Sava Transformation Chronicle (D)

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Abstract: This case study is part of a sequel of cases (from A to D) prepared to be used together in a course on Strategic Management (more in particular on topics related to Mergers and Acquisitions, Business Portfolio Management and Corporate Transformation). Due to the article length restrictions, parts B – D, as well as the case Teaching Note, will be published in a separate article. Please refer to the Teaching Note for more precise suggestions related to classroom use.

Kronika preobrazbe Save (D)

Povzetek: Ta študija primera je del primerov od A do D, ki so pripravljeni za uporabo pri predmetu o strateškem managementu. Natančneje o temah, povezanih z združitvami in prevzemi, upravljanjem poslovnih portfeljev ter korporativno preobrazbo. Zaradi omejitev dolžine članka bodo deli B - D skupaj z navodili za poučevanje objavljeni v ločenih člankih. Za natančnejše predloge glede uporabe v učilnici, se prosim sklicujte na navodila za poučevanje, ki so na koncu prispevka.

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As opposed to many other countries with economies in transition from a former communist or socialist model to free-market economy, the Slovenian government and the media influencing (or reflecting) common sentiment were looking unfavorably on Foreign Direct Investment as the vehicle of economic development. Foreign owners of established local companies were, at best, not very welcome. That is why the positive public reaction to sales of a large part of Sava assets to Goodyear was seen by industry observers being close to a miracle, a clear proof of the influence that Sava management, led by Janez Bohorič, had on Slovenian politics.

Closing the deal with Goodyear in 1997 left Sava cash rich. It had received more than 110 million US$ and was expecting at least another 100 million from cashing in its put option to sell the remaining stake of Sava in Sava Tires and Goodyear Engineered Products Europe. At the same time, it also left the company management facing several demanding issues including, above all, what should be the new strategic orientation of the company.

1998 – 1999: Initial considerations and restructuring

With the production of tires, V-belts and air springs sold to Goodyear, Sava was left with a wide portfolio of engineered rubber products, whose strategic potential the management understood well, since the thorough analysis of it was part of the preparation for negotiations with Goodyear. Still, there were several new elements present, which had to be taken into account when making the final decision about the future of the engineered rubber production in Sava.

For many years Sava management had procrastinated on making the decision about the upgrade of technological infrastructure needed for the production of engineered rubber products. The needed investment into rubber mixing plant was sizeable, estimated at around 40 million US$. Sava also needed a new facility for the production of semi-finished products. When it became clear that Goodyear was interested in buying part of the engineered products portfolio and was ready to share the cost of infrastructure with the production unit remaining in Sava, the management finally moved and made the needed investments, which proved to be critical for efficient future production.

The other big issue was the way Sava looked at the cost position of individual elements of the portfolio in determining their competitiveness (see Exhibit 1). Despite clear signals from Goodyear and quite obvious interpretation of the most basic benchmarking, product costing practices were burdened with blatantly oversized corporate overhead costs. After carving out operations bought by Goodyear (included necessary support functions), costs per unit further increased, since practically no effort was made immediately after the closure of JV contract to reduce the overheads to normal level. Without optimizing these costs, however, it would be difficult to be competitive, especially on the more price-sensitive segments of the portfolio such as bicycle tires or artificial leather.

Finally, Sava had to decide whether to use the proceeds of sales to Goodyear primarily to improve the production technology and develop a range of new products in selected niches, or to join the consolidation process going on in global rubber industry and try to reach global niche dominance through buying few (smaller) international players. Such a purchase would potentially bring the benefit of advanced know-how, as well as international distribution network and B2B contacts. However, Sava had to evaluate whether buying them was better than developing the business organically, which clearly depended on many factors such as target availability, price and timing, along with the M&A integration competence. These strategic issues were not new to the management team, since for several years they had been engaged in discussions with companies from Germany and (former) Czechoslovakia, but without going beyond expressing general interest for such talks.

