

Privately Managed Privatization in the Czech Republic

Lessons Learned

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About the Author

Mark Sanders served as Director at the *Revitalization Agency a.s.* developing and implementing financial and operational strategies for companies in the State-sponsored industrial restructuring program.

Mr. Sanders graduated with a MBA at *Stanford University, Graduate School of Business, California, in 1996.*

PRIVATELY MANAGED PRIVATIZATION IN THE CZECH REPUBLIC

Mark Sanders



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DEFINITIONS AND DESCRIPTIONS OF MAIN ACTORS

The Czech Consolidation Bank ("Česká konsolidační banka, a.s.", since Fall 2001 "Česká konsolidační agentura" hereafter referred to as "KOB" or "CKA", as applicable) - a financial institution owned by the Czech Ministry of Finance, established for the purpose of managing State assets.

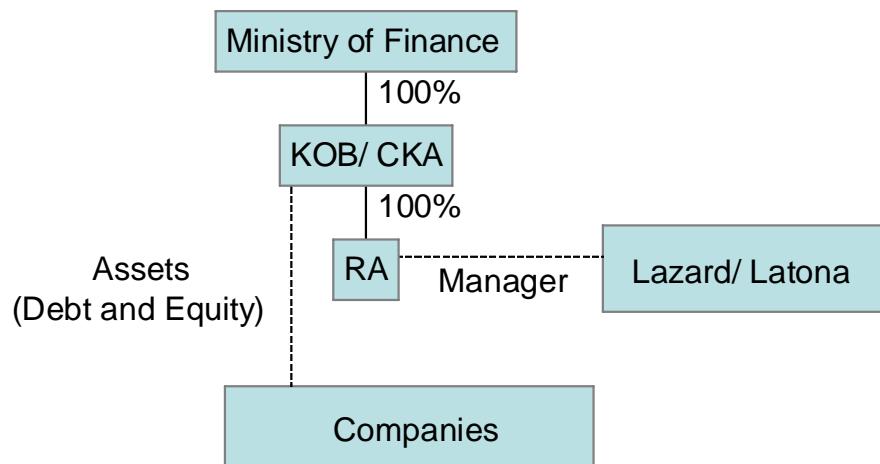
The Revitalization Agency ("RA") - a special purpose vehicle wholly-owned by KOB established for restructuring, managing and eventually selling certain manufacturing firms with substantial debt and equity exposure to the State. KOB hired a professional manager, Lazard/Latona to oversee the Agency

Lazard Freres - a multinational investment bank. Lazard created a joint venture with Latona Associates of Europe to manage the RA

Latona Associates of Europe - a merchant banking group based in the United States. One of the joint venture partners hired to manage the RA

The Manager - a joint venture between Lazard Freres and Latona Associates established to manage the RA, also known as Odien Restructuring Services.

Czech Ministry of Finance - responsible for and owner of KOB and therefore also the RA.





INTRODUCTION

In the late 1990s and the beginning of following decade, the Czech government designed and implemented an innovative industrial restructuring program for eight of the country's most significant, distressed manufacturing companies, as part of a plan to address the widespread financial insolvency of many of the Czech Republic's largest industrial companies and the need to bail out, recapitalize and privatize some of its largest banks.

Operating in a challenging political environment, the independent, professional management of the country's Revitalization program worked to enhance the value of the state assets in its care. However, ultimately, the program's success was undermined by political interference from the outset, and eventually was shut down. The government continued to proceed with the restructuring work of the companies in the program, albeit on a more costly, ad hoc basis.

The discussion below describes the events leading up to the creation of the Revitalization program, the philosophy behind its design and some of the key strategies and techniques used to safeguard and generate value for the state. The RA's program structure addressed independence and supervisory issues; promoting transparency, while providing for government oversight and audit. However, it also provides an illustration of the problems and difficulties that can occur when attempting to address the political influence exerted by interest groups.



THE CZECH CONSOLIDATION BANK AND MACROECONOMIC DEVELOPMENTS OF THE 1990'S

During the first half of the 1990s, the Czech Republic did not employ standard instruments of explicit, rule-based, regulated industrial policy because this would have contradicted the “laissez faire” approach favored by the then right-of-center cabinet. This does not mean, however, that no action in the industrial policy sphere was taken during this period. In fact, a number of state interventions were approved by the cabinet and executed through a special purpose financial institution: The Czech Consolidation Bank (“Česká konsolidační banka, a.s.”, since Fall 2001 “Česká konsolidační agentura” hereafter referred to as “KOB” or “CKA”, as applicable).

KOB was established in 1991 by the former Federal Ministry of Finance as a state monetary institution operating under the supervision of the Ministry with a limited banking license.¹ It was originally established to serve as a “hospital” for non-performing loans (“NPLs”) from the State banking sector, and, as discussed below, it later became the main receptacle of assets from the bail-out of the country’s banking sector in the late 1990s. Especially beginning in 1996, the KOB also started to support and finance large manufacturing enterprises through the allocation of credits (soft loans) to companies that were not able to receive loans from other banks.

With the benefit of hindsight, it is clear that these costly interventions were not successful. Many Czech enterprises, especially those privatized through voucher or coupon privatization (or those auctioned off to budding local entrepreneurs who were able to purchase their companies by borrowing acquisition funds from local, semi-privatized banks) suffered from low work productivity, low competitiveness, over-employment and a lack of capital. In fact, many companies during this period stayed afloat only thanks to government assistance and the unofficial soft loan policy of the country’s large local banks (themselves partially privatized through vouchers). Nevertheless, despite this substantial direct and indirect state aid, the economic and financial performance of these enterprises did not improve. State aid all too often did not facilitate the effective restructuring of the recipient enterprises, and left the Czech taxpayer footing the bill for the companies’ poor financial performance.

The reasons for the lack of success were many, varied, and systemic. For example, corporate governance of companies privatized through coupons or vouchers was typically weak and there were deficiencies in the legal framework (especially bankruptcy law and banking regulation). With respect to KOB, however, one can generalize that the bank’s officers were not trained, rewarded, encouraged or instructed to operate using sound commercial banking and lending principals; nor were they able to generate the reform and restructuring measures that would have

¹ The bank was divided into Czech and Slovak parts after the country’s “Velvet Divorce” in 1993.



ensured an end to future financial reliance on the government. The bank's importance in the Czech economy nevertheless continued to increase. According to published reports by 1998, KOB was the second biggest bank in the country in terms of equity capital, and the fifth largest in terms of assets, becoming the main instrument for government economic intervention and its invisible, unofficial industrial policy.

