3.ECONOMY

THE TURNAROUND OF SIDEX. CAN OTHERS FOLLOW?

Case study

The privatisation of SIDEX - the largest steel maker in South Eastern Europe - in the second half of 2001 was arguably a milestone of structural transformation in the Romanian economy. SIDEX was regarded as one of the largest "black holes" of the economy, becoming an ever growing burden for the state budget. The lack of a resolute approach on SIDEX had been thought to illustrate the insufficient advance of the reform process in Romania; social constraints, underperforming management and industry-specific problems added to the problem. The new owner of SIDEX, LNM ISPAT, a global player in the steel industry, faced the difficult task of turning SIDEX performances around. The year 2002 witnessed history in the making; SIDEX financial results appear encouraging, while the feared social bomb has not blown off.

This paper analyzes the privatisation of SIDEX under many aspects: the deal itself, the determinant factors that laid behind it, its implications for the public budget, the evolution of SIDEX financial indicators, theexperience of LNM ISPAT in restructuring similar companies in distress in other countries. But first and foremost, we consider the SIDEX case in the context of other large state owned loss-making companies in Romania. Can the SIDEX example be replicated in other troubling industries? Or is it a looking-like success story, but only an isolated one?

What lessons should we learn?

This paper holds that the outcome of specific privatisation deals varies with the type of industry and the profile of investor. Metallurgical products are, to a large extent, fungible, and competitive advantage in this industry can be considerably improved through managerial tactics; also, the SIDEX buyer has a global bargaining power, and a worldwide experience in restructuring troublemaking companies. These conditions have not been met on many occasions before; only resembling industries and investors could think of repeating the SIDEX experience in transition economies.

Type of industry and profile of investor

Metallurgy was at the heart of earlier industrial revolutions; it is usually associated with a heavy-type of industry consisting of large production capacities, high consumption of energy, mass employment. Steel industry has been traditionally subject of various foreign trade barriers and foreign ownership limitations. However, steel products are commodities (products are standardized; one can choose to buy Romanian steel over American steel, if price is better). This particularity makes the steel industry global by nature; as globalization advances in all fields, the steel industry is being forced to admit its nature.
Cost-effectiveness must be considered at a global scale and the industry can not escape the wave of consolidation (mergers and acquisitions) already wide-spread in global industries producing global products. Mergers in recent years include Krupp and Thyssen, British Steel and Hoogovens, Nippon Steel and Kawasaki, Usinor and Arbed, not to mention the appetite the LNM Group has proved for ailing mills worldwide; yet, the scope for further consolidation remains as the top ten steelmakers collectively produce only about 25% of the world's crude steel production.
The LNM Group has been buying its way to the status of global investor over the last two decades. The LNM Group comprises LNM Holdings, a family business, and Ispat International, a company listed on the New York Stock Exchange, where LNM Holdings has an 80% stake. LNM Holdings includes: Ispat Nova Hut (Czech Republic), Ispat Sidex (Romania), Iscor Limited (South Africa), Ispat Karmet (Kazachstan), Ispat Annaba (Algeria), Ispat Indo (Indonesia). Ispat International includes: Ispat Unimetal (France), Ispat Germany, Ispat Sidbec (Canada), Carribean Ispat (Trinidad Tobago), Ispat Inland (USA), Ispat Mexicana (Mexico). According to statistics from the International Iron and Steel Institute, the LNM Group was the fourth largest steel producing company in 2000; the group currently appears to have

climbed even higher, closer to the ultimate ambitions expressed by its founder, Lakshi Mittal.

The LNM Group's philosophy is simple: buy distressed steelmakers, with a view to geographically diversify these acquisitions, and apply basic modern management principles and techniques to run them profitable. The LNM Group employs a core team of experts, moving them around from one location to another, to implement cost-cutting measures, marketing changes and market reorientation. Nothing very fancy, but simply effective in an industry with a long track of ill management, inefficient trade connections, and powerful unions. Results were sharp in many cases. Ispat Karmet doubled production in the first five years after acquisition; Ispat Mexicana increased production and shipment seven-fold in the first seven years from acquisition; Ispat Sidbec and Ispat Inland managed to reduce the cost per ton by 42$, respectively 82$, since acquisition; Ispat's plant in Ruhrort reduced manpower costs by 25% in the first two years following acquisition.

