support so that they could buy the remaining stock of 29% on top of the 20% which had been offered for sale to them by the SPA Board. They argued, "if the strategic investor increases capital to a significant extent, and reinvests profits, then the ESOP achieves its main objective, which is nothing</td></tr>
</table>

Date/Period	Description of Event
	else but to increase the company's viability with necessary developments ... [W]e respectfully ask you to make it possible for us to achieve 49% interest which would for some time mean a minority position for our ESOP Organisation." Interestingly, they referred to minority as a temporary state only. In another attempt to enlist decision makers for their case, ESOP and MBO-leaders wrote to SPA Leader. They stated that they were "fighting a phantom battle [i.e. against invisible enemy]" in order to achieve employee ownership. "We approached ... every important leader of the SPA (including Yourself) and obtained their supportive statements ... They even encouraged us to formulate our objectives [and] to use the ESOP to attain them. This reinforced us, all of us. ... Of this preparatory process we informed in detail our colleagues at workers' meetings and in writing, ... mentioning the supporting letters that we had received from You and Responsible Politician and Another Responsible Politician. This repeated encouragement played an important role in the establishment of our ESOP Organisation." They added, "we cannot see that contrary to successive promises and encouragement who/what is the phantom who/that continuously resists and hinders the rational [as interpreted by them, that is] process, often with means beyond words." They hoped the SPA would make it possible for the ESOP to acquire 49% interest with which they could acquire, as they put it, "a stake that is necessary to hold a minority position that could be maintained for at least 1–2 years." Note that holding 49% interest probably also implies 1–2 years delay in achieving their alleged eventual objectives, that is the implementation of a capital increase to finance developments. On behalf of Responsible Politician and SPA Leader, SPA Deputy Director drafted up replies. ESOP was condemned for having teamed up with an unacceptable partner; ESOP's judgement on the privatisation of the industry to date as catastrophic was rejected, as well as the implication that some sort of a phantom within the SPA would obstruct the ESOP's proposals.
	Second round of tender
October 1993	Invitations to make price offers are sent to pre-selected bidders
	Now price and guarantees were the most important elements considered. Advisor estimated a justifiable price of PP1's shares in the region of 160–170% of par. 51% of the registered capital was offered for sale. The remaining 49% was planned to be sold in return of compensation notes and under the framework of the Small Investors Share Purchasing Scheme (a soft-credit scheme that the government attempted to introduce towards the end of its term to promote mass ownership; following long debates shares in only two firms were offered via this scheme before the government was replaced in the 1994 elections). In the final version of the bid invitation, 20% was reserved for sale to the ESOP and 29% was "intended to be used for fulfilling the SPA's other duties."
November 1993	Tender opening: all three invited bidders submitted valid offers Offers are evaluated
	Spanish Industrialist + Hungarian Bank HUF 905m for 51% of the shares: HUF 565m cash at concluding the contract, HUF 339m in compensation note later. For bid bond, HUF 1.131 bn was deposited. After payment, remaining HUF 226m indicated commitment to a HUF 2.262 bn investment programme. Bidders "wish to assist the personnel to get the 20% of the shares allocated to them by SPA." A couple of days later the offer was disqualified because of failing to meet some formal requirements. *Spanish Industrialist individually* HUF 848m, bid bond HUF 1.131 bn, remaining HUF 283m on development. Otherwise identical to SIB. Attached to both offers was a letter from representatives of PP1's ESOP. "We the [ESOP] of PP1 as representatives of the personnel and potential shareholders and partners would like to express our wish to cooperate with you ... as we feel that your presence as majority shareholders and managers

<table>
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<tr><td colspan="2">will secure a bright future for PP1."

Large Atlantic Company

HUF 565m cash; HUF 226m at closing and HUF 113m in each of the subsequent three years. The SPA, with 22% base rate, considered the offer as representing HUF 452m (77% of the nominal value of the stock). Depending on the result of a possible due diligence, LAC retained the right of withdrawal.</td></tr>
<tr><td></td><td>ESOP makes one more attempt for 49% only a few days before SPA Board resolution; a few hours later ESOP takes caution</td></tr>
<tr><td colspan="2">"The ESOP Organisation ... – in full agreement with the organisations representing workers' interest (National Union, Independent Union, Workers' Council, Factory's Council) – expresses its firm interest in acquiring the remaining 29% of shares."

It was late afternoon when, having just received SPA's reply to one of their earlier letters which pointed out that they should focus on preparing to acquire 20% instead of going for 49%, ESOP Leader and MBO leader sent an addendum to their morning fax. Yet, they again stated their interest in acquiring the 29% stock, but denied that Foreign Holding's lawyer represented the ESOP, too.</td></tr>
<tr><td>December 1993</td><td>SPA Board resolution: second round is declared successful, Spanish Industrialist's offer of 135.43% of par value wins; the rest of the bid bond is to finance developments; remaining 49% of shares are taken from Trust to SPA's portfolio; 20% is to go within 45 days to ESOP at same price; decision on 29% is postponed

Spanish Industrialist also wins tender for APP

ESOP reiterates its position to SPA Leader; they receive fast response</td></tr>
<tr><td colspan="2">ESOP and MBO: "The information [SPA Leader was] given does not only show us in poor light but also devalue to a great extent the matter we represent ... We launched an attempt to acquire as much of the 'yet unclaimed' 29% as possible. ... [W]e met an irrational lack of understanding, which ... was generated by the statement of SPA Deputy Director and Trust's commissioner that our ESOP Organisation strove to change the SPA Board's decision and, furthermore, we wished to turn to legal means together with FH. ... We respectfully ask you not to allow that these statements ... continue to exist because they make us appear in false picture as if we were recalcitrant." Although a few sentences of this letter are difficult to understand even to a reader of Hungarian, it is apparent that they were trying to ask the SPA's leader to discipline Deputy Director and Commissioner. They added, "we could not face our employee-colleagues eye to eye if ... we did not obtain minority stake [meaning 49%] at least for the first few years." 49% interest was now intended to be held for five (instead of earlier two) years. We have already noted its implication in terms of possible restructuring.

SPA Leader asked Deputy Director to draft a "a polite reply," including the SPA Board's decision of that day. The reply was sent without delay. Reference to an "irrational lack of understanding" was denied; blaming Deputy Director and Commissioner was objected; the declaration that ESOP did not consider legal action was acknowledged.</td></tr>
<tr><td></td><td>ESOP's Consultant asks SPA to put in writing the offer of 20%, the price, and that the majority owner would provide the ESOP Organisation with the financial resources necessary to repay its debt

Advisor prepares draft agreement between SPA and ESOP</td></tr>
</table>

Date/Period	Description of Event
	ESOP deputy leader (once leader of ESOP II) informs SPA that ESOP cannot take E-loan because Director has not provided a declaration on the company's guarantee for ESOP's debts ESOP Leader presents the same problem; SPA's Deputy Director supports PP1's Director Advisor prepares draft agreement with Spanish Industrialist Spanish Industrialist requests some modifications; most are accepted
Most importantly, the draft agreement required Spanish Industrialist to carry out a capital increase in the sum of HUF 322m and to pay Trust 25% of PP1's profit after the year of 1993. Spanish Industrialist instead proposed that from profits in 1993 and 1994, HUF 322m would be spent on capital increase and HUF 226m on paying out dividends.	
	Share Purchase Agreement between SPA and Spanish Industrialist is concluded
The whole price of HUF 809m was paid the same day, and was subsequently used to reduce Trust's debts. PP1 now became entitled to a tax holiday. The agreement upheld the investor's right to submit claims, should the information he had been given prove to be false. SPA was to vote together with Spanish Industrialist on issues related to modifications of the Articles of Association and sale of assets.	
Sale of minority stock	
January 1994	49% of shares is taken from Trust to SPA's portfolio ESOP guarantee is further debated
Deputy Director urged Spanish Industrialist "pursuant to the agreement between us ... you ... are obliged to acknowledge and support that the [ESOP] Organization ... obtains 20% of the shares of the Company. ... [a] Hungarian Bank is willing to grant the E-loan ... provided that the Company undertakes a guarantee for the repayment of the loan. The Company is required to make such declaration pursuant to Act XLIV of 1992 on [ESOP] Organizations." Spanish Industrialist replied: "... We believe that the workers of PP1 must have every chance to improve their income and to prosper and we are ready to support this objective. In any case it is self understood that you are owners of the 49% of PP1 shares and you can transfer them as per your wish taking into consideration the internationally recognised right of first refusal." Deputy Director pressed on.	
	Director submits report to new owners, reflects on management methods
In a letter written in English, she stated that the Company urgently needed a large cash investment. She also commented that "I am being instructed by you to carry out daily routine works, and my authority of decision making have been suspended i.e. ordering raw materials etc., without having an overview on the working processes of the Company. The most critical by doing so is that the international business relations of [PP1] has been disrupted, before the rules and conditions of transition to the network of connections of the new private owner has been worked out. ... I am not aware of your goals. Having experienced Your methods of management, I have to draw your attention that the Company may get out of control in a short time because of disregarding the principals [viz. principles] of 'Deed of Foundation', other internal rules and regulations, for which I can not take the responsibility."	

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<tr><td>February 1994</td><td>EGM effectuates take-over; since ESOP was to become owner soon, ESOP Leader gets a seat on Board of Directors upon SPA's proposal; Board of Directors (with three members proposed by Spanish Industrialist) concentrates power; Spanish Industrialist's management control is ensured by new appointments; some of Spanish Industrialist's proposals on changes in the Articles of Association are rejected by SPA

Spanish Industrialist reminds SPA that it should vote along under the terms of the Agreement

Spanish Industrialist asks for time to get better informed before undertaking guarantee for ESOP

More ESOP lobbying; letter to MP on the eve of elections, request of SPA's Investigation Office to look into this case</td></tr>
<tr><td colspan="2">Vice President of Workers' Council (who once first indicated PP1's separation efforts, now signing his letter as "a PP1 employee and member of" a governing party-related political body) wrote to MP: "[We] established an ESOP Organising Committee, submitted ... claim to acquire shares, thus we crossed Trust's plans. Director immediately started a counter-action, which aimed at discrediting the ESOP for one and a half year, and was supposed to thwart employee acquisition. Implementation of an ESOP was from the beginning supported by Responsible Politicians, state secretaries, HDF-members of the Parliament orally and in writing. ... Contrary to supporting promises, the SPA's decisions were successively contradictory to the interests of the ESOP Organisation ... The counter-interested lobby managed to achieve that our foreign partner, and thus the ESOP too, were excluded from the second round. ... It must be known that information from the ESOP never reached those with decision-making competence, whereas for those counter-interested there was an open channel to those who were preparing the decisions. ... Director concluded an agreement with SSF ... behind which there has been no work of merit, but the company has paid HUF 1.2m a month since April 1992."

After reviewing the situation in this way, he asked the MP "to use [his] influence to help the employees acquire the remaining 29% currently owned by the SPA. ... [W]e are asking this not only to have an opportunity to influence our future by having an employee interest of 49% but also for the reason that the voting of several thousand constituents belonging to the 1100 people [PP1's employees] be not accidental. What is even more important, let us not give opportunity to those who, in the campaign against the HDF, [would] use the documents which can be fatal in the elections." The documents referred to in the last sentence remained unspecified.</td></tr>
<tr><td></td><td>MP passes it on to Responsible Politician

Responsible Politician passes it on to SPA Leader

SPA Leader passes it on to SPA Investigation Officer

Deputy Director drafts up reply to MP on behalf of Responsible Politician</td></tr>
<tr><td colspan="2">"Vice President ... asked for your help on the basis of imprecise information." The process of PP1's privatisation to date was summarised from Deputy Director's position.</td></tr>
<tr><td></td><td>SPA's Examination Officer assures Vice President that his Office will take necessary measures

Hungarian Bank insists on Company's declaration; Consultant asks SPA for assistance in obtaining ESOP guarantee</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>March 1994</td><td>Local union leader seeks information on ESOP-guarantee from Trust's commissioner; Commissioner is "unable to answer the questions" because that would require disclosure of Agreement, possible only with Spanish Industrialist's permission</td></tr>
<tr><td>April 1994</td><td>Spanish Industrialist submits proposal to SPA on dividends distribution</td></tr>
<tr><td colspan="2">The company's preliminary (not yet audited) balance sheet showed HUF 152m after-tax profits for distribution. Spanish Industrialist claimed "We believe ... this figure ... is realistic but it is misleading since [this] amount is not available. To be more specific the liquid assets (cash and bank deposits) do not exceed the amount of HUF 26m at 31/12/93. The difference between Profits HUF 152m and available 26m has been used for stock increase, investments and other operational expenses by the previous Board of Directors. ... During the contract signature based on Tender and your information we were considering that the HUF 226m [elsewhere given as HUF 249m] were real tax free profits available for distribution since you insisted on that. Unfortunately they were neither available nor tax free. ... For your information the overdue payments the 2nd February 1994, when we took over, were HUF 125m." He would instead proceed to increase of share capital, and distribute dividends a year later.

The SPA sought advice from Trust's State Commissioner who agreed that distribution of HUF 226m was impossible. He also remarked that "Clearly, the case is that the majority owner would like to [i.e. reinvest profit instead of distributing dividend] because then a smaller increase of the registered capital for financing the developments would be necessary on his part." State Commissioner believed that SPA could take advantage of the situation and strengthen its position regarding Spanish Industrialist' support for the ESOP-acquisition.</td></tr>
<tr><td></td><td>Instead of declaration on guarantee, Spanish Industrialist submits a statement to Deputy Director</td></tr>
<tr><td colspan="2">"Upon your request I submit ... my statement to PP1 personnel concerning the purchase of up to 20% shares owned presently by SPA from the PP1 personnel. This is part of my message addressed to the PP1 personnel [in March 1994]." That is, Spanish Industrialist intended to acquire the stock of 20% of the shares not even owned by the ESOP yet. The attached statement read: "we will support ... our workers to buy up to 20% PP1 shares presently owned by SPA. ... The shares will be nominal and can be offered for sale only to Spanish Industrialist or Spanish Industrialist Majority Company. The minority shareholding in no way means extra working rights in PP1. Any shareholder-worker ... can [be] legally laid off. ... Our supporting for this is conditional and is combined with our relations too."</td></tr>
<tr><td></td><td>ESOP makes an offer for 49%: 20% at the price Spanish Industrialist paid, 29% at par; all usual discounts apply, in combination

SPA agrees to distributing dividends in the sum of HUF 18m

Responsible Politician makes last attempt before lost elections; asks Another Responsible Politician and SPA Leader to see if 25%+1 vote was possible for ESOP</td></tr>
<tr><td colspan="2">Another Responsible Politician noted in the margin that he "[did not] really like it."

Deputy Director drafted replies on behalf of SPA Leader to Responsible Politician and Another Responsible Politician. To Responsible Politician, it was stated "your proposal can be realised without any problem. I would also like to ask for your opinion whether we should propose in the brief to the SPA Board the sale of the whole 29% currently owned by the SPA. The administrator in charge – Deputy Director – believes it would be expedient to use this solution."</td></tr>
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<tr><td colspan="2">In reply to his margin note, Another Responsible Politician was told, " [When] Spanish Industrialist ... took control over the company, unfortunately some of the managers did not co-operate with the new majority owner." On Responsible Politician's request it was stated that "we can support the sale of 25%+1 vote even if the original decision of the Board permitted only 20%. A brief had been prepared accordingly..." It was also noted that "Spanish Industrialist is having discussions with International Bank on a very important development" which seemed to be hindered by uncertainty concerning the final ownership structure.</td></tr>
<tr><td></td><td>Spanish Industrialist would also buy remaining 29%
New SPA Deputy Director takes over the PP1-file
SPA blames Spanish Industrialist for failure in selling minority</td></tr>
<tr><td colspan="2">An internal SPA brief attributed the failure "to reasons not in the ESOP's competence," since "the majority owner did not provide the requested declaration because after acquiring the majority a part of the management did not co-operate with the new owner." The SPA had pronounced several times that Spanish Industrialist breached the contract by denying to give the declaration. Spanish Industrialist then proposed "that without taking an E-loan he wishes to finance the ESOP-acquisition himself." Note a margin note here: "Why don't we force him to adhere to the contract?!" Another margin note, made by the SPA Director, asked the New Deputy Director to "think this over again, together with Deputy Director [who was about to leave the SPA for the State Asset Management Co.]! There is even an illegal solution [viz. element] in this!" Director presumably referred to the fact that according to the prevailing law, state property could only be divested by way of a competitive process, whereas the ESOP Organisation had been given the opportunity to acquire shares without having to face competitive bids.

On the back of another copy of this brief a hand-written note asked: "How could the ESOP buy the whole when it cannot pay even for the 20%..."</td></tr>
<tr><td>May 1994</td><td>SPA agrees to Spanish Industrialist's proposal on dividends if postponed sum is paid with interest; Spanish Industrialist says it is too late; Spanish Industrialist submits Claims</td></tr>
<tr><td colspan="2">In Spanish Industrialist's view, SPA should have made proposals before or on the last Board meeting. Now the issue "is subject of the General Assembly to take place ... [later in May]." He reminded the SPA that it had already "agreed on 14.4.94. to distribute HUF 18m," adding that "because of our excellent relations, it is not the best moment during the general Assembly to negotiate, but any LEGALLY supported suggestion on dividends can be discussed. It would have been better to operate the General Assembly without surprises."

At the same time Spanish Industrialist gave notice to the SPA that "we have claims ... since when we took over after the 2.2.1994 we found the following conditions VERY DIFFERENT from the Tender documents. ... Instead of HUF 249m available for distribution we found HUF 125m OVERDUE obligations and one letter ... from Director ... asking for [large] capital investment in cash urgently." Other claims on several accounts were also formulated. Spanish Industrialist also noted, "It was strange that ... 3 Key managers, the General Manager [i.e. Director], the Commercial and the Sales Manager appointed by SPA to PP1 to transfer the company to the private foreign investor were never present after the 2.2.1994 and with strange behaviour," concluding that "the a.m. [aforementioned] serious missing or misleading [information] in the tender are forcing us to ask for indemnification the extent of which will depend on many factors."</td></tr>
<tr><td></td><td>Annual General Meeting</td></tr>
<tr><td colspan="2">The SPA's representative had been authorised to approve distribution of dividends in the amount of HUF 18m. Since the SPA had not received Spanish Industrialist's proposal on members of the boards, its representative had not been authorised to vote on personal issues. The AGM was to be continued in June.</td></tr>
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<tr><td colspan="2">Note that with the AGM closing fiscal year 1993 Director's appointment to the position of PP1's managing director terminated as of May 1994.</td></tr>
<tr><td></td><td>PP1 Local Union appeals to SPA Investigation Office; New Deputy Director explains the situation</td></tr>
<tr><td colspan="2">They complained that employees had not been given any information before PP1 subsidiary's transformation. After the tender, the ESOP Organisation had been offered 20% of the shares but the share purchase contract had not been concluded yet, "due to reasons unknown to us." Thus, as they put it, "at present, the foreign owner in possession of a stock of 51% controls PP1 Co. in 100%." The morale had further worsened. They complained that "we have not received many social and wage-like allowances to date although they are granted in the Collective Agreement, and the owner delays the discussions." They asserted that they "would not like to have to use the most extreme form, strike." They asked the SPA's Office of Investigation to examine "why the employee representation organisations have not been involved in issues related to them, and why we have not been given information on the points of the share purchase agreement that pertain to us."

Investigation Officer requested information from Director, who passed it on to New Deputy Director. Already in June, New Deputy Director prepared a brief for Investigation Officer, stating that "the ESOP ... has not been given a bank guarantee ... The management of the company and the employee representation organisations did not receive the Spanish owner appropriately to the interests of the company. The director and a few of her colleagues immediately went on sick leave, the employee representatives immediately acted offensively. The Spanish owner terminated the 'JGM' ['JGM' was a legal form of organisation, established by employees of a state-owned enterprise to carry out work in their free time by using the assets of the firm. They were paid by the firm under a contract. The legal predecessor of the JGM-form had been devised to bypass wage restrictions that had applied in the communist era.] that had until then operated on Saturdays and Sundays. Productivity of the company did not deteriorate, on the contrary it improved, but those participating [in the 'JGM'] lost considerable extra income." However, Spanish Industrialist did not plan lay-offs, instead he intended to increase the number of skilled workers parallel to installing new equipment. Since June he had introduced bonus wage system and planned to increase wages by 30% parallel to increase of production output, "depending on employees' co-operation." New Deputy Director had also held discussions with representatives of ESOP and PP1's union. They had asserted that they had been misled, because they had been promised that they would acquire the company. They had asked for 25% + 1 vote. New Deputy Director had requested them to co-operate with the Spanish owner in the interest of the company.

On the basis of New Deputy Director's brief Investigation Officer asked the union to better co-operate with the majority owner.</td></tr>
<tr><td></td><td>False alarm on tax accruals</td></tr>
<tr><td colspan="2">To the great surprise of Spanish Industrialist, the Tax Office issued a notification that PP1 should have paid an "interest after state property" between 1991 and 1993 under then prevailing law. With interests and penalty, the amount reached HUF 405m. This decision was based on false interpretation of the law. Eventually the Tax Office, admitting its fault, cancelled its resolution in June. Until then, however, the issue caused debate between the SPA and Spanish Industrialist.</td></tr>
<tr><td></td><td>Spanish Industrialist formally submits cash offer at par for all the minority shares (or 29% if SPA wants to sell 20% to ESOP)</td></tr>
<tr><td>June 1994</td><td>SPA appreciates it but "cannot accept offer"</td></tr>
<tr><td colspan="2">"... because the SPA doesn't have the authorization to sell state holding bypassing tendering procedures." Whether this rule should also have been applied to the planned ESOP-acquisition was left unnoticed. SPA Leader suggested that Spanish Industrialist should "contact the case officer New Deputy Director and [deputy director of the Portfolio Management Division], who might be able to find a solution for you convenience," that is to (yet) bypass tender procedures.</td></tr>
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<tr><td></td><td>Adjourned AGM continues</td></tr>
<tr><td colspan="2">The number of members of Supervisory Board was reduced to three. Spanish Industrialist also wanted an internationally acknowledged auditor (partly because of his talks with International Financial Organisation). One of the Big Six accounting firms was appointed.

A proposal was made on how to regulate transfer of shares. Spanish Industrialist aimed at securing first refusal right for the majority owner concerning the remaining shares. At this time, the proposal was contrary to both the Agreement which reserved 20% of the shares for the ESOP Organisation, and to the SPA's obligation to divest shares representing state property in a competitive tender. Therefore the SPA wanted to approve the proposal only with reservations. On the other hand, the Agreement required the SPA to vote together with the Buyer concerning modifications of the company's Articles of Associations. The issue was postponed to the re-convened AGM to be held in July.</td></tr>
<tr><td></td><td>Spanish Industrialist re-submits Claims

Trust prepares counter-arguments; SPA forwards them to Spanish Industrialist</td></tr>
<tr><td colspan="2">All of Spanish Industrialist's claims were rejected, only the arguments varied.</td></tr>
<tr><td></td><td>Ahead of re-convened AGM, Spanish Industrialist sends SPA notice of "Material breach of our contract"</td></tr>
<tr><td colspan="2">"You delay the voting of the modification of the Articles of Association though as per Art. 5.6 of our Contract you must vote for the modification."</td></tr>
<tr><td>July 1994</td><td>SPA maintains its position</td></tr>
<tr><td colspan="2">SPA "always adheres to its contractual obligations, but it cannot undertake what is contrary to the law and earlier Board resolutions. On the General Meeting ... SPA's representative is authorised to vote for the proposal seeking the modification of the Articles of Association only if the paragraph ... on the first refusal right is augmented" in a way that allows the SPA to sell shares to the ESOP Organisation. Spanish Industrialist was asked to understand the SPA's position, "considering our excellent relations in the past and present."</td></tr>
<tr><td></td><td>Adjourned AGM continues, then is adjourned again</td></tr>
<tr><td colspan="2">The debated paragraph of the Articles of Association was not discussed.</td></tr>
<tr><td></td><td>Spanish Industrialist discusses loan with International Financial Organisation; its executive confirms discussions</td></tr>
<tr><td colspan="2">Spanish Industrialist intended to carry out a major capital investment programme in both companies he had acquired. SPA was afraid that if it forced Spanish Industrialist to agree to ESOP-ownership, the capital investment programme might suffer delay.</td></tr>
<tr><td></td><td>SPA requests ESOP to confirm interest in 20%

(Former) Director appeals to Trust</td></tr>
<tr><td colspan="2">Director's appointment by SPA terminated at the end of May. She was said to have gone on sick leave when Spanish Industrialist took control over PP1. Under the law while on sick leave she could be relieved of her position as managing director, but she could not be legally dismissed from the company. In late June she attempted to resume her employment at PP1. She wrote to Trust's commissioner who had formally appointed her at the time. She stated that her medical treatment was about to end and she intended to return to work. Commissioner forwarded her letter to SPA. SPA's New Deputy Director then wrote to Spanish Industrialist and asked him to see into the matter and find a satisfactory solution. PP1's general manager (Spanish Industrialist's relative, appointed in February)</td></tr>
</table>

Date/Period	Description of Event
	informed SPA that "Director has been on sick leave since February 1994, she has been sending her case cards from time to time to our personnel department. To date she has not called in here, that is at her workplace, to resume her job, neither has she indicated in advance when her recovery can be expected. Of course as soon as she reports in, the Board of Directors that exercises employer's rights will make the appropriate measures." According to the latest information available, former Director was still "at the end of the recovery period" in September 1994.
	ESOP confirms interest in 20%, and as many shares as possible from the remaining 29% Conflict between Spanish Industrialist and employees continue, Collective Agreement is debated; the "atmosphere amongst PP1's employees is extremely bad which ... cannot go on like this for long!" SPA keeps considering possible ways to sell all stock to Spanish Industrialist Ministry supports ESOP but only if Spanish Industrialist's interests are served
	"It must be achieved ... that the Spanish majority owner find a way suitable to his interests to financially support the ESOP-acquisition ... However, considering the Spanish majority owner's plans to carry out major capital investment, special attention must be given to the issue of a possible sale of shares from the remaining 29% to the ESOP, because the ESOP Organisation thus might thwart the capital increase."
	SPA Privatisation Branch Committee and Board approve the extension of deadline to conclude contract with ESOP; Spanish Industrialist is to make a statement on his support for ESOP
	Spanish Industrialist "must be requested to declare in 30 days whether he would be willing to make a statement" on providing a loan in 60 days to the ESOP for its acquisition and on what terms and conditions. According to New Deputy Director, Spanish Industrialist was not against the ESOP-acquisition *per se*, but he wanted a way of financing it which did not need the company to be involved in it as a guarantor. In case of failure of reaching an agreement with Spanish Industrialist, the Board approved that the ESOP could acquire 20% of the shares by paying in instalments on conditions not worse than those of an E-loan. The remaining 29% were decided to be offered for sale in an open tender for a 'cash only' price representing at least 135% of the nominal value. With this decision the Board in fact called Spanish Industrialist and the ESOP to submit competitive bids.
August 1994	Spanish Industrialist is requested to make a declaration Spanish Industrialist learns about new Government's declared policy of preferring cash to 'soft forms' of payment; asks SPA to confirm terms of share sale
	"I have ... carefully read the programme of the new Government 1994-1998 concerning privatisation [that appeared to be in favour of cash proceeds from privatisation], E-credits and C-coupons etc. and we will discuss this matter [later in August]. For the 20% we believe that we are not far from an agreement with the workers and I hope to meet your deadline of 15 September with your co-operation." Regarding the stock of 29% that was for sale via tender, he asked SPA for granting him "the right to ... meet or match the best price after the opening of the offers'."