ECONOMIC DETERIORATION DURING THE SECOND HALF OF THE 1990'S

The weak microeconomic underpinnings of the Czech economy became apparent in the mid-1990s as the trade and payment balances of the country deteriorated rapidly. This in turn resulted in an attack against the local currency, the Czech koruna, during the spring of 1997, a significant increase in interest rates, and abandonment of the fixed exchange rate regime by the Czech National Bank. These negative economic developments were further aggravated by a political crisis that led to the collapse of the then right-of-center coalition government in the fall of 1997; GDP growth contracted sharply. The Czech National Bank's interest rate hike in 1997 was accompanied by more stringent banking regulation, especially with respect to loan loss provisions and recognition of real estate collateral.

Under these circumstances, the lack of microeconomic adjustment (i.e. improvement) in significant segments of the corporate sector was exposed as companies failed to service their debt obligations, and Czech bank portfolios rapidly accumulated non-performing loans. This led to a full scale banking crisis by the end of the 1990s and a wave of corporate insolvencies, including the acute financial distress of some of the country's largest industrial corporations. The lack of microeconomic restructuring in the Czech economy was ultimately reflected in poor economic performance during the second half of the decade. From 1996 – 1999, GDP grew by less than 0.6 percent per annum (World Bank, 2000).



THE REVITALIZATION PROGRAM OF THE SOCIAL DEMOCRATIC GOVERNMENT

UNDERLYING RATIONALE AND POLITICAL CONTEXT OF REVITALIZATION

The Social Democratic government (left-of-center), which came to power in June 1998, faced alarming deficiencies in the capital structures of many of the country's large semi-privatized banks and the *de facto* bankruptcy of some of the country's largest industrial employers. Despite anti-privatization election rhetoric of the Social Democrats, the new government was forced to quickly confront the astronomic cost of recapitalizing the nation's banking sector, and fairly quickly agreed that privatization provided the lowest cost and most effective means of dealing with the situation. With respect to the country's ailing industrial conglomerates, however, the government's preferences and approach were less straightforward. Although the Social Democrats declared completion of industrial restructuring to be one of their economic policy priorities, and a number of different plans were prepared even before the party won the elections in 1998, they faced difficulties designing plans to address corporate restructuring in a relatively cost-effective and efficient manner.

MINISTER OF INDUSTRY AND TRADE'S REVITALIZATION CONCEPT

Among Social Democrats, two versions of a plan called "Revitalization of Czech Enterprises" were circulated and supported. The first version was promoted by the Minister of Industry and Trade, Miroslav Grégr. Grégr's plan involved massive subsidies, soft loans; tax breaks and credit guarantees to prop up large, debt-ridden industrial corporations. In February 1999, the Industry and Trade Minister submitted his plan to the Economic Council of the government. There were unconfirmed reports that the plan was prepared in cooperation with a large privatized bank, IPB (whose NPL portfolio was especially dire, and which therefore stood to benefit from substantially from Grégr's plan). Since IPB had already been privatized, it could not count on the financial ability or willingness of its shareholders to recapitalize the bank in order to address its tremendous NPL portfolio. The Grégr Plan would effectively have recapitalized the bank by recapitalizing some of its largest debtors.

The original Grégr Plan encountered strong opposition from the then Deputy Prime Minister for Economic Policy and Minister of Finance, Pavel Mertlík, who primarily objected to the staggering financial cost, obvious moral hazard, and rent-seeking behavior by bank creditors and corporate shareholders (IPB was both, which is why its collapse in 2000 was so significant for the country financially and



economically). The resulting compromise reduced revitalization's scope and estimated fiscal costs significantly, and attempted to give the government's industrial policy a more coherent framework. However, the persistent differences of opinion within the ruling Social Democratic party about the scope, structure and approach to industrial revitalization, would eventually limit the Ministry of Finance's ability to implement the program it designed and cause the dissolution of the program.

A SECOND REVITALIZATION PLAN

The Czech government agreed on a revitalization concept on April 14, 1999 (Government resolution no. 354/1999). The scheme was limited to a few significant companies. The key difference compared to the Grégr Plan was that the Mertlík Plan aimed for effective change in ownership based on enterprise recapitalization, seeking to emulate the U.S. Bankruptcy Code's Chapter 11 reorganization procedure. That is to say, the revitalization program's main purpose was to financially and operationally restructure the companies in the program and then to find those companies strategic investors. Although it was recognized that it was necessary to address KOB's NPL problem (which grew significantly as a result of the aforementioned pre-privatization bail-outs of several of the country's largest banks), the revitalization program was not designed primarily for this purpose. In fact, the large and complex restructuring cases that became part of the program represented only 2 - 3 percent of the total value of the KOB's NPLs.

KOB created a wholly owned subsidiary, Revitalizacni Agentura, a.s. (hereafter referred to as the "RA" or the "Agency"), and charged it with the implementation of the revitalization program. The RA was to acquire the shares and debts of companies from the pre-privatized banks for a fair market value, i.e., well below book value. The banks' capital was to be subsequently strengthened with an injection from the Government. In the end, however, the Government elected to recapitalize the banks through a transfer of bank NPLs to KOB at much higher values (60% of face value). As a result, KOB was unwilling to transfer the assets to the RA at fair market value, since this would have entailed the government recognizing an immediate accounting loss on the assets it had just purchased from the banks. This would have been politically unacceptable for a number of reasons, including the fact that the losses would have appeared in the state budget and therefore would have had a substantial impact on the country's budget deficit. The unwillingness or inability of the KOB to transfer the assets to the RA effectively undermined one of the key underpinnings of the revitalization program and compromised the carefully constructed independence of the Agency: without control of the assets, the RA was reduced to glorified consulting work for the Government, as opposed to independent asset management, as discussed in more detail below.



THE REVITALIZATION AGENCY'S MANDATE

The Revitalization Agency was established in May 1999 with a mandate to select potentially viable, large, and distressed companies for its portfolio, purchasing their debt and/or equity at fair market value, managing and restructuring these assets to minimize fiscal costs, and maximizing revenues from asset sales through competitive tenders. However, in order to maximize the value of the State's assets through the restructuring and sales process, it was decided that the Agency would hire a professional manager to run the RA and to manage the restructuring work.

CORPORATE GOVERNANCE OF THE RA

The retention of a professional manager was a deliberate act aimed not only at improving the performance of the financially distressed companies in its care, but also to shelter the RA from political interference in its decision making, since it was clear that political considerations in the Czech Republic all too often delivered extremely poor results at high financial cost.

Outsourced management. Although the Agency was 100% owned by KOB, and therefore it was effectively state-owned, the management of the RA was outsourced to a reputable international investment firm. In June 1999, a public tender for the RA's manager was launched. The tender itself was organized in a transparent manner to eliminate any allegations of impropriety and/or corruption. The bids were evaluated by a team of KOB specialists and external experts retained by KOB, including a country director for the European Bank for Reconstruction and Development, a US Treasury Foreign Advisory Service official, and a former Chairman of the US Resolution Trust Corporation. Records of voting were kept and recommendations of the advisory group were submitted to the KOB for approval. The tender and the bid evaluation process were considered models of openness. In October 1999, a consortium consisting of Lazard Frères & Co. LLC, a multinational investment bank, and Latona Associates of Europe LLC, a US-based merchant banking group, became the Revitalization Agency's manager ("the Manager").