Deciding to strengthen at least a selected part of remaining engineered products portfolio clearly meant going for known territory, but also committing to further global expansion, since none of the niches would be of the sufficient size just in the regional markets. On the other hand side, the available funds could have been used for diversification, either a “semi-related” one (such as venturing into chemical industry) or a completely unrelated one. In the latter case Sava would likely look for an industry that was offering consolidation opportunities in Slovenia, as well as the average returns on the employed capital above the fairly meager ones characterizing rubber industry. The management was well aware that they faced the classical “risk – reward” dilemma (see Exhibit 2).

The initial strategic course seemed to be a highly conservative one. In 1998 and 1999 Sava disengaged from 11 engineered rubber product segments (see Exhibit 1), including several that were for years subject to controversy in the evaluation of their potential, such as artificial leather or bicycle tires, both requiring very large volumes and low costs in order to yield satisfactory returns. That still left 10 different product groups that were to be the basis for future company growth. However, Sava did not attempt any international acquisition to strengthen the position of that portfolio. Instead, it further invested in production equipment and development of several new products, as well as tried to further expand its international sales network and maximize the market share in the remaining product categories. The growth ambition was set to 5-10% annually, which many saw as insufficient for an aspiring player with high investment potential.

Since not all of the available funds were used immediately, Sava management decided that the free cash should be temporarily placed into the financial markets, as short-term financial investments, before proper acquisition targets or other “real sector” (i.e. manufacturing) investment opportunities were identified. That would keep the company close to the areas management felt comfortable dealing with, but at the same time condition of sufficient return on investment had to be satisfied. While sound on paper, this approach came with a major problem, typical of M&A oriented strategies: there were very few companies in Slovenia satisfying both criteria. International equity markets, for some reason, seemed not to be that interesting for Sava management.

2000 – 2008: The period of high growth

In 2000 Sava management made a significant turn in its growth philosophy. The company executed a number of acquisitions and started with significant activities in as much as five different industries:

- Chemicals (such as paints and surface treatment, as well as chemicals used in various production processes in textile or artificial leather)
- Trade (with main focus on specialized retail outlets for paints and other chemical products)
- Tourism (including hotels in prime locations in Slovenia, but also smaller facilities such as a golf course and a camping site)
- Financial industry (starting with the purchase of a major share in Gorenjska banka, a regional Slovene bank headquartered in Kranj, which at that time was ranked in the middle section of top ten Slovenian banks in terms of balance sheet size)
- Real estate (Sava became significant player in real estate market).

While media and public opinion remained positive about Sava strategy, some industry experts questioned both the broad choice of industries, as well as the choice of individual targets.

“One would expect that Sava used its investment potential for obtaining at least a dominating regional position in one industry. Instead, it went for a fairly large number of relatively weak players across several very different industries, for none of which Sava management can claim expertize. From risk diversification perspective, such choice may have merit, but achieving sustainable high performance may prove to be difficult.”

Sava Management Board wanted to acknowledge the new nature of the company and its own priority of managing the investment portfolio. Consequentially, in 2002 Sava was transformed into a holding company with 23 subsidiaries and renamed into a joint stock company “Business Group Sava, company for management and financing”. At the same time, the management style did not change much, since the Management Board kept “hand-on” approach, engaging in all important decisions made in subsidiary companies despite the lack of particular industry experience.

The key decisions were made within the Management Board and, more or less, rubber-stamped by the Supervisory Board, which had remained under strong influence of Mr. Bohorič. However, the Management Board seemed not to be completely aligned across all decisions. One of the early acquisitions, the local paints and coatings company Color, led to disagreement whether or not the price paid was too high. This very likely contributed to a major embarrassment, when Helios, a company similar to Color, but larger and better performing, rejected Sava’s take-over offer as inadequate. That acquisition would have made a perfect match, allowing for significant synergies and creating a European level player in paints, coatings and surface treatment products. Having Color in its portfolio without having Helios did not make strategic sense, thus Sava sold Color in 2004.

Further divestments of remaining chemical businesses followed in the period from 2004 to 2006, as well as the equity swap of Sava’s chemical retail subsidiary for increased ownership stake in Merkur, leading Slovenian technical retail company. Several hospitality companies were taken over in that period, primarily thermal water resorts in north-east Slovenia.