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>ESOP submits proposal to Spanish Industrialist</td></tr>
<tr><td colspan="2">Either the company or Spanish Industrialist directly should provide them with HUF 48m necessary to acquire the stock of 20% (HUF 314m at estimated ‘market value’). In any case, Spanish Industrialist was assured that “we support with every means at our disposal the interests of PP1 Company and your owner-interests.” It is apparent from this letter that ESOP and Spanish Industrialist had been negotiating on how Spanish Industrialist could purchase shares from the employees after they got them from the SPA.</td></tr>
<tr><td></td><td>Adjourned AGM continues, a compromise is near</td></tr>
<tr><td colspan="2">Minutes in English: New Deputy Director mentioned that “concerning the 29% an open tender will be advertised where the price is the same 135% [of par] and SPA accepts only cash,” which practically meant the exclusion of ESOP from the bidding. He added, “a delegation of PP1 Union, the Workers’ Council and the Personal Products Industry Trade Union went to the SPA’s [Investigation Office] and perhaps the most important issue they complied [viz. complained] for is that a Collective Agreement has not been concluded.” Spanish Industrialist remarked, “[this] issue is not in the agenda but we can listen to it. Furthermore I would like to inform you that as from June we give every worker up to HUF 3,500 as premium for presence and efficiency and on the minimum salary this is a 30% income increase. Concerning the staff and the managers we give premiums depending on their efficiency. I visited the Converting and Finishing [units] yesterday and at 13.30 p.m. nothing was working.”</td></tr>
<tr><td>September 1994</td><td>Adjourned AGM continues; agreement with ESOP has been reached</td></tr>
<tr><td colspan="2">Minutes in English: “Spanish Industrialist: I would like to notify that we finally agreed with the ESOP Organization about the buying of the 20% of the shares of PP1. The decision of the ESOP Organization was unanimous. I would like to express my deepest appreciation to the ESOP Organization and their leaders for the co-operation. Concerning the 29% of the shares we continue the negotiations and we hope that we can soon finalize the transfer of the shares. ... New Deputy Director: As to the 29% of shares a tender will be advertised ... I do not expect any other bidder but if there is one we will call Spanish Industrialist for final negotiations. We would like to assist Spanish Industrialist. SPA appreciated his efforts.”</td></tr>
<tr><td></td><td>SPA specifies in writing ESOP’s allowance (HUF 164m for the acquisition of a stock of HUF 232m at par; full price would be HUF 315 m)

On the basis of Spanish Industrialist–ESOP agreement, ESOP confirms intent to buy the shares for C-coupons

SPA–ESOP share purchase agreement is then concluded</td></tr>
<tr><td>October 1994</td><td>SPA prepares tender for 29%, asking price is 135% of par, cash only (Ministry reckons only bidder will be Spanish Industrialist, it would be quicker to simply give it to him)</td></tr>
<tr><td colspan="2">In fact SPA did exactly what Ministry suggested, but in a legally acceptable way. The amount of the bid bond was set high enough to deter any bidder possibly interested in a minority stock.</td></tr>
<tr><td>November 1994</td><td>Spanish Industrialist’s bid ‘wins’ the tender</td></tr>
<tr><td>December 1994</td><td>A production line, stopped 5 years earlier, is now re-started</td></tr>
<tr><td>Early 1995</td><td>It is published that “Spanish Industrialist will be 100% owner of PP1 Company. Spanish Industrialist has already bought 51% of the shares in the company, and now he can purchase 29% ...</td></tr>
</table>

Date/Period	Description of Event
	From the SPA's shares a stock representing 20% of the registered capital had been reserved for the employees which the Spanish owner also bought from them." The transaction was actually completed in March.
January 1995 and onwards	A new improvement every month: new equipment is installed, new products are introduced, a new plant and storage facility are being built, workers' hostel will be replaced by a hotel; amount of total investment is HUF 6.5 bn All financial indicators show improvements from 1993 through 1994 to 1995 planned (sales HUF 4.6 bn, HUF 5.4 bn, HUF 9.2 bn; cash flow HUF 450m, HUF 900m, HUF 1,460m, respectively); employment slowly decreasing, production increasing ISO 9001 quality standard is introduced, audited In the meantime, similar developments in Spanish Industrialist's other Hungarian acquisition, total investment amounts to HUF 1.2 bn
August 1995	Merger of Spanish Industrialist's two acquisitions in Hungary

6.6 Refashioning Red Star – Fashion Factory

6.6.1 Introduction

'Fashion Factory' (FF), once called 'Red Star', was one of the largest firms in a certain branch of the fashion industry, operating in six plants with headquarters in Budapest. Its sales to the Soviet Union had completely ended due to the buyers' insolvency, and domestic sales had also decreased, partly because new firms had entered the market. By the early 1990s 80% of FF's production was exported to Western Europe and the USA, exclusively under long term production contracts with Western firms (to the extent of almost 80% of its total production capacity). FF did not sell own brands on Western markets, mainly because of the poor quality of materials from domestic sources. The industry had two seasons, Autumn–Winter and Spring–Summer. After a steady decrease from initial employment of 2600, the number of employees totalled 2100 in 1989 and continued decreasing. In 1989, with assets above HUF 562m at book value, the firm made moderate profits, but in 1990 it just broke even. The management reasoned that this was partly due to a shift in market orientation, and partly due to a wage increase that had been effected following an agreement between the management and representatives of the workers in order to maintain the labour force.

Table 25 Main actors in FF case in order of appearance

Name (acronym, if any)	Note
	Outsiders
German Investors	eventual owners, both taking executive positions after take-over
Financier	provided most of the investment money
FF Group Ltd.	registered abroad, established by Financier and German Investors for the acquisition
Dutch Business Partner (DBP)	important buyer of FF's products; complained about quality; was asked to complain in writing
Loop Ltd.	was helpful with the treasury shares

Note: for a list of actors appearing in all or most of the cases, see Table 15.

6.6.2 Case narrative

Table 26 Event history – critical incidents in FF's privatisation

Date/Period	Description of Event
	The management's initiative
1989	Preliminary discussions with potential investors, mainly business partners Asset valuation German Investors discuss business opportunities in the Western World, decide to seek opportunity in Eastern Europe, particularly in Hungary on the basis of "economic considerations, how safe [they felt], how skilled [the workers] were, accessibility to the Western world"; contact various firms via a banker 'friend', choose FF; keep in touch until opportunity opens up
German Investors included a financial specialist and a renowned industry expert ("one of the best, if not 'the' best in the field," according to both his investor-partner and General Director).	
1990	Joint venture on the basis of one of FF's plants is established
General Director (then director in charge of economic matters): "This plant was one of the best ones	

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">in the 1980s. Then [previous top management] established an Ltd. with a French buyer [of our products], and built a new plant [in the same town]. It took away half of the employees, the better ones, and we lost [large] orders. Of course there was a motive, the previous management gained from it. What remained was a plant without skilled workers, without a buyer. The plant manager was complaining – the French did not want him."</td></tr>
<tr><td>1991</td><td>General Director is appointed

Management appoints Consultant (who later also advises German Investors)</td></tr>
<tr><td>November 1991</td><td>Enterprise Council approves transformation plan; closed tender is planned</td></tr>
<tr><td colspan="2">Some members of the management wished to implement an MBO. Others believed the firm needed a resourceful owner. This view came out as the winner. From the tender announcement (see below) it is clear that management wanted investors who could bring money but would not buy shares which, instead, could be acquired by the management and employees.

One of the directors, and the vice chairman of the Enterprise Council (who was to become ESOP Chairman) were pro-MBO. General Director was against it: "We could convince them that there is no other way. We just did not have money."</td></tr>
<tr><td>December 1991 – January 1992</td><td>Management sends Information Memorandum to business partners and others possibly interested in privatisation</td></tr>
<tr><td>March 1992</td><td>Management and Consultant announce transformation intent to SPA; discussions with SPA begin

By this time, German Investors have thoroughly investigated FF, are ready to structure a deal</td></tr>
<tr><td colspan="2">German Investor: "We made an offer for FF because we thought we could reorganise the company, turn it into a profitable company and make money ... pure businessman approach."

The planned deal: capital increase rather than purchase of shares; asset management of FF for three years followed by flotation; compensation would include stock option, part of profits, and 70% of capital gain upon eventual sale of shares. Business plan included capital investment of HUF 238m to be spent on machinery, volume expansion, technological developments, and new incentive system for workers.</td></tr>
<tr><td>May 1992</td><td>German Investors urge Consultant "to proceed as quickly as possible with the negotiations"; their declared strategy is to implement turnaround</td></tr>
<tr><td colspan="2">"We are aware of a number of similar privatisation in the fashion industry in other countries in the old Eastern Bloc which will increase the current overcapacity ... It is also a fact that FF are currently loss-making. This is further draining their reserves and affecting their cash flow. We need to satisfy ourselves as quickly as possible that we can agree the terms of a deal so that we can be in management control of FF by the 1st September 1992 at the latest."</td></tr>
<tr><td></td><td>Enterprise Council reviews German Investors' offer; its preferences are employee ownership with investors' financial support, and 'organisational integrity'; complying with SPA's request, approves open call for tender</td></tr>
</table>

Date/Period	Description of Event
	"The Enterprise Council ..., modifying its previous position, has decided that it approves an open tender in the privatisation process of the enterprise ... accepting the State Property Agency's position."
	Investment tender
June 1992	DBP is ready "to participate in the privatisation of the FF with" HUF 5m Asset valuation is updated; (new) Auditor believes assets were overvalued earlier Call for tender is advertised by firm, with SPA's approval; Information Memorandum is also sent directly to potential investors; "bidders who undertake capital raising and express an intent to support employee ownership from their own resources" will be favoured
July 1992	Tender opening: two bids
	A domestic company bid for only one plant and was disqualified. German Investors' undertook to maintain employment; develop exports (at least HUF 2 bn annually); double value of SPA's shareholdings; implement sale or flotation within 3 years. FF was valued ... at HUF 413m, subject to adjustments. [German Investors] should be appointed managers of FF under a management agreement, with complete control until flotation or sale. No dividends would be paid until then. German Investors would provide new machinery (min. HUF 238m) in three years. In payment, they would be allocated newly issued shares at par equal to the value of the equipment. In return for management services they would receive each year an allotment of existing shares at par. Upon sale or flotation, they would receive a further 50% of the SPA's capital gain. An employee trust would acquire 5% of the SPA's shares for HUF 10m and the investors would provide HUF 5m to facilitate this acquisition. The trust would also have an option to acquire a further 10% of SPA's shares. Conditions included: conclusion of the deal by September 1992; an audit by an internationally recognised firm; the value placed on FF was to be reduced by any undisclosed liabilities and legal action, and losses incurred since the end of 1991. The crux of the German Investors' business plan was "to double production with the same labour force and to achieve pre-tax profits of at least HUF 606m per annum in three years." They estimated than "FF should then be worth between HUF 2.7 bn and HUF 3.37 bn."
	Enterprise Council approves transformation plan (with parts of German Investors' offer and business plan, but higher employee ownership envisaged) Ministry agrees to transforming FF into a joint stock company and welcomes offer; remarks "the assets have been overvalued, compared to the firm's actual market value" FF reports loss for first half of year
August 1992	SPA First Administrator proposes acceptance of German offer
	"The firm is now in the red the first time since it was established, and its financial position is rapidly deteriorating. Without a quick implementation of privatisation, the threat of bankruptcy will arise."
September 1992	SPA Management Meeting accepts German bid; approved date of transformation 31 August 1992

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">This turned out to be the beginning of lengthy negotiations that were "ludicrous" and took "longer than it should have," according to German Investor. "The company was losing money. When a company goes through this process, it's in a sort of abeyance. ... They didn't really realise it themselves. They weren't capable of doing it. ... They had a bureaucracy that was unsustainable. ... The best illustration was something called economic department which had over 40 people in it. They analysed by hand ... we reduced them to less than 10 people. They didn't produce any managerial accounts, ... no cash flow control ... The company had no marketing ... just responded to customer orders, at low prices. ... They needed ... rapid surgery. ... It was the privatisation process [which took] time; this time was extended because we didn't get the contract. Basically, the company was 15–16 months in the course of being privatised. And it drifted because of that, because lack of investment in many previous years, ... because the company didn't think it could make changes."</td></tr>
<tr><td colspan="2">Negotiations</td></tr>
<tr><td>October 1992</td><td>General Director reports to SPA "the value of the company's own capital has decreased by approximately HUF 173m"</td></tr>
<tr><td colspan="2">He argued that due to the lack of financial resources there had been no significant development in the previous 3–4 years, thus they could not increase the production volume, and for this reason they had run into the red in the first 8 months of 1992. Due to problems with product quality, they had to concentrate all their efforts on trying to keep their existing markets and avoiding necessary lay-offs. The logic was that once privatisation occurred, increasing output would require the same staff which therefore had to be kept even at high costs. General Director also emphasised that the firm was in a very difficult situation, particularly with respect to its cash flow and indebtedness and added that the investors had indicated their willingness to bring in HUF 318m (and not HUF 238m as undertaken in the bid), and asked the SPA to decide fast. Later an Enterprise Council member also urged the SPA to make a quick decision, using almost the same words and arguments as the General Director.</td></tr>
<tr><td>November 1992</td><td>Asset valuation is updated, approved by SPA</td></tr>
<tr><td>December 1992</td><td>SPA brief on results of negotiations with German Investors</td></tr>
<tr><td colspan="2">"The negotiations have successfully been concluded, but in the meantime the firm's economic conditions have been further deteriorating. [Thus], the investors ... wished to modify their offer." The subsequent negotiations resulted in a "compromise solution." The revised offer included lower registered capital of the company to be established by way of transforming FF, lower investment, lower capital reserve; dividends (min. 10%, max. 50%) from 1994; management fee increased. The SPA-brief supported this claim. What First Administrator may have tried to say in a bureaucratic language was something like this: FF is in deep trouble. We tried to get a better deal but couldn't. Either we give it to the German Investors who, by all chance, can turn it around, or FF may go bankrupt.</td></tr>
<tr><td colspan="2">What has the SPA agreed to?</td></tr>
<tr><td>January 1993</td><td>SPA Deputy Director claims that SPA decision was based on incomplete and incorrect information</td></tr>
<tr><td colspan="2">He claimed that First Administrator's brief for the Management Meeting of September 1992 had not presented correctly and thoroughly the Investors' offer.

Consultant: "[Deputy Director's claim] was not true. [First Administration's representation of the offer] was correct, partly because we wrote it. First Administrator then started at the SPA, FF was his first case, did not understand it, we agreed that we would write the briefs. Of course he revised them, but even so ... Deputy Director brought up the case for some reason, he did not like it, I don't know why, but he started to cross it ... He could not say that the SPA's Management Meeting had been stupid, that's why he took on First Administrator. In fact, the deal was not struck earlier only because [a Director] left the SPA. We had already agreed with him, before the tender, he said 'OK it can come like this' [i.e. you can submit the bid with the planned structure of the deal], but then he didn't know</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">he would soon leave ... Deputy Director probably just wanted to improve the SPA's position, he did not have a secret buyer, but he couldn't improve, because FF was indeed on the verge, there was indeed no other buyer, and the Germans insisted ... Then we managed to find a channel to [Director] who took it into his own authority. He negotiated hard, too, and hesitated ... but, contrary to Deputy Director, he did not want to cross it."

German Investor: "we made a firm, clear, distinct offer. This was accepted. The SPA then tried on three occasions to change the rules, to change the terms. ... [T]hey didn't understand the deal very well ... [because of] lack of expertise, [and due to] inexperience ... and they were losing their option because the company was going into a decline." German Investor in a public speech: "They [the SPA] paid quite dearly for the delay [because] the company continued to lose money ... basically at the expense of the SPA."

Consultant in an interview: "[My advice is] the more complicated you make it, the slower it will get through the SPA, but the cheaper it will be."</td></tr>
<tr><td colspan="2">'Make deal or no deal: Pressure on SPA'</td></tr>
<tr><td>February 1993</td><td>German Investors declare no objection to employee ownership

Bank is willing to consider providing an 'Existence-loan' for employee acquisition

Letters from Consultant, Investors, General Director, ESOP Leader, local union leader and Investors' Lawyer urge SPA to make decision; they refer to DBP who wants to terminate business; leader of nation-wide union is enlisted to lobby for the deal</td></tr>
<tr><td colspan="2">This was a concerted effort to push the deal through. German Investor: "The pressure [on the SPA] was orchestrated because it was in everybody's interest that this deal was done. ... As far as Hungary was concerned, the price that we paid ... was minute in relation to other sides of the issue [including a lot of] jobs, exports over HUF 2 bn, a huge contribution to the Social Security Income Tax budget ... [T]he opposite would have been a grave to the exchequer."

Consultant's letter to SPA: "The process has been proceeding so slowly ... that it now risks not only the privatisation but also the very existence of the firm. ... FF's losses ... increased. ... The liquidity position of the firm is bad. ... The firm's most important partner, DBP has announced that unless the firm gets privatised within reasonable time, it will terminate its co-operation with the firm, since it cannot see that ... quality problems will be [solved otherwise]."

German Investor's letter to SPA: "I would remind you that ... at the end of September 1992 ... you personally stated that the terms of our Tender Offer were acceptable ... UNLESS THE CONTRACT IS FINALISED ON THE TERMS OF OUR AGREED TENDER OFFER AS CONTAINED IN THE CURRENT CONTRACT [SOON] THEN OUR OFFER WILL BE IRREVOCABLY WITHDRAWN. ... [I]f FF loses the DBP contract ... we would not take over the business EVEN IF YOU GAVE IT TO US FOR NOTHING."

Although DBP was asked to put its complaint in writing so that it could be shown up to the SPA, the problems existed regardless. However, it was unlikely that DBP would terminate business with FF. General Director: "[DBP] said they saw uncertainty in this change [in top management in 1991] and wanted to make sure we supply them. So they offered a three year long contract," which was still live at the time of DBP's 'warning'.

Regarding other forms of pressure, General Director said, "Consultant could even get an ally in [a smaller coalition party] who would have put forward a proposal in the Parliament [to urge the deal] if our union had supported them." Consultant: "There was a channel to [a higher level SPA executive], too, [a National Bank-executive] talked to him." Consultant had earlier worked for an affiliate of the National Bank. However, both General Director and Consultant noted that "there was no political</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">influence".</td></tr>
<tr><td></td><td>SPA wants to limit at 49% the German Investors' interest obtainable under the management agreement

ESOP Feasibility Study is attuned to German Investors' offer, aiming at the acquisition of the whole SPA-stock from E-loan from September

SPA again attempts to improve its position

German Investors revise offer, with concessions</td></tr>
<tr><td colspan="2">"We cannot go ahead on other than the agreed terms." However, "We are keen to encourage Hungarian participation in the company ... [W]e strongly support the proposal that an [ESOP] is established to acquire the SPA's holding in FF [at 95% of nominal value after the Auditor's report is implemented, which was to specify the amount to be deducted from registered capital due to losses in 1992]. If, and only if, this happens then we would be prepared to renegotiate ..." some elements of the deal.

German Investor concluded in a letter to Consultant: "If he agrees then, given the circumstances, SPA Director will have won big concessions for the SPA and I cannot see how anyone could criticise him. If he doesn't then, it won't help [us] [added in the Hungarian translation done and forwarded by Consultant to SPA: and the firm's employees] but I understand that there will be a big political storm."

Flotation was at this time planned only in 5–6 years because of the delay in privatisation and the current financial state of the company.</td></tr>
<tr><td colspan="2">Agreement</td></tr>
<tr><td>March 1993</td><td>Second Administrator: offer should be rejected; over-ruled</td></tr>
<tr><td colspan="2">Brief: "The assets which even in their present value are worth more than HUF 786m, by way of the German investors' capital injection of HUF 168m, would be transferred to the investors' majority ownership ... [W]e would finance the management of a possibly successful enterprise, thus they would acquire a major firm with a relatively small investment."

A hand-written note on the draft brief appears to suggest that even if the investors' proposal was somewhat disadvantageous, it should be accepted.</td></tr>
<tr><td></td><td>Joint ESOP–German Investors offer, combining German Investors' offer and ESOP-acquisition of existing shares, is prepared; includes some concessions

Addendum to business plan is prepared by German Investors</td></tr>
<tr><td colspan="2">"The ...original Business Plan ... envisaged that the privatisation would be completed by 31st August 1992 ... It also did not take into account the very substantial losses in 1992 ... In the event the privatisation has been delayed with the result that the basic plan has been set back at least 8 months. ... it will not be possible to influence marketing and sales or to introduce our own product range in 1993 as we have missed the Spring selling season for Autumn deliveries. Furthermore, the whole capital expenditure programme and the reorganisation of the company has inevitably been delayed..."</td></tr>
<tr><td>April 1993</td><td>Share Subscription and Syndicate Agreement (the Agreement) is signed

Agreement between German Investors, FF and ESOP organisers: ESOP will submit bid to SPA</td></tr>
</table>

Date/Period	Description of Event
	FF is transformed into joint stock company retrospectively from January 1993

After subscription to new shares by investors, ownership will be: SPA 65.9%, municipalities 4.7%, Investors 29.4%. SPA's holdings are to be reduced by the amount of the audited losses in 1992 (the Adjustment), and eventually sold to ESOP; Investors' holdings were to be increased due to stock option under Management Agreement.

Closing Day of the contract was only in June. General Director: "The privatisation process actually consisted of two phases: when the SPA delayed it, and when we [with the investors] delayed it." The SPA did so by raising objections against the structure of the deal, and the company did so by insisting on an audit to be carried out according to international accounting standards. Because of the delay caused by the SPA, the company and the investors missed one of the 'offering seasons'; "it was an objective to enter in a season."

'Epilogue' to a privatisation

Date/Period	Description of Event
June – July 1993	Investors subscribe to new shares (HUF 168m); take control of management

The new owners introduced changes quickly. First new equipment was installed within a few weeks. (See below for more changes and results. Note here that managers were dismissed before the end of the year, except General Director.)

Consultant, in an interview: "[Some members of the management team] were just simply stupid. The main problem of FF has always been that the top management was bad. It is not good even now." (See more below, November 1994.)

Date/Period	Description of Event
	Third Administrator takes over the FF-file Auditor completes report on Adjustment

Net asset value as of 31 December 1992 was shown to be only HUF 325m (International Accounting) after taking account of the loss of HUF 171m for the year then ended; compared to HUF 595m (Hungarian Accounting) a year before. (The use of different accounting rules probably led to an increase in the amount of adjustment.) The difference was considered to be the amount of losses in 1992, that is the Adjustment. It was to be deducted from SPA's 404m holdings. Thus, FF (as it was before the investment) was effectively valued at a mere HUF 134m. This was further to be reduced by the stock to be transferred to the municipalities, leaving HUF 108m to the SPA, which could now be offered via tender to the ESOP Organisation.

The loss in 1992 (HUF 171m) had in fact already been accounted for when calculating net asset value as of 31 December 1992. General Director: "Everyone forgot that 171m had already been written off." Yet the whole difference between net asset values as of end of 1991 and 1992 was taken as the Adjustment. The SPA's shareholdings was thus to be reduced by the same amount twice. Whatever was left for the SPA as shareholding, Consultant believes "it was not worth more."

The SPA's Audit Office reviewed Auditor's report and suggested that its statements should be accepted.

Date/Period	Description of Event
September 1993	EGM resolution and SPA–FF agreement are made on decreasing registered capital by the Adjustment

SPA was to transfer the shares free of charge; the shares would be taken by the company in its treasury; they would then be cancelled, thus decreasing the registered capital of FF. Since under Hungarian law a company cannot hold more than 30% of its shares in treasury, the agreement prescribed to transfer the stock of 270m in two parts (170 + 100).

SPA Director's hand-written margin note on a related memorandum: "The SPA will remain 50% owner, won't it?" In fact, after the Adjustment and a further increase of the registered capital (see

Date/Period	Description of Event
below), the SPA was to hold less than 30%.	
October 1993	First 'ESOP-tender' is announced, after several postponements
November 1993	EGM approves capital increase HUF 67m
Third Administrator wrote months later: at this General Meeting "the German Investors attempted to cancel the resolution [of September 1993 about the reduction of the registered capital by the amount of the Adjustment], but the minutes have not been prepared yet even to this date. We are aware that Municipalities were not willing to certify the minutes." This quoted part, however, was deleted from the final version of the brief. General Director: "The SPA voted for the proposal [to cancel the resolution], too." At this time, Consultant was FF's director in charge of economic matters. Re-reading the Accounting Act he noted that redemption of the shares concerned would give rise to tax liability. The investors and the management then thought they would wait until they could sort this problem out with the ESOP as a co-owner, since "the SPA then promised to sell its shareholdings to ESOP quickly. Who thought then that it would be dragged-on so long?"	
	Discussions with an International Bank have been under way to finance a large loan for further developments Only ESOP bid on tender, but short of bid bond; tender will be declared unsuccessful in December
SPA's Management Meeting decided earlier that the bid bond could be subsequently put down. Then SPA's Tender Office declared that it would be against the procedures laid out in the tender. The Privatisation Branch Committee decided accordingly. General Director: "they gave us an administrative reasoning; actually they did not dare to take the responsibility that they had agreed to an increase of the registered capital to be subscribed by the Germans which was to decrease the ESOP-chunk." Consultant: "Before the tender, Third Administrator told us that it would be no problem if the bid bond was not put down. FF didn't have money at the time. A paper was attached [to the bid], that if it was necessary, FF undertakes a guarantee. Yet, then the SPA said it's not OK."	
December 1993	Bank provides promissory note, requires considerable guarantee in return of an E-loan for ESOP By the end of year, results of modernisation and new management start to show
General Director: "The Bank wanted so high level of guarantees [from the company] for giving the ESOP an E-loan that it would have jeopardised the Company's own chances to take a loan which it wanted to do for modernisation purposes." Since Investors' taking it over, FF's weekly output increased, considerable sums were spent on new machinery, the production process was restructured, quality improved, labour force decreased, productivity and wages went up, one of FF's plants (considered unviable by management) was sold. FF opened Hungary's largest fashion products retail outlet. Over the whole year FF made losses of HUF 83m (partly inherited from pre-privatisation period, partly due to restructuring costs which could not yet be compensated by the increase in sales). General Director: "Without them it would have been much worse. We would be bankrupt by now." "Survival was at stake." "Apart from a car for [the chief executive], all the money was spent on machinery, ... and they were new ones." German Investor: "[modernisation] needed discipline, ... we invested over [HUF 300m], quite a lot, it needed a big cultural change, ... [my partner] started [work at] 6 o'clock, suddenly [the workers] saw	

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">the chief executive on the factory floor, at six o'clock!"

This cultural change was said to not have been without difficulties. General Director: "Workers complain that [chief executive] shouts. Of course, but first he asks, and shows personally how to do it. He then leaves, turns around, and they just don't it that way."</td></tr>
<tr><td>January 1994</td><td>Second ESOP tender for SPA-stock "representing 29.4% of the registered capital" (smaller proportion than earlier)

Third Administrator asks ESOP to finalise the structure of bid so that they could ask SPA Director for support</td></tr>
<tr><td>February 1994</td><td>SPA's legal department objects planned capital increase ("regardless of the obligations in the Syndicate Agreement") because it offered its stock for sale and the tender is still in the process of evaluation

Third Administrator believes ESOP will submit bid even if the relative proportion of offered stock decreases

Agreement between German Investors, FF and ESOP on financing ESOP's bid

Tender opening: only ESOP bid</td></tr>
<tr><td colspan="2">ESOP offered (as they calculated) 120% of par, all paid in compensation notes, in instalments at 7% interest rate (that of an E-loan), thus combining the advantages of paying in instalments at a cheap interest rate and using cheap compensation notes. The idea of taking an E-loan from Bank had been dropped because it would place too much liability on the company's assets. Instead, German Investors undertook that FF would provide ESOP with the necessary money at 17% p.a. interest, to be reduced if Board of Directors was satisfied with the performance of ESOP-members. Until ESOP repays its debt to FF, the company "has a charge over the shares held by the ESOP in FF."</td></tr>
<tr><td>March 1994</td><td>SPA vetoes increase of registered capital</td></tr>
<tr><td colspan="2">Third Administrator's memorandum to SPA Director: the SPA's vote against the capital increase was "to the great astonishment of the German gentlemen. ... [SPA's lawyers] maintain their view that until the tender is closed the SPA cannot approve the capital increase. ... The German co-owner was completely beside himself at the EGM, and referred to the SPA's obligation which we undertook in the Syndicate Agreement that we should vote alongside the German on the issue of capital increase." Director assured Third Administrator that she had acted correctly.</td></tr>
<tr><td></td><td>SPA's Tender Office says ESOP's bid (combining compensation notes and instalment payment) is legally acceptable

Third Administrator evaluates ESOP bid, pointing out its Net Present Value is equal to 108.55% of par</td></tr>
<tr><td colspan="2">"After the sale of the SPA-shares it can be expected that in a series of increases of the registered capital the ESOP's relative interest will decrease, because the ESOP is under considerable influence of the management, therefore it is unlikely that they can protect their interests at General Meetings."</td></tr>
<tr><td></td><td>SPA prepares for re-convened EGM, with same agenda</td></tr>
<tr><td colspan="2">Third Administrator's new memorandum on the last EGM: "the SPA's vote [then] kicked up some dust, because in the co-owner's view the SPA broke the provisions of the Syndicate Agreement with this vote. This accusation of course lacked any solid foundation, since the Agreement clearly states in its section on voting that 'the SPA agrees to vote with the Purchaser in all votes at any general meeting of the shareholders with respect to all matters except: I) amending the Deed of Foundation of</td></tr>
</table>

Date/Period	Description of Event
the Company; II) raising or reducing the registered capital of the company' etc."	
	SPA Director suggests first the tender should be closed, then the ESOP should be asked what it wants to do ESOP's declaration: if we win the tender, we will "agree to the increase of the registered capital"
ESOP Trustees have made this declaration with 6 'yes' votes and 1 'no' vote. ESOP Chairman was overruled by other trustees.	
April 1994	SPA Privatisation Branch Committee discusses tender and capital increase SPA votes on EGM for increasing registered capital ESOP Chairman is disappointed that SPA has not evaluated their bid yet, asks SPA Director's support for instalment payment ESOP Chairman offers to SPA that ESOP would pay 80% of the nominal value of the stock in compensation notes at the time of entering into a contract; on the same day ... Tender is declared unsuccessful but SPA decides to offer stock to ESOP "outside the tender process on the basis of terms and conditions offered"
Apparently, both SPA's decision to declare the tender unsuccessful but to offer stock to ESOP, and ESOP Chairman's offer were the results of a preceding agreement between the parties. General Director: "Fortunately they rejected the second bid. Fortunately, because then they offered the shares outside of a tender, with significant concessions." For the same stock of HUF 108m, the price went down from the first tender to the actual sale through a series of HUF "101m, then 79m, then 34, and eventually it was even less. It was 21m," that is the actual money they had to pay to obtain compensation notes, then traded by far below face value, which were accepted by the SPA at by far above face value. In fact, the actual rate at which the SPA accepted the compensation notes was proposed as a compromise by General Director.	
	SPA Director officially informs ESOP of declaring the tender unsuccessful but ("empowered by the law") offering a stock (now) representing 23.17% of the registered capital, at 80% of par, to be paid at concluding the contract in compensation notes
In another document the SPA stock at this time was given as representing 21.9% of the registered capital. Keeping an up-to-date account of its shareholding in FF's has apparently proved a difficult task for the SPA throughout the process.	
	ESOP Chairman confirms ESOP wants to take the opportunity Another EGM, on reducing registered capital, due to Adjustment; FF proposes distribution of shares in specie
The management proposed that instead of cancelling the shares that had been taken in its treasury due to the Adjustment, "the stock of HUF 270m transferred by the SPA be distributed in specie amongst the shareholders according to the ownership split as of the day of the EGM. The ownership split would not change either in the case of the capital decrease or the proportional distribution. However, in case of a capital decrease, the difference between the nominal value of the cancelled shares and their purchasing price (which was zero in our case) gives rise to a tax liability."	

