

HUNGARY - REDEPLOYMENT OF FINANCIAL ASSETS, RESTRUCTURING, AND PRIVATIZATION

ENTERPRISE CLASSIFICATION AND SCREENING PROCESS

Introduction

This document serves as official deliverable to USAID under the technical assistance program provided by KPMG Policy Economics Group (KPMG PEG) to the Hungarian State Holding Company (AVRt.). One of the most important foundations for the successful completion of the project is the proper classification of AVRt. enterprises.

KPMG PEG professionals have been actively assessing and screening companies in the AVRt. portfolio as possible candidates for enterprise financial/operational restructuring and privatization advisory services. This has been accomplished through the collection and analysis of available financial and other information published by the Controlling Office of the AVRt. In addition, KPMG PEG personnel conducted several interviews with AVRt. portfolio directors and privatization directors. We describe below the conceptual framework and analytic tools used to screen the enterprises in the AVRt. portfolio,

Enterprise Screening

A. *Quantitative analysis*

In our analysis, KPMG PEG sought to identify the sources of shareholder value (or lack of sources) and to provide structured guidelines for realizing this value. Our efforts were based on the key assumption that the objective is to maximize the inherent value of the enterprise portfolio.

Our initial approach was to benchmark shareholder value by looking at the return on equity (ROE) versus the accepted cost of equity in a given industry. During our preliminary analysis, we found that few companies in the AVRt. portfolio earn sufficient ROE to ensure adequate shareholder return. In order to better understand the issues facing the enterprises prior to privatization, we have further analyzed the components of the ROE. In our analysis, we made use of the Dupont formula to dissect the companies' earnings potential (see Appendix H.).

This additional ratio analysis helped identify the optimum capital structure of the enterprises as a key measure indicating leverage and the need for potential financial restructuring. Through further analysis of ROE in low leverage companies the inherent operating position of a company can be assessed. By analyzing the profitability and sales to asset turnover of an enterprise, the operating conditions of the enterprise can be highlighted as an indicator of the need for operations restructuring. A matrix of the entire

portfolio indicating financial condition versus operational condition was plotted to determine the health of enterprises in the portfolio.

Using the quantitative criteria described above, we classified the enterprises into different categories:

- (1) enterprises that can be privatized with relatively little difficulty;
- (2) enterprises that require financial restructuring;
- (3) enterprises that need to be operationally restructured due to cost or sales/marketing problems;
- (4) enterprises that may be liquidated or, in case of socially sensitive cases, restructured such that losses will be minimized.

We have consistently followed this approach in all of the different AVRt. portfolios, including industry, infrastructure, brand names, and agriculture.

The next task is to determine the optimal time horizon to execute the planned transfer of ownership for the different enterprise categories outlined above. Although in many cases restructuring may be necessary, due to the desire to achieve rapid ownership transfer value, trade-offs may be considered between current transaction potential and future value maximization.

Finally, this analytic understanding can be coupled with an understanding of an individual enterprise situation to allow classification of enterprises. From this initial classification, a set of companies can be selected for implementation of the requisite privatization and/or restructuring program.

B. Qualitative Screening

In certain cases, although the quantitative analysis would not have classified an enterprise in the positive category, based on discussions with AVRt. management, we included companies in the roster, in order to be responsive to AVRt.'s strategic priorities or to reflect certain non-quantitative or very recent information not available from the Controlling Office.

Appendix C lists all 163 companies in the AVRt. portfolio. After the screening exercise, those companies that, at the time of our initial analysis, looked like the most likely candidates for further assistance are listed below:

Infrastructure Portfolio

MAHART - Hungarian Water Transport Corp.
Five Regional Water Works
Five Regional Gas Distribution Companies

Industry Portfolio

Chinion Pharmaceuticals and Chemicals Corp.
Richter Gedeon

Biogal Pharmaceuticals Corp.
EGIS Pharmaceuticals Corp.
Alkaloida Chemicals Corp.
Fuzfo Nitro Chemicals

Agricultural Portfolio

Lake Ferto Reed Farming Corp.
Mezofalva Farming Production and Service
Szerencs Agricultural Corp.

Brand Name Portfolio

Pharmaceutical Research Co.
Zsolnay Porcelain Manufacturing Corp.
Kalocsa Regional Agricultural Corp.
Budapest Meat Company (HERZ)
Tokajhegyalja State Wineries
Therapeutic Aids Factory
HUNGAROPHARMA Trading Corp.

