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CASE STUDIES OF PRIVATIZATIONS IN SERBIA

Branko Radulović
Stefan Dragutinović

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BRANKO RADULOVIĆ
STEFAN DRAGUTINOVIĆ

**CASE STUDIES
OF PRIVATIZATIONS
IN SERBIA**

BELGRADE • 2015

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FOREWORD TO THE ENGLISH EDITION

Similar to other transition countries, privatization in Serbia represented the key element of structural reforms and had multiple goals. Besides increased economic efficiency, those that stand out include higher budget revenues and the development of a domestic equity market. Since the early 1990s, privatization in Serbia was carried out through several different models, but up until now, more than 20 years after its beginning, the privatization process has not been completed. According to the latest data from the Ministry of Economy, Serbia currently has 155 companies in the process of restructuring, and 419 companies are undergoing various phases of the privatization process. In spite of relatively frequent changes of the legal framework governing privatization over the previous several years, mainly focused on accelerating and finalizing this procedure, it is obvious that there has been a halt in privatizations, and that the key issues, which often had a crucial impact on the success of this process – surplus workforce, unresolved ownership issues, debt overhang – remain unresolved.

The companies that have remained non-privatized do not only waste resources, but also impose a constant burden on the national budget, and forego fiscal revenues for the government budgets. The role of local governments in the privatization process, unfortunately, often remains neglected. Management of the privatization process in Serbia is highly centralized – therefore, local governments do not entirely recognize their role in the process, and it seems that they are not fully aware of how much they are actually losing, and how much their budgets could gain, if the companies in their territories would be successfully privatized. As a consequence, local governments do not take an active part in this process and in a number of cases concerns have been raised about privatization in terms of the the resulting effect on the local economy. NALED initiated the development of this publication, with financial support of USAID Sustainable Local Development Project (USAID SLDP), aiming to identify the causes of failed privatizations and their impact on the local economy and, based on analysis of appropriate best practice examples, perceive the potential of further privatizations.

Additionally, the aim of this study is to present the overall business and regulatory environment in which privatizations were performed, and formulate recommendations for improving the regulatory framework for a more efficient completion of the privatization process in Serbia. By presenting case studies of five pairs of successful and unsuccessful privatizations in five selected sectors and by evaluating their effect on local government budgets, and

by analyzing the impact of various privatization models as well as one of the major privatization issues – land ownership – this study provides an overview of paradigmatic examples of successful and failed privatizations. The subject of this analysis are the companies operating in industries significant for the Serbian economy – agriculture, mining and processing industries. Selection was made very carefully, so as to ensure that the examples of successful and failed privatizations were comparable in terms of size, market share and other relevant characteristics before privatization, and that they also reflect the key privatization models and main problems observed in the overall process. Each case study covers the timeline of events, operations and financial performance of companies, assessment of operational restructuring, etc.

Given that the new Privatization Act, adopted in August 2014, prescribes new models of privatization, and that December 31, 2015, was determined as the final deadline for completion of privatization in Serbia, in the final part of this study we offer recommendations to both national authorities and local governments, for efficient completion of this process in Serbia in order to achieve the best possible results for all stakeholders.

We would like to thank Mr. Howard Ockman and USAID's Sustainable Local Development Project for supporting this study and Mrs. Jelena Bojović and the NALED executive office who reviewed and commented on the draft of this study. Djordje Vukotić and Dragan Spirić provided guidance, review and support with respect to legal and local government financing aspects of the study respectively. Danica Jolović provided valuable assistance with many tasks related to this study. Finally, the authors would like to thank the reviewers Ivan Nikolić (Economics Institute, Belgrade), Aleksandra Jovanović (Faculty of Law, University of Belgrade), Ana Knežević Bojović (NALED and Institute of Comparative Law, Belgrade) and Itzhak Goldberg (CASE, Poland and Fraunhofer MOEZ Institute) for their valuable comments and suggestions.

In the English edition we have corrected several mistakes we noticed and expanded the reference data. As always, the authors are solely responsible for any errors or imperfections that may remain in the book.

Authors

1. INTRODUCTION

Privatization in Serbia has been formally going on for a quarter of a century.¹ During these 25 years the public opinion and attitudes about privatization has significantly changed – from it being a necessary evil, as privatization was observed until the late nineties, to its treatment as a *panacea*, the cure to all problems of the Serbian economy during the early 2000s. Yet, a short-term euphoria was followed by huge dissatisfaction with the results achieved from privatization. As a result, nowadays the word privatization in Serbia is often accompanied with the adjectives “predatory” and “rigged” (or such adjectives are implied). Thus, it seems that there is a need to once again engage in proving that private (and privatized) ownership is more efficient than the social or state ownership.² The expectations from privatizations were overly optimistic,

-
- 1 The introduction will not discuss and elaborate on the waves of privatization, models and methods in Serbia – these will be discussed within the section involving case studies. For a comprehensive overview of the models, see Cerović, B. *Tranzicija – zamisli i ostvarenja* (Transition – Ideas and Achievements), Centar za izdavačku delatnost Ekonomskog fakulteta, Belgrade, 2012; Mijatović, B. “Privatizacija realnog sektora” (Privatization of Real Sector) in Begović, B. B. Mijatović (ed.) “Četiri godine tranzicije u Srbiji” (Four Years of Transition in Serbia) CLDS, Belgrade, 2005, “Privatisation in Serbia: Evidence and Analysis”. Cerović, B. (ed.) Centar za Izdavačku Delatnost Ekonomskog Fakulteta u Beogradu, Belgrade, Serbia, 2006.
 - 2 Several empirical studies clearly pointed to the superiority of private sector in Serbia. Goldberg, Radulović and Schaffer (2005) used the data from the 2002 World Bank Survey of productivity and investment environment in their study which shows that the total factor productivity (TFP) of privatized companies is 60% higher than that of unprivatized firms, while the generic private sector has had as much as 80% higher productivity than the sector of socially-owned and state-owned companies. In comparison to other countries, the impact of new companies on TFP is even more significant. However, these results with regard to privatized companies partly pertain to the effect of self-selection. Specifically, if privatization may increase TFP, it is possible that precisely the companies whose productivity was already higher have been the ones to be privatized. Management and employees at more productive companies are more willing to initiate privatization proceedings than those management structures and employees at companies depending on (direct or indirect) state subsidies. See Goldberg, I. B. Radulovic, M. Schaffer “Productivity, ownership, and the Investment Climate: International Lessons for Priorities in Serbia”, Policy Research Working Paper Series 3681, The World Bank (2005). In a more recent study, Nikolić and Kovačević (2014) analyzed privatization’s impact on the basis of financial reports of companies in the 2002–2007 period. The 2001 privatization model partially set into motion restructuring of companies in some areas of the processing industry. Although the new model brought in fresh capital, new technologies and new managerial know-how, the result was significantly weaker than initially expected. See Nikolić, I. M. Kovačević, “The impact of Privatization – Empirical Analysis and Results in Serbian Industry”, *Industrija* Vol.42.: 63–86, 2014.

bearing in mind that it took place in an economy that was exposed to years of sanctions, war, and even before that, decades of socialist self-management. In addition Serbia started the privatization process as the last among countries undergoing transition.³

1.1. KEY ASPECTS OF (UN)SUCCESSFUL PRIVATIZATION IN SERBIA

At the beginning of the privatization phase initiated after the political changes in 2001, many *Serbian companies were like a damaged or salvaged car produced in the mid-seventies or early eighties*, served by three drivers and two mechanics. In most cases such damaged cars had a lien on them (and some were even without a clear title). Despite these facts, drivers expect they will be driving the car again and the creditors expect to recover their claims entirely. The state occasionally provides money for gas and salaries for drivers and mechanics. However, since the car is not working, the gas money is instead used for salaries while the drivers and mechanics wait for their retirement conditions to be fulfilled. In the meantime, the remaining parts that are functioning are wearing out. Almost all expect a buyer who is willing to pay for the car, and will be obliged to keep at least two drivers and two mechanics for another three years. In reality, the damaged car represented a negative value asset, and someone had to pay for the car to be taken to the car scrapyard.

Of course, not all cars were damaged, nor did all of them have that so many excessive drivers and mechanics, but the majority of good cars (companies) had been previously privatized (transferred to the drivers and mechanics themselves). As a rule, the better companies in Serbia, i.e. their management and employees, used the favorable treatment conditions and initiated privatization in accordance with the insider privatization model of the Ownership Transformation Act (hereinafter referred to as OTA).⁴ This *self-selection* significantly contributed to later problems in the implementation and duration of privatization. As stated, many companies did not fit the description of a damaged car, but this metaphor illustrates the *four key aspects of (un)successful privatization in Serbia* which provides the framework for the case study analysis.

The first aspect refers to *unresolved ownership issues*. In addition to the lack of an adequate legal framework that would resolve land and especially

3 For more information on strengths and weaknesses of late privatization, see Cvetkovic, M., A.Pankov, A. Popovic (2007), "Balkan latecomer: The case of Serbian privatization", in Ira W. Lieberman, Daniel J. Kopf (ed.) *Privatization in Transition Economies: The Ongoing Story* (Contemporary Studies in Economic and Financial Analysis, Volume 90) Emerald Group Publishing Limited, pp.221 – 260.

4 The Ownership Transformation Act (The Official Gazette of the Republic of Serbia, Nr. 32/1997, 10/2001). For the 2001 law see Privatization Act (The Official Gazzete of the Republic of Serbia Nr. 38/01, 18/03, 45/05, 123/07, 123/07 – other law, 30/10 – other law, 93/12, 119/12). For the 2014 law see Privatization Act (The Official Gazzete of the Republic of Serbia Nr. 83.

urban construction land issues, the matter of restitution was not resolved either. While the uncertainty regarding construction land and restitution can be called a systemic risk, there was also a specific risk regarding the particular company's ownership. In most case studies, the facilities of privatized companies did not have the adequate permits for use, and in some cases not even a building permit.

The second aspect refers to the *surplus workforce*. The vast majority of companies undergoing privatization had a significant number of redundant workers. To illustrate the point, we may cite a case study of a company that now has nearly 7 times less employees, but reaches the same level of operating revenues as before privatization. During the first period of implementation of the 2001 Privatization Act, any redundancy issues were to be resolved by the buyer, but this proved to be unsuccessful. Given that fewer and fewer buyers were willing to conduct post-restructuring which included high amounts of social programs, the state took over the obligation to resolve redundancy issues. Two problems occurred after this – the first problem was that the reduction of the number of employees was based on the principle of voluntariness, which is why the process took a very long time (in some companies, the number of employees was cut down in four or five iterations). The second problem was the insufficient funds allocated to the so-called Transition Fund.⁵

The third aspect refers to *debt overhang*. Up until 2005, privatization was facing opportunistic behavior of certain state creditors, which blocked the sale of the privatization subject (socially owned enterprise) by imposing their conditions in order to accomplish a more favorable settlement. In order to resolve this issue, the changes in the legal framework introduced a concept of mandatory discharge of debt for state creditors. Given that the discharge of debt referred only to debts up to the end of 2004, and the debts once again accumulated in the meantime, the possibility of applying this institute had a limited period of duration. In the meantime, debts would be piling up once again so that unprivatized companies, as a rule, are again over-indebted.

The fourth aspect refers to *soft budget constraint*.⁶ While various state creditors often obstructed privatization, lacking the good will to write off old debt claims, they simultaneously enabled the same companies to borrow further. A drastic example of soft budget constraint was described in one of the case studies, when the state allowed a privatized company to be exempt from paying taxes and contribution for five years, only later to find the state “linking the years of service” i.e. providing subsidies for unpaid taxes and contri-

5 Informal name for budget appropriation 472 of the Ministry in charge of labor and employment, and previously of the Ministry of Economy. Transition fund provides severance packages for employees who lost their job during the process of privatization.

6 For more on relation between the soft budget constraint and privatization in Serbia, see Goldberg, Itzhak, and Branko Radulovic. “Hard Budget Constraints, Restructuring and Privatization in Serbia: A Strategy for Growth of the Enterprise Sector”, Private Sector Note, World Bank, Washington, DC, 2005.

butions for employees in the company where the state has not had a majority share since 1998.

Unresolved ownership issues, redundant workers, over-indebtedness and persistent soft budget constraint led to several negative effects. The risk of buying a company with the stated problems led to *adverse selection of investors*.⁷ The interest of strategic investors (the key determinants of privatization success) to perform technology transfer, conduct operational restructuring measures and invest in equipment was limited to companies which operated in highly profitable sectors (mainly with an oligopolistic structure) or companies where ownership and redundancy problems were not significant. The number of such companies in Serbia was rather small. Additionally, *Serbia was late-comer, and a large number of potential investors had already invested in the region and weren't interested in new deals*. The problem of adverse selection of investors was additionally affected with the *"preferential treatment" of Serbian nationals and the possibility of making purchases in installment payments*. Even though the intention was to increase the number of interested buyers and allow employees to participate in the privatization process, the provisions allowing installment payments actually stimulated the *moral hazard of buyers and the potential for embezzlement*. A sale with installment payments allowed the adversely selected "buyers" to pay only a portion of the price reached at the auction. After that, the "buyer" makes a decision either to continue the payments or to abandon the company (if the latter action is more profitable). Before abandoning the company, the new owner "tunnels", i.e. transfers the valuable of the property to another legal entity in its ownership and leaves an empty shell, which is then returned to the portfolio of the Privatization Agency. Finally, adverse selection was also enabled with the *elimination of already negligible obstacles to money laundering* within the privatization procedure of 2005.

Failure to resolve these issues led to *a high number of cancelled sale contracts*, and also enabled companies to remain in the 'process of restructuring' for years. According to World Bank estimates, this costs the Serbian economy as much as 0.6% of GDP a year. However, this value is underestimated, as it does not include liabilities to local governments and local public utility companies. Terminated privatizations, companies staying in restructuring for years, a large number of insolvency procedures, represent a potential source of fiscal imbalances and social problems on the local government level. In order to assess the extent of this problem, there is a need to develop the framework for the analysis of privatization effects on the local government's financial position.

7 Even if they bought the company, there was a question whether they would manage to register all property or if some other obstacle would appear. Similarly, even if the investor fulfilled the social program, he could not be sure whether the employees would dismiss their threats of strike, or whether they would demand that additional requirements be fulfilled.

1.2. PRIVATIZATION IMPACT ON LOCAL GOVERNMENTS' FISCAL PERFORMANCE: A FRAMEWORK FOR ANALYSIS

The impact of privatization is multifaceted and influences all aspects of economic life at the local level. In addition to its effect on employment, privatization creates a significant impact on the fiscal performance of local self-governments. Such effects may be a one-time occurrence (arising from the actual sale) or continuous (resulting from a company's business operations after the privatization). The very act of privatization would bring in a *one-time revenue* for local self-government. Article 61 of the 2001 Privatization Act prescribed that 5% of the funds obtained through sales of equity in the privatization process (upon settling the costs of sale and commissions) shall be allocated for the development of infrastructure in the municipality where the privatization subject (company) is seated. In the 2002–2013 period, according to data on the privatization-related funds paid to the budget upon the completed sales through auctions and tenders, *local governments received only EUR 90.3 million, i.e. EUR 7.5 million per year*.⁸ Considering the number of local governments, this is essentially a *symbolic amount per local self-government*. Additionally, the distribution of stated revenues is highly unequal, as the number of privatizations, the size of companies and achieved revenues in different local governments differ drastically. The amount of EUR 90.3 million should be increased, adding the funds from the sale of shares or dividends received by the Shareholder Fund, which should also be distributed in accordance with Article 61 of the Privatization Act. However it is still highly unlikely that this amount would change our previous conclusion. One of the important explicit goals of the 2001 privatization models was (one-time) increase in public revenues, but observed at the level of the local government, this goal has certainly not been achieved (with the exception of few local self-governments).

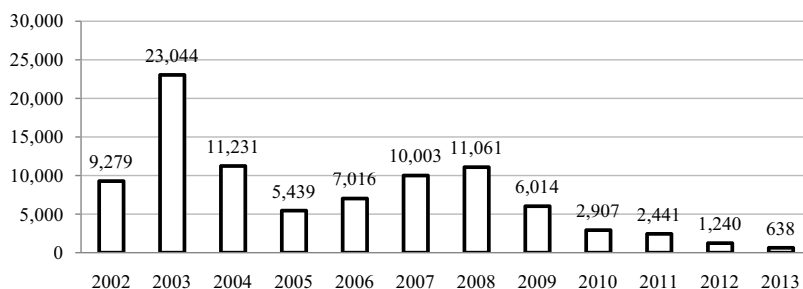
In addition to the methods of public tender and public auction, there was also an opportunity to sell the privatization subject as an insolvency debtor ("selling a debtor as a legal entity") or to sell its assets in *bankruptcy proceedings*.⁹ In this case, the local self-government would only be settling existing

8 For data up until 2004 see IDOM/Seecap "Impact Assessment of Privatization in Serbia", Belgrade, October 2005, contains an overview of local government revenues up to 2004. The date for the given period differs from the data presented in this study. However, there were substantial flaws and discrepancies of certain individual and aggregate data in the stated study. The study is available at the following address: http://www.priv.rs/upload/document/Impact_Assessment_of_Privatisation_Final.pdf (Site visited: September 12, 2014).

9 For more information on the results of bankruptcies in Serbia, see Radulović, B. "Empirical Analysis of Bankruptcy in the Republic of Serbia", *Approximation of Business Law to the European Union's Acquis*, Vuk Radović (ed.), Belgrade University Law School, Belgrade, 2011, 146–183; Radulović, B. "Sparrows and Pigeons – Empirical Analysis of Decisions on Bankruptcy or Reorganization in the Republic of Serbia", *European Union and Serbia – From Transition to Association*, Ivan Vujačić (ed.), Belgrade University School of Economics, Belgrade, 2012, 79–94 and Radulović, B. "New Bankruptcy Act – The Logic

claims. The revenues from the sale of property or sale of insolvency debtor as a legal entity are not distributed in accordance with the Privatization Act – in this specific case, the local self-government's claims are settled as the claims of an insolvency or priority creditor, in the same manner as the settlement of other creditors' claims. Basically, this means that, as a rule, the local government expected revenues are higher in the case of privatization than in the case of bankruptcy.

Illustration 1 The amount of funds allocated to local governments (in 000 EUR) for privatizations realized through public tenders or public auctions in the 2002–2013 period



Source: Authors' calculation based on the data from Privatization Agency

The *continuous effect* of privatization means that the privatized company continues its operations and regularly settles its obligations towards the local government (and local utility companies). To answer the question – which sources of revenue does local government achieves in the case of business operations continuity after privatization – we start from the standard division of revenues into direct revenues, ceded revenues and transfers. According to the Local Self-Government Financing Act, the main sources of local self-government revenues are direct (or own) revenues, revenues distributed from a higher level of authority (ceded revenues) and earmarked and non-earmarked transfers.¹⁰ Additionally, the local budget inflows also include inflows based on debts and inflows based on the sale of financial and non-financial property of the local governments.

Direct revenues in the Republic of Serbia are taxes, fees and charges whose bases are determined by cities and municipalities, (where the law can limit the amount of rate). Direct revenues include:

- Taxes – property tax (excluding the tax on the transfer of absolute rights and inheritance and gift tax)

behind the Absence of Collective Action”, CLDS Fokus – Quarterly Report on Institutional Reforms, II/4, 33–38, January 2010.

10 The Local Self-Government Financing Act (The Official Gazette of the Republic of Serbia Nr. 62/2006, 47/2011, 93/2012 and 99/2013).

- Fees – administrative, utility and residence fee
- Charges – land development, environment protection and improvement (up to December 31, 2013, direct revenues also included the land use fee which was later integrated into the property tax)
- Revenues from – lease of real estate property; sale of movable property; local government operations;
- Interests;
- Self-contribution, grants, donations and other sources.

In practice, this means that a privatized company pays for at least some of these revenues and directly influences the fiscal position of a local government.¹¹

Ceded revenues include taxes and fees whose basis and rates are determined by the central government, where the revenues are distributed between the central and the local governments (cities and municipalities). In other words, the revenues collected on the local government territory are entirely or partially ceded to the local government. According to Article 35 of the Local Self-Government Financing Act, these revenues include:

- a) Revenues from ceded taxes (personal income tax, inheritance and gift tax and tax on the transfer of absolute rights);
- b) Revenues from ceded fees and charges (annual charge for motor vehicles, fees for use of goods of general interest, fees for use of natural resources, etc.).

The single most important ceded revenue for local governments is *personal income tax* which is paid according to the employee's place of residence. All local governments, except for the City of Belgrade, receive 80% of collected personal income tax collected on their territory. In this case as well, successful privatization means that a company keeps paying at least one part of payments to the local governments, where the amount of revenues depends on the number of employees and their salaries. Aside from the duration of influence, the effects of privatization on the local government budget can be divided into direct and indirect. Both instant and continuous effects arise directly based on the impact to direct and ceded revenues. Indirect effects are caused by a privatized company's operations with public utility companies. The effects can be illustrated in the following manner (Illustration 2). The types of levies and their significance differ from one local government to another. The number of levies paid by businesses was reduced following the reform of para-fiscal charges in 2012, and the largest burden was taken up by the budgets of cities and municipalities. Some local governments tried to compensate for the lack of budget funds by focusing the financial burden on a small number of large businesses-taxpayers.¹² This was particularly vis-

11 For the development of case studies we limited the analysis only to the most common sources of direct revenues.

12 NALED (2014) "Non-tax and para-fiscal charges in Serbia 2014", Belgrade.

ible in the cases of several less developed municipalities. For approximation of burden, we used “*business name display fee*” (signage fee), as its accurate share is easy to single out in the local government budget. Table 1 shows that in 2012, smaller local governments relied more on the signage fee, so their share of total revenues was higher. In other words, less developed municipalities often have much higher share of these revenues in the total budget, to compensate for the lack of other revenues.

Illustration 2 Impact of privatization on fiscal position of local self-government

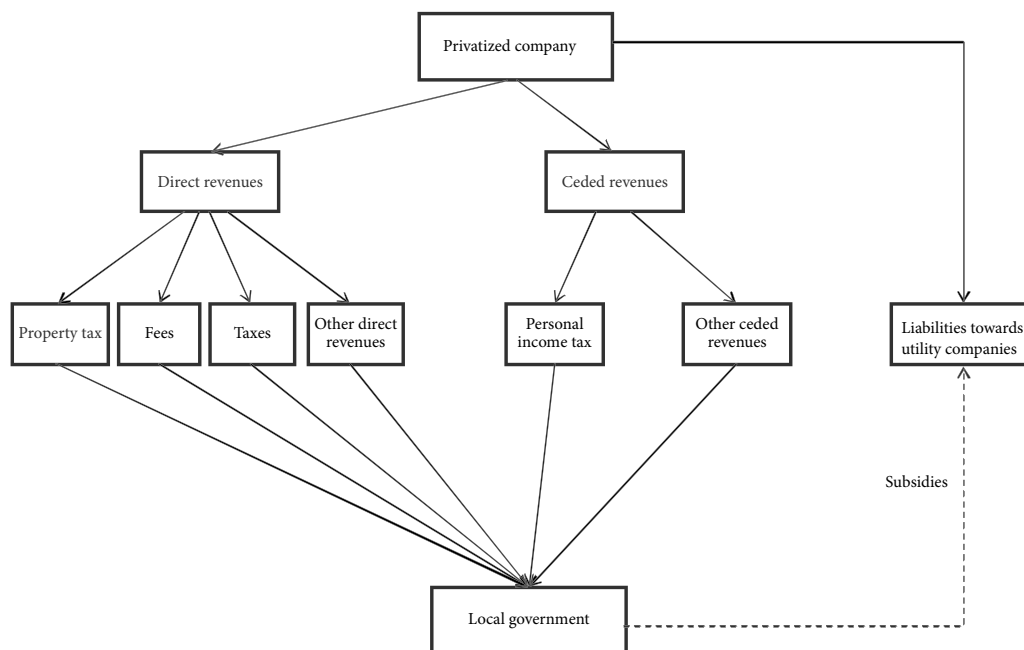


Table 1 Share of personal income tax, signage fee and non-appropriated transfers in 2012 LSG current revenues

City/municipality	Fiscal autonomy LSG (FA)	Share of personal income tax in LSG current revenues	Share of municipal business display fee in LSG current revenues	Share of unappropriated transfers in LSG current revenues
Čačak	87.02%	46.8%	2.9%	12.4%
Gornji Milanovac	81.21%	43.2%	2.7%	17.6%
Kraljevo	69.78%	44.7%	2.0%	23.0%
Raška	76.28%	24.8%	2.0%	21.1%

City/municipality	Fiscal autonomy LSG (FA)	Share of personal income tax in LSG current revenues	Share of municipal business display fee in LSG current revenues	Share of unappropriated transfers in LSG current revenues
Vrnjačka Banja	74.81%	31.0%	1.8%	14.1%
Doljevac	46.36%	29.4%	2.5%	47.2%
Gadžin Han	27.93%	15.3%	0.6%	52.9%
Leskovac	66.63%	41.2%	1.6%	32.0%
Merošina	39.18%	25.4%	0.6%	58.2%
Novi Pazar	66.04%	33.6%	2.4%	29.8%
Sjenica	30.06%	21.1%	0.9%	58.5%
Tutin	36.68%	17.1%	0.7%	59.1%
Beočin	80.85%	33.3%	0.9%	0.0%
Sremski Karlovci	81.97%	43.5%	0.5%	13.3%
Temerin	80.00%	51.9%	0.7%	16.6%
Kanjiža	89.12%	22.8%	0.3%	6.9%
Sombor	78.50%	43.3%	1.5%	16.3%
Subotica	86.73%	43.6%	0.8%	8.8%
Cajetina	89.36%	16.5%	0.5%	10.1%
Nova Varoš	55.60%	24.5%	3.7%	32.1%
Priboj	46.64%	29.8%	3.1%	50.2%
Prijepolje	47.58%	29.8%	3.0%	45.7%
Užice	83.76%	54.7%	1.7%	10.7%
Bujanovac	43.09%	26.0%	3.4%	45.0%
Preševo	32.10%	16.6%	1.6%	51.3%
Vladičin Han	37.80%	21.3%	2.5%	45.5%
Vranje	77.41%	45.9%	3.4%	19.5%
Kikinda	86.49%	34.8%	0.4%	10.3%
Novi Bečej	72.41%	31.9%	1.0%	22.5%
Zrenjanin	89.46%	46.7%	0.8%	7.4%

Source: Treasury of the Republic of Serbia

Note: We excluded two cities from the analysis – Niš and Novi Sad, which are also part of inter-municipal partnerships formed by USAID SLDP

According to NALED's study on non-tax and para-fiscal charges, local governments made further efforts to expand the number of taxpayers and reach of certain forms of tax (property tax above all) in order to compensate for the lost revenues when certain fees were eliminated.¹³ The effect of unsuccessful privatizations is very similar to the stated consequences, given that they lead to a loss of taxpayers or tax reach. Unsuccessful privatization can have particularly negative effects on the local finance, especially in case of large privatized companies. Given that failed privatizations lead to a reduced number of significant taxpayers, they often result in measures whereby the local government tries to compensate for the loss of direct revenues, such as introduction of para-fiscal charges imposed to the remaining businesses. Additionally, indirect pressure occurs given that the utility companies lose regular users of their services, which can greatly impact their performance.¹⁴ An additional effect of failed privatizations is the reduction of LG's fiscal autonomy, as they lead to a significant drop in employment, and therefore a drop of personal income tax share in total revenues and an increased share of transfers from the national authorities.

Table 2 Success of privatizations in selected cities and municipalities (May 2013)

City/municipality	Number of privatized companies	Cancelled	% of cancelled privatizations out of total number of privatized companies	Not privatized	Bankruptcy
Čačak	42	10	23.8%	2	21
Gornji Milanovac	13	5	38.5%	1	9
Kraljevo	25	10	40.0%	8	5
Raška	5	6	120.0%	2	7
Vrnjačka Banja	9	5	55.6%	3	2
Doljevac	2	1	50.0%	–	1
Gadžin Han	2	3	150.0%	–	6
Leskovac	38	23	60.5%	4	35
Merošina	2	1	50.0%	1	1
Novi Pazar	19	4	21.1%	4	9
Sjenica	4	3	75.0%	–	2

13 Ibid.

14 The regression models using the share of terminated privatizations or the ratio between the privatized and companies in insolvency procedure to explain the share of utility fees in total revenues are not viable. One of the reasons is that, based on the available data, it was not possible to allocate appropriate weights to the privatized companies (according to the size of assets, number of employees, sales revenues etc.).

City/municipality	Number of privatized companies	Cancelled	% of cancelled privatizations out of total number of privatized companies	Not privatized	Bankruptcy
Tutin	3	–	0.0%	1	–
Beočin	4	1	25.0%	0	–
Sremski Karlovci	3	–	0.0%	0	–
Temerin	8	2	25.0%	2	2
Kanjiža	18	3	16.7%	1	7
Sombor	41	12	29.3%	8	14
Subotica	76	16	21.1%	7	30
Cajetina	6	–	0.0%	1	3
Nova Varoš	7	1	14.3%	1	9
Priboj	5	1	20.0%	2	3
Prijepolje	8	4	50.0%	–	7
Užice	34	12	35.3%	2	19
Bujanovac	2	1	50.0%	7	1
Preševo	4	2	50.0%	2	1
Vladičin Han	6	3	50.0%	1	2
Vranje	12	6	50.0%	7	10
Kikinda	32	4	12.5%	2	10
Novi Bečej	15	3	20.0%	1	3
Zrenjanin	59	8	13.6%	5	15
Total	504	150	30%	75	234

Source: Regional Atlas of Serbia (2014) and Privatization Agency of the Republic of Serbia

Note: Certain cases enable double counting, given that the termination of privatization can be followed by insolvency – such cases therefore include both cancelled and bankruptcy columns.