Management Services Agreement ("MSA")

The relationships between the Agency, KOB and the Manager, and the responsibilities and obligations of the parties, were delineated in a legal document called the Management Services Agreement. The Manager was to provide services by making available key personnel. The services included *inter alia* the coordination and selection of the candidate companies for revitalization, preparation of restructuring plans for the selected companies, and coordination and organization of implementation of the plans. Also, the Manager was responsible for general administration of the RA, establishment of its procedures and policies, as well as preparation of regular monthly, quarterly and annual reports.



The Manager's remuneration was based on a combination of an annual retainer and fees related to restructuring work on the portfolio companies following the adoption of restructuring plans. The company specific fees were based on a mixture of monthly advisory fees and success fees for completed restructuring transactions. The MSA provided for the crediting of monthly fees against success fees. This was to ensure that the Manager was motivated based on successful restructuring of the companies.

THE AGENCY'S CORPORATE BODIES

The Executive Board consisted of five members, of which three were appointed by the Manager and two by KOB. The Manager was entitled to name the Chairman of the Board, while KOB had the right to name the Vice Chairman. The Board had decision-making authority as per applicable Czech law, with the additional special requirement that prior approval by a supermajority of the Investment Committee be obtained for any restructuring plans and their amendments as well as any transactions exceeding CZK 50 million.

An independent Investment Committee was charged *inter alia* with the approval of the individual restructuring proposals submitted by the Manager. The investment committee consisted of nine members, including all the Executive Board members, plus four "outside" members recruited from the ranks of independent workout or financial specialists. Effectively, the Investment Committee was designated as the body which should prevent and resolve conflicts between the parties, especially KOB and the Manager, while providing an objective, independent assessment of the structure of the individual restructuring plans, including the remuneration of the Manager within the context of individual restructuring plans.

The Supervisory Board, which consisted of nine government appointees, was responsible for monitoring the RA's activities, as per applicable Czech law. It is important to note, however, that the rights of the Supervisory Board did not include the right to change or amend restructuring plans and/or transactions approved by the Executive Board (subject, as noted, to prior approval by the Investment Committee). This arrangement was designed to further insulate the Agency from interference and meddling by the State in its restructuring work.



SELECTION CRITERIA FOR PARTICIPATION OF COMPANIES IN THE RA PROGRAM

The eligibility criteria were deliberately set a) to limit the number of companies to a manageable number of significant debtors with far reaching economic significance, and b) to avoid hopeless cases which should clearly be closed or solved via bankruptcy. The following criteria determined eligibility:

1. *Criterion of national (regional) economic and social significance:* the debtor entity (including subsidiaries of which it is the majority owner) employs over 2000 people;
2. *Criterion of a multiplier effect on the Czech economy:* the volume of materials, work and services purchased from domestic suppliers in the past accounting period exceeded CZK 1 billion;
3. *Criterion of improving bank balance sheets:* the combined size of the non-standard loans from KOB, Česká spořitelna and Komerční banka (two semi-privatized Czech banks) exceeded CZK 3 billion;
4. *Criterion of conditional viability:* in the last accounting period the debtor was EBITDA positive.

Debtors were eligible candidates if they fulfilled at least three of the four criteria. The company itself also had to agree with inclusion into the program, and its existing shareholders had to accept the prospect of a substantial dilution of their equity position. State help was thus conditioned on restructuring, limiting the company management and shareholders' authority and final privatization. The strategy therefore was a *de facto* re-nationalization of the selected companies, if only temporarily.



PORTFOLIO COMPANIES

Based on the above mentioned criteria, the following eight companies were included in the RA's portfolio:

Table 1: Companies Included in the Revitalization Program (Financial data in CZK mil.):

Company	Staff	KoB NPLs	Total Debt	EBITDA	Largest Shareholder	%	Second Shareholder	%
Aliachem	9 000	2 365	4 971	n.a.	Chemapol	23	Aliachem	17
ČKD Praha	12 200	> 3 000	n.a.	n.a.	Inpro	39	Deutsche Bourse	26
Spolana	3 275	1 430	3 566	670	FNM	37	Chemapol Group	29
Škoda Plzeň	14 042	> 3 000	n.a.	n.a.	NERO, s.r.o.	23	Deutsche Bourse	19
Tatra	3 800	3 600	n.a.	n.a.	Škoda	43		
Vítkovice	3 131	n.a.	5 297	2 098	FNM	67		
Zetor	2 241	2 120	2 590	95	KOB	50	Motokov	48
ZPS Zlín	3 400	n.a.	n.a.	n.a.	SIS Fund	21	Česká pojišťovna	19

Note: Later the company *Hutní montáže* was also included in the program; Aliachem, ČKD Praha, Spolana were handled by KOB with the RA assuming an advisory role without an implementation mandate; ZPS Zlín was declared bankrupt and was sold by Latona-Lazard under a separate mandate with the bankruptcy trustee.

Source: World Bank (2000)



APPROACH TO REVITALIZATION

The general approach to restructuring adopted by the RA in handling the largest cases involved several steps:

a) Obtain control over the company

- **Ownership control** was achieved through debt-equity swaps (e.g. in the cases of Tatra and Škoda, see the Case Study Appendices below). In the case of Zetor, the original ownership position of KOB was consolidated via acquisition of shares at a distressed price from the company's private majority shareholder.
- **Gain control over the financial flows of the company** through establishment of a state-owned, special purpose vehicle ("SPV") company that entered into contract manufacturing with the distressed firm in the program. Osinek, in the case of Vítkovice, and RA Traktor, in the case of Zetor, represent cases of the use of such special-purpose ("tolling") vehicles to ring-fence a company's production process. Tolling vehicles allowed production to continue at distressed companies by securing the creditworthiness of the manufacturer's working capital cycle – in effect, carving it out of the distressed company. An SPV, usually with a state guarantee or financing, would contract for the purchase of raw materials that would then be processed by the distressed firm on a contract fee basis. In this way, suppliers which might not have otherwise wanted financial exposure to the distressed entity could be encouraged to continue supplying raw materials for the latter to use in the manufacturing process.

One of the objectives of the use of an SPV for tolling (i.e., contract manufacturing) was to strengthen the position of the owner and the largest creditor (i.e., the State) in negotiations with the company's other creditors. Creditors, knowing that the risk of bankruptcy and discontinuation of operations of the bankrupt enterprise were major concerns for the government, attempted to hold up the State by demanding full repayment of their claims upon threat of filing for bankruptcy. However, once a tolling SPV was established and financial flows of a target company were redirected, the company's going concern value was effectively preserved by securing continuous operations even in the case of a declaration of bankruptcy. The State did not face the abovementioned collateral damages from bankruptcy and resulting unemployment, and as a result, its bargaining position improved significantly.

