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**"Managing risks faced by companies acquired in Central Europe during the 1990's:
EU agri-food acquirers' standpoint"**

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ABSTRACT

Western agri-food companies, which have invested in Poland or/and the Czech Republic, have been contacted in order to assess those acquisitions from the EU acquirers' standpoint: risks that are faced, perspectives of risk management and improvement. Emphasis is being put on Poland and the Czech Republic. A typology of risks faced by those companies is set up. Several risks arise from opportunistic behavior inducing moral hazard and hold-up problems.

OBJECTIVES

In the framework of EU agri-food company acquisitions in Poland and the Czech Republic, the research work aims at:

- identifying risks that agri-food companies have to manage,
- formulating recommendations to public policy makers, farmers' organizations and agri-food processors and retailers.

MOTIVATION AND EMPIRICAL CONSIDERATIONS

The agri-food sector is viewed as a key sector in the transformation process from a centrally planned to a market-drive economy in Central Eastern Europe because an adequate food supply at affordable prices is important for the population and the success of other reforms.

Ten years ago, Poland and the Czech Republic have been implemented agricultural reforms fairly rapidly through privatization and the breaking of state monopolies, and market liberalization. Strong prospects of growth and the perspective of the integration to the European Union have attracted a lot of EU agri-food companies. They have heavily invested

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in Central Europe, particularly in Poland and the Czech Republic, in acquiring agri-food enterprises during the 1990's. So after a decade, it seems natural to try to assess those acquisitions from the EU acquirers' standpoint: risks that are faced, perspectives of risk management and improvement. Emphasis is put on Poland and the Czech Republic.

THEORETICAL FOUNDATIONS

The opening up of Central European country markets has attracted foreign investments from EU agri-food investors. Hughes and Hare (1994), Jackson and Swinnen (1995), Viaene and Gellynck (1999) have assessed the competitiveness of agri-food sectors in Central Europe. They have identified several factors explaining the hard adjustment of the agents along the agri-food chain:

- declining terms of trade for farmers,
- reduced supply of agricultural credit to farmers,
- demise of previous trading arrangements with former COMECON members,
- market uncertainty,
- high inflation,
- state farm restructuring,
- privatization and land reforms,
- privatization of large state food processing monopolies,
- outdated processing technologies.

Those factors are mainly caused by imperfect information and imperfect contracts in the up- and downstream sector leading to opportunistic behavior (Hart, 1995; Gow and Swinnen, 1997). Opportunistic behavior may induce moral hazard problems and hold-up problems (Milgram and Roberts, 1992).

Moral hazard problems arise when a party has no contractual incentive to depart from undesirable activities like shirking, degrading quality, cheating... in order to be better off.

Hold-up problems arise from worries by each party of a contract about possible loss in bargaining power when a contract is signed. Before signing a contract, every potential party holds an option of contracting with different agents. However, when the contract is implemented, one party of the contract may have an incentive to renegotiate the terms of the contract because it has gained some bargaining power. So, when the two parties carry out investments in order to fulfill the contract, one may threaten the other to drop out the contract leading to strong potential sunk costs.

Williamson (1991) states that the hold-up problem may exist because of asset specificity since one partner's investment or activity cannot be redeployed to some second best alternative use and by other users at low cost.

Gow and Swinnen (1999) observed that foreign direct investment in agri-food processing industries in Central Europe has forced competing processors to raise their efficiency and productivity as usual. Further, they have encouraged some increase in the agricultural productivity, investment and output through vertical contracting. Hence, they have contributed to reduce hold-up problems.

McCorriston and Sheldon (1999) have analyzed the imperfect competition in the food sector in Central Europe, which is often characterized by monopoly and monopsony situation. But dominance of a few firms in a given food sub-sector does mean monopoly. State monopolies have been privatized and often acquired by foreign firms. However, firm conduct matters more than firm numbers. Competition authorities assume that there exists potential abuse of market dominance may be observed when a firm holds of a least 30%. Unfortunately, data on concentration ratios or market shares are not available in order to look at food sub-sectors.