Certainly, the privatization effects also depend on the significance and contribution of privatization subject compared to other businesses. The share of terminated contracts significantly differs – in some local governments it has a range of 0% – 20%, while in other LGs it reaches a share of more than 50%.¹⁵

¹⁵ In some local governments, the share reaches more than 100%. The reason is that some of the companies privatized in accordance with the 1997 Ownership Transformation Act,

1.3. CASE STUDY DESIGN

Given that the estimation of total debt owed to the local governments comes from, companies with terminated sale contracts or those undergoing insolvency or restructuring procedure due to lack of data many of these would be highly intricate and subject to errors if included in our study. Therefore the study analyzes ten privatization cases that allow for the calculation of specific effects on local self-government.¹⁶ Ten privatized companies include five companies that were relatively successful in their business performance, and five companies undergoing insolvency or restructuring procedures due to cancellation of their contracts. The initial list contained more than 1,000 socially owned companies. We selected either large or medium companies that had high importance for the local government or cases that vividly exemplified specific aspects of privatization. The degree of freedom in the selection of companies was limited. First of all, each selected privatization case (successful or failed) needed to have an adequate counterpart – a company with the same prevailing activity-sector, be of similar size and have other relevant characteristics before privatization. Secondly, preference was given to companies seated in municipalities covered by the USAID Sustainable Local Development Project (USAID SLDP). These included 32 local governments organized in 8 groups (so called inter-municipal partnerships) and 504 privatization cases.¹⁷ Thirdly, there was an issue of data availability. Based on the performance of unsuccessfully privatized companies, we calculated the opportunity cost for the peer (successful privatization) company as *an alternative (counterfactual) scenario*. In other words, we tried to provide an answer to the question: *what would have happened with the “unsuccessfully privatized” company if it had operated like the “successful” one?* The case studies include a detailed analysis of effects on the direct and ceded revenues in the previous five years, as well as the debts owed by exemplar companies to local utility companies.

1.4. KEY LESSONS LEARNED

Based on the analyses of case studies, we may conclude that “*good privatizations are all alike; however every failed privatization is bad in its own way*”. The case studies clearly indicate that the *crucial factor for privatization success is the role of the strategic investor* which is able to perform tasks such

were partially privatized under the new framework, but the privatization was later terminated. See case study of “Jugoremedija” AD.

- 16 To the extent possible, we tried to design the case studies based on Gilson, S.C. “Creating Value through Corporate Restructuring Case Studies in Bankruptcies, Buyouts and Breakups” 2nd ed. John Wiley & Sons (2010). However, with regards to the aims of this study, all case studies involve the same structure and common topics, and instead of tables we mainly used graphs.
- 17 For more information about the Sustainable Local Development Project see <http://www.lokalnirazvoj.rs/en/about> (Site visited: July 12, 2014).

as the transfer of technology, conduct measures for operational restructuring and invest in the equipment.¹⁸ In the conditions of an unfavorable business environment, such investors are mostly not ready to take additional risks in case the issues of redundancy, unregulated ownership and financial obligations arise.

The local government interest is to have the resources of privatized company efficiently utilized as soon as possible. Case studies show that one of the effects of unsuccessful privatizations is the accumulation of debts towards the local governments and public utility companies. As a rule, in such cases the local governments had a passive attitude. Bearing in mind that they most frequently act as insolvency/unsecured debtors, the local governments and public utility companies experience a very low recovery rate when the debtor goes bankrupt. However, compared to the lost opportunity to gain a new taxpayer and user of utility services through the sale of the insolvency debtor as a legal entity, a low rate of debt collection is a less significant effect of the delay in initiating bankruptcy procedure.

The effects on the local government vary depending on the company's relative position. In certain cases, the contribution of such companies to the local government budget is highly significant and makes up several percent points, but an even higher cost is the opportunity cost of failed privatizations, accounting for millions of EUR. *Comparing the counterfactual scenarios in the case study of pharmaceutical industry privatizations only, such a cost in the 2007–2013 period was EUR 31.6 million.*

The new regulatory framework mitigates only some of the problems (for example, the problem of debt overhang, i.e. debts towards state creditors), but not the issues of redundant workers and land. Regarding redundancy issues, there are two scenarios – when the number of employees needs to be reduced before privatization or bankruptcy procedures, and when the obligations towards employees can be settled through insolvency. The first scenario occurs in companies that can be privatized, but the issue of redundant employees needs to be resolved prior to privatization, i.e. in companies where the obligations towards employees needs to be settled before insolvency due to the company's regional significance or other (economically justified) reasons. The second scenario occurs in cases when the bankruptcy procedure is inevitable. To allow the issue of redundancy to be resolved smoothly in companies in the portfolio of the Privatization Agency, there is a need to amend the Decision on determining a Program for resolving the redundancy issues in the process of rationalization, restructuring and preparing for privatization and increase the amount of budgets funds allocated for the "Transition Fund". According to the proposed budget rebalance, this amount is RSD 2.8 billion, (ca. EUR 23.5 million), which is not enough to settle the redundancy issues of companies in restructuring, and this brings into doubt the entire process

18 For the crucial role of a strategic investor, see Goldberg, Radulović, Schaffer (2005).

of issuing an open call to interested investors. For the sake of comparison, in 2011, the fund amounted to ca. EUR 50 million.

One of the key unresolved issues regarding the rights of privatized businesses entities and their owners: Will the state recognize and acknowledge their right over the land, and to what extent (given that in the moment of privatization, they had the widest possible extent of rights) – will be remain their right to use, which allowed them to construct facilities on the land? This question arose from the moment when the Constitutional Court's Decision¹⁹ abolished the provision of Article 103 Paragraph 1 of the Planning and Construction Act,²⁰ which basically prevented further conversion of the right to land use to ownership right. Given that the right to construction based on the right to land use was disabled after the change of ownership regime over the land (which also allowed the conversion of the same right to ownership right with payment of a fee), the stated Constitutional Court decision made the entire process pointless, and construction land was *de facto* blocked for investments.

Except for several large companies in restructuring, it is not realistic to expect larger brownfield investments. The business environment is crucial in the course of making investment decisions, both in the case of privatizations and for new (greenfield) investments. Whereas many business environment components are exogenous for the local governments (defined on the national level or determined by external circumstances), some of the very important factors are endogenous – and local governments have a crucial impact on them. Even though a number of municipalities improved their business environment, there are numerous options for further upgrade. One of the key factors on the local level is the land development fee, as well as other fees such as the local signage fee (company name display fee). While the land development fee represents a significant source of municipal revenues, other funds such as utility fees do not account for a major source of local budget revenue, and their amount is often arbitrarily determined. Further elimination of para-fiscal burden to businesses at local government level could significantly reduce the cost of doing business, particularly for small and micro enterprises.

1.5. NOTE: SOURCES OF INFORMATION

For the purpose of developing cases studies, the authors obtained financial statements, privatization programs, information memos, reports on conducted control and other documents regarding privatization, restructuring or insolvency, as well as other relevant data, information and documents on the

19 Decision of the Constitutional Court No. I Uz-68/2013 of 10/10/2013 ("Official Gazette of RS", No. 98 of 08/11/2013).

20 Planning and Construction Act ("Official Gazette of RS", No. 72/09, 81/09, 64/10, 24/11, 121/12, 42/13, 50/13, 54/13, 98/13).

selected companies. The financial analysis of business operations used the data from regular financial statements, registries and other available sources. To obtain further required information and documents, the authors used additional sources of information, such as official websites of the analyzed companies, business news portals, sent questionnaires and tried to establish direct contact with analyzed companies. We also collected the data from the Privatization Agency, the Business Registers Agency and other relevant organizations, as well as directly from companies (except when no consent was provided or when data was not available due to a change of accounting software or other reasons).

In the collection of data on direct and ceded revenues of local governments where the companies operate, the main sources used were the data from the companies themselves and local governments' finance departments. In certain cases the authors had to give up the analysis of certain privatization cases due to a lack of or limited information. The depth of performed analysis of business operations, and the market and financial positions of the selected companies was limited to information available and the quality of data and documents provided to authors.

The case studies were prepared according to our best knowledge and they are derived from analyses conducted in accordance with the aims of this study. The authors' starting assumption in the course of developing the case studies was that the presented information and documentation, as well as the information such as financial statements, national authorities' websites, and the authors' independent research, was true and valid. The authors did not control nor review the data or information presented to them or which they obtained by independently. The authors do not express an opinion, or in any other manner provide assurance in terms of validity, comprehensiveness and or regularity in presenting the received data or data obtained through the authors' independent research.

Due to frequent and sometimes major changes of the "Rulebook on the content and form of financial statements for businesses, cooperatives, other business entities and entrepreneurs" in the period for which selected companies were analyzed, certain data in the balance sheets and income statements is not entirely comparable in all analyzed years. The changes of "the Rulebook on the content and form of financial statements for businesses, cooperatives, other business entities and entrepreneurs" occurred in the following years: 2001, 2004, 2006 and 2011.²¹

For the purpose of developing these case studies, the financial data on business operations of selected companies are indicated in EUR. The values

21 Additionally, upon finalization of these case studies, the Statistical Office of the Republic of Serbia performed a revision and harmonization of the system of national and regional accounts with the new European System of National and Regional Accounts (ESA 2010). Following these changes, there are some discrepancies between the macroeconomic indicators used in our study and more recently established macroeconomic indicators of the Statistical Office of the Republic of Serbia.

of companies' balance sheet and income statement were transferred to EUR, using the middle exchange rate of the National Bank of Serbia (NBS) on the adequate date for balance sheet, and average annual exchange rate of NBS for income statements. The table below lists the RSD-EUR exchange rates used in the development of case studies for the period 2000–2013.

Table 3 Average and End-of-year exchange rates RSD/EUR (2000–2013 period)

Year	2000	2001	2002	2003	2004	2005	2006
End-of-year	58.675	59.705	61.5152	68.313	78.885	85.500	58.675
Average	50.193	59.500	60.6940	65.117	72.694	82.990	27.935
Year	2007	2008	2009	2010	2011	2012	2013
End-of-year	79.000	79.236	88.6010	95.889	105.498	104.641	113.718
Average	84.110	79.964	81.4405	93.952	103.043	101.950	113.128

Source: National Bank of Serbia

We should note that due to hyperinflation and significant devaluation of the RSD exchange rate in 2000 and later the high volatility of the RSD exchange rate, certain years show significant discrepancies observing the change of values indicated in RSD and the values denominated to EUR. For this reason, for some years, entirely different conclusions could be derived according to the changes of some financial statements items expressed in RSD and the changes observed denominated in EUR.

2. PRIVATIZATION IN THE PAPER AND PACKAGING INDUSTRY

In this section, we will consider the case studies of the privatization of the socially owned enterprise (“*društveno preduzeće*”) DP “Dušan Petronijević” from Kruševac and the “Wrapping Paper & Packaging Plant (FOPA) – Vladičin Han” A.D. (joint stock company). The companies were selected following an analysis of the privatized companies whose primary business activity was the manufacturing of corrugated board and cardboard as well as paper and cardboard packaging.²² Whilst the former company operates successfully, the latter has been mired in bankruptcy proceedings for the third year running.

DP “Dušan Petronijević” (presently “Duropack” d.o.o.) was privatized through a public tendering procedure in the second half of 2004. As part of the preparations for privatization, significant restructuring measures had been carried out within the company – the entities unrelated to the core business operation had been spun off and the workforce had been cut down by over 40% relative to 1999 levels. The buyer of 70% of the so-called socially-owned capital (the strategic investor) was “Duropack AG”, an Austrian company doing business in the same sector as the privatized company. Prior to the privatization of DP “Dušan Petronijević”, the buyer “Duropack AG” had been present on the markets of almost all neighboring countries. The company had been running at a low capacity utilization rate with excessive workforce and negative operating results. After privatization, the company has been operating successfully, hence the revenues (in EUR) have doubled compared to the pre-privatization period, while its market share has increased by over 50%. In addition to a significant investment, the buyer carried out a whole set of restructuring measures (for including improvement of the quality of the production process, introduction of an integrated management system and compliance of business practices with international standards). The measures taken affected the company’s fiscal contribution which is reflected in the growth of its share in overall ceded revenues and regular payment of its dues to the local government. Therefore, this company is an example of privatization where a strategic investor takes over full control of the company and where there are no particular problems with privatization. Given the facts stated above, the privatization of “Dušan Petronijević” company from Kruševac is a frequently cited example of a successful privatization.

22 While both companies were operating in the same business sector, one should point out that the “Wrapping Paper and Packaging Plant Vladičin Han” A.D. (FOPA) was one of the main suppliers of paper (as raw material) to DP “Dušan Petronijević”, i.e. a part of FOPA business operations was located ‘upstream’ vis-à-vis DP “Dušan Petronijević”.

“Duropack” d.o.o. is one of 25 privatized companies on the territory of the City of Kruševac. By late 2012, as many as 14 contracts concerning the privatization of companies on the territory of the City of Kruševac were cancelled, and some of those companies went bankrupt. A high percentage of cancelled privatization contracts and a relatively big number of still unprivatized companies (ten) as well as their respective sizes do have a considerable impact on the fiscal situation of the City of Kruševac. “Duropack” d.o.o. has no crucial impact on the city budget, but still the privatized company more than doubled its share in terms of both direct and ceded revenues to the city in the 2008–2013 period.

The fate of the “Wrapping Paper and Packaging Plant Vladičin Han” A.D. (“FOPA”) is completely different. Whereas “FOPA” used to be one of the most important companies locally, at the level of local government, with no less than 850 employees in late 1999, today it is a company undergoing bankruptcy proceedings. “FOPA” was one of the first companies to be privatized under the Ownership Transformation Act (Privatization Act). In the first stage of privatization carried out in 1998, the employees, former employees and a small number of individuals outside the company itself became the owners of 60% of the company’s equity. Following the first round of privatization, the company had modest operating results. “FOPA” was a typical example of workers’ shareholder ownership as the company did not substantially change its business operation in organizational, technological, financial and managerial terms. Additionally this company’s example illustrates the conspicuous conflict of interest of employees in their respective capacities as shareholders (maximization of sales value of shares) and workers (keeping their jobs).

The second phase of privatization ensued in 2007 when the employees in their capacity as shareholders sold their majority ownership stake in the company to a foreign investor. However, not only did the Bulgarian investor lack an established reputation in the FOPA’s business sector, but it was also involved in several other unsuccessful privatizations in Serbia. The state had no role whatsoever in this privatization. Neither did it try to set up a majority ownership stake for sale to a foreign investor. In the aftermath of the second round of privatization and subsequent contract cancellation, the company went into decline at an accelerated pace. Except for cash flow problems and a surplus of employees, “FOPA” had a considerable problem with environmental pollution.

The relative importance of “FOPA” for the local self-government was much greater than that of “Duropack” d.o.o. for Kruševac due to the relative size of the company with regard to the rest of the local economy and the under-development of the Vladičin Han municipality. The study estimates that the default on its obligations as a consequence of the company’s collapse was conducive to a loss of 4.3% (and up to as much as 5.7%) in annual direct revenues of the Vladičin Han municipality. Since the state had not sold

its stake in the company, the local self-government did not even generate a revenue stream from the secondary sale of shares. These were not the only negative effects as “FOPA” employed almost a thousand workers at one point, hence the indirect impact on the local self-government was much greater. As a result of unsuccessful privatization and subsequent bankruptcy, the municipal unemployment rate in Vladičin Han skyrocketed and in late 2012 reached 56%. One should note that given the surplus of employees at “FOPA”, the unemployment rate would rise nonetheless, even in the event of a successful privatization, but this figure would certainly be lower. For the sake of comparison one should say that even with a reduction of the workforce as part of preparations for the privatization, the number of employees at “Duropack” is around 50% of people relative to the total prior to the privatization.

If the two cases are mutually compared by the achieved privatization objectives, then the case of DP “Dušan Petronijević” is one of rare privatizations which has fulfilled the key privatization objectives. Namely, the company has improved its efficiency in doing business, made significant investment in equipment, and enabled technology transfer. On top of that, today “Duropack” d.o.o. is regularly paying its dues at both national and local levels. On the other hand, the privatization of “Wrapping Paper and Packaging Plant Vladičin Han” AD has failed to accomplish any of the said objectives.

Privatization objectives	Dušan Petronijević (Duropack)	FOPA
Increase in efficiency of privatized company	+	–
Increase in investments	+	–
Transfer of technologies and know-how	+	–
Increase in public (national and local) revenues	+	–
Hard budget constraint	+	–

In order to illustrate the opportunity cost of the failed privatization a scenario analysis, i.e. a “what if” analysis, was conducted where the historical figures for revenues and expenses of DP “Dušan Petronijević” in the past served as a baseline for projections of fluctuations of assumed operating revenues and expenses of “FOPA” AD Vladičin Han. Having compared the projected and actual operating results, the failed “FOPA” AD privatization had a negative cumulative effect of EUR 7.3 million (net present value) relative to the counterfactual business scenario solely for the 2008–2013 period.

When analyzing the privatization and business operations of these companies, one should bear in mind two characteristics of this business sector. The first pertains to the crucial impact of transport costs which constitute

the key competitiveness factor for packaging manufacturers. As a result, formation of local (regional) markets is common where often some manufacturers assume a dominant position.²³ The other characteristic is a markedly procyclical feature of the sector brought about by the fact that the companies in this sector predominantly do their business with companies from the processing industry sector. Thus, a fall in industrial production and aggregate demand is quickly reflected in the paper, cardboard and packaging production sector.

2.1. CASE STUDY – PRIVATIZATION OF “DP DUŠAN PETRONIJEVIĆ” AD KRUŠEVAC

2.1.1. *Background*

DP “Dušan Petronijević” (hereinafter referred to as the Company, the Firm, “Dušan Petronijević” or “Duropack”) was established in 1961 by the merger of a graphic design and printing company and a tobacco production and processing company.²⁴ In the eighties and nineties, the restructuring effectively trimmed down the Company’s core business to the manufacturing of packaging, i.e. corrugated board, transport boxes and die cut boxes. Privatization of DP “Dušan Petronijević” was carried out through public tender under the 2001 Privatization Act where the Company’s equity at the point of privatization was socially owned (“društveno”) in its entirety.

Following the privatization a consortium consisting of “Duropack” AG from Vienna and “Zobex International” d.o.o. from Belgrade became the majority owner. After the acquisition of the remaining shares, a change of name and organizational transformation into “Duropack” d.o.o., the Company operates today as a member of the “Duropack” group employing about 2,700 workers in 16 plants in South and Central Europe with an annual turnover in excess of EUR 270 million. In 2013, “Duropack” d.o.o. sales revenue totaled EUR 14.9 million which was 1.7 times more than the sales revenue in 2004 when the privatization had taken place.

23 There is a big potential for processing recyclable paper on the Serbian market. Only 12 to 13 percent of waste is recycled in the Republic of Serbia. In the past years, due to lacking manufacturing capacities, a part of the demand and need for paper and cardboard products was met through imports. Taking into account the importance of the transport cost component, this fact shows that there is significant potential for further growth of this sector.

24 In its earliest days, the company’s business activity was the preparation for production, purchase, treatment and processing of tobacco and provision of all types of graphic design and printing services. Changes to the organizational structure led to the spinning off of the printing business in 1984, and then in March 1991 the printing company was split into two parts: the semi-cellulose and paper manufacturer “Cepak” and the packaging manufacturer “Dušan Petronijević”.

Table 4 Background information on “Duropack” DOO Kruševac

Full business name:	DOO (LLC) for manufacturing of packaging Duropack Kruševac
Company code:	07102259
Registered address:	Kruševac
Standard Industrial Classification (SIC) Code:	Manufacturing of corrugated paper and cardboard and packaging of paper and cardboard – 1721
Legal form:	Limited liability company
Status:	Active company
Number of employees (2013)	147
Year of privatization:	2004

Source: Serbian Business Registers Agency

“Duropack” d.o.o. employed about 150 workers in 2013 and owned installed facilities with an annual production capacity of around 20,000 tonnes of corrugated board and packaging. The Company’s production program consists of a broad array of products of various shapes and quality such as: two-ply, three-ply and five-ply corrugated boards, American standard boxes, die cut packaging, inner parts of boxes – pads inserts, corrugated fiberboard, cardboard partitions and cardboard pallets.²⁵

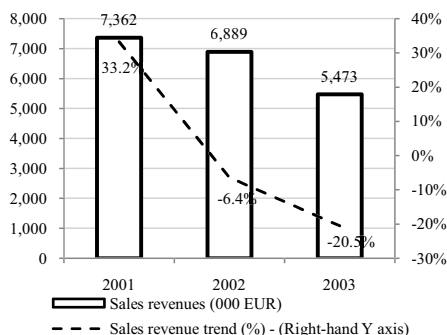
2.1.2. Business operations prior to privatization

The core business of DP “Dušan Petronijević” was manufacturing of corrugated board, transport boxes and die cut boxes. In addition to core business lines, ancillary business lines comprised a production of inner parts of boxes and collection of waste paper in the Kruševac region. The company was primarily focused on the domestic market, whilst a smaller part of its manufacturing output was sold on the market of the Former Yugoslav Republic of Macedonia (FYROM). Although the Company had its presence on the entire Serbian market, around 50% of the total sales were made on the local market within a 200-kilometer radius of the headquarters in Kruševac. The Company had a very diversified client base of about 400 customers, of which none accounted for more than 15% share of the total sales revenues. Clients purchasing Company’s products were businesses from all industry sectors, but buyers from the confectionery, alcoholic and non-alcoholic beverages, chemical and food industries dominated. In the sales revenue structure, the 15 largest customers in 2001 and 2002 accounted for 50% of DP “Dušan Petronijević” total sales revenues.²⁶

25 More details are available at the Company’s web address: <http://www.duropack.rs/rs/duropack-kruisevac/istorijat.html> (Site visited: June 22, 2014).

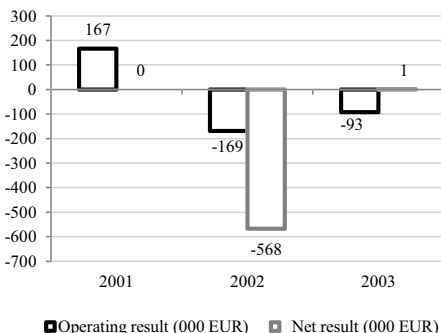
26 Information Memorandum DP “Dušan Petronijević” Kruševac, September 2003.

*Illustration 3 DP “Dušan Petronijević”
Sales revenues
in 2001–2003 (000 EUR)*



Source: Information Memorandum September 2003 and „Duropack” DOO Kruševac

*Illustration 4 DP “Dušan Petronijević”
Operating and net result
in 2001–2003 (000 EUR)*



Source: Information Memorandum September 2003 and „Duropack” DOO Kruševac

For two years prior to privatization, DP “Dušan Petronijević” had *declining sales revenues*.²⁷ In EUR, in 2001, DP “Dušan Petronijević” sales revenues were 33.2% higher relative to the actual sales revenue levels in the previous two years. Declining sales revenue tendency came about as of 2002. In the course of 2002, the Company’s sales revenues dropped by 6.4% despite year-on-year growth of actual production output by 1.8% (Illustration 3).²⁸ Before privatization, the Company had a low capacity utilization rate (only 35%) and weak operating results. Out of total production capacity of 18,000 tonnes per year, the average utilization of production capacity in 2002 was only about 6,500 tonnes, which was equivalent to its production output in the nineties.²⁹ The Company made profit only in year 2001. The principal reason for negative operating results in 2002 and 2003 was a significant drop in sales revenues. On the eve of privatization, in 2003, a significant sales revenue slump of 20.5% occurred.³⁰

27 After the lifting of UN sanctions against Serbia and Montenegro in 2000, DP “Dušan Petronijević” sales revenue in 2001, denominated in the national currency, was 58% higher. However, due to the recorded hyperinflation and significant RSD exchange rate devaluation in 2000, there are considerable discrepancies when looking at the tendency of fluctuation in the Company’s sales revenues value in dinars and the same amounts denominated in EUR. One should note that the average inflation in 2000 was 70% (with the inflation rate reaching 112% at the end of the year), while the dinar devalued vis-à-vis deutschemark by 80% on December 6, 2000.

28 Information Memorandum DP “Dušan Petronijević” Kruševac, September 2003.

29 The biggest sales were recorded in 1998 – 9,555 tonnes.

30 Whereas the 2002 revenue decline was not coupled with a reduction in operating expenses, in 2003 expenditure was lower due to lower costs of goods sold and raw materials expense,

The Company was acquiring materials needed for manufacturing (paper, starch and dyes) primarily on the domestic market (about 80%), of which a significant part of purchases were contracted as barter arrangements. One of the principal problems in their business operations pertained to the quality of raw materials, most significantly the paper, but there were also problems with the dated equipment and lack of automation in one of the production stages.³¹

During the preparations for sale of socially-owned equity, the Company carried out *restructuring measures* so that the units directly unrelated to the core business (maintenance, energy supply and transport services) were spun off. In the last organizational change, on the eve of the 2002 privatization, the parent company was divided into the “Dušan Petronijević” – packaging plant, “D Market” – trade and “Tehnoenergetika” – generation of industrial steam, servicing and maintenance.³² In addition, the Company cut considerably its workforce from 595 to 345 employees in 2012 thanks, above all, to the natural outflow of workers retiring and the decision not to employ new workers. The equipment of DP “Dušan Petronijević” was between 2 and 50 years old. Unlike most ‘socially-owned’ firms, the Company managed to set aside certain funds in the pre-privatization period for the acquisition of new equipment. Thus, in 2001, the Company earmarked RSD 41 million (EUR 687,000) for the purchase of new equipment and renovation of existing facilities, whilst in 2002 another RSD 20.6 million (EUR 334,000) was allocated to this end.³³

2.1.3. Privatization

DP “Dušan Petronijević” was *privatized through a public tendering procedure* under the Privatization Act and the Regulation on Sales of Equity and Assets by Public Tender. Given that DP “Dušan Petronijević” had not started privatization under the Ownership Transformation Act, the subject of sale was 70% of the ‘socially-owned’ equity, whereas out of the remaining part, pursuant to the existing law, 15% was designated for the employees free of charge and the additional 15% was transferred to the Privatization Register. Having launched the initiative and appointed a privatization advisor, privatization proceedings were formally initiated on March 26, 2002. The privatization advisor was the consulting firm “Nmas Uno Proyectos Internacionales SA” (Nmas1) from Spain.³⁴ After the advisors prepared the tendering docu-

but the bottom line was still in the red. High costs due to the write-off of long-term financial investments, which totaled EUR 320,000 in 2002, were instrumental in considerably higher losses relative to the 2002 negative operating result.

31 Information Memorandum DP “Dušan Petronijević” Kruševac, September 2003 and “Duropack” DOO Kruševac.

32 “D market Trgovina” and “Tehnoenergetika” were privatized by auction, but both companies are currently undergoing insolvency proceedings, i.e. bankruptcy.

33 Information Memorandum DP „Dušan Petronijević” Kruševac, September 2003 and „Duropack” DOO Kruševac

34 In addition to lead consultant Nmas1, the advisor consortium comprised BC Excel, Pavić and Manić law firm and South East Europe Capital Partners.

mentation, a public call for bids from interested parties was announced with a deadline of January 30, 2002, but due to lack of interest on the part of potential buyers the deadline was extended for additional two months.³⁵

A key feature of privatization by public tender is the possibility to impose *qualifying criteria* on buyers, thereby partly eliminating the problem of negative selection of buyers. For DP “Dušan Petronijević” buyer qualifying criteria were that the buyer had to be involved in the same business activity, i.e. manufacturing and/or distribution of corrugated paper and packaging for at least the past three years and that the 2002 total revenue amounted to at least USD two million or that the total assets were worth at least USD one million according to the latest financial statement. Hence, turnover and asset size criteria were relatively lenient. Nevertheless, *only one potential buyer purchased the privatization documentation* and was also the only bidder, and subsequently became the actual buyer. A consortium consisting of “Duropack AG” Vienna, Austria, the major member of the consortium, and “Zobex Company International” was the buyer of the 70% of socially owned equity. “Duropack” AG, as the major consortium member, met the stipulated criteria as it was a holding company whose primary business activity was the manufacturing of packaging, including cardboard packaging, exceeding many times over the turnover and asset size criteria.

The sales price for 70% of the Company’s socially-owned equity (of which 51% went to “Duropack AG”, whereas the Serbian consortium member acquired the remaining 19%) was only USD 200,000. There are two crucial reasons for the *relatively low price*. The first is the *absence of competition* since the Austrian investor was the only potential buyer. The second reason were the obligations in respect of the social program taken on by the buyer. More specifically, the contract of sale of the 70% of socially-owned equity also stipulated an *investment and social program*.³⁶ The buyer assumed an obligation

35 Advisor fees were paid from the funds granted by the World Bank. Except for DP “Dušan Petronijević”, the advisor also compiled tendering documentation for other companies in the so-called wood industry pool (Pool 11). Companies such as “Kopaonik” Kuršumlja, “Sloga” Vladičin Han, “ŠIK” Kučevo and “Ukras” Bela Palanka belonged to the pool. For further information on the donation funding the privatizations, see World Bank, Report No. 32662 – Implementation Completion Report (TF-29800 TF-50259 TF-50296 TF-52718) on a Grant in the Amount of US\$ 6 Million to Serbia and Montenegro for Private Sector Development – Technical Assistance Project.

36 Under the Sales Contract, ‘investments’ entailed investments in monetary terms or in kind resulting in the Company’s capital stock increase and/or a loan with a 3-year grace period provided by the buyer or one of its dependent companies excluding the subject of privatization (DP “Dušan Petronijević”). In addition to the set time frame for fulfillment of investment-related obligations, the buyer took on an obligation with regard to the appropriate structure of investments in terms of their purpose, including investment in adequate equipment, facilities and overhaul of existing production facilities. The contract also enabled the buyer to re-allocate individual annual financial obligations with prior consent of the Serbian Privatization Agency by way of transferring some investments to the previous or next year on the proviso that the value of annual investments over the three-year period would not fall below the investment-related obligation for the given year.

to implement a three-year investment program worth USD 2 million (USD 720,000 in the first year, USD 750,000 in the second and USD 530,000 in the third year). The buyer accepted mandatory requirements arising from the social program and additionally took it upon itself to maintain a 3-year moratorium on lay-offs.³⁷ Finally, the buyer assumed the obligation to pay out dividends to shareholders of the subject of privatization to the tune of at least 5% of the profit remaining after tax.³⁸ The Privatization Agency and buyer's representatives signed a sales contract in September 2004, hence around 30 months following the initial launch of the privatization proceedings.

2.1.4. Business operations after privatization

Following privatization, the Company *considerably boosted its sales revenues as well as its physical production output*. After an initial 1.3% sales revenue drop in 2005, the Company recorded revenue growth over the next three years at a rate of as much as 21.8%. The Company's sales revenues denominated in EUR were 78.2% higher than the sales revenues generated in 2004 the privatization year. The principal reason for the significant sales revenue growth in the said period was higher business activity, as illustrated by the growth of the Company's physical production output (Table 5). From 2005 until 2008, the Company's production output grew at an average annual rate of 16.7%.