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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">German Investor: “Well, we only took legal advice. We weren’t advised by Auditor [that] if we cancel the shares we will incur tax liability ... So when we realised this, we said ‘we don’t cancel them, we [could] distribute them in specie’. The SPA got so excited about this.” Auditor, the Hungarian arm of a foreign firm, was later replaced with one of the Big Six accounting firms.</td></tr>
<tr><td></td><td>German Investors and General Director declare “FF will provide [ESOP] with the necessary sums to purchase compensation notes ... by not later than 31 October 1994”

ESOP Chairman again confirms interest to SPA, specifying deadline of payment accordingly; sends draft agreement

Third Administrator finds out that FF has not registered the EGM resolution passed in September 1993 on capital decrease

Auditor is unlikely to approve balance sheet of 1993 “because they have found extremely chaotic conditions during the audit process. ...”</td></tr>
<tr><td>May 1994</td><td>SPA legal department revises ESOP’s draft agreement; upon re-sale of ESOP shares SPA gets 50% of the difference between sale price and what ESOP paid to SPA, except flotation

ESOP Chairman requires explanation from SPA why proportion of stock offered to ESOP decreased</td></tr>
<tr><td colspan="2">The ESOP Chairman was a mechanical engineer by profession who worked in a unit which produced auxiliary parts of equipment. He had been vice president of the Enterprise Council. In 1993 he ran for the position of Director in charge of technical matters, but was not supported by General Director, who considered him a great mechanic but less likely to be a great manager.

ESOP Chairman now insisted on obtaining the original 29.4% of the voting rights, as offered in the tender, and required a detailed presentation of FF’s ownership split “because it is unclear, cannot be legally followed, and financially it is almost incomprehensible for us.” While a few of his sentences are almost as ‘incomprehensible’ for a reader of Hungarian as the FF-privatisation is for him, it is obvious from the letter that ESOP Chairman did exactly what the SPA had been afraid of when it did not agree to an increase in FF’s registered capital in March. ESOP Chairman stated, “it seems there are invisible privatisation transactions behind the open tender,” and demanded a copy of the Syndicate Agreement with all its appendices and amendments.

Consultant’s explanation: FF’s Chairman decided to close a unit in Budapest because its labour force had decreased to such an extent that operations had become inefficient. He wanted to move this line of operations to another plant where labour was abundant. However, he did not know that ESOP Chairman worked in the unit to be shut down. He did not tell any of the other executives about his plan either. He first started building up the new line at the other plant, announced job vacancy there. He wanted to shut down this unit when the other was already in operation. ESOP Chairman immediately realised that he would be dismissed. His defence tactic was that if he was dismissed, he would take them to labour court (for arbitraging disputes between employers and employees) and make the affair to appear as if his dismissal was not due to a simple decision to increase efficiency by moving the operations to another site, but because he was the ESOP Chairman who did not want to lay down for the Germans. “We did not know why he had gone mad.” (This strong attribute is literally translated from Hungarian. In another interview, ESOP Chairman was said to be a “lunatic”.) “He did not know that we did not know [the reason of his behaviour]. He threatened the SPA that he would sue if [the ESOP] didn’t get 29%. SPA got worried, but they didn’t tell us that they were scratching [slang, approx. making a fuss] because of ESOP Chairman. Nobody knew why the other was [making a fuss]. By the time it turned out, it was all ulcerated [approx. ‘a big mess’].”</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">General Director's explanation: "Third Administrator was afraid that ESOP Chairman would take the SPA to court." ESOP Chairman "blackmailed [Hungarian word is translated literally] the company" because in case of a court action, there would be an investigation which may disclose that the Company has not redeemed the shares it received from SPA due to the Adjustment, and that the amount of the Adjustment was arrived at in a way that might lead to further legal action. However, ESOP Chairman "made a mistake, he prepared a report for the SPA which I received in writing," said General Director.</td></tr>
<tr><td></td><td>SPA Director, Administrator, General Director and ESOP Chairman meet to sort out problems

AGM is suspended due to SPA not having received sufficient information

Business Plan for 1994 expects HUF 183m profits

FF's balance sheet and profit and loss statement is not approved by Auditor; submitted to Registration Court with amendments and a suspending clause</td></tr>
<tr><td colspan="2">From Administrator's brief: the auditing process had to be suspended twice because "[the company] could not give the auditors the required documents in time, and the corrections of disclosed deficiencies and incorrect book-keeping were made slowly and clumsily, due to the lack of accounting personnel." The suspending clause pertained to the registered capital of the company since FF had not entered the free transfer of the stock in its books. The auditors also pointed out that the losses of 1992 had already been written off and thus could not justify a free transfer of shares from the SPA to the company. The choice for the SPA at this point was between either accepting that FF would not decrease its registered capital, despite the Agreement and the resolution made in September 1993, or sticking to its previous decisions and forcing FF to execute what had been decided.</td></tr>
<tr><td>June 1994</td><td>'Loop Ltd.' appears as a co-owner of FF; its shareholding is equal to the second part of the Adjustment</td></tr>
<tr><td colspan="2">Hand-written note on Administrator's brief: "Who is this Loop?" There was no answer to this question in any document available to us. German Investors disclosed its identity as follows: "It's us. It's purely a technical manoeuvre," made necessary by legal provisions prohibiting to have more than 30% of shares in treasury. General Director explained that Loop was a client of Consultant. As a favour, 'bought' the stock for HUF 1 (one forint), and granted call option to FF to buy back the stock for HUF 1 (one forint) as soon as the ESOP-deal was finished, when these shares would be distributed amongst the shareholders in specie (without having to negotiate with the SPA). The par value of the stock sold to Loop Ltd. was below the limit that would have required shareholders' meeting approval. "But we made a mistake. We did not enter the transaction in the books." FF has since bought back the shares.</td></tr>
<tr><td></td><td>ESOP's lawyer complains to SPA that FF has not provided him with the appendices of the Agreement; SPA Director urges colleagues to "Try and close it!"

Administrator urges ESOP Chairman to do his best in order to close the deal, otherwise SPA "will have to reconsider its position"

General Director requests copy of contract between ESOP and its lawyer</td></tr>
<tr><td colspan="2">Following common practice, ESOP's lawyer was to be paid by the company. General Director pointed out to ESOP Chairman that the relationship between the Company and the SPA could be</td></tr>
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<tr><td colspan="2">adversely influenced by information that the SPA received directly from the ESOP, without sending it to the company's management. His letter missed the usual greeting and farewell formulas.</td></tr>
<tr><td></td><td>ESOP leader confirms interest in buying the stock, states that with the consent of the investors, FF will provide ESOP with finance not later that end of October 1994

Third Administrator notes in the Board's report on 1993 that a plant was sold for an amount supposedly requiring General Meeting resolution

SPA legal department suggested SPA should not accept Board's report because of the value of the pant sold would have required a General Meeting resolution</td></tr>
<tr><td colspan="2">Administrator's brief: "but the German owners did not bring the matter of selling the factory before the General Meeting, referring to the fact that the payment is made in instalments, and the instalments do not exceed the limit within which the Company's Board of Directors can take a decision." A hand-written note on the memorandum stated that "We do not agree. It is against the provisions of the Deed of Foundation and the Company Act. We go to court!" The legal department based its opinion on the SPA's standardised Deed of Foundation because they had not received FF's actual one. General Director: "We knew our rules better than them. The limit was" higher than the SPA assumed, since it was specified not as a percentage of FF's registered capital (as it usually was in the standard SPA-version) but as a percentage of its 'own capital' (registered + capital reserve). The plant sold now was the same that went into decline in 1990 after the previous management had established a limited liability company with a French partner. General Director: "We wanted to create an opportunity for the plant. The Italian firm [that bought it] came just in time. They had the bait in."</td></tr>
<tr><td></td><td>Ministry objects to voting for FF Board's proposals

Privatisation Branch Committee decides: the SPA should vote against the Boards' report, insist on the execution of September, reject the approval of Balance Sheet and Financial Statement, reject the business plan for 1994, and call the Board to re-submit a better developed plan at a later general meeting</td></tr>
<tr><td colspan="2">Ministry's position: "we suggest that the SPA (as minority owner) firmly object happenings where it can be felt (unfortunately cannot be clearly proven) that a probable manipulation with the capital, capital losses with effect on minority interests, is going on. ... [W]e cannot undertake to give a hand to further loosening of the Syndicate Agreement."</td></tr>
<tr><td></td><td>Re-convened AGM approves proposals, against SPA's objections</td></tr>
<tr><td>July</td><td>SPA considers the possibility of legal action in order to have a resolution of the AGM declared null and void</td></tr>
<tr><td colspan="2">"The Company, at the time the AGM was held, had only a balance sheet and financial statement with restrictions and suspending clause from the auditors. The suspending clause, in our understanding, means that the company does not have (cannot have) a valid balance sheet. In spite of this, the majority owner of course accepted the balance sheet ... The SPA would like to attack in court the resolution about the approval of the balance sheet of 1993."</td></tr>
<tr><td></td><td>SPA files a suit</td></tr>
<tr><td colspan="2">General Director: "The procedure is now [August 1995!] still suspended."</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>SPA asks Supervisory Board to report on the issue of the decrease of registered capital</td></tr>
<tr><td>August 1994</td><td>ESOP Lawyer's commission ends; ESOP Chairman asks SPA for patience until new lawyer is appointed and complains that FF breaches its contractual obligation by not standing for the lawyer's fee

SPA again sends ESOP its version of the contract

German Investor and General Director explain situation with ESOP to the SPA</td></tr>
<tr><td colspan="2">They were "sorry to hear that ESOP Chairman wrote the letter ... . It ... is only a misunderstanding, since the Company has done all in its capacity so that the employees can be owners of the Company. We have given, and continue to give, every requested support if it facilitates progress and requires standard Hungarian, justifiable expenses. ... We ... are willing to pay acceptable fee to any legal firm that is competent and experienced, and thus able to properly inform the ESOP." According to an interviewee the former ESOP lawyer could not speak German, did not have experience in company law, and wanted to charge a certain percentage regardless of the results.</td></tr>
<tr><td></td><td>Supervisory Board Chairperson comforts SPA</td></tr>
<tr><td colspan="2">She had consulted with General Director, and obtained a written statement from FF's lawyer. According to the information thus received, "FF submitted the minutes of the general meeting of September 1993 within the legally required period (15 days) to the Registration Court. This document, according to the certification issued by the court on 12 July 1994, is filed in the company's documents, the related formalities have not been closed yet."</td></tr>
<tr><td>September 1994</td><td>German Investor attempts to sort out things with SPA</td></tr>
<tr><td colspan="2">This letter provides an excellent overview of the case to date and an evaluation of the situation from the investors' perspective. It also gives a brief account of the changes the investors implemented in their efforts to turn around the company and, therefore, is worth quoting in some length.

"Probably one of the most successful privatisations in Hungary is the privatisation of FF. With the help of the State Property Agency a well established Hungarian company and its trained labour force were combined with the capital investment and the marketing and management skills of foreign investors.

Since April 1993, when the Share Subscription and Syndicate Agreement was signed by the SPA, the investors, FF, and the ESOP organisation of FF, the company has made a lot of progress.

New, state of the art, machinery and equipment was purchased out of the capital investment of Investors in the value of over HUF 250m.

Production has gone up ... and should be [even higher] by the end of the year. The quality has improved to such an extent, that not only do we no longer have complaints from customers, but we have managed to increase our prices significantly.

We are very proud of the fact that the wages of the labour force are now 40% higher than in 1993.

We started our program[me] of selling own brand products. In Budapest we have opened [large fashion retail outlet] ... We have opened similar stores ... with local partners in [two other towns] and we plan to open around a dozen more in other towns.

Also, in Germany we are selling on average [many of our own brand] per week. We are presently working on opening stores like [our Budapest retail outlet] in the Munich area [and] possibly in France and Austria.

Besides the successes the company also has to face serious problems. Due to the high losses</td></tr>
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Date/Period	Description of Event

accumulated by the company, plus the cost of the reorganisation and the expansion of the business, there are liquidity problems, but hopefully these will be resolved before the end of the year.

[We] ... are funding further investments in machinery and equipment to the value of HUF 135m this year. This funding will not change the shareholding structure of the company. Also we are advancing HUF 56m as a loan to help solve the liquidity problems.

Unfortunately there have been misunderstandings between the SPA and the company ... due to the lack of communication between the parties. ... One of the issues is the reduction of share capital, which we see as follows:

The Subscription and Syndicate Agreement dated April 1993 stated the following in Clause 1.2.3.:-

'Upon the completion of the calculation of the Adjusted SPA Share Holding ... the Parties agree that all the excess Class A Shares held by the Company as treasury Shares shall be redeemed by the Company without any payment ... Such redemption shall be followed by a reduction in the registered capital of the Company by an amount equalling the nominal value of such treasury Shares in accordance with the Company Law ...'

1. The SPA initially returned shares with the nominal value of HUF 168m to be held as treasury shares. ... [T]he company convened a General Meeting in order to reduce the share capital by this sum. This meeting was held in September 1993 and the appropriate resolution passed.

2. Subsequent to this meeting the company was advised that the cancelation of the shares would give rise to a tax liability and were further advised that the best way to deal with the situation would be to reverse the proposal to cancel the share reduction and to distribute the shares in question in specie to all shareholders ...

3. The Company then convened another General Meeting in order to enact this decision. The resolution was passed to cancel the original resolution to cancel the shares in 1994.

4. The Company's intention is to distribute all shares in specie to all shareholders. The result of this will be that the percentage holding by each shareholder will remain the same and the Company will not incur a tax liability.

5. ...

6. The breach of the terms of the Syndicate Agreement whereby the Company did not cancel the shares was purely a technical breach made in the best interest of the shareholders and the Company and no damages have resulted to anyone. Under Hungarian Law a party to a contract must have suffered damages to have any cause for legal action. In this case clearly no one suffered any damage, indeed all parties benefited.

However, ... the SPA violated the Syndicate Agreement several times. ... The fact that SPA voted against the increase of share capital at the General Meeting [in March 1994] has caused significant damage to the company. ...

The most important problem however is that the privatization has not been completed. Despite the fact, ... that the SPA is obliged to sell its shares to the ESOP at a selling price of 95% of face value, and provide the finance for the purchase if necessary, the SPA has twice rejected the tender offer of the ESOP, both of which were in line with the said Syndicate Agreement. Finally the SPA and the ESOP have reached an agreement, but this agreement has not been completed at todays date. This situation causes major problems and seriously damages the company. The employees, most of whom are members of the ESOP, are held in uncertainty about their ownership, and this is a significant disincentive. The whole concept of the ESOP is that through the ownership of the shares, the employees will put in more effort to increase production and efficiency, but now the situation only discourages them.

In view of the above we would like to ask your help to resolve the outstanding issues, most important of all the completion of the privatisation by the sale of your shares to the ESOP, which is in the interest of all parties concerned."

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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>September 1994</td><td>A renowned international Law Firm is commissioned to assist ESOP</td></tr>
<tr><td>October 1994</td><td>SPA urges ESOP Chairman to send ESOP's version of the contract

Administrator seeks advice from Director</td></tr>
<tr><td colspan="2">"In the last six months we could not make a contract with the ESOP Organisation. The reason for being unsuccessful is that the ESOP is 'using up' the second lawyer already, but they still could not reply to the draft contract that the SPA sent them. The ESOP mainly condemns the Company and the German Investors, that they have not given them every help in putting up the money. In my view the failure is due to the fact that the Company already indicated after the SPA's decision that it would have the money to lend to the ESOP available only around November. ... Shall I wait until they at last say that they want to sign the contract, or should the SPA withdraw, referring to the long time that has passed." Director suggested "If we have another buyer, let's withdraw, if we don't, let's wait! and encourage them!"</td></tr>
<tr><td></td><td>Law Firm sends SPA draft contract; but further delays followed</td></tr>
<tr><td>November 1994</td><td>Position of Chief Executive Officer is created, reporting to the Board, General Director now reports to CEO; position is filled from outside</td></tr>
<tr><td colspan="2">General Director: "It is [the new CEO] who is really the boss now." Financier was losing his patience and wanted to see gains upon his investment. He planned to move one of German Investors to another position where he would have run the foreign marketing arm of the group. It did not happen because it would not help flotation.

Consultant: "Financier has already put in [considerably more money than they undertook in the Agreement], and has not seen results yet. He is getting impatient." "The main problem of FF has always been that the top management was bad. It is not good even now." "German Investors are in effect already fired, they are here only formally. The CEO runs it, because they could not bring what they should have. Mainly because the firm was too big for them, it is Hungarian, and it is spread all over [in several plants]. They could not oversee it. ... This profession is based on people. If the women do it right, OK, ... You have to get them emotionally. The Germans could not take the collective with themselves. They [workers] dislike them [German executives]." "[The German executives'] formal title remained, because of the flotation." "The new CEO doesn't make such mistakes, of course he doesn't go down to the shopfloor either ... but he is not so bad at human relations."</td></tr>
<tr><td>December 1994</td><td>FF closes year with moderate profit</td></tr>
<tr><td colspan="2">However, according to Consultant, this profit was "a lie", that is the result of creative accounting.

Between 1993 and 1995, FF had four Directors in charge of economic matters. The one who held the position at the time of the Agreement was dismissed due to apparent incompetence. Consultant took over only for a short period at the end of 1993, and found that almost nothing was true in the books. Then General Director did the job; "he worked 24 hours a day and could straight things out more or less. The Germans did not accept him because he doesn't speak the language, but they knew they needed him to console the people's spirit. He doesn't have many places to go at his age; he labours through." Two others followed, one senior and one freshly graduated. According to Consultant, neither of them knew the profession well. "German Investors liked it that they could speak the language. But they are not willing to pay for a proper man. And they will not get a proper financial manager for this money." As of this writing, General Director does the job again.</td></tr>
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<tr><td>February 1995</td><td>Contract between ESOP and SPA is signed</td></tr>
<tr><td colspan="2">The company immediately lent ESOP the necessary money, the shares were bought, and now they are kept in the company's safe as a guarantee for the loan the ESOP had received from the company.</td></tr>
<tr><td>March 1995</td><td>ESOP Chairman leaves FF for an executive position at another firm; but officially still holds his position</td></tr>
<tr><td>May 1995</td><td>AGM with a hitch</td></tr>
<tr><td colspan="2">General Director: "ESOP Chairman stated in front of everyone that 'the balance sheet is incorrect', 'the ESOP will go to court'; he took the whole general meeting in a direction that his agenda be discussed seriously. ... His position was similar to what a local party leader used to have. It is only him who counts, the others only give him power by legitimacy. ... [ESOP Chairman] was a bellwether. Workers view ESOP as a representative of their interest [like a union] and choose the loudest [person]. ... [ESOP Chairman] probably thought that the ESOP Chairmanship meant power that he could not obtain elsewhere."

The issue of distributing the treasury shares in specie amongst the shareholders instead of cancelling them was once again brought before the general meeting, which confirmed the cancellation of the September 1993 resolution, and approved the distribution. The SPA, having already sold its shares to ESOP, was not a shareholder any longer, and apparently just "forgot about it" (General Director in an interview).</td></tr>
<tr><td>August 1995</td><td>Problems with ESOP Chairman are about to end</td></tr>
<tr><td colspan="2">General Director: "I very much regret [the ESOP]. Besides the Germans, the management should have" acquired ownership, but then "we thought ESOP was important as an incentive to the workers. But it was longer than the privatisation itself."

In late August, an ESOP meeting was to be held, with electing new Chairman on its agenda.

General Director: "I don't mind who will be the new Chairman as long as he can read and write to the extent that if he signs something, he remembers later." "ESOP Chairman could still go to court; we would win the case but it would be expensive ..., a good lawyer would be necessary, and it would be bad PR".

Consultant: "At the end, he [ESOP Chairman] got [a large sum]. That's what he wanted."</td></tr>
<tr><td></td><td>FF is making profit; wages are up 26% in first half of the year; DBP accepts 18% price increase "because we are indeed better" (General Director); flotation is postponed; "we take the long term view" (German Investor)</td></tr>
<tr><td colspan="2">German Investor in a public speech: "We believe that we constructed one of the model privatisations because it's a combination of an old well-established company with all of its managers and employees as shareholders, combined with Western capital, Western know-how, Western marketing. And we believe that's a good model, really a model privatisation." In an interview he added, "the company would have gone bust by now." Instead, "exports are now over HUF 2.2 bn and rising, these 1400 people [still have jobs and increased wages]." However, "If we were starting again two years ago, we would have made much firmer and quicker moves to get it [the company]."

General Director regards this privatisation "a success. Only the SPA didn't get money, but the budget will [eventually] benefit from corporate tax." However, "with the benefit of hindsight, I would be firmer, and lay off people even before the Germans came in. ... And I would think of myself [see my own interest] more, I don't mean money, just to get the same result with less personal effort."

Consultant: "With a good top management, the results would be even 30–40% higher."</td></tr>
</table>

6.7 A bitter cherry – Personal Products 2

6.7.1 Introduction

'Personal Products 2' (PP2) was created as an industry-wide concern with headquarters in Budapest during a centralisation campaign in the early 1960s. It had once been the only domestic producer of a wide range of personal products, and its market position was protected from import competition. PP2 comprised four plants (three in the capital) and a separate R&D establishment. PP2 also produced licensed products and had a joint venture with a Western firm. Labour force amounted more than 1,500 in 1990. Exports were less than 10% of total sales of about HUF 5.6 bn, on which the firm made pre-tax profit of HUF 292m. Short term loans totalled almost HUF 550m, but the firm's financial position was still stable.

By the beginning of the 1990s, the firm's market share had dramatically decreased, down to some (still remarkable) 40–50% from an earlier 80–90% (on the average of main product groups), most importantly because of import liberalisation and subsequent market penetration of Western companies with enormous expenditures on advertising. Some domestic competitors' new brands had also overcome PP2's positions, mainly in the upper segments of the market.

PP2 was run by General Director from 1990, when his predecessor retired. In September 1990 the Enterprise Council confirmed him in the position. During this year other members of the top management were also replaced due to retirements.

Table 27 Main actors in PP2 case in order of appearance

Name (acronym, if any)	Note
Insiders	
Least Advanced Plant	one of PP2's plants
Most Advanced Plant	one of PP2's plants, located in MAP-town
Basic Material	a separable part of another plant
Managing Director	PP2's chief executive after General Director

Name (acronym, if any)	Note
'In-between' insiders and outsiders	
Tiny Private Company (TPC)	a little Ltd. in MAP-town; became 'banana skin to slip on' for General Director
Outsiders	
American Institutional Investor (AII)	a potential investor; rejected early
Global Market Leader (GML)	a potential investor; deal fell through
First German Licensor (FGL)	PP2 produced FGL's brands
Major German Company (MGC)	interested in PP2's Most Advanced Plant only
Second German Licensor (SGL)	not interested in privatisation but wanted to continue license agreement
Another Global Market Leader (AMGL)	rejected to bid for PP2
Major Foreign Investment Bank (MFIB)	advised SPA; quickly appointed, soon dismissed
Third Global Market Leader	made acquisition in another Central Eastern European country, was not interested in Hungary
Expander	Hungarian firm, fast-growing by acquisitions, backed by considerable foreign capital (see also case on PT)
Empire Builder	principal owner and chief executive of Expander; wished to attach PP2 to the empire (see also case on PT)
Little Mediating Firm (LMF)	asked by SPA to submit bid; only mediated
Large Atlantic Focused Company (LAFC)	owned and run by Raider, raided PP2, scared management, and was admittedly "mismanaged"
CEIG Leader	chief of Central European Investment Group; mediated for Expander (see also case on PT)
Health Care Organisation (HCO)	located in MAP-town, source of basic material for PP2' New Product Family
Domestic Investor and Partners (DIP)	eventual co-owner (with ESOP) of PP2; Partners included PP2's Managing Director and Marketing Director
DIP Leader	domestic entrepreneur with most remarkable wealth, and long experience as industrialist (e.g. PP2's supplier)

Name (acronym, if any)	Note
Small Hungarian Bank	presumably acted on behalf of Expander
New Atlantic Corporation (NAC)	interested in PP2; offer was rejected due to missing bid bond
Bank	provided DIP and ESOP with a promissory note; later rejected to provide money
Dissenter	outside member of PP2's Board of Directors; dissented

Note: for a list of actors appearing in all or most of the cases, see Table 15.

6.7.2 Case narrative

Table 28 Event history – critical incidents in PP2's privatisation

Date/Period	Description of Event
The management's initiative	
October 1990	Enterprise Council votes for transformation Asset valuation is under way Management announces transformation intent to SPA
PP2 needed additional resources in order to stop further decline, to modernise machinery, to alleviate environmental problems, to develop quality and packaging and to keep up with increasing competition. What management hoped to achieve via transformation and subsequent privatisation was to draw on resources with which it could implement its business plans. Amongst those interested were foreign firms and Expander.	
November 1990	SPA requests more information on talks management have had with potential investors General Director submits report; discussions with SPA follow
AII: discussions were terminated because management deemed the asset value established by AII's Auditor much less than the firm's "real value"; GML (owned FGL whose brand was produced by PP2): was interested in a joint venture based on one product line. Management proposed acquisition of shares after transformation instead. MGC: was more interested in contractual production, while setting up its own trading company. SGL: was more interested in maintaining, or extending, the license product range (representing about 20% of PP2 sales)	
December 1990	GML provides Letter of Intent, offering technology transfer, strategic fit, etc. End-of year is the deadline set by municipality to halt production in Least Advanced Plant due to environmental problems
PP2 had no resources to move to another site; deadline was later extended; plant is still operational.	