Shift away from chemical industry was not interpreted as a failure, but as the confirmation of careful selection of investment opportunities, which required focus on industries with high returns. To be truly consistent, that would require exiting tourism and rubber, which was never executed, although Mr. Bohorič several times used that argument in both internal and public debate as a realistic possibility. Instead, he decided to engage majority of available investment potential into increasing Sava position within financial sector in Slovenia.

After Slovenia had joined EU in May 2004, in the period from 2005 to 2008 it experienced a boom of speculative investments and high returns in financial industries. Sava management was able to secure the political support needed in acquiring position in strongly regulated, government influenced banking sector. It also had full support of the Chairman of the Supervisory Board, Mr. Stane Valant, who himself was owner of NFD, one of the private investment funds. This ultimately led to (surprisingly) intertwined interests of NFD and Sava, including some cross-ownerships (see Exhibit 3).

The only exception from the newly found focus was the remaining part of engineered rubber business, consolidated in Sava Tech. It received more than 100 million € of investment into new technology and new product development, but still received no support through M&A activities of Sava. Sava Tech management team prepared a project of acquiring Czech company Rubena, which showed that the investment would be paid back in several years and would allow for leadership in European markets. The proposal was turned down by Sava management in favor of taking equity position in Abanka, another mid-size player in

Slovenian banking market. However, Sava Tech could at least rely on strong professional expertize existing in the company and was successful in organically developing its business, increasing its revenues from 48 million € in 1999 to 120 million in 2012.

The transformation of the kind and size described above was not possible only with the funds received from the sales of rubber business to Goodyear: With more than 510 million € spent on acquisitions, Sava had to take significant debt in the process (see Exhibit 4). Having ownership position in two banks and enjoying strong political support in the country, where dominant economic philosophy was relying on national champions, money in the banks being fairly cheap and lending rules "flexible" made this not only possible, but seen as a smart business strategy, resulting in obvious change of revenue structure (see Exhibit 5). It seemed that nobody from Sava governance structure paid attention to several hazardous caveats.

Except for its core business (Sava Tech), which managed to grow organically, the growth of revenues in the period from 1999 to 2008 was driven more or less only by M&A activities. The acquired hospitality companies, supposed to become new core business, were historically underinvested, while the business as such yielded low returns. Sava had to spent more than 100 million € in the modernization of the hotel and spa facilities, but still none of the acquired companies managed to perform well. Thus, the only profits from newly acquired businesses in that period came from minority positions in financial sector.

While banks in Slovenia, in line with the high GDP growth of the country, performed extremely well between 2000 and 2008, they were financing their expansion from low cost international sources rather than from long-term domestic savings. As a result, in order to keep their books showing matching terms of sources and uses, they preferred to give short-term corporate loans, often in the form of revolving loans, granting "almost automatic" loan extension in the next short-term period. Sava management saw no risk in that and gladly accepted such terms, being confident of their business judgment and political clout. In practice that led to D/E ratio of close to 1 in 2008, which in itself was not seen as exaggerate, but the ratio of short-term loans to long-term ones was 2:1 and the short-term loans became higher than overall Sava revenues in 2007!

2009 – 2016: Crisis, decline and demise

The initial reaction of the Slovenian government to 2008 global financial crisis was a surprisingly naïve one: "our banks hold no toxic instruments, so our economy will not be hurt". Truly, crisis came with the delay, but when it exploded in 2009 it turned into a disproportionally severe one, compared to mainstream EU countries. Slovenian banks lost external financing and the central bank panicked. Short-term corporate loans were not prolonged, many companies started defaulting and, for Sava, the nightmare scenario followed.

The short-term debt that suddenly had to be serviced, although itself disastrous, was not the only problem. Sava's investments in financial sector became a huge burden to the company. The two banks in which Sava had ownership stakes suffered from large amounts of non-performing corporate loans and produced significant losses. The whole banking sector in Slovenia came under severe regulatory pressure to increase the capital adequacy, which proved to be difficult wherever private ownership was significant. Consequentially, valuation of Slovenian banks in the period starting with 2009 dropped dramatically.

The NFD Holding and its satellites faired much worse. Not only that their investments proved not to be prudent enough, but Mr. Valant, their main owner and close business associate of both Sava and Merkur, got involved in a number of court cases due to assumed financial irregularities and was ultimately convicted to jail. NFD Holding declared bankruptcy in early 2015.