Table 5 "Duropack" production output 2005 – Oct 31 2009 (in tonnes)

Period	2005	2006	2007	2008	October 2009
Delivered packaging	8,375	9,871	11,744	13,310	11,768

Source: Report on buyer's compliance with obligations from the contract on sale of DP "Dušan Petronijević" AD Kruševac, dated Jan 15, 2010

The Company suffered considerably from the onslaught of the *economic crisis*, but nevertheless managed to boost sales revenues once again. In 2009, due to the negative impact of the world economic crisis and somewhat diminished production output (Illustration 5) The company yielded a lower sales revenue by 5%. A short-term sales growth trend was recorded in 2010 and 2011 when the sales revenues were rose by 18.1% per year thanks to recovery in the industrial sector and stronger demand. In 2012, in RSD, the Company generated 13.8% sales revenue growth. However, due to significant depreciation of RSD exchange rate to EUR, the Company brought in 2.6%

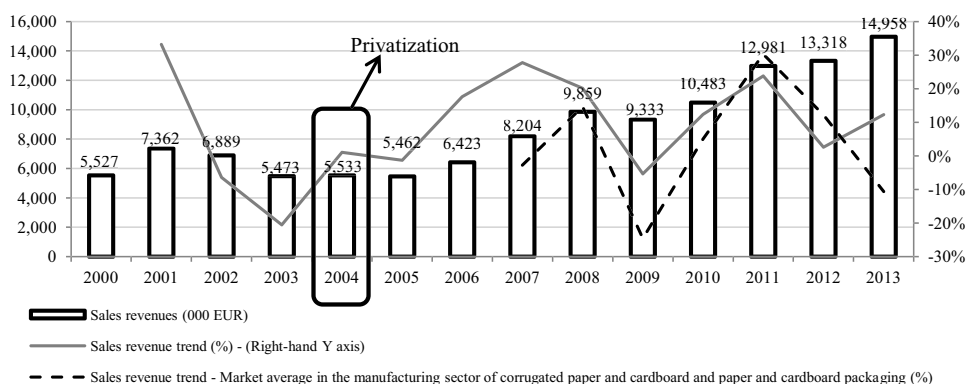
37 DP "Dušan Petronijević" privatization took place at a time when an obligation to guarantee full employment at the privatized company for a period of three to five years was imposed on buyers. In later privatizations such an obligation was scrapped.

38 A Report on buyer's compliance with obligations stipulated in the contract on sale of DP "Dušan Petronijević" AD Kruševac (Compliance report), dated January 23, 2006.

sales revenue growth when denominated in EUR.³⁹ In 2013, thanks to an increase in business activity, the Company achieved 12.3% annual sales revenue growth, denominated in EUR. In the 2011–2013 period, almost entire sales were made on the domestic market. On average, the domestic sales share of total sales in this period was 92.7%.

The major contributing factor to 2004 losses were financial obligations related to *voluntary employment termination*, when 91 employees opted to terminate their employment contracts thereby entitling them to severance packages paid out by the Company totaling in aggregate RSD 41.1 million (EUR 520,000).⁴⁰ In 2004, the cost of salaries and wages per annum rose by 80.8%. A 5.2% increase of raw material and consumables used, i.e. a rise from EUR 2.9 to 3.1 million, also contributed to ending the year 2004 in the red.

Illustration 5 “Duropack” Sales revenues 2001–2013 (000 EUR)



Source: Information Memorandum DP “Dušan Petronijević” Kruševac, September 2003, Serbian Business Registers Agency and “Duropack” DOO Kruševac

As of 2005, the Company has been in the black every year, and substantial profits have been reaped as of 2008. Between 2008 and 2013 the corporate profit per annum amounted on average to EUR 879,000. Excluding the 2010 results, the Company’s profit on average totaled EUR 1 million. In 2010, due to, above all, a considerable rise of raw material and consumables used of 42.1% year-on-year, corporate profit was much lower – EUR 269,000. The Company yielded the highest profits in the past two years (2012 and 2013) – EUR 1.2 million on average.

Financial indicators clearly point to a *significant improvement of business operations following the privatization*. Two years prior to privatization,

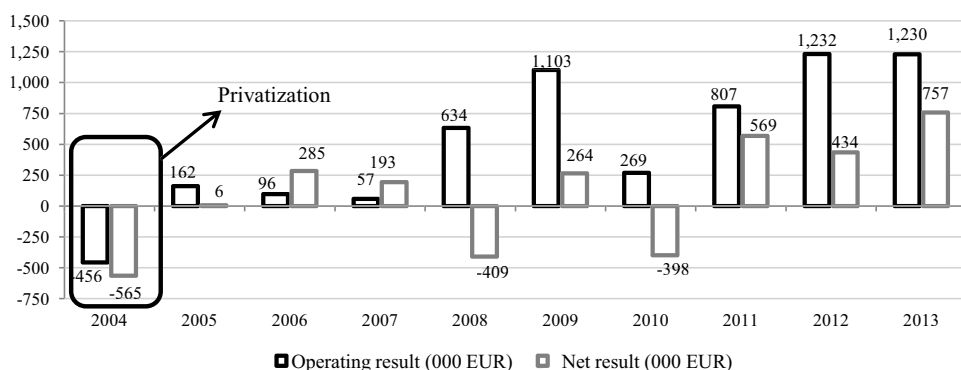
39 Median value of RSD exchange rate for EUR in 2012 fell by 10.9% year-on-year.

40 Compliance Report, dated January 23, 2006.

the sales revenue trend reflected a steady decline of 13.5% on average per year. After privatization, thanks to considerably increased business activity, the Company achieved a constant sales revenue growth denominated in the national currency at an average annual rate of 17.4%. However, due to considerable fluctuations of RSD exchange rates to the EUR, the average sales revenue growth rate denominated in EUR from 2005 until 2013 was somewhat lower at 12%. “Duropack” d.o.o. ***sales revenue in 2013 totaled EUR 14.9 million which was 2.7 times more than the 2004 sales revenue***, i.e. in the year of the privatization.

“Duropack” achieved ***significantly better profitability*** in the period following privatization. Prior to privatization, the Company had recorded much lower profitability (earnings before interest, taxes, depreciation and amortization – EBITDA % and earnings before interest and taxes – EBIT %) relative to the post-2004 period (Table 6).⁴¹ In 2004, when the Company was privatized, negative values for both indicators were registered due to, above all, the high cost of severance pay for employees who agreed to terminate their employment contracts. In all subsequent years, positive values for the said indicators were recorded. Somewhat lower values for analyzed indicators in comparison to previous years were registered in 2007 due to a significant 30% rise in costs of salaries and wages and a 32% increase of raw materials expenses, as well as in 2010 for the same reasons. The 2010 cost of raw material and consumables used were higher by 42.1%, while the cost of salaries and wages rose by 3.4% year-on-year.

Illustration 6 “Duropack” Operating and net results 2004–2013 (000 EUR)



Source: Serbian Business Registers Agency and “Duropack” d.o.o. Kruševac

41 The value of net result indicators in the period prior to privatization is zero, except in 2002 when a negative value of the analyzed indicator was registered due to the operating losses and high expenses incurred by the write-off of a long-term financial investment.

Table 6 “Duropack” Profitability indicators 2001–2013

Year	2001	2002	2003	2004	2005	2006	2007
EBITDA %	5.5%	2.5%	3.3%	-4.9%	8.1%	8.2%	5.6%
EBIT %	2.3%	-2.5%	-1.7%	-8.2%	3.0%	1.5%	0.7%
Net profit %	0.0%	-8.2%	0.0%	-10.2%	0.1%	4.4%	2.3%
ROA	0.0%	-8.6%	0.0%	-11.4%	0.1%	4.6%	2.4%
ROE	0.0%	-11.7%	0.0%	-17.0%	0.4%	13.8%	5.8%
Gross margin	44%	40%	37%	37%	38%	N/A	N/A
Year	2008	2009	2010	2011	2012	2013	
EBITDA %	11.6%	16.8%	7.1%	10.5%	12.9%	11.6%	
EBIT %	6.4%	11.8%	2.6%	6.2%	9.2%	8.2%	
Net profit %	-4.2%	2.3%	-4.5%	4.4%	3.3%	5.1%	
ROA	-4.5%	2.3%	-4.9%	5.5%	4.2%	7.1%	
ROE	-11.1%	6.7%	-16.8%	20.9%	14.1%	21.4%	
Gross margin	34%	43%	30%	33%	36%	35%	

Source: Author's calculation

In the period after the privatization, as of 2004, “Duropack” recorded *positive net results in all years apart from 2008 and 2010*. The principal reason for the negative value of the said indicator in 2004 was the loss incurred, and in 2008 and 2010 – high expenses due to negative effects of exchange rate changes.⁴² The Company could have avoided disclosing its net loss in 2008 in its financial statement, had it resorted to the right stemming from the changes to the Rules on the Chart of Accounts allowing companies, co-operatives and entrepreneurs to allocate expenses resulting from the negative impact of currency exchange rate changes to unrealized liabilities, i.e. to disclose it in the prepayments and accrued income accounts in the balance sheet. “Duropack” Kruševac did not seize this opportunity which was why, despite making profit at the operating level, the Company posted a net loss of EUR 409,000. For the same reason the Company posted another net loss totaling EUR 398,000 in 2010.

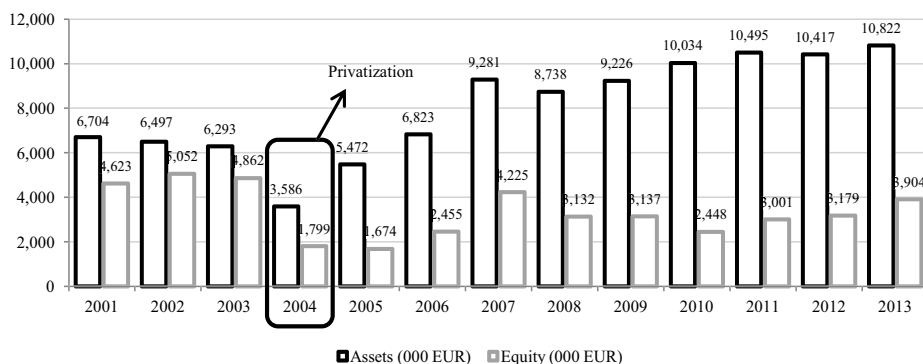
Trends in return on assets (ROA) and return on equity (ROE) indicators show that “Duropack” was managed its assets and equity much more

42 “Duropack” decided to disclose its expenses related to negative exchange rate changes in financial expenses accounts despite a legal possibility to allocate them to unrealized liabilities, i.e. disclose them in prepayments and accrued income accounts in its balance sheet.

efficiently after the privatization. The average value of “Duropack” gross margin was higher after than in the period prior to privatization. “Duropack’s” total assets recorded a steady rise in value in the period after privatization (2004–2013) when denominated in the national currency.⁴³ Total business asset value in late 2013 amounted to EUR 10.8 million and was twice the value of assets in late 2004 the year of Company’s privatization.

With the change to the business volume, the changes to the business asset structure also occurred. “Duropack” fixed assets had a predominant share in the asset structure of 60.5% on average until the end of 2007. In 2008–2013, the average share of operating assets in the overall “Duropack” business assets was 57%. The principal driving force behind the operating assets growth was a larger business operation volume, i.e. the Company’s receivables growth with an average annual growth rate of 22% in the 2005–2013 period.

Illustration 7 “Duropack” Total assets and equity 2001–2013



Source: Information Memorandum DP “Dušan Petronijević” Kruševac, September 2003, Serbian Business Registers Agency and “Duropack” DOO Kruševac

At the end of 2004, the Company’s equity value was EUR 1.8 million, i.e. 61.1% less than in late 2001. The primary reason for the Company’s equity value decrease in late 2004 was the disclosure of loss from the current year and aggregate losses from previous years to the tune of EUR 1.8 million. RSD depreciation with respect to EUR resulted in the Company’s own equity value decrease at the end of 2005. In all other years, “Duropack” registered a growth in its own equity value, except for late 2008 and 2010 when due to the disclosure of net business loss the equity value dropped. At the end of 2013, “Duropack” Kruševac own equity value totaled EUR 3.9 million, i.e. 2.2

43 In EUR such a trend was not present in all the years in the period analyzed. The reason for this are substantial RSD:EUR exchange rate fluctuations which affected the Company’s business assets value trend denominated in EUR. In some years, the RSD exchange rate to EUR would lose up to 15 per cent of its value.

times more than in late 2004, the privatization year. “Duropack” was achieving markedly higher liquidity indicator values after the privatization. Prior to privatization, in the 2001–2003 period, current ratio was registering values below the theoretically optimal level of 2:1, whereas the quick ratio was within the framework of theoretically optimal value of 1:1. This leads us to the conclusion that the Company’s liquidity position was not compromised in the said period. In late 2004, both liquidity indicators had values considerably lower than are theoretically desirable due to a significant growth of other short-term liabilities resulting from severance pays for workers who had agreed to terminate their respective employment contracts with the Company.

Table 7 “Duropack” Liquidity indicators, 2001–2013

Year	2001	2002	2003	2004	2005	2006	2007
Current ratio	1.3	1.3	1.3	0.8	1.0	2.5	1.6
Quick ratio	0.9	1.0	0.9	0.6	0.7	1.8	1.3
Net working capital (000 EUR)	701	427	448	-283	83	1,749	1,684
Year	2008	2009	2010	2011	2012	2013	
Current ratio	2.1	2.6	2.1	2.4	2.9	3.5	
Quick ratio	1.8	2.3	1.8	2.1	2.5	2.9	
Net working capital (000 EUR)	2,361	2,909	2,793	3,514	4,127	4,567	

Source: Author’s calculations

Data from the Privatization Agency’s control report on the buyer’s compliance with contractual obligations point to a conclusion that the Company was regularly paying out wages and severance packages to workers. Given that the Company took out a loan with a 3-year grace period in late 2005 from its parent company for the purchase of indispensable equipment and machinery, as well as for other purposes,⁴⁴ lower values of general and quick ratios were recorded. Even though the said indicators in late 2004 and 2005, respectively, were below the theoretically optimal level, all factors stated above cannot lead to a conclusion that in these years the Company had any substantial problems with liquidity. In all other years the Company’s current ratio, as well as its quick ratio, chalked up values at or above the theoretically optimal level, which suggested a favorable liquidity position of the Company.

Since 2004, the Company has managed to strike a long-term financial balance, suggesting that its long-term assets were funded from long-term sources. Moreover, even a part of its short-term assets were funded from long-term

44 Report on buyer’s compliance with obligations stipulated in the contract on sale of DP “Dušan Petronijević” AD Kruševac (Compliance Report), dated February 6, 2007.

sources. A marked trend of net working capital value growth went to show that there were realistic conditions in place for maintaining permanent liquidity.

The Company did not pay out dividends to shareholders from 2004 until 2010 due to either recorded net business losses or reallocation of funds for other purposes (e.g. the 2006 profit was used to offset a portion of losses from previous years).⁴⁵ Investments came from *the loan provided by the parent company*. “Duropack AG”, the parent company, granted a loan of EUR 1.6 million for investment in machinery and equipment. Out of the total amount, EUR 859,000 was spent in the first year, which was more than was stipulated by contractual obligations for the first year after the privatization.⁴⁶ Over the course of the second investment year, EUR 847,000 was spent to purchase equipment, machinery and spare parts, and pay for installation services.⁴⁷ According to the Company’s management, following the privatization, *over EUR 3 million was invested in the first three years* in the Company.⁴⁸

The buyer improved significantly *the quality of management* so that the Company implemented all relevant standards with respect to the management of quality of processes and products, living and working environment, as well as the integrated management system. Consequently, “Duropack” operates in compliance with the following standards: ISO 9001:2008, ISO 14001:2004 and OHSAS 18001:2007. The *client structure* diversifiedexceptionally diversified following the privatization. Customers purchasing the Company’s products were businesses from all industry sectors, but buyers from the confectionery, alcoholic and non-alcoholic beverages, chemical and food industries led the way. Although the importance of individual clients changes over time, there is no yet a dominant buyer which would account for a prevalent share of the Company’s sales.⁴⁹

2.1.5. Employment, productivity and market share

Prior to privatization, but also in the first period after the Company’s privatization, the declining workforce size trend was apparent. In 2004, relative to 2001, the Company had 221 fewer workers (annual average number of employees), which comprised a reduction in workforce of as much as 43%. Following privatization, *significant reductions in the average number of employees* were recorded in both 2005 and 2008, after which the average annual

45 Ibid.

46 Compliance Report, dated Jan 23, 2006.

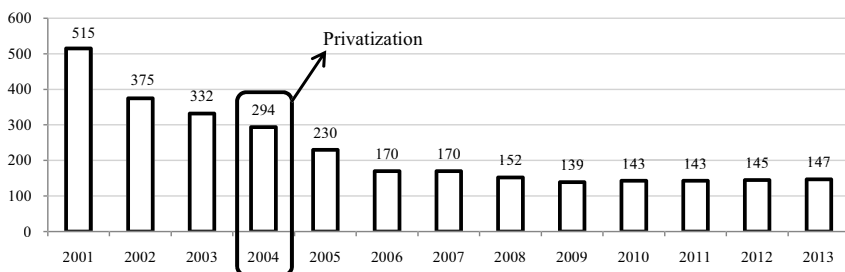
47 Compliance Report, dated Feb 6, 2007.

48 <http://www.ekapija.com/website/sr/page/526686/Kru%C5%A1eva%C4%8Dki-Du-ro-pack-pove%C4%87ava-proizvodnju-za-10-u-2012> (Site visited: May 31, 2014).

49 Prior to privatization, the most important clients would change at the top of the pile every year. In late 2002, the biggest clients were “DIN” Niš, “Tipokomerc” Odžaci and “Rubin” Kruševac with their respective shares in the 2002 Company’s sales of 6.0%, 5.7% and 5.0%. In 2011, the biggest buyers of “Duropack” products were “Henkel Merima” Kruševac, “Magrom” d.o.o. and “Bambi-Banat” AD Požarevac with their respective shares in total sales of 12.9%, 4.6% and 4.5%.

workforce size at the Company stabilized at about 145. This effectively means that the *Company has downsized the inherited workforce by over 50%.*

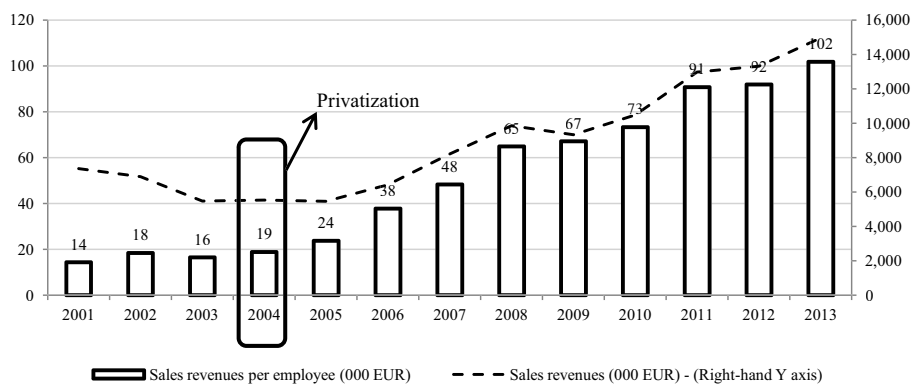
Illustration 8 “Duropack” Average number of employees (2001–2013)



Source: Information Memorandum DP “Dušan Petronijević” Kruševac, September 2003 Serbian Business Registers Agency and “Duropack” DOO Kruševac

Over a three-year period after privatization, the Company reduced its workforce by almost 100 through *severance packages*. In 2005, 91 employees opted to terminate their employment contracts with the Company, of whom 80 left “Duropack” with severance pays under the agreement reached with the trade union, while 11 workers terminated their employment on other grounds.⁵⁰ In 2006, another 13 employees left the Company, of whom 7 did so with severance packages paid out to them under the trade union agreement, while others left the Company on other grounds.⁵¹ In 2007, an additional 18 employees left “Duropack” with severance pays, while part-time employment contracts with 5 workers expired. Another 16 new workers were employed part-time in the same year.⁵²

Illustration 9 “Duropack” Sales revenues per employee and sales revenues in 2001–2013



Source: Author’s calculations

⁵⁰ Compliance Report, dated 23.01.2006.

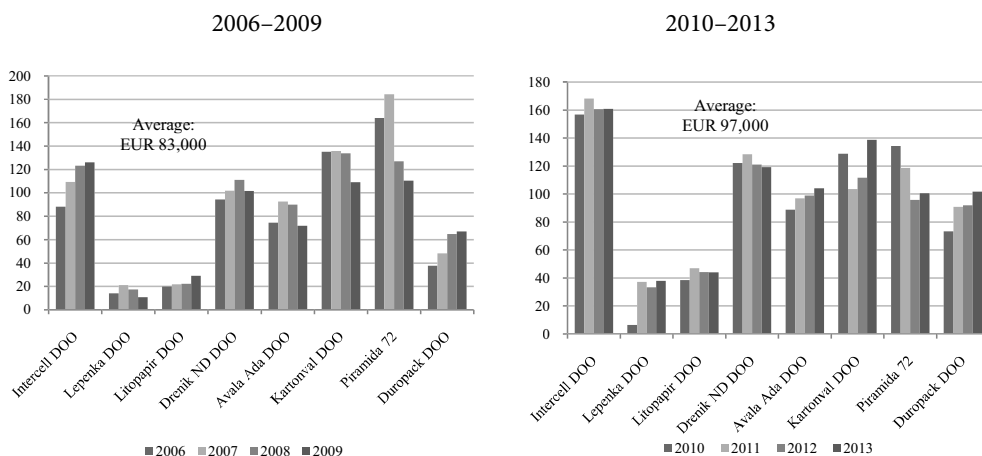
⁵¹ Compliance Report, dated 06.02.2007.

⁵² Compliance Report, dated 15.12.2007.

The decrease in the average number of employees and sales revenue growth has been conducive to the Company's productivity growth measured by sales revenue per employee since 2005. Sales revenues in 2005–2013 were growing annually by 12.2% on average. However, there were significant deviations from the average mark in 2007, 2008 and 2011, respectively, when average sales revenue growth per year totaled 23.9%. The average number of employees at "Duropack" Kruševac dropped from 294 in 2004 to 147 in 2013 on average. *Sales revenues per employee quintupled.*

In the course of the period analyzed, "Duropack" recorded values which were below average for the biggest companies by actual sales revenues in the sector of corrugated paper and cardboard and cardboard and paper packaging manufacturing.⁵³ Average value of the sales revenue per employee indicator for the biggest companies in the sector in terms of actual sales revenues in 2006–2009 was EUR 83,000, whereas in 2010–2013 it rose to EUR 97,000.

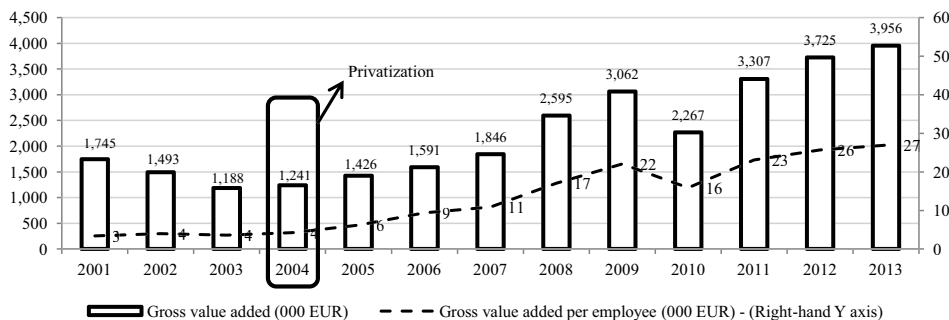
Illustration 10 Sales revenue per employee for the largest companies in terms of actual sales revenues in the sector of corrugated paper and cardboard and paper packaging manufacturing



Source: Author's calculations

Gross value added (GVA) generated by "Duropack" registered a steady rise following the privatization, except for 2010. Due to somewhat poorer operating results in 2010, the Company's gross value added was lower. Average gross value added generated by the Company in 2008–2013 was EUR 3.1 million.

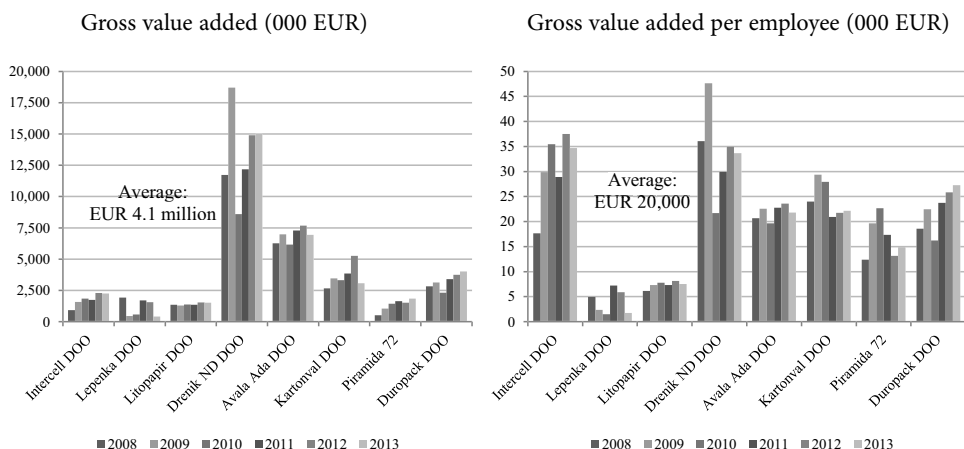
⁵³ "Tetra pak production" d.o.o, a disproportionately bigger company than all the others in terms of the parameters analyzed, was excluded from the analysis. "Tetra pak production" sales revenue per employee in 2006–2013 totaled EUR 1 million on average.

Illustration 11 “Duropack” GVA and GVA per employee 2001–2013

Source: Author's calculations

In all the analyzed years, “Duropack” Kruševac was generating a gross value added which was below par relative to the benchmark set by the biggest companies in terms of actual sales revenues in the sector of corrugated paper and cardboard and cardboard and paper packaging manufacturing.⁵⁴ The biggest companies' actual gross value added in terms of generated sales revenues in 2008–2013 was on average EUR 4.1 million, while the gross value added per employee in the same period was EUR 20,000.⁵⁵

Illustration 12 GVA and GVA per employee for the largest companies in terms of actual sales revenues in the sector of corrugated paper and cardboard and paper packaging manufacturing in 2008–2013



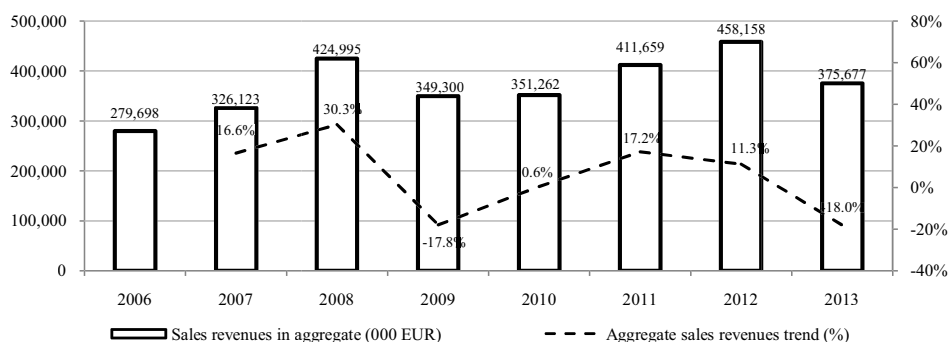
Source: Author's calculations

⁵⁴ “Tetra pak production” d.o.o, a disproportionately bigger company than all the others in terms of the parameters analyzed, was excluded from the analysis. “Tetra pak production” average gross value added in 2008–2013 was EUR 33.7 million, while the gross value added per employee in the same period was EUR 251,000.

⁵⁵ If “Tetra pak production” d.o.o. were to be included in the analysis, GVA per employee would rise to EUR 46,000.

In the 2001–2004 period, there were 8 corrugated paper and cardboard and cardboard and paper packaging manufacturers on the Serbian market.⁵⁶ As previously stated, transport costs were a key factor for packaging manufacturers' competitiveness, hence this led to the emergence of several important market players primarily focused on regional markets. Thanks to the presence of many businesses in the immediate vicinity (such as "Merima" Kruševac at the time), the location of DP "Dušan Petronijević" was relatively favorable. Specifically, about 80% of all the Company's clients were situated within a 200 km radius from the Company's headquarters. Imports of cardboard products in this period was very low.⁵⁷ In aggregate, the average amount of sales revenues generated in the sector of corrugated paper and cardboard and cardboard and paper packaging manufacturing in the Republic of Serbia in 2006–2013 was EUR 372 million. The highest sales revenues in the sector were registered in 2010–2012, when the average sales revenues in aggregate totaled EUR 407 million. The average sales revenues growth rate in aggregate from 2007 until 2011 was 5.7%, where in 2008 and 2011, respectively, a considerably higher growth rate compared to the average for the period analyzed was recorded. *"Duropack" managed to increase its market share relative to 2006 by over 50%.*⁵⁸

Illustration 13 Sales revenues in aggregate generated in the sector of corrugated paper and cardboard and paper packaging manufacturing in the Republic of Serbia (2006–2013)



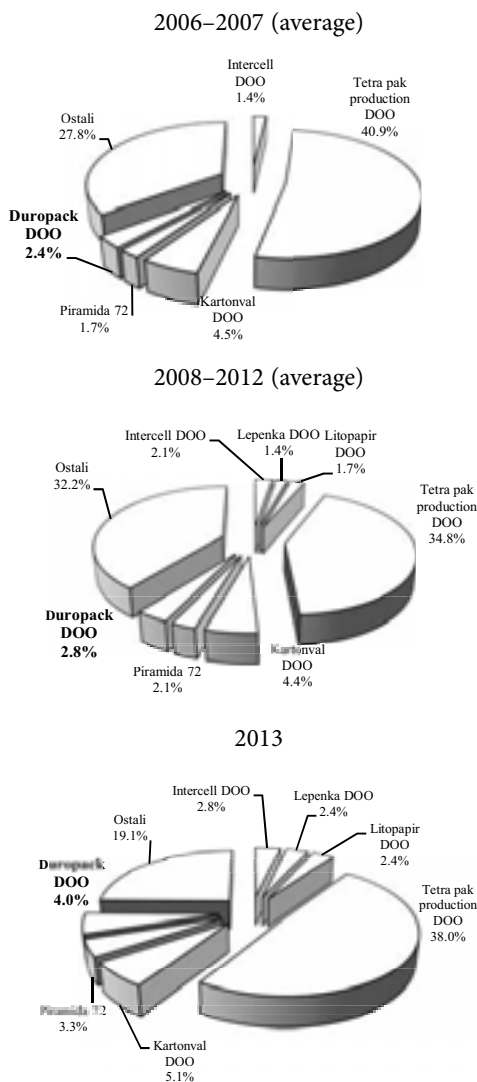
Source: Author's calculations

56 In 2002, DP "Dušan Petronijević" had a 12% share of the Serbia and Montenegro's market.

57 According to the Company's management, the biggest rivals prior to privatization were "Avala Ada" Beograd, "FOPA" Vladičin Han, "Lepenka" Novi kneževac, "Mladost" Odžaci, "Tipografija" Odžaci, "Avaks" Novi Sad and "Karteks" Šabac. Information Memorandum DP "Dušan Petronijević" Kruševac, September 2003 and „Duropack" DOO Kruševac

58 However, we should note that there was a dominant player in the market for the sector of corrugated paper and cardboard and cardboard and paper packaging manufacturing in 2006–2013 – "Tetra pak production" d.o.o. with an average market share of 38%. The other company "Drenik ND" d.o.o. also had a significant market share on average of 11.7%.