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>February 1991</td><td>Transformation Plan with asset valuation is approved by Enterprise Council and submitted to SPA</td></tr>
<tr><td colspan="2">Management believed the firm's still remarkable market share, stable financial position and some of its properties (particularly an unused building in the capital) were attractive for potential investors. It was also acknowledged that the current employment level was high. PP2's re-evaluated asset value was HUF 3.7 bn. At the heart of the transformation would be the involvement of a "serious, capital-strong professional firm," whose "businesses would mostly cover the profile" of PP2. The option of "privatisation in parts," i.e. by breaking up the firm into pieces and selling them separately would, in the management's view, "lead to rapid liquidation of parallel activities, a drastic lay-off, and no longer existence of [the PP2] brand," and thus should be avoided. However, one of PP2's operations, Basic Material, was planned to be sold in an 'asset protection' procedure for about HUF 225m, to be spent on reducing indebtedness.</td></tr>
<tr><td></td><td>An employee of PP2's Most Advanced Plant, on behalf of employees and unspecified foreign investors, wishes to acquire the plant; SPA disregards his announcement
PP2's Consultant does not accept asset valuation</td></tr>
<tr><td colspan="2">Consultant argued the firm's real value was HUF 0.9 bn lower (2.8 bn) than appraised (3.7 bn).</td></tr>
<tr><td>March 1991</td><td>SPA Management Meeting approves privatisation strategy</td></tr>
<tr><td colspan="2">PP2's transformation and privatisation must be carried out in one step; the sale must be carried out by closed (invitational) tender; the minimum price must be HUF 3.7 bn; a stock of ordinary shares of maximum HUF 337m at par can be acquired by employees, with a discount of no more than HUF 180m (against the possible alternative of free employee shares in nominal value of HUF 202m); in exchange for the shares thus given to the employees, the company waive its entitlement to 20% of the proceeds from the sale of shares. Separate sale of Basic Material was approved.</td></tr>
<tr><td></td><td>SPA Board of Directors approves privatisation strategy
Enterprise Council wishes to have better conditions of employee ownership</td></tr>
<tr><td colspan="2">A request was made for free employee shares up to 10% of the equity; the Enterprise Council also remarked that it had no authorisation to waive the entitlement to 20% of the proceeds.</td></tr>
<tr><td></td><td>SPA Administrator wants to raise the price</td></tr>
<tr><td colspan="2">Reasoning: if the SPA repaid the company 20% of the proceeds, the investor would obtain free the part of this amount that was to be left after financing the issuance of employee shares.</td></tr>
<tr><td colspan="2">The GML connection</td></tr>
<tr><td>April 1991</td><td>Invitation and Information Memorandum are sent out to 6 firms (including GML and MGC); Basic Material is offered for sale in a separate tender</td></tr>
<tr><td>May 1991</td><td>A British manufacturer wins tender for Basic Material, offering more than its asset value, and promising capital investment and to maintain employment</td></tr>
<tr><td colspan="2">The deal, however, was not concluded, according to a later SPA-source, "because of the buyer's [unspecified] fault." Talks on the sale of Basic Material were still being held a year later.</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>July 1991</td><td>Main Tender opening: only bid is from GML</td></tr>
<tr><td colspan="2">MGC confirmed, “We would not be able to reach the minimum price ... for the SPA’s shareholding” in the whole firm, but “we could consider paying proportionately much more for Most Advanced Plant alone”.

AGML considered PP2 too diversified, producing too many products with too complicated internal structure. Streamlining the firm and integrating it into the AGML network would require much time and resources. Besides, it was not their policy to produce other firms’ license products, but cutting them out of PP2’s operations would mean an immediate 30% decrease in sales. Therefore, AGML declined interest in PP2 and chose other ways of enter the Hungarian market.

GML’s vice president: “Despite the long journey to this point, we are truly excited by the prospect of a GML–PP2 partnership. The strategic fit is perfect, our people work well together, our Bid fully reflects the future value of the Company. We want to be your partners.” The bid was for 100% of the shares, and included up-front cash consideration (HUF 1.7 bn, less than asking price), assumption of debts (HUF 552m), capital investment programme (HUF 1.7 bn in years 1–5, HUF 1.27 bn in years 6–10), and profit-sharing earn out (50%). 20% of proceeds were claimed back to the company; half of this sum to be spent on issuing employee shares.

GML’s detailed business plan envisaged increasing sales, resulting mainly from GML’s brands. It planned to reduce substantially the range of PP2’s products, but those remaining in a more focused product portfolio were planned to receive significant advertising and marketing support. The plan considered PP2 overmanned by about 400, but promised that “we do not plan dramatic personnel reductions.”

PP2 would to pay royalties for the use of GML’s trademarks and patents, and a management fee for the services provided by GML personnel.</td></tr>
<tr><td></td><td>GML emphasises that “the best interests of employees would be a consideration of major importance”

Enterprise Council accepts management’s evaluation of the offer</td></tr>
<tr><td colspan="2">The management estimated that “the up-front cash price ... could be increased by about an additional HUF 600m without causing GML to lose its interest.” The extent of royalties and management fee was criticised. The management also wanted GML to cover the current level of debts, that had considerably increased during the year. It was emphasised that “staying alone” was out of question; it would “lead to PP2’s falling to pieces, to frittering away of its real value that lies in the market share and qualified personnel, to liquidation of the R&D base that represents a significant human capital, and to contractual manufacturing of license products in the thus created units. ... The present situation of the firm compared to 1990 has severely deteriorated.” The management concluded that “our relatively high [market] share ... and the well-qualified personnel have been acknowledged as the firm’s biggest value. If this value decreases at an accelerating rate, then at a later date the privatisation process can be started again only with worse conditions. We do not have now, nor we will have later, sufficient resources to strengthen our market position and financial stability before a new tender process. For the time being we still have a chance to have the above mentioned factors [of market share and personnel] acknowledged in our favour as improving our bargaining position, but in the event of a drastically worsening, loss making situation we cannot impose conditions on a foreign partner.”

Note that GML’s vice president personally presented the bid to the Enterprise Council.</td></tr>
<tr><td>August 1991</td><td>GML holds discussions with management and SPA, visits a plant and several stores; is still willing to go ahead</td></tr>
<tr><td colspan="2">GML’s Chairman, President and CEO wrote to SPA Administrator “these short experiences confirmed for me the appropriateness of a partnership between the PP2 and the GML Companies.”</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>General Director urges SPA to make a deal, referring to deteriorating position; Consultant also urges SPA</td></tr>
<tr><td colspan="2">Sales revenues in the half of 1991 had been only 87% of the planned level, which put PP2's operations in the red. "For the second half of the year our projected sales opportunities [will be even worse], which further increases our losses, despite our plans for radical cost cutting. Our debts are now amounting to more than one billion Forints and the lack of financial resources available, without privatisation, do not make it possible to improve our market positions. This situation leads the firm into bankruptcy in the short term. ... If the investment decision drags on, in light of the firm's difficulties the bidders' interest may significantly diminish compared to the present bid at hand. ... Hence the question may rightly arise why not we speed up the privatisation process, since as time passes by the market value of the firm continuously decreases ... Therefore I am asking you to be kind enough to present the bid for the firm to the Board of Directors as soon as possible. In my view, a possible delay in the present situation does not serve the interests of neither the firm nor the state budget."

Consultant went even further than General Director, emphasising its disagreement with PP2's management as to the "slack" in GML's bid. "PP2's situation ... has considerably deteriorated and this process shows an accelerating rate. ... its sales revenues are stagnant, stocks are growing, the firm's debts have ... increased, market share is continuously diminishing, but the number of its competitors ... is very much increasing. ... The firm ... has no resources available for modernising [its operations] ... We do not agree with the part of PP2's letter to the SPA that deals with the valuation of the firm. In our view the 'cash reserve' of HUF 600m [in GML's bid] is not realistic, especially ... if we consider [PP2's financial] results of the first six months."</td></tr>
<tr><td></td><td>Sunny prospects begin to dim</td></tr>
<tr><td colspan="2">Commercial Counsellor of the Hungarian Embassy in the USA faxed SPA Leader, informing him that GML requested a meeting with him. "As far as I can see they want to decide after the meeting whether there is an opportunity, or reality, for them to continue to co-operate with PP2, or they should implement an already drafted alternative of a greenfield investment." GML had already established a tiny subsidiary in Budapest. According to another document, "because negotiations with PP2 have been so protracted, GML felt it advisable to establish a presence in Hungary ... to protect our future interests in that market."</td></tr>
<tr><td>September 1991</td><td>New Administrator takes over the case at SPA (Administrator hereinafter)

Empire Builder sends letter of intent; would acquire 51%; it is disregarded by SPA due to ongoing talks with GML

SPA Board wants higher price, declares tender unsuccessful</td></tr>
<tr><td colspan="2">PP2 may not announce a winner of the privatisation tender because no bid met the tender requirements, that is the SPA's price expectations; SPA's management was authorised to hold talks with GML, and other investors if necessary, in order to improve the offer; SPA should conclude a consulting service contract with an investment bank to obtain new offers; minimum price can now be lower than HUF 3.7 bn; PP2 should immediately start transformation prior to the sale.</td></tr>
<tr><td></td><td>SPA Leader informs management of Board's decision, explains immediate transformation by the need of accelerating the privatisation process

Board's resolution is incorrectly published, GML's lawyer requests explanation from SPA, SPA explains GML is not excluded but other investors will also be sought</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>GML Vice President is to meet SPA Leader, still interested “provided that negotiations can be concluded by” end of month</td></tr>
<tr><td colspan="2">“[W]e will, of course, review both the current macro economic situation in Hungary, and importantly the financial results of PP2 operations during the first half of 1991. This up-to-date information will necessarily have an impact on our position.” This may suggest that GML might have already been prepared to exit by unacceptably curtailing its original offer.</td></tr>
<tr><td></td><td>SPA quickly appoints MFIB to be financial advisor

Administrator publicly insinuates management’s misdemeanour, indicates possible delay</td></tr>
<tr><td colspan="2">Administrator was asked in the press, “Can PP2’s management be condemned for their demeanour?” He answered: “It is understandable that the firm’s management urges the privatisation since they want to have security for themselves as well as their company as soon as possible. Judging personal responsibility is very difficult in such a situation, since bad faith cannot be presumed.” Note that later the management will be condemned for delaying privatisation. Administrator also stated in the interview, “We cannot prolong the decision more than two months. If we happen to accept no bid, it is possible that we shall have to announce a new tender.” Of course, this meant prolongation.</td></tr>
<tr><td></td><td>GML–SPA meeting</td></tr>
<tr><td colspan="2">GML’s position as summarised by its lawyer: “Our client wishes to reiterate, that if in your perception the purpose of the discussions ... is to increase the amount or improve the terms of the bid submitted by GML (as suggested in published press reports), our client is not prepared to engage in negotiations on that basis. On the contrary, GML considers that in that event it would better serve the interests of all parties that our discussions be terminated here and now.” In fact, GML reduced its offer and claimed an increase in the amount to be transferred back to the company from the proceeds of the sale, since “the financial results of PP2’s operations ... indicate that the downward trend ... has in fact accelerated [and] several of our competitors have aggressively entered the Hungarian market. ... GML believes it important that it considers, on the basis of our advice, that the refusal of the SPA to award the tender to any of the bidders constitutes, legally, a rejection of all the bids submitted. In passing we note that in any event the validity of our bid submitted would have expired, under its term on September 30, 1991.”</td></tr>
<tr><td></td><td>GML puts forward reduced offer, then a revised one</td></tr>
<tr><td colspan="2">1st version: HUF 1.63m cash, including assumption of debts HUF 1.02m, thus proceeds to SPA HUF 610m. SPA’s representatives pointed out that a similar amount had been offered for only Most Advanced Plant. The meeting ended in 15 minutes.

2nd version (next day): only to constitute the principal “terms on which GML now considers feasible the acquisition of 100% of ownership of PP2.” Cash payment HUF 1.953 bn, less: HUF 136m to be retained in or returned to PP2 for capital improvements, less HUF 136m to be retained in or returned to PP2 for employee shares, HUF 552m to be allocated for prepaying, retiring or re-negotiating all of PP2’s indebtedness to banks at closing, leaving HUF 1.13 bn to SPA. SPA would retain ownership of Least Advanced Plant, except for machinery and equipment specified by GML, and of the presently unused building (the one management had thought to be valuable).</td></tr>
<tr><td>October 1991</td><td>MFIB forwards SPA’s requirements to GML, requests counter-offer

GML submits counter-offer</td></tr>
<tr><td colspan="2">For 100% of the shares, cash HUF 951m, plus servicing debts HUF 866m, plus HUF 136m for equipment, plus 50% of net profit achieved above original business plan (if any); less value of shares retained by municipalities, less HUF 136m to fund employee shares. GML and PP2 would waive entitlement to 20% of proceeds. SPA keeps Least Advanced Plant, unwanted building, and Basic</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">Material. GML would intend, but would not be obliged, to make substantial capital investments. A number of conditions apply.</td></tr>
<tr><td></td><td>Upon SPA's request, Competition Office states GML would not constrain competition, on the contrary
GML withdraws</td></tr>
<tr><td colspan="2">The formal written notification was preceded by an informal agreement between GML and the SPA.
As Vice President reasoned, "we have undertaken a more comprehensive review of the PP2 company's performance and prospects. Further, we have fully assessed the future liabilities and investment returns, and have concluded that we cannot go ahead with the PP2 acquisition. Frankly, the passage of time and the understandable deterioration of the business had adversely affected the fundamental values of the PP2 business."
A foreign analysis (published later) aptly described the situation: Western multinationals "have been busy further eroding PP2's market share, poaching its best executives and withdrawing license agreements." On events yet to happen the analyst wrote, "PP2's most dynamic executives are voting with their feet. ... PP2's go-ahead marketing head now works for GML. ... SGL ... has taken back distribution of [its brands] which had been licensed by PP2." (Actually, SGL had established a firm in Hungary to sell its products, and replaced the license agreement with PP2 with a year-on-year renewable manufacturing contract. As a result, PP2 was likely to lose volume and certainly the profit generated in trade.) The analyst concluded that "western multinationals have built up local sales and distribution organisations to the extent that they do not really need PP2." He believed that "when Western executives go cherry picking in Eastern Europe, they look for state companies like Hungary's PP2." Juicy targets. However, the market share of this kind of firm, though large, is perishable which gives an extra handicap to Eastern Europe's privatisers, "never in a very strong position," who "can find themselves with all the bargaining power of a stall owner trying to get rid of a load of rotting fruits. Cherries indeed."</td></tr>
<tr><td colspan="2">Privatisation postponed</td></tr>
<tr><td></td><td>MFIB drafts up options for SPA</td></tr>
<tr><td colspan="2">"Seeking revised terms on which GML would agree to acquire PP2; approaching MGC to review whether it is willing to pursue its earlier proposal; making fresh approaches to the limited number of alternative purchasers (given the deteriorating financial condition of PP2, this alternative will not be a simple undertaking)".</td></tr>
<tr><td></td><td>SPA and MFIB review situation</td></tr>
<tr><td colspan="2">It was believed that GML's withdrawal may have been motivated not only by PP2's gloomy results and prospects, but also by GML's own restructuring efforts at that time, including lay-offs of several thousands of employees around the world.</td></tr>
<tr><td></td><td>MFIB drafts up more options; lectures SPA</td></tr>
<tr><td colspan="2">As above, plus "undertake public flotation of the shares of PP2 on the Hungarian, Vienna or another international stock exchange; explore alternative manufacturing and/or licensing agreements with GML and other international consumer products companies; seek an orderly liquidation of PP2's assets." Some general advice were also given. MFIB concluded that "it must be stated that had MFIB been involved in the PP2 privatisation from its inception, or even from the date of the bid deadlines, we believe the outcome would have been different. This experience illustrates the importance of bringing in advisors early into the privatisation process," adding that despite its late involvement MFIB could achieve results, and remained committed to the privatisation process in Hungary.</td></tr>
<tr><td></td><td>Debate between SPA and GML on press release; the press is 'full of PP2' and keeps the topic live for weeks</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">The largest circulation daily was persistently seeking 'the true reason' of why GML stepped back and thought to have found it in the slow, clumsy and complicated state procedures, and eventually, in GML's lack of trust in the current government. A weekly referred to 'experts' who thought GML's withdrawal resulted from a collusion of major international firms that may have divided the East European market.</td></tr>
<tr><td></td><td>Expander confirms interest in acquiring 51%; values PP2 at HUF 2.548 bn, less debts about HUF 1.1 bn; or Expander would acquire 10% and option until end of 1992, but total management control in option period; offer valid until end of month, then extended until mid-December

SPA requests competitive offer from LMF, acting on behalf of unspecified foreign investor</td></tr>
<tr><td>November 1991</td><td>Transformation preparations continue: Transformation Plan is updated, approved by Enterprise Council

Administrator explains failure to SPA Board</td></tr>
<tr><td colspan="2">He claimed that GML had incorrectly reasoned, because the results of PP2's half-year trading had already been known to GML when it submitted its letter of intent [of October]. He also referred to foreign press sources reporting that GML was about to close many of its plants world-wide and to cut a couple of thousands jobs. At about this time GML was indeed reported to be in the red.

In reviewing MFIB's recommendations, Administrator excluded the renewal of discussions with GML. He considered re-approaching MGC inappropriate, too, since it would contradict their intention to sell PP2 as a whole. Finding alternative investors did not look a promising option either. In passing he also noted that the contract with MFIB was to expire at the end of the year or could be revoked with 10 days notice. Administrator stated that PP2's financial collapse was not an immediate threat. PP2's partner in a joint venture intended to buy-out its share, which promised financial relief.

Administrator proposed transformation, and postponement of privatisation. The registered capital of the transformed company was proposed to be HUF 2.02 bn (considering that the firm's book value was HUF 2.012 bn, the 'business value' of PP2 as estimated by MFIB was about the same, and that a similar sum seemed to be justified by the offers received from GML and Expander).</td></tr>
<tr><td></td><td>SPA Management Meeting formulates strategy for PP2, later approved by Board: PP2 would transform into a joint stock company, implement streamlining measures, some of its assets (the unused building, Basic Material, the interest in the joint venture) would be sold in 'asset protection procedure' for the purpose of decreasing its indebtedness; actual privatisation is prolonged to next year

SPA and PP2 sign agreement: PP2 would waive its right to retain 20% of proceeds from share sale if it received free employee shares equal to 10% of equity

SPA indicates it is not satisfied with MFIB's recommendations, and signals there will be no need for an advisor since Expander is at hand; MFIB can either assist in negotiations with Expander (although contract is to be made in Hungarian), or "with mutual understanding, we will terminate the contract"</td></tr>
</table>

Date/Period	Description of Event
	MFIB objects, in vain
MFIB's letter concluded, "MFIB has enjoyed our harmonious day-to-day relationship with you and your team and is keen to continue to work with the SPA on any occasion."	
	MFIB is still playing the role of an active advisor when Administrator considers it incapable of action, and its further assistance in the negotiations with Expander unnecessary
December 1991	SPA revokes contract with MFIB MFIB submits last invoice; payment is made in a month
"MFIB enjoyed working with the State Property Agency and was surprised and disappointed by the sudden termination of our engagement, and the manner in which it was handled. We do however hope to work with the SPA in the future...".	
	SPA holds discussions with Expander PP2's union "could only accept" privatisation with a "capital-strong" partner who would guarantee PP2's further development, develop production with capital investments, maintain present level of employment and create new jobs SPA Board prescribes to get a competing bidder
Administrator suggested that the Board should accept Expander's offer as an invited ('closed') bid in comparison with that of GML, but the Legal Directorate opposed, since the law did not permit such a solution. SPA's management was obligated by the Board to obtain at least one more offer. Actually, LMF had already been asked to make an offer.	
	LMF practically offers only (unspecified) consulting service in tandem with an (unspecified) investment bank SPA requests Expander to submit a detailed offer PP2 is transformed; registered capital HUF 2.02 bn, 8% to go to municipalities
January 1992	Expander submits less favourable offer, considers several factors deductible from cash payment, does not provide business plan and employment policy, requires option for three years with total management control Employee of Most Advanced Plant, on behalf of unspecified "individual investors" repeats interest in acquiring Most Advanced Plant SPA resolution: Expander's offer and Most Advanced Plant-employee's interest are refused, sale of individual assets must continue, PP2's privatisation must continue through an open tender, the SPA must enter into a contract with an investment advisor TPC is established by eight owners with minimum capitalisation in 'MAP-town' (location of PP2's Most Advanced Plant)

<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">The event of establishing TPC may seem irrelevant in PP2's privatisation process. Yet, it is recorded here in timely order. Its relevance will be apparent in due time as the story proceeds.</td></tr>
<tr><td colspan="2">The LAFC connection</td></tr>
<tr><td>February 1992</td><td>Preparations start for the visit of LAFC's President to Hungary
LAFC's Assistants contact SPA twice</td></tr>
<tr><td>March 1992</td><td>LAFC's Assistants contact SPA again
LAFC's Assistants cancel President's visit because a tender announcement could not be arranged (as hoped for by LAFC); instead, LAFC Europe's President will visit SPA</td></tr>
<tr><td>April 1992</td><td>LAFC's Assistants have not received answer, writes to SPA Director
SPA confirms General Director in his position
CEIG Leader is interested in acquiring PP2; is willing to bid only in a closed tender</td></tr>
<tr><td colspan="2">For some time CEIG was treated by the SPA as an independent potential bidder. CEIG Leader was actually acting on behalf of LAFC throughout this phase. CEIG Leader had good relationship with both LAFC and Expander. LAFC and Expander were business partners in the Hungarian market.</td></tr>
<tr><td>May 1992</td><td>CEIG Leader (travelling on an equity raising trip for Expander) informs SPA Leader of an unspecified Atlantic company contemplating investment in Eastern Europe; the unspecified company can be identified as LAFC
LAFC's Assistants forwards LAFC Europe President's letter to SPA Leader; following discussions with management and SPA, still interested in acquiring 100%, accepts tender but wants a speedy process
SPA Leader asks Administrator to send LAFC a positive reply and request a concrete offer
Efforts to sell selected individual assets continue, with some misunderstanding and without results</td></tr>
<tr><td colspan="2">A foreign offer was made concerning the unused building of PP2. Management's counter-offer was considered informal by the investor, noting in a letter to their representatives in Hungary that "We must have answers to all our proposals, so that we can prepare alternative business projections and plans ... We wish to receive our original offer, with the appropriate mark-up or addendum signed by the PP2 management. This is the businesslike manner to have a contract or understanding be developed. ... Please convey a copy of this letter, properly translated, to the PP2 management, so that they will know we are serious business people."
The building is still (as of early 1995) a part of PP2's assets. The sale of Basic Material has not been implemented either. Only PP2's interest in the joint venture, for which the foreign partner had offered a very attractive price, was sold.</td></tr>
<tr><td></td><td>Tender for consultants is announced; from nine applications, PP2's Boards ranks a German consulting firm first</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td>June 1992</td><td>LAFC's Assistants urge reply to LAFC Europe President's letter (and re-send it)

A draft reply is prepared but not sent</td></tr>
<tr><td colspan="2">In the draft, written on behalf of (but not signed by) SPA Leader, the SPA apologised for the delay in replying and asked LAFC to send a concrete offer, in the knowledge of which the SPA would announce the terms and conditions of the sale of PP2 in a closed tender.</td></tr>
<tr><td></td><td>German consulting firm is approved by SPA to be Advisor; Advisor is asked to draft a contract

A new SPA Administrator is assigned to the PP2 project

LAFC Assistants again urge reply, re-send original letter</td></tr>
<tr><td colspan="2">LAFC's Assistants were aware that SPA Leader had given Administrator the letter to draft an answer. Administrator informed LAFC's Assistants that the answer had already been drafted and was to be forwarded to SPA Leader for signature. Yet, LAFC had never received an answer, and on further inquiry LAFC's Assistants were informed that Administrator was with the SPA no longer. Later in June the PP2-case was completely taken over by another directorate of the SPA.</td></tr>
<tr><td></td><td>AGM increases the value limit up to which the management could take decisions without prior approval of the General Meeting of Shareholders, i.e. the SPA; General Director urges SPA to quickly conclude privatisation, "time is passing by ... how long shall we wait?"</td></tr>
<tr><td>July 1992</td><td>SPA Board decides PP2 can be sold without competitive bidding to LAFC if it offers as good conditions as GML's were; Advisor is informed its services are not needed, but will be re-contacted in case LAFC-deal falls through; at a meeting with LAFC, SPA specifies conditions</td></tr>
<tr><td colspan="2">Asking price for the unconditional (not preserved for employees) SPA-stock (87% of share capital) was HUF 1.7 bn; LAFC should undertake to provide PP2 with finances of at least HUF 552m; LAFC should implement a capital investment programme amounting to at least HUF 2.97 bn within 10 years; LAFC should preserve current employment for at least one year.</td></tr>
<tr><td></td><td>SPA sends LAFC conditions in writing, asks detailed offer in a month

CEIG Leader, on behalf of LAFC, asks SPA some clarification, and requests to stop negotiations concerning the sale of Basic Material; request is accepted

Meeting between SPA Deputy Director and (new) Administrator, and General Director, PP2's Chairman and Union Leader</td></tr>
<tr><td colspan="2">"Representatives of PP2 insisted on being involved in the discussions with LAFC before the sale of PP2, to learn about LAFC's business plan – with special regard to environmental issues and [one major business] of PP2 that represented more than 50% of its production, including Basic Material – before the sale contract would be concluded. ... Those present agreed that the contract dated ... November 1991 between the SPA and PP2 [on free employee shares for waiving 20% of sale proceeds] is still valid, but the legislation and circumstances have changed so that the SPA cannot issue new, free employee shares. ... Therefore, [SPA] gives the employees common shares</td></tr>
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<tr><td colspan="2">representing 5% of the registered shares on the condition that in the event of dismissal the owner is obliged to buy them back for double of its nominal value." That is, if LAFC acquires PP2 and makes an employee who is also holder of such registered shares redundant, it will have to buy the employee's shares at 200% of par.

Despite the fact that the unlawfulness of the said contract was recognised now, it was declared null and void only at the end of the year.</td></tr>
<tr><td colspan="2">Enter insiders</td></tr>
<tr><td></td><td>Management (including all plant managers) announces intent to buy-out the firm (with employees, if there is interest)</td></tr>
<tr><td colspan="2">"The country needs an enterprise in [this industry] the majority of which is in Hungarian ownership. In this way it can be ensured that there will be products with about 40% share in the domestic market that are available for everyone" at acceptable price and quality. Other reasons included the need to preserve the 'human capital' on the technology side, and the domestic reinvestment of the profits. Some interviewees indicated that the buy-out attempt was also triggered by the fear of LAFC. Management saw LAFC not as a potential partner but as a firm "negotiating on the basis of a three minutes run around the factory". One may infer other reasons from later events.</td></tr>
<tr><td></td><td>Some owners of TPC in MAP-town sell interest to other owners; it is also entered in the minutes of TPC's owners' meeting that its managing director has made a contract with PP2; TPC has exclusive rights to wholesale PP2's New Product Family</td></tr>
<tr><td colspan="2">In early October an abstract of the registration of TPC was issued by the local Registration Court, which confirmed the above mentioned changes in the ownership.</td></tr>
<tr><td></td><td>Interim financial report shows modest profit</td></tr>
<tr><td colspan="2">The sale of the interest in the joint venture and some streamlining measures seemed to have brought fruits. Stock of PP2's own products and its short and long term debts had dropped by half.</td></tr>
<tr><td></td><td>SPA Deputy Director prepares briefs for SPA Leader and Responsible Politician, proposes change of strategy</td></tr>
<tr><td colspan="2">"We analysed PP2 and our conclusion is that the trouble is not with the product quality (quality of PP2's products – as laboratory analyses show – is better than that of GML's or AGML's products [a similar opinion with very similar words was later presented by some executives to this researcher]), neither that the management is incompetent (we know the Anglo-Saxon, German and Japanese management principles and methods, they have already been taught at the university for 20 years), but the problem is that the firm does not have an interest-free source of 670m Forints for financing the production and sales, and buying new machinery. ... If PP2 had this sum available, its pre-tax profit, recently just around breaking-even, would jump to HUF 400–450m. ... Instead of professional investors [viz. western firms in the same industry] we had better look for financial [viz. institutional] investors, and after a 2–3 year long period of recovery we should sell the shares via public flotation (in parallel on the Vienna, Frankfurt and London Stock Exchange). In this case it is realistic to expect HUF 3.0–3.4 bn, that had originally been targeted, for the stock of about HUF 2.02 bn."