As the New York Times put it11, the LNM Group has become global "… by cheaply acquiring huge money-losing state-owned mills from governments desperate to remove them from state banks". The seller's eagerness to sell is a major ingredient in the LNM Group's success. Governments in emerging economies, or in more conservative states, want to escape social pressures and fiscal burdening; at least in the Eastern countries, some international financial institutions give a willing hand as well: EBRD granted a 100 mil.USD loan for the LNM's investments in Sidex, and a 450 mil.USD loan for the LNM's investments in Karmet. The scandal that burst out in Britain, stressing a contribution from Mittal to Tony Blair's campaign, followed by a letter signed by Blair, and addressed to the Romanian Prime-Minister, in support of the privatization of SIDEX, fuelled allegations of external political endorsement, not to say pressures, in favor of the SIDEX deal. It is noteworthy that the privatization of SIDEX marked high on the agenda of IMF and World Bank programs in Romania; and the privatization of Nova Hut came only weeks before general elections were held in the Czech Republic.

Coincidentally or not, another factor that might have influenced LNM's decision to invest in Romania is the country, considered to belong to the group of developing economies, is therefore exempted from the 30% surcharge on steel imports imposed by US only a few months after the acquisition of SIDEX. The LNM Group avoids this barrier through its affiliates in Trinidad Tobago, Romania and Algeria, not to mention that it is the only global competitor to run plants in each of

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[11] Peter Green, "Betting Big on Reviving 'Black Holes' '', New York Times, July 7, 2002.

the three NAFTA countries. Mittal even says12 that the imports control in US are a blessing in disguise, as they stimulated consolidation in the industry and boosted steel prices.
It should be said that, given the industry turmoil, SIDEX difficult financial position, and other competitors lack of interest for Eastern European mills, LNM was probably the only potential investor with a global exposure, willing to take over the operations of SIDEX. Usinor also expressed its interest, but only as management was regarded; and US Steel was the only American steelmaker to make an acquisition in Eastern Europe (Slovak Republic).

The SIDEX deal

LNM's acquisition practice indicates a tendency for paying low amounts for the controlling stake (seeking for market power inducements wherever possible), and committing to invest more in restructuring and technological and environmental upgrading. SIDEX case, quite similar to that of Karmet, made no exception from this approach (see figure 1), as a result of LNM's strong bargaining power and, correspondingly, the low bargaining power of the Romanian state.

Fig. 1. Comparison between various recent acquisitions by LNM

Company acquired	Production capacity (million tonnes)/ no. of employees	Price for controlling stake, mil. USD	Total investment commitment, (incl. price paid outright), mil. USD
Sidex	4.5 / 27000	70	500
Nova Hut (Czech Rep.)	2.7 / 12000	20	905
Karmet (Kazakhstan)	6.3 / 72000	450	800
Mexicana	4.0 / n.a.	25 plus 195 in government bonds	n.a.

Source: ispat.com, worldsteel.org, international press

The final deal, as set out in the Emergency Ordinance 119 of September 2001 - that came to be known as the "SIDEX ordinance" -, provides LNM with a wide range of incentives and facilities, summarized below:

[12] According to Financial Times, February 10, 2003.

- a debt-equity swap, as all receivables owned by state institutions, companies and authorities over SIDEX were converted into shares, at the nominal rate of 25000 lei/share. Subsequently, these resulting shares were sold to LNM at a rate of 3300 lei/share. Existing minority shareholders at that time, two SIFs included, were not permitted to contribute to the corresponding increase in social capital.
- five years exemption of customs duties and VAT for imports of equipment, raw materials and other products related to technological and environmental upgrading.
- five years VAT exemption on domestic market acquisitions related to technological and environmental upgrading.
- three years postponement of VAT payable for all other types of transactions.
- three years postponement of social contributions.
- five years profit tax exemption.
- a series of employees' rights are to be provided by the state in case of individual leaves.

