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Consultancy Report

Hungarian Sectoral Seed Review

Agricultural Input Marketing Support - Hungary
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Hungarian Seed Industry Analysis

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I. Introduction

The objective of this program was to develop a corporate development plan for the privatization of Agrowest, Semen, Mezomag, and Jasz-Kun. The plan concentrated on privatization issues related to management philosophy, domestic and export markets, and organizational and financial structure. The most to be accomplished within the allotted time horizon was the completion of basic research, development of a fundamental plan, and familiarization of senior management with the corporate planning environment and its near and medium term objectives and goals.

The scope of work includes:

1. Study and recommendations for individual firm market plans;
2. A basic operating plan for a newly developed organizational structure; and,
3. An analysis of the company specific financial situations.

The above results have been integrated into a single strategic operating, development, plan. Individual company profiles were completed.

Project team members reviewed one company per week. At the end of each week, team members presented preliminary observations and findings to senior company officials. These observations included recommendations for productivity and financial accounting improvements. Company responses to the consulting teams recommendations have been integrated in the individual company profiles. The team prepared individual company reviews. The company analysis included: production analysis; cost accounting and financial analysis, human resource organization; and, marketing. The scope and quality of each company report was contingent on the information provided by company officials.

II. Background[1]

a. General Overview

Hungary has a long tradition in seed production. Approximately 4% of cultivated land, or 150,000 hectares (1992), is used for seed production. The

[1]A more detailed historical overview of the Hungarian seed situation can be found in the original project proposal.

total value of seed production is about 13 billion HUF (U.S. $15 million[2]). As a result of changing land ownership, declining agricultural investment, and draught, total cultivated acreage has substantially declined. Total seed production acreage has declined from 1990 by 33% reaching 150,000 hectares in 1992.

b. Corporate Structure of the Hungarian Seed Industry

The national seed production and distribution monopoly in Hungary was Vetomag Vallalat (VV) which operated until December 31, 1989 and is now in the process of liquidation. VV succeeded the expropriated Mauthner Company which until after World War II was Hungary's largest international seed organization. For forty years, VV controlled the national export and domestic seed markets originally developed by Mauthner Company.

Twelve autonomous seed production and trading Kft corporations were formed from VV's regional distribution centers in November 1989. One of the Kfts was Kertimag which dealt primarily with horticultural products from Budapest. The remaining eleven Kfts, which comprised a national seed network for Hungary's nineteen rural counties are referred to as the "Seed Group" or the "Kfts". Two of these Kfts are operating profitably, the remaining 10 are either on the brink of bankruptcy, waiting to file, or have filed for bankruptcy protection.

The organization chart for the entire Seed Group including VV, Vetomag Kereskedohaz Rt. (VK) and the Kfts is shown on the following page. According to documents previously provided to ACDI, VK was formed "to coordinate the companies belonging to the Seed Group and carry out domestic and foreign trading activities." The remaining Kfts strongly object to any domestic presence of VK contending that its purpose was to manage export trading activities for the Seed Group and not to compete with the Kfts which nominally own VK.

There are several major constraints negatively impacting the remaining Seed Company Kfts, including:

- o Lack of capital;
- o Underdeveloped agricultural based credit system;

