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MANAGEMENT/EMPLOYEE BUY-OUTS IN ZIMBABWE

TWO CASE STUDIES

Field Report

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I. MANAGEMENT/EMPLOYEE BUY-OUTS IN ZIMBABWE:

TWO CASE STUDIES

A. METHODOLOGY

The two cases presented are real-world deals. The people are real, the businesses are real, the negotiations are real, and the opportunities are real. The case information was developed by acting as an actual investor. Although by agreement with USAID the writer will not invest in these particular deals, he is actively investing in management and employee buy-outs in Zimbabwe and directly experiencing today the opportunities and constraints that confront M&EBO activity in practice.

B. THE CASES

Two cases are presented. Bernstein Clothing Company is a 400 employee garment manufacturer making mens clothing, notably Van Heusen shirts. Bernstein was sold by the Bernstein family in 1991 to TA Holdings, a (relatively) large Zimbabwean conglomerate. The top-heavy management structure of a conglomerate in a fashion business nearly guarantees failure, particularly in Zimbabwe's increasingly competitive environment. Profits have dropped precipitously since 1991. Operating management is anxious to relieve itself of head office oversight and wishes to buy the company. TA asks a purchase price to recover its original investment, which is too high. However, it is likely that as Bernstein continues to fail TA will eventually wish to sell the company at any price and be forced to self-finance the transaction. Management is enthusiastic, but their ideas for lifting profitability are difficult to implement and prone to failure. However, less risky but creative marketing strategies might greatly improve Bernstein's profitability. If management can access creative business thinking and effective implementation, returns on investment could reach as high as 100%. That's a big 'if'.

The Red Fox Hotel is a 53 employee, middle-market hotel in the Harare suburbs. It is owned by a white Zimbabwean family which lost interest in managing it long ago. As a result, the hotel's operations have suffered. An experienced and capable but not particularly creative manager from another hotel wishes to buy Red Fox. If he can raise Z$1.0 million to purchase the moveable assets, it is likely that a pension fund could purchase the real estate for Z$2.0 million and lease it to him. It appears that the business can be turned around by converting unused floor area to additional guest rooms, improving service and improving marketing. However, prior to our meetings with him, the manager/buyer did not have a clear notion of the operational improvements required for the buy-out to survive and prosper. 'Real' returns could be in the area of 25% annually if solid, creative business thinking can be accessed. This is another big 'if'.

C. CONCLUSIONS

In general, management buy-outs are successful when operating profits are increased and business value is enhanced. If successful in Zimbabwe, benefits would accrue to everyone. For instance:

- Sellers would be un-burdened of money losing operations, management distraction, or illiquidity;
- Management would enjoy increased wealth;
- Employees' jobs would be more secure, wages could rise and employee ownership plans could be remunerative;
- Government would enjoy higher tax revenues;
- More jobs would be created;
- More consumers would have more or better products at better prices;
- Economic wealth in the economy would increase as a result of increased productivity.

Many of the basic requirements for success already exist in Zimbabwe:

- These case studies demonstrate that investable deals exist in Zimbabwe;
- Indigenous management talent with appropriate technical skills such as production, accounting, engineering and the like are in sufficient supply;
- Indigenous management have had some years of middle-management experience since Independence;
- Most of the 'enabling environment' is in place - good physical, civil, legal and financial structures have been maintained, the workforce is relatively educated, etc.;
- Despite almost universal opinion to the contrary, capital is available for solidly finance-able deals. Several equity investment firms already exist in Zimbabwe, and if positive results were demonstrated, more would spring up. Banks, merchant banks, pension funds, corporations and even private individuals have sufficient capital. These institutions are conservative but could be convinced, through positive results, that indigenous buy-outs are fiduciarily prudent. However, with inflation at 25%, lending costs are too high, except for the most profitable deals.

However, buy-out success depends upon improving the operating business. Neither management nor employee buy-outs will, on their own, help to improve the economic scene in Zimbabwe. Capital and technical skills alone do not create profits. Buy-outs, like business, are not formulaic - they require creative, flexible, open-minded, dynamic thinking and intense motivation.