Cultural Portfolio

Budapest Film Studio
MOKEP - Film Distribution Co.
Edito Musica Budapest Music Publishers
Szikra Press Corp.
Sporting Facilities Co.

C. Notes on Enterprise Elimination

Short explanations can be found below explaining the reasons for eliminating the remaining companies from the initial screen. Although some of these companies were able to pass the financial requirements, they were screened out of the process for the following reasons: companies that have already been privatized, most often through Employee Stock Ownership Plans, or are in an advanced stage of privatization were eliminated from the screen; companies working with existing Western advisors were screened and companies whose successful privatization was dependent upon the introduction and passing of new government legislation were screened out of the process.

Since this initial screening, however, the AVRt. indicated its need and desire to involve KPMG PEG's assistance in certain companies even in cases where it already has appointed a Western advisor. These enterprises are marked with asterisk.

Energy and Gas Portfolio

Enterprises in this portfolio were eliminated from the target list of companies as all are currently working with Western advisors, and are in advanced stages of the privatization process.

Infrastructure Portfolio

Malev Airlines(*), Hungarocamion, Matav and Antenna Hungaria(*) were eliminated from the initial list of available companies. Malev has been privatized through a partial sale to

Alitalia; Hungarocarion is in poor financial condition and is burdened with significant environmental problems; Matav has already been privatized; and Antenna Hungaria is waiting on new legislation to be written and passed by parliament before privatization which is expected to take an extended period of time.

Industry Portfolio

Dunaferr, Hungalu, Raba, Ikarus, and Borsodchem are some of the largest and most problematic of Hungary's heavy industry enterprises. Each of these companies has significant financial, operational and environmental problems. We have been advised that the EC PHARE program will be funding assessment work of many of these enterprises and as a result they have been screened out of the process.

Agricultural Portfolio

Most companies from this portfolio have been screened out of the process because the enterprises are subject to the Land Law which has not yet passed through Parliament. The Land Law states that (i) no economic entity can own land, (ii) the AVRt. does not have the jurisdiction to sell land, and (iii) the AVRt. cannot grant long-term leases. In addition, all enterprises are subject to the Restitution Law which is scheduled to be resolved by March 1994 but is expected to take longer.

Forestry Portfolio

Enterprises from this portfolio have been screened out of the process because all are subject to the Land Law described above.

Research and Development Portfolio

Enterprises in this portfolio have been screened out of the process because they have been run as not-for-profit organizations and lack the financial and organizational infrastructure necessary for successful restructuring and privatization. Additionally, most of the enterprises are owned by a consortium of companies in their respective sectors and are not run as individual enterprises.

Brand Names Portfolio

The Herend Porcelain Company, Szegedi Paprika, PICK Szeged have already gone through some form of privatization and thus have been eliminated from the list of potential companies. MERTCONTROL and State Administrative Computer Services are companies that did not pass the financial screen and also lack the industry positioning necessary for a successful privatization. Matra Copper Mining and Mecsek Uranium Mining are companies with significant environmental liabilities. Pecunia Hungarian Mint, Bank Note Printing Press and CD Hungary are enterprises which will not be privatized by the AVRT. Rt. due to their strategic importance. Gaming Corp. has been screened because of its ownership of casinos and other gambling establishments. Technika Foreign Trade and Mechanical Laboratories have been screened out as they are active in the development and trade of weaponry.

Cultural Portfolio

The majority of enterprises in this portfolio are small and those that are potentially attractive for restructuring and privatization services have already been privatized. The Dialog, Objektiv, Hunnia, MOVI and Hungarofilm companies are small organizations employing less than 10 people and would not be suitable candidates for our purposes.

Hungarian Film Laboratories, MAFilm, Hungarian Dubbing, Pannonia and Kecskemet Animated have all been privatized through ESOPs or investment. National Textbook Publishing and Library Services are run as not-for-profit organizations. And finally, Athenaeum Press, Communal Press and HUNGEXPO are currently working with Western advisors.

Financial Institutions Portfolio

The banks and other financial institutions were not subjected to the screening criteria as an integral part of this assistance program is geared toward helping the banks clean their loan portfolio. Therefore the inclusion of the commercial banks for possible KPMG PEG involvement was assumed as given.

D. Top 10 Enterprise List

Within the list of companies that have been targeted as potential candidates for enterprise restructuring and privatization work at the time of the initial screening process, a shortened list of 10 companies has been arrived at that provides the greatest prospects for success. Since then, due to the change in the AVRT's assistance requirements and as a result of the Memorandum of Understanding between USAID and the AVRT., the emphasis of the assistance shifted to include companies that have relatively weak prospects for privatization. Those companies are not included in the list and brief explanations of each company listed below:

(1) Mahart - Hungarian Water Transport Corp.