The debt equity swap is an usual practice in the acquisition of heavily indebted companies. It erases overdue debts (at a discount premium) and it gives the buyer the opportunity to start the operations without historic debts. The LNM itself obtained a similar deal on the acquisition of Nova Hut, all debts to the state being cancelled and a large banking loan being rescheduled. However, this should not make us disregard the fact that such global hunters, LNM included, end up paying almost nothing for the assets of the companies they bought. The Mexican company bought by Ispat is a very modern one, built up by the Mexican government in the 80's for over 2.2 billion USD; Ispat bought it for an aggregate sum of just above 200 mil.USD.
SIDEX total assets mounted to over 1.1 billion USD at the time of acquisition; yet, it is unclear how much LNM actually paid for the business as such (if one leaves debts aside). One might be tempted to submit that the total sum paid by LNM for SIDEX only covers for the equity derived from the debt-equity swap. Following facts, that may lead to such a remark, are documented from multiple sources[13]:

- LNM paid 70 million USD to the Romanian state in exchange for around 90% of SIDEX, including a 70% stake hold by APAPS and an almost 20% stake resulted from the debt-equity swap.
- SIDEX financial statements recorded, at the end of December 2001, an increase in social capital, in the form of subscribed unpaid capital, of an amount slightly above 70 mil.USD. This subscribed capital was

[13] SIDEX financial statements, LNM and Romanian Government press releases, APAPS reports, etc.

then paid, according to SIDEX financial statements as of first semester 2002.

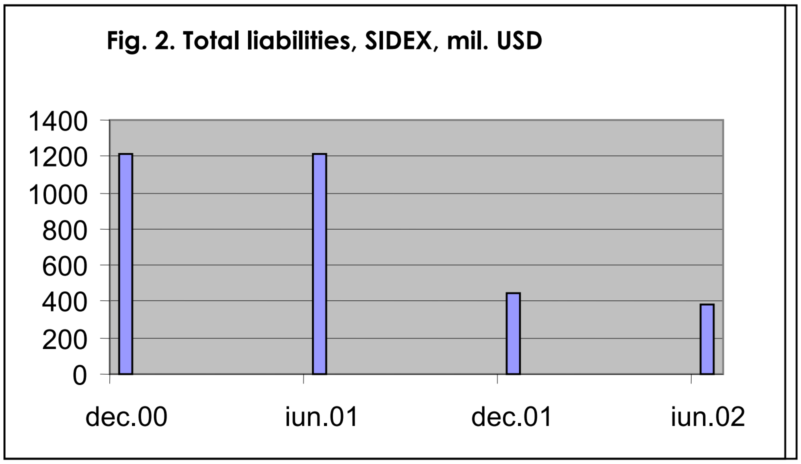
- SIDEX liabilities diminished (see figure 2) by around 770 mil.USD between end of first semester and end of year 2001 (in this time interval, the "SIDEX ordinance" came into force). If we transform this difference in liabilities, at a rate of 9 cents per dollar - as it is suggested to us by the discount rate applied in the debt-equity swap -, it results a sum exceeding 69 mil.USD.

Another striking feature of the post-privatization episode, allegedly not comprised in the privatization deal, is that the Romanian Government, using RICOP resources as well, is supporting ISPAT SIDEX plan of job reductions (7400 employees left jobs voluntarily to take advantage of various compensatory schemes); monthly payments add to about 1,3 mil.USD and are expected to last until end of 2004.

These controversial aspects asides, one must admit that the new owner of SIDEX is doing well to cut costs, improve efficiency, and even increase production. The key elements of the restructuring program implemented by LNM representatives at SIDEX are[14]:

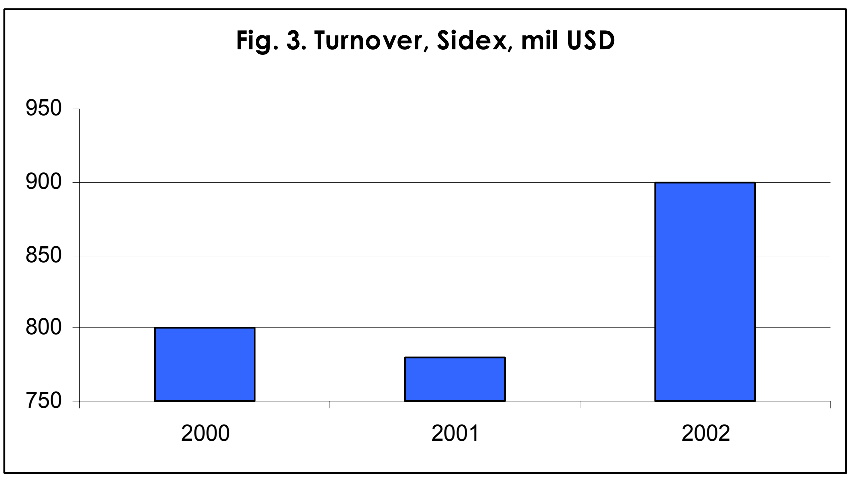
- top local management was replaced by LNM Group senior executives;
- put an end to the barter system. The barter system used to be the main source for profit for small intermediate trading firms, at the expense of SIDEX; the mixed department for sales and acquisitions functioning with SIDEX before was closed down. The 100 mil.USD loan from EBRD helped increasing liquidity on short term.
- long term supply contracts were negotiated
- a system of authorized dealers was implemented. Only authorized dealers were allowed to distribute SIDEX products; and each authorized dealer must inform SIDEX on the final destination of each delivery.