In a brief prepared to another SPA Leader, Deputy Director repeated his arguments, stating that "by analysing PP2's balance sheet we concluded that it would not be advisable to do PP2's privatisation in too great hurry. ... By the end of the year a pre-tax profit of HUF 225–270m can be expected ... the firm has considerably reduced its debts ... its principal problem is that it does not have an interest-free source of HUF 560–670m." He added that his proposal would also be advantageous since there would be no threat that the new owner would liquidate the existing businesses and "fill up the market, dominated by PP2 so far, with its own products produced somewhere (such a threat seems realistic</td></tr>
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Date/Period	Description of Event
with GML and LAFC)."	
	LAFC sends draft agreement
It reflected an acceptance of SPA's all conditions with only minor modifications.	
August 1992	Brief is prepared for SPA Board in the light of upcoming legislation
"The Act No. LIV of 1992 [new privatisation law], which is to come into force [in four weeks] applies very stringent requirements for open as well as closed tender processes. It is likely that already in our current, ongoing matters the SPA will be expected to meet these requirements, so it is not advisable to omit to announce a tender," adding that "for that matter, this is made *almost* [emphasis added] obligatory by the employee buy-out offer," indicating that it was a matter of consideration what was obligatory for the SPA. Elsewhere the brief took a firmer position: "In sum, legislative changes make it impossible to implement the sale without a tender process, [and] at the same time the favourable changes in the economic environment of the organisation call for a reconsideration of the privatisation process since the matter is now about a company whose value is increasing." Therefore, "We do not consider the sale to professional investors [a good choice]. At the moment, in the case of the discussions with LAFC, this means that we should take a position which would result in no agreement."	
	LAFC – SPA meeting; also attended for a short period by LAFC's principal owner and Chairman
SPA may have deliberately posed conditions unacceptable for LAFC. This assumption seems to be confirmed by later developments. Note that for a long period during Summer 1992 SPA Leader was on holiday. At the time it was speculated that he thus wanted to wait until he could see if his position was firm enough. During this period, another SPA Leader was handling matters of importance, such as the LAFC–PP2 deal.	
	(another) SPA Leader is advised by SPA legal department
The SPA's Board "can declare the tender a closed one but cannot omit the tender altogether"; the offer the employees made in the meantime "is itself a factor questioning the feasibility of implementing the Board's decision [of July]. The solution is not that two interested parties agree with each other but that we have their offers competing."	
	According to (another) SPA Leader's letter to LAFC, SPA Board defers discussion of LAFC–PP2 deal; (another) SPA Leader also seeks LAFC's reaction to several questions
"To facilitate Board discussion" next week, he asked LAFC's answer to the following questions: "Would LAFC accept a situation where the SPA retains a 'golden share' in PP2? Would LAFC participate in a bid in conjunction with PP2 workers in which PP2 workers purchase 25% or more of PP2's shares in addition to the 10% already designated as employee shares? Would LAFC participate in a future public offering of PP2 shares on the Budapest Stock Exchange following its purchase of PP2 shares?" Other questions were listed on a further one and a half page. Finally he remarked that SPA did not plan to sell immediately PP2 by tender. "However, it may be in LAFC's interest if we reintroduce PP2 to the tender process when LAFC feels comfortable with that process and feels ready to participate."	
	Internal poll shows overwhelming employee support for buy-out attempt; ESOP Organising Committee is established, comprising three plant managers Brief for SPA Board repeats PP2's "value can be considered

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<tr><td></td><td>increasing"; a tender is proposed with LAFC and employees competing; requirements are to be based on GML's offer

SPA Board resolution: negotiate with LAFC for better conditions, 15% employee ownership can be realised</td></tr>
<tr><td colspan="2">Ministry's representative questioned the need to sell PP2 rapidly and supported new tender; (another) SPA Leader recommended combining foreign investment and employee ownership, while Responsible Politician did not support the tender or the sale of a substantive stock to employees because that would not provide much needed capital but proposed to try and improve the conditions with LAFC.</td></tr>
<tr><td></td><td>Deputy Director informs LAFC that Board has discussed LAFC's offer; suggests further meetings</td></tr>
<tr><td>September 1992</td><td>Events are summarised in a brief for SPA Leader

Some negligible offers are made by small mediating service firms

LAFC withdraws</td></tr>
<tr><td colspan="2">LAFC Assistant's explanation: "when [LAFC's executives] were in Budapest [in early August], they did not want to meet the SPA. ... SPA Leader was on holiday, but [another SPA Leader] insisted that they should meet and they agreed. Then [another SPA Leader] came up with entirely new and impossible claims that are totally unheard-of in the West, as if the preceding discussions had not occurred. He made [LAFC's executives] and [LAFC's principal owner] very angry. LAFC's offer was exactly what the SPA required for its share. ... [Another SPA Leader] thinks that after LAFC's HUF 4.8 bn+ investment the SPA still can control the firm and share its profit. LAFC's reply, in which it is withdrawing the offer, will hopefully teach the SPA that business cannot be done in this way." Note that (another) SPA Leader had joined the SPA from abroad (later he left the Agency), graduated with an MBA-degree in the West and subsequently worked there (just as LAFC's Assistant who wrote the quoted letter in not forgotten full command of Hungarian).

LAFC's letter of withdrawal pointed out that all the three main questions, as well as many other issues and the proposition that PP2 would be re-introduced into a tender, had constituted fundamental diversion from the structure they had outlined in their proposal. These considerations and their observations in PP2 during their visit in early August had let them conclude not to go ahead with PP2's acquisition on the basis of the originally outlined structure or those alternative structures SPA Leader had proposed in his letter.</td></tr>
<tr><td></td><td>LAFC's Assistants furnish SPA Leader with correspondence between LAFC and (another) SPA Leader; ask him to contact LAFC

SPA Director informs management of possible new tender, asks ESOP Organising Committee to submit ESOP Feasibility Study and buy-out proposal</td></tr>
<tr><td colspan="2">The SPA Board's last resolution had not included reference to a new tender.</td></tr>
<tr><td></td><td>A brief, prepared for SPA Leader weeks later, shows unawareness of the withdrawal</td></tr>
<tr><td colspan="2">The brief remarked that the SPA had not yet received answer from LAFC to their fax of August proposing further discussions. Then they were informed by LAFC's Assistants that "LAFC a l l e g e d l y withdrew from the transaction." "We [viz. the staff of the directorate concerned] have not received a refuting answer from LAFC, neither we have knowledge whether the</td></tr>
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<tr><td colspan="2">management of the SPA received such an answer. Did LAFC indeed step back from the transaction?" This question was asked by those who were supposed to furnish information.</td></tr>
<tr><td></td><td>PP2's Board is also unaware of withdrawal</td></tr>
<tr><td colspan="2">Dissenter, a PP2 Board member, argued in a fax to SPA Deputy Director against the LAFC-deal weeks after the withdrawal. She believed that LAFC's owner, "Raider [real name misspelled in fax] is a real estate agent by his original profession and one of his major businesses is buying and selling firms." For that matter, Chairman and principal owner of LAFC was indeed an active "boat-rocker, initiating many organisational and ownership changes in the ... industry," as it was reported in a Western professional journal. He was also known as an orchestrator of leveraged buy-outs in the USA during the 1980s. Dissenter also remarked that Raider "has very good relationship with one of [USA company's] top executives who created Expander in Hungary. Expander has already put its hand on [four Hungarian firms in retail and manufacturing] and attempted to acquire [another retailer]. ... If PP2 were privatised with LAFC, it would have high likelihood that 80% of the manufacturing capacity of the Hungarian [personal products] industry, along with the whole retailer network selling [personal] products would get under the control of one hand" implying that LAFC, if succeeded with the acquisition, could pass on PP2 to Expander. Dissenter's letter may also provide an explanation to the earlier postponement of PP2's privatisation when Expander made an offer.</td></tr>
<tr><td>October 1992</td><td>SPA Leader attempts to renew relationship with LAFC
LAFC is reluctant, seems to blame (another) SPA Leader</td></tr>
<tr><td colspan="2">"As per your earlier guidelines and recommendations, we submitted a good faith offer ... When [we] visited the SPA early in August, it was made clear to us that our offer was not acceptable as submitted. Representations and verification of PP2's financial results, environmental issues, possible workforce reduction, are all critical elements needed to make such an acquisition. [Another] SPA Leader indicated that the SPA had different ideas about all these, from our earlier understanding."</td></tr>
<tr><td></td><td>ESOP Organising Committee submits Feasibility Study, going for all SPA-shares or, alternatively, 51%</td></tr>
<tr><td colspan="2">General Director, in a press interview: "we would welcome a foreign partner, but are opposing the sale of the whole firm to a foreigner. There is a threat that they would only want to get our market share and terminate the production of Hungarian products, or would not be willing to pay for research and development, given they have their own labs at home." Another press report: "the Ministry, when it saw the support of 96.5% [of employees for an ESOP], aligned itself with the company, so the SPA cannot disregard this initiative any longer."</td></tr>
<tr><td></td><td>SPA brief believes LAFC is still interested; suggests LAFC's "actual offer" should be treated as one bid for the new tender; ESOP Feasibility study should be accepted only if 30% of SPA-shares is sold in this scheme, because PP2's survival would be risked in a majority employee ownership</td></tr>
<tr><td colspan="2">Conflicts in and around PP2</td></tr>
<tr><td></td><td>Dissenter informs Deputy Director of the results of a database search on PP2's patents</td></tr>
<tr><td colspan="2">PP2, as a company, paid a fee to the inventors for the use of the patents. Dissenter, who worked for a patent and trademark consulting firm, stated that the "biggest inventors" (whose income from the patents was the highest) included six of PP2's previous and present executives, including General Director, the R&D Deputy General Director, and the Chairman of the Board.</td></tr>
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<tr><td></td><td>SPA Directorate asks Investigation Office for checking information; Investigation Office commissions Solicitor to look into it</td></tr>
<tr><td colspan="2">Inter-departmental memorandum: "PP2's management established a limited liability company called TPC in MAP-town. In our view the managers are financially interested in both the Company's patents and the aforementioned TPC to such an extent that they are impeding the Company's privatisation."</td></tr>
<tr><td></td><td>SPA requests General Director to convene an EGM where the establishment of the ESOP Organisation is to be approved
Dissenter presses General Director to provide information on numerous issues so that she can evaluate ESOP Study
PP2's Board supports ESOP, except Dissenter</td></tr>
<tr><td colspan="2">Dissenter, although supporting the principle of employee ownership, objected to its planned realisation. She also criticised several specific details of the Feasibility Study, and asked for additional information. Others reminded her that "checking the details and numerical errors is not the task of the Board." In the voting, Dissenter was overruled, as well as on other issues (new "Organisation and Procedures Manual," increase of General Director's salary, the extent of payments for patents). Some days later Dissenter sent a detailed evaluation of the ESOP Feasibility Study to SPA, noting that "it is financially impossible since they want to make profit from selling property that is, on the other hand, is a security of the E-loan." "It is clear that they calculated backwards, starting from profit that is considered necessary for repaying ESOP-debts, and ... adjusting all other figures to this." On one copy of the ESOP Study, a draft calculation was made by an SPA staff member, noting in a margin note: "Dream! Full of contradictions!"</td></tr>
<tr><td>November 1992</td><td>PP2's Chairman informs SPA of Board's support for ESOP
Brief for SPA Leader suggests the Feasibility Study should be accepted, but with only 10% ESOP-interest; hints on management's misdeed</td></tr>
<tr><td colspan="2">"Our Directorate has come to know that the Company's management is likely to impede the process of implementing the privatisation, therefore in co-operation with the Investigation Office we are carrying out an investigation into the Company's operations and the privatisation-hindering attitude of the management."</td></tr>
<tr><td></td><td>Brief for SPA Management Meeting</td></tr>
<tr><td colspan="2">The management's attitude as presumably impeding privatisation was again mentioned.</td></tr>
<tr><td></td><td>SPA Director requests General Director to change date of EGM from November to December; also informs him of Solicitor's assignment, but with disguise</td></tr>
<tr><td colspan="2">SPA Director stated that the law required SPA to have the value of shares appraised by a registered expert, and for this job SPA had commissioned Solicitor, to whom General Director was required to grant access to information.</td></tr>
<tr><td>December 1992</td><td>Dissenter discusses "problems in PP2's internal way of operation" in a fax to SPA</td></tr>
<tr><td colspan="2">She objected that the management was acting without involving the Board of Directors, criticised the lack of recovery measures that should have been taken by the management, and added: "therefore, I have strong opposing feelings against the ESOP-programme, because it would only serve to strengthen the position of the present management, as it manoeuvres for freedom from the control of</td></tr>
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<tr><td colspan="2">the SPA. ... I consider the buy-out of the whole PP2 by the employees financially unfounded on the one hand. On the other hand, with the present way of managing the firm PP2 can collapse within one or two years.”</td></tr>
<tr><td></td><td>SPA Management Meeting decides, previously chosen Advisor must be re-contacted

Solicitor’s report for SPA Investigation Office on assumed misdeed</td></tr>
<tr><td colspan="2">The report, among other things, discussed the R&D policy of the firm, its patents, and its relationship with TPC. Below are main points of the report.

Research and development had been mainly carried out by the Company’s own R&D Base, supplemented by co-operation with outside institutions, e.g. Scientific Institution where the present Chairman of the Board worked, and the R&D Deputy General Director had come from.

The report stated that “at the beginning of 1992 ‘covering’ the products with internal patent agreements apparently increased. .. [T]he Company’s managers have a vested interest ... in the agreements on utilisation of internal patents.”

In July 1992, the Company made an agreement on the utilisation of an internal patent pertaining to an additive of New Product Family-products. The patent holders included several top managers, although no payment had been made yet. New Product Family was based on raw material available from HCO. At the end of April, PP2 granted exclusive rights to TPC to wholesale New Product Family, and allowed TPC as commissioned merchant to pay in 30 days after goods were sold. TPC, with the legally possible minimum capital, had no stocks, warehouses, or previous experience in trade. One of its owners was Mr. Commonsurname, manager of Most Advanced Plant, whose apartment on the second floor of a building was the registered location of TPC. Other owners included Ms. Commonsurname (actually Mrs. HCO-director), Ms. X whose Budapest-address was identical to that of PP2’s General Director (who had been the manager of Most Advanced Plant for three years before moving up to headquarters), Ms. [R&D Deputy’s surname, under same address], and Ms. Y (address same as that of PP2’s Technical Deputy General Director). However, sales through TPC were not flourishing.

According to some sources, those concerned had already sold their shares in TPC, yet the cited investigation report referred to them as present owners of TPC.</td></tr>
<tr><td></td><td>Brief is prepared for Responsible Politician; another for SPA Management Meeting</td></tr>
<tr><td colspan="2">“The existence of TPC proves the unethical behaviour of the management.”</td></tr>
<tr><td></td><td>PP2’s Local Union Leader attempts to support General Director with faxes to SPA Leader, Responsible Politician, and Chief of Nation-wide Union

EGM: General Director goes on early retirement; new Managing Director is appointed; PP2–SPA agreement of November 1991 is null and void; discussion of employee shares is deferred; ESOP Feasibility Study is to be revised</td></tr>
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<tr><td colspan="2">SPA Representative announced that General Director had asked the SPA in a letter to accept his early retirement. It is understood that the letter was backdated. It included only one short sentence and no reasoning whatsoever. In the press, General Director's early retirement was attributed to "health reasons." In one paper a hint was made to an SPA-investigation preceding the EGM.

The new Managing Director's bonus-tasks, that were to be rewarded with an amount equal to 120% of her base salary, included the development of a new business strategy, executing a cost cutting programme, and "getting things straight" in the field of R&D (40% of base salary), and managing the privatisation (80% of base salary).

The Board of Directors was also subject to changes. Dissenter remained a member.</td></tr>
<tr><td colspan="2">Second privatisation tender</td></tr>
<tr><td>January 1993</td><td>Brief for Responsible Politician suggests 51% to be sold in tender, 26% via ESOP and in share–compensation notes swap, 15% to be preserved for transfer to Social Security System

Responsible Politician names PP2 as an example "where maintaining the national character [viz. majority of domestic ownership] would be advisable"</td></tr>
<tr><td>March 1993</td><td>SPA and Advisor debate fee; Advisor's capabilities are questioned

Advisor estimates PP2's value at about HUF 1 bn; would tie success fee to this value, and break-up fee to (higher) par value

SPA contracts with Advisor

Advisor prepares Information Memorandum

Managing Director is reported to work on strategic and organisational renewal</td></tr>
<tr><td colspan="2">Payments of over HUF 225,000 had been centralised to the Managing Director's authority, strict limits had been set for maintenance, wages, etc. "These are things we do not make jokes about," said an executive in an interview at about this time. However, work on organisational issues and on a 'strategic business plan' had already started under the previous General Director.</td></tr>
<tr><td></td><td>SPA extraordinary Board meeting discusses privatisation of large companies, including PP2; misdeed of previous management is brought up again; some false press reports make a fuss; new tender is mentioned as already decided upon</td></tr>
<tr><td colspan="2">Press reports: "It is believed that the management can be held responsible for the delay to date; the SPA's Investigation Office is launching [emphasis added, note verb tense] an investigation into the matter." "The management's behaviour is being investigated [emphasis added] at PP2. Not only did they impede the implementation of the privatisation, but it also came to light that the company of the General Director's wife is the wholesaler of PP2's New Product Family-products. Not less than two world-famous giants presented offers, but both withdrew. ('The LAFC-transaction was not capably managed by the SPA' – acknowledged Responsible Politician)." Another article reported what the SPA's spokesperson had said about PP2's privatisation, then continued as follows: "In connection with this, Responsible Politician stated: 'this thing is very urgent because until the transaction is completed, everybody will steal everything that could be stolen'. Responsible Politician self-critically added, that the SPA handled the LAFC-transaction clumsily."</td></tr>
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<tr><td colspan="2">Note that Responsible Politician's remark about stealing had actually pertained to another firm. Also note that the SPA-investigation had been concluded months earlier, yet some articles hinted as if the investigation were to be launched only now. Similarly, references were made to PP2 management's "family skeleton in the cupboard," stating that the General Director's wife had interest in TPC, although she seemed to have already sold her interest in TPC in Summer 1992.

It appears that it was this SPA Board Meeting that prescribed a new tender for PP2, although it seems to have been treated as self-evident for several months.</td></tr>
<tr><td></td><td>Ministry objects to open, unrestricted tender</td></tr>
<tr><td colspan="2">In a letter to the SPA Leader, Ministry's representative explained that he had arrived late to participate in the SPA Board's discussion on PP2. His written position made it clear that "we do not agree to an open tender, without any restrictions." According to a study prepared in the Ministry at about this time, "it is reasonable to maintain Hungarian national majority in PP2. ... Only this can ensure that products in everyday use will be available to low-income strata of the population, and that the presence of the firm's low and moderately priced products will hold back the price of imported products, as well as the intention of foreign firms operating in Hungary to push up the prices." It was proposed in the study that the Hungarian majority should be achieved through the use of ESOP, management buy-out (with E-loan), and perhaps 'mass-privatisation'.</td></tr>
<tr><td></td><td>SPA–Managing Director–ESOP meeting is scheduled</td></tr>
<tr><td colspan="2">The meeting was to be held about the ESOP-interest. According to an overheard telephone-conversation, SPA Administrator requested Managing Director to convince ESOP to be satisfied with 10–15%.</td></tr>
<tr><td></td><td>Prompted by press news, (previous) General Manager protests to (another) Responsible Politician who fends off</td></tr>
<tr><td colspan="2">General Director particularly objected to what Responsible Politician had been reported to say on his role in PP2's privatisation. From General Director's letter to (another) Responsible Politician: "... I clearly proved that ... my wife had terminated her membership in [TPC] even before TPC and PP2 got into business relationship. When I was told one day before the general meeting of shareholders [emphasis in original], that I would be dismissed for this and that the new managing director had already been designated, I proved with documents that I had not done anything either unlawful or unethical. Then we agreed that I would submit a request, dated back by two weeks, for early retirement since I had no other choice." Then General Director claimed that attributing the failures of PP2's privatisation to the management and himself was a false accusation and that he could prove the contrary with a vast amount of data and documents. He also blamed the SPA for delaying the process at several points and for setting the price higher than the management had suggested, and noted that some apparently wanted to shift responsibility to others even by using false accusations. In sum, he asked Responsible Politician to have an investigation conducted which would evaluate his role, otherwise would turn to legal action and publicity.

At about the same time General Director's lawyer urged the company to transfer his client's severance pay, which had earlier been rejected by PP2's Board.

General Director's letter went through all levels of the SPA hierarchy down to Administrator. The reply, written on behalf of Responsible Politician and carrying his signature, presented two counter-arguments. First, if nothing unethical had happened, "then the question arises, why did your wife acquire interest under her maiden name in a company that has exclusive rights to trade the products of the company run by you. [Second, when] the SPA representatives presented you with the facts undisclosed by the investigation, it was you who asked for our consent concerning your early retirement. With this, we consider this matter closed."</td></tr>
<tr><td>April 1993</td><td>Minimum asking price is estimated by Advisor as HUF 2.13 bn (the firm's value was estimated at HUF 1 bn a month earlier)</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>PP2's Board meeting: Ministry's position on Hungarian majority is presented, Board declares support and suggests profits should be retained

Advisor receives calls from interested parties</td></tr>
<tr><td colspan="2">Most importantly, the British firm that had been attempting to acquire Basic Material for a long time, now pressed SPA to sell it at last; at the end it offered HUF 350m for it; SPA Leader considered the separate sale of Basic Material a possible option since "if there is a good offer, there is rarely a better"; SPA Director argued it would make the sale of the whole PP2 very difficult; SPA eventually kept Basic Material as part of the company now being offered on a tender.</td></tr>
<tr><td>May 1993</td><td>Two-round tender is advertised, 51 potential investors are directly invited; 78% of registered capital is offered; bid bond of HUF 60m is required; all forms of payments (cash, E-loan, instalment) are accepted

SPA Director's decree on how SPA should vote on PP2's AGM</td></tr>
<tr><td colspan="2">The AGM should approve the business plan for 1993 with the attached note that the planned profit level is "unrealistically low." The revised ESOP Feasibility Study, aiming at either 15% or 25% interest in PP2, should also be approved. All profit must be distributed (to SPA).</td></tr>
<tr><td></td><td>Managing Director informs members of PP2's Board that DIP, including herself, will submit a bid

AGM resolutions: as in SPA Director's decree</td></tr>
<tr><td>June 1993</td><td>PP2's Board of Directors resolution (3 for, 2 against): contracts above HUF 1m contracted value must be approved by Board; Managing Director is required to submit monthly written report

Advisor issues written declaration, denying the case of "asymmetric information" (insiders' advantage)

Tender opening: some are only interested, others submit bid</td></tr>
<tr><td colspan="2">Small Hungarian Bank (representing a Hungarian financial investor who in turn had "good relationships with international strategic investors") did not submit a bid, but stated it would be interested if conditions were better. Circumstantial evidence suggests that Small Hungarian Bank actually represented Expander. A Hungarian consortium wanted to acquire the unused building only.

Those who submitted a bid included NAC, DIP, and ESOP (Organising Committee).

NAC only expressed preliminary interest and failed to put down the bid bond. The tentative offer: HUF 2 bn for all shares offered for sale, option for the rest; HUF 1.1–1.7 bn further investment in equipment; NAC had no other significant interest in Europe, intended to turn PP2 to its European centre.

DIP and ESOP referred to each other in their bids. According to interviewees, DIP Leader sat down with every manager (including ESOP leaders) who tended to co-operate since an independent ESOP-acquisition had been ruled out by the SPA. One interviewee thought "the group led by DIP Leader seemed to be the last resort." In a prior agreement the ESOP had received the necessary guarantees from DIP Leader, thus it became possible that "considering the circumstances the employees would not be excluded from this new asset-distribution [viz. appropriation]" as ESOP Leader put it. He added, "with this minority, ESOP had to undertake a flexible, cooperative approach."

DIP's offer: management would get shares (9% altogether, Managing Director 3 times more than 9 others); on the basis of an agreement with a French company to subscribe to new shares thus</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">acquiring 31%, increase of registered capital was undertaken; flotation by the end of 1995 and parallel increase of registered capital by minimum 20% via public offer; ESOP's bid was supported by DIP, an agreement had already been made. In the business plan, profit forecast was higher than in management's plans; management's achievements in PP2's financial consolidation were acknowledged. "Developments" were promised in the amount of HUF 1.1 bn in three years, financed from sale of some property and capital increase. Attachments included promissory note from Small Bank that would, in consortium with other banks, provide E-loan (for ESOP only if in tandem with DIP). Financial structure, if ESOP is accepted (in brackets, if ESOP is rejected): acquisition of 63% (78%), at 110% (100%) of par value, 75% (75%) of price paid from in E-loan, 14% (13%) with C-coupons, 11% (12%) in cash.

ESOP Organising Committee's offer: 15% of stock at par, the minimum necessary cash plus E-loan; pleased to co-operate with DIP.</td></tr>
<tr><td></td><td>Advisor evaluates offers</td></tr>
<tr><td colspan="2">NAC "has to be excluded," because of not meeting the requirements concerning the bid bond. The other two bids actually meant only one, considered as "unlikely to meet the SPA's expectations," because only a small part of the price was cash. Advisor noted, "although the offered price seems favourable in comparison to the company's expected profitability, we assume that the SPA in this case would not accept to such a large extent a state-subsidised loan." Advisor finally recommended to modify the tender and allow for individual acquisitions of certain assets only.</td></tr>
<tr><td>July 1993</td><td>A foreign journal believes PP2 is bound to fail under pressure from "multinational bullies";</td></tr>
<tr><td colspan="2">Foreign executive in Hungary is quoted: "when PP2 falls out, it's gonna be a bloody tough market. Then the fun will start." Journalist speculates, if socialists win next elections, PP2's fall will be slow.</td></tr>
<tr><td></td><td>SPA Management Meeting evaluates offers</td></tr>
<tr><td colspan="2">A brief, prepared for the SPA Privatisation Branch Committee, Management Meeting and Board of Directors, excluded NAC's offer that "could not be considered either an offer or a declaration of acceptance, and does not constitute a binding agreement between NAC and SPA." Note that it was the first round of the tender, when non-binding offers were invited. The brief presented two options: 1) as proposed by Advisor, 2) the SPA would accept "DIP's offer combined with ESOP, asking them to modify their offer in the hope of a higher price." The second option was proposed, noting that this would also satisfy the Ministry.

On a copy of this brief an SPA staff member noted, "there is no hope to achieve a higher price." He also noted, "a two-round tender cannot be closed at this point," as if it had been considered. Other margin notes, probably made on the management meeting, included: "a declaration must be obtained from Advisor that the management was cooperative. Then immediately to the Board, without Management Meeting."

The Management Meeting did discuss the case, noted that a second round had to be announced, and decided to invite DIP and ESOP to submit their final and binding offer. It was also noted that Managing Director and Marketing Director were members of DIP, therefore Advisor was required to declare that the management was cooperative and everyone had the same chance to obtain information. (Advisor had already issued such a declaration which, in light of the above, was obviously dated back.) The brief to be prepared for the Board was required to specify the price at which the acquisition would be made. Then the brief could be submitted to the Board.</td></tr>
<tr><td></td><td>Deputy Director (on behalf of Director) invites DIP to submit final offer

NAC's Assistants (acting on behalf of MGC earlier) requests SPA to help in obtaining more information on PP2</td></tr>
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<table>
<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>SPA Director rejects NAC; refers to failing to meet tender requirements

SPA Director requests modification of the Management Meeting's resolution "considering that an invitation has already been sent out" to DIP; SPA Leader gently lectures colleagues</td></tr>
<tr><td colspan="2">SPA Director pointed out in a memorandum to SPA Leader that the Management Meeting's resolution could not be adhered to: the brief for the Board could not specify the price until the final offers were submitted. The Board was to meet in two weeks, but the deadline for the final offers was four weeks.

In a margin note, SPA Leader asked why the SPA could not ask for the final offers within a shorter deadline; in another note to the Administrator he remarked, "If you have a problem with the resolution of [date of resolution], why did you send out the letter [the next day]? Why did not you wait until we sort this out in-house?!? Not the modification of the resolution should be ... requested, but to try and execute it."</td></tr>
<tr><td></td><td>Lack of Board meeting</td></tr>
<tr><td colspan="2">The Management Meeting (that was not supposed to discuss the case but did) was not followed by a Board meeting (that was supposed to discuss it but did not). Neither this researcher, nor a new administrator (in his attempt to learn about past resolutions to which he was required to adhere to after taking over the case several months later) could not find any sign of a Board meeting that should have decided on how to proceed with the PP2-tender. Nonetheless, DIP and ESOP were invited to submit a final offer.</td></tr>
<tr><td></td><td>Advisor sends invoice after success of first round

EGM approves partial payment for (retired) General Director; modifies Managing Director's bonus tasks</td></tr>
<tr><td colspan="2">80% of salary for facilitating PP2's privatisation to a conclusion by the end of the year was still granted but only if Managing Director was not one of the acquirors. 20% of salary was granted if after-tax profit in 1993 would be twice as much as specified earlier. Managing Director did not welcome the SPA's decision on curtailing her likely income and requested an explanation from SPA's representative. In two different versions of the minutes two slightly different explanations were provided, both referring circumspectly to "new factors to be considered".

One Board member agreed with SPA. Dissenter pointed out that the first ESOP study had expected four times higher profit level at the time.</td></tr>
<tr><td></td><td>NAC confirms preliminary (still not binding) offer</td></tr>
<tr><td colspan="2">We could find no sign of ever seriously considering this offer. Apparently, by failing to put down the bid bond, NAC excluded itself from further opportunities.</td></tr>
<tr><td></td><td>DIP and ESOP submit final offers

Brief for Management Meeting and Board evaluates offers</td></tr>
<tr><td colspan="2">NAC's confirmation of somewhat revised preliminary offer was not considered as a valid bid. For 75% of shares NAC tentatively offered HUF 2 bn, plus capital expenditure programme of HUF 0.6–1.1 bn; needed 30–60 days to submit final offer.

DIP's final offer: acquisition of 63% interest, at 80% of par (referring to further analysis revealing PP2's prospects worse than thought); willing to pay par, if 20% was repaid to Company; claimed all dividends after 1993. Financial structure if 80% of par: 5% cash, 10% C-coupon, 85% E-loan (in case of deal at par, structure is almost as in first offer). Attachments included promissory notes from a small bank (providing small part) and Large Bank (providing large part of E-loan). Large Bank</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td colspan="2">required PP2 to do at least 30% of its banking business with Bank.

