Mergers & Acqusitions in the Hungarian sugar industry: an interview with Mr. András Kovács

The Austrian AGRANA company acquired the Hungarian-owned Magyar Cukor Rt. (Hungarian Sugar Co.) early 1997, reducing number of owner groups that hold the 12 Hungarian sugar producing plants from 4 to 3. With this move AGRANA added a further 5 plants to its already existing 2 and increased its share of the Hungarian sugar market over 50%. The decision to close a plant was taken soon afterwards. In addition, management decided to pass ownership in two plants on to Eastern Sugar Hungary, a subsidiary of Tate & Lyle of Britain. Soon it became public that the new owner intends to shut down the two plants. At the same time the French-owned Béghin-Say group closed one of its 4 plants. This events received immense publicity. This interview about the strategic aspects of the case has been conducted with Mr. András Kovács, who played an influential role in the privatisation of the Hungarian sugar plants as the CEO from 1989 to 1992 of the now French-owned Mátra Sugar Co., and in the subsequent acquisition as the commercial and marketing director of the Hungarian-owned Hungarian Sugar Co.

Could you describe the main phases of the privatisation of Hungarian sugar plants and the industry structure leading to the recent events?

Negotiations with foreign investors began in 1989, the first privatisation was in 1990. The first privatisation wave of the Hungarian sugar industry was completed in 1991. Three foreign investors acquired minority stakes at this stage. It should be noted, however, that the privatisation contracts signed with Hungarian Privatisation Agency guaranteed majority voting rights and deferred actual majority ownership in shares to later date. During the first phase of privatisation of 12 Hungarian sugar plants, only 5 remained in state ownership. During 1992, when privatisation negotiations resumed, it became apparent that no potential acquirer showed interest in those remaining 5 plants. Investors already present in Hungary tacitly assumed that bankruptcy of those plants was pre-programmed in any case, and the their markets could then be taken over. The year 1993 was a turning point in the privatisation process, as the state owner announced a call for tender for the remaining plants. The second phase of the sugar plant privatisation process ended in November 1994, when the remaining 5 plants where bought out by a joint company, primarily owned by the leading managers of the plants, and by sugar-beet producers in minority.

Please describe the process in which the management of the five remaining sugar plants obtained control over the company!

During the second quarter of 1993 the managers of the five sugar plants created a new limited liability company with the aim to draft an acquisition strategy in case there was no foreign investor interested in the privatisation. The call for tender gave advantage to offers featuring sugar-beet suppliers in the deal. Following earlier unsuccessful attempts to sell them one-by-one, the five plants were offered for sale as a single group. For political reasons it seemed necessary for the management team to include sugar-beet producers in the consortium for the tender offer to be successful. The buy-out vehicle company was owned by managers in 60%, whereas 40% belonged to the sugar-beet producers. A contract guaranteed the control of company to the managers over a period of 15 years. The long period was due to chosen privatisation method: the transaction was to be paid in instalments over several years. The loan was taken out from the Hungarian Privatisation Agency itself. The privatisation contract stipulated the first instalment to be due in 2 years time only.

What were the motivating factors for foreign investors to show interest in the Hungarian sugar industry?

The sugar industry is highly regulated, both in Europe and globally. Sugar counts as strategically important in Hungary, too. Governments usually aim at remaining a self-sufficient producer, guaranteeing the market protection up to the extent of domestic demands. Thus, acquisition was the only possible point of entry to the Hungarian sugar market, coupled with the fact that, due to industry-wide capacity surplus, greenfield investments would have been uneconomic. For the players in the international sugar industry with considerable accumulated financial resources, acquisition seemed the best option for entry.

How did the foreign strategic investors integrate their newly bought plants, what organisational changes occurred?

The sugar plants remained separate legal entities, but continued working in the form of a holding structure. Béghin-Say opened headquarters in Budapest with full decision authority over the four acquired plants. The Austrian AGRANA directs its Hungarian operations straight from Vienna.

What happened to former managers?

In most cases former Hungarian managers retained their positions. Their authority has been drastically reduced with the advent of real ownership control, a new situation which had frequently caused conflicts. On the other hand I think that the reduction in their authority has been compensated with wages multiplied in real terms.

How did market competition amongst the interest groups develop?

As a result of the high production costs, sugar plants almost exclusively sell on the national market. The world market price for sugar tends to be low anyhow, as it is mostly the pooling of national production surpluses. Richer nations also subsidise sugar export to a greater extent than Hungary can. The products are hardly differentiated, and brands command only a small premium price. The main competitive weapon is price. Due to the oligopoly structure in the sugar industry, price competition reduces aggregate profits at the level of the industry. The five Hungarian sugar plants caused quite a distress. They often offered price discounts so that to help their cash flow position. In addition, the use of substitute products is the source of important competition, and it is now spreading in Hungary.

Are substitutes indeed so significant?

Sugar-beet production is threatened by the appearance of isoglucose on the Hungarian market, offering a perfect sugar substitute for industrial consumers. The capacity of the substitute production in Hungary is equivalent of 150 000 tons of sugar, which is quite remarkable, considering that total demand for is in the range of 450000–500000 tons. In the European Union, as soon as development of substitute products began, a quota of 2% was set for these products.

On the global scale there is intense competition between multinational companies concerned with sugar and its substitutes. Soft drink producers also play a major role in the competitive bottle, which is intensely fought in economic and political spheres as well. Considering the Hungarian situation, interestingly, some players directly, others indirectly (through ownership ties) are involved both in sugar refining and substitute products.