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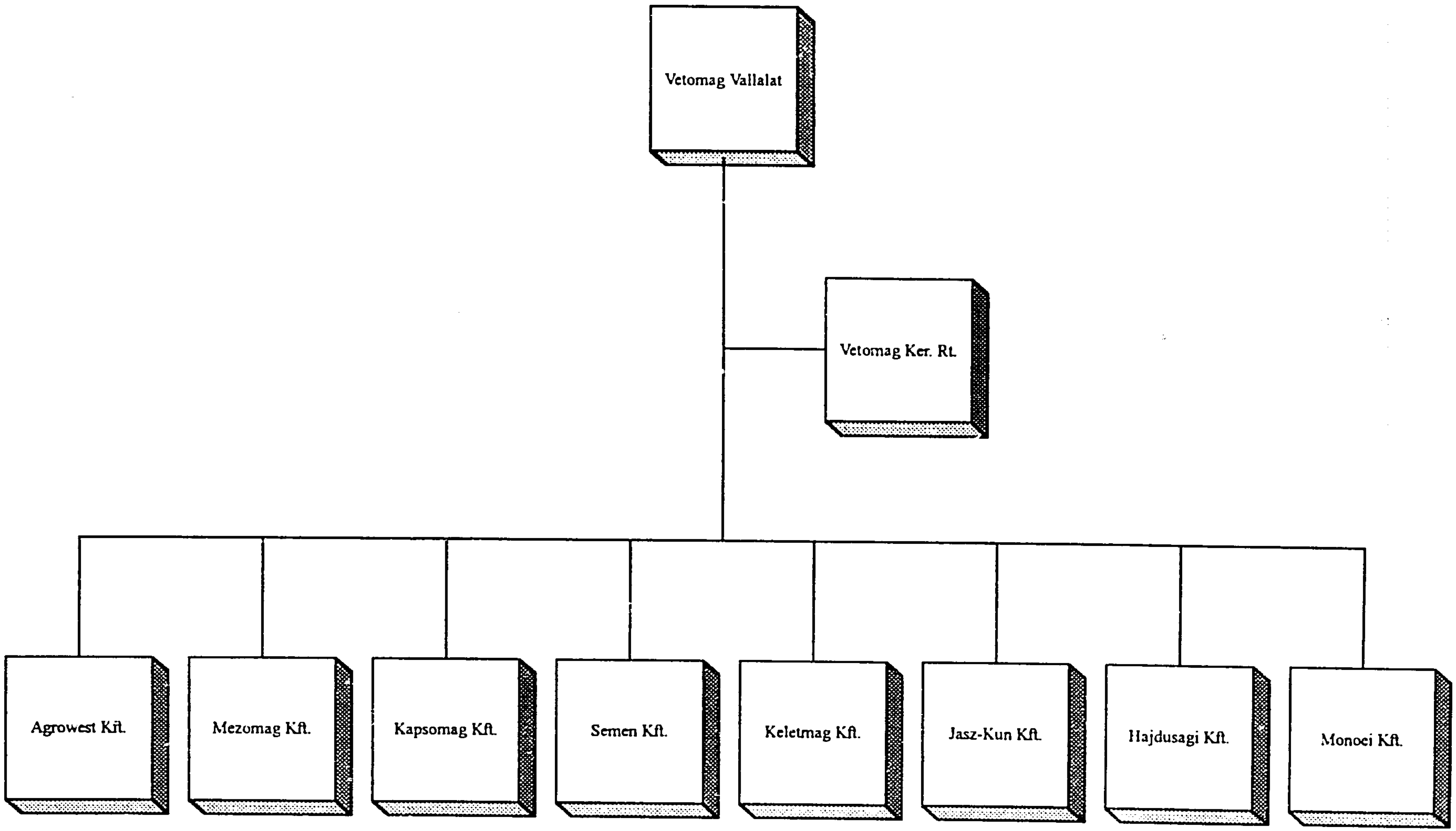
[2]Based on a August 28, 1993 U.S. - Hungarian Exchange rate of 90 HUF.

Seed Group Organization



- Lack of cost accounting systems;
- Lack of sales and marketing opportunities;
- Lack of liquidity;
- Lack of knowledge concerning surviving in a market economy;
- Continuing high interest rates;
- Lack of marketing channels; And,
- Loss of market share.

All of these factors mean that the private agricultural seed sector can be expected to experience continuing near and medium term financial and operational difficulties.

III. Production Overview

Recent changes in Hungarian property privatization laws have created many small scale farms on lands once owned by cooperatives or state farms. This has resulted in a grower base that is relatively new to farming and seed growing.

The production capacity of the Hungarian seed industry has many positive attributes, including:

- Relatively stable raw material supply in the various local markets. And,
- The technical level of seed production is good.

The industry as a whole is subject to substantial surplus productive capacity. This has resulted in redundant production facilities and surplus labor.

a. Production Systems

Under the former system, production, cleaning, and distribution were centralized. Seed cleaning facilities were engineered to use vertical production lines rather than horizontal processing lines. This type of vertical production process maximized labor usage and downplayed economic and production efficiencies. The structure of the former system was competitive globally so long as prices were fixed and sales were tightly controlled. However, the changing domestic economic environment has established the fact that

Hungarian seed production facilities are generally inadequate with respect to other global seed producers.