Illustration 14 Market shares in terms of total sales revenues in the sector of corrugated paper and cardboard and cardboard and paper packaging manufacturing

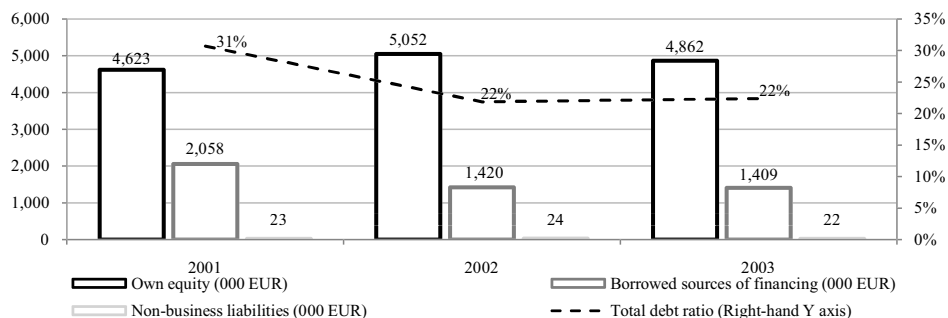


Source: Author's calculation based on Serbian Business Registers Agency's data

2.1.6. Financial restructuring

In 2001–2003, prior to privatization, DP “Dušan Petronijević” had a relatively low debt level and average equity value was EUR 4.8 million. The Company's liabilities were mostly short-term payables whose average share in total liabilities was 71%.

Illustration 15 “Duropack” debt levels, 2001–2003



Source: Author's calculations

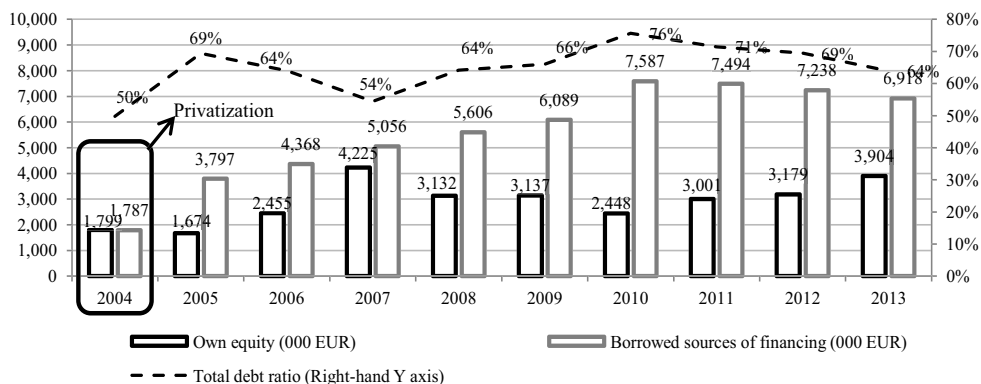
A more significant debt increase was first recorded in 2005 as a result of the parent company's loan for investment in equipment and manufacturing facilities. In all other years, the overall debt level was relatively stable at 0.7. In absolute terms, the level of borrowed sources of financing was steadily rising up until 2010 at an average annual rate of 31.2%, predominantly due to the growth of long-term liabilities. At the end of 2004, the Company's long-term liabilities stood at EUR 129,000, only to rise to the EUR 5 million mark in late 2010. In the liabilities structure from 2005 until 2013, long-term liabilities, i.e. long-term loans, had a predominant share of 67.6% on average. After 2010, the debt remained flat and subsequently the amounts from borrowed sources of financing have gradually decreased.

The Company completed a *capital increase* by issuing common stocks in November 2007 as part of the buyer's obligation to invest under the contract on sale of the Company's socially-owned equity. The issuer put out the second issuance of shares worth RSD 128.9 million (about EUR 1.2 million) whose nominal value was RSD 1,000 per share. Vienna-based “Duropack” AG was the buyer. The payment was effected by way of the debt-to-equity swap to the tune of EUR 1.6 million on the basis of the loan which parent company “Duropack” AG from Vienna previously paid into the Company's account.⁵⁹ Following the capital increase, “Duropack GmbH” decided to buy out the remaining shareholders and become the sole owner of the Company. The *buyout procedure took almost four years*. After several buyout offers between 2008 and 2011, “Duropack” became in August 2011 the owner of 96.4% of the total shares issued, thereby satisfying the requirement from Article 34, para. 1, of the Law on Takeover of Joint Stock Companies, in effect at the time, with regard to compulsory acquisition of the stakes of a small group of reluctant shareholders (*squeeze-out*). The compulsory acquisition of the reluctant shareholders' stakes was carried out under the same conditions as stipulated in previous buyout offers – at a price of RSD 1,000 per share. In this respect,

59 Compliance Report, dated Feb 6, 2007.

“Duropack” is probably the ideal model exemplifying in practice the intentions of the Privatization Act to ensure that a buyer, through a sale of the majority equity stake of 70%, gain immediately a controlling stake as well as an incentive to “shut down” the joint stock company for the sake of cost-effectiveness and easier management. “Duropack” was one of several dozen companies which succeeded in completing the process despite the then higher threshold for compulsory acquisition of a small group of shareholders’ stake of 95%.

Illustration 16 “Duropack” debt levels on, 2004–2013



Source: Author's calculations

2.1.7. The relationship between the company and local government

Kruševac is the center of the Rasina administrative district. On the Kruševac territory, under the Privatization Act, 34 companies were privatized (25 by auction and 7 by public tender). In as many as 15 cases (11 auctions and 4 tenders), the privatization contracts were cancelled.⁶⁰ The importance of “Duropack” d.o.o. for the local community of Kruševac is proportionate to the company’s size, and the most important characteristic of this company’s social responsibility is reflected in its compliance with regulations, regular payment of taxes, as well as salaries to its employees.

IMPACT ON LOCAL GOVERNMENT DIRECT REVENUES⁶¹

The table shows the Company’s share in paid taxes on land and property of legal persons, special environmental protection fee, municipal business sign display fee and construction land usage fee relative to the total actual

60 The most important cancelled contracts pertained to two large companies from Kruševac – Trayal and Župa.

61 Actual calculation of “Duropack” d.o.o. payments share in the total direct and ceded revenues of the City of Kruševac may deviate slightly from the figures presented in the table because the financial statements of the said local government comprise accounts at the level of three digits (group level) or four digits (synthetic accounts) which do not allow for an accurate disaggregation of actual revenues into ceded and direct ones as is the case

direct revenues. The Company's share is relatively low, but it is commensurate with the Company's size and its place in the structure of Kruševac economy. Direct revenues paid in total from 2008 until 2013 were RSD 7.4 million, exceeding the actual amount of dues in the said period, thereby illustrating the regularity of payments generating public revenues.

Table 8 "Duropack" share in total direct revenues of the City of Kruševac

Year	2008	2009	2010	2011	2012	2013
Direct revenues-actual (000 RSD)	466,172	622,489	516,997	634,687	632,626	581,689
"Duropack" d.o.o. (000 RSD)	373	977	1,516	1,550	1,534	1,428
Share in direct revenues (%)	0.08%	0.16%	0.30%	0.25%	0.25%	0.25%

Source: City Administration, Finance Department

IMPACT ON LOCAL SELF-GOVERNMENT CEDED REVENUES

The Company's share in the local self-government's ceded revenues in the analyzed period was growing and is currently slightly above 1%. The table shows the Company's share of paid income taxes and other ceded revenues in aggregate with respect to the total ceded revenues of Kruševac in the analyzed period. This table also shows that the "Duropack" d.o.o. fiscal contribution to the Kruševac budget was increasing year after year as the share of paid ceded revenues in the total realized ceded revenues was growing. "Duropack" d.o.o. doubled its share in the analyzed six-year period, but one should take into account that changes to the legal framework regulating financing of local self-governments occurred in late 2011, fully coming into effect in 2012, whereby twice as much of the income tax due was collected by local self-governments as opposed to the previous period. Higher contributions arose from the fact that from 2010 until 2012 the income tax amounts paid by the Company almost tripled, which in the case of "Duropack" d.o.o. meant that the Company was raising average salaries and wages. In the period analyzed, total income tax paid amounted to RSD 52.1 million, and its share in the actual ceded revenues was 4 times higher than in the case of direct revenues.

Table 9 "Duropack" d.o.o. share in total ceded revenues of the City of Kruševac

Year	2008	2009	2010	2011	2012	2013
Ceded revenues – actual (000 RSD)	826,894	773,339	782,440	972,046	1,532,738	1,399,454
"Duropack" d.o.o. (000 RSD)	3,943	4,473	5,435	8,078	14,999	15,189
Share in ceded revenues (%)	0.48%	0.58%	0.70%	0.84%	0.98%	1.09%

Source: City Administration, Finance Department

when the revenues are shown at the levels of analytical (five-digit level) and subanalytical (six-digit level) accounts.

PUBLIC UTILITIES DUES

Based on data collected, “Duropack” d.o.o. was regularly paying its dues for public utility services, i.e. for water supply and waste water drainage, to JKP “Vodovod Kruševac”. In the 2008–2013 period, the Company paid a total of RSD 8.7 million in total. For another public utility service – waste disposal – provided by JKP “Kruševac”, in 2008–2013 “Duropack” paid RSD 12.3 million.

Table 10 “Duropack” d.o.o. dues to public utility services (000 RSD)

Public Utility	2008		2009		2010	
	payable	receivable	payable	receivable	payable	receivable
JP Vodovod, Kruševac (water supply and sewage)	1,433	1,310	1,468	1,451	1,767	1,801
JKP Kruševac (waste disposal)	2,012	1,782	1,663	1,660	2,109	1,989
Total	3,445	3,091	3,131	3,111	3,876	3,790
Public Utility	2011		2012		2013	
	payable	receivable	payable	receivable	payable	receivable
JP Vodovod, Kruševac (water supply and sewage)	778	647	1,833	1,773	1,399	1,833
JKP Kruševac (waste disposal)	1,979	2,144	2,213	2,176	2,319	2,213
Total	2,757	2,791	4,045	3,949	3,718	4,045

Source: JP Vodovod Kruševac and JKP Kruševac

2.2. CASE STUDY – PRIVATIZATION OF WRAPPING PAPER AND PACKAGING PLANT “VLADIČIN HAN” A.D.

2.2.1. Background

“Vladičin Han” Wrapping Paper and Packaging Plant (hereinafter referred to as “FOPA”, the Company or Firm), has its headquarters in Vladičin Han and was established in 1961. It is situated in the Vladičin Han industrial zone, in the proximity of the Morava River. The construction of paper and semi-cellulose plant started in the 1960s and the production began in 1969. There were major investments in the Company’s capacities in the course of 1970s. The Company was manufacturing packaging paper and cardboard using recycled paper and cardboard as raw materials, i.e. the product range consisted of packaging paper, cardboard panels and cardboard boxes. The biggest part of the manufacturing output, about 90%, pertained to paper pro-

duction, whilst cardboard production made up the remaining 10%. In 2008, the installed production capacity was 45,000 tonnes of paper and 35,000 tonnes of packaging a year. In 2000, “Papir servis” a small company from Niš was merged with the Company so that, in addition to the existing three organizational units – cardboard, paper and joint services, respectively, a fourth one was appended. The Company focused on the low-quality and low-price market segment. Outdated technology considerably contributed to such a decision. On top of that, obsolete technologies presented environmental risks of pollution of waterways with industrial waste.

The Company's privatization was carried out in two stages. The “first round” of privatization took place in 1998 under the Ownership Transformation Act when 60% of shares issued were distributed free of charge to the employees. Another 30% of the shares issued were offered for sale at a discount, whilst the remaining 10% were transferred to state funds.⁶² For this reason the Company was not listed in the Privatization Agency's portfolio, but the state (through funds) was present as a minority shareholder. In 2007, the “second round” of privatization ensued. In their capacity as small shareholders, the employees sold their shares on the stock exchange to a Bulgarian investor (a consortium of Bulgarian companies) whereby the new owner acquired 52% stake in the Company. Persons connected to the said buyer had participated through other business entities in many privatizations which, as a rule, would failed, plunging privatized businesses into bankruptcy proceedings.

Failing to take necessary measures as part of operational and financial restructuring, the Company had been hit by crisis even prior to the “second round” of privatization. The *status quo* persisted until 2007 when the management tried to find a strategic partner. The weak negotiating position of employees and management in their capacity as owners, as well as the selected type of sale, did not provide crucial protection from the failure on the part of the buyer to fulfil the previously negotiated conditions. Soon after the changes to the Company's ownership structure, following many strikes, a sudden slump in production output occurred accompanied by a marked cash flow problem. At the same time, all the way until 2009, even though the majority stake had been privately owned ever since 1998, the Company had operated under the conditions of *soft budget constraint*, i.e. the Company had not been paying its dues in terms of taxes and contributions.⁶³ In case of

62 Report on economic/financial status of the bankruptcy debtor AD FOPA Vladičin Han.

63 Soft budget constraint is defined as a situation in which the state allows (state- or socially-owned) company to continue operating, despite the losses, thanks to direct or indirect subsidies. The concept of soft budget constraint was first defined by Hungarian economist Janos Kornai. Standard references for ‘soft budget constraint’ are as follows: Kornai, J., “Economics of shortage”, North-Holland, Amsterdam, 1979, and Kornai J. “Soft budget constraint”, *Kyklos* Vol.39:3–30, 1986.

“FOPA”, soft budget constraint pertains to tolerance for non-payment of taxes both nationally and locally, as well as “bridging the gaps in employees’ length of service”.

Table 11 Background information on “FOPA” AD Vladičin Han

Full business name:	Wrapping Paper and Packaging Plant, Joint-Stock Company, Vladičin Han
Company code:	07105886
Registered address:	Vladičin Han
Standard Industrial Classification (SIC) Code:	Paper and cardboard manufacturing (1712)
Legal form:	Joint-Stock Company
Status:	Company in bankruptcy proceedings
Number of employees (2013)	3
Year of privatization:	1998/2007

Source: Serbian Business Registers Agency

In July 2011, following a court ruling whereby the privatization contract was cancelled, insolvency and enforcement against the Company’s assets (which was already under way) brought about initiation of the bankruptcy proceedings and related injunctions (automatic stay). A decision handed down by the Commercial Court in Leskovac ushered in bankruptcy proceedings for “FOPA” which have not been completed to date. *The court’s decision to open the bankruptcy proceeding was passed in July 2014, almost three years after the initiation of the bankruptcy proceedings.*⁶⁴ According to the initial estimate, liquidation value in 2012 totaled RSD 755 million (around EUR 7.2 million), whereas the liabilities in total amounted to RSD 612 million (EUR 5.9 million).⁶⁵ Given that no sale of the bankruptcy debtor’s property has taken place to date, creditors’ claims have not yet been settled. Local government has attempted to promote the Company, i.e. its assets, as a possibility for a ‘brownfield’ investment since this is a location of 18.8 hectares with an entire infrastructure, including buildings with a surface area of 48,476 square meters, but without any success so far.⁶⁶

64 Decision of the Leskovac Commercial Court to initiate the proceedings is available at: <http://pretraga2.apr.gov.rs/publicdocsvc/doc/getdocbyid?id=0000111729050&hash=6187E6C3760CE4CF863DD841369F2A1F7E9B6F60> (Site visited: Aug 25, 2014).

65 Report on economic/financial status of the bankruptcy debtor AD FOPA Vladičin Han obtained from the Bankruptcy Supervision Agency.

66 “FOPA” is one of the companies featured on the Vladičin Han municipality’s list of potential brownfield investments: <http://www.vladicinhan.org.rs/Opstine3/Cir/Siteview.asp?ID=41> (Site visited: Aug 31, 2014).

2.2.2. Company's business operation prior to privatization⁶⁷

After the “first round” of privatization in 1998, the Company did not substantially change its business operations in organizational, technological, financial and or management-related terms, hence this was a typical example of worker shareholding. Prior to the “second round” of privatization, the Company was recording a considerable drop in its business operation, and experiencing also other problems in its business activities. From 2004 until 2006, “FOPA” sales revenues were falling – in 2006 sales revenue totaled EUR 3.74 million, which was by a third less than the 2004 sales revenue and over 50% less than in 2002 when the sales revenue was EUR 7.9 million. In accounting terms, the Company was in the black, but the profit was low (EUR 48,000 on average), as well as the net result, with a crucial role of the change in the value of inventory.

Illustration 17 Sales revenues
2004–2006 (000 EUR)

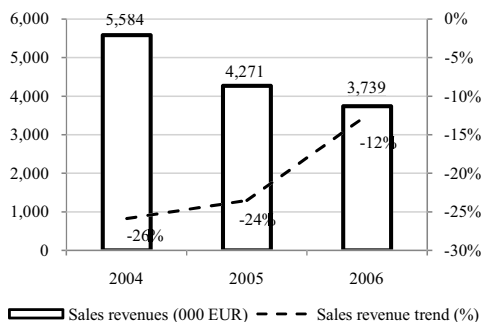
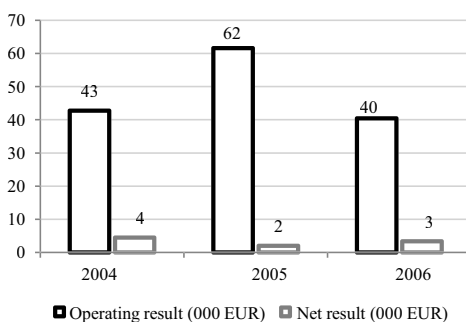


Illustration 18 Operating and net result
2004–2006 (000 EUR)



Source: Serbian Business Registers Agency

Source: Serbian Business Registers Agency

Given that *no ownership concentration had occurred*, the employees in their capacity as shareholders did not have an interest to supervise the management, but, above all, looked to safeguard their wages.⁶⁸ In the 2004–2006 period, raw material and consumables used made up 58% of operating expenses on average, whereas the share of the cost of salaries and wages was 34% (between EUR 1.5 and 2 million a year). In 2007, with a new majority owner of the Company, the share of the cost of salaries and wages reached 41%. This is a considerably higher share in overall operating expenses compared to “Duropack” where these costs have been constantly below 20%.

⁶⁷ This section deals with the Company's business operations in the period prior the second stage of privatization.

⁶⁸ For arguments about the ramifications of employees shareholding see Mijatović, B. “Privatization of Real Sector” in Begović, B. and B. Mijatović (ed.) “Four Years of Transition in Serbia”, Center for Liberal-Democratic Studies, Belgrade, 2006.

On one hand, the *employees were clearly against the privatization* which would run the risk of job losses. The Company's management had a similar motive as the arrival of a reputable strategic investor would scrap their privileges. On the other hand, the lucrative aspect to the sale of shares represented an incentive to sell the shares to the new majority owner. For a short while the *status quo* after the first round of privatization was tenable because neither the management, who remained in managerial positions (due to ownership dispersal and an ability to exert direct influence on the employees/shareholders), nor the employees themselves were interested in any substantial changes to the business operations. However, in the long run, without restructuring and with grappling with crisis in business, such a state of play was not sustainable. As the business deteriorated, facing increasingly more frequent financial difficulties, the Company started looking for a potential buyer, but, given the financial and every other aspect of the Company's business (excessive workforce, outdated technology, environmental pollution, etc.) as well as unrealistic demands vis-à-vis the price of shares, it was *too risky and too late for reputable strategic investors to get involved*. The factors stated above, as in the case of many other companies, led to an adverse selection of investors.

2.2.3. Privatization

The Company started preparations for the privatization process as far back as 1991, when a decision was made to issue internal shares, thereby converting the Company's legal status to a joint-stock company with mixed ownership. However, the "first round" of "FOPA" AD privatization was conducted seven years later, in 1998, under the provisions of *the Ownership Transformation Act*⁶⁹, when the Company's shares were distributed free of charge to the employees. The Company falls into a group of companies which were among the first, before the 2001 wave of privatizations under the OTA, to be privatized in accordance with this law. After the first round of privatization through the distribution of shares free of charge, the management delayed coming onto the capital market so that as late as 2007 an application for admission to the over-the-counter (OTC) market was presented to the Stock Exchange at the time when negotiations with a potential buyer were under way. The Stock Exchange passed a decision to include the Company's stocks in the OTC market in May 2007. The total number of shares was 893,380 (with a nominal value of 60 dinars and an allocation price per share of 386 dinars), out of which about 538,000 shares were in the hands of 1,156 shareholders who had participated in free distribution of stocks. One should point out that a previous attempt on the part of the "FOPA" A.D. shareholders as-

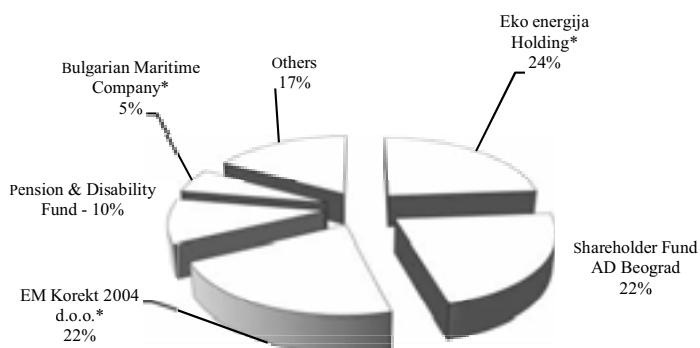
69 Under the Ownership Transformation Act (OTA) all the employees and former employees were entitled to free shares to the tune of DEM 400 for each year of their respective length of service. "FOPA" issued a maximum amount (60%) of free shares as stipulated by law

sociation to carry out preparations and achieve as high a price as possible had been made. To this end, a valuation of the Company's equity had been conducted according to which its equity was valued at EUR 23.4 million, whilst the price of a share was estimated to be as much as EUR 26.6.⁷⁰

According to the then management, in negotiations with the potential investor they demanded that the investor, in addition to the majority stake takeover, provide operating funds for production, invest in an environmental protection scheme, and pay outstanding taxes and contributions for the employees. The "Brikel" corporation from Bulgaria offered EUR 8 per share, which was EUR 2 less than in the original offer on account of additional liabilities accrued by the Company. From August 27 until September 6, 2007, 457,417 shares were traded on the exchange at a price of 640 dinars (EUR 8). The consortium of Bulgarian companies paid about EUR 3.66 million for the said package (app. 51% of shares). Having acquired the majority stake, the buyer ceased purchasing the remaining shares on offer. However, despite the lower price, shareholders who had spent most of their working lives at the Company and who managed to sell their shares on average around several thousand euros each.

The buyer itself did not have an established reputation in the paper and packaging business sector. Though, previously the connected persons had participated in the purchase of "Božo Tomić" paper plant in the city of Čačak which, following a failed restructuring, also ended up in bankruptcy.

Illustration 19 Ownership structure after the "2nd round" of privatization



Source: Central Securities Register

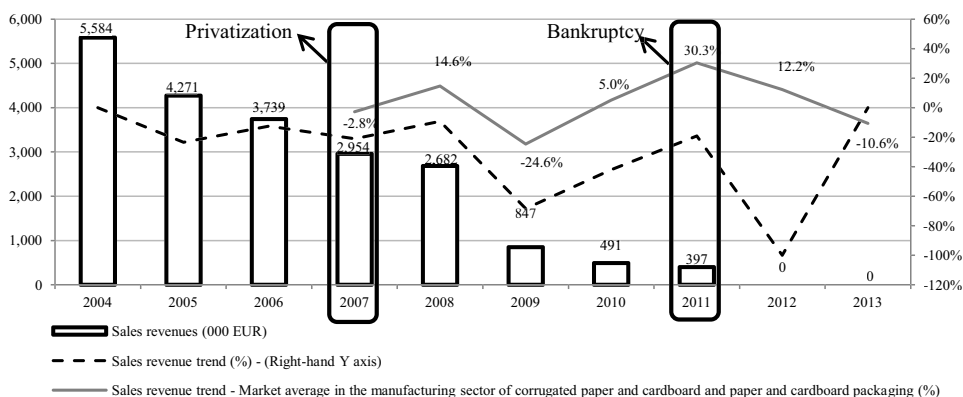
*There is a registered first-rank lien

70 Serbian Association of Minority Shareholders, "New valuation of "FOPA" A.D. Vladičin Han equity, Analysis of company's business operations and proposal for privatization of remaining socially-owned equity", Belgrade, July 2006.

2.2.4. Business operations after privatization

After the second round of privatization in 2007, the Company recorded a significant slump in its business. Following the sale of stocks to Bulgarian investors, a series of strikes and stoppages resulting in a considerable sales revenue drop. Given that Bulgarian investors did not agree to the demand to settle outstanding debts to the employees, there were several work stoppages. The employees went on strikes demanding 12 unpaid wages and payment of contributions for the past five and a half years. Clashes escalated to such a degree that the workers seized the head office building and threw out the management. Due to the employees' strike and stoppages, the annual sales dropped to below a million euros. Further decline in the Company's sales persisted for another two years so that the 2011 sales totaled only about EUR 400,000, at which time the bankruptcy proceedings came into effect. In 2012 and 2013, "FOPA" AD Vladičin Han had no sales revenues.

Illustration 20 "FOPA" AD sales revenues 2004–2013 (000 EUR)

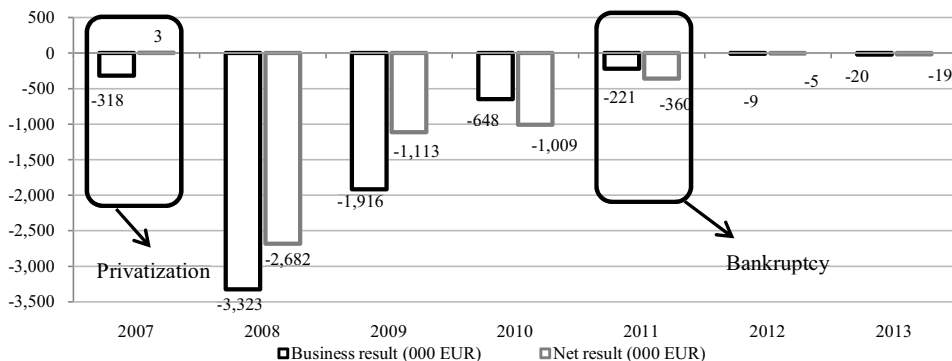


Source: Serbian Business Registers Agency

As of 2009, due to dwindling sales brought about by frequent employees' strikes and work stoppages, "FOPA" AD was making considerable losses in its operating as well as net losses. In 2008, the Company incurred a significant operating loss despite the fact that sales revenues did not drop drastically. This was due to a considerable reduction in the value of its inventories to the tune of EUR 1.1 million. On top of this, "FOPA"AD had negative financial results in almost all the years following the privatization as a consequence of a substantial rise in financial expenses (EUR 90,000 on average).⁷¹ The operating loss in aggregate in the 2007–2011 period amounted to EUR 6.4 million.

⁷¹ "FOPA" recorded a significant increase in financial expenses of 65.8% in 2008, when the said expenses rose from EUR 128,000 in 2007 to EUR 211,000. In the following years, the expenses considerably dropped. In 2011–2013, "FOPA" did not have financial expenses. Other operating results in 2007–2009 were positive and averaged EUR 534,000, whereas

Illustration 21 “FOPA” AD operating and net profit 2007–2013 (000 EUR)



Source: Serbian Business Registers Agency

After the second round of privatization, the Company registered a significant deterioration in profitability indicator due to frequent strikes and stoppages.

Table 12 “FOPA” AD profitability indicators 2004–2013

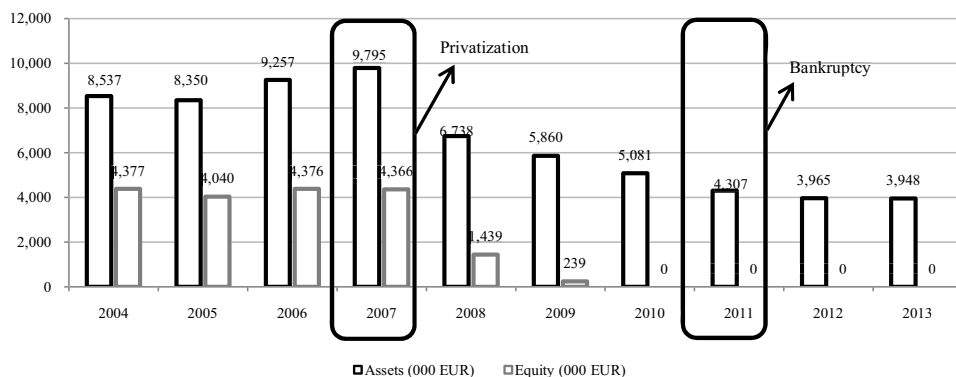
Year	2004	2005	2006	2007	2008
EBITDA %	3.9%	4.7%	3.7%	-7.4%	-120.3%
EBIT %	0.8%	1.4%	1.1%	-10.8%	-123.9%
Net result %	0.1%	0.0%	0.1%	0.1%	-100.0%
ROA	0.1%	0.0%	0.0%	0.0%	-32.4%
ROE	0.1%	0.0%	0.1%	0.1%	-92.4%
Gross margin	N/A	N/A	N/A	N/A	N/A
Year	2009	2010	2011	2012	2013
EBITDA %	-216.5%	-116.6%	-48.9%	–	–
EBIT %	-226.2%	-131.8%	-55.7%	–	–
Net result %	-131.4%	-205.4%	-90.5%	–	–
ROA	-17.7%	-18.5%	-7.7%	-0.1%	-0.5%
ROE	-132.7%	-844.5%	–	–	–
Gross margin	N/A	N/A	N/A	N/A	N/A

Source: Author’s calculations

in 2010 and 2011 they were negative and averaged EUR 260,000. Other revenues in the analyzed three years were EUR 1.4 million on average, while the remaining expenses were EUR 1.2 million having increased several times over in comparison to the previous period.