So, the research work provides complementary observations.

METHODOLOGY AND DATA

Using the Structure-Conduct-Performance model presented on figure 1 (Scherer, 1980), the risks faced by Polish and Czech subsidiaries of EU agri-food investors have been analyzed through the point of view of agri-food western acquirers.

The EU agri-food enterprises, which have invested in Central Europe, have been selected using data from the French agri-food press agency «AGIA alimentation». A survey was conducted to reach the objective through a questionnaire sent to the top managers or international managers in order to know:

- their motivations to acquire an agri-food enterprise in Central Europe
- specific risks and constraints they are facing
- their solutions to manage such risks and constraints
- their suggestions to improve the situation

After having got the results of the survey, companies were contacted again in order to improve the analysis of risks along the agri-food chain.

Thirty agri-food enterprises have answered, corresponding to a global turnover of 180 billion Euros and 538,000 employees.

RESULTS

The results are presented below. It is remarkable to notice a large consensus among the answers to the questionnaire. Western agri-food investors' motivations for processing food in Poland and/or the Czech Republic are analyzed. A typology of risks faced by Western agri-food investors is set up. The way Western agri-food processors and retailers manage risks due to moral hazard and hold-up problems is examined.

Western agri-food investors' motivations:

Macroeconomic data are provided in table 1. The economic environment is perceived as very positive by all Western agri-food investors in the sample:

- After the harshness of the transition economy in the early 90s, their subsidiaries are very profitable in a growing agri-food market during the late 90s.
- Inflation rates are decreasing to levels around or below 10% (the inflation rate in the Czech Republic was even lower than 4% in 1999).
- Poland and the Czech Republic have convertible currencies.
- Poland and the Czech Republic are perceived as politically stable since they have already experienced governmental alternations over the decade.

- The two countries are quite socially stable with homogeneous ethnic groups in Poland.
- People have European culture with Christian roots similar to Western Europe.
- Global convergence of political decisions and economic regulations towards EU integration is observed. Every western agri-food investor in the sample anticipates the joining of Poland and the Czech Republic to the European Union.
- Poland and the Czech Republic are experiencing steady high economic growth rate (up to 6 or 7 % per year in Poland).
- In both countries, consumers' purchasing power is increasing, providing room for increasing demand for elaborated products.
- Brand development may be carried out quite easily in those two countries because Polish and Czech consumers are hungry for western brands. This fact meets the objective of « global branding » that is more and more common among western agri-food companies.
- Agri-food firms are attracted by the low costs of agricultural commodities.
- Agri-food firms want to have a significant market share and strategic position in the future Europe, particularly in the processing of sugar and rapeseed. Privatization and the restructuring of the agri-food sector open opportunities for entering the Eastern European market or for reinforcing existing positions. Hence, firms operating at the first processing stage (sugar extraction from sugar beets, oil crushing from rapeseed) were particularly motivated in operating in Poland and the Czech Republic in order to get the « first mover advantage » before growing competition. Western firms acquired sugar refineries in order to obtain their sugar production quota with high domestic prices in those countries when Poland and the Czech Republic join the European Union.
- Poland and the Czech Republic seem to be good bases to produce and export to other Central and Eastern European countries. Trading firms view Poland and the Czech Republic as a basis to import and export agricultural commodities in Central and Eastern Europe. Dairy processors view Poland and the Czech Republic as a basis to supply the Russian and Western market with typical Slavic products.
- Polish and Czech executives are keen on importing and adopting western know-how in order to improve their efficiency.

Typology of risks observed by EU agri-food investors:

At the firm level, most western agri-food investors face several types of risks: 1/ risks due to failures of legal systems, 2/ financial risks, 3/ risks due to poor substructures, 4/ transaction and transportation risks, 5/ climatic risks, 6/ risks due to moral hazard problems caused by administration agents, 7/ risks due to moral hazard and hold-up problems caused by farmers' behavior, and 8/ risks due to moral hazard problems and hold-up problems caused by workers at processing units and modern retailers' stores.