Despite a difficult economic environment, the seed industry has undergone major structural changes. Over the past two years, more than 180 small seed cleaning plants surfaced. These small facilities are capable of cleaning cereals, oilseeds, and certified seed. This makes it possible to use more seed stored on the farm. In addition, these on-site cleaning facilities have substantially lowered their production and overhead costs.

Domestic seed cleaning production should continue to reorient themselves towards on-site cleaning. The surveyed companies should re-engineer their equipment. The production process should be changed from centralized cleaning to on-site cleaning using vertical seed production lines. This strategy should not exclude mobile cleaning units as an option. A medium to long term strategy should establish a network of smaller fixed cleaning plants in productive growing regions.

b. Proprietary Varieties

The surviving Kfts should consider establishing joint venture research and development departments. The purpose of these departments is to breed varieties which will be the exclusive property of the Kfts. Before engaging in any proprietary variety seed development, the Kfts should establish legal rights to the proprietary seeds. The focus of any proprietary seed development should be on higher margin varieties (for example crimson clover).

The emergence of proprietary varieties will enable true marketing rather than pure selling programs to be established. For example, consider a seed cleaning company that sells only commodity variety seed. The basic characteristic of commodity type seeds are that they have low margins and are relatively easy to obtain. In order for a seed company to make money, substantial volumes of this type of commodity seed must be sold. Proprietary seed varieties are characterized by high margins and well defined seed ownership. In order for someone to purchase proprietary seed they must buy it from the company that produces it and no other company. The marketing campaign for seed companies with proprietary seeds is targeted to a certain well defined market. In order to achieve a certain level of profits, the seed company does not have to sell massive volumes of proprietary seed.

c. Seed Transportation

In the present situation in Hungary, some companies are paying for the transportation of seed. This adversely impacts the cost structure of the various companies. In any seed transaction, the buyer should pay the transportation costs.

d. Production Cost Control

The Hungarian seed industry uses inadequate cost controls. In order to ascertain true individual product contribution margins, all surviving Kfts must exercise tighter cost and cost accounting controls which can be accomplished by:

- Analyzing current staffing;
- Turning in daily timesheets;
- Developing job descriptions;
- Switching to horizontal technology to reduce labor redundancies and energy costs; And,
- Establishing more efficient cleaning plants.

Seed companies that can adapt their production operations and tighten their production cost controls to the changing market environment will survive.

IV. Financial Overview

The ratios below detail the operating efficiency, liquidity and debt structure of the four companies surveyed. This can be best utilized by seed companies to compare their operations to similar enterprises. The current ratio, which is current assets divided by current liabilities, shows a firm's ability to rapidly repay its short-term debt. The quick ratio is a narrower definition of liquidity than the current ratio. It is calculated by dividing cash and receivables by current liabilities. All of the surveyed companies have low liquidity, especially when considering the quick ratio. This, together with the high ratio of debt to equity makes traditional bank financing unlikely.

Inventory turnover, which is cost of goods sold divided by inventory, illustrates how quickly a company is able to rotate its stocks. A low number may indicate that the company is not selling its products fast enough and, as a result, has its cash tied up in its goods. The receivables turnover ratio, which is sales divided by receivables, shows how quickly a company can convert its credit sales into cash. On average, it takes a KFT about 63 days to collect a good account. Unless interest is collected a firm could lose 6% on its credit sales due to the cost of financing and inflation. A receivable could take up to a year to collect if the original sale, for example, is in March of 1993 to a farmer for payment in-kind. The farmer will not be able to pay with seed until August/September. The seed Kft is not able to sell the seed until the next growing season. By selling on credit this Kft may be losing a minimum 21 % to 36 % on their accounts receivable.

Comparative Company Financial Ratios

(As of December, 1992)

Accounts Receivable Turnover	Inventory Turnover	Debt-to-Equity	Current Ratio	Quick Ratio
RANGE				
5.3 to 6.3	1.9 to 2.7	5.3 to 5.8	0.91 to 1.17	0.29 to 0.46
AVERAGE				
5.7	2.3	5.6	1.06	0.40

The Seed Companies are facing serious financial difficulties because they do not earn enough money to fund their operations. The following strategies to reduce interest costs, improve cash flow and return to profitability should be implemented:

- o **Reduce credit sales** as a percentage of total sales. Every month a receivable is outstanding, 3% is lost due to inflation.