Prior to privatization, total business assets value had been rising including in 2007. Overall business assets growth was exclusively the result of the growth in value of inventories (total value of “FOPA” operating assets grew from EUR 4.8 million in late 2004 to EUR 6.5 million at the end of 2007). At the same time, the Company’s fixed assets value dropped from EUR 3.7 million in late 2004 to EUR 3.3 million at the end of 2007.

Illustration 22 “FOPA” AD assets and equity 2004–2013



Source: Serbian Business Registers Agency

Following the completed second round of privatization, the Company’s business assets declined considerably, above all, as a result of a decrease in operating assets incurred by a 60% drop in the value of inventories. After the new owner’s arrival to “FOPA” AD, it was found that the inventories value had been overestimated, which resulted in a reduction from EUR 4.3 million (the value of inventories in late 2007) to EUR 1.7 million in late 2008. The Company’s business assets value continued to decrease in all the subsequent years at an annual rate of 10%.⁷²

The Company had *conspicuous problems with liquidity* which was reflected in a significant reduction of current and quick ratios.⁷³ As of 2008

72 After a drop in value by 40.9% in late 2008, the Company’s operating assets value continued to fall until late 2012 at a year-on-year rate of 16.5%. The Company’s operating assets value in late 2012 totaled EUR 1.8 million as opposed to EUR 6.5 million in late 2007. In the operating assets structure in the period from late 2009 until the end of 2012, the biggest drop in value was recorded in inventories and accounts receivable at an average year-on-year rate of 20.1% and 16.7%, respectively. After the completed second round of privatization, “FOPA” AD Vlačićin Han fixed assets value declined at an average year-on-year rate of 15.1%. The biggest fall in “FOPA” fixed assets value was registered in late 2010 when the Company’s fixed assets dropped by 46.3% year-on-year. “FOPA” fixed assets value in late 2010 was EUR 1.3 million as opposed to EUR 2.5 million in late 2009. The primary reason for the slump in the fixed assets value at the end of 2010 was a decrease in value of the Company’s facilities and equipment of 46.7%, plummeting from EUR 2.4 million to EUR 1.3 million.

73 In all the analyzed years, the Company’s current ratios, as well as quick ratios were recording values below the optimal level of 2:1 and 1:1, respectively.

a share of long-term assets was funded from short-term sources. With net working capital there was a negative trend, i.e. year after year the operating assets values were decreasing and short-term liabilities were on the rise. The Company could not service its debts arising from taxes, contributions and outstanding wages, and it also had significant unpaid commercial liabilities.

Key sources of short-term borrowing were business entities connected to the owner. Thus, among the Company creditors were “Nova Srbijanka”, “Trajal”, “Vulkan”, “Rudnik Kovin”, as well as one of the owners – “Eko Energija” from Bulgaria. The companies listed above granted loans to “FOPA” in excess of RSD 150 million by the end of 2008.

Table 13 “FOPA” AD liquidity indicators on December 31, 2004–2013

Year	2004	2005	2006	2007	2008
Current ratio	3.4	3.0	2.5	1.8	0.7
Quick ratio	1.0	0.8	0.8	0.4	0.3
Net working capital (000 EUR)	3.431	3.376	3.491	2.914	-1.485
Year	2009	2010	2011	2012	2013
Current ratio	0,6	0,6	0,5	0,5	0,4
Quick ratio	0,2	0,3	0,2	0,3	0,3
Net working capital (000 EUR)	-2,231	-2,094	-2,357	-2,174	-2,175

Source: Author’s calculations

In 2009, the employees, trade unions and local government attempted to take over a controlling stake in the Company. Representatives of employees, local self-government and the branch trade union of chemical, non-metal, energy and mining workers “Nezavisnost” put forth a proposal to the Ministry of Economy that the state take over the controlling stake in the company with the support of small shareholders and thus try to find a new strategic partner.⁷⁴ No solution to the failing business operations of “FOPA” was found. Already in February 2009, the Tax Administration tried to settle outstanding tax claims through the sale of immovable assets (the cardboard and paper production facilities). Illiquidity and a number of claims lawsuits resulting in enforcement against “FOPA” property first led to the imposition of security measures on July 24, 2011, followed by the initiation of the bankruptcy proceedings on September 8, 2011, as ordered by the Commercial Court in Leskovac. A year prior to the initiation of bankruptcy proceedings, but after the new Bankruptcy Act came into force, the majority owner tried to extract “FOPA” AD assets through a contract on transfer of assets in order to settle pecuniary liabilities. In July 2010, the new “FOPA” AD Vladičin Han management concluded the contract on transfer of movable and immovable

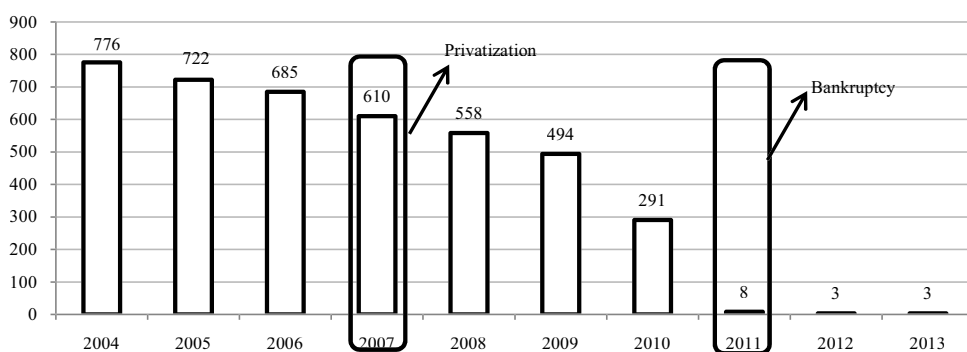
74 http://www.gshner.rs/index.php?option=com_content&task=view&id=131&Itemid=99.

property in order to settle pecuniary liabilities to the parent company, i.e. the buyer – “Interkomers Grup Plus” from Sofia.⁷⁵ According to the Report on the economic/financial status of the bankruptcy debtor, the disputed contract and subsequent disputed annexes were concluded after the launch of bankruptcy proceedings, i.e. in the period of bankruptcy debtor’s inability to pay debts. Given that the settlement resulting from the contract and annexes pertained to only one creditor, thereby entailing damages to other creditors, the requirements were met for initiation of the proceedings to challenge the bankruptcy debtor’s legal transactions.⁷⁶

2.2.5. *Employment and productivity*

In the period after the first round of privatizations, the number of employees hovered between 850 in 1999 and 905 in 2000. Judging by its workforce size, “FOPA” AD was one of the most important employers in the municipality of Vladičin Han. After 2000, the number of employees gradually declined, hence the Company entered the “second round” of privatization with a workforce reduced by a third relative to 2000. On the eve of the “second round” of privatization, the Company’s workforce numbered 610 employees. In the following period, the number of employees continued to fall, hence in the 2004–2009 period there was a further reduction of 282. In 2010, another 203 workers left the Company, and in 2011, due to bankruptcy proceedings at “FOPA” AD, the overall number of employees first fell to 8, and then only 3 were deemed necessary for the implementation of bankruptcy proceedings.

Illustration 23 “FOPA” AD average number of employees by year (2004–2013)



Source: Serbian Business Registers Agency

Even though “FOPA” AD was operating as a predominantly privately-owned company, the state “bridged the gaps” in employees’ length of service in order to settle the social problems. “Bridging the gaps” in employees’ length of service constitutes effectively an indirect subsidy whose beneficiaries are em-

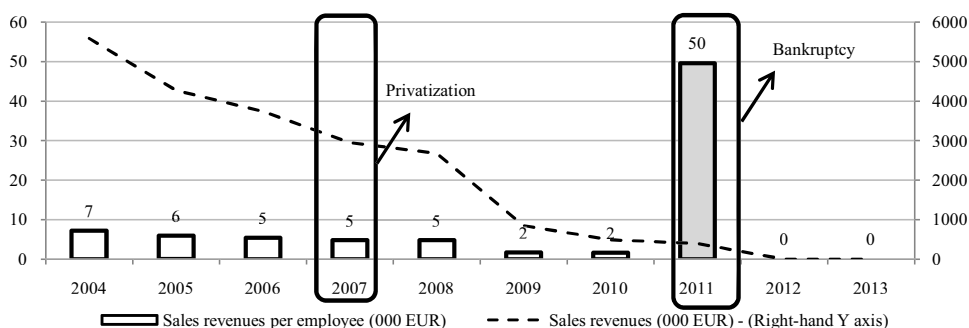
⁷⁵ Report on the economic/financial status of the bankruptcy debtor AD FOPA Vladičin Han.

⁷⁶ Ibid.

ployees of the privatized companies or, as in the case of “FOPA”, unsuccessfully privatized companies. The Government of the Republic of Serbia adopted a Conclusion to settle outstanding liabilities vis-à-vis contributions for the retirement and disability insurance of “FOPA” employees, thereby “bridging the gaps” in the “FOPA” employees’ length of service, for the 2004–2010 period. The amount stipulated in the Government’s Conclusion, as designated for the “FOPA” employees, was RSD 139.4 million (EUR 1.3 million).⁷⁷

Thus, *the state had effectively allowed the Company to accrue liabilities for over six years only to settle these liabilities itself from the public budget.* The practice of “bridging the gaps” in employees’ length of service creates a strong incentive for employees, even when their salaries and wages have not been paid, to stay with the companies which have not yet been privatized or where privatization has failed as they will nonetheless be entitled to retirement benefits despite the employer’s non-payment of due contributions. This fact is a good indicator of soft budget constraints under which Serbia’s privatization process unfolded.⁷⁸

Illustration 24 “FOPA” AD Sales revenues per employee and sales revenues 2004–2013



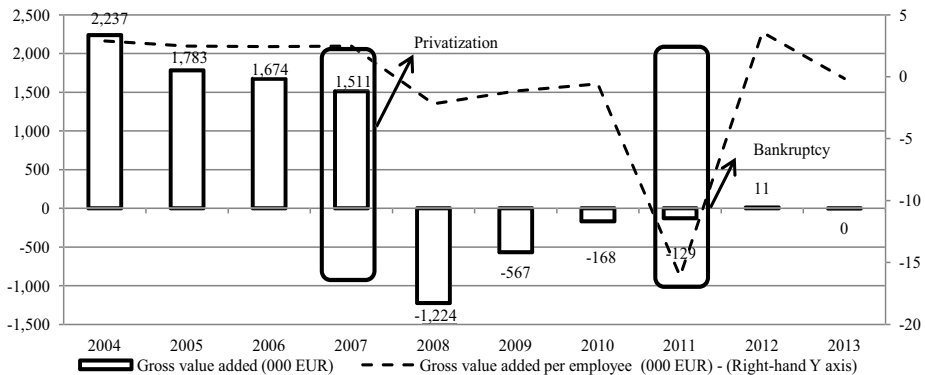
Source: Author’s calculations

77 Bridging the gaps in employees’ length of service was realized by way of the contract on borrowing in order to bridge the gaps in employees’ length of service against the funds designated in the 2011 budget as part of section 17 of the Ministry of Finance, function 90 – social protection not classified elsewhere. The Government’s Conclusion is available at: <http://www.trezor.gov.rs/uploads/file/povezivanje%20staza/Zakljucak%20Vlade%20o%20povezivanju%20staza%20od%2021.aprila%202011.pdf> (Site visited: July 20, 2014).

78 Technically speaking, a part of the transfer to the pension fund designated for payment of current pensions is declared as a budget payment for the purpose of bridging the gaps in the length of service of employees whose companies did not pay due contributions in the previous period. Whereas there is no budget expenditure increase in the current year, such an operation does accrue implicit liabilities of the state on account of future pensions. “Length of service is directly proportional to the initial pension amount, hence the payment designated to bridge the gaps in the workers’ length of service effectively increases the state’s liabilities to workers – future pensioners. The phrase “bridging the gaps in employees’ length of service” is, therefore, a euphemism for an increase in the implicit state debt to future pensioners.” For more information see M. Arsić, “Reforms in Socially-Owned and State Companies”, Quarterly Monitor, no. 28, January-March 2012.

“FOPA” AD sales revenues per employee from 2004 until 2007 totaled between EUR 5,000 and EUR 7,000. After the privatization, at first the sales revenue per employee hovered around EUR 5,000, but then slipped to EUR 2,000. In 2011, following the introduction of bankruptcy proceedings to the Company and, consequently, considerable reduction of workforce, the analyzed indicator registered a value which was much higher than the average in the said period, hence this year is to be disregarded.

Illustration 25 “FOPA” AD Gross value added (GVA) and GVA per employee 2004–2013



Source: Author's calculations

Both before and after the privatization, the Company had several times lower levels of productivity measured by gross value added per employee compared to other companies in the same sector. According to financial statements, in the 2004–2007 period, prior to the second round of privatization, “FOPA” was recording a positive gross value added on average of EUR 1.8 million. After the completed second round of privatization and considerably poorer operating results due to many strikes and stoppages, “FOPA” AD registered negative values for the observed indicator. GVA per employee was several times lower (between EUR 2,000 and EUR 3,000) relative to other companies operating in the same sector where GVA per employee averaged about EUR 20,000.⁷⁹

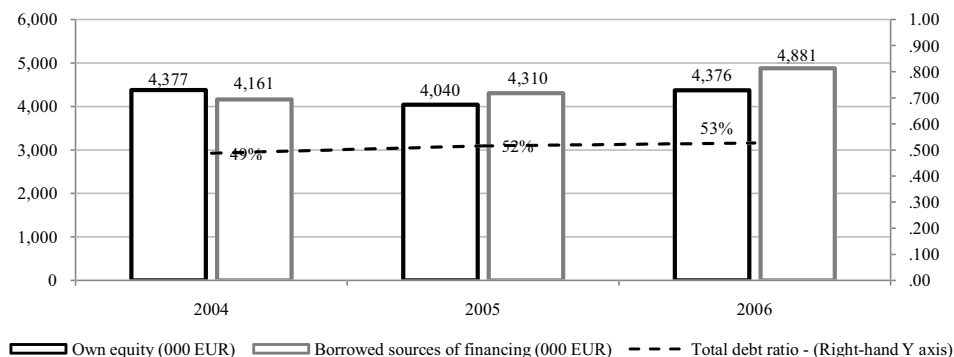
2.2.6. Financial restructuring

In the period prior to the second round of privatization, i.e. from late 2004 until the end of 2007, the Company's overall debt level was relatively stable – 0.5. In the structure of the Company's total liabilities from late 2004 until the end of 2006, long-term liabilities had an average share in the overall liabilities of 30%, whereas short-term liabilities stood at 21%. In the structure

⁷⁹ See the case study related to the privatization of DP “Dušan Petronijević.

of short-term liabilities in the analyzed period, business-related liabilities had an average share of 46.3%, whilst other short-term liabilities totaled 33.9% and short-term financial liabilities – 10.8%.

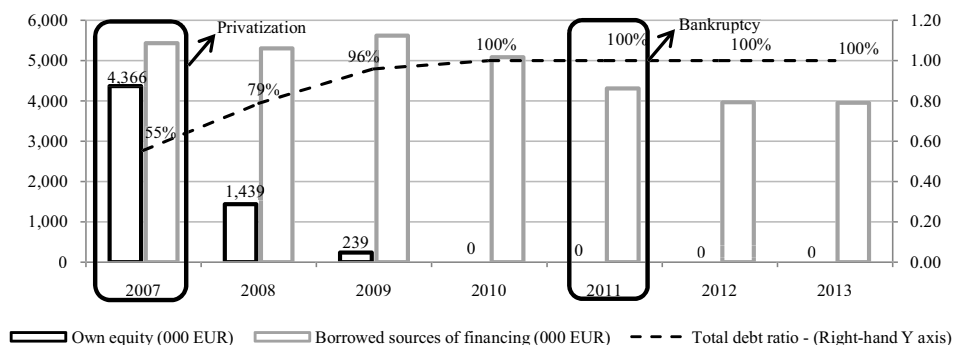
Illustration 26 “FOPA” AD debt levels, 2004–2006



Source: Author's calculations

After the second round of privatization, the total debt level rose up to the point where the entire business operations of “FOPA” AD were financed through borrowing. Following 2007, the Company's total liabilities were entirely short-term liabilities. From late 2007 until the end of 2010, a significant decrease in the Company's equity was registered. The primary reason for such a drop was the disclosure of current losses as well as the losses from previous years. As of 2010, “FOPA” AD was disclosing losses greater than its equity: EUR 767,000 at the end of 2010; EUR 1.1 million in 2011; EUR 1 million in 2012; and EUR 1.1 million in 2013.

Illustration 27 “FOPA” AD Vladičin Han debt levels on December 31, 2007–2013



Source: Author's calculations

2.2.7. *Relationship between the company and local self-government*

Vladičin Han is a municipality in South Serbia with a population of 20,587, according to the 2012 estimate, and falls into the category of one of the least developed municipalities with an average wage of RSD 29,984. The total number of unemployed in the municipality (3,883) is higher than the number of those employed (3,052). The unemployment rate in 2012 was as high as 56%. Following the closure of privatized companies, the municipality has only one medium-sized company and not a single big company. Out of 11 companies privatized on the territory of Vladičin Han municipality, 7 were privatized by public auction and 1 was privatized by public tender. Other companies were either not privatized or, like “FOPA”, subjected to the privatization procedure under the old law so that they were not entered in the Privatization Agency’s portfolio. As many as 6 companies are bankrupt, one of which is “Delišes” whose restructuring was suspended in 2013. Three privatized companies had their privatization contracts cancelled. Fiscal autonomy of the municipality of Vladičin Han is weak – the share of unappropriated transfers in total current revenues is 45%, while the local tax burden of the private sector in 2012 (approximated by the position 716100 Other taxes paid exclusively by companies, i.e. entrepreneurs, i.e. collected business sign display fees) made up 2.4% of the total current revenues, which means that the municipality of Vladičin Han is in the group of those municipalities that partly substitute other sources of revenues with taxes levied on the private sector.

LIABILITIES TO LOCAL GOVERNMENT

As the Company is undergoing bankruptcy proceedings, with only three employees and several consecutive business years in the red, “FOPA” AD has lost the significance that it previously had for the local community. It is in the interest of the local government and local population that the assets in possession of the Company be activated in the bankruptcy proceedings thereby creating an opportunity for employment.

IMPACT ON LG DIRECT REVENUES

Since 2008 “FOPA” AD has not effected a single payment for its dues constituting direct revenues for the local government’s budget. In this period, the Company’s local tax liabilities which represented direct revenues for the local self-government totaled RSD 7.56 million. However, the debt with interest on December 31, 2013, amounted to as much as RSD 13.75 million. Had “FOPA” AD been operating and paying its dues, the Company’s importance for the overall economy of the municipality would have been very significant. In the 2008–2011 period, the Company’s share would have been between 4.3% and 5.7%. This illustrates the impact of the Company’s privatization on the budget of the municipality of Vladičin Han.

*Table 14 “FOPA” AD share in total direct revenues
of the municipality of Vladičin Han*

Year	2008	2009	2010	2011	2012	2013
Direct revenues (000 RSD)	31,327	22,852	46,727	36,031	62,802	75,054
FOPA– payments (000 RSD)	/	/	/	/	/	/
FOPA– apportioned liabilities (000 RSD)	1,370	1,159	2,009	2,053	513	455
Share of payments in direct revenues	/	/	/	/	/	/
Potential share in direct revenues	4.38%	5.08%	4.30%	5.7%	0.8%	0.6%

Source: Municipal Administration, Finance Department

IMPACT ON LOCAL GOVERNMENT CEDED REVENUES

The table shows the “FOPA” AD total share of income tax and other ceded revenues of the Vladičin Han municipality. “FOPA” AD fiscal contributions were falling year after year, and the Company’s share in the analyzed six-year period fell from 1.94% in 2008 to negligible 0.01%. (only RSD 5,617, in 2011). In 2012 and 2013, for the duration of bankruptcy proceedings, there were no payments.

Table 15 “FOPA” AD share in total ceded revenues of Vladičin Han municipality

Year	2008	2009	2010	2011	2012	2013
Ceded revenues – actual (RSD)	71,833	66,840	66,994	89,907	144,656	131,804
“FOPA” in bankruptcy – payments (RSD)	1,391	357*	178*	5*	/	/
Share in ceded revenues (%)	1.94%	0.54%	0.27%	0.01%	/	/

Source: Finance Department of Vladičin Han Municipality

*Enforced collection of payments (Tax Administration of the Republic of Serbia)

PUBLIC UTILITIES DUES

“FOPA” AD has its own water supply and no outstanding debts to JKP “Vodovod”, the local water supply utility company. At the same time, since 2008, the Company has been a defendant in a lawsuit brought by “Porr-Werner&Weber”, the waste disposal utility. Apart from this no payments were made to public utilities in the analyzed period.

2.3. WHAT IF ANALYSIS

As part of a “What If” analysis, a projection of assumed trends for values of individual positions in the profit and loss account of “FOPA” AD was made in order to illustrate and quantify the impact of the counterfactual outcome. Given the limited access to available data and the intention to present as precisely as possible **one of the possible alternative scenarios for privatization** of “FOPA” AD, the quantification of this scenario comprises assumed business operations of the Company up to the level of operating profit/loss.

The following assumptions were made for the purpose of projections of assumed values for operating revenues, expenditure and net results of “FOPA” AD:

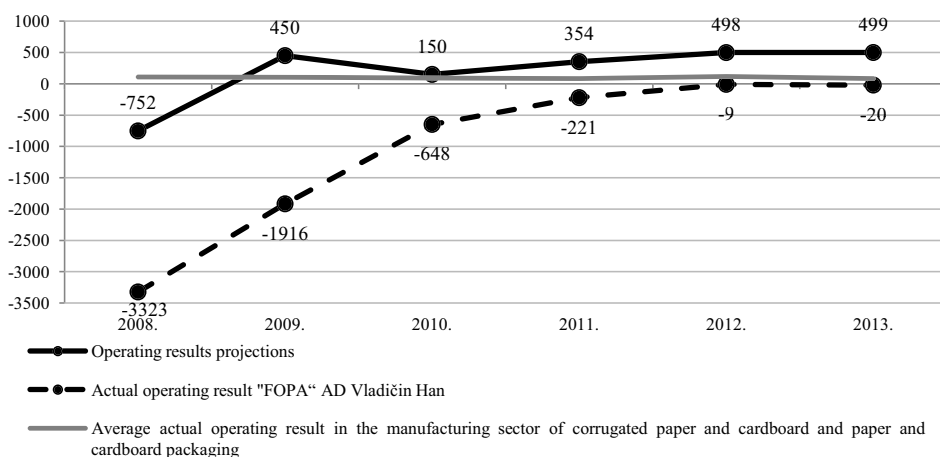
- 1) The basic premise is that an alternative buyer taking over a majority ownership stake in “FOPA” AD would implement all aspects of the business policy which were applied to the buyer of DP “Dušan Petronijević” (“Duropack” d.o.o.), an example of a successful privatization in the sector of manufacturing of corrugated paper and cardboard and paper and cardboard packaging. All specifics of business operations typical of “FOPA” AD have not been taken into account, instead the starting point are the specific business traits of DP “Dušan Petronijević” (“Duropack” d.o.o.) which are also applicable to “FOPA” AD. In addition, we assume that market conditions in which DP “Dušan Petronijević” (“Duropack” d.o.o.) operates apply to the business environment of “FOPA” AD.
- 2) The year zero for projecting assumed values for operating revenues, expenditure and final operating results is the year of “FOPA” AD privatization, i.e. 2007.
- 3) The baseline for projections of trends in assumed values for “FOPA” AD operating revenues and expenses are the fluctuations of the historical values for operating revenues and expenses recorded in business operations of DP “Dušan Petronijević” (“Duropack” d.o.o.), as an example of a successful privatization, for the 2008–2013 period.
- 4) The baseline for projections of “FOPA” AD assumed sales revenue values are historical data for DP “Dušan Petronijević” (“Duropack” d.o.o.) sales of products and services in the 2008–2013 period.
- 5) The baseline for projections of assumed values of a) revenues from own use of products, services and merchandise, b) changes in the value of inventories of work in progress and finished products, and c) other operating revenues is the historical share of the above revenue categories in DP “Dušan Petronijević” (“Duropack” d.o.o.) sales revenues in the 2008–2013 period.
- 6) The baseline for projections of assumed values for expenses as part of business expenditure, i.e. a) purchase costs of goods sold, b) costs of raw materials, c) costs of salaries, fringe benefits and other personal expenses, and d) other operating expenses, is the historical share of

the above expenses in DP “Dušan Petronijević” (“Duropack” d.o.o.) sales revenues in the 2008–2013 period.

- 7) Due to lack of adequate data, an approximation of trends in values of the costs of depreciation and provisions has been made. With the approximation of the costs of depreciation and provisions, historical data for the rate of changes to the value of the costs of depreciation and provisions for DP “Dušan Petronijević” (“Duropack” d.o.o.) in the 2008–2013 period have been used.
- 8) A year after the completed second round of “FOPA” AD, it was established that there was a significant decline in the value of inventories, hence, this decrease in the inventories valued at EUR 1.1 million has been taken into account when projecting assumed values for “FOPA” AD sales revenues in the 2008–2013 period.

Results stemming from the alternative scenarios for “FOPA” AD privatization are presented in the illustration below. Based on the projections of calculated values for operating results, “FOPA” AD would be making a profit above average in the sector of manufacturing of corrugated paper and cardboard and paper and cardboard packaging in all the analyzed years, except for the first year of 2008 due to considerable decline in the value of inventories.

Illustration 28 Alternative scenario for successful “FOPA” AD privatization – Overview of projected and actual operating results in 2008–2013 (EUR 000)



Source: Author's calculations

Based on comparison between the projected and actual operating results, taking into account the assumptions above, the failed privatization of “FOPA” AD led in aggregate, to EUR 7.3 million worse operating result in current values, than the those arising from the alternative scenario of a successful privatization for the 2008–2013 period.

Table 16 “FOPA” AD projected assumed of operating income, expenses and operating profit 2008–2013 (000 EUR)

Year	2008	2009	2010	2011	2012	2013
Projected operating incomes	2,544	3,371	3,796	4,695	4,810	5,397
Sales revenues	3,550	3,361	3,775	4,675	4,796	5,387
Revenues from own use of products, services and merchandise	15	11	8	0	0	0
Increase in value of inventories of work in progress and finished products	58	62	68	73	85	74
Decrease in value of inventories of work in progress and finished products	1,080	64	55	54	70	63
Other operating revenues	0	0	0	1	0	0
Projected operating expenditure	3,296	2,921	3,646	4,341	4,312	4,898
Cost of goods sold	119	144	62	38	30	106
Raw material and consumables used	2,266	1,817	2,584	3,096	3,058	3,426
Cost of salaries and wages	517	527	546	695	719	798
Costs of depreciation and provisions	127	116	117	139	121	124
Other operating expenses	266	317	338	373	384	444
Projected operating result	-752	450	150	354	498	499
Actual operating result of “FOPA” AD	-3,323	-1.916	-648	-221	-9	-20
Actual average operating result in manufacturing of corrugated paper and cardboard, and paper and cardboard packaging	110	106	93	82	117	85

Source: Author's calculations

3. PRIVATIZATION IN MINING INDUSTRY

In this section, we will consider the case studies of the privatization of DP “Rudnik” from Rudnik and DP “Suva Ruda” from Raška. The companies were selected following an analysis of the privatized companies whose primary business activities were the exploitation of ore deposits, ferrous and non-ferrous, precious and other metals. The former company operates successfully after the privatization, whereas the latter (despite the fact that bankruptcy proceedings resulted in the sale of the bankruptcy debtor as a legal person) has never resumed its production and finds itself once again on the verge of another bankruptcy.

Bearing in mind the markedly procyclical character of the industry, global recession trends are quickly reflected in the sector of mineral raw materials and mining exemplified, above all, in the fall in prices of mineral raw materials on the world markets. This drop in prices of metals, along with a reduction in physical production output volume, was precisely the reason why DP “Rudnik” was recording a considerable decline in sales revenues in the period prior to privatization resulting in financial difficulties for the Company. The trend of DP “Rudnik” shrinking business activities came to a head in July 2003, when the Company suspended its production due to the blocking of its account and found itself on the verge of bankruptcy. The Company resumed its business operations through a commercial agent and re-launched production in the mid-November 2003. Prior to privatization, DP “Rudnik” registered net profit the last time in 1999, whilst losses in aggregate over the 2000–2004 period exceeded EUR 3 million. Poor operating results had led to a significant increase of debt levels in the period preceding the privatization when the Company had been almost entirely funded from the borrowed sources of financing.

DP “Rudnik” was privatized on September 23, 2004, by public auction. Upon privatization, the Company considerably improved its business operations. The buyer – “Contango” d.o.o. – was established with the intention to trade in metals and their concentrates as its core business, as well as in final products from the metal sector. The buyer invested a total of EUR 5.4 million in fixed assets from the moment of acquisition of the Company until late 2013. Following the privatization, “Rudnik” AD sales revenues were growing; albeit with fluctuations caused by the non-ferrous metal price trends on the world market. Only a year after the privatization, for the first in five years, the Company made a operating profit.

The privatization of “Rudnik” is a typical example of the buyer lacking full information about the situation of the subject of privatization; a factor which has been a major problem in the implementation of privatizations.

Firstly, bankruptcy proceedings were launched against the subject of privatization, but no one presented clearly this information to the buyer over the course of the privatization procedure, hence the buyer was forced to respond exceptionally fast in order to prevent enforcement against the assets of the subject of privatization. Secondly, due to a lengthy time span between the moment when DP “Rudnik” liabilities were registered and the actual time of privatization, the buyer came across considerable additional liabilities which had not been disclosed in the privatization documentation on DP “Rudnik”.

Having acquired a 70% ownership stake in “Rudnik” equity, the buyer increased it by converting the debt into ownership stakes, and then acquired the stakes of minority shareholders to eventually become the sole shareholder in January 2012, after which “Rudnik” was transformed from an open joint-stock company into a limited liability company.

The attitude towards privatization on the part of both the management and workers was positive so the buyer did not have any major problems with the employees. The Company changed its employee structure, but retained approximately the same number of employees relative to the pre-privatization period. In this respect, “Rudnik” stands out from the lion’s share of successful privatizations; a fact which makes it quite exceptional. Workforce retention and a rise in salaries and wages on average make “Rudnik” d.o.o. a significant contributor to the financing of the local government. Total amount of taxes based on employee’s wages and temporary service contracts paid by “Rudnik” d.o.o. to the municipality of Gornji Milanovac in the 2004–2013 period was RSD 193.6 million, but in the last three years in this period, after changes to the local government’s financing framework, ceded revenues from these same sources totaled around RSD 90 million (about EUR 800,000).