This is the ingredient that's missing from the Zimbabwe scene. Without creative business thinking and comprehensive implementations, indigenous buy-outs either will not materialize or will fail under the pressures of the various risks, such as:

- Increased financial leverage;
- Expectations of new owners that ownership, in and of itself, brings wealth;
- Lack of 'the buck stops here' experience;
- Lack of realization that what creates successful businesses is more than simply doing a job; its providing a better product or service cheaper than the next guy;
- A desire to display one's status rather than to increase business value;
- A desire for rewards today rather than investment for the future;
- A cultural imperative to support one's extended family with money or jobs, rather than investing for the future and hiring the best people; and
- To show a gain, business value must keep pace with inflation at 25% annually, which is a tough hurdle.

One must remember that buy-outs are risky. In and of themselves they will do nothing to correct the problems in Zimbabwe's economy. There is a substantial risk that business performance in bought-out companies could deteriorate, leaving the particular company, the indigenous community and the entire country worse off. The negative effect of buy-outs gone bad is much greater than buy-outs never having occurred in the first place.

Nevertheless, with the right inputs, buy-outs can be a very powerful force for quick and effective change. What Zimbabwe needs most for buy-outs to succeed is what America, with its pioneering and entrepreneurial spirit, does best:

- Creative identification of new or, in MBO's, incremental business opportunities.
- Creative financial structuring.
- Orientation to the customer (i.e., marketing).
- Focused and agile implementation of business strategies.

This writer believes that USAID could add significant value to wealth creation and indiginization by bringing to bear in Zimbabwe the creative, innovative and intensive business style of American business in indigenous buy-outs. This cannot be achieved through short-term consultancies in the buy-out context where capital, businesses and lives are at risk. The gestation period to develop a deal might be one year, and the successful implementation will require two or more years.

USAID might wish to consider methods for bringing American entrepreneurs and creative financial people to work side-by-side, long-term with Zimbabweans to develop and implement management and employee buy-outs. For example, USAID could support:

- Long-term contracts for American buy-out professionals, managers who have lived through buy-outs, or businesspeople who have sold their businesses to work with and inside particular buy-outs in Zimbabwe;
- Remuneration in the form of small ownership positions in the buy-outs. By working in exchange for an ownership position, the American would be fully committed to the success of the deal, which would benefit all concerned.;

- Supporting establishment of a buy-out advisory firm, with expatriate assistance, which would be compensated largely through equity in the deals.

Success in buy-outs, which results from improved business profitability, can become a model for Zimbabwe's society to emulate. The practice and the rewards of productivity and innovation will become tangible. However, success in buy-outs is not guaranteed, regardless of financial schemes, technical assistance and 'enabling environment'.

Success in buy-outs results from success in business. Precious few indigenous Zimbabweans are equipped to take the sow's ears of so many Zimbabwean businesses and turn them into silk purses. But, many Americans are so equipped.

II. BERNSTEIN CLOTHING

A. THE COMPANY

Bernstein Clothing Company manufactures men's shirts and other clothes for sale in Zimbabwe and 11 other countries in southern Africa. Its primary product line is Van Heusen shirts and trousers, sold under license from the UK franchisor. The Company has approximately 400 employees, current annual turnover of Z$19.9 million (US$2.4mm) and pre-tax operating income of Z$1.7 million (US$0.2mm).

Bernstein is a subsidiary of TA Holdings, a diversified conglomerate with the 14th largest capitalization on the Zimbabwe Stock Exchange. TA, originally Tobacco Auctions, used excess tobacco income to acquire an insanely diversified group of nearly 100 separate businesses at a time when investing outside of Zimbabwe was impractical. TA is primarily black managed, but its stock is held by pension funds and financial institutions which are controlled by the (primarily white) financial community.

Bernstein was established in 1939 by the Bernstein and Meyer families, which were related by marriage. The business was well managed and profitable over the 50 years it remained in this family's hands. TA acquired Bernstein in late 1991 from the family for approximately Z$6.0 million (US$2.0mm). Pre-tax earnings at the time were Z$2.4 million (US$0.8mm). Profits this year will be approximately US$0.2 million. TA's investment has been disastrous.

Bernstein Clothing has two 100% owned subsidiaries, London Shirt Manufacturing and National Wholesalers (Pvt) Limited. The companies all operate from the same premises, leased from the Meyer family, in an industrial area of Harare. The up-market clothes are manufactured under the Bernstein name and the middle market clothes under the London Shirt name. National Wholesalers is a factory outlet for imperfect or over-stocked merchandise produced by the Company.