[14] as described by senior ISPAT SIDEX executives in the article mentioned from the New York Times



Note: financial data converted at ROL/USD end period exchange rate
Source: computed from www.rasd.ro

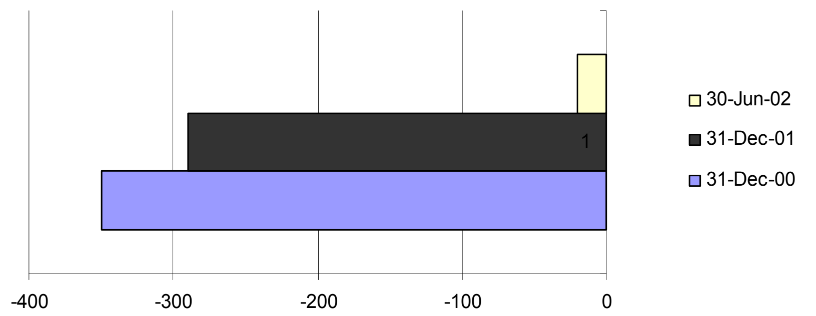
These moves, among other restructuring efforts, led to improved financial indicators shortly after the acquisition (see figures 3 and 4). It is remarkable that turnover increased while the number of employees shrinked by almost one quarter.



Note: data for end year 2002 are annualized, based on first semester 2002.
Financial data converted at ROL/USD period average exchange rate
Source: computed from www.rasd.ro

These results should, nevertheless, be treated with precaution, as the financial records of such a global corporation like LNM is a complex web of financial links; one should not overlook the fact that affiliate's profitability is influenced by the thrive to achieve overall profitability and profits are sometimes recorded on purpose in those countries with a more favourable fiscal environment; in Romania, LNM benefits from numerous fiscal incentives, as described above.

Fig. 4. Net result (profit/loss), SIDEX, mil.USD



Note: financial data converted at ROL/USD period average exchange rate. Source: computed from www.rasd.ro

Is SIDEX a model to be replicated?

- **First thing to emphasize in the SIDEX case is the specificity of the industry. Steel is a commodity**, hence steel products[15] made in Romania are, at least in theory, competing with steel products elsewhere.

From this perspective, the steel industry is comparable to the cement industry. Cement is one of the success stories of the privatization process in Romania; foreign capital has become predominant in this industry since 1998 (following the Lafarge-Romcim deal), and all the major five cement producers in Romania are now owned by foreign companies. Most privatization deals on this market were the result of direct sales, as it was the case for SIDEX as well. On the other hand, post-privatization competition in the cement industry proved limited, as a former oligopoly industry has changed to a sum of regional monopolies (allocation of market shares between competitors).

- **Another feature of SIDEX is that it already had a large domestic market**. SIDEX products, despite alleged low quality, had numerous domestic buyers, given their price and accessibility.

In this respect, SIDEX can be compared to the carmarker Dacia. Dacia had a large domestic market, despite alleged low quality of cars. Although carmaking is a global industry, the competing products are different in terms of quality and brand awareness; the product is not a commodity. Renault announced plans for a new car produced at the

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[15] There are two main groups of steel products: long products, respectively flat. LNM Group has a balanced portfolio of long and flat products. SIDEX produces more flat products, that compete with flat products elsewhere.

