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International Privatization Group
Case Study # 3

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

POLAND

In late February, 1991, the Polish privatization program was at a crucial stage. The government needed to demonstrate its ability to move forward with the large enterprise privatization program and contribute to the development of Poland's capital markets. Thus far, the program had proceeded slowly, and a pilot public offering had shown mixed results. Consequently, a "privatization offensive" had been declared by Lech Walesa's new government in January, 1991.

Grzegorz Medza, one of the program managers within the Ministry of Ownership Changes, was responsible for the next phase of public offerings in Poland. His choice as the most appropriate candidate for privatization under the next phase was furniture manufacturer Swarzedzkie Fabryki Mebli S.A. (SFM). Grzegorz had been working closely with the International Finance Corporation (IFC), the chosen advisor for SFM, on a restructuring plan for the company. Pressure was building to complete the next transaction, and Grzegorz would be meeting with Privatization Minister Janusz Lewandowski the following day to present a strategy for ensuring the success of the SFM offering.

Economic Performance

Since January 1, 1990, the Polish economy had undergone a radical transformation. Its "big bang" reform program was designed as part of a linked triad of liberalization, stabilization and privatization techniques, intended to move Poland towards a market-based economy. Finance Minister Lescek Balcerowicz had taken a series of rapid steps to stabilize the economy, and liberalize both prices and international trade and finance.

To eliminate the budget deficit, consumer, enterprise and energy subsidies, which previously accounted for over 30% of budget, were largely eliminated. Real positive interest rates were imposed, eliminating the supply of free credit to inefficient firms, and bankruptcy was legalized. Additionally, the government overhauled its exchange rate system. The zloty was set at 9,500 Zl per US dollar, a substantial devaluation from the year-end rate of 6,500 Zl. Finally, prohibitively high taxes were imposed to restrain wage increases, which previously were generously indexed, and prices on most goods were decontrolled. By early

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This case was written by Maria C. Kozloski under the supervision of the International Privatization Group and James E. Austin Associates, Inc., as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

1991, the State controlled only 5% of consumer prices and 5% of producer prices, covering goods such as public utility rates and transportation fares.

The shock treatment had eliminated the fiscal deficit in the first four months of 1990, inflation had been reduced to approximately 5% per month, and the trade balance had swung to a US$ 2.2 billion surplus at year-end (Exhibit 1). Furthermore, shortages of goods had been all but eliminated.

But the economic and social costs of the reform program had been substantial. Unable to access free credit and government subsidies, plants had cut back production. In 1990, gross domestic product had fallen 12%, and industrial output had declined 27%. Unemployment had risen from virtually zero in 1989 to 1.1 million by December, 1990, representing 6.1% of the labor force, while average real income had fallen by 30%. By the end of that same year, the Polish government had accumulated over US$ 40 billion in external debt.

The Privatization Program

Privatization Legislation

After 40 years of communist rule, approximately 90 percent of Polish industry lay in state hands, in a highly centralized, monopolistic system dominated by heavy industry. Poland had close to 8,000 state-owned enterprises, many of which were perceived to be badly mismanaged.

The Polish parliament adopted a privatization law on July 13, 1990, after six months of lengthy debate. The Act on the Privatization of State-Owned Enterprises established the Ministry of Ownership Changes and charged it with preparing privatization guidelines and carrying out the privatization process. Two privatization options were specified by the law: (1) liquidation, in which the assets of unprofitable or failing firms could be sold or leased to private investors or management and employees; and (2) creation of a joint-stock company. A joint-stock company was 100% owned by the State Treasury, yet was fully autonomous and controlled by its own board of directors. The Treasury had up to two years to sell the shares of joint-stock companies to the private sector.

The joint-stock company method of privatization could be initiated by enterprise management with the approval of the workers' council; by the firm's founding body (i.e., the ministry with supervisory responsibility over the given enterprise); or by the Ministry of Ownership Changes, with the Prime Minister's approval. Joint-stock companies could be sold by auction, public offering, or negotiated basis after public invitation. Employees would be eligible to buy up to 20% of the shares at preferential prices, and foreigners could buy up to 10% freely and up to 100% with Ministry approval. Although other options were not sanctioned, the legislation did not rule out management-employee buyouts, leasing, voucher schemes, and other privatization techniques.

The Ministry of Ownership Changes

The officials of Ministry of Ownership Changes were largely young and new to the field, brought in from universities, rather than business or government. Their main task in the fall, 1990, was to design a privatization work plan. Many countervailing proposals were debated regarding the mechanics of share distribution and the types of privatization techniques, and a wide range of objectives were considered. Ultimately those objectives deemed most important by the Ministry were (in approximate order of priority):

(a) successful transaction, i.e., privatization actually achieved
(b) speed
(c) privatized company does not go bankrupt in the short-to-medium term
(d) company purchased mainly by domestic investors
(e) transparent procedure adopted for sale
(f) transfer of skills to Polish counterparts
(g) development of capital markets
(h) replicability of transaction
(i) sale proceeds

Generally, there was agreement that different strategies would be needed to privatize different types of enterprises. Privatization techniques (i.e., public offerings, joint ventures, etc.) would have to be matched with large, medium and small enterprises. A great deal of attention was focused on large enterprise privatization, since large enterprises accounted for the majority of employment and output in Poland, and were expected to provide models for privatizing a large portion of the Polish economy.

The Department of Large Enterprise Privatization was headed by Vice Minister Krzysztof Lis (Exhibit 2), with Jacek Chwedoruk serving as the Department Head for the program managers. It was the program managers who worked directly on the large enterprise transactions, coordinating the interactions between the Ministry and the advisors to Polish enterprises undergoing privatization.

Grzegorz Medza had joined the department as one of several program managers. He was in his late twenties and held an economics degree from Warsaw University. Grzegorz symbolized the new generation of market-oriented thinkers in Poland. He was considered somewhat of a maverick by his colleagues, with an outspoken personality and persuasive mannerism.

Pilot Program

On November 30, 1990, five of Poland's 500 largest state enterprises were privatized in the country's first public offering. These enterprises were chosen based on their financial profitability, export position, market presence, and quality of management. Their capital assets were evaluated by Western consulting firms, and a major advertising campaign was launched to promote the sale of shares. One additional large state enterprise was privatized in the fall, 1990, through a management-employee buyout.

The goals of the pilot program were to set positive examples for future privatizations, develop appropriate procedures for transactions, begin building a skill base within Poland for such transactions, and assist in the development of capital markets. Plans were heavily influenced by the British Know-How Fund, one of the primary donors of aid to Poland at that time. The British group believed public offerings were the most politically acceptable means for selling large enterprises to the public. Under the program, priority was to be given to small investors, thus attenuating the fears associated with foreign direct investment.

Over 120,000 individuals applied for shares, with the majority buying very small blocks of shares (one to four blocks of five shares each). The program was coined a "success", but only one of the five issues was fully subscribed in the initial subscription period. As a result, the government had been forced to extend the subscription period by three weeks, and take temporary share holdings in four of the five companies. One additional issue was fully subscribed by the end of the three weeks, and institutional investors were sought after to take stakes in the remaining three companies.

The pilot program uncovered a series of problem areas. The evaluation of assets proved to be a slow and expensive process. Establishing a realistic asset valuation was difficult in a post-communist economy, since asset book value was usually irrelevant, and price distortions and subsidies, until recently, had made profit and loss calculations impossible. Additionally, the state-owned commercial banks, entrusted with selling the shares, were unable to handle the task effectively. Highly bureaucratic procedures resulted in long lines, deterring potential investors and wasting a considerable amount of investors' time. Investor funds were tied up close to one month while the allotment procedure for share allocation was completed. Finally, limited purchasing power and the perceived risk of investing in shares for the first time had further dampened investor demand.

The New Mandate

Revised Privatization Approach

The pilot public offering coincided with Poland's first presidential election. On December, 9, 1990, Lech Walesa won the election, and installed his new government in

January, 1991. A key priority was to clarify the privatization mandate and speed up the pace of the program. The view that reform would fail without massive immediate privatization was gaining wider acceptance. Poland's economy was continuing to deteriorate due to decline in Comecon trade, drop in international competitiveness, and some erosion in fiscal and monetary restraint.

The new Minister for Privatization, Janusz Lewandowski, argued that too much time and energy had been exerted on a small number of public offerings, while insufficient attention had been given to small privatizations and unconventional methods. In a recent interview, he stated:

> We will develop through public offering the sales only of the best companies, in a way similar to the British and French styles....But we can't depend on public offerings.[1]

Lewandowski, along with Prime Minister Jan Krzysztof Bielecki, had been wary of public offerings since the pilot operation. Both felt that the technical difficulties had proven to be too great, and that the waiting lines to buy shares were reminiscent of the communist system. The consensus within the Ministry was that the "disaster" of the first five public offerings should never be repeated. Klaus Hermann, a project manager working in Grzegorz's department, was one of the most vocal public offering critics. In his view, the Ministry's previous approach to large enterprise privatization tackled the problem from the wrong angle. He believed enterprises should be analyzed first, and then the privatization technique determined.

On the other hand, Grzegorz along with the IFC and a minority within the Ministry, argued that public offerings were still the most effective method of privatization for a large number of companies. This was because a genuine valuation process took place, wide public participation was achieved, and (assuming the offering was designed to include institutional or block investors) the company came under the control of real owners who had purchased their shares and would ensure that ownership interests were represented.

Institutional Context for SFM Offering

A new public offering strategy was adopted on February 14, 1991. This strategy called for privatizing a steady stream of enterprises on a "production line" basis, as opposed to setting up a system to handle a specific group of companies, as was done with the first set of offerings. Grzegorz and other Ministry officials, with the assistance of the IFC, intended to build an institutional framework upon which to base future offerings:

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[1] "Poland begins race to privatize state enterprises this year," Plan Econ Business Report, February 21, 1991.

What is needed is a production line which takes companies from A to B, where A is the point at which the company is selected as a candidate for privatization through public offering, and B is the point at which the company is privatized.

The critical elements of the new approach included: an established structure (Exhibit 3); task specialization; the capability to handle one company at a time without losing economies of scale; and a simple share distribution system. Institutions would become experienced in particular aspects of the public offering system, allowing them to move faster up the learning curve. Also "one-at-a-time" offerings would put less strain on the market's absorptive capacity, and an on-going educational campaign would be combined with company-specific public relations efforts.

Distribution System

Central to the new "production line" approach was the new share distribution system. Grzegorz had convinced both Vice Minister Lis and Jacek Chwedoruk to adopt a simplified distribution system designed on a "first come, first served" basis, in which individual investors would know immediately if they received shares when they applied for them at the bank.

With this system, waiting time to learn the outcome of the allotment process would not be necessary, and investors paying cash would not forego interest while funds were tied up during an allotment period. Additionally, storage costs for Convertible Treasury Bonds[2], a popular form of payment among small investors, would be avoided. These costs had accounted for 40% of bank administrative fees during the pilot public offering.

The IFC played a major role in preparing the new distribution strategy, and hired Bank PKO as the lead bank to set up a share distribution network. Bank PKO was already underway developing a communication network linking local bank branches with its central office in Warsaw. This computerized system would facilitate the application process, through quicker calculation of CTB values and immediate output of receipts and transaction records at teller windows. Finally, a separate bank would be hired to handle share sales to institutional investors through an allotment process. The Ministry expected approximately 30% of shares for each enterprise to be targeted for institutional investors in the next phase of public offerings.

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[2] CTBs were issued by the Polish government, beginning on December 1, 1989. These bonds, available only to Poles, accrued monthly interest at a zero real interest rate, and could be used to buy shares in privatized companies at a value equal to 20% above the nominal value of the bonds plus accrued interest. Many state enterprises had granted bonuses to employees using CTBs, to avoid excess wages tax. Approximately Zl 200 billion worth of CTBs were outstanding.

The Candidate

SFM was one of Poland's leading producers of high-quality furniture; its product line ranged from inexpensive, flat, ready-to-assemble furniture parts and mattresses to higher quality solid wood furniture and upholstered sofas. It had been established as a state-owned enterprise in 1952, taking over the assets of two formerly private furniture companies nationalized in 1948. SFM's brand-name was well-known in the domestic market, and approximately 80 percent of production was exported to Western countries, predominantly Sweden and Germany. SFM had been one of the original selections for the pilot privatization program in the fall, 1990; however, its sale had been delayed due to its high short-term debt. In Grzegorz's opinion, "SFM was the guarantee that we would be successful in the next public offering." He added:

> There are better candidates in terms of their financial positions, but Swarzedz has the image. We need to show the public that we can sell companies and develop the stock market.

Company Advisor

Grzegorz was working closely with an IFC team responsible for preparing SFM for privatization. The IFC had been deeply involved in Poland's privatization program from its initial stages, and had recently assisted with the development of the new share distribution strategy. In August, 1990, the Ministry had chosen the IFC as the advisor for SFM.

IFC Investment Officer Gavin Wilson coordinated the SFM project, and drew on a number of resources, both within and outside the IFC, to conduct the SFM appraisal. Polish legal experts and consultants were called upon for various analyses. Grzegorz had tremendous respect for Gavin, a graduate of Oxford University and the MBA program at Stanford University. In Grzegorz's opinion, Gavin not only had the managerial and financial expertise to develop alternative privatization strategies for SFM, but also understood the Ministry objectives for the privatization program and its concerns regarding public offerings. Grzegorz relied heavily on Gavin's analysis, and the two were working long hours to prepare the privatization proposal for Minister Lewandowski.

Organization

SFM, as a state-owned enterprise, had been managed by a General Manager, appointed by the Polish Government, in conjunction with an Employee Council elected by workers. Upon transformation to a joint-stock company[3], the Employee Council was

[3] SFM was entered into the commercial register on October 31, 1990, as a joint-stock company with 2 million shares of Zl 25,000 (US$ 2.63) par value each.

eliminated and a three-member Management Board and nine-member Supervisory Board were created. The Supervisory Board represented owners' interests, and appointed and supervised management (Exhibit 4).