1. Business

The company manufactures predominantly men's wear and has a reputation of producing high quality shirts. They also produce some ladies' and children's wear. Due to existing excess capacity, the company has also started to produce work-suits and overalls. The work process involves style designing, cutting of materials, grading and machining of the garments. There are three production lines:

- Full Made Production Line for Up Market Shirts
- Ordinary Production Line for Middle of the Range
- Separate Production Line for Mixed Garments.

The company's main and traditional product ranges, brand names, and approximate average share of turnover are as follows:

BRAND NAME	TARGET MARKET	% of Turnover
* Van Heusen	- Top Market Shirt	15%
* Belaire	- Up Market Shirt	15%
* Sartorius	- Middle of the Range Shirt	15%
* Spurs	- Casual Wear	15%
* Colours	- Younger Menswear	10%
* Farayi	- Ladies Wear	5%
* Pierrot	- Children's Wear	5%
* Other items		20%

The Van Heusen license is central to the company's business operation and quality assurance. Materials used in the manufacturing of items with the Van Heusen trademark are supplied and verified by the licensor. Further, the licensor inspects samples of the finished products on a regular basis. The relationship between the licensee and the licensor is extremely cordial and the licensor has continuously expressed satisfaction with product quality, sales turnover, royalties and the degree at which the company has managed to penetrate especially the Zimbabwean upper-market for shirts.

The terms of the License Agreement require that the company pays royalties in the amount of 5% of net invoiced sales of Van Heusen label products and that the company spend an additional 5% of sales on product advertising directed at consumers. The licensor reserves the right to terminate the agreement on thirty days' notice in the event of any of the following:

A. Any Breach or Default by the Licensee Not Remedied Within The Notice Period.
B. Any Transaction Resulting in the Transfer of Control of the Licensee to Any Person, Firm or Body Corporate Not Approved by the Licensor, or
C. The Licensee Becoming Bankrupt, Being Wound Up, Placed in Receivership or Compromising with Its Creditors.

2. Assets

Bernstein Clothing is asset poor. Virtually the only assets are simple sewing machines, inventories and receivables. The Company operates from rented premises owned by Bermac (Pvt) Limited, a company owned by the Bernstein/Meyer family. The lease arrangement on the property runs for 5 years and is due to expire by December 1995. The company has a non-exclusive option to renew the lease for a further 5 years, but at a price to be negotiated.

The company has an installed capacity of 198 heavy duty industrial sewing machines. The company has also modernized a section of its design operations and uses computer aided systems to design some of the items. The plant is operated on one shift, five and a half days per week. Production capacity is much greater than this, as additional shifts could be added. The company's production capacity is as follows:

* Basic Shirts 4,000 Units Per Week
* Up Market Shirts 2,750 Units Per Week
* Other 2,500 Units Per Week

The value of inventories and receivables, net of trade payables is approximately Z$15.0 million (US$1.8mm). The level of inventories at Z$12.0 million is clearly excessive, and can be reduced through intensive working capital management.

3. Market

In Zimbabwe terms, Bernstein is a fairly large private manufacturer and an outstanding producer of men's suit-wear garments. The main outlets for the company's products are the domestic chain stores and assorted clothing retailers. Because of reliability of supply, quality of product and competitive prices especially for the middle of the range products, the company believes that it has a particular advantage in the market place. Approximately 15% of sales are through National Wholesalers, the company's factory outlet store.

Exports account for only about 20% of production, although the company has exclusive Van Heusen license for all of southern Africa, except South Africa. Significant exports to South Africa were conducted through an agent, who is a relation of the previous owners. The South African market became less and less attractive for the company's products because the particular benefits for the Zimbabwe clothing industry provided by the 1962 Zimbabwe/South Africa trade agreement had been severely eroded over time as the agreement was made in terms of Zimbabwe dollars whose value has progressively fallen. This resulted in a smaller and smaller share of exports qualifying for preferential entry to South Africa. Moreover, business arrangements which Bernstein made with the agent in South Africa worked to the detriment of the company, as a relic of the pre-TA ownership. The European Market has always been attractive to Bernstein because of the advantages of Lome. As a result the company has obtained orders, although relatively insignificant, from France, UK, Poland, the Netherlands, Scandinavia and the USA.