ESOP's final offer: acquisition of 15%, at 80% (largely E-loan); at par if 20% was repaid by SPA to Company. Attached: promissory notes

The SPA-brief failed to specifically mention NAC's preliminary offer but attached Advisor's letter on this. In sum it was stated that, considering the Property Policy Guidelines, the prospects of the industry, and the Company's loss of markets and dynamic developments made by its competitors, "it seems expedient to sell PP2 at par value to DIP (63% of the registered capital) and ESOP (15% of the registered capital)," adding that 20% of the proceeds was to be transferred back to the company. Thus, it was proposed to sell the shares at 80% of par if the buyers waived this 20%.

A hand-written footnote suggested that the sale should be executed at par, and the Share Sale Contract should include an agreement on the 20%. According to a later note made by the legal department, in case of a sale to an ESOP organisation, it was not required by law to transfer back the 20%</td></tr>
<tr><td>August 1993</td><td>SPA Management Meeting: sale at 80% of par, 20% of proceeds to be waived, the contract must include guarantees concerning the developments undertaken by the bidder

SPA Board resolution: tender is successful, DIP can buy 63% at par, ESOP can buy 15% at par, SPA's management is authorised to negotiate on the 20% and settle this issue in the contract

Managing Director states in an interview, PP2 has reduced the range of its products, stopped producing loss-making products, cut costs; the firm is making profit

SPA Director considers the deal exemplary; "It was worth going all the way long this bumpy road"

Dissenter raises voice against deal</td></tr>
<tr><td colspan="2">Dissenter prepared long report on the first half of 1993. In the cover letter she stated, "Although PP2 has in principle been privatised and in practice it is absolutely unnecessary to write any report on the first half of the year," yet she sent it, concluding that "the management's work is practically zero, and from becoming owners they will not turn to stallions [viz. superb], only they can continue stealing without any control. ... In the worse case they roll out a couple of hundreds of millions, then let it go bankrupt. ... If DIP Leader does not hit the table [viz. introduce tight control] and remove his partners from managerial positions, unfortunately this scenario is likely to happen, and by the end of 1994 there will be nothing to be floated on the stock exchange."

In another document prepared at the same time, Dissenter proposed to reprimand Managing Director and eventually dismiss her because she had not achieved any of the objectives set at her appointment.

At this time, a foreign journal quoted industry experts: "without significant capital investment and know-how from a multinational company, PP2 is likely to continue losing market share to the foreign competition and will either go bankrupt or be put back up for sale".</td></tr>
<tr><td></td><td>Negotiations with DIP and ESOP</td></tr>
<tr><td colspan="2">From indirect sources it is understood that there was no immediate agreement on the 20% repayment.</td></tr>
<tr><td>September 1993</td><td>SPA Director calms Dissenter</td></tr>
<tr><td colspan="2">Thanking her for the report "that reflects your worry about PP2's future, as well as your thorough work," he stated that DIP and ESOP have won the tender, the contract was likely to be concluded soon, and finally asked Dissenter "with due respect, that in the interest of PP2 until the conclusion of the contract the Board co-operate [grammatical incorrectness in Hungarian original]".</td></tr>
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<tr><th>Date/Period</th><th>Description of Event</th></tr>
<tr><td></td><td>ESOP is formally established; ESOP Leader is a plant manager
Share Sale Contract with DIP is concluded
SPA Director is reported to say “we implemented change of owners in the least worst way”
Share Sale Contract with ESOP is concluded</td></tr>
<tr><td colspan="2">The deal as in the contracts: DIP acquired 51% at par; 20% of proceeds would be transferred back to company, therefore sale price less 20% was to be paid but buyer was to cause company to waive the 20%; employee shares were to be issued “to the extent of 20% of the repaid sale price” (note that this may be a simple mistake, but it literally means 20% of the 20%); a remaining SPA-stock of 12% (originally preserved for those subject to Compensation Acts), and another stock of 14% (preserved for Social Security System) were to be converted to non-voting shares bearing fixed interest; at least 25% of profit in 1993 was to be distributed; buyers were to be penalised if they failed to “initiate” increase of registered capital by HUF 340m, also if failed “to attempt” flotation before end of 1995. ESOP acquired 15% at par.</td></tr>
<tr><td></td><td>DIP sends SPA a Clause to Contracts, indicating problem with E-loan</td></tr>
<tr><td colspan="2">The Clause was “made necessary to obtain Bank’s guarantee as soon as possible,” adding that “Bank stated that if they received this Clause signed by 3 p.m. on Thursday this week, then the PP2 case would be discussed on Tuesday next week.” The Clause stated that the Contracts would be effective after the buyers [DIP and ESOP] signed the necessary contracts with the banks.</td></tr>
<tr><td>October 1993</td><td>PP2’s Board meeting: Dissenter’s proposal is not discussed, disagreement on regulating employer’s right over Managing Director</td></tr>
<tr><td colspan="2">Dissenter had submitted an evaluation of PP2’s economic activity in the first half of the year but, according to the minutes, she withdrew it from discussion because “it has lost its relevance.” The Chairman proposed that he would exercise employer’s rights over Managing Director. The proposal was accepted with two votes against (Dissenter and another Board member “firmly objected”). Also with 3:2 vote the Board approved that contracts with more than HUF 1m contracted value could be made only with Managing Director’s prior approval. Those who voted for these proposals included the Chairman (a young academic), Managing Director and one of her deputies.</td></tr>
<tr><td></td><td>DIP requests SPA to approve new terms of payment</td></tr>
<tr><td colspan="2">“Due to the Large Bank’s delay in evaluating the loan, we were forced to look for a new co-financing bank, in addition to Small Bank, and to work out a new structure.” The proposed new structure of financing the acquisition involved a lower amount, and a much higher proportion of compensation notes and less E-loan. DIP: HUF 60m cash as retained bid bond, C-coupons HUF 653 m, E-loan HUF 111m; ESOP: negligible change only.</td></tr>
<tr><td>November 1993</td><td>Brief for SPA Board proposes acceptance of DIP’s request
SPA legal department states “on the basis of [an earlier SPA Board] resolution there is no possibility to switch forms of payments, the buyer is bound to his own previous offer”
EGM: DIP Leader attends but EGM is adjourned due to delay in executing the Contract; it is announced that “Bank has not responded to the application for credit, therefore we looked for a new bank”; it is also announced that the company provides funds</td></tr>
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Date/Period	Description of Event
	for the acquisition of the ESOP-shares In a letter to SPA Director and Administrator, Dissenter complains about management and makes one more attempt to block the deal Administrator "understands [Dissenter's] worries and would like to calm" her

Dissenter argued: "In the last two years I was representing the SPA's interest on the Board. The interests of the SPA and the firm were in harmony: the objective was to have a prosperous company. With the event of transferring the majority stock – it seems to me – this harmony dissolves, therefore on the day when PP2's shares will be owned by DIP, I retire from my position as member of the Board." Another Board member had already quit and was quoted by Dissenter as stating "the Board is captured by the management." Dissenter continued, "it is pointless to have a Board which, due to its personal composition, is unable to reprimand the management for lack of economic results, for the unjustified increase in costs, for the 'creative accounting', for successively not observing the company bylaws and Board resolutions." The Board's Chairman was said to have "delayed [the] discussion [of Dissenter's analysis of the Company's situation] until the end of September, then made it impossible to discuss it on the Board meeting. ... The minutes are not a true account of what was said at the meeting. ... I cannot, and do not want to represent the SPA's interest better than the SPA itself wants to. Therefore I am asking the SPA's kind instruction as to ... what measures are considered necessary on my part now, considering that the shares have not been endorsed to DIP yet and there is a chance that, due to the lack of the E-loan, they will not be."

Note that Dissenter misspelled SPA Administrator's name on her letter. SPA Administrator, then, misspelled Dissenter's name and calmed her not to worry "since the cash part of the price has already been transferred to the SPA and the matter of the E-loan and compensation notes is in progress".

From interviews conducted with PP2's executives, Dissenter's critical attitude seems to have been loaded with personal motives as well. According to Managing Director, the reason behind the "everyone steals, cheats and tells lies" kind of memoranda that Dissenter prepared was her intention of becoming managing director herself. She said, "Yes, I did a couple of things that were not absolutely in the spirit of the law [referring to the company bylaws], but she [Dissenter] did not understand that a company can easily be paralysed with tight rules." A close observer thought that Dissenter's behaviour may have been explained by politically loaded instructions from outside. According to this view, Dissenter, as well as Managing Director herself, were supposed to "politically clean" the firm. After some time, Managing Director did not want to comply with this expectation since she realised that a total confrontation with the existing management would probably paralyse this company "driven by fossilised bureaucratic routines that are not easy to change in long discussions that Managing Director had with the existing management," as a consultant who advised the company at this time put it. Then Managing Director was focusing on keeping the firm operational and ensuring stability (e.g. by tightening budgets) rather than on major changes. From the latter, not only the personal changes but also the strategic and organisational changes (technological developments, renewal of the marketing unit) failed to be implemented. According to the consultant quoted above, Managing Director, in her "somewhat feminine rivalry with Dissenter," formed an alliance with the existing management against whom she thought to be a challenger. It also appears from the interviews that the management wanted to hand over a stable firm; some improvements were indeed achieved. In addition, "supplies were filled up, since it had an influence on our start in 1994." On the other hand, management did not want to take the risk of introducing major changes before closing the privatisation process. As Managing Director put it, "I did not do a lot of things. Decisions were made in a 'just not to cause any problem' way." Another executive (also a Board member) stated, "then we felt that somehow out latitude is limited." This executive blamed not only the uncertainties that surround privatisation but also "the incompetence and obstruction of the Board that tied up the hands of the management, leaving no room for independent decisions at all" (referring only to Dissenter and another member who had retired from the Board earlier). As she explained, Dissenter did not have a partner in the first year (under the previous General Director); Board

<table>
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<tr><td colspan="2">meetings then ended with 4:1 votes. From 1993, Dissenter could team up with new members of the Board. After a few months, however, she had only one ally left, since first Managing Director, then the chairman of the Board changed position.

Managing Director drew the following lessons: "One should not be put [obviously by the SPA] into a situation where the execution of impossible tasks is expected when privatisation is in progress. For a thorough rationalisation, three years would have been necessary, but in the meantime we had to consider privatisation, when you cannot make a move. By handing over an operational firm, I fulfilled what was expected from me."</td></tr>
<tr><td></td><td>As suggested by SPA management, SPA Board accepts DIP's request "without wanting to set a precedent"</td></tr>
<tr><td colspan="2">Since the Contract, according to the rules, could not be modified, the parties revoked it altogether and concluded a new one, on the terms proposed by DIP; other conditions unchanged.</td></tr>
<tr><td></td><td>Responsible Politician asks (another) Responsible Politician for help to preclude similar problems</td></tr>
<tr><td colspan="2">Responsible Politician summarised the situation, noting that the SPA Board "had been presented a proposal on concluding a [revised] contract – with DIP – without a tender since there had already been two calls for tender." Note that there had indeed been two calls, but the rules required two unsuccessful tenders so that state assets could be divested outside of a bidding process. It was also recalled that "the Board approved [the new structure] on the condition that the buyer, in the course of the transaction, cannot suffer material loss." Note that this condition was set by the seller. Finally, "considering that the buyer had a valid promissory note on the E-loan at the time of submitting the bid, and that he could not sign a credit agreement with the bank in 60 days after concluding the contract [between SPA and DIP]," Responsible Politician asked (the other) Responsible Politician "to intervene at the banks so that the situation described above cannot thwart the sale of state property."</td></tr>
<tr><td></td><td>Payments are made; shares are endorsed

EGM: take-over is effectuated; remaining SPA-shares are converted; min. 15% of after-tax profit will be distributed to SPA; company bylaws are modified; Boards are re-elected; PP2 undertakes a guarantee for all ESOP-debts, and (with SPA representative's objection, but without her voting) for all DIP-debts (after taking the E-loan)</td></tr>
<tr><td colspan="2">Earlier the SPA legal directorate did not recommend the share conversion since "the fix dividends do not compensate for losing the opportunity to make an influence." It was also objected to approve some of DIP's proposals on the modification of the company bylaws since "they would deprive the general meeting of shareholders of fundamental strategic decisions (and thus we [SPA] will not even know about it)." The new Board of Directors included the previous chairman (now vice president), Managing Director (who became Executive vice president), DIP Leader (President and CEO) and his two advisors. ESOP was represented in the Supervisory Board. Board members' remuneration was set unusually high. SPA Administrator did not vote on the guarantee provided by the company for both ESOP and DIP, apparently on the consideration that on the same EGM the SPA shares had just been converted to non-voting shares. On the "technical scenario" of the EGM (which specified time, venue, participants, schedule, coffee breaks etc.) the name of Responsible Politician appeared. It is understood that he attended the EGM as a guest. Several months later he (then no longer being a politician responsible for privatisation) was elected to Chairman of PP2's Supervisory Board.</td></tr>
<tr><td>January 1994</td><td>SPA transfers large success fee to Advisor</td></tr>
<tr><td colspan="2">Note that DIP was not mediated by Advisor. Advisor's original calculation of the success fee was even 1.5 times higher then eventually paid.</td></tr>
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<tr><td></td><td>Changes in top management: existing top managers remain (some in new positions), new positions are also created

DIP Leader sheds light on the reason of problems with Large Bank; is “disillusioned about Hungarian banks, they ‘cross’, he says, and make the Hungarian investors’ position difficult wherever possible” (press interview); DIP Leader is also reported to “worry about foreign ownership of the domestic trade”; PP2 is founder of “Domestic product – Domestic Jobs” Foundation; PP2 is reported to want to attract foreign capital into joint ventures for mutual benefit</td></tr>
<tr><td colspan="2">From the interviews this researcher conducted at PP2, a more detailed explanation arises as to why DIP could not realise its payment in the original structure even if it had obtained a promissory note from Large Bank and, upon request of Large Bank, it had financed a study that showed enough guarantees for repaying the loan. It seems that Empire Builder, head of Expander, may have attempted to acquire PP2 without entering into the bidding process. Bank’s rejection of providing the E-loan despite its earlier commitment was suspected to have been motivated by the assumption that in case the winning bidder, due to the loss of its bank support, was rejected by the SPA, PP2 could be acquired by Expander outside of a tender. “They [Large Bank] wanted to play it into the hands of others,” as an interviewee put it. That it did not happen was due to the support of another bank and particularly the SPA’s willingness to change the terms. The other bank’s support was won partly because of personal relationships. As an executive (formerly DIP Leader’s advisor, currently Board member, soon to be CEO) explained later in the press, “today you need three things for business success: knowledge, work, and luck. I do not list here personal network; that did not play a role in the acquisition of PP2. In certain cases this of course played a role – for example in the case of financing – but I had to build only on relationships that I had built during my previous business activity.” DIP Leader later said in an interview, “there was no need of lobbying”.

Note that the new structure of payment was more favourable for the buyer, since compensation notes – now the dominant part in the price – could be obtained much more cheaply. On the other hand, it meant a larger immediate financial burden.</td></tr>
<tr><td>February 1994</td><td>On the eve of general elections, Responsible Politician considers 1993 the most successful year of privatisation; PP2’s privatisation is voted one of the best by journalists

New SPA Administrator takes over the PP2 case</td></tr>
<tr><td>Spring 1994</td><td>PP2’s advertising activity is apparently intensified but still behind foreign brands that are reported to gain market share

Computerised managerial information system is being introduced

Rationalisation programmes in several fields are launched

Since PP2’s does not enjoy tax holiday due to foreign ownership, new owners encourage managers to prepare proposals on projects with which tax concessions and preferential loans can be obtained; PP2 gets tax relief due to its undertaking a capital expenditure programme that will protect environment, while maintaining employment; other preferential sources are secured</td></tr>
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<tr><td></td><td>PP2 wants to acquire most of the SPA-stock

Board meeting: DIP Leader remains President, new CEO is appointed</td></tr>
<tr><td colspan="2">The newly appointed CEO had previously worked for ESOP and DIP Leader as a consultant, and had been Board member since take-over. Even earlier, he had pursued a political career, had been actively involved in transforming party-owned property into private property, and abandoned political career in 1990 for starting business consulting as founder and leader of his own firm.</td></tr>
<tr><td></td><td>AGM, with SPA's unclear voting rights</td></tr>
<tr><td colspan="2">New Administrator noticed that the SPA-shares had not been formally converted to non-voting shares; yet, previous Administrator did not vote even in December 1993. New Administrator believed the SPA should still vote. New Administrator explained: "I was convinced to prepare two separate briefs, one on the acquisition [of remaining SPA-shares by DIP], the other on the 4–5 problems I saw in the past events [one being the voting issue, another the lack of a Board resolution in July 1993, a third the conversion of shares without required Board's approval]. I was also persuaded that I should submit it to the Privatisation Branch Committee instead of the Board. I told them it wouldn't work, there would be questions, and so it happened. ... I'm getting the reprimands now [for rocking the boat], looking for a job ... The Privatisation Branch Committee meeting was yesterday, they postponed the decision and there will be an investigation." New Administrator believed that the previous Administrator made mistakes, then moved with her boss to another position, and now they were trying to cover up the problems. New Administrator also found that the SPA database showed impossible financial information on PP2.</td></tr>
<tr><td>Autumn 1994</td><td>PP2 attempts to make large acquisition into retail, apparently teaming up with foreign investors, but competing with other foreign investors

Interviewees at PP2 consider its privatisation a success; the need to team up with a foreign company is acknowledged "they could just wash us down [viz. drive the company out of business]"; DIP Leader says "Managers could change pace," "I'm not a loser type"</td></tr>
<tr><td>Spring 1995</td><td>An investigation is conducted on PP2's privatisation; legal procedure is considered; state attorney does not see "well-founded suspicion" to justify action</td></tr>
<tr><td>Summer 1995</td><td>Planned capital investment programme in the amount of HUF 2.8 bn for the next 5 years is reported</td></tr>
</table>

CHAPTER SEVEN

7. Case analysis

7.1 Introduction

In this chapter, cases are analysed, main findings are summarised, and subsequently matched with our framework.

First, each case study is evaluated in the light of the framework presented in sections 4.3 and 4.4. We take each concept of the framework one by one and place each case on the dimensions of the features of the concepts in simple variants of Miles and Huberman's (1994) conceptually ordered matrix. This will provide the basic building blocks for further analysis. Features of the firm's privatisation process, strategy-making and strategy content, its performance during privatisation, the outcome of its privatisation, and the extent of its turnaround attainment are discussed. These discussions are kept concise only to indicate major points, except for the first case study on Food and Beverage 1, which is considered a 'prototypical' case for the purpose of the emergent model and thus demands more detailed analysis.

Second, we look across the cases and compare them in order to explore relationships between concepts. Pairwise relationships are depicted in variable-by-variable matrices. This phase of the analysis will provide 'construction segments' consisting of building blocks.

Third, an overall evaluation of case study evidence in the light of our hypothesised scenarios is presented. The result of this phase of the analysis is the supporting structure, assembled from the construction segments, of the emergent theory of privatisation and firm behaviour in national transformation.

7.2 Building blocks for analysis

7.2.1 FB1 in the light of the framework

Features of the privatisation process – politicisation and politicking

FB1's privatisation process is considered highly politicised with immense politicking going on throughout the privatisation process. These broad qualitative judgements are underpinned below by pointing out events and circumstances that suggest high politicisation, and by noting tactics used by various players to influence the outcome of the privatisation process.

Our inference that FB1's privatisation process was ***highly politicised*** seems corroborated by the following events and circumstances:

- The authorities' expeditious commitment to the Expatriate Investor's offer in December 1989 and January 1990 occurred at a time when the government was in effect an interim one, yet facing the responsibility for divesting power in an organised way. In this situation, the bureaucrats' remarkably swift action in committing themselves to one of the possible alternatives may have been driven either by a self-interested attempt to reap benefits from a situation under their control, or by a desire to show an example of their compliance with preferences (including the encouragement of foreign investment) that the new government was likely to represent. In any case, it was probably the political changes that induced swiftness which, by setting the process on a certain path, resulted in far-reaching consequences.

- The political climate in 1990 was clearly encouraging the 'revolution of department leaders' in a journalist's words or, as an interviewee put it, a 'micro-level movement of social resistance'. Only a couple of months before, and particularly after the general elections, FB1's middle managers could rightfully assume that the time had come for them to do 'local justice', their discontent appeared politically legitimate.

- The argument over issues of authority that developed in March–April 1990 between the newly founded SPA and the Ministry that had earlier exercised nominal governance over FB1 seems to be an example of institutional instability due to political changes that enabled middle managers to seek 'justice' from one representative of the state when they perceived unjust treatment on the part of the other.

- At a time when earlier 'spontaneous privatisation' received much publicity and attention, transparency of privatisation became an important political priority that required the authorities to announce an open tender in April 1990.

- Throughout the privatisation process, various players were seeking support from politicians, sometimes at the highest level.

- In August 1990, there was a growing concern both at the SPA and the Ministry that they should probably withdraw from the planned deal; yet, because on the surface such a decision could have appeared as an example of unfair treatment of foreign investors in Hungary, it was decided to go ahead. This decision, however, also meant that by the time this route eventually proved to be a dead-end, considerable damage had been done and valuable time had been lost.

- The growing movement of independent unions provided background for local opposition. This could be used by the discontented middle managers to build up support from below and, in yet another way, politically legitimise their action.

- In 1992, political developments encouraged management and employees to enter the bidding and to use politically loaded arguments.

We group ***organisational politicking tactics*** that appear to have been used by players in this privatisation process under four labels: building coalition, manipulating information, manipulating time, and exerting pressure by going public.

- **Building coalition:** In this privatisation, one had to take sides. Some, like the Deputy general director in charge of economic matters who was also Chairman of the Enterprise Council, were understood to be close associates of the Director General who also enjoyed support from the leader of the traditional union. Others took the other side. Initially, only two people were on this side, soon it was three, and then four when a middle manager who later became Independent Union Leader was asked to join. By the time this group publicly entered the arena, their numbers had increased up to nine, which was soon to increase to fourteen. It was about this time that this group received support from two important sources. First, a deputy general director who had been a professional mentor of the two who started to organise the opposition did not take either side openly for a long time but completely withdrew to his strictly defined professional area. Yet, by providing his middle managers with access to information, he enabled the opposition to make a calculated case. Second, the middle managers established an independent union to which dozens, and soon hundreds of workers joined, which meant about 700 signatures attached to every protesting letter.

General Director's similar efforts were less effective. Regarding outside supporters, he attempted to line up customers and technical experts with very modest results. Due to his political background, there was limited opportunity to enlist political supporters, whereas the middle managers sought and sometimes successfully formed alliances with politicians and the local community. As to internal allies, the middle manager who got a seat on the Supervisory Board upon General Director's proposal did not desert. General Director's efforts also included sending a middle manager on a business trip to a Western country, and promises of promotions. However, this was said to have led to counter-effects, since some of General Director's associates became uncertain whether it was worth remaining loyal. After all, it was their positions which General Director was offering to those who were discontented.

- **Manipulating information** appears to be a tactic frequently used by many. General Director and his associates *withheld information* from the opposition, and used the tactic of *setting the agenda*, for example at the Enterprise Council meeting that was to choose between the offers. An alternative way of manipulating information can be labelled as *swaying opinion*, used, for example, by General Director when he commented on the proposals of Licensor and Expatriate Investor, adding that "I can state in my full responsibility that this management is not committed to anyone, only to the Enterprise Council, and to all the employees of the firm." A similar technique is '*hinting*'. The group of middle managers, for example, hinted in a protesting letter that the sale they were against would solve the problem of "some missing stock." The innuendo certainly implied a misdeed done by General Director.

A variant of this tactic is *giving false assurance*, used by General Director when he stated, "We must wait until the end of the Parliament's present sitting. If an unfavourable decision were made, I can take measures against it." Similarly, New Managing Director and his deputy (probably somewhat deceiving themselves, too) assured the management and employees assembly that they were on the way to finding the best possible investor for FB1. The same tactic was also used in Spring 1990 by SPA Leader.

Probably the most direct way of manipulating information is *providing false information*, for example by General Director and his deputy on the prospects of the firm, thus promoting Expatriate Investor's proposal by implying that he came to the rescue. Another example is General Director's presentation of the advantages of the purchase of used equipment through Expatriate Investor. Providing false information was also used repeatedly by state bureaucrats, when they described Expatriate Investor's offer as the best, and concluded that the offer "is provably [not probably] advantageous to both the firm and Hungary."

A more sophisticated way of manipulating information is to *conceal* it, that is to make it public in a way that will attract the least possible attention. This tactic may be necessary when due observation of legitimate procedures is unavoidable, not permitting more blatant ways of making information available only to those pre-selected. In April 1990, for example, new bidders were invited, in principle, to submit bids but the short public announcement placed amongst small ads probably did not reach a wide audience.

Finally, the opposition may simply be *excluded from access* to information. Leaders of middle managers, for example, were not members of the Enterprise Council. However, when one of them was proposed by General Director to sit on the Supervisory Board in an effort to gain his support, the challenged let the challengers get close to the information.

- **Manipulating time** is a tactic that may appear either as delaying a process, in the *'braking' variant* of this tactic, or as an effort to push through an issue towards an *a priori* defined and favoured outcome, in the *'accelerating' variant*. Note the hurry with which Enterprise Council meetings were convened, and the state bureaucrats' successful attempt to rapidly put the issue of drawing the firm under direct state control on the Parliament's agenda. The 'accelerating' variant often results in *'cementing biases'*, by putting the unfolding events on a path that limits the range of subsequent choices. A prominent example may be the option granted to Expatriate Investor just before the new government took control of privatisation. Those in decision-making positions realised that "it is not advisable to implement the sale until the state property agency whose establishment has been approved by the Parliament becomes operational, and the sale could not be executed in the time available either." An option, and even before that a letter of intent which any democratic government would be inclined to honour clearly increased the chances for the favoured outcome.

  Another way of manipulating time is *setting deadlines with a hidden agenda.* It may be important that the deadline should precede a certain event, or the time span for a certain activity should be restricted, or both. This was the case with the tender announcement in 1990 that allowed 14 days to submit bids for FB1 on the eve of the general elections.

- **Exerting pressure by going public** was perhaps the most efficiently used group of tactics of the discontent middle managers. *Press campaigns*, public *demonstration*, court *litigation*, and a flood of *protesting letters* are examples. An important element of these tactics that the opposition must be made aware of it. This seems to be the case when, for example, those discontent not only protested but also let the other side know that they had already protested (or, as a warning, would protest) on other fora, probably expecting that the recipient of their letters would want to avoid being questioned by superiors or other outside influencers.

In sum, the year of 1990 in FB1's privatisation process apparently fits what the literature on organisational power calls the ***young Turks game*** (see Mintzberg, 1983; see also Zald and Berger, 1978, on bureaucratic insurgency). The phrase suggests a game played for the highest stakes, a kind of a coup. Unlike state-level coups d'état which usually involve higher level executives, an organisational coup – as at FB1 – expands deeply into the organisation, throughout middle management or sometimes even lower. Finally, either to change some fundamental aspects of the way a firm is functioning or to effect an unexpected succession in the structure of legitimate power-holders is the objective, the young Turks game is usually initiated by a small but critical group from within the organisation which needs to seek dominant external influencers. In FB1's story, these typically included politicians.

FB1's example suggests that the young Turks game, if played out to the extreme, may result in negative total payoff. Figuratively, this privatisation story suggests that politicking over the slices may shrink the whole cake, and the winner only has remnants left behind after a destructive warfare. Players going for a bigger slice of the cake may have deceived themselves, assuming that the size of the cake will not be affected by their action[68], or simply may not have cared[69], and there was no corporate governance in place to effectively manage the fierce clash of interests (see below).

[68] Analogously to the 'fixed-pie expectations' described in the literature on negotiations (see Pinkley, Griffith and Northcraft, 1995), we might label this the 'fixed-cake expectation'.

[69] Since the winning position (the size of the slice post-privatisation) is compared to one's earlier position (the size of the slice before privatisation), regardless of the size of, and the damage to, the whole cake.

Features of strategy – strategy-making and strategy content

FB1's strategy-making appears to have been vague, and the content of its strategy was drift. FB1 was deep in organisational politicking; "it was a period of big fights." Strategy-making was suppressed by tactical moves driven by motives related to privatisation rather than business strategy. In fact, some business decisions seem to fit rather to a personal strategy for privatisation than to a corporate strategy for business conduct.

FB1's performance during privatisation

Market share: Losing position in an increasingly competitive market. Financial position: Substantial losses, sharply rising indebtedness, liquidity problems becoming frequent.

At a time when competition was getting more and more intense, drifting in fact meant sinking rapidly; no wonder that FB1 dropped back from third to fifth on the league table, and its financial position seriously deteriorated. "The financial burden accumulated by the then [1989–1990] managers of the firm must have reached [an amount equal to about 80% of the firm's net asset value]," said an interviewee. "FB1's bank creditors were becoming nervous at the Company's financial position," stated Advisor, and repeated in an analysis, that "FB1's financial position has markedly deteriorated, most particularly in 1991 ... given FB1's indebtedness, the banks control the destiny of the company and the shares command no value." Total debts assumed by management and employees when FB1 was sold in 1992 reached about 150% of the firm's net asset value.