To make things worse, Sava's equity share in Merkur became toxic, too, since the company also went down under the burden of debt and a botched attempt on privatization. The affair ended with Merkur CEO, glorified by the Slovenian business community just a year before the crisis as one of the true captains of the industry, receiving lengthy jail sentence for financial manipulations he had performed in his attempts to save his investments.

The whole Sava strategy collapsed. From that moment on the company entered a prolonged agony, trying to reach some kind of settlement with the banks. In 2010 the loss was a staggering 100 million € on the revenues of 176 million, driven primarily by impairments of minority stake financial positions in Merkur, Abanka, Gorenjska banka and companies from NFD circle. Losses in 2011 reached more than 150 million € (see Exhibit 6). Due to losses and capital impairments, its balance sheet structure soon became unsustainable.

In April of 2012 the Shareholder Assembly accepted the business results and decided not to pursue any liability claim of the Management Board members. All three members of the Management Board resigned and received financially attractive exit packages, for the first time creating unison negative media coverage. Supervisory Board composition was changed, too, and Mr. Matej Narat, a former banker, was appointed as the new President of Management Board. Sava started selling off individual parts of the group. The first to go was Sava Tech, its only consistently profitable business. In almost a cynical twist of history, it was sold to the same Czech company that was the potential acquisition target several years before. The price achieved was extremely low by industry standards (70 million € on annual sales of 120 million), which was the source of new rumors on lack of transparency of Sava M&As[1].

During the whole period from 2012 to 2016 Sava was fighting to pay off interest and short-term loans as well as to restructure debt. The proceeds from Sava Tech were seen almost as a "drop in the sea" of financial obligations, while the remaining tourism business was not strong enough to meet even the daily needs of the group.

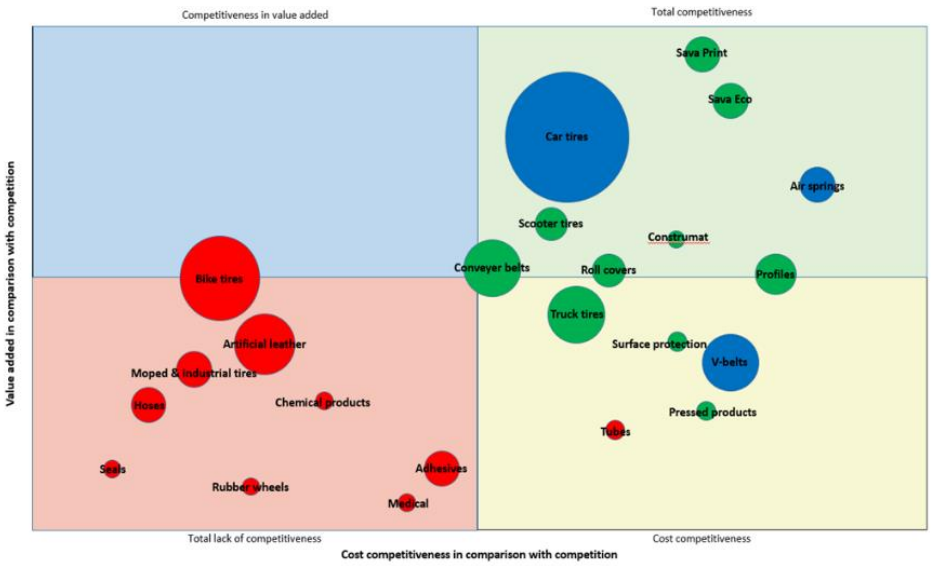
With debt piling and negative equity rising, the company entered into Slovenian version of Chapter 11 procedure ("forced settlement"), with close to 42% of its equity bought by a specialized US fund York and 45% transferred into the ownership of two state funds. The only remaining assets of some value were the hotels and thermal resorts, which became target of speculative appetites of several players from local politics and business community.

After almost a century of company existence, trading with Sava stock was stopped in August 2016.

[1] Four years later this seemed to be confirmed, since the Czech owners sold Sava Tech to Trelleborg at the price said to be more than 110 million €.