Typical of Zimbabwean businesses, and perhaps a relic of the English style of business, the company focuses insufficiently on sales and marketing. The focus is universally on production, under the build a better mousetrap theory. Sales staff number between only 5 and 7, and work purely on salary with no sales commission. No independent sales representatives are utilized. Sales can be characterized as order-taking from the large chain stores in Zimbabwe. Few efforts or expenditures are made to develop the remainder of the southern Africa market.

4. Competition

Bernstein operates in a very competitive environment. There are some 800 clothing manufacturers in Zimbabwe, of which about 600 are informal sector operators employing fewer than 30 employees. Of the remaining 200 formal sector manufacturers, about 30 are exporters, but of these only less than 10 firms account for over 80% of total clothing exports.

(in millions of dollars)

	90/91	91/92	92/93	93/94	94/95
Turnover					
Zim$	$17.3	$16.8	$14.3	$22.4	$19.9
US$	5.8	3.6	2.3	2.9	2.4
Gross Profit %	33%	28%	11%	22%	33%
Operating Income					
Zim$	$4.1	$2.4	($0.6)	$1.7	$1.7
US$	1.4	0.5	(0.1)	0.2	0.2
Garments produced (mm)	0.8	0.7	0.5	0.6	0.4
Average price ($US)	$7.07	$5.18	$4.51	$5.04	$6.34

Notes:

1. Declining profitability due mainly to sales volume factors - both price and volume.
2. Declining prices due in large part to devaluation of Zim dollar, but mostly to changes in product mix.
3. Declining volumes due in large part to lack of effective selling effort and to loss of South Africa volume, which was not profitable.
4. Gross profit % recovered in 1994 as retrenchments followed sales decline.

Bernstein's financial performance has plummeted since the 1991 acquisition, due in part to macro-economic conditions in Zimbabwe, but also due to the inappropriateness of a conglomerate owning a clothing business. Clothing, a fashion business, requires nimble and flexible management. Unfortunately, even more than in the United States, Zimbabwe conglomerates retain decision-making authority at the head office, far from the actual operations. This, combined with the steep learning curve which TA's relatively new black management team faces and the impossible task of managing 100 enterprises in Zimbabwe's economic environment of high inflation, structural adjustment and drought-cause recession, has resulted in disaster for TA's investment.

B. THE DEAL

1. Opportunities

There is reason to believe that profitability can be greatly enhanced. Bernstein could use creative marketing strategies to by-pass the traditional retailers, whose high costs make Bernstein's products unaffordable for almost all Zimbabweans. The resulting sales volume increases would cover the overhead burdens currently affecting profitability. Volume increases of 35% in the top product lines could increase profitability by 5 times. Management believes sales of these products could be increased 100% by utilizing these strategies.

Sensitivity Analysis - The projections are extremely sensitive and dependent upon sales growth to spread factory overhead and administration overhead more widely. Other costs are mainly variable with sales volume. By a wide margin, the most sensitive independent variable is sales volume and price.

3. Risks

This is a risky deal as it depends upon an impressive increase in sales volume to result from untested sales techniques. It also depends upon continuity and improvement in Zimbabwe's overall economy, the continuation of the Van Heusen license, continuation of existing management and a host of other factors. Over all, as is often the case, the largest risk is whether or not management can do the job.

Risk could be substantially reduced through the input of additional management talent. If a venture capital backer can be attracted, its focus on bottom line results and implementation of clear strategies could be invaluable. The fact remains, however, that the clothing business is fairly unique and unpredictable. A shortage of talented, successful clothing executives exists in Zimbabwe, particularly among the indigenous communities.

Current management has suggested contacting the former Bernstein//Meyer family owners of the company to participate in a management buy-out as a minority shareholder and active board member, working intimately, although off-premises and not on a daily basis, with senior management. The attractions of such an arrangement are undeniable, as a known success factor, with a financial interest, is introduced into the mix.

4. Valuation

Value can be determined on the basis of assets or on the earnings potential. Bernstein's assets include sewing machines and related equipment, inventories, receivables, a trained employee force, an existing customer base, a reputation for quality and a 30 day revocable Van Heusen license. The hard assets can be fairly valued at approximately Z$2.0 million (US$.25mm) while the working capital is valued at Z$15.0 million (US$1.8mm). The value of the soft assets, termed goodwill, is more difficult to determine, but considering the company's declining performance should not be worth more than Z$1.0 million (US$.12mm). Thus, the total purchase price would be Z$18.0 million (US$2.2).