Tolling using an SPV was completely legal since the SPV did not attempt to maximize or redirect profits at the expense of other creditors (which is illegal in the Czech Republic). As a result, creditors were unable to take legal action against the SPV's activities, their delaying tactics vis-à-vis the government/KOB were undermined, and the RA-proposed restructuring measures could be implemented.



The tolling concept was an original contribution of the Revitalization Agency to Czech finance, and is regarded as one of the more useful ideas to have been developed and applied in the Czech restructuring environment to protect large industrial enterprises during the work-out process.

b) Debt-equity swaps

In the cases of both Tatra and Škoda, debt for equity swaps of the claims held by KOB and Česká finanční (another government agency) were implemented to obtain control of the companies. As a non-cash solution, the swaps acknowledged that the bad loans inherited from the past could not be repaid from the companies' continuous operations and that recovery in the case of bankruptcy would have been close to nothing (average recovery ratios in bankruptcy at that time did not exceed 3-5% of the face value of the original claim). In fact, market values for the firms could (and actually were) realized subsequently from the proceeds from the sales of shares. Also, improved balance sheets and reduced leverage led to better standing in the eyes of commercial banks, which were then willing to provide operating and project financing on acceptable commercial terms. Another benefit of the swaps came from improved payment terms from suppliers and customers due to the more solvent status (i.e. improved credit-worthiness) of the companies. This in turn reduced direct cash outlays on the part of the government.

c) Strengthening working capital

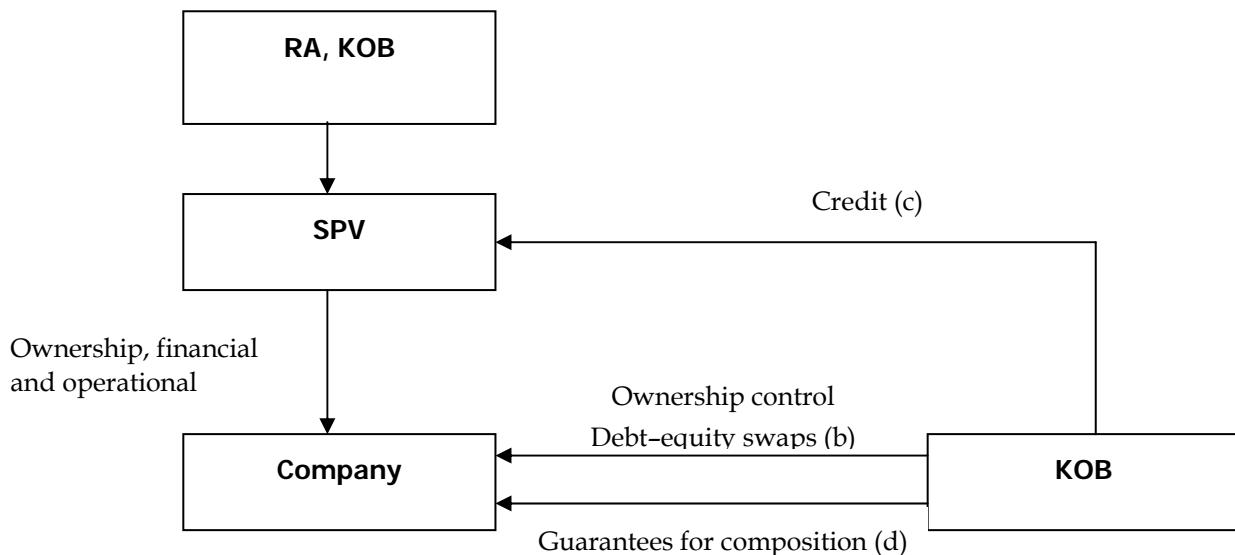
Typically, for companies in the RA program, KOB provided financing for company operations either indirectly, as discussed (via tolling vehicles such as Osinek or RA Tractor), or directly, after debt-for-equity swaps, to ensure sufficient degrees of financial stability and managerial control over the enterprises. Also, improved payment terms could be extracted from suppliers which received sufficient degrees of comfort to do so (SPVs always honored the agreed payment terms and were effectively guaranteed by the State).

d) Dealing with other creditors through composition (i.e., settlement) procedures

Unilateral debt-equity swaps in most cases would not provide sufficient debt reduction for the companies in the revitalization program, and additionally, these swaps were excessively costly for the government – effectively giving remaining creditors an unwarranted free ride. As a result, composition proceedings (akin to a US style reorganization) were initiated in some cases (e.g. Vítkovice and Zetor). In the case of Vítkovice, the composition was accompanied by a buyout of small creditors by the State in order to aggregate its debt position and secure the approval of the composition by creditors. KOB facilitated the process by guaranteeing repayment of the claims in the composition up to the agreed value (in both cases the legal minimum under the Czech bankruptcy and composition law was a 30% payout to unsecured creditors).



SCHEME 1: GENERAL MODEL OF STATE INTERVENTION IN REVITALIZATION COMPANIES



Operational restructuring

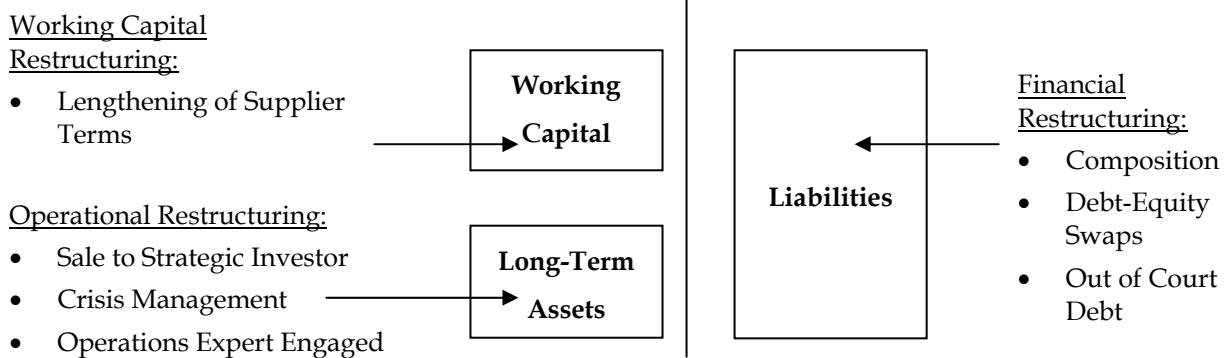
In addition to the financing structures and transactions noted above, the Revitalization Agency designed restructuring plans also often included introducing new corporate management to implement the agreed restructuring plans.