Risks due to failures of legal systems:

- Regulatory problems (inconsistent rules and lack of stable rules, for example high and fluctuating import duties from 10% to 40% on raw materials and finished goods) mentioned by every western firm
- The heavy weight of the administration impedes the process of establishing new activities.

Financial risks are observed:

- The cost of access to debt capital is quite high. The cost of borrowing (interest rate) is a lot higher than the inflation rate in both countries particularly in the short term and usually

banks do not lend money beyond 3 or 5 year. It is a barrier for farmers and agri-food companies to enter new technologies and to reinvest. The high cost of debt capital limits borrowing capacity and investment (mechanization, refrigerators...) profitability.

- Commercial legislation does not protect creditors efficiently. As a result, terms of payment are generally not met. Risks of payment defaults by clients are quite important.

Risks due to poor substructures (road network in poor conditions, small network of highways...) result in logistic inefficiencies. Indeed, poor road infrastructure has consequences to access to fields and to transport agricultural products (sugar beets, cereals...). It implies a lot of small deliveries.

Transaction and transportation risks due to farm structure: Scattered small farms increase transaction and transportation costs for the collection of agricultural products (sugar, cereals, and milk...) by processors in Poland.

Transaction and transportation risks due to retailing structure: Small and scattered retailers increase processors' distribution costs, i.e. transaction and transportation costs.

Climatic risks are mentioned by food processors. Their input supply is dependent on local harvests of rapeseed and sugar beets that fluctuate because of the harshness of the continental climate with strong frosts in winter or in spring. For example, two very rude winters in 1995 and 1996 in Poland led to poor rapeseed yields, whereas Poland generally exports its rapeseed surplus.

Risks due to moral hazard problems caused by administrative agents:

- Inefficiency and disorganization of the administration because of instability of State agents and corruption also impede business activities,
- Bureaucratic habits of workers and problems with customs (lost time, bribes) are noticed.

Risks due to moral hazard and hold-up problems caused by farmers' behavior:

- The quality of agricultural products is low because farmers do not meet technical specifications, but prices of agricultural products are low in both countries compared to EU prices.
- There are difficulties in improving the quality of agricultural products in Poland because of the small size of farms. Since average farm size is 7.5 hectares in Poland, it is difficult and very costly to train thousands of farmers. Moreover, farmers produce several different products in order to diversify production risks away and to be independent to feed animals (pigs very often). They usually are not specialized on a given production. As a result, it is not easy to motivate farmers to be trained (even during one day) in order to improve their technical methods of a given production.
- Several firms noted farmers' bad habits (for example, antibiotics and/or water in milk).
- Collection of agricultural products is more costly because it is difficult to enhance farmers' groups because any co-operative or farmers' association is perceived as a way to reduce individual freedom and go back to bad memories of farm collectivization.
- Some processors notice a lack of partnership between farmers and manufacturers. Because farmers want to be independent, they are very reluctant to gather their supply of

agricultural products and write agreements with processors. But this may be crucial for processors who need particular input quality (variety, agricultural practices...).

Risks due to moral hazard and hold-up problems caused by workers at processing units and modern retailers' stores:

- Language barrier between Slavic languages and EU languages causes management problems. It is difficult to find local managers who both are entrepreneurial and fluent in English or French or German. Language barrier does not ease communication among employees and management from western executives inside companies because foreigners do generally not know the Polish and the Czech languages. Consequently, problems may arise between local staff and western expatriates because of language misunderstanding.
- Up to now, most local managers do not have an occidental mind for business in terms of entrepreneurship and team skills. Several companies report that some local managers, who are entrepreneurial, are very aggressive with their colleagues because they want to succeed by themselves.
- There exists a lack of work commitment among workers. Managers of food processing plants and supermarkets observe workers' weak motivation habits of low-productivity, but recognize that wages are low.
- There does not exist the habit of working to fulfill specified requirements (quality specifications).
- Western agri-food investors also notice that it is difficult to hire managers with entrepreneurial spirit.