Mahart is responsible for all waterborne or related transport activities in the country and is experiencing severe financial and operational hardship. The AVRT. has asked KPMG PEG to begin work on this enterprise immediately. Our two phase assignment has recently been completed and now we await further mandate from the AVRT.

(2) Alkaloida Chemicals Corp.

The smallest of the pharmaceutical companies. The AVRT. Rt. has requested KPMG PEG's immediate assistance in the sale of this enterprise to a strategic investor.

(3) Richter Gedeon

This is Hungary's largest pharmaceutical company. The AVRT. Rt. has received proposals from financial partners but is more interested in privatizing this important strategic asset with a strategic partner. A comprehensive privatization plan may be required by the AVRT.

(4) Biogal Pharmaceuticals Corp.

The second largest pharmaceutical producer in Hungary. The AVRT. needs assistance in developing a comprehensive privatization plan that will maximize the value of the enterprise while minimizing the time necessary for successful privatization.

(5) Lake Ferto Reed Farming Corp.

Manufacturer and processor of reed used in roofing based products. The AVRT. may be seeking assistance in a privatization plan for this enterprise. Employees are interested in an ESOP which the AVRT. disagrees with. A strategic assessment and a privatization plan may be required.

(6) *Zsolnay Porcelain Manufacturing Corp.*

The second most well recognized porcelain producer in Hungary. This company requires financial and operational restructuring assistance as a significant amount of its revenue was derived from exporting to former Yugoslavia.

(7) *Budapest Meat Company (HERZ)*

The second most well recognized sausage producer. PICK Szeged submitted a bid for HERZ which was initially rejected on anti-monopoly grounds but subsequently accepted. HERZ is financially distressed and requires significant financial restructuring and AVRt. may require assistance to negotiate the structuring of the transaction with PICK.

(8) *MOKEP - Film Distribution Co.*

National film distributor. Uncertainty surrounds the potential privatization of this company as the AVRt. wishes to keep ownership in domestic hands while at the same time attract a foreign strategic partner. Strategic and privatization plans are required for the companies successful privatization.

(9) *Szikra Press Corp.*

The largest Hungarian printing company; produces most of the Budapest daily newspapers. The company requires operational restructuring assistance and a privatization plan.