Exhibit 1

Competitiveness of Sava sales programs

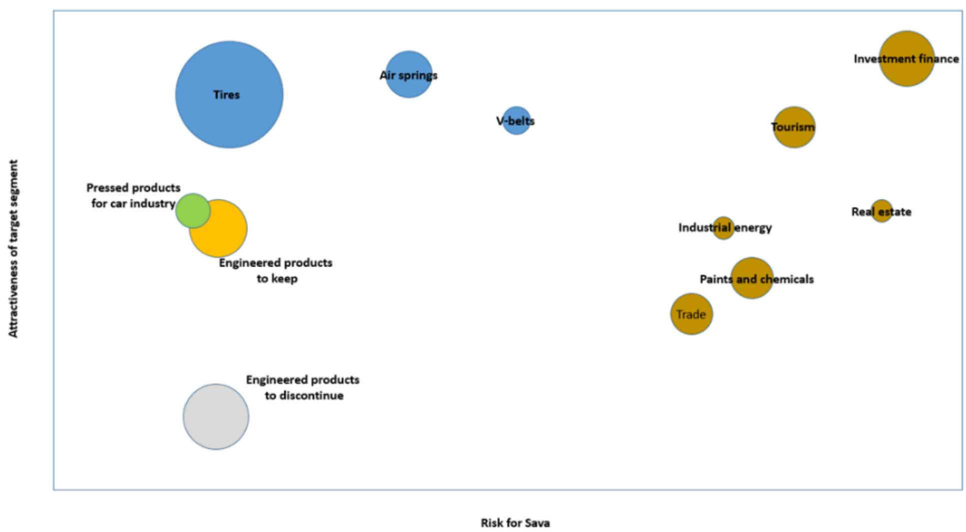


- Segments to terminate
- Segments to keep
- Segments sold to Goodyear

Source: Case writers' data

Exhibit 2

Estimate of investment potential and risk per target segment considered by Sava management in 1998



Source: Case writers' data

Exhibit 3

Major cross-ownership positions (end of 2011)

Partner	Sava's share in partner's equity	Partner's share in Sava's equity
Gorenjska banka	45.90	2.81
Abanka Vipa	23.83	0.22
NFD Holding	24.65	4.33
NFD 1 investment fund	23.35	5.03
Maxima Invest*	21.77	1.70
Merkur**	8.20	6.72

*** Maxima Invest was associated with NFD Holding, investment group controlled by Stane Valant, Chairman of Sava's Supervisory Board**

**** Retail company Merkur had headquarters close to Kranj, approximately 10 km from the headquarters of Sava, Merkur CEO Bine Kordež was seen as having same political affiliation as Sava CEO Janez Bohorič**