The Management Board ran SFM on a daily basis, and was headed by Chairman Andrzej Pawlak, a decisive individual with an assertive top-down style of management (Exhibit 5). Mr. Pawlak was involved in all decision processes, delegating little authority. The plant managers were knowledgeable and technically capable, yet did not have profit responsibility. They relied heavily on the Chairman's judgement.

Sixty-five percent of SFM's total labor force consisted of production workers, with an established tradition of producing high quality furniture. But labor turnover was high. Skilled workers often migrated among the small workshops in the area, depending on wage differentials. Small workshops had greater flexibility in granting wage increases. All wages at SFM were based on seniority.[4]

There were two unions at SFM, with a total of 1,682 members and presence in three of the eight plants. Management-union relations were considered cordial. But it had taken close to two months for SFM management to convince its Employee Council to agree to privatization. Workers feared unemployment, yet desired higher wages.

Production Operations

SFM had absorbed four additional private furniture manufacturers since its establishment in 1952. It was considered a large company, by international furniture industry standards, employing 3,262 workers and operating eight plants within one hundred kilometers of Swarzedz, in the vicinity of Poznan. All eight plants were centrally managed from headquarters, and they produced a wide variety of medium to high range furniture on predominantly old machinery.

SFM's main plant (Plant No. 1) was located in Swarzedz, and produced upholstered furniture, ready-to-assemble wall units and case goods in an integrated manufacturing facility. Processes ranged from timber curing, drying and warehousing, to veneer cutting and splicing, and laminating. Similar to SFM's other plants, Plant No. 1 suffered from inefficient production flows and cramped spacing, and relied on labor intensive working methods (see Exhibit 6).

The most modern facility was located in Mosina (Plant No. 5). The "new" portion of this plant had begun production in May, 1989, on new machinery provided through a

[4] As an example, a production worker with four years experience earned 970,000 Zl per month ($102 using exchange rate of 9,500 Zl/$).

leasing agreement with IKEA, a Swedish furniture distributor. In exchange for leased machinery, IKEA had the right of first refusal on all output, and received approximately 70% of Mosina's total production (ready-to-assemble wall units and upholstered furniture). Currently, space at Mosina was only half-used.

Profitability varied by plant (Exhibit 7). Mosina was the loss-maker, due to the high materials and fixed costs resulting from the product design requirements of IKEA products and the large lease payments made on equipment with low capacity utilization.

Quality at all plants was high compared to Western standards, although in many cases it was achieved only through an additional stage of manual refinishing. SFM's existing operations had been influenced by the centuries-old tradition of cabinet making in the Poznan vicinity. Relatively small units employing traditional skilled craftsmanship were combined to form SFM's industrial organization, and SFM continued to rely on traditional carpentry skills.

The direct labor productivity and average revenue per square meter were similar to Yugoslavian levels, but significantly lower than German standards (Exhibit 8). Wage rates were approximately 10% of those in Germany, and represented less than 20% of net sales.

Product Line

SFM produced more than 300 varieties of furniture pieces. Its products were made from pine and oak veneer, and covered or laminated chipboard, as well as from solid wood. Although models changed constantly due to market preferences, SFM's product mix had changed little over the past three years (see Exhibit 9).

Contribution margins (i.e., sales prices less total direct costs) for products ranged widely (approximately -40% to +60%), since a cost-based formula was seldom used in calculating selling prices (see Exhibit 10). Selling prices depended on client negotiating skills, SFM's existing price level with the client, and the market requirements of Sweden and Germany. All export contracts were denominated in foreign currency.

Currently, margins varied considerably between export and domestic markets. It was not expected that higher prices could be negotiated in the near future since SFM lacked a well-known international brand name. Domestically, higher margins were achieved as a result of both brand name and the substantial appreciation of the real exchange rate since export prices had been last negotiated.

Market Position

SFM exported approximately 80% of production, one-third of which went to IKEA, a Swedish furniture distributor with worldwide outlets. IKEA bought mainly high volume, low priced, ready-to-assemble furniture items. IKEA paid low prices, due to the Mosina leasing agreement which granted price discounts and imposed a ceiling on annual price increases. In 1990, cost increases had led to substantial losses on several items, and SFM had since been granted price increases after threatening to halt production.

The remainder of sales were to German clients who purchased higher quality products, including solid wood wall units, tables, chairs and bedroom sets. The margins received were typically higher than for IKEA products. SFM had plans to develop export markets for these products in France, Great Britain and Japan.

Ninety-eight percent of SFM exports were handled by PAGED, the foreign trade organization responsible for paper, pulp and other wood processing industries. Although PAGED had assisted in the development of SFM's export market, it served the entire Polish furniture industry and had been unable to create either a strong brand name or specific market niche for SFM products in foreign markets. SFM paid approximately Zl 12 billion in annual commissions to PAGED.[5] According to an IFC report, "for these commissions, a Western company would typically expect a considerably greater level of service than is being provided to SFM".

The remaining 20% of SFM's production was reserved for the domestic market, which historically had been given low priority by SFM. SFM's brand name was well-known domestically, and the company had an 8% share of the local market. Unlike SFM, other companies tended to specialize on narrow product segments, and did not have the quality to match that of SFM. SFM expected to face stiffer competition from several joint ventures (including IKEA, Poland in the retailing sphere) and from a large number of small private workshops. About 2,500 to 3,000 such establishments operated in the Swarzedz region alone. Nonetheless, there was a large backlog domestic demand, and new market opportunities existed in segments such as office furniture. SFM opened a retail outlet in Poznan in December, 1990, and had plans to open a second one in Swarzedz.

Financial Position

SFM posted profits between 1986 and 1989, with net income rising from 5% of sales in 1986 to more than 50% of sales in 1989 (Exhibits 11 and 12). During these years, SFM

[5] Commissions included: (i) 3.6% base commission paid to PAGED Warsaw on all sales to foreign clients; (ii) an additional 3.5% (and up to 5% in one case) commission to PAGED Westfalen for all sales to German clients; and (iii) 2% commission to PAGED Warsaw for sales to German customers and IKEA for PAGED's guaranteed payment to SFM within approximately 30 days after the shipping date.

benefitted from its export strategy, due to the relatively low domestic labor and materials costs. The 1989 results were inflated due to exchange rate gains, interest income and subsidies received in connection with sales to the Soviet Union.

In the first nine months of 1990, SFM earned a positive net income, and expected earnings before interest and taxes of Zl 43 billion for the year, or 16% of sales. However, SFM began to experience financial difficulty in the third quarter, and expected a net loss for the year (Exhibit 13). Its export revenues remained constant, while production and working capital costs rose due to domestic inflation.

To finance working capital needs, SFM turned to short-term debt, paying a 56% interest rate or more. In 1990, after the Bank Gdanski increased lending to SFM ten-fold, SFM was paying monthly interest of Zl 2.5 billion, or 10% of net sales. Its short-term debt had risen from Zl 4 billion to Zl 59 billion (of which Zl 55 billion was owed to Bank Gdanski, and Zl 4 billion to PAGED and its affiliates). The heavy debt burden syphoned the cash flow from operations, leading to further debt increases and higher interest payments.

SFM management had also granted a salary increase in November, 1990, which substantially exceeded the maximum allowed by the government. As a result, SFM incurred an excess wages tax of more than Zl 5 billion in both November and December. Since January 1, 1990, privatized companies did not have to pay this tax.

Privatization Strategy for SFM

After careful review of the IFC enterprise appraisal report, Gavin had laid out the various privatization options for SFM to Grzegorz. Three options were under consideration.

Sell A Controlling Block

The first option involved selling a controlling block of shares to a technical partner, probably foreign, who had the skills to provide restructuring support to SFM and restore profitability. Once the company was restructured, the government would sell its remaining holding.

This was the least attractive option to the IFC. Despite weaknesses, the IFC believed SFM possessed the basic technical know-how to enable it to overcome its present difficulties with consulting assistance, and avoid a sale of equity to a technical partner.

Postpone Sale and Fully Restructure

The second option called for postponement of sale, up to one year, until SFM was fully restructured. The Polish Government, as shareholder, would be heavily involved in managing and funding this process, as well as bearing the risk of failure. However, the Government would have a wider range of alternatives for selling its SFM shares after restructuring.

The major advantages to this option included the higher price attainable following the restructuring and the lower risk for individual investors. On the negative side, it was unclear that the Government possessed the requisite skills to micro-manage SFM.

Partially Restructure and Public Offering

The final alternative called for the sale of SFM through a public offering, once an operational and financial restructuring plan had been designed and partially implemented. This option would aim to stop the sharp cash outflow in the short term and lead to an improvement of SFM's profitability in the medium to long term.

If restructuring was undertaken as an option, Grzegorz had to consider which aspects of SFM's organization, operations and finances would be targeted prior to the public offering and which would be left for a later phase.

Business Restructuring: The IFC identified technical improvements, with assistance from SFM management, which could be implemented in two phases. Phase I included minor but necessary investments and operational improvements, which could be implemented quickly and relatively easily prior to sale of the enterprise (Exhibit 14). These steps would be designed to focus on the following:

(a) improvement of production flows and work place arrangements
(b) review of raw materials logistics
(c) reorganization of plant production programs to concentrate production of each type of furniture in one or two plants
(d) investments to facilitate Phase I restructuring, such as the use of outside technical consultants and the purchase of basic computer equipment

Phase II restructuring involved major optimizing investments and operational improvements, requiring significant capital expenditure and a precise definition of long-term policies and strategies. The IFC believed these changes should be implemented by SFM's new owners, and included the establishment of profit centers and a marketing department, extensive technical improvements, and implementation of management information systems.

Financial Restructuring: The IFC considered SFM's debt situation to be the major obstacle to privatization:

> Operational and organizational changes will improve SFM's operating margins substantially; but, without a financial restructuring, it will take 18 to 24 months at least for the company's free cash flow to become positive. It is doubtful whether SFM would be able to secure the financing it needs (about Zl 20 to 25 billion) to last this long, and even if it did, it would take about 4 years before shareholders would be able to receive any dividends from the company.

Four options were considered viable for reducing SFM's debt: (i) the Polish Government could take over SFM's debt; (ii) SFM's main creditor, Bank Gdanski, could swap its debt for equity and its stake could be included with a subsequent offering of the Government's stake; (iii) SFM could make a primary issue of stock using the proceeds to pay off the debt; or (iv) SFM could exchange its current debt for a longer term loan. The IFC believed option (iv) was unrealistic, given the current state of Polish capital markets.

Option (i) probably presented the fastest alternative, since SFM's major creditors (Bank of Gdanski and PAGED) were both state-owned, thus facilitating negotiations. This alternative would significantly reduce the risk of investing in SFM, and increase the equity value of the company. The Ministry of Ownership Changes would assume SFM's debt obligations, totalling about Zl 60 billion. The Ministry would subsequently repay these debt obligations from the proceeds of the public offering. The Ministry of Finance, which had to approve this option, required a guarantee that the proceeds to the State would be at least as great as the value of the debt assumed. There was also concern over the type of message this method would send to managers of other state enterprises.

Option (ii) required that the two parties, SFM and Bank Gdanski, agree on the values for the bank's outstanding loan and SFM's equity, as well as on the level of the debt-for-equity swap. If the bank did not sell the bulk of its stake at the same time as the State, there was a risk that it could end up with a controlling interest in SFM, yet lack the management ability to improve SFM's operating efficiency.

Option (iii) involved a primary issue of SFM stock, conducted simultaneously with the secondary sale of Government-owned stock. It was unclear whether this would be allowable according to Polish legal standards. Moreover, the debt of SFM would remain on the books at the time of the offering, increasing the risk of an undersubscribed issue.

Share Breakdown: Once the partial restructuring was completed, the IFC recommended that the public offering be designed to target both individual and institutional investors, with the following breakdown of shares:

Employees	20%
Individual Investors	50-60%

Institutional Investors 20-30%

According to the IFC report:

> On the one hand, the Ministry should aim for broad participation by Polish individuals; on the other hand, a completely dispersed ownership structure would not allow owners' interests to be effectively represented and would probably result in the company being run less than efficiently. One or more large investors, whether active or passive, is needed to ensure that management runs the Company with a profit motive.

Company Valuation

Irrespective of the alternative chosen, Grzegorz also had to consider valuation options. The IFC had considered several valuation methods in conducting its analysis of SFM.

Book Value: Estimating book value required making adjustments for distortions in exchange and inflation rates. Once SFM's balance sheet had been adjusted to take these distortions into account, estimations ranged between US$ 12 million and US$ 24 million (or US$ 4 to US$ 12 million using historical balance sheets).

Liquidation Value: Liquidation value was calculated through an asset appraisal process. There were two main problems with this method: (i) there was no open market for real estate, buildings and equipment; and (ii) most SFM buildings and installations were old. Based on similar assets in Germany, the value of SFM's equipment, buildings and installations was estimated at US$ 6 million, and the value of its current assets (assuming 75% were liquidated) was estimated at US$ 6.8 million. This resulted in a total asset value of US$ 12.8 million. Less current liabilities of US$ 9.4 million, the approximate liquidation value of SFM was estimated at US$ 3.4 million.

Discounted Cash Flow: The discounted cash flow method was based on the net present value of the future cash flows accruing to shareholders, which were represented by the dividends paid out each year. Gavin had found projecting cash flows for SFM to be not as "mysterious" as he originally thought. Mr. Pawlak had detailed information in his head regarding the expected number and types of furniture he would sell in the next year, as well as the costs to produce these items. SFM had long-term relations with its clients, and did not expect a change in sales pattern. Using this basis, Gavin was able to compile cash flow projections for 1991 through the year 2000 (Exhibit 15).

The SFM projections were based on the existing production capabilities of SFM, the contribution margin of each of the products currently produced, and improvements envisaged under a partial restructuring plan prior to a public offering. The IFC assumed restructuring would begin immediately, and the full benefits would be phased in over three years. Preliminary calculations indicated the following range of values for SFM:

Discount Rate	DCF Value (US$)
20%	12.9 mm
25%	9.4 mm
30%	7.0 mm

Gavin had not yet settled on an appropriate share price for SFM. In determining one, he was considering how a comparison with the share prices of the five companies listed on the Warsaw Stock Exchange would affect his recommendation (Exhibit 15).