Features of privatisation outcome – corporate governance and resource replenishment

FB1 was acquired by management and employees, mostly from an Existence-loan. Not only were they unable to refill the company's resource base but they also drew on the company's resources in order to repay their debts. In addition, FB1 did not become entitled to a tax holiday.

Effective corporate governance was not in place for a long time. The same persons controlled the company's top management and its Board of Directors, and they also held relative majority stake in the vehicle which nominally owned the firm. After a while Independent Union Leader, in his capacity as a director of the vehicle, made a hesitant attempt to introduce some outside control but his efforts did not represent a significant challenge for the top management, partly because he deemed that another row amongst management would inevitably lead to the firm going under. It was only about a year after the sale of the shares that the Bank introduced more effective control.

Turnaround attainment

FB1 is a clear-cut example of turnaround failure. It was only Domestic Investment Firm that took firm measures to stem the losses and to put the company on a path of recovery, while the completion of the turnaround was left to Major International Company which eventually acquired FB1 two years after the sale of 80% of the shares to the management and employees. The story this case tells is simple: the ownership arrangement of an organisation that is torn apart by a fierce privatisation process and left without inevitable prerequisites of a sound strategy will likely be ephemeral.

7.2.2 PT in the light of the framework

Features of the privatisation process – politicisation and politicking

In PT's privatisation, low politicisation was coupled with a moderately high level of politicking. One of the three major decisions that appear to have been based at least in part on political considerations was that the SPA Board prescribed selling further shops in the Pre-Privatisation scheme. While this decision raised problems for those (SPA administrators and the firm alike) who were expected to execute it, a turning point in the flow of events did not result from the SPA's much debated "Third Point." The other politically motivated decision, namely the appointment of some members of PT's Board of Directors as political patronage, did not have any apparent effect on this privatisation. Third, the general political climate was favourable for an

ESOP-acquisition, again without major influence since the ESOP-Bank bid did not need to be politically supported to win against CEIG's low value offer.

Politicking was present in several phases of this privatisation process, but typically, in contrast to FB1 or PP1 for example, it did not involve long and hostile periods of strife. In the very beginning, it took much negotiation and lobbying to convince decision-makers not to auction the whole firm 'shop by shop'. Then CEIG Leader's tactics to increase his odds and ESOP Leader's counter-move are worth noting. The conflict between ESOP and the Bank seems to have been devoid of politicking, except the ESOP's efforts to win the SPA over its case. Finally, although the change in the top management involved some politicking, again mainly in the form of alliance building with the SPA, it took place quickly.

Features of strategy – strategy-making and strategy content

Strategy-making during the privatisation process was increasingly focused at PT. From about 1992, when competition was already in 'full swing', measures aimed at recovery were taken, which gained impetus after concluding the privatisation in 1993.

PT's performance during privatisation

Market share: Decline is followed by increase. Financial position: Decline is followed by stabilisation.

Losing market share until about late-1992. Since then, slowly regaining positions.

Profit is made in 1990 and 1991 under easy accounting rules, while short term liabilities sharply increased. Loss is made in 1992. Since then, gradual consolidation but in 1994, the situation is still 'tight'.

Features of privatisation outcome – corporate governance and resource replenishment

Moderately effective corporate governance may be ensured by the Bank which appears to have a larger influence than its minority interest in the firm would suggest. Resource replenishment, however, seems to have been rather low. The amount of capital raising was modest; PT's resources are used to repay ESOP-debts. Management is still gradually implementing a turnaround strategy, a "relatively risky" one since "there are really no resources to finance" the necessary developments.

Turnaround attainment

Most importantly because of low resource replenishment, turnaround seems to be handicapped and carried out at a slow pace. It is indicative that flotation, which at the time of bidding was planned to happen in 1995, is now postponed to an unspecified date.

7.2.3 FB2 in the light of the framework

Features of the privatisation process – politicisation and politicking

FB2's privatisation process appears to have been influenced by political considerations, but these seem to have had only limited effect on the final outcome. In the early stage of the process, the overall plan for transformation and privatisation "changed several times ... often according to political interests. ... The concept was often determined by local [viz. parochial] interests." However, cross-ownership and management-employee majority (the latter never seriously considered by the management) had been ruled out relatively early. The Ministry's attempts to secure a larger stake for the employees and the farmers were probably driven in part by political objectives (note the Ministry's reference to an indigenous owners' class), but these attempts eventually failed. The Ministry's objection may have made the negotiation process a little longer than it would have been otherwise, but without initiating a turning point in the flow of events; the process still remained an economic bargaining between a resourceful and determined acquiror ("We want to acquire FB2") and a seller with low bargaining power. Similarly, although Responsible Politician was involved in the process towards its end, his involvement served the quick conclusion of the agreement and not any discernible political objective (other than an *economically* successful privatisation, that is). Interestingly, the SPA Board's decision to emphasise in a press release the "national interest in drawing a multinational into this industry" seems to reflect a political consideration in that the Board felt it necessary to explain its decision. In addition, FB2's privatisation process seems to have been devoid of 'party politics'.

Regarding the other distinguished feature of the privatisation process, namely politicking, FB2's privatisation is low on this dimension, too. In contrast to FB1, this firm avoided 'raging conflicts'. The management and the boards of the company were apparently working in tandem. FB2 did not become the subject of oversized ambitions. We have seen no example of any party attempting to have its own way through the use of political means. Indeed, there was no need for using political tactics; sheer economic bargaining power and its use to the full appear to have determined this privatisation.

Features of strategy – strategy-making and strategy content

FB2 is an example of focused strategy-making and – at least attempted – recovery. Facing growing competition and decreasing domestic demand, and being hit particularly by the shrinking commissioned warehousing business, FB2 was rapidly losing profitability. The management considered it a top priority to keep the firm viable not only because of the bank's judgement but also because of the upcoming privatisation. Once the main objectives had been defined, various measures were introduced to achieve it. "Tough cost-cutting measures" that were "unusual, different from previous practice" were taken, purchasing needed approval from top management, revenues and costs were continuously monitored. In order to maintain financial stability, weekly cash flow reports were prepared, buyers' solvency were monitored. On the other hand, efforts were made to increase revenues. Sales campaigns were launched. Organisational changes that aimed at improving the firm's relationship with the market were also made: the staff of the department that dealt with the farmers was renewed, and an export department was created. Management also placed greater emphasis on the co-operation between marketing and production. While maintenance work had to be delayed, quality remained a priority; ISO 9000 quality standards were introduced. All this was made in concert: "It was not that I decided. We had meetings, debates, then once we decided, everyone represented that. On the Supervisory Board and the Board of Directors we had people who did not go for personal gains but for the firm's interest," said General Director. The Supervisory Board stated on its first meeting that it intended to assist the management, and then it regularly reviewed the firm's situation. Regardless of all the efforts, the firm's position certainly deteriorated. Yet, by the end of the privatisation process it was still in business with a relatively healthy financial position, and ready to reap the benefits of resource replenishment provided by the acquiror.

FB2's performance during privatisation

Market share: no significant difference in relatively small initial market share. Financial position: moderate profit, stability maintained against severe shocks.

The company's financial position was said to be "balanced," with no delays in payments (November 1992). In 1992 FB2 achieved profit despite severe shocks (particularly due to a sharp decline in commissioned warehousing business), although less than planned. Cash flow was regarded as "well-managed" by the Supervisory Board (April 1993). At the Annual General Meeting of May 1993, General Director could state: "we have accomplished our main objectives, the company is profitable and financially stable in a difficult economic environment."

Features of privatisation outcome – corporate governance and resource replenishment

In contrast to FB1, FB2 was acquired by a resourceful foreign company. Both effective governance and a high level of resource replenishment were in place, as applied under the acquiror's corporate strategy. However, being subordinated to MM's global corporate strategy meant not only access to substantial resources (note the large investment from September 1995), but also being downgraded to the status of a production unit.

Turnaround attainment

It is too early to fully evaluate turnaround attainment. Yet, on the basis of available information, turnaround success seems granted. Note General Director's comment: "As soon as market opportunities improve – you see, this market is very much dependent on a general standard of living – the firm will be doing very well." With the resources provided by MM, the company can now prepare for better market opportunities.

7.2.4 PP1 in the light of the framework

Features of the privatisation process – politicisation and politicking

Politicisation and politicking were both high in PP1's privatisation. Regarding the influence of politics on privatisation, note the involvement of Responsible Politician and party politicians which clearly initiated a turning point in the flow of events in 1992, but was less successful towards the end of the government's term. Also note that the reasoning of various parties often included political justifications. For example, breaking up the Trust was considered necessary not only because of economic rationale, but also because in that way "power-saving" by the old *'nomenclature'* would be impeded. An interesting element in this regard is SPA Leader's rejecting, yet informative, reply to Local Party Politician who wanted to have a bigger say in the process, and particularly in determining PP1's top management.

The most prominent example of the turning points in the flow of events caused by politicking is the 'decentralisation' concept, that is the dismantling of Trust, which stemmed from the subsidiaries' lobbying activity. Another example of how politicking influenced decision-makers is the change in the Ministry's position: "following several requests made by Trust's PP1 Subsidiary (its ESOP I Organising

Committee), we considered the firm's transformation once more and concluded that it is necessary to change the position we have had till now."

Similar tactics that were observed in FB1's privatisation can also be seen in this case. One of them, also used by Independent Union Leader and the middle managers of FB1 but not pointed out earlier, was what we may label *'shifting up responsibility'*. This tactic can be seen in use whenever PP1's ESOP and MBO leaders refer to encouragement they have received from Responsible Politician and other high ranking officials, as in the following quote: "we informed in detail our colleagues at workers' meetings and in writing, ... mentioning the supporting letters that we had received from You and PR and APR. This repeated encouragement played an important role in the establishment of our ESOP." Another point to be noted in PP1's case is that to raise a 'voice of discontent' effectively, it is necessary to find *direct communication channels* to the decision-makers, that is to overcome the bureaucratic routine of passing the issue down the hierarchy, until the complaint that was originally directed to the highest level is handled by the very same person whom the complaint was about. This requirement, however, seems to drive those dissatisfied with the current path of events into playing politics. This is what the middle managers of FB1 were good at. By using various means of politicking they ensured that they were listened to. ESOP leaders of PP1 also attempted to communicate directly with top level decision-makers, but less and less effectively as time passed by. Finally, to conclude the list of examples of tactics of politicking, note the *use of time* at PP1. Trust's management, for example, submitted the memorandum of PP1's ESOPs to the Enterprise Council, knowing that it would not discuss it due to late receipt. By the time of the next Enterprise Council meeting, the whole issue was dealt with by a newly created committee, led by a deputy of Trust's General Director.

What makes politicking special in PP1's case are, first, the conflicts between the parent company and the subsidiary and, second, the rivalry between the two ESOP organising committees, which later turned into a conflict between the united ESOP supported by some managers on one side, and Director and her allies on the other. An implication of this is that tracing alliances becomes more difficult for the outside observer since there are more possible partners to team up with and more possible links between them. However, when the Spanish Industrialist took over the firm, he was confronted with a situation that seems to resemble the Bedouin proverb on quarrels:

> I against my brother,
> I and my brother against our cousin,
> I, my brother and our cousin against the neighbors,
> All of us against the foreigner.
>
> Quoted by Bruce Chatwin in: The Songlines, ch. 30, "From the Notebooks" (1987).
>
> *Source:* The Columbia Dictionary of Quotations Copyright © 1993 by Columbia University Press.

Features of strategy – strategy-making and strategy content

In contrast to other firms in our small sample, PP1 faced a more benign environment. Strategy-making, as in FB1, was subordinated to privatisation. It focused on achieving independence from Trust and preserving workers' benefits (see March 1993, on '13th month salary', social assets, wage rise) but remained vague in terms of setting priorities for business policy. Vague strategy-making and drift produced less dramatic consequences in terms of performance, since the firm was less pressed by competitive forces. Even so, after the take-over the new owner seemed to have found a few 'skeletons in the cupboard', including less than expected profit for distribution, substantial overdue payments, and a call for an urgent capital investment, not to mention deserted managers and low morale amongst workers.

PP1's performance during privatisation

Market share: High/dominant initial market share is not seriously challenged by competition. Financial position: Profitability decreases. Most of profit shown after 1993 turns out to have been spent.

> "Unlike other state-owned monopolies or near monopolies that have rapidly lost market share over the past three years to foreign competition, PP1's market share is not expected to change" but the firm needs a major upgrade. (Consultant, August 1993)

> "We believe ...[the amount of reported profits] is misleading ... The difference between Profits HUF 151m and available 26m has been used for stock increases, investments and other operational expenses by the previous Board of Directors." At the same time, "overdue payments ... when we took over were HUF 125m." (Spanish Investor in April 1994.)

Features of privatisation outcome – corporate governance and resource replenishment

From early 1995, Spanish Industrialist owns all the shares in PP1, and from August 1995 his two Hungarian acquisitions will be merged, which suggests that effective corporate governance will be ensured. There are also signs of considerable levels of resource replenishment – note the investments since the end of 1994. We may assume, however, that a part of the additional resources had to be used on compensating for the 'skeletons in the cupboard', that is the assumed, but not found profit for distribution, and other unexpected drawbacks.

Turnaround attainment

From early 1995, impressive improvements are reported. On the basis of limited public information PP1 is, eventually, on the way to a successful turnaround. However, similar improvements could have started earlier if Spanish Industrialist had taken full control earlier.

7.2.5 FF in the light of the framework

Features of the privatisation process – politicisation and politicking

FF's privatisation does not show signs of political influence. The level of politicking during the privatisation process, on the other hand, is considered moderate. FF's privatisation presents a clear example of alliance building. In addition to lobbying by a banker and a nation-wide union leader, the investors, their consultant, the management and the firm's suppliers acted in concert to put pressure on the SPA. This case is also an example of internal organisational politicking within the SPA.

Yet, what is most characteristic in this case is the intense politicking after the majority interest had been obtained by private owners, and thus privatisation, strictly speaking, had already occurred. Due to the hostile conflicts between ESOP Leader and the management, and because ESOP Leader did have bargaining power, turnaround efforts noticeably suffered delays.

Features of strategy – strategy-making and strategy content:

German Investor's words aptly describe the situation:

> "the company was losing money, when a company goes through this process, it's in the sort of abeyance. ... They didn't really realise [the problems] themselves. They weren't capable of doing it. ... They had a bureaucracy that was unsustainable. ... The company had no marketing in the sense we understand it ... just responded to customer orders, at low prices. That all had to be changed. ... They needed, you know, fast, rapid surgery. ... Basically, the company was 15–16 months in the course of being privatised. And it drifted because of that, because lack of investment in many previous years, ... because the company didn't think it could make changes."

FF's performance during privatisation

Market share: not applicable. Financial position: From moderate profits in 1989 and breaking even in 1990, accumulated losses.

> "It is also a fact that FF are currently loss making. This is further draining their reserves and affecting their cash flow." (Investor in May 1992)

> "The firm is now in the red the first time since it was established, and its financial position is rapidly deteriorating. Without a quick implementation of privatisation, the threat of bankruptcy will arise." (SPA Administrator in August 1992)

> "The value of the company's own capital has decreased by approximately HUF 173m." (General Director in October 1992)

Features of privatisation outcome – corporate governance and resource replenishment

FF's privatisation resulted in both effective corporate governance (with two of the investors/owners being in top executive positions) and high level of resource replenishment.

Turnaround attainment

There is no doubt that the firm is on the way to a successful turnaround. However, despite the high level of resource replenishment, the firm has as yet not produced expected results. Managerial incompetence (which could be integrated in our framework as a somewhat lower level of resource replenishment) and cultural clash, as Consultant believes, may provide a plausible explanation. In addition, it also appears that due to the delay in the privatisation process and because of the subsequent tug-of-war with ESOP Chairman, FF started the implementation of a turnaround strategy with a handicap.

7.2.6 PP2 in the light of the framework

Features of the privatisation process – politicisation and politicking

PP2's privatisation process seems to have been moderately politicised. There are a few features and turning points in the flow of events that seem to have been caused, at least in part, by political considerations:

- From Summer 1992, the insiders' buy-out attempt and the following change in the SPA's strategy for the firm's privatisation was probably encouraged by the politically motivated changes in the overall privatisation policy (see subsection 3.4.2), however, it may have only been a tactical move to force the SPA to consider their offer as a competing bid against LAFC, thus to prolong the privatisation process in the hope that LAFC would withdraw in the meantime;

- A Responsible Politician's hint on the "national character to be preserved in firms like PP2" as well as the Ministry's reasoning for Hungarian majority indicated political motives in work;

- Dissenter's dissent may have been backed by political supporters, just as the appointment of the new Managing Director.

The last point leads to politicking that is considered moderately intense in PP2's case, and revolved around:

- conflicts between Dissenter (and, for a relatively short period, her allies in the Board of Directors), and the top management (both before and after the appointment of the new Managing Director);
- a 'latent' or 'hidden' conflict between the top management and LAFC, in that the former apparently attempted to prevent the latter from implementing the acquisition, and for that end the management seems to have sought alliance with the Ministry and the SPA;
- a somewhat concealed rivalry between two different groups of possible domestic acquirors, the first led by DIP Leader, the second (allegedly) led by Empire Builder.

However, while it appeared intense in some relationships, politicking apparently remained localised in that conflicts usually involved a small number of people, in contrast to FB1 and PP1. In addition, there was no conflict between the plants and the headquarters. Neither there was a strife between the management and ESOP on the one hand, and the outside investors on the other, which made the 'transitional period' relatively smooth.

Features of strategy – strategy-making and strategy content

Similar to the features of its privatisation process, PP is also between the extremes in terms of strategy-making and strategy content. Strategy-making appears to be focused enough in terms of priorities set by the management to cope with environmental challenges. The content of the management's intended strategy even reflects an attempt to implement recovery. However, in PP2's case it seems particularly important to distinguish between intended and realised strategy. While the management may have had firm intent on what they should do, for a while realised strategy still resembled drift rather than recovery. It was only when the new Managing Director took her position that the firm indeed implemented some measures aimed at stabilisation of PP2's position, but even in this period action seems to have been impeded by inertial forces of this large organisation, and by uncertainty surrounding privatisation.

PP2's performance during privatisation

Market share: Initial dominant market share had decreased by privatisation and continued declining during the privatisation process. Financial position: From initial indebtedness, continued deteriorating. Losses and debts were accumulated. From mid-1992 and particularly in 1993, financial consolidation with modest results.

> "Our debts are now amounting to more than one billion Forints ... This situation leads the firm into bankruptcy in the short term." (General Director in August 1991).

> "PP2's situation ... has considerably deteriorated and this process shows an accelerating rate. ... [I]ts sales revenues are stagnant, stocks are growing, the firm's debts have far increased, market share is continuously diminishing ..." (Consultant in August 1991).

In 1992, profit is made, mainly due to the sale of PP2's interest in the joint venture.

Features of privatisation outcome – corporate governance and resource replenishment

The corporate governance resulting from this privatisation is assumed to be moderately effective on the basis of the ownership split, and because the majority owners may have to give some concession in return to the support received from the management and the ESOP in the privatisation.

Similarly, resource replenishment is moderate only. It is indicative that at the time of concluding this case study (Autumn 1994), planned investments in the range of HUF several hundreds of millions were reported by interviewees. The largest project related to an opportunity to obtain tax concessions. According to a brief press report in June 1995, PP2 planned to carry out a capital expenditure programme of about HUF 2.8 bn in the next five years. This amount is less than seems necessary in a competition with the largest multinationals. PP2's principal owner was reported in the press to say that PP2 would not spend large sums on advertising. Yet, in this industry advertising is one of the major competitive weapons, and PP2's competitors belong to the most agressively advertising firms in Hungary.

Turnaround attainment

On the basis of the latest available information, it is too early to evaluate PP2's post-privatisation performance. Nevertheless, its turnaround can reasonably be regarded as handicapped by the privatisation process, in that the firm had lost valuable time while its competitors strengthened their positions. PP2 is one of the cases that point to the relevance of 'procrastination' of privatisation. Whether a privatisation process is short or long *per se* does not seem to be a useful approach to evaluate the process. 'Procrastination' is defined here as the ratio between the length of the actual process and the time span in which the firm could have been (and, considering the poor position of the firms involved, should have been) privatised with a satisfying result. In other words, what has been done is compared to what could have reasonably been achieved. The 'optimal privatisation point' in this context is defined accordingly. It means the point when the opportunity to conclude the deal satisfactorily is missed and the process becomes procrastinated. In the case of a 'procrastinated privatisation' this ratio is greater than one. However, the ratio may also be less than one, when the process concludes with 'premature hastiness' in a deal that results in a less than satisfactory match of owner(s) and firm.[70]

It is important to emphasise that 'a satisfying result' is considered here from the perspective of the state and the organisation itself. To take the example of PP2, it seems that the first tender could have resulted in a successful privatisation for both the state and the firm. GML's offer, if accepted, would have yielded considerable proceeds to the state budget. It would have also ensured PP2's future development. Moreover, turnaround could have started as early as in Autumn 1991. In contrast, the

[70] In fact, we may assume that some privatisation processes become procrastinated in an effort by the decision-makers to prevent 'premature hasty deals' from happening.

privatisation process was 'procrastinated' for two more years, and ended with less cash for the state and less resources for the firm. Note that the Competition Office did not object to the deal, and import had long been liberalised. Unless there was some other reason unknown to us that made it impossible to conclude a deal – even on somewhat worse conditions than the original offer – with GML (for example, GML only pretended an acquisition intent), it is reasonable to consider PP2's privatisation procrastinated. Whether this procrastination resulted in a temporary solution that may be followed by the establishment of a joint venture with a foreign partner remains to be seen.

7.2.7 Summary of case evidence

In this section, case evidence is summarised in tables and figures, following the order of concepts in the process framework (see Figure 6).

The case studies indicate (see Table 29) that firms do vary according to the extent of politicisation and politicking of their privatisation processes.[71]

Table 29 Cases by privatisation process

Case	Politicisation	Politicking
Food and Beverage 1	High	High
Precious Trading	Low	Moderate
Food and Beverage 2	Low	Low
Personal Products 1	High	High
Fashion Factory	Low	Moderate then High
Personal Products 2	Moderate	Moderate

[71] The cases also indicate that politicking is not exercised *against* privatisation, as Schipke (1994:187) assumes on the part of the old *nomenclature* ("ministerial bureaucrats, enterprise directors, workers and /in certain cases/ local governments"), but *for a different* outcome of the privatisation process in terms of winners and losers.

Furthermore, in many cases these attributes tend to appear in tandem. This relationship is apparent in cases with high levels of both politicisation and politicking. In addition, two out of three cases with low politicisation show moderate levels of politicking (which turned into intense strife at Fashion Factory, but only in the 'follow-up' phase of privatisation). This suggests that 'macro-level politicisation' may create favourable conditions for 'micro-level politicking'.

The fact that some level of politicking seems almost inevitable in privatisation processes may also be explained by the transformational nature of not only macro-level systems of society and economy but also of micro-structures of the firms. In particular, legitimacy of the management or, in other words, the existing power structure may be subject to challenges. In cases like Food and Beverage 1 and Personal Products 1, where the challengers succeed in involving outside, most often political, influencers and thus increasing their bargaining power, the 'normal state' of politicking may be further heightened, resulting in a politically loaded organisational upheaval.

Firms also differ according to their strategy-making and strategy content during privatisation (see Table 30).

Table 30 Cases by strategy-making and strategy content during privatisation

Case	Strategy making	Strategy content
Food and Beverage 1	Vague	Drift
Precious Trading	Increasingly focused	Drift/Recovery
Food and Beverage 2	Focused	Recovery
Personal Products 1	Vague	Drift
Fashion Factory	Vague	Drift
Personal Products 2	Moderately vague	Drift/'Hesitant' Recovery

It is important here to distinguish between intended and realised strategy, as well as between the processes which they result from (see Figure 2). Personal Products 2 is perhaps the most characteristic example that formulation of intended strategy may be focused, yet the formation of realised strategy (strategy-making) remains vague. In other words, the management do have rather well-defined priorities as to what should be done but the pattern of behaviour of the whole organisation does not reflect those priorities. Similarly, PP2's intended strategy appears to aim at recovery, but its realised strategy resembles attributes of a drift.

The properties of these concepts also tend to go in tandem, vague strategy-making producing a drift strategy, and focused strategy-making producing a consistent pattern of behaviour aimed at recovery.

The six cases show different performance trends in the course of privatisation (see Table 31, overleaf). One firm, Food and Beverage 2, managed to maintain its stability against the severe shocks it had to face. Three firms were in decline throughout the privatisation process, although the extent of PP1's deterioration was only modest due to its relatively benign environment. In two cases (Precious Trading and Personal Products 2) initial decline turned into stabilisation towards the end of the privatisation process. These are also the cases where we observed increasingly focused strategy-making and their strategy content shifting from 'drift' to 'recovery'.

Table 31 Cases by performance during privatisation

Case	Overall Trend and Change in Performance Indicators
Food and Beverage 1	*Decline* Market share: Losing position in an increasingly competitive market Financial position: Substantial losses, sharply rising indebtedness, liquidity problems becoming frequent
Precious Trading	*Decline, then stabilisation* Market share: Decline is followed by increase. Financial position: Decline is followed by stabilisation.
Food and Beverage 2	*Maintained stability* Market share: no significant difference in relatively small initial market share Financial position: moderate profit, stability maintained against severe shocks (particularly due to sharp decline in commissioned warehousing business)
Personal Products 1	*Modest decline* Market share: High/dominant initial market share is not seriously challenged by competition Financial position: Profit shown after 1993 turns out to have been spent
Fashion Factory	*Decline* Market share: not applicable Financial position: From moderate profits in 1989 and breaking even in 1990, accumulated losses.
Personal Products 2	*Decline, then stabilisation* Market share: Dominant initial market share had decreased by privatisation and continued declining during the privatisation process Financial position: From initial indebtedness, continued deteriorating. Losses and debts were accumulated. From mid-1992 and particularly in 1993, financial consolidation with modest results.

The effectiveness of corporate governance is high in three cases and low in one case (see Table 32).

Table 32 Cases by privatisation outcome

Case	Corporate Governance	Resource replenishment
Food and Beverage 1	Defective	Low (Negative)
Precious Trading	Moderately effective*	Low
Food and Beverage 2	Effective	High
Personal Products 1	Effective	High
Fashion Factory	Effective	High
Personal Products 2	Moderately effective*	Moderate

* Hypothesised evaluation only.

Effective corporate governance was coupled with high resource replenishment in all three cases, while defective corporate governance and low resource replenishment characterised Food and Beverage 1. Available evidence is not sufficient to judge two others. At Precious Trading, corporate governance is assumed to be moderately effective, as a result of a possible compromise between management and employees who hold majority and the Bank that holds minority stake but can also exercise control through its credit policy. At Personal Products 2, outside owners might have to make concessions to management and employees, hence the presumably moderate effectiveness of corporate governance.

Note that there are two 'pure combinations' of both properties of privatisation outcome being either high (effective governance – high replenishment) or low (defective governance – low replenishment). Assuming the risk of simplifying, the other two cases (where moderately effective corporate governance is coupled with moderate or low levels of resource replenishment) will be collapsed into one 'in-between' case hereinafter.

In our sample there was no case with defective corporate governance and high resource replenishment – a situation that one might label as 'managers' heaven'. This finding should come as no surprise. Intuitively, such a situation occurring after privatisation would be difficult to explain, considering generally accepted theories of objectives of economic actors in market economies based on private ownership. In fact, the transformation of Central-Eastern Europe, at least in its economic dimension, may in essence be about the termination of managers' heaven where poorly performing firms were continuously refilled with resources taken from better performing ones.

There was also no example of effective corporate governance coupled with low resource replenishment, although both Precious Trading and Personal Products 2 may develop into such a situation.

7.3 Relationships between concepts

Now we build 'construction panels' from the basic building blocks by exploring relationships between concepts.

The relationship between privatisation process and strategy is illustrated in Figure 8 (overleaf). Privatisation process and performance in the course of privatisation are similarly matched in Figure 9 (overleaf). In both figures, firms are depicted according to their position on the dimensions of the conceptual properties. Note that properties of strategy-making and strategy content are combined into 'factors' (vague–drift *versus* focused–recovery) since these properties were found to be interlinked (see Table 30 on page 282, and accompanying text).

Figure 8 Privatisation process and strategy

Privatisation process	Strategy-making – Strategy-content: Vague–Drift	Focused–Recovery
Low politicisation Low politicking		Food and Beverage 2
Low politicisation Moderate/High politicking	Fashion Factory	⇨Precious Trading⇨
Moderate politicisation Moderate politicking	⇨Personal Products 2⇨	
High politicisation High politicking	Food and Beverage 1 Personal Products 1	

Note: The arrows indicate direction of change.