Source: Case writers' data

Exhibit 4

Excerpts from Sava Balance Sheet

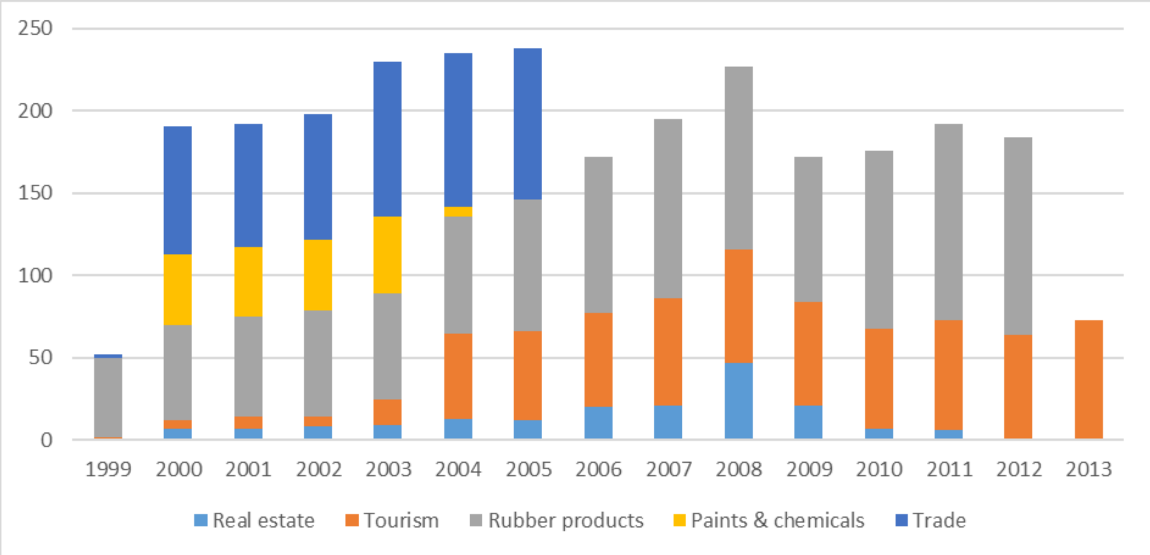
Year	Equity (mil. €)	Debt (mil. €)	Total liabilities (mil. €)
1999	222.3	67.9	290.2
2000	244.2	177.5	421.7
2001	250.3	162.1	412.4
2002	235.5	178.9	412.4
2003	233.7	186.3	420.0
2004	377.9	215.4	593.3
2005	392.9	258.1	651.0
2006	432.5	242.1	674.6
2007	545.4	406.3	951.7
2008	482.4	439.2	921.6
2009	475.4	466.0	941.4
2010	323.3	437.5	760.8
2011*	165.8	442.5	611.4
2012	67.3	413.6	480.9
2013	16.2	310.1	326.2
2014	-21.2	306.7	285.5
2015	-24.5	307.6	283.1

*** At the end of 2011 Sava had 361.1 million € short-term and 81.4 long-term debt**

Source: Case writers' data

Exhibit 5

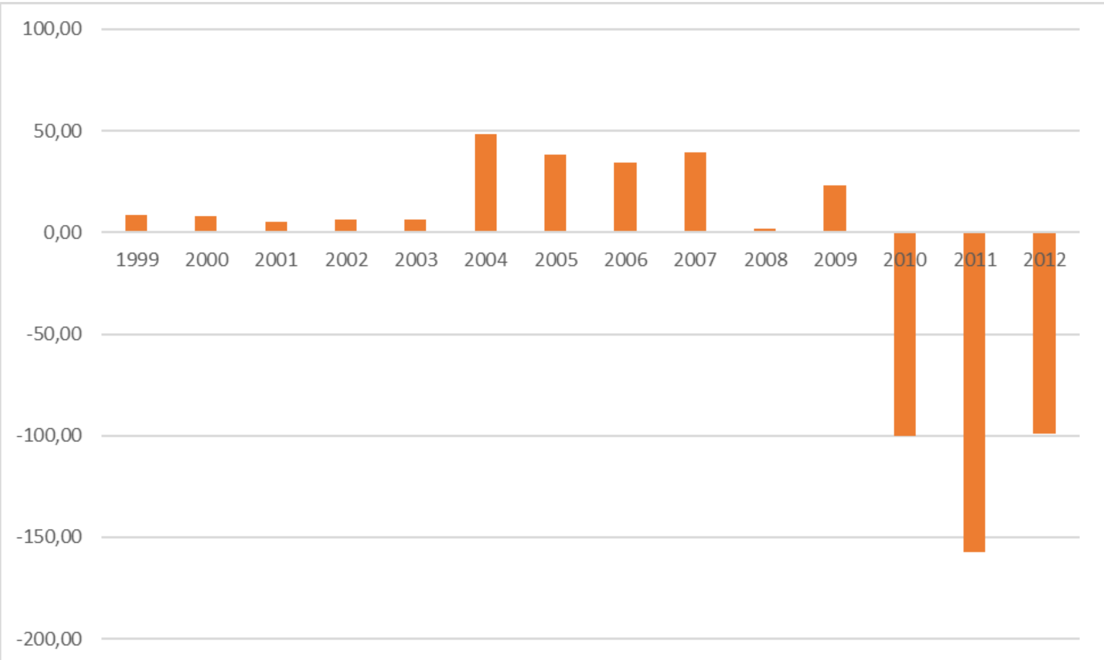
Structure of Sava revenues (in million €)