Dacia plant, to be competitive on foreign markets; however, four years after privatization, Dacia focus is still on the domestic market. Better management techniques were certainly introduced by Renault; yet, the results could not had been as spectacular as in the SIDEX case. Steel does not need to be re-invented to make it profitable and competitive in world markets; cars do sometimes, and Dacia is an example. Domestic market is a buffer for Renault's Dacia, until technological upgrading makes the car competitive abroad.

Such a buffer does not exist, unfortunately, for other bad performing industries and firms in Romania. The truckmaker Roman, for example, does not have a sufficient domestic market. The turnover/employee ratio, as of December 2001, was around 4300 USD, as compared to SIDEX pre-restructuring turnover/employee ratio (also on December 2001), which was 28300 USD. As figure 5 shows, Roman losses almost one dollar for each two dollars sold.

Fig. 5. Roman selected financial indicators, mil. USD

	31.12.1999	30.06.2001	31.12.2001	30.06.2002
Total liabilities	132.4	49.8	56.3	59.3
Turnover	52.3	16.7	37.9	22.6
Net result	-21.2	-8.5	-17.0	-9.9

Note: financial data converted at ROL/USD end period exchange rate (for liabilities) and period average rate (for turnover and net result)
Source: computed from www.rasd.ro

Roman has constantly lost domestic market in favour of imported trucks. ARO and ROCAR have also constantly lost domestic market in favour of imported vehicles, making them unattractive for a potential buyer in quest for a competitive product. In their cases, technological upgrading is probably more expensive than the cost of greenfield investment, not to mention that, in a restructuring, sensitive job cuts need to be taken. Good examples in this regard are Landini-Laverda in the tractor-making and INA-FAG in roll-bear industry. These two foreign investors decided not to buy Tractorul, respectively Rulmentul Brasov, but to set up new production facilities (in Buzau, and ironically Brasov).

- To replicate SIDEX story for another company, we need not only a similar commodity-type of industry and an existing market potential for company's products, but also, and maybe foremost, another LNM-type of investor. This is to say a global player in the respective industry, aiming at creating competitive advantage over global competitors by taking over emerging markets. In Romania, LNM obtained a bunch of fiscal facilities, debt swaps at discount rates, and a global advantage by avoiding US's surcharge on imported steel.

Can another foreign investor obtain similar market power inducements? They actually did, but failed in most cases to make a more competitive product and to increase overall welfare. OTE-Romtelecom and Noble Ventures – CS Resita deals are noteworthy. Both investors obtained numerous facilities and incentives, but the final result was disappointing; CS Resita is now back under state's administration, while OTE scored rising operational losses and was even fined by the Competition Council for monopolist behaviour. An explanation why these deals proved underperforming might had been the fact that these foreign investors had no global reach. They were, at the best, regional or niche players; their managerial experience in reviving distressed companies was limited, and their international network was not sufficiently expanded. **Therefore, the incentives and facilities obtained in Romania offered them a local competitive advantage, but not a global competitive advantage.**
This does not rule out the possibility that companies without a global exposure could engage in taking over troublemaking industries or firms. Such cases are however the exception rather than the rule, and case-by-case explanations can be found. Take the local investor MYO-O, who bought Semanatoarea few years ago (after the global investor New Holland abandoned acquisition plans) and is now close to finalize negotiations for Tractorul Brasov; MYO-O actually used to be a dealer for Semanatoarea and Tractorul products and their market knowledge lies probably behind their acquisitions.

Warnings

- The SIDEX case should not be regarded as a benchmark for other large loss-making companies, unless a mix of conditions is met: a commodity-type of industry, or at least an industry with an appetite for consolidation, an existing demand for company's products, and a global reach investor with focus on emerging markets.

This is not to say that other stories (it is too early yet to call them success stories) could not occur; but not necessarily following the SIDEX example.

- **The improved financial indicators of SIDEX should be treated with caution**, given the complex web of financial relations within such a transnational corporation as the LNM Group. Moreover, a precedent has recently been set within the LNM Group regarding disinvestment. LNM closed its Irish mills in mid-2001, only few years after acquiring them, and few months before buying SIDEX. It is worth mentioning that, of all countries with LNM operations, Ireland was probably the one with the fastest pace of real convergence with the EU, in terms of wage differentials and environmental norms. The expected time of Romania's admission in the EU, 2007, coincides with the moment LNM's fiscal incentives at SIDEX come to an end.