- o **Use buyer financing**. For large crops like wheat or rape seed, there may be buyers who are willing to provide bank guarantees. A letter of credit, should assure prompt payment. Upon collection, the loan can be repaid immediately, minimal interest expense is incurred and a reasonable profit will be made. The key to profitability in this low margin transaction is quick loan repayment.

- o **Convert debt to equity** or to long-term credit with an interest free period. Although high interest debt will be eliminated by the equity infusion, a favorable line of working capital still needs to be provided.

Low interest, long-term debt could also be provided by an outsider. This debt can have a convertibility clause and should have a one to two year period where interest is not paid or capitalized.

- **Determine a break even point**. The companies must understand how much they have to sell and at what margin to determine whether they can cover their fixed costs and interest payment. This way, appropriate adjustments can be made to the product mix and the form of financing before problems occur.

- Prepare a monthly sources and uses of cash statement. This indicates to management how much, where, and whether any funds are expected from borrowing, investment or other operations.

a. Mergers

Among the eleven company's that ACDI reviewed, there have been several instances where it was thought that a joint marketing, distribution or product development arrangement would be beneficial. ACDI evaluated the possibility of merging two companies determining the possible consequences. The case study of the merged companies is illustrated in the appendix.

When attempting to merge or combine operations companies should investigate whether combining two weak companies into one will make a stronger company. The combined company must produce greater economic and financial efficiencies. A merged company must be able to:

- increase economic efficiencies quickly;
- reduce redundant labor as soon as deemed appropriate;
- consolidate production facilities and equipment;
- reduce duplicate overhead costs;
- consolidate and paydown short and long term debt by selling off plant and equipment that is not necessary.

b. Banks and Financing

The Hungarian financial sector has developed rapidly since the separation of commercial banks from the former state dominated banking system. Despite numerous constraints, banks have become more like commercial banks with competition in the sector increasing and new financial instruments being introduced. Bad loans in the bank's portfolio have led to higher interest rate spreads between lending and borrowing rates. This reduces the size of the banking industry because it crowds out potential borrowers as well as potential depositors.

Large changes in economic conditions - changes in relative prices, loss of traditional export markets, and loss of import protection- have led to substantial changes in the profitability of many of the companies surveyed. Formerly profitable enterprises have become loss makers. Firms that are not covering their operating costs destroy the country's economic resources and should be closed.

In Hungary's current situation it is extremely important that the companies work directly with the banks in enterprise restructuring, and, indirectly in privatization efforts. If banks are to play a larger role in the restructuring process, and the emphasis is to be shifted from liquidation to restructuring, then debt for equity swaps must be made easier for both the company and the bank. At present, the banks' equity holdings that are acquired in the course of financial restructuring cannot be kept for more than 6 months if they exceed the legal limit for investments. This time period appears too short in order for the bank to capture the benefit of its restructuring operation in the price. As a general rule, to benefit from a corporate restructuring, the sophisticated investor will wait one to two years to allow the company sufficient time to build up its cash flow.

The companies should also consider the fact that the Hungarian banking industry is becoming more competitive. As a result, seed companies must utilize their spare resources to their best effect, surveying different banks to determine who will provide the cheapest loan conditions possible.

V. Marketing Overview

A generic trait of the Hungarian seed industry is its lack of marketing focus, analysis, and vision. The industry's product line is too broad and lacks individual and specific product identity. Former methods for production, distribution and sales are inadequate in the current economic environment and should be quickly drastically modified. The seed industry as a group should consider the following:

- Eliminate nonprofitable product lines. Individual Kfts should focus on its most profitable product lines (those with high contribution margins) and reduce the number of seeds that it cleans. Individual Kfts should focus on 10 proprietary varieties at most.

- Establishing joint marketing agreements between Kfts which can allow companies to offer a broader selection of products. This will assure a wide distribution of seed varieties across the country.