As in the case of “Rudnik”, the period before the privatization of DP “Suva Ruda” had been marked by a decline in business activities and the poor financial situation of the Company. The crisis in its business operations had come to a head in August 2002, when DP “Suva Ruda” suspended its production due to a marked cash-flow crisis and undermined financial position, after which essentially the Company never recovered. Prior to privatization, in the 2004–2007 period, DP “Suva Ruda” operating revenues were below EUR 10,000 on average, and the Company was consistently making business losses.

As the liabilities to workers were not settled, in 2005 the employees took out legal action seeking payment of outstanding wages and contributions. One day before the scheduled auction sale of DP “Suva Ruda” assets, a decision on restructuring was passed which was why the said auction did not take place. The decision on restructuring was not made as part of a plan, nor was there a possibility for the Company to be restructured in the manner stipulated by the Privatization Act. Nevertheless, the decision provided protection to the Company against enforcement, i.e. bankruptcy, for a short time. The Development Fund filed a motion for initiation of the bankruptcy proceedings against “Suva Ruda”, although the Company was protected by the deci-

sion on restructuring. However, the Commercial Court ordered the initiation of bankruptcy proceedings.

There was no particular interest among potential investors in the “Suva Ruda” enterprise. As part of the bankruptcy proceedings, a fourth attempt to sell the bankruptcy debtor as a legal entity was successful. “Koncern Farmakom MB” Šabac which, at the time, was a majority owner of several lead, zinc and antimony mines, purchased “Suva Ruda”. The buyer announced the re-launch of production in the “Suva Ruda” mine on several occasions, but was increasingly delaying acting upon it. Funds for the re-launch of production were provided in 2011, when the International Financial Corporation (IFC) granted a EUR 40 million loan to the buyer (the parent company) and additionally another credit line of EUR 80 million through commercial banks. Despite frequent announcements about an investment in necessary assets required to re-start production in the mine, this has essentially never happened, i.e. the mine has never gone back into its production.

The disrupted cash flow position of “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. was the consequence of the fact that the Company, since 2008 never resumed production. In the meantime, the buyer was plagued by financial difficulties which, after months of long-failed negotiations with creditors, resulted in the bankruptcy proceedings in September 2014. Interestingly, the buyer considerably increased the value of total business assets and equity of the Company in late 2012 thanks to a new valuation of ore deposits owned, but the independent auditor refrained from giving his opinion. The future of “Suva Ruda” is relatively uncertain bearing in mind that the parent company is undergoing bankruptcy proceedings as well as that it used 100% of its stake in the Company as collateral.

DP “Rudnik” privatization achieved all key objectives. This privatization improved business efficiency and resulted in investments in equipment and transfer of know-how. In addition, today “Rudnik” d.o.o. is regularly paying its dues at both the national and local level. On the other hand, The DP “Suva Ruda” privatization, i.e. the sale of bankruptcy debtor as a legal entity, achieved – but only partially – the goal of a one-off increase in public revenues due to relatively high price of the sale of the bankruptcy debtor.

Privatization objectives	Rudnik	Suva Ruda
Efficiency of privatized company	+	–
Increase in investments	+	–
Transfer of technologies and know-how	+	–
Increase in public (national and local) revenues	+	+/-
Hard budget constraint	+	–

In this context, the DP “Suva Ruda” privatization did not provide for a more efficient utilization of resources, but at least it did not result in an accu-

mulation of losses. The key loss is reflected in the missed benefits due to lack of investment and failure to re-launch production (under the assumption that it would be profitable). Given that DP “Suva Ruda” did not even re-start the production, the results obtained in an analysis of an alternative scenario, i.e. the “what if” analysis, would not be representative, therefore the said analysis was not conducted in this case study. The same conclusion is to be inferred with respect to the estimate of DP “Suva Ruda” privatization’s impact on the local self-government’s revenues.⁸⁰

Taking into account the relative importance of DP “Suva Ruda” for the municipality of Raška, further delays of investments and re-starting of the production will have a negative impact on the fiscal position of the municipality. Raška is one of the local self-governments with a high incidence rate of cancelled privatizations and unemployment rate in 2012 was 43.5%.. In the municipality of Raška, except for “Suva Ruda” which was sold as a bankruptcy debtor, another ten companies were privatized by public auction. As many as 6 privatizations were cancelled. In case of 5 companies, these were open proceedings where some of these companies were resold as part of bankruptcy proceedings. Two companies have not been privatized yet and they are listed in the Privatization Agency’s portfolio. Gornji Milanovac has a much higher privatization success rate as only three privatization contracts have been cancelled out of 10 in total (9 by public auction and 1 by public tender).

3.1. CASE STUDY– PRIVATIZATION OF “RUDNIK” DOO GORNJI MILANOVAC

3.1.1. *Background information*

The “Rudnik” mine and the mining town of Rudnik are situated in Central Serbia. The town is a part of the Gornji Milanovac municipality. Polymetallic deposits in the “Rudnik” mine consist of a large number of ore bodies spread over an area of around 3 kilometers in length and over 1.5 kilometers in width. Lead, zinc, copper and silver are the main metals in existing ore deposits.⁸¹ The extracted ore contains 2.8% of zinc, 3.12% of lead, 0.43% of copper and 109 grams of silver per tonne on average.⁸² According to the 2003 estimate, reserves of polymetallic mineral raw materials totaled 672,000 tonnes. Relative to local ore deposits, and particularly in comparison to average values for ore deposits on the European continent, the content of metals in Rudnik ore deposits is low.⁸³

80 In the case of DP “Suva Ruda” we did not succeed in collecting all the necessary data, however, as the company was not even operational, we assume that the amounts in absolute terms and the Company’s relative share in direct and ceded revenues were negligible.

81 In addition to primary metals, the ore deposits contain accompanying metals such as bismuth, cadmium, wolfram, arsenic and iron, as well as gold and platinum-group elements (PGE).

82 DP “Rudnik” Rudnik Privatization Program, January 2004, Serbian Privatization Agency.

83 Interview with representatives of “Contango” d.o.o. Belgrade.

Table 17 Background information on “Rudnik” d.o.o.

Full business name:	Rudnik i flotacija Rudnik d.o.o. Rudnik
Abbreviated business name:	Rudnik d.o.o.
Company code:	07192762
Registered address:	Rudnik
Standard Industrial Classification (SIC) Code:	Exploitation of ores and ferrous, non-ferrous, precious and other metals (0729)
Legal form:	Limited liability company
Status:	Active company
Number of employees (2013):	430
Year of privatization:	2004

Source: Serbian Business Registers Agency

Intensive mining in Rudnik started only after World War 2. The socially-owned company “Rudnik” (hereinafter referred to as the Company or “Rudnik”) was established in 1954, and operated until 1989 as a subsidiary of the “Trepča” mining company. **The Company is in the business of ore extraction and processing and production of lead, zinc and copper concentrates.** In the past 20 years, the “Rudnik” mine has been almost exclusively using the method of frontal excavation, top to bottom, with open-pit mining (room-and-pillar mining).⁸⁴ Ore is transported by trucks to the crude ore bunker at the flotation plant, and subsequently crushed to be carried by conveyor belts to the mill bunker where the fine grinding process takes place. Finely ground ore, mixed with water and special reagents, or pulp, is prepared for the flotation process which produces concentrates to be sold on the market and tailings to be deposited in the tailing pond.

Since its inception to the current date, the Company has undergone several status-related and organizational changes. Prior to privatization, the Company had experienced great problems with liquidity. It had been incurring losses and found itself on the brink of bankruptcy. **The Company was privatized on September 23, 2004, by public auction.** Belgrade-based “Contango” d.o.o. purchased the majority stake in the Company at the public auction, thereby becoming the first owner of a mine with underground exploitation of ore to be privately owned in Serbia after 1945. In January 2012, “Contango” became the sole shareholder, and in June 2012, “Rudnik” was converted from an open joint-stock company to a limited liability company.

84 According to the Company’s statement, in the past sixty years, this method has been used to extract about 70% of all the ore excavated from “Rudnik” ore deposits.

3.1.2. Business operations prior to privatization

Following the 1990s crisis, when *the Company suspended its production at one point for about three years*, a short-lived period of recovery ensued. However, as of 2001, there was another period marked by a decrease in the physical production output and sales revenues, as well as growing losses.⁸⁵ Reduced production output volumes and a fall in metal prices on the world market were conducive to a significant slump in sales revenues. In 2002 alone, the production output volume for zinc, lead and copper concentrates dropped by 18%, whilst the fall in average prices on the world market was 12.2%, 5.1% and 1.3% for zinc, lead and copper, respectively.⁸⁶ As a result of the market turmoil, DP “Rudnik” sales revenues denominated in EUR in 2002 per annum fell by 19.2%.⁸⁷

On the eve of privatization, such circumstances brought the Company to the brink of bankruptcy. The crisis in its business operations came to a head *in July 2003*, when the *Company suspended its production* due to the blocking of its account.⁸⁸

Table 18 DP “Rudnik” production output volumes 2001–2004 (in tonnes)

Product	2001	2002	2003	2004
Zinc concentrate	5,581	4,690	2,490	3,205
Lead concentrate	3,561	3,247	1,855	1,935
Copper concentrate	2,006	1,208	415	459
Total	11,148	9,145	4,760	5,599

Source: DP “Rudnik” Rudnik privatization program, January 2004, Serbian Privatization Agency and “Contango” d.o.o. Belgrade

85 In the early 1990s, DP “Rudnik” fared much worse in its business operations than in the 1980s. In the late nineties, first signs of a recovery emerged, but it was short-lived. As shortly as in 2001, another period was marked by a slump in physical production output and sales revenues, as well as growing losses. In 2001, the last recovery year before privatization, the growth of physical production output was 12.4%. In the same year, “Rudnik” significantly increased its sales revenues denominated in EUR by as much as 174% due to, above all, a rise in sales to a domestic client – RTB Bor (i.e. RTB smelter and refining plant). The Company also registered a 147.9% revenue growth from sales on foreign markets despite a significant fall of copper and zinc prices on average by 12.9% and 21.4%, respectively.

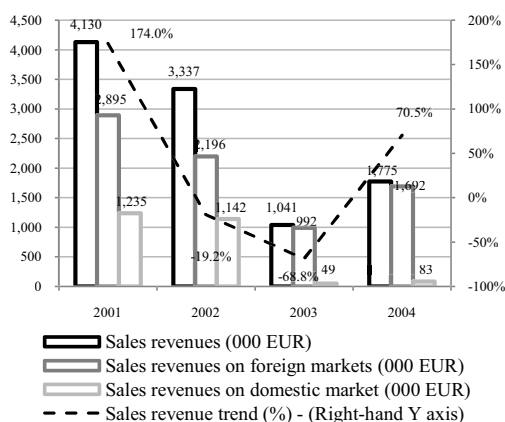
86 Price fluctuations for non-ferrous metals on the world market in this case study are based on data from the International Monetary Fund (IMF), available at <http://www.imf.org/external/np/res/commmod/index.aspx>.

87 Ibid. A considerably more conspicuous slump in sales revenues of 24.1% in 2002 was recorded on foreign markets as opposed to the 7.6% sales revenue drop on the domestic market. A similar trend persisted in the course of 2003 when the sales revenues, despite the rise in average metals prices on the world market, were lower per annum by 68.8%.

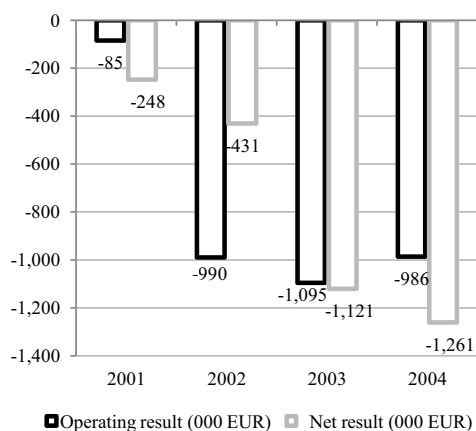
88 In Serbia, an account blocking procedure permits creditors holding bills of exchange to block a debtor’s accounts pending repayment. This mechanism represents the preferred way of debt collection. However, it usually triggers a race by creditors holding bills of exchange concerned about the company’s deteriorating financial position.

After a hiatus of several months precipitated by the blocking of its account, in mid-November 2003, the Company resumed its business operation through a commercial agent and re-launched production.⁸⁹ The suspension of production and subsequent resumption of business operations through a commercial agent by the end of 2003 contributed to a slump in sales revenues by 68.8%. In 2004, thanks to an increase in the Company's business activities (growth of physical production volume by 17.6%)⁹⁰ and soaring metal prices on the world market (prices for zinc, lead and copper went up by 34.3%, 93% and 73.3%, respectively), the first high sales revenue growth rates were recorded (70.5%). However, actual revenues in 2004 were less than half the revenues generated in 2001.

*Illustration 29 Sales revenues
2001–2004 (000 EUR)*



*Illustration 30 Operating and net results
2001–2003 (000 EUR)*



Source: DP “Rudnik” Rudnik privatization program, January 2004, Serbian Privatization Agency and “Contango” d.o.o.

The last time that DP “Rudnik” recorded a positive net operating result (EUR 115,000) was in 1999. In each following year the Company reported losses, which reached a total of EUR 1.26 million in 2004. Thanks to the resumption of production and a significant rise in metal prices on the world market, the Company achieved somewhat better results, but still was in the red by EUR 986,000.⁹¹ Given the drop in business activities, both expenditure and revenue declined resulting in the said losses in the 2000–2004 period. In the business expenditure structure, the cost of salaries and wages and the cost of materials in the analyzed period made up an average 65.1% of total busi-

89 Serbian Privatization Agency's Compliance report, dated September 22, 2006, and an interview with representatives of “Contango” d.o.o. Belgrade.

90 Compliance report, dated March 25, 2005.

91 DP „Rudnik” Privatization Program, January 2004, Serbian Privatization Agency.

ness expenditure.⁹² As a result, **cumulative losses in the 2000–2004 period totaled over EUR 3 million.** The gravity of this problem in the Company's business operations was also reflected in the fact that the negative net result in 2001–2002 on average made up 9.5% of the Company's sales revenues whereas in late 2003 the net loss exceeded the Company's actual sales revenues.⁹³

Poor operating results were conducive to a significant debt increase of the Company. As a consequence of the higher debt levels, in the 2001–2004 period, the Company recorded a considerable rise in financial expenses (average increase per annum amounted to 53.6%). In 2001–2003, prior to privatization, DP "Rudnik" was focused on a smaller client base. The whole production output of zinc and lead concentrates was sold on foreign markets, whereas the copper concentrate production output was designated for the domestic market, i.e. to "TIR" in Bor in its entirety. Zinc and lead-concentrate buyers were mostly companies based in Switzerland which were processing it in Bulgarian smelters, and then selling the metals on commodity markets. Earlier, lead and zinc concentrates had been processed on the domestic market – in "Trepča" and "Zorka" Šabac. However, these smelters were not operational in the said period or were plagued by financial problems which were disrupting their normal operations.⁹⁴ Significant investments in facilities at DP "Rudnik" had been made in late 1970s and over the course of 1980s. In late eighties, a fire in the flotation plant gutted the whole facility, but soon a new modern flotation plant was up and operational. The Last investments in the equipment prior to privatization were made in the 1999–2001 period.

3.1.3. DP "Rudnik" privatization

The subject of privatization was a 70% stake in DP "Rudnik" equity. Total fixed assets on June 30, 2003, were estimated to be worth RSD 454.9 million (EUR 7.1 million), with the lower bound range of RSD 364 million (EUR 5.7 million) and the upper bound range of RSD 546 million (EUR 8.5 million).⁹⁵

Table 19 Estimated value of fixed assets, December 31, 2002

	Carrying value	Adjusted carrying value
Fixed assets (000 EUR)	2,334	1,146

Source: DP „Rudnik” Rudnik privatization program, January 2004, Serbian Privatization Agency and "Contango" d.o.o. Belgrade

92 Other operating expenses had a significant share in total business expenditure of 18% on average (DP "Rudnik" Rudnik privatization program, January 2004, Serbian Privatization Agency).

93 In 2004, due to the re-start of production and favorable trends on the global metal market, the net business loss share in the Company's sales revenues was lower year-on-year, totaling 71.0%.

94 Privatization Program, January, 2004. Consulting company "Beoconex" d.o.o. from Belgrade carried out the valuation of DP "Rudnik" equity on June 30, 2003.

95 Ibid.

“Contango” d.o.o. from Belgrade, the buyer of DP “Rudnik”, was established in September 2003 with an intent to trade in metals and their concentrates as its core business as well as in final products of the metal sector. On September 23, 2004, at the second bidding round of a public auction, “Contango” d.o.o. purchased the majority stake in “Rudnik”. The Company was sold at the starting price of RSD 85.7 million (about EUR 1.146 million) EUR in the second bidding round.⁹⁶ The buyer resorted to an option provided by the law and effected the payment with immature old foreign currency savings bonds. In addition, the buyer presented a EUR 248,000 bank guarantee issued by Komercijalna banka AD Belgrade, valid until February 12, 2006. The guarantee was returned to the bank on April 4, 2005.⁹⁷ In late 2004, the majority owner registered the unpaid subscribed capital to the tune of RSD 18.8 million (EUR 259,000).⁹⁸

In addition, the buyer took upon itself to fulfil contractual obligations vis-à-vis investments and the social program. Investment-related obligation totaled RSD 18.8 million.⁹⁹ As part of the social program, future employer/majority owner’s obligations were specified. The privatization program stipulated the buyer’s obligation to compile within a year its own social program for resolving the issue of redundancies. This program was supposed to offer other jobs along with occupational retraining to redundant workers, or to pay out severance packages of EUR 200 (equivalent RSD amount) per year of their length of service in case of lay-offs. Also, the buyer assumed an obligation to pay all the dues to employees upon the conclusion of an agreement on severance pay for redundant workers over the course of 2003, as well as to pay all the outstanding benefits to disabled workers and implement all the protective measures at work as required by law and internal rules of procedure and instructions. The buyer also assumed a contractual obligation to respect all the rights of employees laid out in the collective agreement and other general Company’s by-laws, as well as that it would not lay off workers for a year after the signing of the contract.¹⁰⁰ Following the expiry of the said period, pursuant to the social program, the buyer could lay off redundant employees provided that they are paid for each full year of their respective length of service the six-month’s worth of average monthly gross wage preceding the month in which the employment is terminated. If the average monthly wage in the six-month period preceding the month in which the worker was made redundant was higher than the guaranteed EUR 200, the employer was under obligation to pay out the six-month’s worth of the employee’s average wage.

96 Calculated at the NBS median rate of June 28, 2003. The starting price at the first auction was 20% of the upper bound in the range of estimated capital value. If the first auction fails, at the second bidding session the starting price is set at 20% of the lower bound in the range of estimated fixed capital value.

97 Compliance Report, dated September 22, 2006.

98 Comments enclosed with 2013 financial reports, Rudnik d.o.o.

99 Calculated at the NBS median rate of June 28, 2003.

100 Contract on sale of socially-owned capital by public auction, dated September 28, 2004.

The privatization of “Rudnik” AD is a typical example of the buyer’s lack of full information about the characteristics of the subject of privatization. Upon the acquisition of the Company, the buyer found that there were significant *discrepancies between the actual situation of “Rudnik” AD and the information on the Company’s financial situation* provided by the Privatization Agency in the privatization procedure. Total liabilities to suppliers were higher than the amount presented to the buyer at the time of privatization. Arrears owed to suppliers, as subsequently established by the buyer, amounted to about USD 3.3 million. On top of that, the buyer also found that there was an outstanding debt in unpaid wages totaling USD 463,000. This piece of information had neither been disclosed to the buyer in the course of negotiations on the sale of the Company.¹⁰¹

The privatization of “Rudnik” AD was the first and only such experience for the buyer – “Contango” d.o.o. from Belgrade. At the point of taking over the Company, *the buyer had no knowledge that bankruptcy proceedings against the subject of privatization had already been launched*, since this fact had not been clearly presented to the buyer in the course of the privatization procedure. Specifically, bankruptcy hearings had already been scheduled in mid-October 2004. The most likely reason for the initiation of bankruptcy proceedings had been the intention of some creditors to send a credible signal and force the new owner to settle outstanding debts in order to avoid bankruptcy. The buyer responded quickly and settled all the creditor claims and lawsuits by the end of 2005, thereby preventing the possibility of creditors settling their claims by the sale of the Company’s assets or in bankruptcy proceedings. In addition, due to a considerable time lapse between the point when DP “Rudnik” liabilities were registered and the privatization, *the buyer found significant liabilities which were not disclosed in the privatization documentation*.¹⁰²

Apart from the large debt burden, *the buyer also had to come to terms with additional problems* such as poor working habits and work ethics of employees, deficient classification of jobs and job descriptions, ineffective organization and management, inadequate working hours, lack of monitoring of expenses and poorly designed remuneration system which was based neither on performance nor merit. Having taken full operational control over the Company, the buyer first had to settle all the bankruptcy creditors’ claims and then pay all the arrears to other suppliers. In addition, relationships with suppliers had to be mended and restored. In order to boost the production, it was necessary to invest heavily in the modernization of equipment and facilities. The biggest problem with which the buyer had to cope was the recruitment of both unqualified and highly qualified workforce. Parallel to this, the new owner had to change the work habits of employees, as well as those of managers so as to create a market-oriented management structure.¹⁰³

101 Figures presented in this segment were obtained in interviews with “Contango” d.o.o. representatives.

102 Ibid.

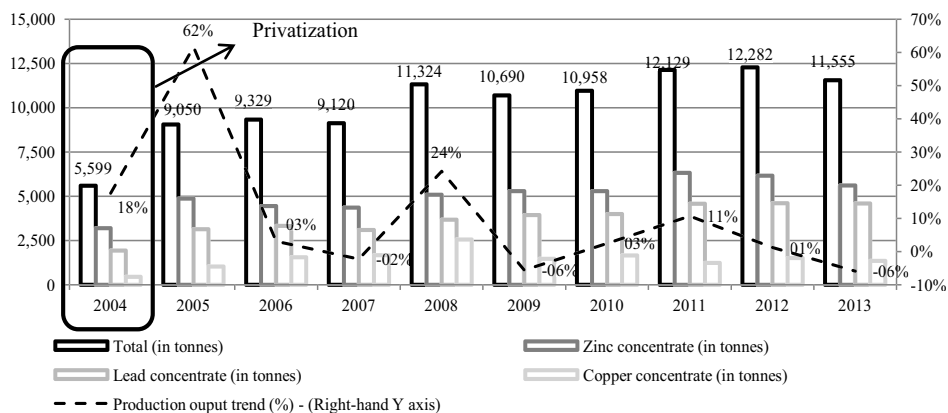
103 Ibid.

3.1.4. Business operations after privatization

Following the management takeover and completed investment, “Rudnik” considerably improved its business operation. Thanks to investments in equipment and a series of operational restructuring measures, “Rudnik” significantly increased, and subsequently maintained the achieved production output volume. Immediately after the privatization, in late 2004 and early 2005, on account of its subscribed capital, the buyer invested RSD 19 million (EUR 259,000) in equipment.¹⁰⁴ Investments were made in machinery and production so that the overall investment in equipment in 2005–2006 totaled around EUR 954,000.¹⁰⁵ “Rudnik” AD continued to increase zinc, lead and copper concentrate production output volume in the following years.

After the privatization and investments, having boosted the production output volume and thanks to the favorable industrial metals market trends, the Company continued to increase its sales revenues until the economic crisis broke out. Due to low sales levels in 2004, 2005 sales revenues were 2.1 times higher year-on-year. In the following two years, the Company’s sales revenues grew at an average annual rate of 50%.

Illustration 31 “Rudnik” production output 2004–2013 (in tonnes)



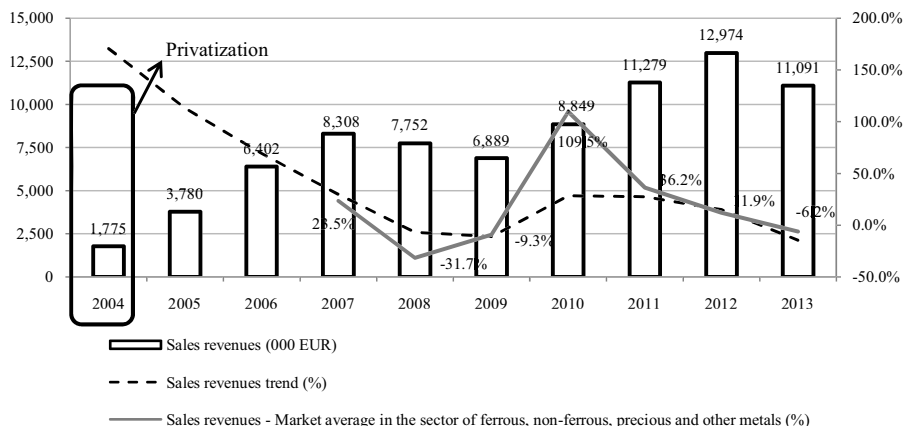
Source: “Contango” d.o.o.

Bearing in mind the markedly *procyclical characteristic of the mining industry*, the global economic crisis inevitably had a significant impact on overall business operations of the Company in 2008 and 2009. The Company’s sales revenues in 2009 fell by 17.1% compared to 2007 sales revenues. In the next three years, in the 2010–2012 period, due to a recovery of the world economy, the Company’s sales revenues rose at a rate of 23.6% on average per year.

¹⁰⁴ Comments enclosed with 2013 financial reports, Rudnik d.o.o.

¹⁰⁵ Compliance Report, dated September 22, 2006.

Illustration 32 “Rudnik” sales revenues 2004–2013 (000 EUR)



Source: Serbian Business Registers Agency

Revenues were growing overall with some fluctuations caused by non-ferrous metal prices trends on the world market. Favorable trends on the metal market considerably boosted sales revenues and overall operating results of the Company in the 2005–2007 period. Prices for copper, lead and zinc were rising at average annual rates of 111.9%, 100.1% and 137.9%, respectively.¹⁰⁶ The world economic crisis and a slowdown in global industrial production triggered a price downswing for copper, lead and zinc on the world market in 2008 and 2009. The 6.7% decline in the Company's sales revenues was largely attributable to a plunge in zinc prices on world metal exchanges at an average rate of 42.3%.¹⁰⁷ In 2009, a new drop in zinc, lead and copper prices on the international industrial metal markets was recorded resulting in a further slump in sales revenues of 11.1%. A similar downward trend on the metal market emerged in 2013. Due to a decline in average copper, lead and zinc prices on the world industrial metals market in 2013 at a rate of 16.9%, 10.9% and 13.0%, respectively,¹⁰⁸ the Company registered a slump in annual sales revenues of 14.5%.

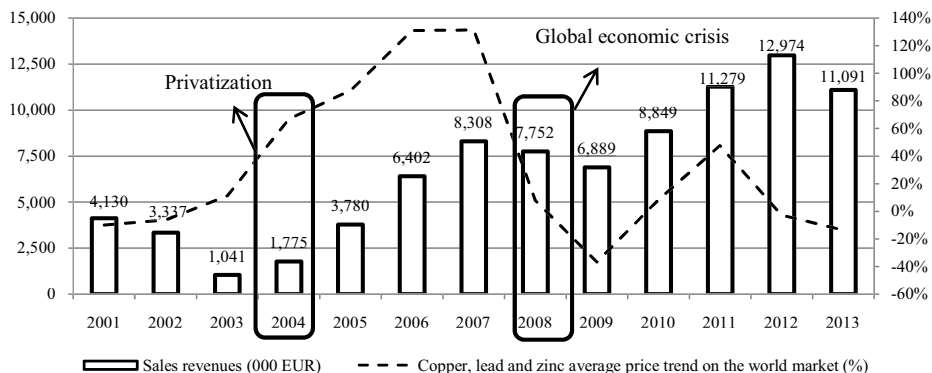
Only a year after the privatization, for the first time in five years, “*Rudnik*” made an operating profit totaling EUR 380,000. Positive operating result was achieved thanks, above all, to rising sales and favorable conditions on the world metal markets, despite a 50.6% increase in the cost of materials. In the following years, the Company was making profit on average of EUR 2.3 million per year, except in 2008 and 2009, when the annual operating profits were EUR 281,000 and EUR 197,000, respectively.

¹⁰⁶ Prices were calculated using IMF data, available at: <http://www.imf.org/external/np/res/commmod/index.aspx>.

¹⁰⁷ Ibid.

¹⁰⁸ Ibid.

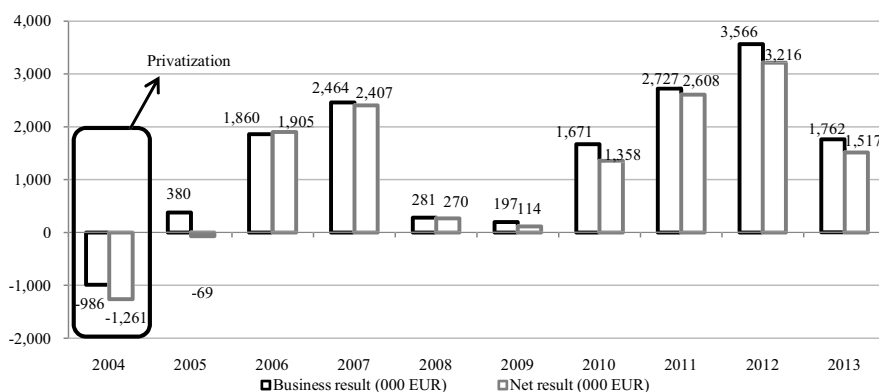
Illustration 33 “Rudnik” sales revenues 2001–2013 (000 EUR)



Source: DP „Rudnik” Rudnik privatization program, January 2004, and Serbian Business Registers Agency

The primary reason for significantly lower operating profits in this period was a decline in metal prices on the world market as a consequence of the global economic crisis. In late 2006, “Rudnik” AD posted a positive net operating result for the first time to the tune of EUR 1.9 million after four years of net business losses.¹⁰⁹ In the subsequent years, positive net results of EUR 1.6 million on average were recorded, with the exception of 2012 when the Company’s net operating result was EUR 3.2 million.