Management of hold-up problems by agri-food processors:

Food processors emphasize how important it is to secure their supply in terms of quality. In order to limit hold-up problems, all industrial companies in the sample stated that they established in those countries in partnership with local companies. Most of them underwrite contracts with individual farmers. But, they would prefer to deal with farmers' association in order to decrease their transaction costs.

Further, farmers' association may set its own rules and incentives to avoid moral hazard and hold-up problems among its members. Farmers' association may also promote farmers' training so they adjust their technical and management skills to produce the input quality and quantity processors need.

Some processors suggest that some vertical integration could be a way to establish long-term partnerships. Others mention that some interprofessional organization between farmers and processors in a given sub-sector could solve many moral hazard and hold-up problems. In the cereal sector, processors help farmers in financing seeds, pesticides and fertilizers in order to get cereals they need in terms of quality (seed variety...) and quantity.

Management of hold-up problems by Western supermarket operators:

Western supermarket operators have preferred to start from scratch and build new stores, may be because they wanted to build very different relationships with suppliers (agri-food processors and farmers) in terms of quantity, quality, logistics. However, they have also set up contracts with farmers directly, particularly for fruits and vegetables.

CONCLUSION

Western agri-food companies, which have invested in Poland or/and the Czech Republic, appreciate the improving economic environment that favors corporate investments.

Results show that western companies which have invested in Poland or/and the Czech Republic face several types of risks:

- risks due to failures of legal systems,
- financial risks,
- risks due to poor substructures,
- transaction and transportation risks,
- climatic risks,
- risks due to moral hazard problems caused by administrative agents,
- risks due to moral hazard and hold-up problems caused by farmers' behavior,
- risks due to moral hazard and hold-up problems caused by workers at processing units and modern retailers' stores.

Results show that Polish and Czech governments face challenges to enhance the agri-food business. In order to provide better economic conditions, they have to:

- improve and stabilize economic legislation,
- improve financial legislation to protect creditors, to lower the difference between interest rates and inflation rates and to enhance medium term loans,
- preserve State services (customs,...) from corruption,
- improve State services efficiency,
- improve substructures (roads),
- improve food regulations in terms of product quality,
- improve future managers' education in management,
- enhance farmers' organizations to improve the collection of agricultural products of high quality and to enhance farmers' training.