- Create marketing and sales departments whose priorities (in conjunction with the Finance and Production Departments) should include analyzing product costs and contribution margins. This will enable the company to develop a rational sales policy and product line.

- Hire and train sales and marketing staff with appropriate personality traits and the desire to learn and succeed in sales.

- Establish monthly and/or seasonal sales goals for not only the company and its individual products but for each sales representative.

- The above mentioned sales goals should be coordinated with the field department and accordingly adjusted on the basis of the size and the quality of the crop.

- Initiate a cash only sales policy for the next two years until financial conditions have improved.

- Undertake joint venture agreements with respect to warehousing seed products. This will allow for the concentration of product in certain key areas throughout the country. It will also reduce overall transportation charges. This agreement should be coordinated into a broader proposal for the establishment of a retail sales network.

- Create joint marketing agreements with suppliers of complementary products such as fertilizers, chemicals, and equipment.

- o Make company and variety specific sales and promotion brochures and information packages.

- o Operating with very thin margins for short periods is a marketing strategy to gain market share. However, this kind of marketing strategy sustained over long periods is extremely dangerous unless substantial profits from other products in a company's product mix are used to expand the company's revenue base and to counterman potentially adverse economic conditions.

- o Establish and train a sales team. Particular attention to the selection of appropriate sales personnel must be made. Individuals who are generally more comfortable working in production and accounting may not be suitable for working in marketing functions. The training should include establishing good customer relations and how to develop effective marketing techniques.

a. Developing a Market Plan

All companies should create annual marketing plans. A marketing and sales plan should be started in September of each year for the following crop year. The marketing and sales plan should be compared on a monthly basis to the actual results and adjusted accordingly.

Before a marketing plan can be written, the following criteria must be established:

- o Clear cost accounting rules;

- o Contribution margins must be clearly defined for each crop. These margins must include an allocated overhead and the true labor costs; And,

- o Gross contribution to profits must be clearly understood.

A marketing plan must take all of the above mentioned criteria and evaluate the product mix in light of the companies fixed, operating costs and breakeven point(s). This analysis should enable companies to optimize its production mix and marketing strategy.

b. Gross Margin Analysis

The table below is an illustration of prospective operating incomes required by a company to cover its fixed costs for any given level of sales and gross margins. The example below is merely a tool. A company should vary its product mix with respect to each crops contribution margin to optimize its potential gross revenues.

Gross Margin	Sales Volume (MHUF)		
	500	750	1,000
15%	75	112.5	150
20%	100	150	200
25%	125	187.5	250

c. **Potential Sources of Information**

A market plan must include a forecast of supply and demand. In order to facilitate this analysis, sources of market information include:

Domestic Market Information

- Various Hungarian Universities;
- Ministry of Agriculture;
- Commodity Exchange Data-KSH Data;
- Former State Farm Annual Reports;

Foreign/Export Market Information

- OECD International Trade Statistics;
- EC Agriculture and Economic Reports;
- U.N. Food And Agriculture (FAO) Reports;
- Foreign Trade Bureaus in Various Embassies based In Budapest;
- Various International Chambers of Commerce.

d. Marketing and Promotion

Many surveyed companies are constrained by limited financial resources. Marketing and promotion of products need not be adversely impacted. A company can successfully market products even with limited promotional budgets. Cost effective promotion techniques include:

- Publishing a product list and distributing it to existing and potential customers;
- Attending trade shows;
- Sponsoring youth organizations or sports teams;
- Field days and demonstration plots;
- Product or promotional give aways;
- Publishing and distributing variety performance data sheets to existing and potential customers;
- Establish a library of customer references. Use customer testimonials (references) to promote varieties.
- Packaging advertising-putting the companies name, location and identity logo on each product sold;
- Keep computerized customer data base including information on customers birthday, family, former orders, financial condition, potential crops to be planted; complements and complaints.

e. Developing Marketable Products

For the seed companies to become more profitable, the companies must:

- Obtain or develop private varieties;
- Produce private variety seeds up to the standards required by consumers;
- Distribute the seed to growers for final product marketing.