Illustration 34 “Rudnik” Operating & net results 2004–2013 (000 EUR)



Source: Serbian Business Registers Agency

¹⁰⁹ “Rudnik” AD recorded a negative net operating result in 2005 of EUR 69,000 due to high financial and other expenses. “Rudnik” d.o.o. registered a considerable rise in other revenues in 2004 on account of, above all, identified expenses from previous years as well as in 2005 on the grounds of expenses arising from the contractual risk protection. Other expenses in 2004 grew from EUR 14,000 to EUR 280,000, and additionally in 2005 to EUR 363,000.

“Rudnik” AD was recording significantly higher profitability indicator values in the post-privatization period. Profitability rate indicators (EBITDA % and EBIT %) prior to the privatization, i.e. in the 2001–2004 period, had been increasingly lower year after year. The said indicators had recorded negative values in 2001 and 2002. A slump in sales and business activities in this period had been the driver behind such a downward trend.

Table 20 “Rudnik” profitability indicators 2001–2013

Year	2001	2002	2003	2004	2005	2006	2007
EBITDA %	3.1%	-24.1%	-86.8%	-26.8%	24.0%	36.7%	37.3%
EBIT %	-2.1%	-29.7%	-105.2%	-55.6%	10.1%	29.1%	29.7%
Net result %	-6.0%	-12.9%	-107.6%	-71.0%	-1.8%	29.8%	29.0%
ROA	-5.8%	-8.5%	-23.0%	-23.6%	-1.1%	29.7%	29.3%
ROE	-8.5%	-12.2%	-37.6%	-48.8%	-2.5%	51.6%	40.0%
Gross margin	55%	41%	19%	42%	59%	68%	67%
Year	2008	2009	2010	2011	2012	2013	
EBITDA %	13.9%	12.0%	25.7%	30.1%	31.1%	19.7%	
EBIT %	3.6%	2.9%	18.9%	24.2%	27.5%	15.9%	
Net result %	3.5%	1.6%	15.4%	23.1%	24.8%	13.7%	
ROA	3.0%	1.4%	16.1%	25.3%	25.6%	12.5%	
ROE	3.9%	1.7%	20.5%	31.6%	29.8%	13.8%	
Gross margin	58%	55%	66%	66%	70%	65%	

Source: Author’s calculations

Following privatization, however, thanks to a significant improvement in business operations, the Company fared much better. On average, in the post-privatization period, except for 2008 and 2009, EBITDA and EBIT stood at 29.2% and 22.2%, respectively. In 2008 and 2009, due to a drop in sales as a result of the fallout from the world economic crisis, the said indicators had much lower values. “Rudnik” AD had been constantly posting negative net operating results from 2001 until the completion of privatization in 2004, and consequently negative net result rates. After privatization, as of 2006, the Company was registering positive net operating results so that in this period the net operating result rate was an average of 17.6% .

Negative gains on assets (ROA) and gains on own equity (ROE) confirmed that the Company was not efficiently managing its business assets and equity in the 2001–2005 period. This changed after the privatization, as of 2006, when the average ROA value totaled 17.8%, whilst the average

ROE was 24.1%. Finally, average gross margin had been much lower in the period prior to privatization, from 2001 to 2004, when on average it had totaled 39%, whereas in the post-privatization period the average figure was 64%.

The buyer acquired ownership over the Company first by the conversion of debt to equity, and then by acquiring ownership stakes of minority shareholders. By late 2006, liabilities for investments were registered as liabilities which might be converted to capital. In an entry in the businesses register, the majority owner increased its stake with an additional 19,035 shares, thereby increasing its ownership stake to 73.51% of equity. On December 31, 2011, pursuant to the Joint-Stock Company Takeover Act (Article 12), Contango" d.o.o. acquired additional shares and became the owner of 96.5% of "Rudnik" AD shares. This percentage provided for a *"squeeze-out" of the remaining shareholders* so that in January 2012 "Contango" became the only "Rudnik" shareholder. The new owner continued to invest in fixed assets. As of 2005, when the buyer "Contango" d.o.o. took over entirely the operational management of "Rudnik" d.o.o., a total of about EUR 5.4 million had been invested in equipment (Table 21).

Table 21 "Rudnik" Investments in fixed assets 2005–2013 (000 EUR)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Capital expenses	688	532	1,569	269	190	146	815	991	240	5,439

Source: "Contango" d.o.o. Belgrade

In the period 2010–2013, "Rudnik" AD was selling all its products on the domestic market, i.e. *the Company was generating its entire sales revenues in transactions with its parent company* – "Contango" d.o.o. from Belgrade. Transactions with the parent company were carried out at prices formed on the world market, i.e. there were *no transfer revenues or expenses out of reach*.¹¹⁰ Parent company "Contango" was selling the products acquired in this manner on other markets. In the 2011–2013 period, the biggest "Rudnik" suppliers were domestic companies. Its biggest suppliers, in terms of their respective shares in overall liabilities to suppliers in the country, were "Atlas Copco" with an average share of 23.4% and electricity supplier "Elektrodis-tribucija Čačak" with an average share of 13.6%. Other suppliers had considerably lower shares in overall liabilities of the Company with respect to its suppliers.¹¹¹

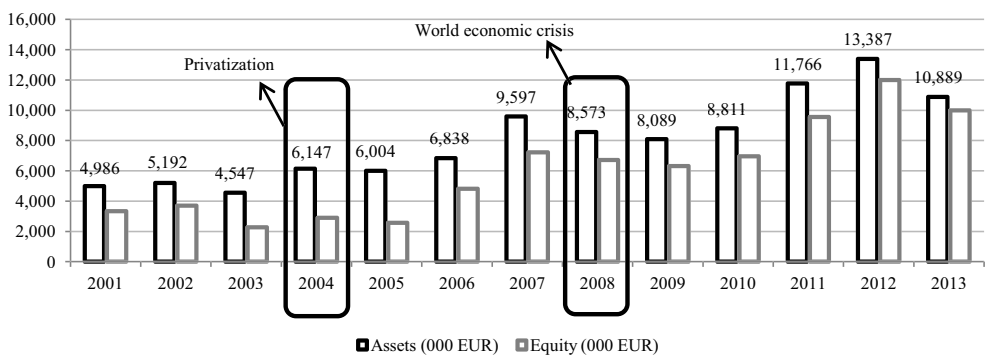
Due to significantly higher business activity, the primary driver behind the growth of the total business assets of "Rudnik" AD was the growth of op-

¹¹⁰ Comments enclosed with 2013 financial reports, Rudnik d.o.o.

¹¹¹ Comments enclosed with financial reports for 2011, 2012 and 2013, Rudnik d.o.o.

erating assets value, whilst good operating results were the principal reason for equity growth. After privatization, “Rudnik” AD significantly increased the value of its business assets and equity. A considerable increase in the value of the Company’s fixed assets was recorded in late 2007 and again in 2011 as a result of investments in fixed assets. At the end of 2007, the Company’s fixed assets value was 17% higher year-on-year, and at the end of 2011 – 12%. In all the post-privatization years, the primary driving force behind the growth of the total business assets value was the growth of operating assets value, whose average annual growth rate totaled 40.2%. In the Company’s operating assets structure, from 2005–2013, inventories had the biggest share (61% on average).

Illustration 35 “Rudnik” Assets and equity on December 31, 2001–2013



Source: DP „Rudnik” Rudnik privatization program, January 2004, and Serbian Business Registers Agency

A crisis in liquidity marked the pre-privatization period. The Company’s current ratio and quick ratio from 2001 until 2004, had been recording values below the theoretically optimal values of 2:1 and 1:1, respectively. In the said period, there was a noticeable downward trend which implied further deterioration in liquidity to the point where the Company was no longer capable of servicing its short-term liabilities with operating assets. As of 2002, the Company could not establish a long-term financial balance indicating that the Company’s long-term assets were not entirely financed from long-term sources. There was a negative trend in the said indicator (net working capital), year after year the operating assets value was declining whilst the short-term liabilities were rising. The marked downward trend in net working capital value showed that the Company could not sustain permanent liquidity. This liquidity crisis came to a head in mid-July 2003 when the then DP “Rudnik” had to suspend its production due to the blocking of its account.

Table 22 “Rudnik” Liquidity indicators on December 31, 2001–2013

Year	2001	2002	2003	2004	2005	2006	2007
Current ratio	1.3	0.4	0.3	0.2	0.3	0.9	1.9
Quick ratio	0.7	0.1	0.1	0.0	0.0	0.1	0.9
Net working capital (000 EUR)	256	-775	-1.472	-1.995	-1.728	-102	1.393
Year	2008	2009	2010	2011	2012	2013	
Current ratio	1.8	2.2	3.0	3.5	7.0	7.7	
Quick ratio	0.6	0.8	1.3	1.9	4.2	2.6	
Net working capital (000 EUR)	1,196	1,609	2,889	4,868	7,510	5,416	

Source: Author’s calculations

After privatization, “Rudnik” AD had no problems with liquidity. A conspicuous upward trend in liquidity ratio values testified to a significant improvement of the Company’s liquidity in the post-privatization period, i.e. from 2005 to 2013. As of 2007, current ratio values were close or significantly above the theoretically optimal value of 2:1. Quick ratio values were growing more slowly and the Company started achieving the values close or above the theoretically optimal value of 1:1 as of 2007. In the third year after privatization, the Company succeeded in establishing a long-term financial balance, which went on to show that long-term liabilities were entirely financed from long-term sources. Moreover, even a part of short-term liabilities was funded from long-term sources. The marked upward trend in net working capital growth pointed to the fact that there were realistic conditions in place for maintaining permanent liquidity.

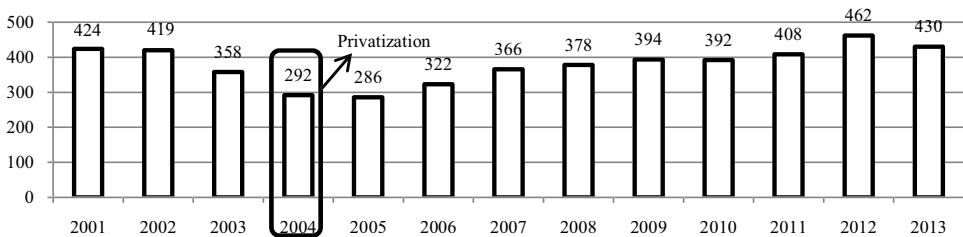
3.1.5. Employment and productivity

Since the acquisition of a majority stake in the Company, “Contango” d.o.o. from Belgrade did not have any problems with the employees. Salaries and wages were never paid late, and the payroll fund increased several times over relative to the payroll fund at the time of privatization. The buyer’s general impression was that the employees recognized its motives and intentions to invest in the protection and safety of workers, and continuous exploration in order to increase ore deposit reserves, thereby extending the mine’s life-time. Based on all of this, the workers realized that making quick profits was not the motive behind the acquisition of “Rudnik” rather the ambition for a financially successful long-term business operation.¹¹²

112 Interview with “Contango” d.o.o. Belgrade representatives.

The Company changed the employee structure, but retained approximately the same workforce size compared to the pre-privatization period, which is exceptionally rare. As part of preparations for the pending privatization, the Company was reducing the average number of employees so that there were 294 employees at the time of privatization.¹¹³ Immediately after the privatization, another 50 workers left the Company, but from then on the average workforce size increased due to an rise in business activities. In 2007, the average number of employees reached the level of 2003, one year before the privatization. In late 2013, the average number of employees at the Company was 430, which equates to 2001 employment level.

Illustration 36 “Rudnik” average number of employees by years 2001–2013



Source: DP „Rudnik” Rudnik privatization program, January 2004 and Serbian Business Registers Agency

The Company had four organizational units (“Jama”, “Flotacija”, “Energetika” and “Teop”). According to the management, on June 30, 2003, DP “Rudnik” had a surplus of employees in all organizational units. In the management’s view, there were 105 redundant workers. According to the privatization program, there were 336 employees, but at the time of privatization – 294.¹¹⁴ From the day of privatization until September 22, 2006, i.e. the fourth control carried out by the Serbian Privatization Agency, the Company hired 149 new workers, whilst over the course of the same period 168 workers left the Company. Out of the total number of workers who left the Company, 113 terminated their employment on the following grounds:¹¹⁵ a) voluntary termination of employment contract with the employer – 24; b) cancellation of employment contract by employee – 42; c) natural labor drain – 17 employees; d) termination of employment contract due to a cessation of the need for work – 17; e) due to severe violations of work discipline, the Company terminated employment contracts of 9 employees; f) upon the expiry of fixed-term contracts, 4 workers left the Company; g) remaining workers left the Company on other grounds.

¹¹³ Compliance report, dated September 29, 2005.

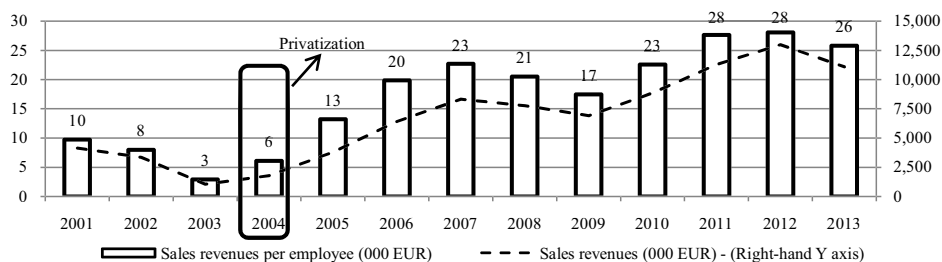
¹¹⁴ Ibid.

¹¹⁵ Ibid.

“Rudnik” had considerable employee fluctuations and there was a lack of skilled labor for work in the pit, i.e. for ore excavation, which was why vacancies for new workers were always available. In addition, due to a lack of skilled workers with adequate qualifications (underground mining engineers, engineering geologists and qualified miners), the Company had employed 12 citizens from FYR Macedonia by October 10, 2005, complying in the process with applicable legal regulations.¹¹⁶ On two occasions “Rudnik” reorganized job positions, tasks and working processes, and a new classification of jobs and job descriptions was carried out which showed that there were redundant workers at “Rudnik” AD. The first reorganization was completed on June 30, 2005, which led to a decision declaring redundant 10% of the total workforce of 297 on June 15, 2005.¹¹⁷ The same decision was passed once again on January 16, 2006, which should have resulted in a 10% reduction of the overall number of employees (290), however, it was not carried out by September 22, 2006.¹¹⁸

In the 2001–2003 period, a significant slump in sales revenues (19.2% in 2002 and 68.8% in 2003) had a crucial impact on productivity decline (measured by sales revenues per employee), despite the reduction in the number of employees in the said period. In 2004, due to the 70.5% sales revenues growth and the biggest cut in the workforce size (66 employees), the Company recorded a rise in productivity. In the following years, an increase in the Company’s business activities and sales had a dominant impact on the productivity trends measured by the sales revenues per employee, except in 2008 and 2009. The fact that the average number of full-time employees at the Company in 2005–2012 rose by 172 further corroborates the previous statement.

Illustration 37 Sales revenues per employee and “Rudnik” sales revenues 2001–2013



Source: Author’s calculations

In comparison to sales revenues per employee indicators of other companies posting the biggest sales revenues in the sector of exploitation of ferrous, non-ferrous, precious and other metals, “Rudnik” was registering values

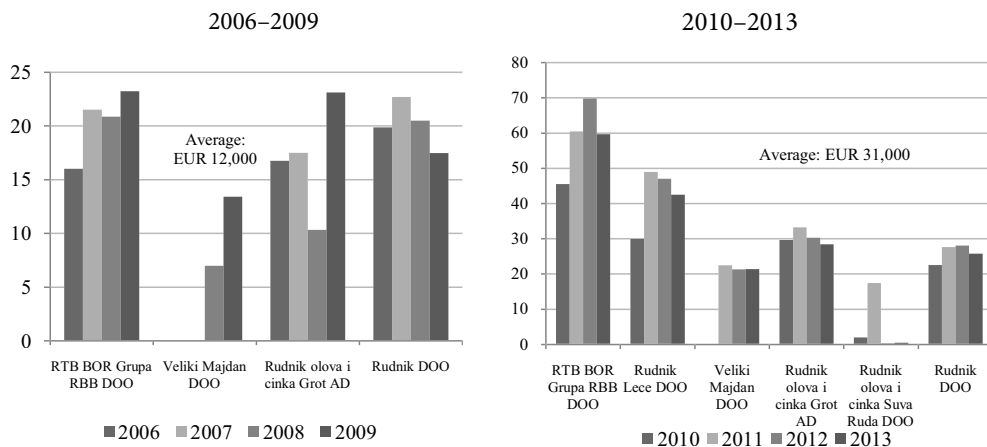
¹¹⁶ Compliance report, dated September 29, 2005.

¹¹⁷ Ibid

¹¹⁸ Compliance report, dated September 22, 2006.

significantly exceeding the average mark of EUR 12,000 in the 2006–2009 period. However, after 2009, “Rudnik” AD was recording values which were slightly below the average mark of EUR 31,000.

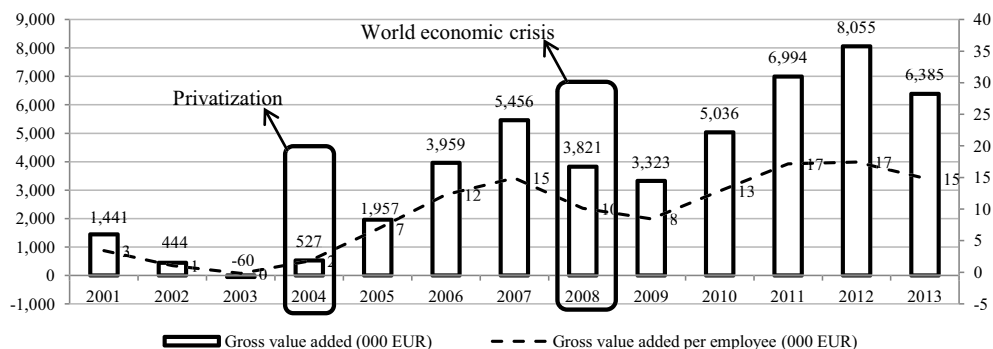
Illustration 38 Sales revenues per employee of the largest companies by sales revenues in the mining sector (ferrous, non-ferrous, precious and other metals)



Source: Author's calculations

Gross value added generated by “Rudnik” AD declined constantly in the 2001–2003 period, when it had a negative value of EUR 60,000. After the privatization, in the 2005–2012 period, due to an increase in business activities and sales (as well as significantly better operating results), the Company quadrupled its gross value added. Total gross value added per employee registered the same trend as the sales revenues per employee, where the considerably better operating results of the Company had a dominant impact on the rise of this indicator's value, bearing in mind that the number of employees increased significantly.

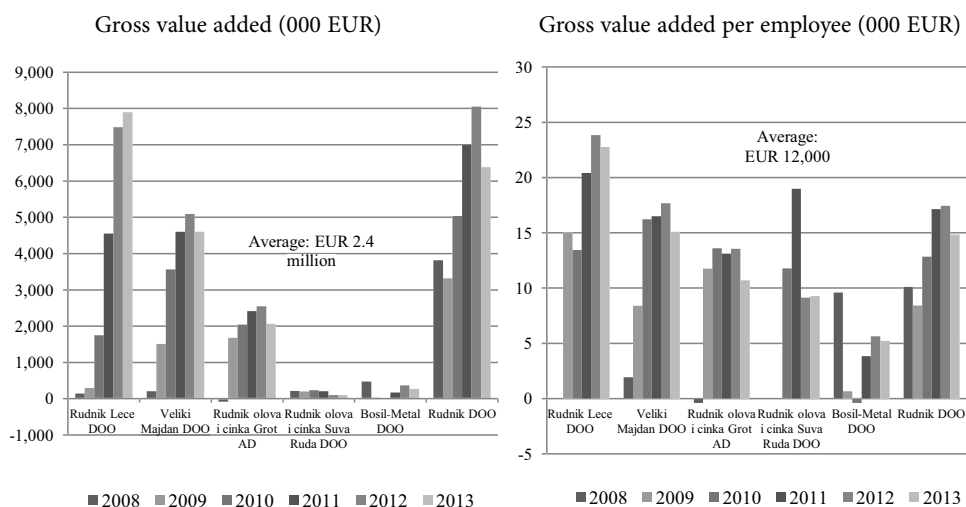
Illustration 39 Gross value added and gross value added per employee, “Rudnik” 2001–2013



Source: Author's calculations

Within the years of the period analyzed, except for 2012, “Rudnik” AD generated gross value added which was above the average for the largest companies by actual sales revenues in the sector of exploitation of ferrous, non-ferrous, precious and other metals.¹¹⁹ “RTB Bor” is the company with the largest gross value added by far, and on average it totaled EUR 38.8 million. Among other companies in the sector of exploitation of ferrous, non-ferrous, precious and other metals, “Rudnik Leće” d.o.o., “Veliki Majdan” d.o.o. and “Rudnik” d.o.o. stood out with the biggest gross value added indicator values of EUR 3.7 million, EUR 3.3 million and EUR 5.6 million, respectively, in the 2008–2013 period.

Illustration 40 GVA and GVA per employee of the largest companies by actual sales revenues in the mining sector (ferrous, non-ferrous, precious and other metals) 2008–2013¹²⁰



Source: Author's calculations

3.1.6. Financial restructuring

In late 2001 and 2002, the Company's total debt ratio remained approximately the same despite the increase in short-term payables at a year-on-year rate of 62%, on average, which was due to, above all, the growth of Company's own equity value based on the effect of the restatement of capital. A sudden surge in the Company's debt levels was recorded in late 2003 and 2004, when the Company was (almost) entirely funded from borrowed sources of financing. A significant deterioration of the Company's financial position occurred as a result of a considerable decline in the Company's own equity value of almost 40% in late 2003 on account of the restatement of capital arising from the pay-

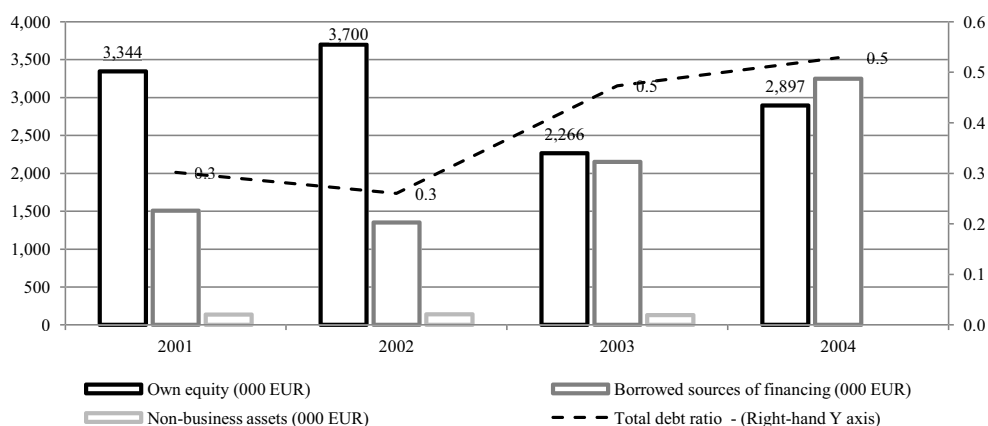
¹¹⁹ Due to significantly higher values for analyzed indicators relative to other competitors, RTB Bor was not taken into account.

¹²⁰ RTB Bor was not taken into account.

ment of losses from previous years¹²¹ and due to an upsurge in the Company's short-term liabilities, which in late 2004 were 86.8% higher than in late 2002.

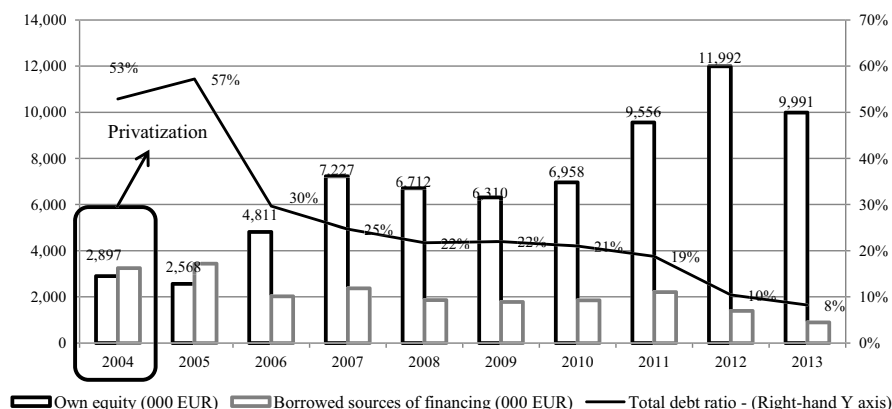
Soon after privatization, the Company's financial situation significantly improved. The share of borrowed sources of financing in total business assets of "Rudnik" AD was initially reduced from 60% in late 2005 to 30% in late 2006. In all the subsequent years, the Company's total debt ratio gradually decreased so that in late 2013 the Company was almost entirely financed from its own equity. The primary reason for the financial recovery of "Rudnik" AD was a significant growth in the value of its own equity stemming from the Company's good operating results, which in late 2013 was 2.9 times higher than the Company's own equity in late 2005.

Illustration 41 DP "Rudnik" debt levels on December 31, 2001–2004



Source: Author's calculations

Illustration 42 DP "Rudnik" debt levels 2004–2013



Source: Author's calculations

121 Interview with representatives "Contango" d.o.o. Beograd

3.1.7. Relationship between the company and local self-government

Gornji Milanovac is a city in Central Serbia, the center of the municipality with a population of about 45,000. The importance of “Rudnik” d.o.o. for the local community is commensurate with the Company’s size, and the most important characteristic of this Company’s social responsibility is reflected in compliance with the regulations, regular payment of taxes and salaries and wages to employees.

IMPACT ON LOCAL SELF-GOVERNMENT DIRECT REVENUES

The table shows the structure and total amount paid by “Rudnik” d.o.o. to the municipality of Gornji Milanovac in taxes, fees and other direct revenues of the municipality of Gornji Milanovac. A significant increase in direct revenues of the municipality paid by the Company is conspicuous in 2005, a year after privatization. Total direct revenues of the municipality of Gornji Milanovac generated by “Rudnik” d.o.o. in the 2004–2013 period amounted to RSD 13 million.

Table 23 Paid taxes, fees and other direct revenues of Gornji Milanovac municipality (RSD)

Direct revenues	2004	2005	2006	2007	2008
Tax on transfer of absolute rights	–	–	–	–	19,120
Property tax	137,239	1,719,087	1,249,642	1,588,147	1,337,638
Tax on registered weapons	40,800	41,160	10,320	9,350	12,240
Business sign display fee	8,400	8,400	8,400	5,308	13,265
Drainage fee	–	–	–	–	–
Total amount collected from “Rudnik” d.o.o.	186,439	1,768,647	1,268,362	1,602,805	1,382,353
Direct revenues	2009	2010	2011	2012	2013
Tax on transfer of absolute rights	–	60,531	31,466	8,762	–
Property tax	1,337,816	1,285,313	1,214,870	1,174,714	1,430,474
Tax on registered weapons	13,380	14,640	16,225	20,440	22,890
Business sign display fee	8,400	24,000	24,000	24,000	60,000
Drainage fee	–	–	26,563	1,899	–
Total amount collected from “Rudnik” d.o.o.	1,359,596	1,384,484	1,313,125	1,229,816	1,513,364

Source: „Contango” d.o.o.

IMPACT ON LOCAL SELF-GOVERNMENT CEDED REVENUES

The following table shows the amounts of taxes on personal incomes in aggregate paid by “Rudnik” d.o.o. After the initial drop in collection of taxes on personal incomes in 2005, a year following the Company’s privatization, parallel to the recovery of production, a rise in the number of employees and rising wages lead “Rudnik” d.o.o. to increase significantly its contributions to the local self-government’s budget through paid taxes on personal incomes. The total amount of taxes on salaries and wages and temporary service contracts taxes paid to the municipality of Gornji Milanovac by “Rudnik” d.o.o. in the 2004–2013 period reached the RSD 193.6 million mark, whereas in the past three years, after the changes to the framework for financing local self-governments, the ceded revenues on this account totaled only around RSD 90 million.

*Table 24 Taxes on personal incomes paid
to Gornji Milanovac municipality (000 RSD)*

Direct revenues	2004	2005	2006	2007	2008
Income tax	9,632	9,254	14,243	12,853	16,471
Temporary service contracts tax	782	468,557	538	658	260,035
Total amount collected from “Rudnik”	10,414	9,723	14,781	13,511	16,731
Direct revenues	2009	2010	2011	2012	2013
Income tax	6,835	20,697	6,910	31,769	29,474
Temporary service contracts tax	342	505	631	470	768
Total amount collected from “Rudnik”	17,178	21,202	27,542	32,239	30,243

Source: „Contango” d.o.o.

In addition, the local government generated considerable revenues thanks to its share in the distribution of royalties for mineral raw materials usage. In the 2006–2013 period only, “Rudnik” d.o.o. paid RSD 263 million in mining royalties. Under Article 137 of the Mining and Geological Explorations Act, *40% of mining royalties collected are the budget revenues of the Republic of Serbia, another 40% is allocated to local self-governments on whose territory the exploitation of mineral resources takes place, whilst the remaining 20% are the line ministry’s own revenues.*¹²² In 2013 alone, the revenue generated on this account totaled almost RSD 63 million.

¹²² Article 136 of the new Mining and Geological Explorations Act, adopted in November 2011, prescribes royalties for mineral raw materials usage which are based on the revenues from sales of non-processed mineral raw materials or the revenues from sales of technologically processed mineral raw materials generated by the holder of a mining license.

Table 25 Royalties for mineral raw materials usage – “Rudnik” d.o.o. (000 RSD)

Year	2006	2007	2008	2009	2010
Levied royalties	2,632	19,932	18,933	19,423	27,336
Year	2011	2012	2013	Total	
Levied royalties	38,703	73,360	62,716	263,035	

Source: „Contango” d.o.o.

PUBLIC UTILITIES DUES

Based on collected data, “Rudnik” d.o.o. did not have significant outstanding debts to JKP “Gornji Milanovac” for utility services provided.

Table 26 “Rudnik” d.o.o. dues to JKP “Gornji Milanovac” (000 RSD)

Dec 31, 2004		Dec 31, 2005		Dec 31, 2006		Dec 31, 2007	
payable	receivable	payable	receivable	payable	receivable	payable	receivable
182	728	1,508	1,588	912	1,040	1,010	1,067
Dec 31, 2008		Dec 31, 2009		Dec 31, 2010		Dec 31, 2011	
Payable	receivable	payable	Receivable	Payable	Receivable	payable	Receivable
527	724	987	1,257	1,086	1,257	1,472	2,190
Dec 31, 2012		Dec 31, 2013					
Payable	Receivable	Payable	Receivable				
2,263	2,469	889	1,151				

Source: “Contango” d.o.o.