To summarize, the RA's overall restructuring strategy typically included three phases:

1. Financial restructuring (liability side of balance sheet);
2. Working capital restructuring (current assets and current liabilities);
3. Operational restructuring (long-term assets).



SCHEME 2: GENERAL RESTRUCTURING STRATEGY





RESULTS OF THE REVITALIZATION PROGRAM

When assessing the performance of the Revitalization Program, it is worthwhile to look at the several possible criteria:

1. To what extent did the Program and the implementing agency, the RA, deliver what was originally expected?
2. Did the companies included in the Program survive?
3. What were the total costs and what were the alternatives?
4. Are there any general lessons applicable to other transition economies in general?

1. DEVIATION FROM THE PLAN

According to the original structure of the Revitalization Program, the RA should have acquired stakes in the participating companies at fair market value. Once purchased, the companies would be evaluated and restructured financially and operationally before being sold through tenders. Critically, as noted, the ownership of the assets by the professionally managed agency was designed to ensure that decisions were insulated from political interference.

However, before the purchases could take place, the Czech Government decided that the state-owned banks would be recapitalized in a fundamentally different manner. Initially, it was expected that banks would sell their bad loans at fair market value (recognizing the losses resulting from such transfers in their P&L's). At the same time, they would create the requisite provisions (i.e. write-offs) for their remaining non performing loan portfolio.

Instead, large volumes of non performing loans were transferred to KOB at inflated prices. While this essentially accomplished the banks' recapitalization, albeit indirectly; it did so at much higher cost than the original alternative. The net benefactors were the banks' minority shareholders, which did not have to suffer a fair, but painful, dilution of their equity. Instead, the minority shareholders received handsome windfall profits.

Following the inflated acquisition of the NPLs by KOB, the Revitalization Agency could only acquire the NPLs of the participating companies after reappraisal marked them down to fair market value. This, in turn, would have resulted in the immediate booking of losses by KOB – a political impossibility for the Government and its budget. Consequently, the RA was not able to obtain effective control over the companies in the program, and was relegated to a purely advisory capacity. At the same time, as a result, the Manager declined to take an equity stake in the RA, although there was an interest allegedly in investing in the companies that were revitalized at a later stage. The RA's activities were thus shortly after the program's inception constrained to a purely advisory, and therefore significantly diluted, role compared to the original concept design. At the same time, the structure put in place to insulate the program from political interference was compromised.



REVITALIZATION – THE CAUSE AND A VICTIM OF POLITICAL CLASHES

As noted above, the revitalization concept was effectively derailed early on when the Government opted for an indirect recapitalization of the country's failing banks, and the RA failed to purchase and control the program's target assets. Another factor that contributed to the program's weakness was the political conflict between the Minister for Trade and Industry, Miroslav Grégr, and the Revitalization Program's main architect, Deputy Prime Minister for Economic Policy Pavel Mertlík. Grégr never did accept the substantial changes to the plan he originally devised, and made frequent efforts to extend the program both in terms of the volume of resources, as well as the number of companies involved, while at the same time having his Ministry assume control of the program. Any failure on the part of the RA to live up to initial expectations was immediately seized upon by Grégr to assail publicly and privately not only the RA, but also its main political sponsor, Mertlík. As Mertlík's position within the cabinet gradually weakened, so did support for the Program in general, and its implementing agency, the RA, in particular.

Finally, as a by-product of this infighting, the Agency, which should have been equipped by KOB with sufficient capital resources to carry out its activities, soon found itself starved for equity by its sole shareholder. In this way, the Government attempted to hang on to an additional lever to influence the activities of the Manager and the Program in general.

DISMISSAL OF THE RA AND ITS MANAGER

When Minister Mertlík resigned in April 2001, the Program's days were numbered. Relations between the State and the Manager's successor, Odien Restructuring Services, deteriorated dramatically. The dismissal of KOB's management by the new Minister of Finance, Jiri Rusnok, and their replacement by management openly hostile to the Program and to Odien, lead inevitably to the termination of the relationship in the Fall of 2001 amidst public accusations of incompetence, lack of cooperation and impropriety. In the end, the soured relationship led to the initiation of arbitration proceedings by Odien. The lawsuit, however, was later settled by both parties.

In sum, one of the key objectives of the design of the Revitalization Agency was to shield its operations from political interference and pressures from special interest groups. This feature of the program was well regarded by international financial and development institutions such as the OECD and the World Bank (World Bank, 2000). Nevertheless, depolitized decision-making vis-à-vis revitalization project companies came at a price, since it threatened the activities of interest groups with influence in political circles. Moreover, and perhaps partially as a result, the fact that the RA did not obtain control over the enterprises participating in the program, made any insulation from political pressures purely theoretical. Ironically, the RA in the end depended directly upon the political support of the



Finance Minister for its existence and independence in decision making. Once the support vanished, so did the RA.

2. DID THE COMPANIES INCLUDED IN THE PROGRAM SURVIVE?

The performance and development of four companies (Zetor, Vítkovice, Tatra and Škoda Plzeň) that were included in the revitalization program, and where the Agency was directly involved in the workout, is reviewed in some detail in the Appendices to this document.

3. DESIRED OUTCOMES AND MEASURES OF SUCCESS: WHAT WERE THE TOTAL COSTS AND WHAT WERE THE ALTERNATIVES?

Clearly, the main political objective behind the establishment of the RA was to keep the companies in the program afloat and to avoid the political costs resulting from their bankruptcy, including the associated rise in unemployment (which would have involved direct fiscal costs). The companies selected were, for the most part, simply too big to permit failure for any government that could afford it. A secondary objective was to reduce the fiscal expenses associated with revitalization to an acceptable level. Finally, some of the members of the cabinet (most prominently the program's chief architect, Deputy Prime Minister and Minister of Finance Pavel Mertlík) wanted to implement the revitalization program in a transparent manner which would win acceptance from international financial institutions, organizations and ultimately, the public.

As noted in the Appendices, none of the companies involved in the program discontinued its operations. One way or another, all of the companies were re-privatized. Clearly, the nominal value of the claims, and the acquisition costs paid by KOB, were several times higher than the actual revenues from re-privatization. This, however, has more to do with the government's decision to recapitalize the country's failing banks than with the decision to rescue the failing firms. Had the claims been appraised at their fair market value as originally intended, we can speculate that the acquisition cost would have been around 10% of the face value of the claims (this estimate is actually higher than the expected historical recovery ratio of KOB in the case of bankruptcy). Under this scenario, the revitalization program would probably have ended up with a significant profit - certainly if the proceeds from the sale of Vítkovice Steel in 2005 (CZK 7 billion) are included! The impact on government finances, however, should be netted of the fiscal cost of the direct equity injections.