VI. Conclusions and Recommendations

Any financial strategy for seed companies requires restructuring debt to reduce interest payments. In general, to improve liquidity all companies surveyed must decrease the level of debtors and the collection period for that debt. A much tighter balance between debtor collection periods and creditor payment periods should be undertaken. The companies must make further aggressive steps to ensure financial stability including the recommendations below.

a. Developing a Proprietary Brand and Diversified Product Line

- Good seed varieties encompass characteristics such as vigor, high yield, disease and insect resistance. To maintain current markets and develop future markets, the seed industry must provide varieties possessing such characteristics at the desired location and time. These markets can only be viable when such seed varieties are available, when farmers and other consumers know that a given variety of seed exists, when the resource credit facilities to pay for seed are available, and most importantly, when the use of a variety is expected to enhance profits.

- Hungarian seed companies should develop proprietary varieties. In Hungary, the Company (or, Grower) should take their seed tags to the county and fields are registered. After the crop emerges, a seedling inspection is conducted. In the spring of each year a crop inspection takes place. Certification is based on:

- Passing field inspections;

- And, the resulting seed crop passing minimum purity and germination tests.

The certification of new varieties provides protection of inventor's property rights in certified varieties. The certification allow's the breeder to exclude other's from selling, offering for sale, reproducing, importing, or exporting the variety as provided by law for up to 18 years.

The financially viable companies should:

- Select their five most profitable crops by contribution margin and volume;

- Obtain exclusive marketing and production rights to varieties of those crops subject to making the Hungarian national list.

- o Enter those varieties on the national list.
- o Produce, promote and market those brand varieties once the seeds are listed.

b. Privatization and Buyouts

A fundamental aspect of privatization is the political will to privatize. Hungarian privatization efforts have been hindered by the lack of political motivation with respect to the seed industry and agriculture in specific. Privatization efforts should include debt for equity swaps and employee stock ownership plans (ESOPS) on reasonable terms.

- o Seed company valuation is an important issue. Some companies have a market value that has drastically been eroded. A few of the seed companies have some economic or financial value. Standard appraisal techniques are difficult to apply in the absence of a market for a seed company's corporate assets, with accounting information that is inappropriate for company valuation. A discounted cash flow method was not attempted because it was deemed unacceptable as it rests on the assumption that the state owns and is selling the full profit potential of the privatized company. Selling at a price which discounts these gains is likely to remove the very incentive which is required.

There is no ideal recipe for privatization or leveraged buyouts. Each option proposed requires some form of trade-off. A general framework within which buy-outs might be expected to take place may involve the following elements:

- o The selection of the various techniques available to be used to privatize a particular set of assets;
- o The need to deal with various key components of the privatization process itself; and,
- o The need to establish a satisfactory post privatization corporate environment.
- o The establishment of an overall privatization framework must include an emphasis on improving financial and production efficiency.

The principal areas of the sales process to be dealt with concern several factors:

- If a full employee buy-out is not possible, there is a need to include employee participation in the equity of the privatized concern to generate incentives and to avoid resentment which might arise if privatization took the form of a sale to a third party or narrow management buy-out.

- Valuation difficulties would argue for some form of contingent pricing arrangements.

- There may be a need to use innovative techniques to allow certain transactions to be financed in the absence of sufficient personal wealth, underdeveloped domestic capital markets, and sizes of transactions which are too small to attract foreign investors.

- The newly privatized company must establish an integrated business plan with organizational structure, narrowly defined personnel responsibilities, and with well-specified financial reporting and auditing responsibilities.

c. Competing With Vetomag Kereskedohaz (VK)

- The Kfts must become more aggressive with respect to the sales and marketing of seeds. The Kfts should establish their own links with foreign seed companies.

- The Kfts must sell only for cash.

- Kfts that have outstanding obligations to VK may be able to use their equity in VK as a way to reduce the outstanding liability.

- The seed companies should sell their shares in VK to raise cash.

- The Kfts must develop proprietary seed varieties to compete with VK. A strategic alliance with small Kfts to research and develop proprietary seed varieties is an option that should be considered.

- The Kfts must establish a seed market niche. It is imperative that the Kfts reduce their total seed product line. A niche product has a higher contribution margin than other seed products.

d. Marketing Recommendations

- o Joint marketing and research and development arrangements between various Kfts should reduce total operational costs.

- o A joint marketing agreement between several firms will allow Kfts to sell a fuller product line.