On an earnings basis, the Zimbabwe Stock Exchange is valued at approximately 6.2 times net after-tax income. Applying this multiple to Bernstein's current earnings yields a price of approximately Z$6.0 million, including all current assets.

The variability between TA's asking price (Z$10 + net current assets of Z$15), the asset value of Z$18 and the multiple of earnings value of Z$6, is due to the lack of profitability commensurate with capital invested. TA continues to finance the assets of Bernstein, which yield less than a 6.0% return, versus a capital cost in the Zimbabwe environment of 30% or more. Either the business is not viable (i.e., the assets can not earn their keep) or the company is ill-managed. The answer is indicated by the competition. The clothing industry is suffering currently, but those companies engaged in non-commodity items are surviving with reduced, but adequate profitability. Bernstein's performance should be comparable to these non-commodity producers.

Return on capital can be increased by (1) reducing the capital, primarily inventories, invested in the business, and (2) increasing profitability by increasing sales volume. However, the value of the business currently is not higher than the true asset value - Z$18.0 million of which Z$15.0 million is working capital.

5. The Players

To negotiate a deal, the needs of each party involved must be understood.

a. Seller

In January 1994 a decision was made to sell the business at an asking price of Z$10 million (US$1.2mm). No legitimate buyers were discovered, except the current acting Managing Director, who was unwilling to pay that price. Bernstein was taken off the market in January 1995, as sale activity was disruptive to employee morale and strategic decision-making.

TA's chairman and managing director, Ariston Chambati, was recently appointed Zimbabwe's Minister of Finance. His replacement as Managing Director, Tim Chiganze, realizes the strategic value of shedding many of TA's non-core businesses - for both financial and operational reasons - and supports the idea of a management buy-out of Bernstein.

However, price remains to be determined. TA's asking price, at Z$10.0 million plus net working assets of Z$15 million, is unrealistic and irrational, given current profitability. As TA increasingly focuses on increasing its share price (currently US$0.10 at 4.3 times net income) over and above its image, they will eventually realize that a conglomerate's capability of turning around a clothing company is extremely limited, and the business should be shed, almost regardless of price. As is common in the 'deal' business, this would require substantial relationship building.

TA's needs are to recoup its investment, shed itself of further losses and management responsibilities, and to protect its self-image. TA paid approximately Z$6 million for the company in 1991. Asking price is Z$10 million plus net working capital of Z$15 million. Bernstein owes TA Z$13.1 in addition to working capital financing. This debt rose from the acquisition of the company which was debt financed and passed on to the company. The interest charges which accrued to the company in 1995 were Z$4.3 million. The interest burden has continued to grow and to be capitalized.

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b. Management/Employees

Bernstein's current acting Managing Director is C. Ncube, who, in his former position as marketing director, attempted a management buy-out. Ncube replaced the prior Managing Director, terminated on company performance grounds in January 1995. Ncube is a capable man with many ideas for enhancing value in the business, particularly and appropriately in marketing. His initiatives have been stymied by TA's top heavy corporate structure.

Other competent managers could also play a role in the buy-out. However, looking at the attributes of the entire team, there is insufficient real-world experience in having ultimate bottom-line responsibility. The learning curve would be steep.

Management seeks ownership under terms which do not jeopardize the success of future operations - primarily a reasonable price and attractive financing terms.

c. Former Owners

Bernstein operated profitably at the time it was owned by the Bernstein/Meyer families due in part to the exclusion of foreign competition and in part to the owners' wide knowledge and experience of the industry. Success in the clothing industry depends on thorough product and market knowledge and properly motivated staff. It is imperative that a new ownership structure be put in place which includes the Bernstein/Meyer family or similar persons. Contact with the Meyer family has not been initiated, but they may be attracted by the opportunity to resurrect a business run by the family for 50 years - an emotional attachment can be strong. Moreover, a good financial deal can be struck, as they will have confidence in improving profitability. The reduction in risk that their involvement would ensure would be invaluable to every other participant in the deal.

d. Lenders

There is little here to attract third party lenders, particularly in this very conservative banking community. The asset base is weak and the earnings history is disappointing. To finance working capital at 35% interest rates is prohibitive.

e. Equity Investors

Equity financiers may be attracted, but only so long as the amount of capital involved is very small and the potential return very high. Venture Capital Company of Zimbabwe, Zimbabwe Progress Fund, Hawk Ventures or other equity players might well invest if the potential returns were indeed highly attractive.