What developments did the new owners realise at the Hungarian sugar plants?

They have invested over 10 billion forints to date (100 million DM), which kept the Hungarian sugar refining industry still alive, after several years of loss-making. Very little was spent on actual developments. In fact, pre-privatisation investments were at much higher levels! There are investors who openly declared that no significant investments will be made unless Hungarian sugar market is cleared up, judging the domestic sugar market to be too insecure. Most finances were used to maintain liquidity.

How did plant performance develop in terms of costs?

The real prices fell due to high inflation. Costs were not reduced sufficiently, despite of staff lay-offs. The single most important cost is the raw materials, sugar-beet, where we managed to pass on, to some extent, the negative tendencies to the producers.

Energy costs can only be reduced with significant investments into modern technology. Depending on which plants will continue to operate, significant technology modernisation will occur only later, allowing for subsequent capacity increase and better product quality.

What where the reasons for the recent acquisitions?

For AGRANA the most important reason was the capture of the market share of the target, rather than the capacity of the acquired plants. With technology improvements even 2 plants would be enough to cover its market share in Hungary.

The initial plan of the company formed by the managers of the five plants was to maintain the functioning to the plants, which would also secure their management positions. Real profit for themselves as owners was merely distant possibility. Their plan included to unite the management of the five plants under a single unit, secure finances necessary for basic operations, and to create Hungarian sugar industry regulation ready for the EU. Owner-managers judged these three aspects to be the prerequisites for company survival and long-term profitability.

The plants were swiftly merged. Managers then placed great emphasis on speeding up the process of restructuring the sugar market. No regulatory framework existed in Hungary for the sugar market, and potential over-production was only avoided by self-restriction of producers' capacity outputs. This is still the case today. Producers agree on output level from year to year.

Price increases to follow inflation were not possible in the sugar market. The Hungarian Sugar Co. thus did not see any potential profits on its operations. Other producers solved cash flow problems by pouring more finances into their plants. Maintaining plants as going concerns required high re-capitalisation.

If managers intended to retain their managing positions, why did they not contact potential financial investors?

The managers had a clear and elaborated plan to increase capital. 4 billion Forints would have been raised by company bonds (guaranteeing lower interest rates than bank loans), supplemented with a capital increase to be effected by the Hungarian Privatisation Agency (HPA). Ultimately HPA executives did not vote in favour of the plan. Negotiations with strategic and financial investors followed, without success. Parallel to these events, negotiations with AGRANA started during summer 1995. Soon it became apparent that AGRANA considered the acquisition of the majority stock in the company as the only acceptable outcome of the negotiation. This alternative then proved the only feasible one.

What was the position of the Office for Competition Policy?

The office had to agree with the deal because AGRANA obtained about 50% of the Hungarian sugar market. After due investigation the office gave its consent.

How did the two other sugar producing groups in Hungary react?

There has been no official reaction, but if one is considering that AGRANA immediately bought 2 of the 5 plants, one can assume a pre-arranged deal between the interested parties.

What changes did occur after the change of owner?

Main strategic objectives remained the same, although there is a shift in strategic emphasis. Whilst the previous owners focused on remaining competitive, the new owner tries to achieve market leadership.

Significant cost reductions could be gained if some of the sugar plants were closed down and other plants were upgraded with new production technologies resulting in capacity increases. This possibility also incurred to the previous Hungarian owners, but it would have been difficult to implement a decision on which plant to shut down, due to possible conflicts between the managers of all the five plants.

AGRANA, having acquired the Hungarian Sugar Co. and its five plants, enlarged its control to seven plants altogether. It is obvious that some of these will be closed in the near future. On the top of over-capacity, technology investments will also necessitate the closure of further plants in the long run. The remaining question is only which plant to close?

Were the plant closures predictable?

Already in 1989, industry analysts predicted plant closures to occur when foreign companies take ownership in some of the 12 Hungarian sugar refineries.

The sugar industry is highly concentrated. This is observable at the level of owners and at the output levels of the plants, which are constantly falling. The level of capacity per plant is thus constantly increasing. This trend occurred in Western Europe during the 1970s, and the same trend is showing its first signs in Central Europe now.

Does Hungary's joining the EU pose a threat to the sugar plants?

An important fact to be noticed from our case is that the foreign owners of the Hungarian sugar plants did not retreat, even after facing huge financial losses. One can argue that these financial requirements are relatively small compared to sales and profit levels of the parent companies. But why do they continue their operations?

The same big players can be identified in the EU as in the privatisation of the Hungarian sugar plants. These companies' share of the sugar market quota will grow automatically with EU entry of Hungary. Expected profit levels of the Hungarian sugar plants should then be equivalent to those in the EU, and they will have an enlarged market that is stable due to the quotas. This is why they have supported the Hungarian loss making companies. To me it seems that foreign investors have long term, strategic plans. On the other hand, with the EU entry, the Hungarian sugar plants will still stay in business because each country has its own production quota, securing a future for the best Hungarian sugar companies.

What role did politics have in the whole process?

Several times political decision makers assumed decisive roles. We can take the privatisation process as an example, or the negotiations for capital increase. In the case of Hungarian Sugar Co., politics even played a role in the management team! Politics is involved when determining the national and international sugar production quota. Initially, multinational enterprises could take advantage of their organisational size and negotiation skills during privatisation: they could obtain majority voting rights even with holding minority stock. Since then, however, it has appeared that size can be disadvantageous. It can make foreign companies in Hungary inflexible, since they must refrain from doing things that could hurt their international reputation.