Grzegroz's Position

Grzegorz would be meeting with Minister Lewandowski the following day regarding the SFM privatization. The Ministry was under intense political pressure to privatize the next large enterprise in Poland, yet was wary of proceeding without a coherent strategy. The Ministry expected Grzegorz to present a full strategy for pressing ahead with the process.

Grzegorz realized he would have to make a convincing argument to gain approval for SFM as the candidate for Poland's sixth public offering. Many of the options under consideration represented a new approach for Poland. Thus far, no Polish company had undergone restructuring prior to sale. And while the partial restructuring strategy advocated by the IFC apparently addressed some of the key obstacles to successfully privatizing SFM, it also raised many issues and introduced new risks. In addition, the new public offering system was untried, and Grzegorz wondered whether or not SFM was the best candidate for the new mechanism. In his presentation, Grzegorz would need to carefully highlight how each potential risk and contingency arising from the recommended privatization strategy would be addressed. Grzegorz looked at his watch and began outlining his strategy.

Exhibit 1
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Economic Indicators

	1986	1987	1988	1989	1990E
DOMESTIC					
Real GDP (zloty billion)	6,471	6,600	6,870	6,886	6,060
Real GDP (% change)	4.2	2.0	4.1	0.2	(12.0)
Consumer Prices (avg % change)	17.7	19.3	60.0	258.1	558.3
Industrial Production (% change)	4.2	3.2	4.8	(1.4)	(27.1)
Population (million)	37.6	37.8	37.9	38.0	38.2
Total Employment (million)	17.2	17.1	17.0	16.9	16.3
Socialized Sector Employment (million)	12.4	12.3	12.2	11.8	10.8
Avg Nominal Monthly Wage (zloty) (a)			48,179	171,651	856,534
Year-end Nominal Monthly Wage (zloty) (b)			105,745	610,598	1,520,601
Real Wages (avg % change from previous year)			10.1	13.6	(30.2)
FISCAL					
State budget revenues (as % of GDP)	39.9	34.2	35.5	30.8	32.8
State budget expenditures (as % of GDP)	41.0	37.7	37.0	37.0	31.8
State budget balance (as % of GDP)	(1.1)	(3.5)	(1.4)	(6.1)	1.0
EXTERNAL					
Trade balance (US$ million)	1,035	1,040	941	240	2,214
Average exchange rate (Zl/$)	175	265	431	1,439	9,500
Year-end exchange rate (Zl/$)	198	316	503	6,500	9,500
Convertible Currency External Debt (US$ million)	33,528	39,249	39,165	41,387	49,021

E = estimated

(a) Average nominal monthly wage for the entire year in socialized sector.
(b) Average nominal monthly wage for December of given year in socialized sector.

Registered Unemployment	(in thousands of persons)	(% of labor force)
Dec-88	5	—
Dec-89	10	0.1
Jan-90	56	0.3
Feb-90	152	0.8
Mar-90	267	1.5
Apr-90	351	1.9
May-90	443	2.4
Jun-90	568	3.1
Jul-90	699	3.8
Aug-90	820	4.5
Sep-90	926	5.0
Oct-90	1,008	5.5
Nov-90	1,089	5.9
Dec-90	1,126	6.1

SOURCES: The Institute of International Finance, Inc.; The International Monetary Fund

Exhibit 2
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Ministry of Ownership Changes

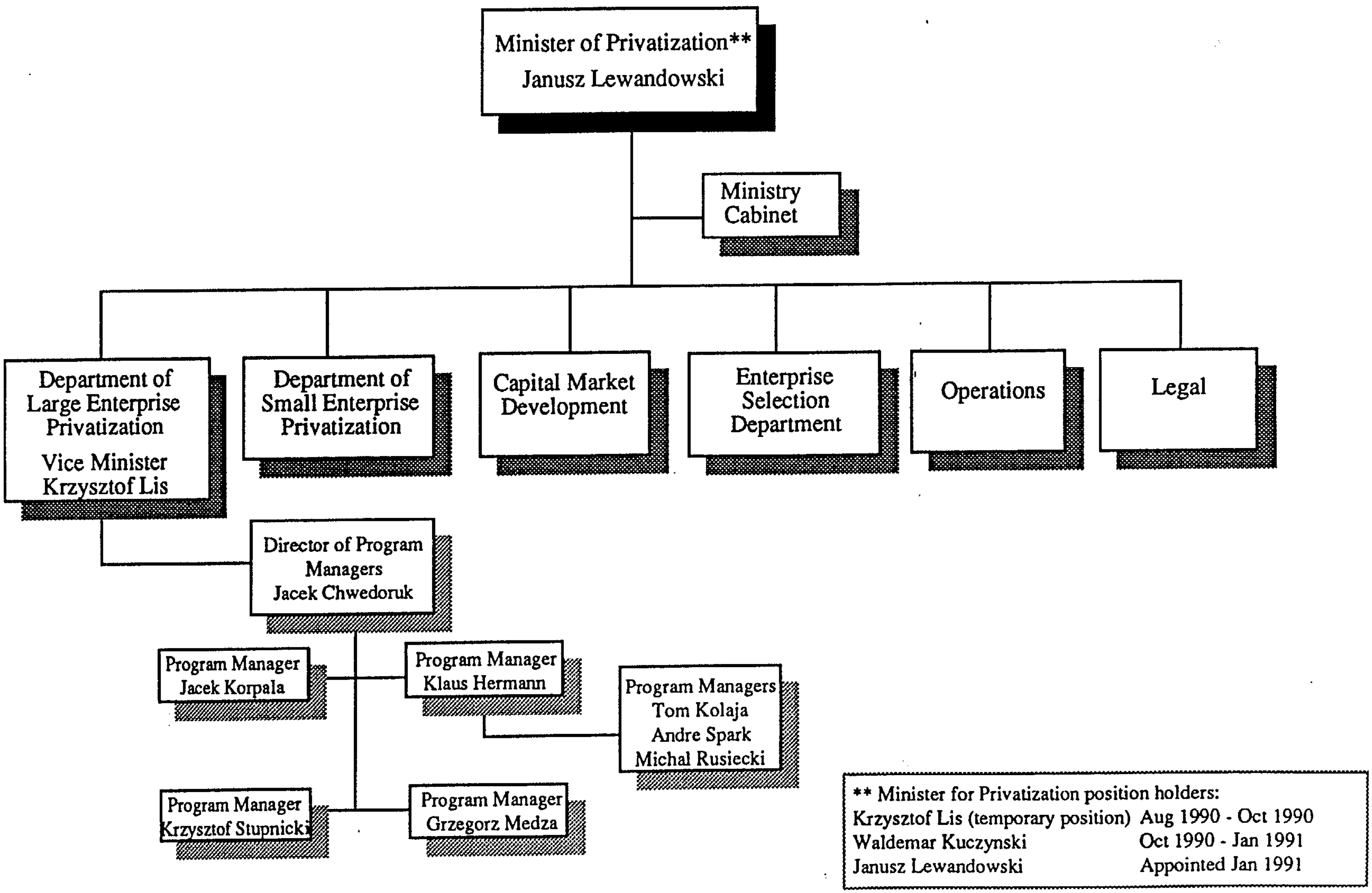
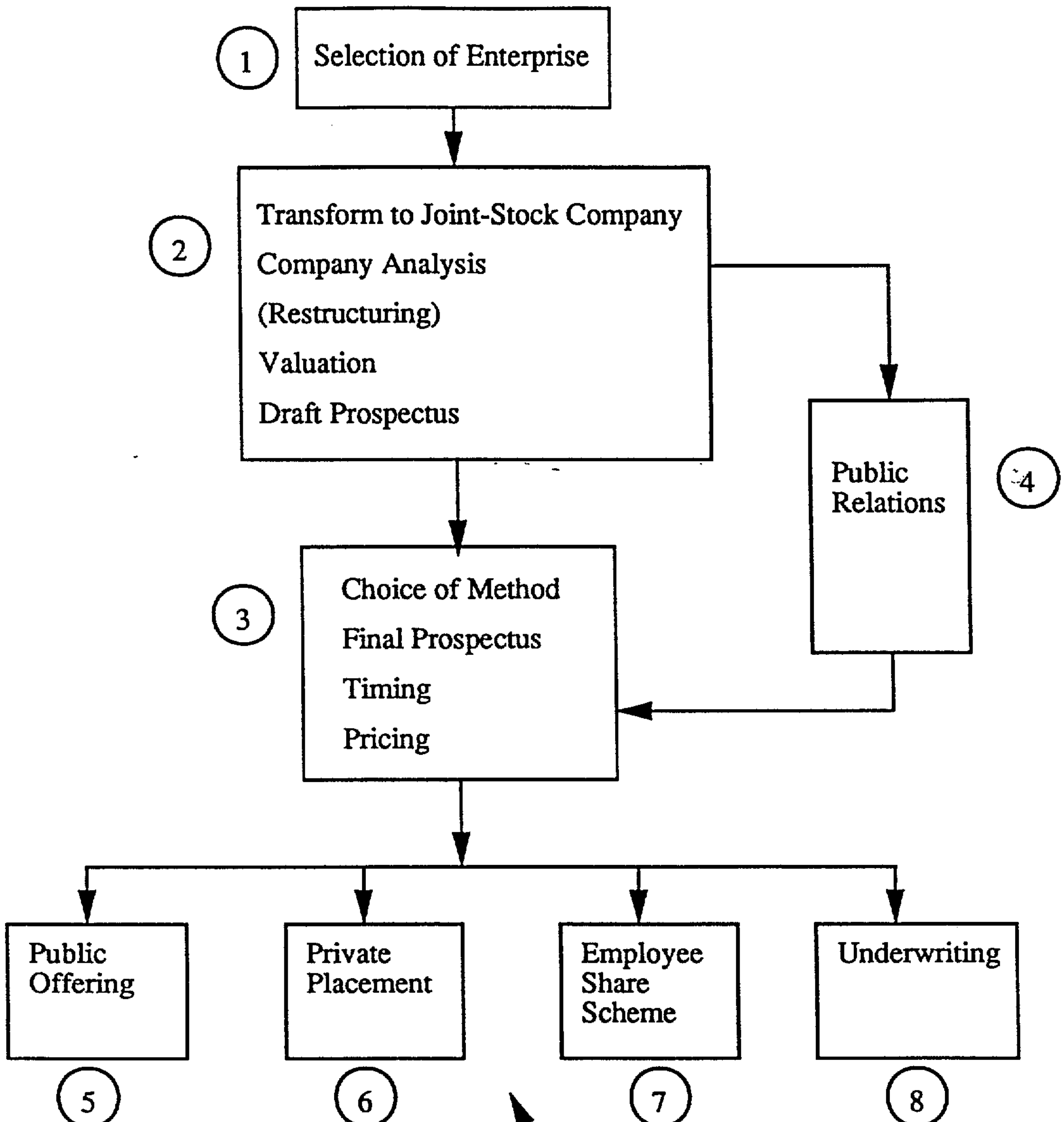


Exhibit 3
SWARZEDZKI FABRYKI MEBLI S.A. (A)
Public Offering Production Line



Players:
1. Ministry
2. Consultants
(plus lawyers, auditors)
3. Deal Manager/Ministry
4. PR Firm(s)/Deal Manager
5. Receiving Agents
6. Deal Manager/Broker
7. Deal Manager/Company/Other
8. Deal Manager/Other

The above method envisions a three-pronged privatization. First, a public offering itself is arranged; second, a private placement is conducted; and third, shares are sold to employees. As an optional element, an underwriting group might be arranged.

SOURCE: "Production Line Approach to Public Offering", presentation by Gavin Wilson, IFC, to the Ministry of Ownership Changes, February 14, 1991, Warsaw, Poland.

Exhibit 4
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Supervisory and Management Board Members

SUPERVISORY BOARD:

Appointed by the Ministry of Ownership Changes:

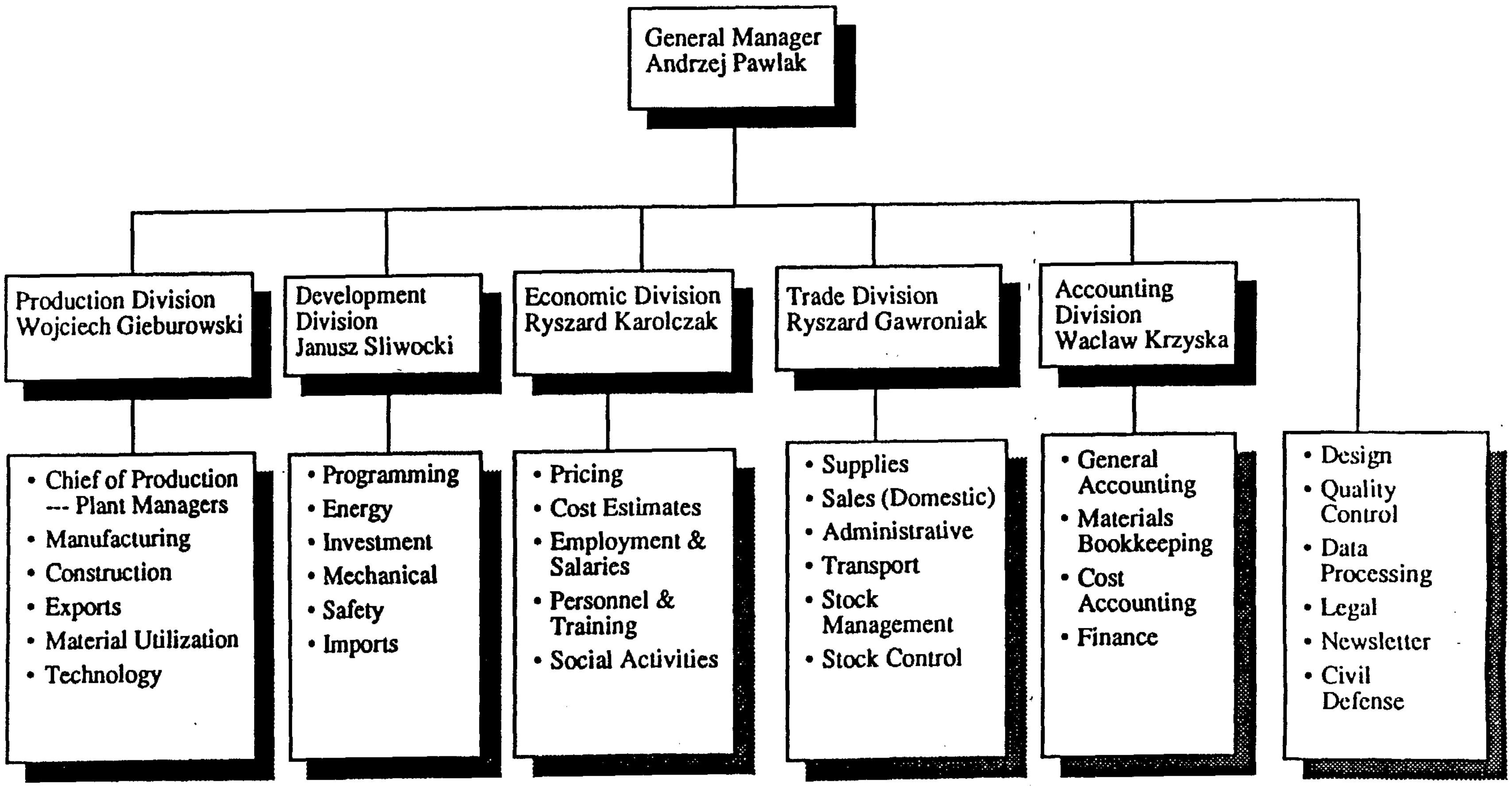
Mr. Waldemar Frackowiak	Chairman of the Supervisory Council. Ph. D., Economics, senior lecturer at Poznan Economic Academy. He is a specialist in the developmental strategy of enterprises, and has attended courses on organization and development strategies of companies in the USA. He is a consultant with Petex in Poznan. Age: 41 years.
Mr. Bodgan Karasinski	M.Sc., Economics, manager of the Bank of Gdansk, Poznan branch office. He has been employed in banking since 1947, and has served as branch office manager since 1954. He is a specialist in enterprise financing and organization. Age: 68 years.
Mr. Hieronim Postaremczak	Ph. D., Economics, manager of the consulting company Petex in Poznan. For seven years, he was the general manager of ZETO Poznan (a local state-owned enterprise involved in electronic data processing). He is a specialist in enterprise economics and organization, as well as financial and economic analysis. Age: 64 years.
Mr. Andrzej Pradzynski	M.Sc., Engineering, in construction. He is co-owner of the joint venture company Protim. Age: 53 years.
Ms. Dorota Szewczak	M.Sc., Economics, Deputy Manager of the Poznan office of the Treasury since 1969, where she has been employed since 1949. She is a certified public accountant, consultant to the Association of Accountants and a member of the committee examining candidates for certification in accountancy. She is the author of several articles concerning financial and tax policies. Age: 60 years.
Mr. Leszek Zalewski	Ph.D. , Law, a senior lecturer at the Faculty of Law and Administration at Adam Mickiewic University, Poznan, Age:40 years.
Elected by Employees:	
Mr. Marek Hoppe	M.Sc., Engineering, in timber technology. He has been employed in Plant No. 1 (Swarzedz) since 1978, first as a foreman, then promoted to production department manager. Since 1984, he has been the manager of Plant No. 1. Age: 38 years.
Ms. Barbara Kubzdyl	Employed by SFM since 1973, originally as a cashier. She later transferred as a clerk to the financial department, where she became deputy manager and finally manager in 1987. Age: 40 years.
Mr. Wlodzimierz Tylmann	Employed by SFM since 1977 in Plant No. 2 (Swarzedz) as a machine-setter and calibrator. Age: 53 years.

MANAGEMENT BOARD:

Mr. Andrzej Pawlak	President of the Management Board. Ph.D., Engineering, in timber technology. He start working for SFM after graduating in 1960. He was initially chief engineer and, from 1976 until its transformation in 1990, was the General Manager of SFM. Age: 59 years.
Mr. Ryszard Karolczak	Ph.D., Economics. He has been employed by SFM since 1963. He became senior economist in the Economics Division, then a manager of the Organization Planning and Analysis Department, and, since 1988, has been a Deputy Manager of SFM. He is also Chairman of the Poznan regional bank of the Polish Economic Society, and an advisor to the consulting firm Petex. Age: 53 years.
Mr. Janusz Sliwocki	M.Sc., Engineering, in timber technology. He started working for SFM after graduating, first in the Technology Department, and then as plant manager of Plants No. 1 and No. 5. In 1972, he became the General Maintenance manager and, in 1976, the first Deputy Production Manager. Age: 46 years.

SOURCE: Swarzedzkie Fabryki Mebli report, International Finance Corporation, January, 1991.

Exhibit 5
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Organizational Chart



SOURCE: Swarzedzkie Fabryki Mebli report, International Finance Corporation, January, 1991.

Exhibit 6
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Description of SFM Plants

The following summary of SFM's individual plants is based on September, 1990 figures. Revenue for 1990 is calculated using January to September, 1990 actual output, plus October to December estimated volumes. Prices are assumed to be at the September, 1990 level throughout the year.

Plant 1: Swarzedz

Total personnel	801
Production space	13,680 sq. m.
Storage space	10,900 sq. m.
Revenue	Zl 112.8 billion (US$ 12.0 million)
Main products	IKEA type, straight case furniture, upholstered furniture, main veneer preparation

This plant is considered the main plant, located nearby company headquarters. Part of the production is for IKEA, part are IKEA models sold on the local market. Other furniture produced is trendy and on the cheaper side. Part of the production program is not appropriate for the factory's particular production system. Production facilities are cramped and narrow; warehouses are far away; the machinery used is mainly old; the flow of production is inefficient; and the working methods are labor intensive.

Plant 2: Swarzedz (chairs)

Total personnel	284
Production space	5,362 sq. m.
Storage space	1,215 sq. m.
Revenue	Zl 25.5 billion (US$ 2.7 million)
Main products	Chairs and corner benches

This plant, also located in Swarzedz, is housed in cramped old buildings. A relatively new big building has not yet been utilized. The wood cutting section is antiquated, the wood kiln dryers are obsolete. The production flow is widely inefficient.

Plant 3: Kostrzyn

Total personnel	137
Production space	4,720 sq. m.
Storage space	2,700 sq. m.
Revenue	Zl 23.9 billion (US$ 2.5 million)
Main products	Dining and casual tables

The plant at Kostrzyn, about 12 km. east of Swarzedz, consists of a number of separated narrow buildings and spaces within those buildings. The machinery section is cramped. Assembly lines have been installed, but were not designed for efficient operation.

Plant 4: Poznan

Total personnel	209
Production space	7,470 sq. m.
Storage space	4,940 sq. m.
Revenue	Zl 42.2 billion (US$ 4.5 million)
Main products	Oak furniture for export, wall units, credenzas, TV cabinets

This factory is located north of Poznan, about 15 km. from headquarters. It is housed in a big building, which is subdivided into small units making production flow impossible to organize in an efficient manner. Production consists of a combination of high quality oak furniture and low quality furniture.

Plant 5: Mosina

Total personnel	887
Production space	24,830 sq. m.
Storage space	10,190 sq. m.
Revenue	Zl 104.1 billion (US$ 11.1 million)
Main products	IKEA case furniture, beds and mattresses for IKEA and domestic, central solid oak wood preparation, tables, school furniture (steel and wood)

This factory is located 30 km. from headquarters, and contains two main sections: the "old factory" produces school furniture, bed frames and tables. Production is hindered by cramped spacing within narrow buildings. The majority of machinery is old, the kiln dryers and the drying method are out-dated, as are the production methods. Solid wood transport and storage are very labor intensive. The "new factory" was built on wide open land, under an IKEA leasing agreement, and contains all new machinery. Space is only half-used, lacquering is a bottleneck, and the panel cutting section is underutilized. Part of the new installation is a coal and wood waste fired heat energy plant, which appears far too big for the factory. The excess boiler capacity is planned to be used to supply heat to the town of Mosina.

Plant 6: Koscian

Total personnel	232
Production space	3,280 sq. m.
Storage space	2,595 sq. m.
Revenue	Zl 43.8 billion (US$ 4.7 million)
Main products	Credenzas, vitrinas, cupboards, cabinets with panel and glass doors, corner benches

This factory, located 60 km. from headquarters, is subdivided into narrow spaces. Production lines are cramped and do not follow a logical production sequence. Variety of production is too diversified.

Plant 7: Rawicz and Bojanowo

Total personnel	200
Production space	4,686 sq. m.
Storage space	3,280 sq. m.
Revenue	Zl 25.5 billion (US$ 2.7 million)
Main products	Cupboards, credenzas, corner benches, tables, upholstered furniture

These two factories lie approximately 100 km. from headquarters. Rawicz produces a variety of furniture in spread out and narrow buildings, making a logical and efficient production flow difficult to set up. Bojanowo produces only upholstered furniture.

Plant 8: Gostyn

Total personnel	218
Production space	2,915 sq. m.
Storage space	955 sq. m.
Revenue	Zl 28.9 billion (US$ 3.1 million)
Main products	Wall units, cupboards, credenzas, tables, junior desks, bedframes, night tables

The factory is about 70 km. south of Poznan and consists of a former multi-story grain mill. The facilities are not suited for furniture production, due to the need for vertical transport and the narrow, but spread out conditions.

SOURCE: International Finance Corporation

Exhibit 7
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
SFM Sales and Profit by Plant
(Based on September, 1990 prices)

	Exports (as % of plant sales)	Domestic (as % of plant sales)	% of Total Sales	Cost as % of Plant Sales: Materials	Labor	Fixed Cost	Gross Margin as % of Sales
Plant 1: Swarzedz	60.5	39.5	18.8	53.5	7.6	16.9	22.2
Plant 2: Swarzedz (chairs)	96.0	1.6	7.5	28.6	15.3	29.0	27.1
Plant 3: Kostrzyn	96.8	3.2	7.0	35.6	16.7	18.4	29.3
Plant 4: Poznan	79.4	20.6	11.4	29.4	13.6	15.7	41.4
Plant 5: Mosina	87.2	12.8	28.6	84.1	7.3	40.9	(32.3)
Plant 6: Koscian	90.5	9.5	12.7	29.0	16.7	15.1	39.2
Plant 7: Rawicz	91.3	8.7	6.8	52.2	15.3	21.6	10.6
Plant 8: Gostyn	80.6	19.4	7.3	42.9	18.7	19.4	19.0
Totals	82.8	17.2	100.0	52.7	11.4	24.1	11.9

SOURCE: International Finance Corporation

Exhibit 8
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
SFM Productivity by Plant
(Based on September, 1990 prices)

	Direct Labor	Factory Space (sq. m.)	Revenue (US$ MM)	Space (sq. m. per person)	Revenue (US$ per person)	Revenue (US$ per sq. m.)
Plant 1: Swarzedz	566	24,580	12.0	63	21,200	488
Plant 2: Swarzedz (chairs)	188	6,577	2.7	42	14,360	411
Plant 3: Kostrzyn	95	7,420	2.5	82	26,320	337
Plant 4: Poznan	144	12,410	4.5	86	31,250	363
Plant 5: Mosina	619	35,020	11.1	84	17,930	317
Plant 6: Koscian	179	5,875	4.7	42	26,260	800
Plant 7: Rawicz	126	7,966	2.7	62	21,430	339
Plant 8: Gostyn	158	3,910	3.1	36	19,620	793
Total/Average	2,075	103,758	43.3	59	20,870	417
Int'l Estimates:						
Yugoslavia				65-80	23,000	450
Germany				70-85	130,000	1,400

SOURCE: International Finance Corporation

Exhibit 9
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Breakdown of Sales by Category of Furniture

	1987	1988	1989	1990
Case Furniture	39	41	43	43
Tables	7	7	7	7
Chairs	7	7	8	7
Upholstered Furniture	30	29	28	38
School Furniture	7	7	6	3
Other	10	9	8	2
	100%	100%	100%	100%

SOURCE: International Finance Corporation

Exhibit 10
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Contribution Margins of Selected Products
(September, 1990 figures unless otherwise stated - Zloty '000)

Item	Sales Price	Labor Cost	Materials Cost	Selling Cost	Total Direct Costs	Contribution Margin
EXPORTS		(Nov. '90)				
Mattress, Sultan 120	441	43	544	44	631	(43%)
Sofa, Kunglav 2 Seater	1,053	154	831	104	1,089	(3%)
Wall Unit, Kavalier 80HGD	268	24	170	27	221	18%
Table, 3345	1,779	231	637	183	1,051	41%
Glass Door Cabinet, 747/2	4,682	613	1,315	487	2,415	48%
Chair, 790	583	65	161	61	287	51%
Wall Unit, Munster 3.0	10,336	1,201	2,370	1,075	4,646	55%
Chair, Magda 6181	656	75	149	55	279	57%
EXPORTS VS. DOMESTIC						
Armchair, 2862 (export)	714	106	284	74	464	35%
Armchair, 2862 (domestic)	950	106	284	12	402	58%
TV Cabinet, Albatross 48362 (export)	468	76	230	49	355	24%
TV Cabinet, Albatross 48362 (domestic)	900	76	230	12	318	65%
Table, 2213 (export)	1148	179	384	119	682	41%
Table, 2213 (domestic)	1500	179	384	20	583	61%

SOURCE: International Finance Corporation

Exhibit 11

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

Balance Sheet (zlotys million)