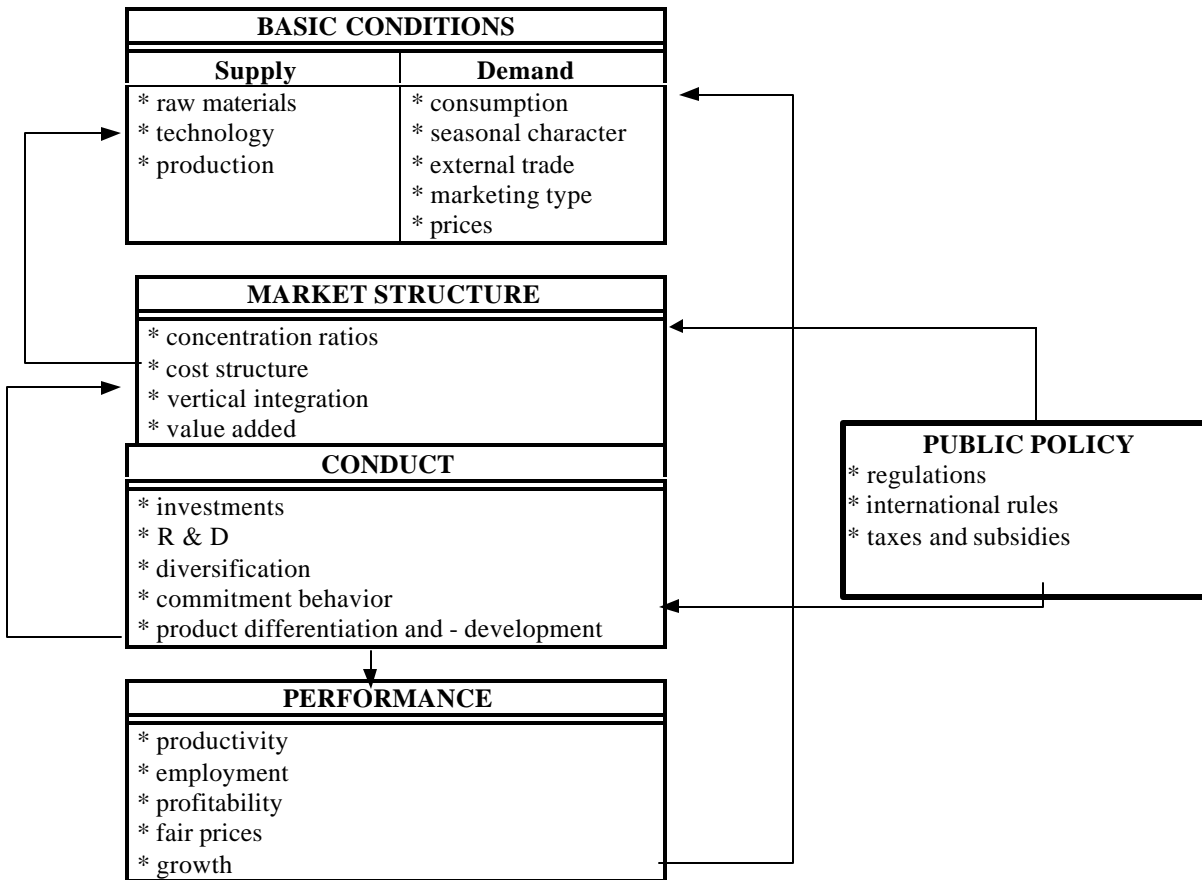
In order to solve risks caused by moral hazard and hold-up problems, agri-food companies have tried to:

- improve efficiency in collecting agricultural products from a lot of small Polish farms in enhancing farmers' groups,
- improve efficiency in getting agricultural products of high quality and paying agricultural products according to quality,
- motivate low paid workers used to bureaucratic habits in linking salary to productivity,
- improve managers training in entrepreneurship.

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Figure 1 - The Structure - Conduct - Performance Model



Source: adapted by the authors from F.M. Scherer, *Industrial market structure and economic performance*, Rand Mc Nally, 1980.

Table 1 - Key Economic Figures about Poland and the Czech Republic

	Poland	Czech Republic
Number of inhabitants in 1999 (in millions)	38.7	10.3
GNP/inhabitant in US\$ based on purchasing power parity in 1999	7,250	10,700
Annual change in GNP volume 1999/1998	+ 3.5 %	+ 1 %
Share of agriculture in the GNP in 1998	7 %	5.1 %
Unemployment rate	13.9 % (February 2000) 11.9 % (February 1999)	9.8 % (March 2000) 8.4 % (March 1999)
Annual inflation rate	9.8 % (December 1999)	3.5 % (January 2000)
Short term interest rate (3 months)	17.0 % (January 2000)	5.4 % (January 2000)
Long term interest term (10 years)	7.7 % (January 2000)	7.7 % (January 2000)
Market capitalization in billion US \$	21 (in 1999)	121 (in 1999)
Market capitalization in percentage of GNP	9 %	25 %
Number of companies quoted on the National Stock Exchange	143 (January 2000)	276 (January 2000) 9 (in 1990)

(Source: BNP Paribas and BERD)