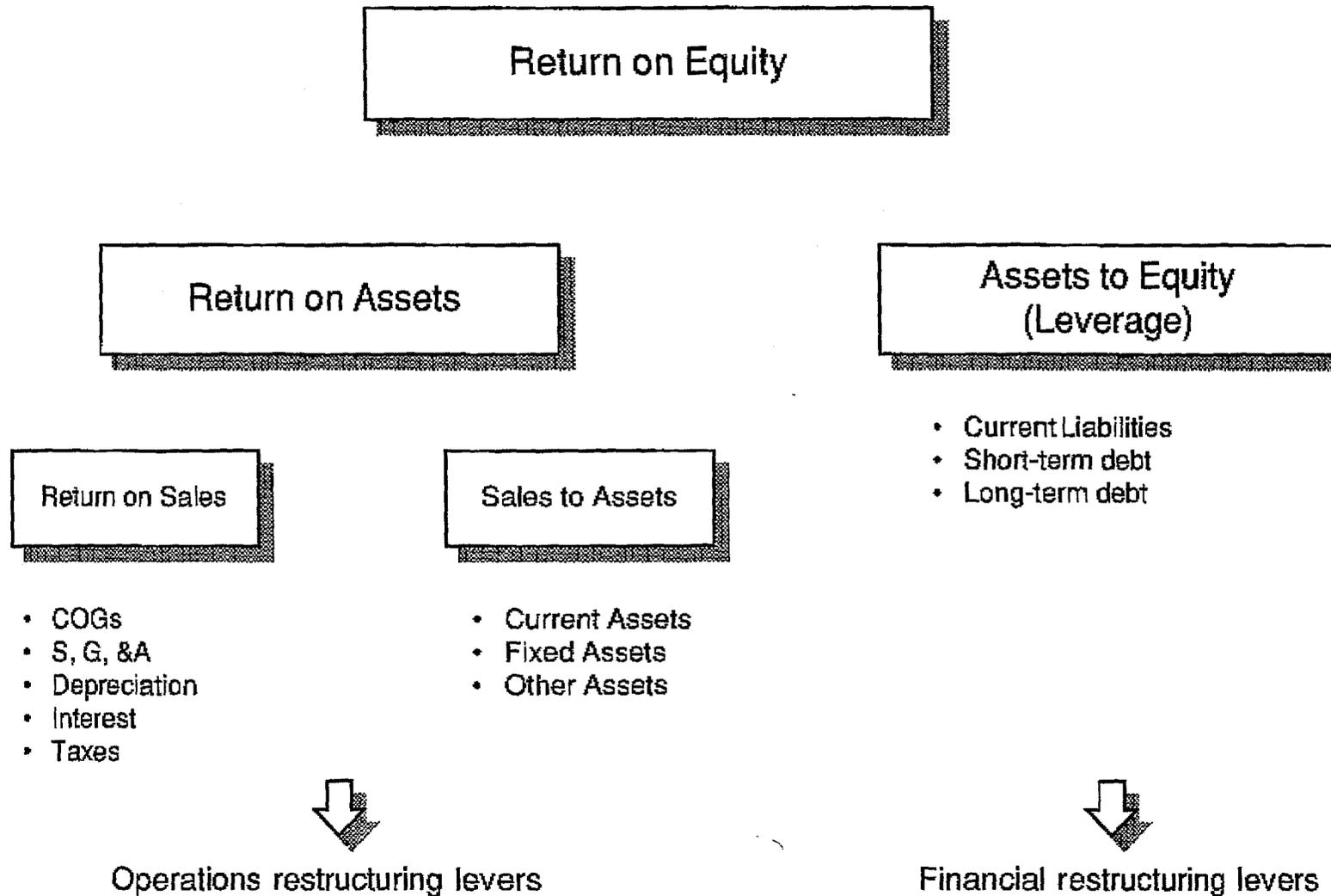
(10) *Sporting Facilities Co.*

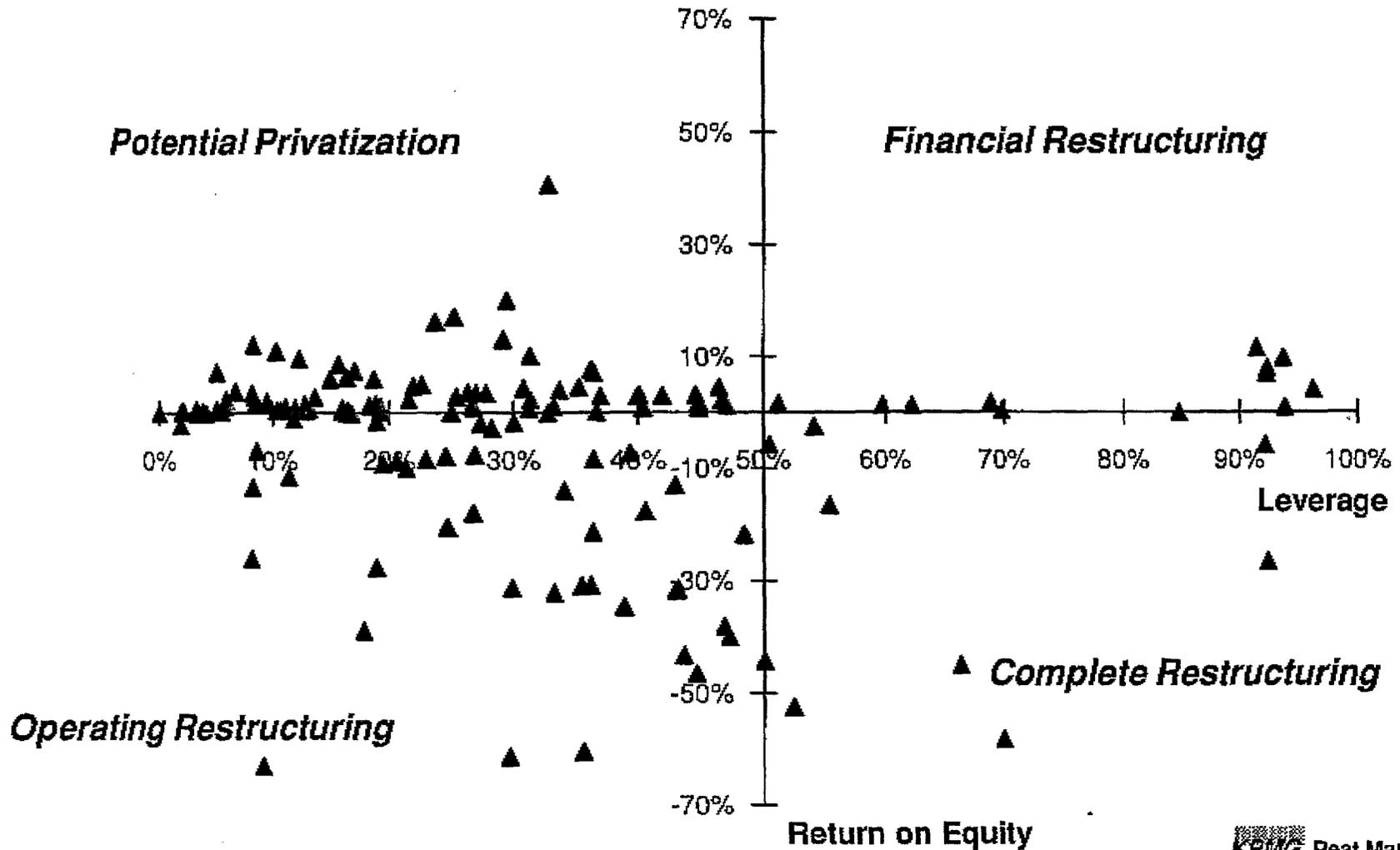
Owner and operator of public not-for-profit sporting facilities located on prime Danube river real estate. A strategic plan is required to balance-off the needs of the public with the commercial potential of the real estate.