As of December 31:	1986	1987	1988	1989	Sep-90
ASSETS					
Current Assets					
Cash	10	88	185	4,037	2,524
Accounts Receivable	337	657	1,466	8,244	20,125
Other Receivables	62	232	163	921	3,455
Inventories	1,708	2,331	3,116	18,213	56,234
Total Current Assets	2,117	3,308	4,930	31,415	82,338
Net Fixed Assets					
Buildings	1,187	1,185	2,512	6,182	67,746
Plant and Equipment	838	926	1,388	5,091	38,249
Construction in Progress	588	1,188	3,651	3,131	12,667
Intangible Assets	49	63	320	996	1,726
Long Term Investments	1	1	13	14	87
Total Fixed Assets	2,663	3,363	7,884	15,414	120,475
Long Term Loans	0	0	0	136	136
Total Assets	4,780	6,671	12,814	46,965	202,949
LIABILITIES and SHAREHOLDERS' INTERESTS					
Current Liabilities					
Bank and Other Loans	863	945	1,365	7,554	53,109
Accounts Payable	184	357	921	5,777	11,888
Other Payables	481	668	1,704	6,459	15,178
Total Current Liabilities	1,528	1,970	3,990	19,790	80,175
Long Term Liabilities					
Long Term Loans	580	1,077	2,395	364	135
Shareholders' Interests					
Foundation Fund	963	963	1,941	1,941	9,916
Retained Earnings	1,709	2,661	4,488	24,870	112,723
Total Shareholders' Interests	2,672	3,624	6,429	26,811	122,639
Total Shareholders' Interests and Liabilities	4,780	6,671	12,814	46,965	202,949

SOURCE: International Finance Corporation (audit conducted by KPMG Accountants)

Exhibit 12
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Income Statement (zlotys million)

For year ending December 31:	1986	1987	1988	1989	1990 (9 mos.)
Gross Sales	5,901	8,281	13,637	41,449	194,112
Cost of Sales					
Material	3,282	4,130	6,388	15,876	106,822
Employment	1,423	1,706	2,555	10,972	34,823
Depreciation	77	107	195	307	4,467
Other Costs	858	1,275	2,428	3,003	32,451
	5,640	7,218	11,566	30,158	178,563
Gross Profit	261	1,063	2,071	11,291	15,549
Other Income	761	769	316	10,534	4,393
Extraordinary Gains	4	68	614	5,008	5,390
Extraordinary Losses	19	35	75	470	5,000
Sales Tax	640	685	956	2,137	7,495
Profit Before Taxes	367	1,180	1,970	24,226	12,837
Income Taxes	78	242	527	2,817	5,014
Net Income	289	938	1,443	21,409	7,823

SOURCE: International Finance Corporation (audit conducted by KPMG Accountants)

Exhibit 13
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
1990 Quarterly Results (zlotys billion)

	1Q-90 Actual	2Q-90 Actual	3Q-90 Actual	4Q-90 Estimated	Total
Gross Sales	52.8	64.7	69.1	88.2	274.8
Cost of Goods Sold	(44.4)	(59.3)	(75.1)	(80.3)	(259.1)
Other Income/Expenses	9.4	12.0	9.2	(0.3)	30.3
Earnings Before Interest and Taxes	17.8	17.4	3.2	4.6	43.0
Interest	(6.4)	(8.6)	(10.8)	(9.3)	(35.1)
Profit Before Tax	11.4	8.8	(7.6)	(4.7)	7.9
Income Tax	(4.6)	(3.5)	----	----	(8.1)
Net Income	6.8	5.3	(7.6)	(4.7)	(0.2)

SOURCE: International Finance Corporation

Exhibit 14
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Summary of Projections, 1991-2000
(Constant Zloty Million, January 1991 Prices)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net Sales	404,793	461,198	509,865	545,289	569,102	599,311	609,253	617,391	637,720	660,129
Net Income	(14,788)	(2,923)	491	19,972	25,877	32,435	36,031	37,784	38,430	39,914
Outstanding Short Term Debt										
Outstanding Securities	3,923	3,063	5,387	11,972	22,727	35,632	52,908	72,691	92,959	114,081
Short Term Interest Paid										
Total Long Term Debt										
Paid In Capital	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190
Workers Participation										
Total Equity	270,402	267,480	267,602	272,595	279,065	287,173	296,181	305,627	315,234	325,213
Total Assets	301,928	303,053	307,303	314,066	320,759	330,361	338,978	348,167	359,077	370,512
Cash Generation	4,393	17,808	22,646	44,027	51,233	59,091	64,586	68,239	70,785	72,927
Cash Dividends Paid			368	14,979	19,408	24,326	27,023	28,338	28,823	29,936

Discount Rate Calculation:	
risk-free rate	6%
market risk premium	7%
risk for Poland	+/- 3%
risk due to debt restructuring	+/- 5%
project uncertainty (i.e., investor response, process of selling shares, etc.	+/- 5%
	+/- 25%

SOURCE: International Finance Corporation

Exhibit 15
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Market Comparisons - Pilot Public Offering Candidates

Company	Nominal Value per share Zl ('000)	Book Value per share Zl ('000)	Issue Price per share Zl ('000)	Issue Price / Nominal Value (%)	Issue Price / Book Value (%)
EXBUD	50	164	112	224	68
TONSIL	40	52	80	200	154
KABLI	50	65	70	140	108
KROSNO	50	95	65	130	68
PROCHNIK	20	46	50	250	109

SOURCE: International Finance Corporation

International Privatization Group
Case # 3

SWARZEDZKIE FABRYKI MEBLI S.A. (B)

POLAND

The Polish Ministry of Ownership Changes, with the International Finance Corporation (IFC) acting as advisor, privatized one of Poland's most modern furniture manufacturers, Swarzedzkie Fabryki Mebli, S.A. (SFM), in May, 1991. The allocation of shares for small investors, which began on May 20, sold out on the first day of the two-week offer period, and those allocated for large investors were oversubscribed by 12 percent. Of the company's 2.5 million shares, 36 percent were reserved for small investors, 40 percent for large investors and 16 percent for employees (Exhibit 1). Foreign investors took a 24 percent stake in SFM, including 3 percent allocated to the IFC.

The SFM transaction was the first fully underwritten public offering in Poland, and the first time a Polish company underwent financial restructuring prior to privatization. Additionally, it was the first time shares were specifically allocated into separate tranches for large and small investors, avoiding a widely dispersed shareholder profile -- a major drawback of public offerings in post-communist economies. Finally, the public offering was the first to combine a primary capital increase of 500,000 shares with a sale of the Government's 1.4 million shares.

Financial Restructuring Plan

A prerequisite for the SFM privatization was the correction of its debt problem. At the time of sale, SFM owed approximately Zl 40 billion to Bank Gdanski, Zl 20 billion to the Ministry of Finance (due to excess wages tax), and Zl 6 billion each to PAGED and to Jacobson, PAGED's German partner.

Initially, the IFC proposed the use of a debt-equity swap, in which SFM's main creditor, Bank Gdanski, would exchange its debt for equity in SFM and then sell this equity at the same time as the State sold its stake. The IFC believed this would be the most politically acceptable option for the Ministry. Bank Gdanski was supportive of the agreement; however, it backed out at the last moment.

At this point, the IFC felt the Ministry of Ownership Changes would consider

This case was written by Maria C. Kozloski under the supervision of the International Privatization Group and James E. Austin Associates, Inc., as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

assuming the debt of SFM, on behalf of the State Treasury and with the approval of the Ministry of Finance. Pressure was growing to complete the next public offering, and SFM appeared to be an appropriate candidate if its debt problem was resolved. After lengthy discussions and the backing of Prime Minister Bielecki, the Ministry of Finance agreed to assume SFM's debt obligations, but insisted on an underwriting agreement for at least the amount of debt assumed. Proceeds from the public offering were subsequently used to repay SFM's debt obligations.

Underwriting Agreement

Four domestic banks underwrote Zl 42 billion of the public offering of SFM, and the Polish Development Bank underwrote Zl 34 billion. The domestic banks included Bank Gdanski, Wielkopolski Bank Kredytowy, Pomorski Bank Kredytowy and Polski Bank Rozwoju. In the event that the public offering were not fully subscribed, the banks were to purchase SFM shares, at a discount, up to a level which would result in proceeds of Zl 76 billion (i.e., more than Zl 76 billion worth of shares if they are valued at the full issue price). The share price discount was granted to cover the banks' underwriting fees.

Share Distribution Mechanics

The share offering of SFM was segregated into small and large investor tranches. The small investor tranche was administered by Bank PKO of Warsaw, using the "first come, first served" distribution system. The large investor tranche was administered by Bank Staropolski of Poznan, using an allotment system. The IFC assisted both banks with setting up the new share distribution system.

Bank PKO set up a 200 branch bank network (80 branches of which it owned) to distribute shares to individual investors. Bank PKO also developed a computerized network linking the bank branches and its central Warsaw office, and had the capability to track sales patterns on a daily basis. The computerized system facilitated the processing of applications and the use of Convertible Treasury Bonds (CTBs) as forms of payment. The result was a drastic reduction in average queuing time per applicant, compared to the first set of public offerings.

Shares were allocated to the branches based on estimated demand per branch and the size of the branch (Exhibit 2). Branches initially received 500,000 of the 900,000 shares designated for the small tranche. By keeping reserve shares in Warsaw, shares were quickly reallocated to "hot selling areas", and recollection of unsold shares was avoided in this offering. Participating banks divided 6,250 SFM shares among them in a tier incentive scheme (Exhibit 3).

The large investor tranche received 1,000,000 shares, including 500,000 existing shares and 500,000 newly offered shares. A total of 1,117,000 shares were applied for, equalling 11.7% oversubscription. Domestic large investors accounted for 49.4% of the applications and foreign large investors accounted for 50.6%. WARTA, a Polish insurance company, took the biggest stake in the company (13.8% of total shares) (Exhibit 4).

Employees of SFM were allocated 400,000 shares, and were eligible to purchase shares in the company at a 50% discount from the issue price. The employee share offer scheme began in mid-July, 1991, and employees had one year to make their purchases. Although employees at the plant were generally interested in buying shares, money was a problem. As a production worker with 30 years of SFM experience stated, "I am interested in what is going on, and I would buy shares but I do not have the money to do so."

Finally, 100,000 shares were kept by the State to settle claims made by heirs of the company's pre-war owners. A further 75,000 shares went to the IFC as partial payment for their advisory services, and 18,750 shares were reserved for the stock market "broker" for SFM.

Primary Issue of Stock

The secondary sale of the State's 1.4 million SFM shares was combined with a primary issue of 500,000 SFM shares. The proceeds from this issue remained with SFM, and were expected to be used to reduce its obligations to trade creditors, to satisfy working capital needs and to fund the physical restructuring plan. Since the proceeds from the primary issue were not used to pay off bank debt or the tax liability, the issue price per share was not reduced as a result of the capital increase.

Post-Privatization Restructuring

After privatization, the IFC sent Dr. Itzhak Goldberg to SFM for four weeks to familiarize management with decision making based on economic factors, as well as to set up a financial management and managerial accounting system. According to Dr. Goldberg, "The approach was to identify people within the company who are ready for change and set up teams of employees and consultants who will ensure sustainability of the new systems."

Prior to privatization, SFM had implemented minor operational changes, including a reconfiguration of the product mix based on contribution margin analysis. Post-privatization, the focus centered on: (i) management information systems; (ii) marketing development; (iii) profit centers; and (iv) cost cutting.

Dr. Goldberg's main task was to develop a computerized system to analyze the accounts receivables and payables of SFM, and establish a routine of cash management. SFM booked revenues before cash was actually received, and did not have an accurate picture of in-coming cash flow. Additionally, many of SFM's domestic clients with overdue payments, continued to receive goods. As Dr. Goldberg described, "the objective of domestic sales staff seems to be 'to ship product', with little attention to collection". No terms of sales or contracts existed for the domestic clients, and some clients tried to return furniture which did not sell.

Despite SFM's increased attention to contribution margins, Dr. Goldberg uncovered negative or close to zero margins in export and some domestic sales. Average margins were too low to cover fixed costs, particularly labor costs. Nonetheless, SFM increased wages again by 30% in July, 1991. The IFC believed SFM had to reduce its employment level, which remained at 3,200. This would be a difficult step, since Andrzej Pawlak, president of the Management Board, knew almost all his employees personally.

Stock Market Performance

SFM shares were offered on the market at 50,000 Zl/share.[1] The price per share had fallen to 47,500 Zl/share on the first day the company's shares were traded (June 25, 1991), and had not returned to its issue level in eight weeks of stock market activity (Exhibit 5).

A primary reason for the decline in share price was due to CTB speculation. CTBs had been distributed as bonuses by state enterprises to their employees, to avoid excess wages tax, and over Zl 200 billion worth of CTBs were outstanding in Poland. Many recipients of the CTBs preferred cash, and an informal market had developed in which the CTBs traded at 70% of their face value. Small investors received 120% of the face value plus accrued interest when using CTBs to buy shares in privatized companies. Thus, by using CTBs, they were able to purchase SFM shares at a significant discount.

These speculators immediately sold off their shares when SFM began trading on the stock market. By doing so, they were insured of a high return despite a decline in share price. Stock market experts expected the price of SFM to bottom out after CTB speculators took their profits; however, the share price continued to decline in early August, 1991 after a brief upturn on July 16, 1991.

[1] The IFC initially recommended a Zl 40,000 share price for SFM in February, 1991. The share price when the company was publicly offered in May, 1991, equalled Zl 50,000. This rise was attributed to domestic inflation between February and May, 1991.