- o Establish joint marketing and sales arrangements with other companies selling fertilizers or insecticides.

- o Of several issues found to be important to Hungarian seed handlers, the major area of concern focused on the uncertainty of demand. Other factors, such as price variability and farmer financing are also considered to be major problems confronting the industry. Seed companies consider the financial positions of most farmers to be unstable, making it extremely difficult to predict survivability. Shifts in plantings of major crops and declining acreage in marginal areas contribute to over-supplies of seed in selected areas of the country.

- o Most Hungarian seed companies have limited product lines. Many firms in the United States or in the European Community are diversified into other areas complementary to seed, such as chemicals or fertilizers.

- o In the United States or Western Europe providing complementary services (i.e. chemicals, fertilizers etc.) is not a result of minimizing the risk associated with seed sales, but maintaining cash flow throughout the year and providing customers with products associated with seed. The diversification of products into other areas enhances seed sales as well as consumer loyalty.

e. Strategic Operating/Business Plan

The tables below provide a guideline for the seed companies in developing a strategic business operating plan. The tables are subdivided into four component parts including:

- o Finance and Accounting;

- o Operations and Human Resources;

- o Marketing; and,

- o Production and Technology.

Each component is further subdivided into objectives and implementation methods. It is recommended that the companies review the strategic business plan outline, designate an action officer for each of the four subcomponents; and establish implementation target dates.

Strategic Operating Plan

Corporate Function	Objective	Implementation Method
Finance and Accounting	Reduction of Company Debt:	- Classify debtors on the basis of debt size and age. - Develop Credit References for Customers. - Request Debtors who are 90 Days in arrears to settle debts immediately or collection procedures will commence.
	Reduction in Debtor Collection Period	- Discount Price for Prompt Cash Payment - Monthly Analysis of Collection Periods - Keep Accurate Records of Penalty Interest.
	Reduction In Inventory (Stock Levels)	- Develop Better Communication Between Sales and Production Departments - Discount and Sell Obsolete Stock
	Harmonizing Collection and Payment Periods	- Stagger Purchases to the time needed instead of purchasing months in advance. - Buy more on credit than with cash.

Corporate Function	Objective	Implementation Method
Finance and Accounting continued	Develop Integrated Financial Information Systems	- 1. Develop a cash flow Budget in December for the upcoming year. - 2. Develop a revenue forecast from the marketing department. - 3. Develop a cost budget from the production department. - 4. Develop a payments schedule from the finance department. - Put 1, 2, 3, and 4 together in a single business operating plan. - Compare actual results to the planned operating plan and adjust as is deemed necessary.
	Develop and Introduce a Pre and Post Calculation System	- Develop and Perform Individual Product Cost and Profitability Analysis - Keep Accurate Records of Employee Time Sheets as it Applies to Crop Cleanings
	Obtaining Loans With Lower Interest Rates	- Increase and Broaden Bank Connection's - Lower Debt
Operations and Human Resources	Establish a Clear Corporate Organizational Structure	- Develop Independent Accounting Units - Profit and Cost Centers - Establish Proper Employee Appraisal Systems

Corporate Function	Objective	Implementation Method
Marketing	Introducing Proprietary Brand Seed	- Identify seed market trends. - Develop more contract based production. - Discuss with other seed Kfts the possibility of establishing joint Research and Development programs. - Develop proprietary seed variety.
	Establishing More Effective Marketing And Sales Department(s)	- Set sales goals for each product and sales representative. - Establish sales territories for individual sales representatives. - Create product and company brochures. - Establish training programs for sales representatives.
Production and Technology	Establish More Effective Cost Accounting Controls	- Keep a fieldman's Diary. - Keep more efficient detail on labor allocation with respect to individual crops. - Develop daily, weekly, monthly production cost reports.

	Cleaning Efficiency	- Move from centralized to multiple site cleaning operations. - Move from vertical to horizontal cleaning operations. - Explore the possibility of mobile cleaning units. - Store more seed in bulk as opposed to bag or bin form. - Move stored seed to the cleaning equipment by air rather than by forklift. - Reclean, reprocess screenings immediately. - Automatic sampling should used rather than hand sampling.