Figure 9 Privatisation process and performance during privatisation

Privatisation process	Performance: Decline	Stabilisation
Low politicisation Low politicking		Food and Beverage 2
Low politicisation Moderate/High politicking	Fashion Factory	⇨Precious Trading⇨
Moderate politicisation Moderate politicking	⇨Personal Products 2⇨	
High politicisation High politicking	Food and Beverage 1 Personal Products 1	

Note: The arrows indicate direction of change.

The pattern to be noted in Figure 8 is the diagonal arrangement of the firms which suggests a relationship between properties of the privatisation process on the one hand and properties of strategy on the other. It appears that the higher the politicisation and politicking in the privatisation process, the more indeterminate and feeble the strategy.

Figure 9 shows a very similar pattern. Low politicisation and low politicking are coupled with maintained stability, whereas high politicisation and high politicking seem to contribute to the decline of the firm (where the extent of the decline also depends on the benevolence of the environment).

The similarity of these patterns allow us to combine them in a single pattern, as depicted in Figure 10.

Figure 10 Privatisation process, strategy, and performance

	Strategy-making – Strategy-content	
Privatisation process	Vague–Drift	Focused–Recovery
Low politicisation Low politicking		Maintained stability (FB2)
Low politicisation Moderate/High politicking	Decline (FF)	⇨Decline then stabilisation (PT)⇨
Moderate politicisation Moderate politicking		⇨Decline then stabilisation (PP2)⇨
High politicisation High politicking	Decline (FB1) Modest decline (PP1)	

Note: Performance during privatisation. The arrows indicate direction of change.

Finally, in Table 33 (overleaf) the cases are evaluated according to the level of turnaround attainment following privatisation. In most of the cases, it seems too early to say if firms *ended up* as examples of turnaround success or failure. Performance data on a sufficiently long period are not yet available. However, we do have one firm in the sample that has already gone through two post-privatisation phases. The other cases provide some evidence on the basis of which plausible evaluation can be formulated regarding whether these firms are at least *moving towards* a successful turnaround or not.

Table 33 Cases by turnaround attainment

Case	Turnaround attainment
Food and Beverage 1	Turnaround failure
Precious Trading	Handicapped Turnaround
Food and Beverage 2	Turnaround success
Personal Products 1	Handicapped turnaround
Fashion Factory	Handicapped turnaround
Personal Products 2	Handicapped turnaround

Thus, FB1 has clearly failed, while FB2 is most likely to succeed in terms of achieving a strategic turnaround. In all the other cases, turnaround seems to have been handicapped. Within this group, PP1 and FF appear to have a high probability of overcoming the handicap and eventually achieving turnaround success. Whether PT and PP2 will follow suit remains to be seen.

7.4 Bringing it all together: privatisation scenarios, privatisation outcome and turnaround attainment

Our findings suggest three overall, 'idealised' scenarios that encompass properties of privatisation process, strategy, and performance during privatisation, and will be called 'privatisation scenarios' for short. These scenarios are labelled as 'going through', 'muddling through', and 'struggling through'. Their properties are briefly summarised in Figure 11 (overleaf).

Figure 11 Overall scenarios of privatisation, strategy and performance

Properties	Scenarios: Going through	Muddling through	Struggling
Privatisation process			
• politicisation	low	both moderate,	high
• politicking	low	or opposite	high
Strategy			
• strategy-making	focused	in between, or	vague
• strategy content	recovery	progressing	drift
Performance during privatisation	maintained stability	delayed stabilisation	decline

Going through: In this privatisation scenario, a firm is 'going through' the process in the sense that it is hit by environmental shocks and has to face challenges while being equipped with inadequate resources, yet it endures the 'transformation experience' with the least possible losses. Its privatisation process is devoid of raging conflicts and jockeying for positions, which enables the dominant coalition to concentrate on keeping the business as healthy as possible while facilitating a privatisation that will bring resources for completing a turnaround. The example of this scenario in our sample is Food and Beverage 2.

Muddling through: Some firms are 'muddling through' the transformation period. Their privatisation exhibits moderate levels of politicisation and politicking, or a moderate/high extent of politicking with a lower level of politicisation. Internal conflicts may be generated by organisational members who see an opportunity to increase their power, but are unable to enlist enough support to overcome the existing dominant coalition, like Dissenter in the case of Personal Products 2. Alternatively, as at Precious Trade, the conflicts may be resolved by the removal of a key person. In any case, conflicts appear to be limited in scope and effect. Once the issue of legitimate power is resolved, privatisation is not hindered any longer by unsettled power contests and organisational efforts may be more effectively directed to pursuing recovery. Since these efforts have been delayed, the firm enters its post-privatisation era with a handicap.

Struggling through: Firms like Food and Beverage 1 and Personal Products 1 are 'struggling through' several years of interregnum. Organisations are in a constant state of flux emanating from long-drawn-out strife between clashing interests. Bargaining power of the contenders may be raised by taking advantage of high politicisation of the privatisation process. In the absence of outside restraint, self-control and forbearance, politicking can drag on and on. Considerable energy is diverted from managing the business and consumed in the political arena, leaving performance to be determined by the momentum of habitual routines rather than any deliberate and concerted effort to achieve recovery. The firm entangles in a downward spiral where unrestrained power contests and lack of resources exacerbate drifting; this leads to the firm's position further deteriorating; which may intensify the strife over the slices of the shrinking cake.

The privatisation scenarios outlined above may be coupled with different outcomes of privatisation. In Figure 12 (overleaf) we match the three scenarios and three possible combinations of corporate governance and resource replenishment. These three combinations include the two 'pure cases' where both attributes are either 'high' or 'low'. The third combination is defined as an 'in-between case', created by collapsing the two actually found cases ('moderately effective – low' and 'moderately effective – moderate'; Precious Trading and Personal Products 2, respectively) into one.

Figure 12 Cases by privatisation scenarios and privatisation outcomes

	Corporate governance – Resource replenishment		
Scenarios	**Effective – High**	**In-between**	**Defective – Low**
'Going through'	Food & Beverage 2		
'Muddling through'	Fashion Factory	Personal Products 2 Precious Trading	
'Struggling through'	Personal Products 1		Food & Beverage 1

There are two 'pure extreme cases' in the sample: Food and Beverage 1 is characterised by the 'struggling through' scenario and an unfavourable outcome of privatisation on both of its properties, whereas Food and Beverage 2 is an example of the 'going through' scenario and a privatisation outcome that is favourable for future performance. The rest of the cases represent variants of 'mixed conditions'.

There was no case in our small sample that would follow the scenario of 'going through' and end up with a privatisation outcome unfavourable for turnaround attainment. This might be attributed to the small number of cases. If such a combination exists in the population, our hypothesis would be to assume a handicapped turnaround due to deficiencies of the outcome of privatisation. One could also theorise, however, that the joint occurrence of the 'going through' scenario and owners who exercise defective governance and bring no resources may not happen, and conclude that such a case does not exist in the population of privatised firms. This might be the case. Assuming that actors can, at sufficient levels of confidence, predict whether a potential owner would bring about effective governance and provide high resource replenishment[72], and further assuming that the

[72] In the case of two or more potential owners, the ability to distinguish between them would be a sufficient assumption.

objective of at least some of the actors who are able to influence the outcome of privatisation is to improve the firm's performance, we may also assume that these actors will attempt to resist a take-over by weak and resource deficient potential owners. Since these aspiring acquirors are resource deficient, they will probably have to either give up or rely upon politicking in order to increase their bargaining power against the resistance. Thus, the privatisation process will turn into one of the other two scenarios.

In Figure 13 the previous figure is replicated, but the firms are now replaced with the level of their turnaround attainment following privatisation (see Table 33). This reveals a pattern that largely corresponds to our propositions (presented in section 4.4 and summarised in Figure 7) and further refines them.

Figure 13 Privatisation scenarios and outcomes, and turnaround attainment

	Corporate governance – resource replenishment		
Privatisation Scenarios	**Effective – High**	**In-between**	**Defective – Low**
'Going through'	turnaround success (FB2)		
'Muddling through'	handicapped turnaround (FF, PP2, PT)		
'Struggling through'	handicapped turnaround (PP1)		turnaround failure (FB1)

CHAPTER EIGHT

8. Conclusion

In this final chapter we summarise the theory that emerged from this research and evaluate it in the light of the literature, attempt to place this study in a broader context, and suggest some directions for further research.

A middle range theory of privatisation and firm behaviour in national transformation

In Chapter 1 we asked, under what conditions can privatisation facilitate turnaround of privatised state-owned firms. We found that privatisation can not only facilitate turnaround of state-owned firms as commonly assumed but, under specific circumstances, it can also severely hinder a turnaround, depending on both process and outcome characteristics of privatisation.

In this thesis we have reviewed two relevant streams of literature that can theoretically inform our empirical study (Chapter 2). The first stream of literature helped us formulate a strategy-view of firm behaviour patterns, as applied to so-called socialist firms in particular, while the second provided a general understanding of privatisation as seen from the agency theory-perspective. In addition, an overview of the Hungarian privatisation process (Chapter 3) and lessons from a pilot study (section 3.6) contributed to an emergent model by highlighting some practically relevant issues.

On these foundations we built a framework (sections 4.3 and 4.4) to study the research question. In this framework, factors that determine turnaround include 1) the level of *politicisation* of the bargaining process in which the question of future ownership gets resolved, 2) the level of organisational *politicking* that surrounds both privatisation and strategy-making processes, 3) the effectiveness of *corporate governance*, and 4) the level of *resource replenishment* brought about by privatisation. We have suggested in the framework that turnaround attainment is influenced by privatisation process and outcome variables, whereas strategy-making and strategy content provide the mechanism through which privatisation plays out its effect.

We attempted to further explore, corroborate and refine this model in an empirical study. Following a *multiple, longitudinal case study design* (Chapter 5), in-depth case studies were prepared on six firms. We presented case narratives in the form of critical event lists (Chapter 6), and evaluated the cases in the light of the emergent model (sections 7.2). These evaluations served as building blocks for exploring relationships between properties of privatisation, strategy, and performance (section 7.3). The findings were then matched with the framework (section 7.4). The theory that emerged endeavours to explain and predict the differences in the performance of privatised Hungarian firms that need to achieve turnaround in the context of national transformation.

1. Characteristics of the privatisation process, of which politicisation and politicking were explicitly considered and found to be interlinked, have an effect on properties of strategy, of which consciousness of strategy-making and the coping pattern of strategy content were explicitly considered and, again, found to be interlinked. Low levels of both politicisation and politicking seem to facilitate focused strategy-making and recovery, whereas high politicisation and politicking produce vague strategy-making and make firms drift.

2. Consequently, performance of firms during the privatisation process varies between the opposites of sustained stability and decline (which may be cushioned by the 'benevolence' of the firm's environment).

3. Thus, we found that typical scenarios, as dynamic configurations of the privatisation process, strategy-making and strategy outcome, and performance during privatisation, are likely to occur in the transformation period.

4. These scenarios, coupled with different privatisation outcomes, are likely determinants of turnaround attainment by privatised firms.

Essentially, it is suggested that the more procrastinated and politicised the privatisation process, the more handicapped the turnaround, which might not be offset by effective corporate governance and a high level of resource replenishment at the end of the process.

There are a number of implications that can be formulated on the basis of this theory. These implications are loosely grouped below as pertaining to the evaluation of the results in the light of prior literature, of the methodology employed, and of the Hungarian privatisation. Further implications concern possible directions of future research.

Evaluation of the results in the light of prior literature

The results of this study are in line with and extend prior literature. The dominant economic model, which is based on the agency theory, emphasises corporate governance resulting from privatisation as superior to that under state-ownership. The theory that has emerged from this study maintains the importance of corporate governance following privatisation. However, it also directs attention to *corporate governance* during the privatisation process, and indicates that corporate governance resulting from and immediately following privatisation may also be defective. In addition, the role of *resource replenishment* is explicitly considered.

Corporate governance. By establishing a 'process view' of privatisation in the study of Central-Eastern European transformation, the emergent theory sheds light on some previously unexplored issues that appear relevant both for theoretical advancement and policy evaluation. It suggests that *corporate governance in the course of privatisation is necessarily defective*. In the only case where the privatisation process apparently went smoothly (FB2, 'going through' scenario), there appeared to be a congruence of objectives; that is, there was no need to align conflicting goals by means of corporate governance. In all the other cases, where goal conflict was present to a considerable extent, it was the deficiency of corporate governance (its inability to manage a clash of interests) that made it possible for politicking to emerge.

Consequently, *losses are inevitable* in every privatisation where goal-conflict is present, which might be the general case. Some players, going for a slice of the cake, may assume they have enough bargaining power to come out of the process as winners. Others may be mistaken by their belief that the size of the cake will not be affected by their action. In any case, if corporate governance is indeed necessarily defective, it implies that the total payoff to the actors involved in the privatisation process will probably shrink.

Even if corporate governance were effective in the course of privatisation, the 'cake' seems likely to suffer damage. A certain *'minimum level of transformational loss'* exists regardless of the smoothness of the process. This is because resource replenishment is delayed and even the efficient use of the existing resources is impeded by the fact that managerial decisions are thwarted by uncertainty that surrounds issues of ownership. It follows that the primary task of a government that attempts to manage the transformation process may be less a maximising one in terms of proceeds from privatisation than a minimising one in terms of inevitable 'transformational losses' (provided it has any choice to prioritise).

Resource replenishment is an obvious requisite for a turnaround, yet neglected in prior literature. Not only does the emergent theory explicitly include this issue but it also suggests an important *trade-off between* properties of the *privatisation process and* the level of *resource replenishment* required for a successful post-privatisation turnaround. The privatisation process may exacerbate the firm's situation, thus rendering a proportionally higher level of resource replenishment necessary if a turnaround is eventually to be achieved (assuming product market competition). Even if the firm is thus saved and put on a path of sustainable growth, this certainly implies inefficient resource allocation at the macro-level. In the worst case, the increment in resource replenishment due to a 'muddling through' or 'struggling through' privatisation process may push the required level of total resource replenishment higher than the eventual owner is able to provide, resulting in the firm's turnaround failure.

Evaluation of the methodology

We employed a multiple, replicative, small sample design that involved longitudinal, in-depth case studies based on various sources of information. This methodology suited the dynamic nature of the research question and appears to have brought results uncovered by previous research. Most importantly, the case study design allowed the discovery of the dynamic interplay between privatisation and strategy, and its effect on turnaround attainment as a particular facet of performance. It could also serve an important purpose of any research dealing with complex contemporary phenomena: that of the in-depth description which might enable other researchers to formulate new hypotheses and test them with more robust methods, thus advancing our knowledge in a cumulative way.

However, the case study design was not without difficulties. Leaving aside problems of securing access, dealing with complexity, and labour intensity, the most important limitation of this study is the generalisability of the findings.[73] Our findings are bounded within a specific (even though probably not very confined) context, and it requires further research to see if they bear out in different settings. We single out three contextual constraints upon the generalisability of the theory.

First, the general context of this research was Hungary where the management initially had quasi-ownership entitlements and bargaining was a chief mode of operation. In some other countries, where these initial conditions were absent, effective corporate governance during the transformation period might be achieved, thus lessening the latitude of politicking, preserving the firms' productive capabilities, and eventually making the completion of privatisation less urgent.[74] In

[73] Although proponents of this methodology (for references, see section 5.2) have made the point that results should be generalised first of all to the emergent theory, this still does not eliminate the issue of external validity in terms of the scope of the population implicated by the theory.

[74] On the importance of time pressure in non-cooperative game-based barganing, see Balakrishnan and Eliasberg (1995).

addition, privatisation techniques other than those chiefly used in the Hungarian privatisation may also curtail the possibility for barganing in the transformation period.

Second, politicisation may be less an important feature in other countries with different macro-economic and political conditions. In particular, domestic resource abundance (as in the re-united Germany) or even a less pressing resource scarcity (for example, lower foreign debt, as in the Czech Republic) may permit the attainment of desired social objectives with less harm than in Hungary, with the additional benefit of a likely perpetual social support for the government's privatisation policy.

Third, the selection of firms for this study was confined to those that were hit by shocks and faced challenges in the beginning of the transformation period. Thus, the performance position of these firms were soon deteriorating and called for a rapid turnaround strategy. In other words, the subjects of our case studies were mostly firms that soon reached the 'optimum privatisation point' from which the privatisation process could be considered 'procrastinated'. This issue will be discussed in more detail below.

Implications for the evaluation of the Hungarian privatisation

This theory emphasises evolving processes from which a new structure emerges. It focuses on the privatisation process in particular, and sheds light on how properties of this process affect properties of strategy and eventually its post-privatisation performance. However, as structure emerges from process, so does process spring from structure. We need to see not only the process side of the phenomenon under study but also the structural context that largely influences process characteristics.

The Hungarian privatisation process is path-dependent and embedded in a complex web of social, political and economic factors that characterise contemporary Hungary. The effect of these factors may be best grasped through the constraints they impose upon choices between opposites of dilemmas. These dilemmas include, for example, the choice between 'liberalisation first, privatisation second', or *vice versa;*

reduction of foreign debt *versus* restructuring prior to privatisation; speed *versus* transparency of privatisation; etc.

In the emergent theory, formulated at the level of the firm, we have considered policy choices as given elements of the context of firm-level processes, and investigated their effects. However, as we have pointed out in the conclusion to our review of the Hungarian privatisation policy, the government had to face some constraints in choosing a policy that would satisfy one or other side of a dilemma. Below we examine only one dilemma in detail, which is most apparent in the cases and most closely related to the emergent theory.[75] This emanates from the contradiction between existing constraints and desired ends, namely between the shortage of indigenous capital *versus* the objective of strengthening, or rather creating, a domestic 'middle class'.

Unless the legitimacy of the government's attempt to influence long-term social relations is questioned, this contradiction translates into the policy dilemma of transferring ownership entitlements to those who can pay for them, or creating an opportunity for the wider population to participate in the appropriation of state property. The first option implies privatisation mainly in favour of the old *nomenclature* and foreign owners. The second option may blur the rules by which privatisation decisions are made and make room for politicisation which, in turn, probably increases the latitude for politicking.

Politicisation of the privatisation process results from a political intent to implement a socially desired ownership structure in the context of a shortage of domestic capital, while politicking seems to emanate from goal conflict in the context of politicisation. Both are given, integral elements of privatisation. They are not 'good' or 'bad' *per se;* only their effect can be considered in value-laden terms. How, then, are politicisation and politicking to be evaluated?

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[75] See references in Chapter 3 for discussions of other 'dilemmatic' policy choices.

In general, *privatisation* can be conceived of *as a mechanism for potential owners and firms to be matched.* In this selection mechanism, *politicisation and politicking act as a filter* that is supposed to ensure that potential owners are selected according to some higher level set of objectives. The mechanism goes amiss if the eventual owner who gets selected is unable to provide sufficient resources, or the firm 'bleeds out' (even if it is not the objective of any of the actors[76]) before the issue of eventual ownership would get resolved.

The effect of politicisation and politicking clearly becomes detrimental when they make the privatisation process procrastinated.[77] After the 'optimal privatisation point', the damage to the total payoff will increasingly exceed the 'minimum level of transformation loss'.[78] In some cases, decision-makers may not be able to execute a privatisation at the optimal point due to some external influence. In other cases, in an effort to prevent premature, hasty deals from being concluded, they may not recognise that the privatisation process has in fact reached the point where an adequate match of owner and firm would be ensured. Thus, privatisation may result in a situation in which a politically favoured but resource deficient owner is unable to complete resource replenishment at the necessary level.[79]

In such cases, politically motivated favours seem to have been misdirected. Neither economic rationality will be satisfied, nor social and political objectives will be met. This presents another dilemma: the government, if it wishes to achieve its social

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[76] That is, assuming that the management (perhaps in collusion with external players) attempts to reduce the value of the firm to increase the possibility of acquiring it.

[77] Earlier we defined 'procrastination' as the ratio of the length of the actual privatisation process to the length of a process that could have yielded a satisfying result. This concept emerged in the course of the case analysis; see subsection 7.2.6.

[78] Although proceeds to the state from the privatisation of the firms were not explicitly considered in our study, the cases provide sufficient evidence to observe that there was no reward for the state that could compensate for the losses due to procrastination.

[79] We consider competition (particularly import competition resulting from liberalisation) devoid of significant restrictions, as was the case in the early 1990s for those Hungarian industries that we cover in this thesis.

objectives, should grant concessions to favoured groups to acquire such state property that does not call for significant levels of resource replenishment; however, for such a property there are likely to be cash-paying bidders whom the government, under the pressure of high foreign debt, cannot afford to disregard.

This does not necessarily imply that the fastest and less politicised the privatisation, the better. As our case studies indicate, one cannot reasonably expect that an adequate match of owner and firm would be ensured in the fastest possible process. In the given context of privatisation, however, politicking is a principal mechanism of preventing an inadequate match (a premature, hasty deal before the optimal point) from happening. Paradoxically, even in this 'positive' role politicking appears to bring harm to the total payoff, and the dilemma translates into a choice between different levels of losses.

The above discussion offers a plausible resolution to the last dilemma brought up here, which is the choice between privatisation *versus* facilitating the 'endogenous' development of the emergent private sector. It appears that a government may attempt to execute privatisation of firms facing similar situations to those covered by our case studies, by selling them as soon as possible for cash (also in the hope that in the beginning of the transformation period the electorate's support is sufficient enough for such a policy). At least some firms that are believed to need less resource replenishment may be earmarked to be acquired later by emerging domestic entrepreneurs. Finally, small entrepreneurship could be facilitated[80] from the resources that are probably only wasted if used to create unsustainable matches of owners and firms.

[80] Including the creation of opportunity to acquire *individual assets* of state-owned enterprises.

Implications for further research

Several issues which were raised in our literature review or which emerged from the cases have not been discussed in detail due to lack of sufficient case evidence, or have not been followed up because of our deliberate effort to focus only on the most important variables and their relationships. These issues, six of which are listed below, lend themselves to further research.

First, how does *information asymmetry* affect privatisation? It was evident from the case studies (note the examples in subsection 7.2) that information asymmetry is a major advantage of insiders which the state could only cope with somewhat arbitrarily, acting upon beliefs rather than knowledge. We have in effect subsumed information asymmetry under the various tactics of politicking; in further research, a possible way of enhancing our theory could be the analysis of this phenomenon on its own in the context of national transformation.

Second, where does the *bargaining power of various actors* come from? Apparently, some have bargaining power simply due to economic resourcefulness (note Mighty Multinational's dealing with the SPA). Others' bargaining power are 'artificially' created in the pursuit of social and political objectives (see the cases of Food & Beverage 1 and Personal Products 1). However, there appeared actors in the cases, often only single individuals, who seemed to have been able to exercise considerable (or even blocking) power rooted in specific micro-level circumstances (as in the case of Fashion Factory).

Third, what is the role of *bureaucratic routines and organisational culture* prevailing within the State Property Agency? How are preferences and expectations transmitted to case officers? Assuming that there is something to be learnt from a sample of one, the SPA should be a prime candidate for such a research inquiry due to its unique status. For example, our cases hinted that the phenomenon of 'covering up' might have been prevalent. In addition, what are the mechanisms of *negotiation amongst the various agents of the state* and what is the effect of their being divided? An example is the relationship between the State Property Agency and the Ministries.

Also note that issues which had earlier been discussed by the SPA's Board of Directors were later pre-negotiated at the level of the Privatisation Branch Committee (created after only approximately two years into the process) between various agents of the state. This also implies the involvement of interests represented by different state agents.

Fourth, *what role do coalitions and networks play* in privatisation? Apart from pointing out some examples of alliance building that seem to have established the relevance of the issue, we have not explored it further, although it emerged as an important one on the basis of our review of the Hungarian privatisation process. We have been confronted with the situation that such an inquiry is "necessarily hampered by the subtle, hidden, sometimes even illicit nature of coalitions" (Stevenson, Pearce and Porter, 1985:256).[81] Yet, a more directed research with an appropriate methodology might reveal more evidence about this phenomenon and its role in privatisation.

Fifth, when can we say privatisation is complete? It appears that politicking may continue after 'privatisation' (in the sense of divesting the majority of the state's shareholding). However, the remaining state shareholding, even if in the minority, continues to shape firm behaviour since it is still the subject of a contest. Fashion Factory is the most pertinent example here. In terms of firm behaviour, the *concept of privatisation may have to be redefined* and considered to have occurred when this minority state ownership ceases to have a behaviour-shaping effect, that is when the uncertainty surrounding the eventual future of state minority is eliminated, and the private owner(s) can indeed act at will.

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[81] Although the authors confine the term to intra-organisational coalitions, the problem applies and is probably further exacerbated if one is interested in coalitions and 'networks' based on personal and social relations across several organisations (cf. section 3.5 of this thesis).

Sixth, if corporate governance in the course of privatisation is necessarily defective, what can prevent the management from abusing its existing power and take advantage of its privileged position. Is there not more than corporate governance to discipline managers? Mainly on the basis of Food and Beverage 2, it appears that one can also consider another force, namely *ethics*, that may significantly determine the likely scenario and its outcome — if only in a few cases.

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Appendix: Special terms, abbreviations and acronyms

Table 34 Special terms used in this thesis

Terms	Meaning
Compensation-note	Tradable security bearing fixed 17% annual interest; see section 3.4.
Deed of Foundation	To establish a company, two separate documents were necessary: Articles of Association and Deed of Foundation, the latter first issued by the founding state organ (e.g. a ministry) when the state-owned enterprise was created, and modified by the SPA at the time of transformation.
Deputy General Director	Second level of management; each deputy is normally in charge of a certain field; functional directors are not necessarily deputy general directors.
Existence- or E-loan	Soft loan scheme to facilitate participation of domestic citizens in privatisation; evaluated by commercial banks according to standard criteria but risk to banks are reduced by state-owned Guarantee Fund.
General Director	Usual title of the chief executive of a state-owned enterprise; this title is normally used after transformation when the official title is managing director.
Own capital	Approximately: equity; of a SOE before transformation.
Reserved capital, or capital reserve	Approximately: retained earnings; of a SOE before transformation.
Strategic (or professional) investor	A potential acquiror, usually a foreign company, that is involved in the same business as the firm to be sold.
Transformation	Corporatisation (commercialisation), conversion of a state-owned enterprise into a company-form.

Table 35 Abbreviations and acronyms used in this thesis (except case studies)

Abbreviations	Meaning
AFD	Alliance of Free Democrats
AGM	Annual General Meeting of shareholders
CEO	Chief Executive Officer
CMEA	Council of Mutual Economic Assistance
Collective Agreement	made between an employer and employees; usually specifies more favourable conditions to the workers than the standard rules of the Labour Law; if there is no Collective Agreement, Labour Law automatically applies
EGM	Extraordinary General Meeting of shareholders
ESOP	Employee Share Ownership Programme; see 3.4
HDF	Hungarian Democratic Forum, largest coalition party, on government between 1990–1994
HSWP	Hungarian Socialist Workers' Party (the communist party)
IPS	Institute for Privatisation Studies
MBA	Master of Business Administration degree
MBO	Management Buy-Out
MP	member of Parliament (in this thesis, MPs who are mentioned all sat for a coalition party)
R&D	Research and Development
SAMCo	State Asset Management Company
SOE	state-owned enterprise
SPA	State Property Agency

Table 36 Acronyms used in the case studies, in alphabetical order

Acronyms	Meaning	Acronyms	Meaning
ADO	American Department Store Operator	IMF	Italian Manufacturer Firm
AII	American Institutional Investor	LAC	Large Atlantic Company
AMC	Atlantic Major Company	LAFC	Large Atlantic Focused Company
AMEC	Another Major European Company	LMF	Little Mediating Firm
AMGL	Another Global Market Leader	MEC	Major European Company
APP	Another Personal Products	MEC	Middle East Company
CCC	Co-ordination Consultation Committee	MFIB	Major Foreign Investment Bank
CEIG	Central European Investment Group	MGC	Major German Company
CPC	Central ESOP Preparatory Committee	MIC	Major International Company
DBP	Dutch Business Partner	MM	Mighty Multinational
DDC	Disqualified Domestic Consortium	NAC	New Atlantic Corporation
DIF	Domestic Investment Firm	OPP	Other Personal Products
DIG	Domestic Investment Group	PP1	Personal Products 1
DIP	Domestic Investor and Partners	PP2	Personal Products 2
FB1	Food and Beverage 1	PT	Precious Trading
FB2	Food and Beverage 2	SEC	Small European Company
FF	Fashion Factory	SF	Swiss Firm
FGL	First German Licensor	SGL	Second German Licensor
FH	Foreign Holding	SIB	Spanish Industrialist and Bank
FTP	French Trader and Partners	SLPP	Second Largest Personal Products
GML	Global Market Leader	SPA	State Property Agency
HCO	Health Care Organisation	SPP	Small Personal Products
HUF	Hungarian Forint	SSF	Small Service Firm
IFI	International Financial Institution	TPC	Tiny Private Company

Note: For detailed descriptions, see introductions to cases.