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Concluding Remarks

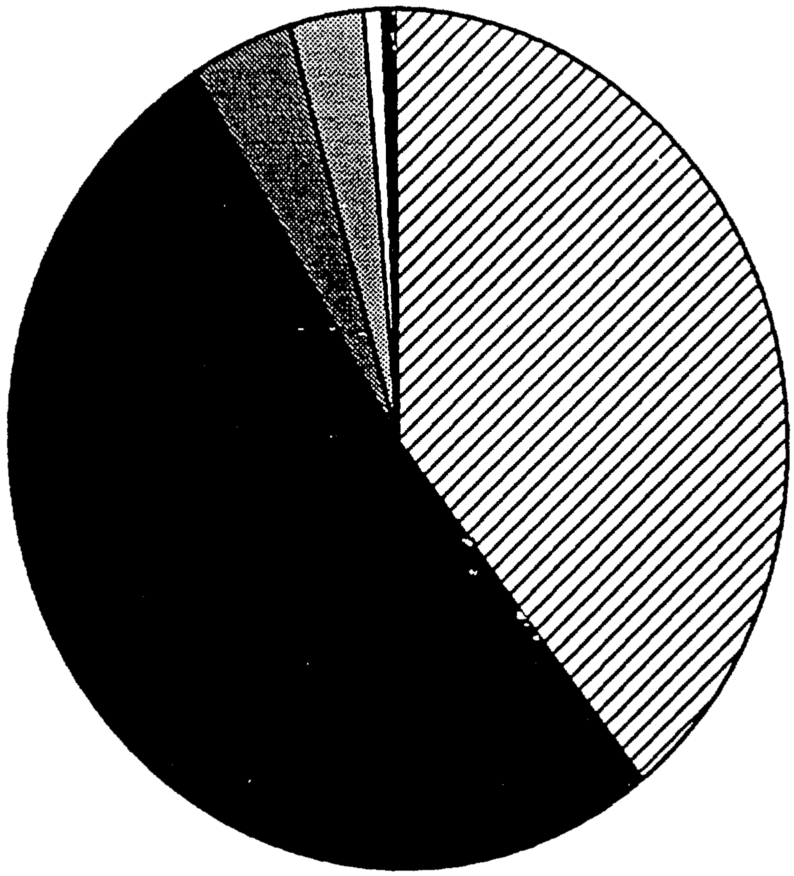
The SFM privatization, with its immediate sell-out of shares, improved the image of Polish public offerings, and was touted as a "success" by newspaper reporters worldwide. The transaction also established the beginning of an institutional framework for Polish public offerings. The "first come, first served" distribution system and the 200-branch banking network set up by Bank PKO were reused in Poland's seventh and eight public offerings. Shares of shirt manufacturer Wolczanka and beer producer Zywiec sold out quickly, just weeks after the SFM transaction, using similar mechanics in Poland's public offering "production line" strategy.

Grzegorz Medza, the Ministry official responsible for the SFM offering, believed he had shown that public offerings were a viable option for certain Polish enterprises. Gavin Wilson, the IFC advisor for SFM, commented:

> The outcome of the Swarzedz sale is extremely good news for the Polish privatization program. Success in this business spells success for future offers. The first thing is that people have a better understanding of the market. Secondly, this transaction has pushed Polish capital markets forward. The privatization of Swarzedz has created an infrastructure which will make it easier for the Ministry to put other firms up for public sale.

However, as SFM was learning, privatization would not correct all the company's problems. SFM still had to focus on key restructuring plans to establish itself as an internationally competitive furniture manufacturer.

Exhibit 1
SWARZEDZKIE FABRYKI MEBLI S.A. (B)
Final Share Distriubtion



- Large Investors: 1,000,000 shares (40%)
- Small Investors: 900,000 shares (36%)
- Employees: 400,000 shares (16%)
- State (for claims): 100,000 shares (4%)
- IFC (for services): 75,000 shares (3%)
- Stock exchange "broker": 18,750 shares (0.75%)
- Participating banks: 6,250 shares (0.25%)

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Exhibit 2
SWARZEDZKIE FABRYKI MEBLI S.A. (B)
Share Distribution by Banks

Small Investor Tranche ("first come, first served" share distribution)

Branches	Shares	Total	Reserve Projections
90 Small	700	63,000	100,000
100 Medium	2,650	265,000	150,000
10 Largest	7,200	72,000	250,000
200		400,000	500,000

Reserve for Small and Medium	400,000
Reserve for 10 Largest	100,000
Total Shares Small Investor Tranche	900,000

SOURCE: International Finance Corporatic, Bank PKO

Exhibit 3
SWARZEDZKIE FABRYKI MEBLI S.A. (B)
Tier Incentive System

6,250 shares x 50,000 Zl/share = Zl 312,000,000

Incentive system for medium and small branches

Each group receives:

Rank	Million zlotys
1	18
2	15
3	12
4	9
5	6
(top 5 of 90 smallest)	60
(top 5 of 100 medium)	60
Total medium/small	120

Incentive system for largest 10 branches

Rank	Million zlotys
1	30
2	20
3	10
Total 10 largest	60
Total medium/small	120
Total Bank PKO, Central Warsaw Office	132
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* The participating banks in the SFM offering were allocated shares according to their performance. Banks were ranked , with 1 being the "best".

SOURCE: International Finance Corporation, Bank PKO

Exhibit 4
SWARZEDZKIE FABRYKI MEBLI S.A. (B)
Large Investor Tranche Results

DOMESTIC INVESTORS

	Investor Name	No. of Shares Allotted	% of Total Outstanding Shares
1	Big SA (Bank)	10,000	0.4%
2	Bank Morski	10,000	0.4%
3	Marian Lenczewski	10,000	0.4%
4	Ryszard Krauze	22,000	0.9%
5	Bank Handlowy Kredytowy (Wroclaw)	86,000	3.4%
6	WARTA Insurance and Reinsurance Co. Ltd.	345,000	13.8%
	Total Domestic	483,000	19.3%

FOREIGN INVESTORS

	Investor Name	No. of Shares Allotted	% of Total Outstanding Shares
1	London-Based Broker	22,000	0.9%
2	London-Based Broker	25,000	1.0%
3	Beta Funds Limited	33,000	1.3%
4	Genesis Emerging Markets Fund Ltd.	77,000	3.1%
5	London-Based Fund	106,000	4.2%
6	The East Europe Development Fund Ltd.	125,000	5.0%
7	PAGED Westphalen GMBH	129,000	5.2%
	Total Foreign	517,000	20.7%
	Overall Total	1,000,000	40.0%

SOURCE: Bank Staropolski

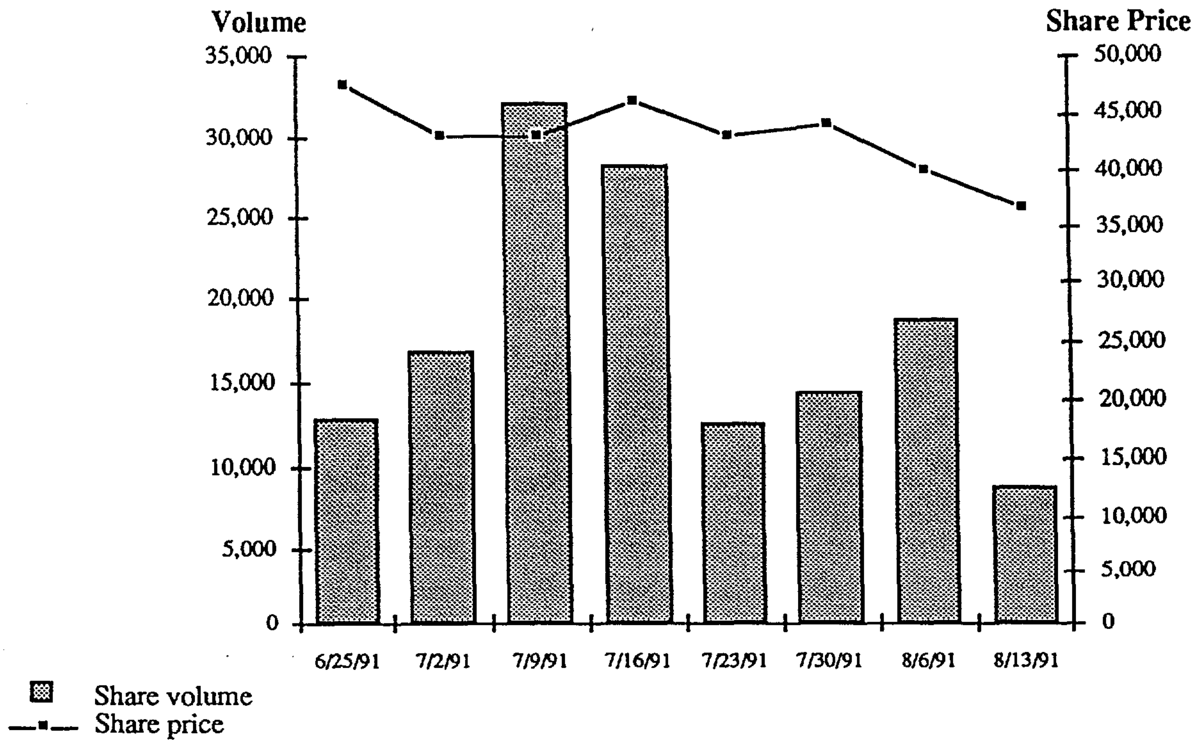
Exhibit 5
SWARZEDZKIE FABRYKI MEBLI S.A. (B)
Stock Exchange Performance

Warsaw Stock Exchange:
As of 8/13/91:

Total Volume	ZL 2,073,970,000
Total No. of Shares Transacted	20,149
Total No. of Listed Companies	7
WIG (Warsaw Index)	78.7 (where 100 represents each stock at issue price)

SFM Perfomance:
Issue Price: 50,000 Zl

Week	Volume	Price
6/25/91	12,800	47,500 Zl
7/2/91	16,930	43,000 Zl
7/9/91	32,020	43,000 Zl
7/16/91	28,180	46,000 Zl
7/23/91	12,590	43,000 Zl
7/30/91	14,530	44,000 Zl
8/6/91	18,834	40,000 Zl
8/13/91	8,812	36,500 Zl



Source: Warsaw Stock Exchange

International Privatization Group

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

POLAND

Teaching Note

Case Overview

COUNTRY:	Poland
INDUSTRY:	Furniture Manufacturing
DECISION MAKER:	Grzegorz Medza, program manager in the Department of Large Enterprise Privatization, Ministry of Ownership Changes
ISSUES:	Privatization: restructuring, public offering strategy, share distribution

In late February, 1991, Poland's privatization program is at a crucial stage. Its large enterprise program is proceeding slower than expected (only 6 of 500 large enterprises have been privatized), and a pilot public offering has shown mixed results. The economy continues to deteriorate, and the growing consensus is that economic reform will fail without massive privatization.

Grzegorz Medza, a program manager in the Department of Large Enterprise Privatization within the Ministry of Ownership Changes, has assisted in the redesign of the Ministry's public offering and share distribution strategies. His choice as the next large enterprise to be privatized, preferably through public offering, is Swarzedzkie Fabryki Mebli S.A. (SFM). However, Grzegorz faces several obstacles: the new Minister for Privatization, Janusz Lewandowski, is skeptical about public offerings as an appropriate privatization vehicle for Poland; SFM's short-term debt is escalating and, as a result, its privatization has already been delayed once; and no state enterprise in Poland has been restructured prior to sale. Grzegorz is meeting with the Minister Lewandowski the following day to propose a strategy for privatizing SFM.

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Case and Audience

The SFM case has been developed for use in privatization training programs in developing countries. Program participants are expected to be government officials with responsibility for privatization transactions, yet with limited experience in this field.

Learning Objectives

The SFM transaction can be used to highlight several aspects of designing a privatization strategy. The case teaching session can be managed to provide students with an opportunity to apply negotiation skills and experience in various aspects of undertaking privatization transactions, including:

(1) Selecting a privatization candidate.

(2) Timing of the transaction; debating the issue of financial and/or operational restructuring of state-owned enterprises prior to sale.

(3) Valuating the enterprise to be sold.

(4) Implementing a public offering strategy and a share distribution mechanism.

Discussion Questions

(1) What are the decisions Grzegorz Medza faces in developing a privatization strategy for SFM?

(2) What are the weaknesses of SFM as a privatization candidate?

(3) Is it necessary to financially and/or operationally restructure SFM prior to sale? Why or why not?

(4) What privatization strategy should be used for SFM?

(5) How would you address SFM's short-term debt problem?

(6) At what price should SFM shares be sold to the public?

(7) What are the advantages of the new public offering strategy? the "first come, first served" share distribution system? What potential problems can you foresee implementing these new mechanisms? Is SFM the best candidate to test the new mechanisms? Why?

Teaching Plan and Case Analysis

Problem Diagnosis

1. What are the decisions Grzegorz Medza faces in developing a privatization strategy for SFM?

The purpose of this question is to provide a framework for analyzing the key dimensions of privatization transactions. Students play an active role in developing this outline, and will later consider the interrelatedness of these decisions as each is separately addressed. Meanwhile, the instructor can get a sense of students' understanding of the case, and bring out any key areas that were missed.

Students are likely to propose the following decision making areas (Annex I) :

(a) Privatization mechanism
- Public offering
- Technical partner/joint venture
- Other (i.e., auction, trade sale, management-employee buyout, sale of assets, franchise, management contract)

(b) Privatization timing
- Privatize now; let the new owner(s) restructure
- Restructure fully before privatization
- Design and partially implement a restructuring plan; privatize when viability is shown

(c) Restructuring
- Organizational
- Operational
- Financial
    - Extended maturity of debt
    - Government assumes debt prior to privatization
    - Creditor(s) swap debt for equity
    - Primary issue of SFM stock, proceeds used to pay off debt

(d) Valuation methodology
- Book value
- Liquidation value
- Discounted cash flow
- Other (i.e., P/E multiple)

2. <u>What are the weaknesses of SFM as a privatization candidate?</u>

SFM appears to be a "good" candidate in many respects. It is a leading manufacturer of high-quality furniture, which exports 80% of production, predominantly to Sweden and Germany, and has a well-known domestic brand name. However, SFM suffers from structural weaknesses, which have been identified by the IFC during the enterprise appraisal process. These weaknesses should be addressed by students, since they affect the attractiveness of SFM as a privatization candidate and should be considered in the development of the company's privatization strategy.