For the four companies reviewed in the Appendices some detail, one can summarize the results as follows:

- Zetor: total KOB exposure in 2000 was approximately CZK 4 billion. Of this, the bank recovered CZK 310 million from sale proceeds and an additional CZK 700 million from the refinancing of the working capital loan plus interest income on loan, i.e. recovery ratio over 25%.



- Vitkovice: total KOB exposure in 2000 was approximately CZK 6.5 billion, of which about 50% has been recovered. This does not include privatization revenues from the sale of Vitkovice Steel by Osinek.
- Tatra: total KOB exposure in 2000 was approximately 4.5 billion, of which about 25% was recovered.
- Skoda: total exposure of KOB in 2000 was approximately 4.5 billion, of which about 8 % was recovered.

One can reasonably argue that revitalization proved more effective than ad hoc collection efforts of KOB through bankruptcy proceedings. Many creditors, certainly at the time of the Revitalization Program's operation, believed the bankruptcy process in the Czech Republic necessitated a complete write-off of their claims against the company. To avoid bankruptcy proceedings, a composition process was often initiated by the RA to maintain a degree of control over the companies (again, composition is akin to the debtor-in-possession principle under a US reorganization; creditors take control of the company's reorganization rather than the company being liquidated or sold by a court appointed administrator) even though the price paid for control was a hefty 30% payback on the claims of unsecured creditors, guaranteed by the KOB. While at first blush this appeared expensive for KOB, especially in the case of Zetor, the recovery ratios seem to vindicate the strategy. Obviously, another factor which is difficult to compute with precision, but certainly should be included in the equation, is the tax revenue preserved by the State through several channels. Corporate income tax collected from the restructured companies to date has been modest, since they have benefited from massive tax shields through tax-loss-carry-forward provisions of the Czech tax code. However VAT revenue, personal income tax and social security taxes have been significant.

CZECH “REVITALIZATION” WITHOUT THE REVITALIZATION AGENCY

The RA's dissolution heralded a return to the Government's former bad habits, which again resorted to ad hoc bailouts and exposed itself to being held up by other creditors and the moral hazard of those large debtors which avoided hard restructuring decisions at the taxpayers' expense. This is not surprising, understanding that a bankruptcy framework more conducive to a market-based environment is still absent in the Czech Republic. Whereas Vítkovice was essentially restructured, its productivity improved, and revenues from re-privatization produced a handsome return for the effort, Nová Huť – another large steel company previously in better condition than Vítkovice, was still cash-starved not long after its ad hoc bailout by the Government outside the RA program framework. Eventually, the government's entire exposure in Nová Huť – 67% of the equity and CZK 4.8bn in debt – was sold for CZK 660 mil. to LNM Holdings in 2002. The recovery ratio of about 10% is well below that of Vitkovice and comparable to the disastrously derailed restructuring case of Skoda, a.s.



The moral hazard illustrations and implications of the government's non-systemic approach to the bailouts of failing industrial companies are obvious. The Government's predominantly political, as opposed to economic, decision-making before the Revitalization Program (and to some extent after its abandonment) was facilitated by the often hidden costs of such interventions. Also, the country's relatively low level of government debt made the interventions possible (i.e. affordable) and the markets did not punish this behavior by pushing up interest rates on public borrowing. The Government bailouts also evidenced substantial cases of rent-seeking, as, for example, in the aforementioned bailout of Nová Huť. Here, management, trade unions, and bank creditors colluded with the would-be investor to maximize their gain at the expense of the Government, and thus taxpayers. In particular, the Government in this case was backed into granting exclusivity to the investor by the above-noted cabal of local and international banks when they threatened to bankrupt the company just weeks before the country's general elections in June 2002. In sum, despite its shortcomings, the results of the RA program, and the flawed restructuring work of the KOB before and after the program, demonstrate the efficacy and potential benefits of moving economic decisions out of the political realm. One can only speculate about the successes the RA might have achieved if the assets it was charged with managing were in fact transferred to the Agency – allowing the Manager to make decisions in a politically insulated environment.

THE DISCIPLINING EFFECT OF THE EU

More recently, the political temptation to prop up failing firms has been somewhat suppressed by the Czech Republic's accession to the EU. As a result, the country's state aid policy, including bailouts, requires obtaining EU consent (n.b. the law on state aid came into force in 2000; the Czech Office for the Protection of Competition was charged with reviewing compliance with EU and local EU harmonized law). EU accession has also *de facto* increased the political (as well as the financial) costs of the kinds of bailouts that have been part of the Czech economic landscape since 1990 – although attempts to seek rents remain far from nonexistent.



APPLICABLE LESSONS

Why are insulation from political interference and transparency important?

- a. What are some of the methods that can be used to achieve transparency and independence?
- b. Should the hired a professional manager? What particular value and skills could an independent manager bring ?
- c. The strengths and weaknesses of the RA.

THE BENEFITS OF INSULATION FROM POLITICAL INTERFERENCE AND TRANSPARENCY

One of the main lessons that can be derived from the Czech Revitalization program experience is that corporate governance and contractual arrangements that reduce, mitigate and – if possible – eliminate political interference in what is in essence an asset management exercise are extremely important preconditions for satisfactory performance. The key legal foundation document of the RA, the Management Services Agreement, created a governance structure for the program that made political interference virtually impossible as long as the parties honored and fulfilled their mutual rights and obligations. Financial decision-making for the company's in the Program rested with a professional manager selected through a competitive tender. Decisions concerning remuneration per case and the approval of a particular project's design were in effect in the hands of outside members of the Investment Committee selected by both contractual parties for their professional skills and integrity. The Investment Committee thus was designed to serve as the venue for internal dispute arbitration.

In reality, however, even though the restructuring plans for the portfolio companies were innovative (perhaps even ingenious for the local operating environment) proper implementation remained beyond the RA's actual ability. Why? The RA case presents a powerful argument for sticking to the original plan and maintaining the integrity of concept design for the duration of the program. Despite the careful efforts of project planners to account for anticipated attempts to assert undue influence over the RA's activities, once the fundamental structure of the program was altered (i.e. the RA did not own or control the assets it was charged with managing) the Manager found that it not only had to develop plans to rescue the companies, but also had to operate in a politically charged environment in which special interest groups worked actively to undermine the RA's activities through obvious rent-seeking behavior.

Indeed, one can argue that the RA's achievements were well below original expectations, and attribute this directly to the fact that the RA did not own or control the assets it was originally supposed to acquire at fair market value. With hindsight, it is clear that the RA was predestined to fail from the moment the decision not to transfer the assets was taken by KOB and Ministry of Finance, respectively. This



effectively precluded proper motivation of the Manager of the RA; diluted its responsibility, power and accountability and subsequently gave rise to both justified and un-justified criticism of the performance of the RA and its Manager.