While these companies were targeted as the most likely candidates for financial and/or operational restructuring with an ultimate aim toward the successful privatization of each of these enterprises, it is expected that as our work continues in country other enterprises may be added and/or subtracted from the list, in order to reflect the dynamic conditions of AVRt.s portfolio.

AVRt. Enterprise Classification

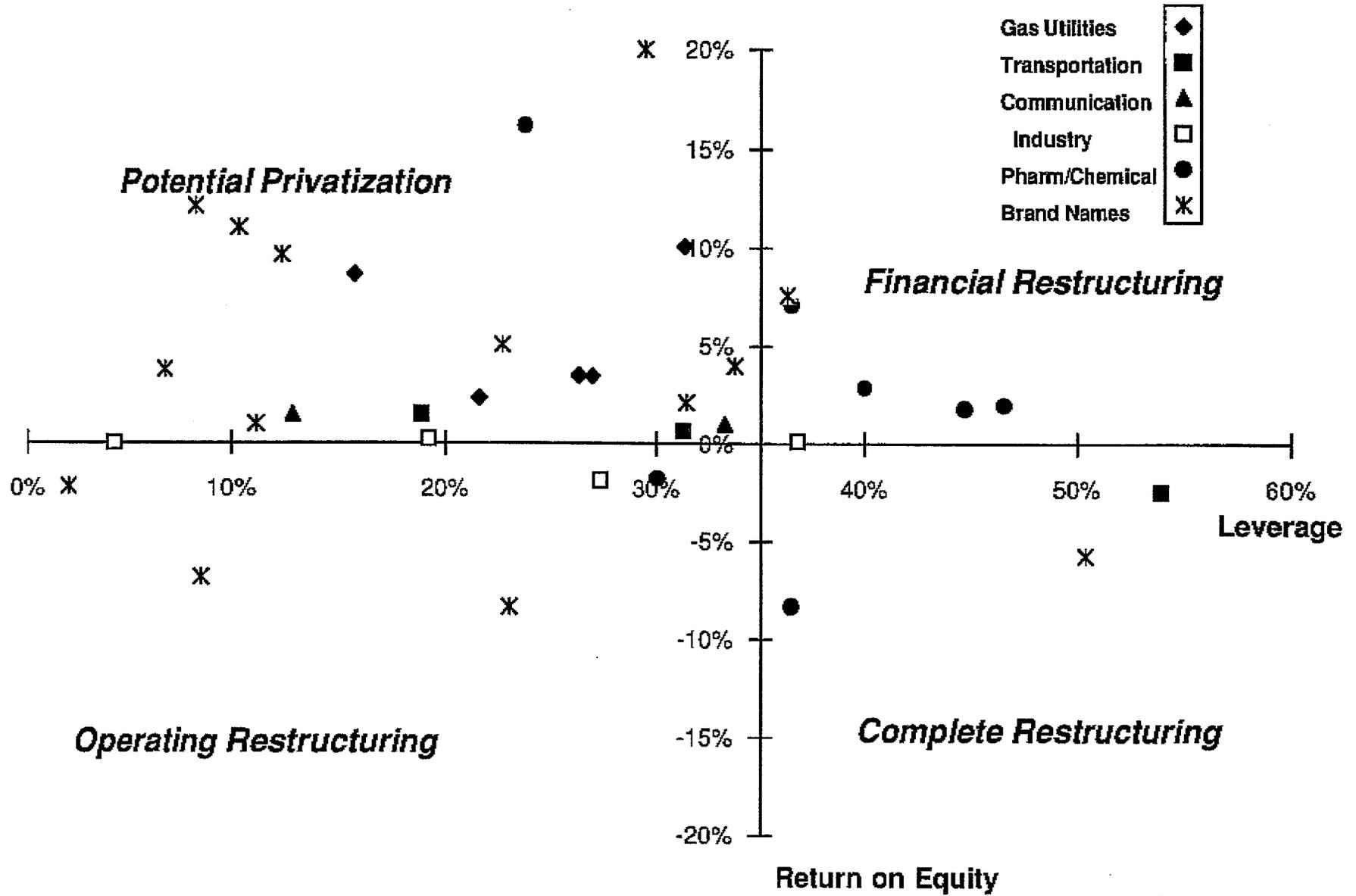
Appendix A - Dupont Analysis



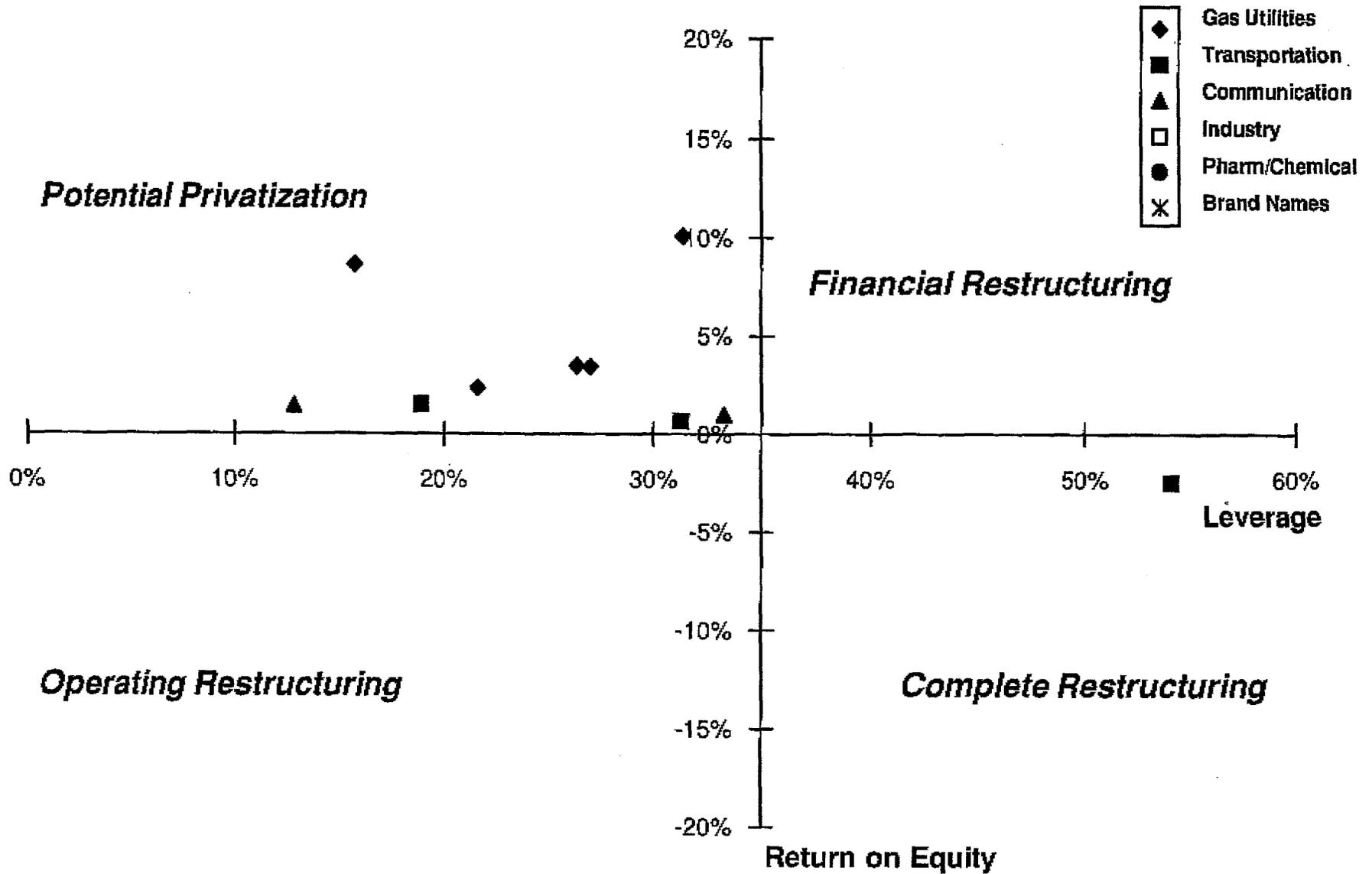


A

AVRt. Enterprise Classification