A wide range of responses is likely to result from this discussion, and will tend to fall in the following categories (Annex II):

OPERATIONAL:

<u>Inefficient production flows</u> - Exhibit 6 includes a brief description of SFM's eight plant facilities. Seven of the eight plants have been described as having inefficient and/or cramped production flows.

<u>Low productivity</u> - SFM's direct labor productivity and average revenue per square meter are similar to Yugoslavian levels but significantly lower than Germany levels. The average revenue/person at SFM is US$ 20,870, which is 91% of the average level in Yugoslavia (US$ 23,000), and 16% of the average level in Germany (US$ 130,000). The average revenue/square meter at SFM is US$ 417, which is 93% of the average level in Yugoslavia (US$ 450) and 30% of the average level in Germany (US$ 1400).

<u>Variance in plant profitability</u> - Plant profitability varies widely, as shown in Exhibit 7. SFM's most modern facility, Mosina (Plant No. 5) is the loss-maker due to high materials and fixed costs resulting from the product design requirements of IKEA products and the large lease payments made on equipment with low capacity utilization. Space at Mosina is only half-used.

<u>Variability in product profitability</u> - Contribution margins (i.e., sales prices less total direct costs) for SFM's products vary widely. As shown in Exhibit 10, margins range from approximately -40% to +60%. The company seldom uses a cost-based formula in calculating selling prices; rather, selling prices depend on client negotiating skills, SFM's existing price level with the client, and the market requirements of Sweden and Germany. Due to fixed contracts, SFM has suffering substantial losses on a number of IKEA items, and just recently negotiated high selling prices after threatening to stop production of IKEA products.

<u>Serving diverse markets</u> - SFM serves both the export and domestic markets with over 300 varieties of furniture pieces. Contribution margins vary not only by product,

but also by market. Considerably higher margins are achieved when the same product is sold domestically rather than exported, due to SFM's better brand name in Poland, as well as the substantial appreciation of the real exchange rate since prices were last negotiated. Thus, the IFC believes SFM has a lot to gain from actively managing both product and market mix.

ORGANIZATIONAL:

Hierarchical decision making - SFM is run from the top-down, with Andrzej Pawlak, head of the Management Board, involved in all decisions, delegating little authority. Plant managers do not have profit responsibility. Despite being knowledgeable and technically capable, they merely aim to fill orders issued by headquarters.

Lack of marketing capability - Ninety-eight percent of SFM exports, equalling 80% of SFM's total production, are handled by PAGED, the Polish foreign trade organization responsible for paper, pulp and other wood processing industries. This government agency has no stake in SFM's performance. Given the level of commissions paid to PAGED, the IFC believes a Western company would typically expect a considerably greater level of service. Additionally, due to SFM's dependence on PAGED, the company has not developed a strong sales and marketing capability of its own. SFM lacks a trained sales force and is unable to keep abreast of market developments. In referring to Exhibit 5, displaying the SFM organizational chart, students should note the absence of a sales and marketing department.

High labor turnover - SFM benefits from the pool of skilled craftsmen in the Poznan area, due to the centuries-old tradition of cabinet making. However, SFM competes with 2,500 to 3,000 small woodworking shops in the area for its labor supply. These small shops have had greater flexibility granting wage increases than SFM, and workers tend to move frequently between SFM and the small shops according to the wage differentials. Consequently, SFM offered wage increases in November, 1990, despite facing high excess wages taxes.

FINANCIAL:

Escalating short-term debt - SFM posted profits between 1986 and 1989, but began suffering losses in 1990. With 70% of its production exported, at fixed prices in foreign currency, SFM cannot freely raise prices and its export revenues have remained stable. However, production and working capital costs have risen due to escalation in domestic inflation. SFM has turned to short-term debt to cover its losses, paying 56% interest rates and spending 10% of net sales on interest payments. Its debt to Bank Gdanski rose ten-fold in 1990.

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Lack of management information systems - SFM has extensive accounting and cost control systems, yet the information gathered is not properly analyzed and is not used for marketing, planning or budgetary purposes. Information is not packaged in ways to allow management to project sales revenues or margin profitability, to plan production levels, etc.

3. Is it necessary to financially and/or operationally restructure SFM prior to sale? Why or why not?

This question serves as an introductory to question 4 (regarding the privatization strategy for SFM), since choice of a privatization strategy will depend on one's belief in the need for restructuring of SFM. There are two key issues: (i) the need for financial and/or operational restructuring; and (ii) the extent of restructuring that will have to take place prior to sale of the company.

Generally speaking, there are three options available for SFM regarding the timing of the transaction and, thus, the level of restructuring to take place prior to sale: (1) privatize now; let the new owners restructure; (2) fully restructure the company, then privatize; or (3) design and partially implement a restructuring plan, privatize when viable.

Student responses will tend to focus on options (2) and (3), which have been specifically considered by the IFC. It is also interesting to consider the viability of option (1). Enterprises in developing countries are sold, even with a negative discounted cash flow value, when governments are willing to sell enterprises at low prices in return for placing firms in the private sector. But is this really an option for SFM? Probably not, since the company is well-known in Poland and public outcry would result if SFM was sold at a "giveaway" price. Furthermore, public pressure is growing to rejuvenate the large enterprise privatization program in Poland, and SFM has already been once targeted for public offering but was excluded from the December, 1990 sale due to its financial condition. Grzegorz and the IFC intend to use SFM to demonstrate the "success" (as measured by full subscription of shares and simplistic share application procedures) of the new public offering and share distribution strategies.

The main obstacle then to privatizing SFM is its high short-term debt. But will solving the debt problem alone ensure the future viability of the firm? The IFC argues that unless efforts are made to improve long-term efficiency and profitability, debt measures will be temporary. The question then centers on whose responsibility it is to deal with efficiency and profitability issues, and the necessity of addressing these issues prior to sale of the company. Additional issues to consider include: (i) cost of restructuring; (ii) how will restructuring be funded?; (iii) management's ability to implement a restructuring plan; and (iv) the expected impact of restructuring. The pros and cons of the various privatization strategies proposed by the IFC and discussed in question 4 are shown in Annex III.

4. <u>What privatization strategy should be used for SFM?</u>

Given the discussion on restructuring, this focuses attention more specifically on the pros and cons of the privatization strategies recommended by the IFC (Annex III), as well as to introduce any additional options they considered. By asking a student to recommend one specific strategy, the student is forced to present and defend his or her decision. As a follow-up, the instructor can broaden the discussion by asking why other options were not chosen.

The three strategies recommended by the IFC include: (1) technical partner; (2) fully restructure, then sell, preferably through a public offering; and (3) design and partially implement restructuring plan, then sell, preferably through public offering. Additional privatization mechanisms include: trade sale; auction; management-employee buyout; asset sale; franchise; and management contract.

5. <u>How would you address SFM's short-term debt problem?</u>

Four options were presented by the IFC. It is useful to debate the pros and cons of these options (Annex IV), and consider them in the context that no state enterprise in Poland has been financially restructured prior to sale. The discussion can also be broadened by asking students what other options could be considered.

6. <u>At what price should SFM shares be sold to the public?</u>

This question encourages students to look at the valuation of SFM. Whether or not they go through the actual calculations, students are prompted to analyze the steps taken and assumptions made in conducting the valuation.

The first component of the valuation is the cash flow projections. Annex V includes the balance sheet and income statement projections for SFM, which were used to arrive at the cash flow projections in Annex VI. Basically, the IFC calculated a discounted cash flow, assuming 75% of net income would be paid out as cash dividends. For the horizon value in the year 2000, the book value of SFM was used. Typically, a price/earnings multiple would be used to value a company at the end of the projections period; however, the IFC chose to use book value due to the absence of publicly-traded companies in Poland. Annex VI includes a sample discounted cash flow calculation.

The second component of the calculation is the discount rate. There was a lot of discussion over the exact rate to use, with concerns raised such as the risk of SFM failing after privatization, the fact that SFM needed to go through debt restructuring, the risk of Poland versus other countries, etc. An approximate value was finally agreed upon (see

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calculation below) and the discounted cash flow was calculated for a range of discount rates around this approximation. This generated a range of share prices, which were debated and a final share price was agreed upon. From the final share price, the final discount rate was backed into.

<u>Calculation of the discount rate:</u>

6%	risk-free rate
7%	market risk premium
+/- 3%	risk for Poland
+/- 5%	risk due to SFM debt restructuring plan
+/- 5%	project uncertainty (i.e., investor response, the actual process of selling shares, etc.)
====	
+/- 25%	

In the original proposal given to the Ministry, the value of SFM was calculated at $8.4 million (or approx. Zl 80 billion, using an exchange rate of 9,500 Zl/$ which was in place at the time of valuation and a discount rate of approximately 27%). This equalled a share price Zl 40,000, given 2 million shares in the company. The debate ranged between using 37,000 to 47,000 Zl/share; 40,000 Zl/share was considered a "good round number".

In making the final decision on the issue price, the IFC wanted to take into account the perceived value of SFM to potential investors and the prices of comparable securities (Annex VII). The IFC wanted to acknowledge the fact that every capital market has its own trading range, despite the fact that Poland's market was in a preliminary stage of development. For example, if all companies in a certain market traded at a discount to book value or at a low P/E ratio, it would be difficult to launch an equity issue which did not correspond to these established standards.

Thus, the Zl 40,000 recommended share price was compared to the share prices of the first five "pilot" issues. Two ratios were looked at: (1) issue price/book value of share; and (2) issue price/nominal value of share. The issue price for the first five fluctuated between 30-150% above nominal value, and from 68-154% above book value. However, this was not considered a definitive range, since the market contained only a small number of companies. Also, nominal value is a somewhat arbitrary figure, akin to "par value" in the US. The share capital of SFM equalled 50,000 million zlotys, leading to a nominal value per share of Zl 25,000. Secondly, book value is based on accounting conventions and often does not bear any relation to real underlying value. Nonetheless, the value of 40,000 Zl/share fell within the range which existed for the first five "pilot" cases, suggesting to the IFC that this issue price would "make sense" in the market, and accurately reflect SFM's estimated corporate value.

Suggested follow-on questions include: Do you agree with how the discount rate and share price were derived? What would you have done differently? Although there are no "right" answers, these questions will serve to stimulate debate on how to approach valuation when such approximations must be made. Finally, the instructor can encourage students to analyze the assumptions made by the IFC, and identify areas for sensitivity analyses. Annex VIII contains results of sensitivity analyses conducted by the IFC.

7. What comments do you have regarding the new public offering strategy? the "first come, first served" share distribution?

If time permits, the instructor can choose to delve into the background issues for the SFM privatization. This case is taking place soon after the pilot public offering of five companies in December, 1990. As a result of that experience, the Ministry has since redesigned both its public offering and share distribution strategies; yet, neither strategy has been tested.

"Production Line" Public Offerings

Prior to this case, five large enterprises were sold in Poland in a simultaneous public offering. There are several arguments in favor of a simultaneous or "batch" public offering. From the perspective of SFM, these include: (i) overall public awareness of the issue would be higher; (ii) the fixed cost of implementing a nationwide distribution system would be spread across more than one transaction; (iii) SFM would benefit from the State's public relations campaign; (iv) certain administrative activities (i.e., printing of application forms and prospectuses) would be centrally handled; and (v) there would likely be less confusion among the public about the timing and mechanics of the share subscription process.

On the other hand, "one-at-a-time" public offerings have the following benefits for SFM: (i) higher public interest for a separate offering if the companies which were to be included in the "batch" were unattractive investment prospects or have poorly prepared offering documentation which hurts the overall issue; (ii) tailored public relations campaign; and (iii) distribution system which could be adjusted to take account of areas of likely high demand for shares (i.e., Poznan).

According to the Ministry, the "production line" approach is expected put less strain on the market's absorptive capacity, and create a perception of continuous progress. Additional benefits anticipated by the Ministry include: (i) media campaigns could be better harmonized, with a general education campaign interspersed with specific campaigns for individual companies; (ii) the coordination effort would become less critical, allowing the Ministry to concentrate on substantive matters such as selection, pricing and choice of method of sale; (iii) companies could be privatized when they were ready, instead of having to wait for the rest of the batch or being forced to go before they were fully prepared; (iv) queues to buy shares would likely be shorter with one or two companies on sale at a given moment; and (v) chances of setting a permanent infrastructure for privatizations would increase.

"First Come, First Served" Distribution System

The "first come, first served" distribution system was expected to offer the following benefits: (i) since there was no possibility of Convertible Treasury Bonds (CTBs) having to be returned to the subscriber, they could be redeemed immediately and did not need to be stored (thus saving up to 40% of the costs of the distribution system); (ii) investors using cash would not forego interest on money deposited with the receiving bank; (iii) the simpler procedures (including the use of one form) would lead to shorter queues at receiving agents, since each investor needed only to queue once (rather than go back a second time to learn the outcome of the allotment procedure), and the queuing time per investor would likely decline; (iv) surplus orders would not result since only the amount of shares on offer would be sold; and (v) the system would likely appear more transparent and less arbitrary without the use of an allocation process based on algorithms.

Concerns, however, existed with this type of share distribution. For one, there would be no way to avoid long queues on the first day of sale. Secondly, there was no way to target "desired" small investors, and, irrespective of how good the initial allocation of shares was made to the branches, it was likely that one or more branches would run out of shares to sell, and the problem of reallocation of shares would arise.

CLOSING

The last five to ten minutes can be used to "recap" the key issues of the SFM case (Annex IX), or to launch into a broader consideration, such as: Was SFM an appropriate privatization candidate?

Finally, the "A" case for SFM is accompanied by a "B" case, which describes the outcome of the public offering of the company in May, 1991. The "B" case can be distributed simultaneously with the "A" case, or as a handout following the case session. The latter approach is recommended, since debate is less likely to be stifled if students do not know the transaction outcome prior to the case session. If the instructor chooses to delve further into the "B" case during a follow-on training session, recommended questions include: Was SFM a "successful" public offering candidate? Does the government have any role to play post-privatization? What further information should be analyzed regarding the transaction (i.e., costs involved)? What should be done, if anything, to ensure that all employee shares are bought during the one year employee share subscription period following the transaction?