The fact that there were understandable reasons for KOB and the Czech Government to deviate from the originally approved concept embedded in the "Management Services Agreement" did little to make relations among the contractual parties tenable. In essence, the MSA was rendered obsolete just weeks after its signing and the Program's delicate, sophisticated legal structure became dysfunctional as a consequence. It took months of negotiation, and the filing of lawsuits, for the parties to finally address their differences. The time and energy used to debate the amendment of the framework, and, later to end it, was something the RA could hardly afford, and distracted attention from its core revitalization mandate.

While, as noted above, one can only imagine what the results of the Program would have been if the Manager had been in a position to fulfill its mandate in an environment free from political pressure and interference, it is clear that the priority the Program's architects gave to insulating its activities was well justified.

METHODS TO ACHIEVE TRANSPARENCY AND INDEPENDENCE

- Decisions were taken at the Executive Board level, with independent oversight, as opposed to the Government dominated Supervisory Board;
- Professional integrity of management can be verified by an independent internal body to provide a degree of comfort to the government counterparty (i.e. the RA went at great lengths to achieve this objective by forming an Investment Committee with pre-approval rights on key decisions). The autonomous outside directors acted, in effect, along the lines of US non-executive directors;
- Records of the projects and any actions taken – including justification of the underlying economic rationale–were kept and presented regularly to the Government oversight Supervisory Board;
- The Supervisory Board, as noted, of the RA was comprised of political appointees who could – and indeed did – ask for specific explanations concerning projects on an *ex post* basis;
- The financial accounts of the RA were audited both internally and externally by an independent, reputable audit firm;
- The RA was closely monitored by the government and the media. Due to the change in the RA's concept, all of the projects had to be submitted to the Government for approval (significantly, the Government never rejected a project proposal with respect to a portfolio company in which the RA was directly involved). At the same time, the required approval of the government for RA proposals limited the ability of the Agency to act independently;



- Consider posting records of key meetings and documents publicly (on an *ex post* basis);

BENEFITS OF HIRING A PROFESSIONAL MANAGER

- Experience and know-how unavailable within public sector;
- Commercial decisions often require specific skills and personality characteristics not found among or suited to public staffers and bureaucrats;
- Reputational capital of the Manager should guarantee and ensure professional integrity;
- Thoughtfully designed remuneration framework should reward success and align the manager's interests with the economic objectives of the asset owner. Such compensation schemes are rarely found in the public sector for a variety of reasons.

A SUMMARY OF SOME STRENGTHS AND WEAKNESSES OF THE RA

General:

- The RA performed its dedicated asset management tasks and did so with a clear legal mandate from the Czech Government.

Corporate Governance Level:

- Ambiguous financial structure – the RA, as a subsidiary of KOB, was entirely reliant upon KOB for funding its operating budget. One of the ways that the government attempted to influence and interfere in the RA's operations was by withholding funds.
- The RA program itself was widely discussed in the news media, the complexities of the program and the nature of the dispute between the Government and the Manager made it difficult to have an intelligent discussion. Instead both sides resorted to mudslinging to try to gain the upper hand in their dispute,
- Although the RA did not have a Code of Conduct, all employees were required to read and sign the company's Operation Manual which specified a list of rules and regulations for company employees. In addition, the reputational capital contracting of the outside manager was meant to ensure that high professional standards were met.
- In terms of independence and supervisory issues, the RA's program structure did an excellent job, theoretically, of promoting transparency, while providing for government oversight and audit. The division of the Program's decision-making bodies (i.e. Supervisory Board, Investment Committee and Executive Board) and their responsibilities was designed to ensure that the



ownership interests of the State and those of the Manager were represented and balanced, while, at the same time, ensuring independent management of the assets. The independent Investment Committee, in particular, served as the venue for resolving any asset management and restructuring disputes that might arise. Its independent members (approved by both KOB and the Manager) served both as arbiters for the two parties, and guarantors that neither side could push through decisions or policies without getting approval from a majority of the autonomous committee members.

Core Business Level:

- The retention of a professional manager by the RA was meant to ensure that the management and sale of the companies in the revitalization program would be competently arranged through transparent, value maximizing processes and programs. Engaging appropriately incented professionals specifically experienced in the organization of corporate sales and restructurings was intended to ensure that the RA's core asset management and disposal business were run efficiently and effectively.



APPENDICES – FOUR EXAMPLES OF COMPANIES INCLUDED IN THE REVITALIZATION PROGRAM

Zetor

Zetor, a tractor company located in the Moravian city of Brno, has a long history of government rescue operations: by 1996, its KOB debt burden had already been recapitalized twice. In July 1998, another rescue attempt was initiated when 34% of the company was sold to Motokov International, a Czech foreign trade company. Motokov gained an additional 13.74% of the company's shares in 1999. The KOB still owned 49.9%, but Motokov controlled and managed the company and had an option to purchase the remaining shares. However, Motokov was clearly unable to manage the company effectively, as it suffered from its own financial problems and most of its revenues were derived from Zetor tractor sales. The economic and financial situation at Zetor deteriorated rapidly and the assembly lines came to a halt in 1999.

There are still debates about whether it was worth saving Zetor at substantial cost to the taxpayer. Interestingly enough, this was also the position of the RA management, which tried to accomplish the Czech version of a US pre-packaged bankruptcy, presenting the plan to the Regional Commercial Court in Brno in Winter 1999/2000. The Court's reaction to the plan, however, was openly hostile. Zetor was subsequently included in the revitalization program and the government approved a three step plan prepared by the Revitalization Agency to revive the company's tractor production in March 2000.

1. To protect any working capital facility from the risks of bankruptcy, the RA established the subsidiary company, RA Traktor, s.r.o., (a tolling vehicle) which applied for and received a CZK 700 million loan from KOB for the assembly of tractors for firm export orders insured by the Export Credit Guarantee Agency (EGAP).
2. Motokov sold its shares in the company to the state (for CZK 31 million) and the company was thus completely re-nationalized. The KOB gained control over the company, and the restructuring process under the supervision of the Revitalization Agency began.
3. There was still the issue of Zetor's enormous debts which put the company under constant threat of bankruptcy. Following the rejection by the Court of a prepackaged bankruptcy, a composition process was started under the relevant provisions of the Czech Bankruptcy and Composition Law to settle outstanding debts of CZK 6.48 billion. The company proposed to pay off 30% of the unsecured claims. Also, KOB issued guarantees up to CZK 800 million. The composition was then approved by the creditors in May 2001. In March 2002, the supervisory board of ČKA approved the sale of the company to HTC Holding from Slovakia for CZK 310 mil. Today Zetor is a moderately profitable



private company and has repaid the CZK 700 million working capital facility to KOB in full, including contractual interest.

Table 2: State Interventions in Zetor (CZK mil.)

