

MBO leads to success story in Northern Moravia

Medium-sized firms have always been seen as a primary target for privatization through the management buyout (MBO). Lisovny plastických hmot (LPH) in Vrbno pod Pradědem, one of the leading Czechoslovak plastics producer, provides an illustration of successful MBO activity in the Czechoslovak privatization.

LPH, národní podnik. originally had eight manufacturing divisions, including plants in Vrbno pod Pradědem, Bruntál, Budišov, Chuchelná, Lutín, Mikulovice and Vyškov. In 1990, the company was demonopolized by ministerial decree and split into eight separate legal entities, the largest of them being the state-owned enterprise LPH Vrbno pod Pradědem. This sizeable spin-off (1992 output CZK 551 million), focusing on the production of molds and thermoplastic moldings through injection molding, was subsequently privatized through management buy-out by direct sale to the limited liability company LPH Vrbno pod Pradědem in August 1992.

MBO or management-led employee buy-out (MEBO)?

The basis for the MBO was a successful privatization project prepared by the management and approved by the Ministries of Industry and Privatization. In 1992, the LPH limited liability company had nine owners, all of them former senior managers of the privatized state enterprise. The inclusion of the wider body of employees as stakeholders is sometimes recommended (resulting in the so-called MEBO) in gaining broad-based acceptance for privatization and enabling it to be carried out swiftly. The managers recognized the employees' role, but at the same time they were well aware that excessive employee control might make it difficult to effect necessary restructuring after privatization and might make decision-making too cumbersome. They decided in favor of patient negotiation with the nearly 800 employees, which resulted in reconciliation of the management's business plan targets with long-term collective agreement principles. At the end, most of the employees supported the management's ambitious plan.

Capital needs

There are typically severe limits on availability of capital for Central and East European managers to meet their financing needs, and LPH managers were no exception. Given the lack of private or venture capital in the Czech Republic at that time, the only feasible form of MBO was a leveraged form. The nine managers put together just CZK 180 thousands, the minimum required by law. Fortunately, as the company was located in the region with the highest unemployment in the Czech Republic, it received preferential treatment from the government allowing payment to the Fund of National Property to be made in 4 annual installments, complemented by a bank loan covering the first installment.

Naturally, the purchasers were extremely dependent on bank loans. There was a constant need for sufficient cash flow to service debt on a relatively short term. At the same time, the new owners' business plan required further financing in order to support regular upgrading of technology.

In 1995, the nine partners invited the German firm Gardena to enter the company as a tenth equal partner. In exchange, the new partner injected a supplement of needed cash both in equity and debt, to be repaid through subcontracted supplies of LPH-produced plastics moldings.

Company restructuring

The MBO showed the strong commitment of the company's manager-owners to achieving medium and long-term development. Perhaps the most vivid illustration of management's dedication was their response to the catastrophic floods in the region in 1997. Soon after the first flood warnings, they mobilized employees to come in on a critical weekend to move important machinery and create special fortifications against the approaching floodwaters. As a result, the company escaped severe flood damage.

Management succeeded in reaching several important milestones through an aggressive restructuring plan. They were able to successfully reorient the company's commodity structure toward highly specialized production, while improving quality to receive ISO 9001 certification from the German agency TUV CERT in 1996. These measures improved access to international companies such as IKEA, Hella and Volkswagen, while LPH's direct exports increased manifold. At the same time, relative production costs were reduced and labor productivity was increased by over 50% in spite of wage increases. In a region where unemployment remains high, LPH continues to produce close to full capacity in three shifts. Due to restructuring, the company was able to reach regularly after-tax profits of over CZK 20 million and positive cash flow of roughly CZK 50 million. Based on these strong results, LPH succeeded in repaying all of its privatization obligations by 1996. Its equity had risen from CZK 180 000 to over CZK 100 million.

Moral: Management must be committed to the company

The management buy-out of LPH is an illustration of how MBO can be an important and successful form of privatization. The key factor in LPH's success has been the commitment of the management team to the company's success and their recognition of the need for important restructuring measures. In many other cases, manager-owners have not acted in the long-term best interests of their company (putting their own short-term gain above the company prosperity) or have collapsed under the pressure of long-lasting financial distress created by unavoidable debt burden. As a result, many Czech leveraged buy-outs have led companies to the brink of bankruptcy.

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