Example - Seed Kft. Merger Case Study

The national seed production and distribution monopoly in Hungary was Vetomag Vallalat (VV) which operated until December 1989. Twelve autonomous seed production and trading Kft corporations were formed from VV's regional distribution centers in November 1989. Many of the eleven seed Kfts are either bankrupt or are operating under severely impaired financial conditions.

Recognizing the problems associated with surviving under the current economic environment in Hungary, the general managers from two Kfts have begun discussions which will eventually lead to combining both companies into a single operating company.

The Companies:

Kft. - A is a marginally profitable seed cleaning company. The company has four production lines. The production lines are vertical. Vertical production imposes limits on efficient seed cleaning. The company is involved in seed production, purchasing, processing and distribution of many grass seeds, winter rape, fodder rape, barley and winter wheat. The company is majority owned by VV whose assets have in turn been mortgaged to OKHB. The company is also partially owned by foreign investors.

Kft. - B is seed company that is very close to bankruptcy. Sales have declined by more than 40 % over the past two years. The company's cleans seed from two production facilities. One plant has equipment that is laid out vertically. The other, much smaller plant, has equipment which is laid out horizontally. Due to the draught, the plant has insufficient production volume. As a result per unit costs have been rising.

The Result:

After some discussions, the two general managers from Kft A and Kft B agreed to merge. The following balance sheet shows the composition of assets, liabilities and equity for two merged seed companies. The consolidated companies have restructured their production, accounting, and marketing staff. A number of staff members have been let go because it was thought that their position(s) was redundant.

The companies also reduced the number of crops cleaned from their total product line. As a result, the company was able to shut down two of their production lines. The merged company was able to introduce changes in organization and management structure, but problems on the balance sheet still persist. Although 90% of total assets are current, the health of the company is not as strong as it appears.

- Only 170 MHUF (50%) of accounts receivable is collectable due to the state of the economy. Assuming 340 MHUF (60%) of inventory can be sold, the true amount of current assets is 560 MHUF.

The above situation adversely impacts the newly merged entity's ability to reduce debt and interest payments.

- Short term credit of almost 400 MHUF at an interest rate of 30% means debt service of 120 MHUF annually. Even if credit was lowered to 300 MHUF, interest payments are 90 MHUF.

- Fixed assets of 108 MHUF are likely to have a market value below book value. It is almost impossible for the companies to reduce debt to a manageable level when this is combined with reduced current asset value.

Assuming fixed costs of 150 MHUF and interest payments of 100 MHUF, the company needs 1,250 MHUF of sales and a 20% contribution margin in order to break even. With the decline in Kft market shares, this target will be difficult to meet.

Recommendations:

Merging two companies is an optimal solution provided that operating efficiencies can be obtained from the consolidated company. Due to the distance between seed companies, few operating efficiencies and reductions in fixed costs can be obtained. It is likely, that the only savings are in the reduction of duplicate administration functions such as accounting.

A merged company must be able to:

- increase economic efficiencies quickly;

- reduce redundant labor as soon as deemed appropriate;

- consolidate production facilities and equipment;

- reduce duplicate overheard costs;

- consolidate and paydown short and long term debt by selling off plant and equipment that is not necessary.

The above merged company is unable to complete any of these steps. Hence, any proposed merger would not be effective.

	12/92
Current Assets	
Cash	39.4
Accounts Receivable	337.0
Inventory	560.6
Investments	7.3
Total Current Assets	944.2
Fixed Assets (Net)	
Land & Building	48.8
Machinery and Equipment	43.2
Other	9.7
Intangibles	1.076
Financial Assets	10.4
Total Fixed Assets	113.1
Total Assets	1,057.3
Liabilities & Equity:	
Current Liabilities	
Accounts Payable	114.2
Bills of Exchange	68.8
Short-term Credit	397.9
Other	253.5
Total Current Liabilities	834.4
Accrued Liabilities	26.0
Long-term Debt	0.000
Provisions	34.9
Other Debt	0.000
Total Liabilities	895.3
Equity	
Capital	152.4
Current RE	10.1
Total Equity	162.1
Total Liabilities & Equity	1,057.3

Appendix - Company Profiles

Agrowest

Mezomag

Semen

Jasz-Kun