Date	Amount	Note
November 1994	1 370	Debt-equity swap
End of 1996	3 700	Capital decrease
End of 1996	3 686	Shares bought by the KOB
June 2000	2 656	Capital decrease to pay off the accumulated debt
June 2000	31	Purchase of Motokov's share by the state.
August 2000	700	KOB's credit
December 2000	800	KOB's guarantees in compensation

Source: Kreuzbergova, 2004

Vítkovice

Vítkovice is one of the largest metallurgical and machinery conglomerates in the Czech Republic. In 1999, when it faced an acute financial crisis, the company employed 14 thousand people. The company defaulted on CZK 9.5 billion in debt, and banks refused to provide further financing to keep the loss-making company afloat. Since the company was located in the region already suffering from high unemployment (14.4% at that time) the government was desperate to prevent further significant job losses.

In September 1999, the Government approved a bailout package of CZK 2.8 billion, consisting of a combination of cash to keep the company going and debt write-offs. However, the bailout was not accompanied by any restructuring measures and only a few months later, the company was again on its knees, unable to pay wages on time and forced to restrict production due to a lack of material inputs and working capital.

This time, under the auspices of the Revitalization Program, the same approach later successfully replicated for Zetor was chosen: a) a ring-fenced operational financing (tolling) vehicle was established through an SPV controlled by the State's National Property Fund (Osinek, a.s.), b) operational restructuring was initiated by a new crisis management team and c) composition under the Czech Bankruptcy and Composition Law was effected to reduce debt to a sustainable level.



The composition process was preceded by the buyout of small creditors by the State; the objective being primarily to aggregate the debt position of the State so as to reduce hold up opportunities and to prevent rejection of the composition during the creditors' meeting. Creditors approved the composition plan in November 2000 (again, the legal minimum 30% payoff to unsecured creditors was offered and agreed) and the company, as a result, escaped the threat of bankruptcy. The KOB guaranteed repayment of the creditors taking part in the composition up to a total amount of CZK 3 billion.

Subsequently, the company was restructured: the metallurgical subsidiary (itself carved out in 2001) was sold first to the NPF-owned Osinek in 2002 (to avoid calling in of KOB guarantees), and subsequently to a foreign investor for CZK 7 billion in 2005. The parent company was privatized to a domestic investor. By mid-2005, the entire conglomerate had been successfully re-privatized and is producing impressive profits for the new investors.

Table 3: State interventions in Vítkovice (CZK mil.)

Date	Amount	Note
September 1999	2 800 consisting of:	Approved by the government
Autumn 1999	500	Bridge finance facility for wages, working capital and other necessary payments
Autumn 1999	600	Česká finanční assumed company claims of CZK 1.7bn and discharged them for CZK 600 mil.
	1 700	Debt-equity swap of the KOB claims
2000	1 000	Česká inkasní's resources used to settle Vítkovice's creditors
February 2000	400	Debt in Česká inkasní paid off by Vítkovice
March 2000	2 800	KOB's credit to Osinek
October 2000	700	Claims of Vítkovice's creditors purchased by Česká finanční

Source: Kreuzbergova, 2004



Tatra

Tatra, a heavy-duty and off-road truck producer, suffered from financial difficulties resulting from the dramatic decline of sales to the Russian market following the revolution (Russia being by far the largest customer for the company's products in the 1980s). Production almost came to a complete halt in the beginning of 1999, and the company found itself unable to pay wages in full or service its debt to the creditors.

In a series of steps, Tatra was effectively renationalized. The KOB bought 43.5% of the company's shares from Škoda Plzeň for CZK 140 million and Česká finanční purchased 14.97% from investment funds for CZK 55 million. In addition, KOB also purchased claims held by Komerční banka with a face value of over CZK 3 billion for CZK 1.8 billion and provided Tatra with operational credit facility amounting to CZK 400 mil. Subsequently, KOB swapped CZK 4.1 billion in debt for equity via a subsidiary company of the NPF - Kras Brno.

Table 4: State interventions in Tatra (mil. CZK)

Date	Amount	Note
1999	140	KOB purchases Škoda's 43.5% stake
1999	55	Česká finanční purchases 14.97% from investment funds.
1999	400	KOB provides credit
2000	4 100	Debt-equity swap of KOB claims

Source: Kreuzbergova, 2004

With financial restructuring complete, a tender for the sale of Tatra to a strategic partner was managed by Latona and Lazard through the RA. In 2001, an American investment company, SDC International, in cooperation with US construction equipment maker TEREX, offered CZK 1.25bn for 91.61% of Tatra. Today, the company is controlled by TEREX, and operates at a modest profit.

Škoda Plzeň

Škoda Plzeň, the country's largest heavy engineering firm (no relation to Škoda automobile, owned by VW), got into serious financial troubles during the second half of 1990s.

In autumn 1999, shareholders decided to substantially decrease capital by 75% (from CZK 9.479 billion to CZK 2.369 billion) to write-off the past losses. In March 2000, a new company - Škoda Holding, a.s. was founded by Škoda Plzeň and its creditors, including KOB, in cooperation with the Revitalization Agency. Škoda Holding



acquired 19 operating companies in exchange for promissory notes offered to Škoda, a.s. creditors. Through this scheme, the viable operating core of the company was ring-fenced from the risk of bankruptcy, and under the law in place at the time, from the risk of liquidation.

Škoda, a.s. was in fact declared bankrupt in September 2001. However, Skoda, a.s. management and its bankruptcy trustee remained the majority shareholder of Škoda Holding, and they successfully used this position to oppose the restructuring plans proposed by the RA and effectively to hold up the Government to extract various financial concessions and derail the restructuring process. Eventually in December 2002, KOB, following the termination/withdrawal of the RA and Odien mandates, sold its position in Škoda Holding (48% equity stake) to Appian Group (nominally, a Delaware company) for CZK 350 million. The loss of control over the restructuring process translated into a low recovery ratio of 8-9% of the face value of KOB's claims. Today, Škoda Holding, a.s. and its operating companies are for the most part delivering impressive profits to the private investor, and Appian has sold several of the 19 subsidiaries for an aggregate consideration that exceeded KOB's total receipts from its debt and equity interests.

Table 5: State Interventions in Škoda (CZK mil)

Date	Amount	Note
1992	1 888	Debt cancellation
April 2000	2100	Capitalization of bills acquired by KOB for its claims
March 2002	140	Capitalization of KOB's (ČKA's) claims in Škoda Těžké strojírentví
March 2002	900	Loss of ČKA from transaction Škoda Steel (debt-equity swap)

Source: Kreuzbergová, 2004



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Stevana Sremca 4 • 11 000 Belgrade • Serbia
t +381 11 303 3456 • f +381 11 334 5350

1514 N. Longfellow Street • Arlington, Va 22205 • US
t +1 571 594-2863

info@jeffersoninst.org