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Annex I
Swarzedzkie Fabryki Mebli S.A. (A)
Board Plan

B1

Decisionmaking Areas

PRIVATIZATION MECHANISM

- Public Offering
- Technical Partner
- Other (i.e., management-employee buyout, etc.)

TIMING

- Privatize now
- Fully restructure, then privatize
- Partially restructure, then privatize

RESTRUCTURING

- Operational
- Organizational
- Financial

VALUATION

- Book Value
- Liquidation Value
- Discounted Cash Flow
- Other (i.e., P/E ratios)

Annex II
Swarzedzkie Fabryki Mebli S.A. (A)
Board Plan

B2

SFM Weaknesses

ORGANIZATIONAL

OPERATIONAL

FINANCIAL

Annex III
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Privatization Strategies Recommended by the IFC

(I) Technical Partner

Pros	Cons
capital equipment	friction, esp. if foreign
financing (equity/debt)	SFM had basic technical know-how
marketing skills	shares sold at discount
accounting/cost control knowledge	high staffing levels of SFM
management know-how	

(II) Full Restructure; Delay Sale

Pros	Cons
Wider range of selling options	Heavy govt. involvement; complex
Higher price attainable	Govt. bears risk of failure
Lower risk to individual investors	Did govt. have skills to manage SFM?
	Delay sale of well-known SOE
	Impact on privatization program image
	Set unreplicable precedent
	Govt. lack of funding
	New owner undoes restructuring plan

(III) Partial Restructure; Sell Through Public Offering

Pros	Cons
Stop short-term cash outflow	Cost of restructuring plan
Improve medium to long-term profitability	Risk of plan failure
Sell SFM as soon as possible	Risk capital losses for individual investors
Get program back on track	

Annex IV
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Debt Restructuring Options

(i) GOVERNMENT TAKEOVER OF DEBT

Pros	Cons
fastest alternative	sets precedent
reduces investment risk	no govt. proceeds from sale
increases equity value	need equity proceeds > debt assumed

(ii) DEBT-EQUITY SWAP

Pros	Cons
politically acceptable option	Bank Gdanski - controlling interest
relatively easy to implement	may not exchange full value of debt
	how to value equity per share?
	exact portion depends on bank-govt. negotiations

(III) PRIMARY ISSUE TO REPAY SFM DEBT

Pros	Cons
	debt stays on books
	legal uncertainty

(IV) EXCHANGE SHORT-TERM DEBT FOR LONGER TERM LOAN

Pros	Cons
	undeveloped Polish capital mkts
	debt stays on books

Annex V

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

SFM Projections: Balance Statements, 1991-2000

(Constant Zlotys Billion, January 1991 Prices)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
CURRENT ASSETS										
Cash	3,600	3,869	4,129	4,022	3,953	4,068	4,159	4,255	4,395	4,589
Accounts Receivables	24,605	27,987	30,940	33,159	34,735	36,584	37,323	37,990	39,376	40,865
Inventory of Raw Materials	31,920	35,902	39,936	41,129	40,547	41,313	40,751	40,267	41,515	42,853
Work in Progress	13,174	14,724	16,274	17,431	18,252	19,226	19,602	19,952	20,687	21,469
Inventory Finished Goods	8,782	9,816	10,849	11,621	12,168	12,817	13,068	13,301	13,791	14,313
Securities	3,923	3,063	5,387	11,972	22,727	35,632	52,908	72,691	92,959	114,081
TOTAL CURRENT ASSETS	86,004	95,361	107,515	119,334	132,382	149,640	167,811	188,456	212,723	238,170
FIXED ASSETS										
Land and Buildings	225,396	225,396	225,396	225,396	225,396	225,396	225,396	225,396	225,396	225,396
Machinery and Equipment	86,678	86,678	86,678	86,678	86,678	86,678	86,678	86,678	86,678	86,678
Installations	1,390	10,890	25,140	44,140	63,140	82,140	101,140	120,140	139,140	158,140
Vehicles and Office Equipment	8,894	8,894	8,894	8,894	8,894	8,894	8,894	8,894	8,894	8,894
Long Term Investments	2,148	2,148	2,148	2,148	2,148	2,148	2,148	2,148	2,148	2,148
TOTAL FIXED ASSETS	324,506	334,006	348,256	367,256	386,256	405,256	424,256	443,256	462,256	481,256
LESS: Accumulated Depreciation	110,982	130,513	151,468	174,324	199,079	225,735	254,290	284,746	317,101	350,113
NET FIXED ASSETS	213,524	203,493	196,788	192,932	187,177	179,521	169,966	158,510	145,155	131,143
DEFERRED ASSETS										
Engineering	3,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000
Supervision										
Pre-operating Expenses										
Interest During Construction										
Cap. Foreign Exchange Fluct.										
TOTAL DEFERRED ASSETS	3,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000
LESS: Accumulated Amortization	600	1,800	3,000	4,200	4,800	4,800	4,800	4,800	4,800	4,800
NET DEFERRED ASSETS	2,400	4,200	3,000	1,800	1,200	1,200	1,200	1,200	1,200	1,200
TOTAL ASSETS	301,928	303,054	307,303	314,066	320,759	330,361	338,977	348,166	359,078	370,513

SOURCE: International Finance Corporation

Annex V (cont'd)
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
SFM Projections: Balance Statements, 1991-2000
(Constant Zlotys Billion, January 1991 Prices)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
CURRENT LIABILITIES										
Short Term Debt										
Accounts Payable	31,526	35,574	39,701	41,471	41,694	43,187	42,797	42,540	43,843	45,299
Other Short Term Debt										
Retirement Fund										
Current Portion of LTD										
TOTAL CURRENT LIABILITIES	31,526	35,574	39,701	41,471	41,694	43,187	42,797	42,540	43,843	45,299
LONG TERM LIABILITIES										
Zloty - Long Term										
TOTAL LONG TERM LIABILITIES										
LESS: Current Portion of LTD										
NET LONG TERM LIABILITIES										
SHAREHOLDERS' EQUITY										
Paid In Share Capital	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190
Other										
Retained Earnings	(14,788)	(17,710)	(17,588)	(12,595)	(6,125)	1,983	10,991	20,437	30,044	40,023
Reserves and Other										
TOTAL SHAREHOLDERS' EQUITY	270,402	267,480	267,602	272,595	279,065	287,173	296,181	305,627	315,234	325,213
TOTAL LIABILITIES AND CAPITAL	301,928	303,054	307,303	314,066	320,759	330,360	338,978	348,167	359,077	370,512

SOURCE: International Finance Corporation

Annex V (cont'd)

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

SFM Projections: Income Statements, 1991-2000

(Constant Zlotys Billion, January 1991 Prices)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
NET SALES	404,793	461,198	509,865	545,289	569,102	599,311	609,253	617,391	637,720	660,129
PRODUCTION COSTS										
Variable Costs										
Wood	121,364	138,355	155,980	169,987	180,537	195,249	195,728	197,428	203,300	210,548
Materials	130,840	146,233	161,628	161,780	153,016	150,251	146,645	142,891	147,441	151,845
Direct Labor	49,901	55,771	61,735	65,543	67,996	70,525	72,317	74,190	77,320	80,972
Electric Power	13,024	13,675	14,359	15,077	15,830	16,622	17,453	18,326	19,242	20,204
Other Costs	24,771	26,010	27,310	28,676	30,109	31,615	33,196	34,855	36,598	38,428
Leasing Expenses	12,471	13,938	15,405	6,331						
Fixed Costs										
Depreciation	18,580	19,530	20,955	22,855	24,755	26,655	28,555	30,455	32,355	33,012
TOTAL COST OF GOODS SOLD	370,951	413,512	457,372	470,249	472,243	490,917	493,894	498,145	516,256	535,009
GROSS INCOME	33,842	47,686	52,493	75,040	96,859	108,394	115,359	119,246	121,464	125,120
OPERATING EXPENSES										
Sales Expenses	34,845	35,542	36,253	36,978	37,717	38,472	39,241	40,026	40,826	41,643
General Administration	3,795	3,871	3,948	4,027	4,108	4,190	4,274	4,359	4,446	4,535
Education Fund	4,241	4,241	4,241	4,241	4,241	4,241	4,241	4,241	4,241	4,241
Land Usage Tax	5,148	5,754	6,360	6,788	7,064	7,433	7,552	7,646	7,900	8,176
Amortization	600	1,200	1,200	1,200	600					
TOTAL OPERATING EXPENSES	48,629	50,608	52,002	53,234	53,730	54,336	55,308	56,272	57,413	58,595
OPERATING INCOME	(14,787)	(2,922)	491	21,806	43,129	54,058	60,051	62,974	64,051	66,525
OTHER EXPENSES										
Interest Short Term Debt										
Interest Long Term Debt										
Dividends Received										
Loan Profit Participation										
TOTAL OTHER EXPENSES										
INCOME BEFORE TAX	(14,787)	(2,922)	491	21,806	43,129	54,058	60,051	62,974	64,051	66,525
WORKERS PARTICIPATION										
INCOME TAX				1,835	17,251	21,623	24,020	25,189	25,620	26,610
NET INCOME	(14,787)	(2,922)	491	19,971	25,878	32,435	36,031	37,785	38,431	39,915

SOURCE: International Finance Corporation

Annex VI
SWARZEDZKIE FABRYKI MEBLI S.A. (A)
Summary of Projections, 1991-2000
(Constant Zloty Million, January 1991 Prices)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Net Sales	404,793	461,198	509,865	545,289	569,102	599,311	609,253	617,391	637,720	660,129
Net Income	(14,788)	(2,923)	491	19,972	25,877	32,435	36,031	37,784	38,430	39,914
Outstanding Short Term Debt										
Outstanding Securities	3,923	3,063	5,387	11,972	22,727	35,632	52,908	72,691	92,959	114,081
Short Term Interest Paid										
Total Long Term Debt										
Paid In Capital	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190	285,190
Workers Participation										
Total Equity	270,402	267,480	267,602	272,595	279,065	287,173	296,181	305,627	315,234	325,213
Total Assets	301,928	303,053	307,303	314,066	320,759	330,361	338,978	348,167	359,077	370,512
Cash Generation	4,393	17,808	22,646	44,027	51,233	59,091	64,586	68,239	70,785	72,927
Cash Dividends Paid			368	14,979	19,408	24,326	27,023	28,338	28,823	29,936
Book Value in Year 2000										325,213

SOURCE: International Finance Corporation

SFM Shares Outstanding (prior to privatization) = 2,000,000

Dividend Payout Ratio 75%

Foreign Exchange Rate 9,500

	NPV (Zl)	NPV (US$ mm)	Price/Share (Zl)	
20%	121,552	12.79	60,776	
21%	114,732	12.08	57,366	
22%	108,413	11.41	54,207	
23%	102,552	10.79	51,276	
24%	97,110	10.22	48,555	
25%	92,052	9.69	46,026	
26%	87,346	9.19	43,673	<== Debated Share Price Range
27%	82,962	8.73	41,481	
28%	78,876	8.30	39,438	
29%	75,062	7.90	37,531	
30%	71,500	7.53	35,750	

Annex VI (cont'd)

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

Summary of Projections, 1991-2000

(Constant Zloty Million, January 1991 Prices)

Specific Cashflow Assumptions made by the IFC:

(1) sale prices of products correspond to those prevailing in September, 1990, except for a few products whose price increased as a result of price negotiations that took place in October and November, 1990.

(2) wood prices were assumed to increase 2% per annum in real terms from the price prevailing in January, 1991 (the prices prevailing in September, 1990 were incrased by 10% to reflect January, 1991 prices).

(3) the costs of materials (including imported items) were based on September, 1990 figures, corrected upward by 5% to reflect January, 1991 prices.

(4) labor costs incorporate a salary increase of 50% granted to the employees of SFM in November, 1990, and assume real wages will rise 4% per annum.

(5) all other production costs were assumed to be constant in real terms.

(6) all short-term debt, except suppliers' credit, was removed.

SOURCE: International Finance Corporation

Annex VII

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

Market Comparisons - Pilot Public Offering Candidates

Company	Nominal Value per share Zl ('000)	Book Value per share Zl ('000)	Issue Price per share Zl ('000)	Issue Price / Nominal Value (%)	Issue Price / Book Value (%)
EXBUD	50	164	112	224	68
TONSIL	40	52	80	200	154
KABLI	50	65	70	140	108
KROSNO	50	95	65	130	68
PROCHNIK	20	46	50	250	109
SFM, Feb 91	25	56	40	160	71
SFM, May 91	25	56	50	200	89

SOURCE: International Finance Corporation

Annex VIII

SWARZEDZKIE FABRYKI MEBLI S.A. (A)

Sensivity Analyses Conducted by the IFC

MARKET GROWTH

% of Base Case	SFM Value (US$ mm)
85	(10.3)
90	(2.8)
95	4.7
100	9.4
105	13.3
110	17.3
115	20.6

PRODUCTIVITY IMPROVEMENTS

% of Base Case	SFM Value (US$ mm)
85	----
90	----
95	5.6
100	9.4
105	12.1
110	13.7
115	15.2

WOOD PRICES

% Real Growth p.a.	SFM Value (US$ mm)
0	11.2
1	10.8
2	10.3
3	9.9
4	9.4
5	9.0
6	8.5
7	7.9
8	7.2

LABOR RATES

% Real Growth p.a.	SFM Value (US$ mm)
0	12.0
1	10.7
2	9.4
3	8.1
4	6.4
5	4.8
6	2.2
7	(2.3)
8	(7.1)

DIVIDEND PAYOUT RATIO

Dividend Payout Ratio	SFM Value (US$ mm)
55%	8.8
65%	9.1
75%	9.4
85%	9.7
95%	10.1

ZLOTY DEVALUATION, (end 1991)

%	SFM Value (US$ mm)
0%	9.4
5%	13.8
10%	16.9
15%	20.1

SOURCE: International Finance Corporation

Annex IX

Swarzedzkie Fabryki Mebli S.A. (A)

<u>SFM Key Strategic Decisions</u>