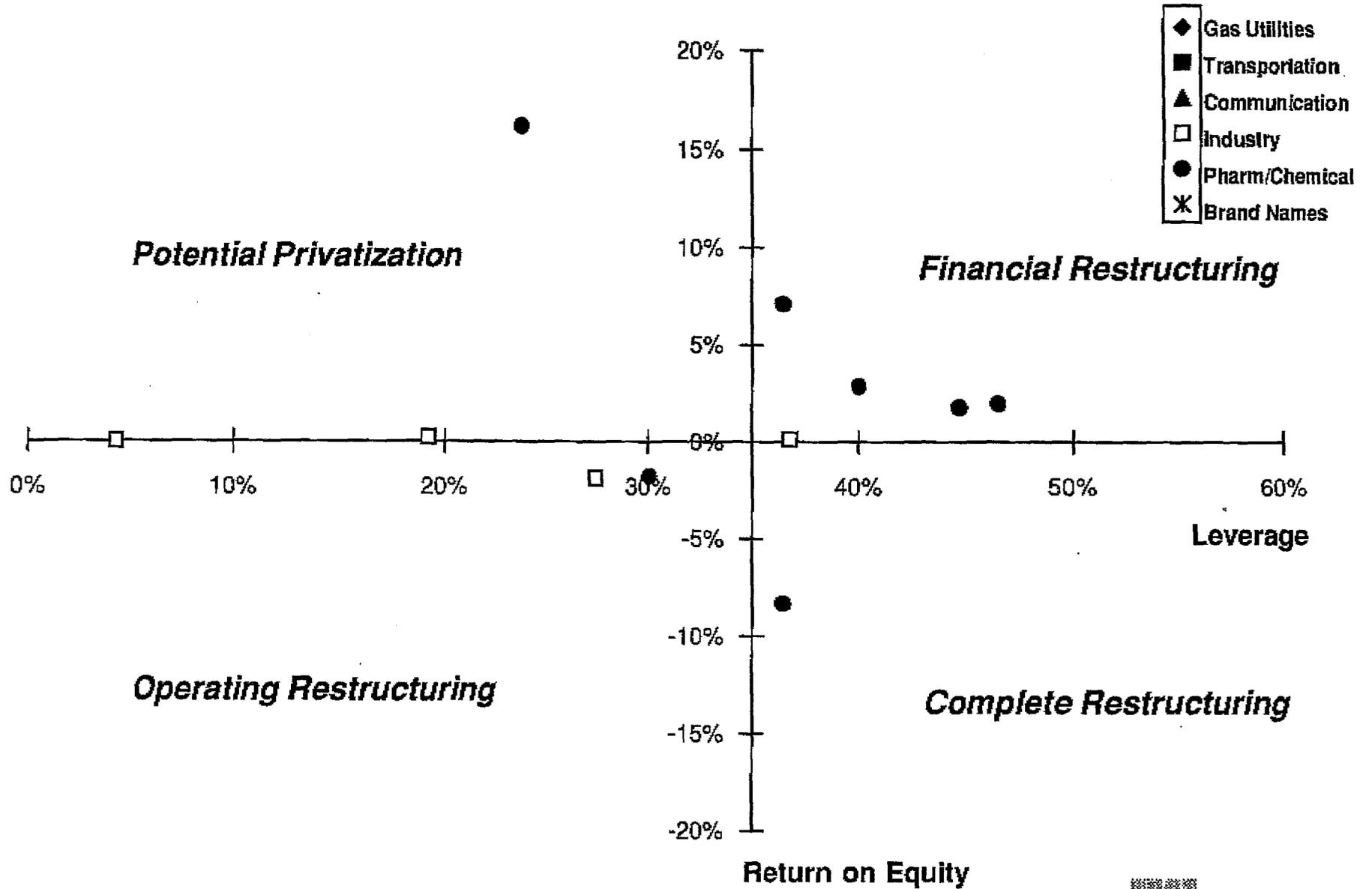


AVRt. Enterprise Classification

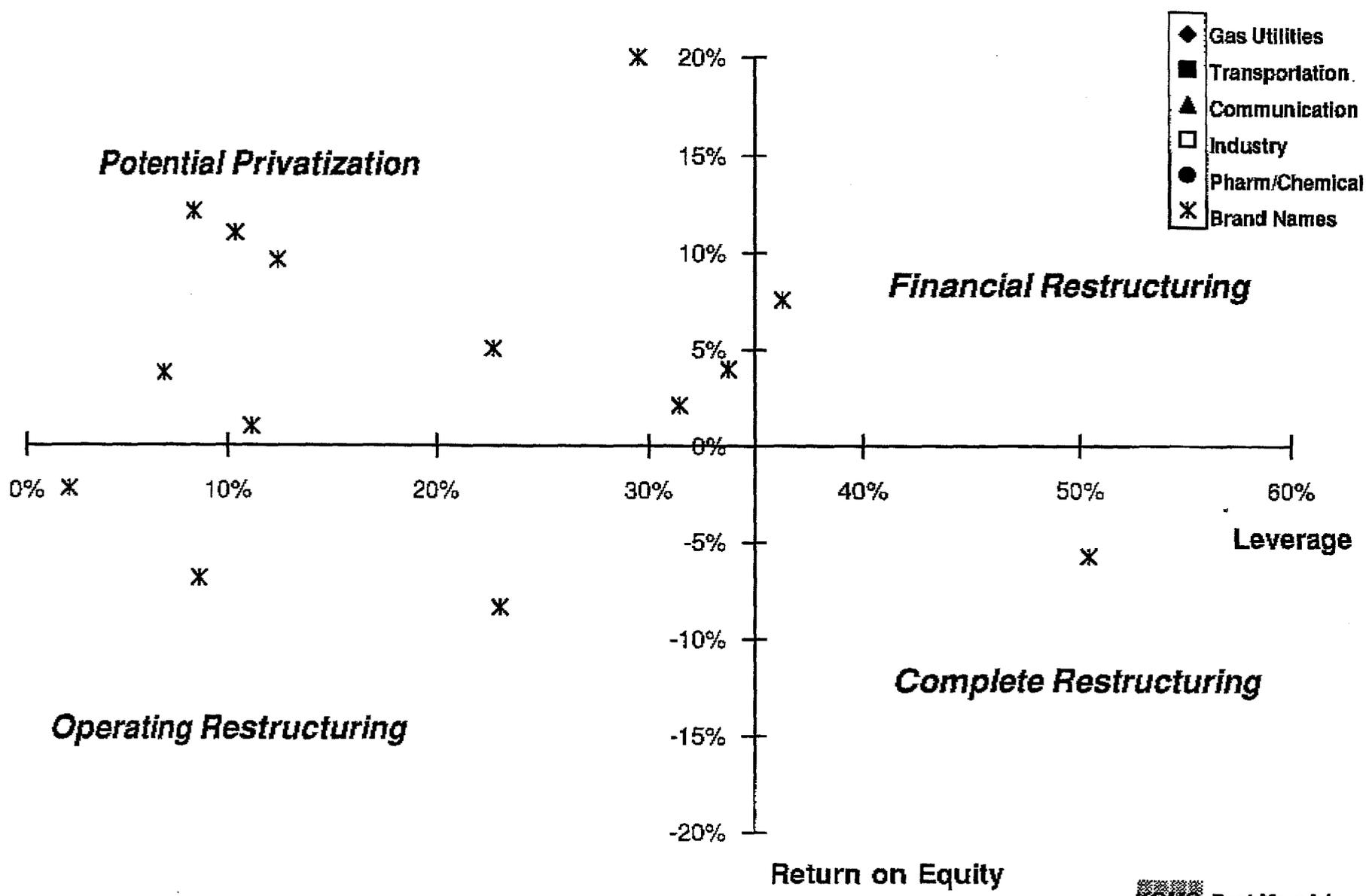


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AVRt. Enterprise Classification



AVRt. Enterprise Classification



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