Source: Case writers' data

Exhibit 6

Sava profit / losses (in million €)



Source: Case writers' data

Sava Transformation Chronicle

Teaching Note

Sava Chronicle sequel of cases (A to D) describes the challenges and outcomes related to the process of strategic transformation of Sava, a rubber products manufacturing company from Slovenia, in the period from 1995 to 2016. The cases deal with the following main situations:

- Case A: Briefly recounts the history of Sava and presents the external setting in 1995, as well as the challenge of the expiry of JV contract between Sava and Continental, which puts in jeopardy Sava's ability to stay a viable player in car tire and engineered rubber products market;
- Case B: Summarizes the thinking behind the selection of strategy responding to the challenge presented in Case A, leading to negotiations between Sava and Goodyear, successful closure of new JV contract and resulting challenge of transforming both the JV part and the remaining part of Sava;
- Case C: Presents the challenge of transforming Sava Tires, the newly formed JV between Goodyear and Sava, from the point of view of Richard Johnson, newly appointed Managing Director, as well as actions taken to (successfully) resolve these challenges;
- Case D: Presents the challenge of selecting the right strategy for Sava of using the proceeds from sales to Goodyear to achieve sustainable, profitable growth; details the three phases of transformation: initial hesitation, unrelated diversification and final crisis, allowing for discussion about reasoning behind individual choices taken and causes of ultimate transformation failure.

The sequel can be used in a number of courses, typically on the MBA level or within executive education programs. Some examples of the usage include:

- Strategy course, focusing on the topic of sources of sustainable growth;
- Strategy course, focusing on the topic of diversification challenges;
- Strategy or change management course, focusing on the topic of transformation priorities;
- Leadership course, focusing on the role of charismatic leader in corporate transformation and the tendency of charismatic leaders to derail due to hubris induced by prior successes;
- Corporate governance / Business ethics, focusing on ethical challenges related to large-scale transformation and critical role of corporate governance in managing them.

The use of various conceptual frameworks, such as SWOT, five forces analysis, portfolio management, diversification typologies, risk management matrix, or transformation management can be illustrated through the case analysis and discussion process .

Stanko Cvenkel, Richard Johnson and Slavko Koren contributed the material for this case written by Professor Nenad Filipović solely as a basis for class discussion. The case is not intended to illustrate either the effective or ineffective handling of a business situation. Some information may have been disguised to protect confidentiality.

The sequel allows for ample discussion on core issues related to and illustrated in individual cases. Using role play is possible for every case (for example - but not limited to - Sava vs. Continental in Case A, Sava vs. Goodyear in Case B, management vs. employees in Case C, Management Board vs. Supervisory Board vs. management of subsidiaries in Case D). While some understanding of the setting (manufacturing industry, Central Europe in the period from 1995 to 2015) is beneficial, it is not mandatory, since core issues are universal. If the whole sequel is used, two 90-minute blocks might be appropriate for class discussion, not including the preparation time.

The preparation may be structured around the following questions:

Case A:

1. What options are available for Sava management in response to the challenge of expiring JV contract with Continental?

2. Should Sava management try to narrow down these options to as few as possible as early as possible, or try to keep them open as long as possible? Why?

3. How should the industry dynamics and market trends influence the management's thinking about the options?

4. How should the Sava competences (or lack of them) influence the management's thinking about the options?

Case B:

1. Did the Sava management handle the negotiation process appropriately? Would it be beneficial for the parties to do anything else in the preparation for the deal closure?

2. What should Goodyear see as the priorities immediately after the contract came into force?

3. What should Sava see as the priorities immediately after the contract came into force?

Case C:

1. What do you see as rationale behind Johnson's initial priorities? Would you modify the list? If yes, how? If not, why not?

2. What were the principle strengths of the change process, leading to positive outcome?

3. Does the choice to have a production unit in a small EU member country appear as sustainable over long run? What might be the pros and cons of moving it to a low labour cost or a large local market country?

Case D:

1. How do you see the arguments in favour of the growth strategy chosen by Sava management? Against it?

2. Was the final failure primarily the result of unexpected turmoil in financial markets due to 2008 global financial crisis, or you see other factors being more important? If latter, which factor were decisive?