3.2. CASE STUDY – PRIVATIZATION OF “SUVA RUDA” RAŠKA

3.2.1. Background

Raška ore field is located on the western slopes of Mt. Kopaonik and covers the surface area of about 500 km². Out of several potential ore deposits, three zinc ore deposits locations have been explored: Sastavci, Kiževak and Karadak. Only the Kiževak deposit had been active from 1986 until 2002 as an open pit in the 2nd ore zone and partly in the interzone section where over 2 million tonnes of lead-zinc ore had been extracted. In the 1st zone of Kiževak ore deposit additional explorations were carried out establishing additional reserves of the lead-zinc ore. According to a rough estimate, ore reserves in this location totaled about 4 million tonnes in the partially explored

zone, whilst in the potentially promising zone the ore reserves were estimated to be about 1.5 million tonnes.¹²³

In the 1990s, “Suva Ruda” mine was incorporated in the “Trepča” mining complex to enable its recovery and settlement of debts to creditors (incurred prior to the merger) and, in particular, to discharge the liabilities with respect to its workers. Given that this did not come to pass, creditors took legal action. In July 2005, the Privatization Agency passed a decision on restructuring, whereby the Company was protected from enforcement. However, bankruptcy did occur after the Development Fund of the Republic of Serbia filed a motion to initiate bankruptcy proceedings. As the debtor had not been operating since 2002 as the production process could not be re-started, hence the bankruptcy proceedings ensued. Following several failed attempts to sell “Suva Ruda”, the mine was finally acquired by “Konzern Farmakom M.B. Šabac” at the starting price of RSD 587.3 million (EUR 7.4 million) in February 2008.

*Table 27 Background information on
“Konzern Farmakom M.B. Rudnik Suva Ruda” d.o.o.*

Full business name:	Konzern Farmakom M.B. Šabac – Rudnik olova i cinka Suva Ruda DOO Raška
Abbreviated business name:	Konzern Farmakom M.B. Rudnik Suva Ruda DOO Raška
Company code:	17288849
Registered address:	Raška
Standard Industrial Classification (SIC) Code:	Exploitation of ores and ferrous, non-ferrous, precious and other metals (0729)
Legal form:	Limited liability company
Status:	Active company
Number of employees (2013):	11
Year of privatization:	2007

Source: Serbian Business Registers Agency

Although the buyer planned to re-launch production in September 2010, at 30% of the planned maximum production output, i.e. 100,000 tonnes of ore, this did not take place due to financial difficulties of the buyer. Instead, the “Suva Ruda” mine business operation was reduced to a minimum, and in mid-2014 the Company had its account blocked because of the outstanding debt of over EUR 1 million.

123 Report on economic-financial situation of bankruptcy debtor, August 31, 2006, Serbian Privatization Agency.

3.2.2. Business operations prior to privatization

In the 1990s, due to lack of its own assets required to finance lead and zinc production and overall poor financial situation, “Suva Ruda” mine (hereinafter referred to as the Company, the Firm or “Suva Ruda”) was incorporated in the “Trepča” mining-metallurgical-chemical industrial complex (“Trepča”). The intention was to enable the recovery of “Suva Ruda” and the settlement of debts to creditors incurred prior to the merger, and, in particular, to discharge the accrued liabilities with respect to its employees. Several years on, none of the liabilities had been discharged. Moreover, the Company itself lost any ability to control or have any insight into the management of its own assets.¹²⁴

The crisis came to a head in August 2002, when DP “Suva Ruda” suspended its production due to a severe liquidity crisis and a precarious financial situation from which the Company has never truly recovered.¹²⁵ Prior to privatization through bankruptcy, in the 2004–2007 period, DP “Suva Ruda” sales revenues totaled on average EUR 33,000, whereas in 2005 and 2006 sales revenues dipped below EUR 10,000.¹²⁶ The Company was obviously not operational. After 2004, DP “Suva Ruda” was steadily making business losses. The biggest loss was registered in 2004 amounting to EUR 869,000. High financial expenses contributed significantly to a rise in net business losses in all the analyzed years. The Company posted its biggest net loss to the tune of EUR 1.1 million in 2004. DP “Suva Ruda” net business loss in 2005–2007 averaged EUR 355,000.¹²⁷

Illustration 43 Sales revenues
2004–2007 (000 EUR)

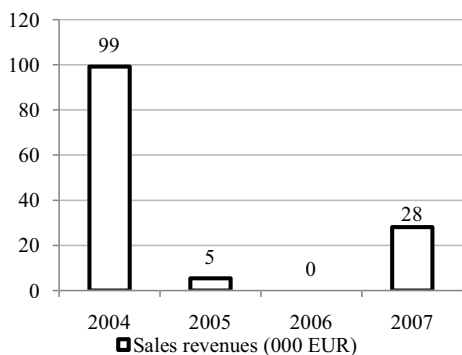
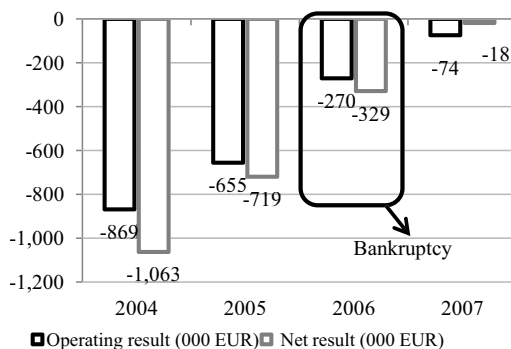


Illustration 44 Operating and
net results 2004–2007 (000 EUR)



Source: Report on economic-financial situation of bankruptcy debtor, Aug 31, 2006

124 Ibid.

125 Ibid.

126 Ibid.

127 Ibid.

As the outstanding debts to workers were not cleared, in 2005 the employees brought civil charges against the then DP “Suva Ruda” seeking the payment for outstanding wages and contributions. DP “Suva Ruda” did not have the funds necessary to settle the workers’ claims which was why the employees and former employees petitioned for enforced payment of their claims against the Company. This effectively testified to the fact that the employees themselves did not believe that production would be resumed nor that they would keep their jobs.

Pursuant to the enforcement rulings, the Municipal Court scheduled an auction to sell the entire assets of “Suva Ruda” Raška mine. Following consultations with the Ministry of Energy and Mining, the new management of DP “Suva Ruda”, appointed in late June 2005, applied to the Privatization Agency for a restructuring procedure to be implemented at DP “Suva Ruda” so as to preclude the sale of assets. A day before the scheduled auction, the Privatization Agency passed a decision on restructuring of the subject of privatization – DP “Suva Ruda”.¹²⁸ Thanks to the decision on restructuring adopted one day prior to the scheduled auction, the sale of assets by auction was not carried out.¹²⁹ *The decision on restructuring was not made in accordance with any plan, nor was there any possibility to restructure the Company as prescribed by the Privatization Act*, therefore the sole reason for passing such a decision was to offer protection to the Company against enforcement and sale through bankruptcy proceedings.

There was a new twist when one of the major creditors – the Development Fund of the Republic of Serbia – petitioned for initiation of bankruptcy proceedings against “Suva Ruda”. In accordance with the then regulations, the passage of the decision on restructuring of DP “Suva Ruda” implied that all the creditors were to file the lists of their respective claims, incurred by the end of 2004 inclusive, with the subject of privatization undergoing restructuring. Given that in the case of DP “Suva Ruda” no sale by public auction or tender took place since the major creditor, the Development Fund, petitioned for bankruptcy proceedings against the debtor, Article 20 of the Privatization Act was not applied.¹³⁰ Pursuant to the petition filed by the Development

128 The rationale for its decision on restructuring, as stated by the Privatization Agency in its customary explanation, was that the privatization procedure could not be implemented due to the existing status-related and organizational form of the company as well as the existing capital structure and registered amount of liabilities. The decision on restructuring is available at: <http://www.priv.rs/Agencija+za+privatizaciju/2362/Odluka+o+restrukturiranju+drustvenog+preduzeća+Rudnici+olova+i+cinka+Suva+Ruda+Raška.shtml> (Site visited: July 21, 2014).

129 Report on economic-financial situation of bankruptcy debtor, August 31, 2006, Serbian Privatization Agency.

130 The previous Privatization Act, Article 20, para. 1, stipulated the acquittance of state creditors’ claims against the subject of privatization in their entirety, in which case they were to subsequently settle the claims from proceeds generated by the sale of equity or assets of the subject of privatization.

Fund, although there were no legal grounds for it since the Company was in the process of restructuring, the Commercial Court in Kraljevo ruled in late May 2006 that the pre-bankruptcy proceedings be initiated in order to determine the rationale for bankruptcy.¹³¹ A month later, the court found that there were grounds for instituting the bankruptcy procedure and ordered that the bankruptcy proceedings against the bankruptcy debtor be initiated. As the Company was socially-owned, the Privatization Agency was appointed as a bankruptcy administrator. The bankruptcy estate value was estimated to be RSD 1.17 billion. At the point of initiation of the bankruptcy proceedings, the Company employed 250 workers, whereas the overall number of employees prior to bankruptcy had been somewhat higher.¹³²

3.2.3. Privatization

Given that DP “Suva Ruda” had not been operating since August 2002 and that there were no operating assets available to re-start production, the bankruptcy administrator concluded that there were neither the conditions in place, nor the interest on the part of the bankruptcy debtor to carry out reorganization, hence further proceedings resulted in bankruptcy in order to protect the interests of creditors and preserve the value of the bankruptcy estate.¹³³

The sale of the bankruptcy debtor, except for minor parts of machinery, was not effected by way of disposal of portions of the debtor’s assets. Instead, the bankruptcy debtor was sold in its entirety as a legal entity. The reason for the bankruptcy debtor’s sale is obvious. Namely, the bankruptcy debtor had been granted several licenses and permits for exploitation of ore fields, utilization of open pits and usage of erected facilities, among which the most important was the Decision to grant the exploitation of field 336/A-B/ from 1982 issued by the then Energy, Industry and Civil Engineering Committee of the Republic of Serbia. The institute of sale of the bankruptcy debtor as a legal entity is somewhat unique and specific to the bankruptcy framework in the Republic of Serbia, but its advantage is precisely reflected in cases such as DP “Suva Ruda”. An alternative in the form of sale of assets, i.e. the sale of individual assets, would require a renewed procedure for the issuance of exploitation permits. In addition, given that the assets have a specific and limited purpose, the likelihood of sale of such assets would be significantly diminished, as would the expected price. On the other hand, since the Company was sold as part of the bankruptcy proceedings, the buyer did not take on any investment-related obligations.

131 The records of the proceedings are available at the following address http://tpson.portal.sud.rs/Libra_Trgsud_Portal/pregled_docket.cfm?q=A0D39265C670B8892E70C1E907C97044 (Site visited: July 22, 2014).

132 The report on economic-financial situation of bankruptcy debtor, August 31, 2006, Serbian Privatization Agency. Ibid.

133 Ibid.

There was no great interest in the sale of the bankruptcy debtor as a legal entity. Public auctions were held in early July 2007 (the first auction; starting price of RSD 1.17 billion), in September 2007 (the second auction; starting price of RSD 1.05 billion – 10% reduction), in October 2007 (the third auction; starting price of RSD 822 million – 30% reduction), and finally in December 2007 (the fourth auction; starting price of RSD 587 million – 50% reduction).¹³⁴ In the fourth attempt to sell the bankruptcy debtor DP “Suva Ruda” as a legal entity by public auction, the entire assets of DP “Suva Ruda” consisting of immovable property (buildings and facilities on open pits “Kiževak”, “Sastavci” and “Rudnica”, and the head office building in Raška) and equipment (production lines at the flotation plant, machinery and electrical equipment) were sold to “Koncern Farmakom MB” Šabac at the starting price of RSD 587,317,504 (EUR 7.4 million), i.e. an amount which was 50% below the estimated value. Thereafter, the Commercial Court handed down a ruling on the conclusion of the bankruptcy proceedings, except against the bankruptcy estate, as there were several lawsuits involving larger claims for which some assets had been previously reserved.¹³⁵

By all criteria, DP “Suva Ruda” bankruptcy proceedings were relatively efficiently implemented. The pre-bankruptcy procedure was instituted in May 2006 and the whole proceedings were concluded in December 2007, hence it took less than 20 months. The Decision on the distribution of bankruptcy estate resulted in the 100% settlement of creditor claims in terms of both principal claims and interests accrued until the date of the initiation of bankruptcy proceedings. A subsequent ruling of the bankruptcy judge also provided for the payment of interest accrued after the date of initiation of bankruptcy proceedings to the creditors.¹³⁶

The buyer, “Koncern Farmakom MB”, was established in 1989 as “Farmakom d.o.o.”, a trading company involved for the most part in imports of assets for production in the chemical industry sector. Over the course of the first decade since its inception, “Farmakom” was growing rapidly operating in conjunction with the “Zorka Šabac” company. Following changes in market conditions in Serbia and the launch of the privatization process, the company shifted its focus from trade towards manufacturing and started acquiring manufacturing companies undergoing privatization. In 2006, “Farmakom d.o.o.” became a concern which from then on operated under the name of “Koncern Farmakom MB”. In addition to “Suva Ruda”, “Farmakom MB” was

134 The sale was carried out pursuant to Articles 109, 110 and 111 of the Bankruptcy Act (“Official Gazette of the Republic of Serbia” no. 84/2004) and the National Standard no. 5 on the manner and procedure of realizing assets of the bankrupt debtor (“Official Gazette of the Republic of Serbia” no. 43/2005).

135 Decision of the Commercial Court in Kraljevo is available at the following address: <http://pretraga2.apr.gov.rs/publicdocsvc/doc/getdocbyid?id=0000071957968&hash=5A2737EB21B334A43D1AE0B7305B55670ED6CCD1> (Site visited: July 22, 2014).

136 The decision of the Commercial Court in Kraljevo (St. 12/2006), dated May 9, 2011.

the majority owner of several mines.¹³⁷ In 2014, “Farmakom MB” brought together fifteen dependent companies and operated in three industry sectors: agriculture, metal processing and mining. “Farmakom MB” owned 15 mines extracting mostly antimony, lead, zinc and nonmetals.¹³⁸ “Farmakom MB” concern was grappling with serious financial difficulties due to excessive indebtedness which resulted in the initiation of bankruptcy proceedings against “Farmakom MB” in September 2014.

3.2.4. Description of business operations after privatization

Despite a serious intention on the part of “Konzern Farmakom MB” to re-start production at “Suva Ruda” mine, the decision to do so was increasingly more delayed. Following the purchase of the entire assets of DP “Suva Ruda”, the buyer stated several times its intention to designate necessary funds for the acquisition of new equipment in order to replace outdated equipment.¹³⁹ According to the new owner, given that “Suva Ruda” was an open-pit mine, preparations for production would not require a long time to enable the mine to re-start it. Initially, the buyer intended to re-launch production in September 2010, initially at 30% of the planned full capacity, i.e. about 100,000 tonnes of ore.¹⁴⁰ The buyer apparently intended “to invest over EUR 30 million”.¹⁴¹

Several signs indicating that funds for the re-start of production were being provided appeared in 2011 when “*Farmakom MB*” was granted a **EUR 40 million loan** by the International Financing Corporation (IFC) as well as an additional credit line of EUR 80 million by domestic commercial banks (“Erste banka” – EUR 30 million, “Komercijalna banka” – EUR 35 million, “Banka Intesa” – EUR 10 million and “Čačanska banka” – EUR 5 million).¹⁴² The intention of “Konzern Farmakom MB” was to use the loans to re-start production at four new mines within the “Farmakom MB” group, including “Suva Ruda” mine, thus employing between 300 and 500 new workers in Serbia, and to further expand throughout the region. The deadline for re-launching production at the “Suva Ruda” mine was extended to the first half of 2012.¹⁴³

137 Except for “Suva Ruda”, the mines owned by “Farmakom MB” were as follows: “Zavorje”, “Štira”, “Brasina”, “Dolić”, “Stolice” “Kik”, “Rujevac”, “Ravnaja”, “Rajićeva Gora” and “Leće” on the territory of Serbia, as well as “Lojane” and “Suva Reka” in Macedonia.

138 Information from the web site of “Konzern Farmakom MB” – <http://www.farmakommb.co.rs> (Site visited: August 29, 2014).

139 <http://www.nadlanu.com/pocetna/aktuelno/ekonomija/Velike-rezerve-olova-i-cinka.a-50998.292.html> (Site visited: August 31, 2014).

140 <http://www.farmakommb.co.rs/concern/project/lang/sr> (Site visited: July 28, 2014).

141 <http://www.ekapija.com/website/sr/page/642096/Farmakom-MB-pokre%C4%87e-rudnik-Suva-ruda-Planirana-investicija-od-30-mil-EUR> (Site visited: August 31, 2014).

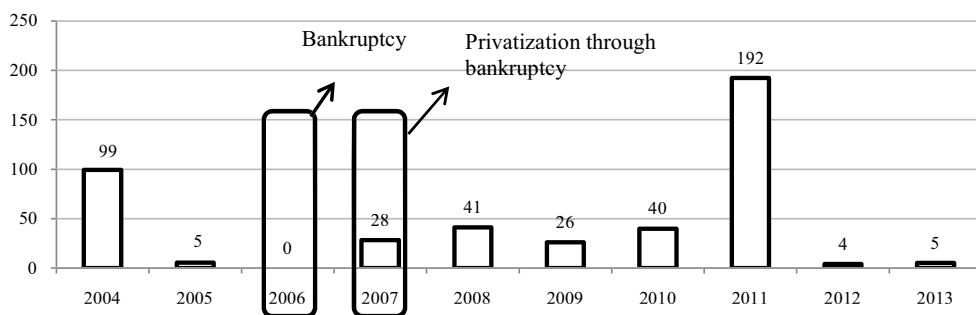
142 Details on the approved arrangement are available at the following address: http://ifcext.ifc.org/ifcext/spiwebsite1.nsf/projectdisplay/spi_dp30167 (Site visited: August 31, 2014).

143 <http://www.capital.ba/farmakom-mb-dobio-kredit-od-120-miliona-evra/> (Site visited: August 28, 2014).

The announcement that necessary funds for the re-start of production would be provided did not materialize. In 2012, “Koncern Farmakom MB” earmarked RSD 662.8 million (about EUR 5.9 million) for the purchase of equipment for mines, machinery, and passenger and freight vehicles. The largest part of the said amount was used to purchase the equipment for mines owned by “Koncern Farmakom MB”.¹⁴⁴ However, according to former employees of “Suva Ruda”, despite the announcement that a portion of the funds from the IFC loan and domestic commercial banks would be designated for the re-start of production at the “Suva Ruda” mine, this did not come to pass by July 2012 inclusive. In this period, all the workers of “Suva Ruda” had already been laid off and paid-off, whilst only several employees from the management and security staff were coming to work for years. Former employees said that a part of the existing more valuable equipment from the “Kiževak” pit and other locations had been sold prior to privatization, and that another portion of the equipment was sold later on, whereas the rest of the machinery was outdated and useless.¹⁴⁵

In the 2008–2013 period, “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. entire sales revenues were generated by sales of goods, and not by the sales of the Company’s products. From 2008 until 2010, sales revenues recorded modest values averaging EUR 36,000. In 2011, somewhat higher sales revenues of EUR 192,000 were registered, but then in 2012 and 2013 the Company continued failed to generate insignificant sales revenues; keeping levels considerably below the sector’s average of EUR 5.3 million.

Illustration 45 Revenue from sale of “Rudnik Suva Ruda” d.o.o. 2004–2013 (000 EUR)



Source: DP „Rudnik” Rudnik privatization program, January 2004, and Serbian Business Registers Agency

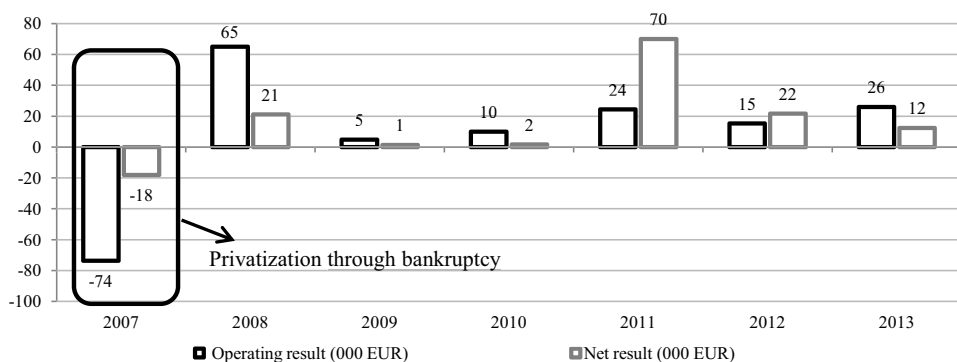
In the post-privatization period (2008–2013), “Suva Ruda” d.o.o. had a positive though negligible operating result of EUR 24,000 on average. The

¹⁴⁴ Comments enclosed with consolidated financial reports for 2012, “Farmakom M.B. Šabac”.

¹⁴⁵ <http://novosti.rs/vesti/naslovna/aktuelno.293.html:389773-Rudnici-bez-para-i-rudara> (Site visited: August 31, 2014).

profit was generated through an increase in inventories of unfinished and finished products and services presented in accounting statements instead as a result of sales or an increase in sales of own products. Significant deviations from the average mark were recorded in 2008 when the Company's operating result was EUR 65,000. The principal reason for operating profits yielded in the 2008–2013 period were not the sales or growth in sales of own products, but the revenues generated by increasing inventories of products, services and merchandise amounting to EUR 256,000 on average, i.e. the Company's operating profit was not generated through its core business activity but thanks to an increase in the value of inventories of unfinished and finished products and services at the end of the accounting period.

Illustration 46 Operating and net results "Rudnik Suva Ruda" d.o.o. 2007–2013



Source: Serbian Business Registers Agency

The Company's net result in the 2008–2013 period totaled only EUR 21,000 on average. Considerable deviations from the average stated above were registered in 2011, above all, due to significantly higher other revenues of the Company relative to the previous year, when the Company's net operating result was EUR 70,000. In the meantime, the buyer of "Suva Ruda", "Koncern Farmakom MB" experienced financial difficulties and on account of its over-indebtedness. In late 2013, in terms of consolidated operating results, "Koncern Farmakom MB" posted a loss greater than its equity totaling EUR 37.6 million. The overall value of "Koncern Farmakom MB" interest-bearing liabilities as of Dec 31, 2013, was EUR 298.9 million and comprised 52.2% of the total liabilities. *As of March 24, 2014, accounts of 11 dependent companies of "Koncern Farmakom MB" were blocked due to an outstanding debt of EUR 182 million.* The intention of the "Koncern Farmakom MB" owner was to implement as soon as possible the previously drafted plans for reorganization (UPPR) of 8 out of 10 companies operating as part of "Farmakom MB". According to the owner, "Koncern Farmakom MB" accounts were blocked first by commercial banks because of the outstanding loan-related debts, which consequently led to the blocking by other account holders.¹⁴⁶

146 <http://www.novimagazin.rs/vesti/bogicevi-vratiju-sve-dugove> (Site visited: August 31, 2014)..

Apparently, *the funds needed for the re-start of “Suva Ruda” mine production were appropriated, but were not used for this purpose*. Bearing in mind all the circumstances, a conclusion may be inferred that ever since the completion of the “Suva Ruda” mine privatization through bankruptcy necessary conditions to re-launch the production and further develop the privatized company have never been met.

Whilst *the financial performance indicators do not offer a worthwhile insight*, we are presenting them for the sake of comparison. Financial performance indicators – earnings before interest, taxes, depreciation and amortization – EBITDA and earnings before interest and taxes – EBIT % in the privatization year, registered negative values. In the 2008–2013 period, markedly high relative values for the said indicators were recorded due to, above all, low sales revenues. The only exception to this rule was in 2011 when the relative values of analyzed indicators were much lower, but still high, on account of higher sales revenues generated by “Suva Ruda” mine in that year.¹⁴⁷

Table 28 “Rudnik Suva Ruda” d.o.o. profitability indicators 2004–2013

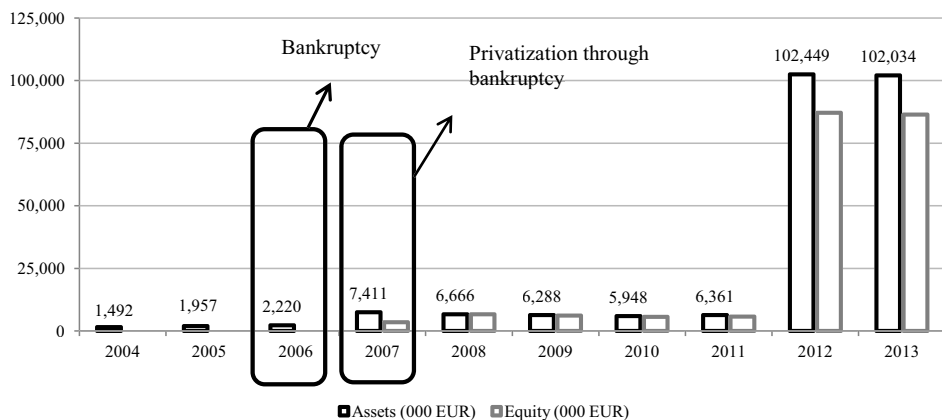
Year	2004	2005	2006	2007	2008
EBITDA %	-613,8%	-9148,3%	–	-156,8%	498,9%
EBIT %	-875,8%	-12061,0%	–	-261,5%	157,8%
Net result %	-1070,7%	-13239,7%	–	-64,1%	51,3%
ROA	-142,5%	-41,7%	-15,7%	-0,4%	0,3%
ROE	–	–	–	-1,0%	0,4%
Gross margin	N/A	N/A	N/A	N/A	N/A
Year	2009	2010	2011	2012	2013
EBITDA %	516,1%	323,4%	75,0%	689,0%	746,6%
EBIT %	18,4%	25,0%	12,7%	367,9%	493,8%
Net result %	5,4%	4,5%	36,4%	519,1%	234,2%
ROA	0,0%	0,0%	1,1%	0,0%	0,0%
ROE	0,0%	0,0%	1,2%	0,0%	0,0%
Gross margin	N/A	N/A	N/A	N/A	N/A

Source: Author’s calculations

¹⁴⁷ Low sales revenues were also the reason for high relative values of net operating result rate in the 2011–2013 period.

In 2012, a new valuation of the mine and its ore deposits in possession of “Farmakom MB” was carried out. As a result of the new valuation of ore deposits owned by “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o., the total business assets and equity value of the Company rose significantly in late 2012. Specifically, in 2012, “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. **total equity increased more than tenfold** – from EUR 5.7 million to EUR 87.1 million due to the effect of the restatement of capital to the tune of EUR 81.9 million resulting from the positive impact of the change in fair value of equity, i.e. ore deposits of the Company. The owner estimated that it would be exploiting the ore from its mines for the next 50 years, hence, in accordance with its accounting policies, it carried out a new valuation of ore deposits which increased the ore deposits value by RSD 15.9 billion (EUR 140.8 million).¹⁴⁸ This was precisely the reason why the total value of “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. fixed assets, including facilities and equipment, was multiplied by a factor of 20, i.e. it skyrocketed from EUR 5 million to EUR 101.2 million. An independent auditor refrained from giving his opinion with respect to the credibility of the consolidated financial reports “*due to inability to obtain appropriate evidence which would provide the basis for the auditor’s opinion on the matter*”. The independent auditor refrained from giving his opinion on account of, *inter alia*, his dissenting view *vis-à-vis* the valuation of assets and liabilities of individual companies that were a part of “Koncern Farmakom MB” d.o.o. Šabac.¹⁴⁹

Illustration 47 Assets and equity 2004–2013



Source: Serbian Business Registers Agency

148 Comments enclosed with 2012 consolidated financial reports, “Koncern “Farmakom M.B. Šabac”.

149 Report of independent auditor “Confida Finodit” DOO Belgrade on the consolidated financial reports of “Koncern Farmakom M.B. Šabac”, dated September 27, 2013, Serbian Business Registers Agency.

Liquidity issues of “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. were related to the Company’s failure since 2008 to revive production. In late 2008, immediately after the completed privatization process, the current ratio was registering exceptionally high values as a result of the Company’s consolidation, i.e. due to a significant decline in short-term liabilities which dropped from EUR 3 million in late 2007 to EUR 12,000 in late 2008. However, an analysis of the quick ratio showed that this indicator’s values were hovering around zero, suggesting that “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. practically had no highly liquid assets which could be relatively quickly converted to cash. Almost the entire operating assets of the Company in the analyzed period consisted of inventories. Such values of the quick ratio suggested a disruption in the Company’s liquidity and a real possibility of the existence of problems in the servicing of current liabilities. Positive values of net working capital indicated that the Company’s long-term assets were entirely financed from long-term sources. The Company’s sources of financing in the 2008–2013 period (almost) entirely pertained to the Company’s own equity.

Table 29 Liquidity indicators 2004–2013

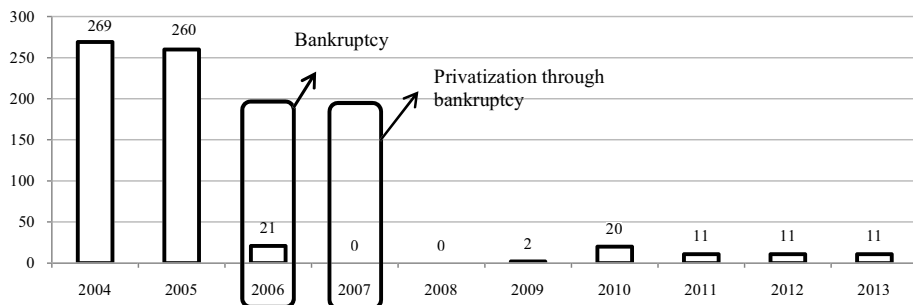
Year	2004	2005	2006	2007	2008
Current ratio	0.6	0.5	0.3	2.5	20.9
Quick ratio	0.4	0.3	0.2	2.5	0.1
Net working capital (000 EUR)	-314	-626	-903	4,411	257
Year	2009	2010	2011	2012	2013
Current ratio	3.7	2.3	2.0	1.4	1.1
Quick ratio	0.0	0.1	0.3	0.0	0.0
Net working capital (000 EUR)	369	455	649	391	174

Source: Author’s calculations

3.2.5. Employment and productivity

In the year of privatization through bankruptcy and the post-privatization year, “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. did not have any employees. Employment of new workers took place in the course of 2010, when the Company had an average of 20 employees, but this number shrank in the following years to just 11.

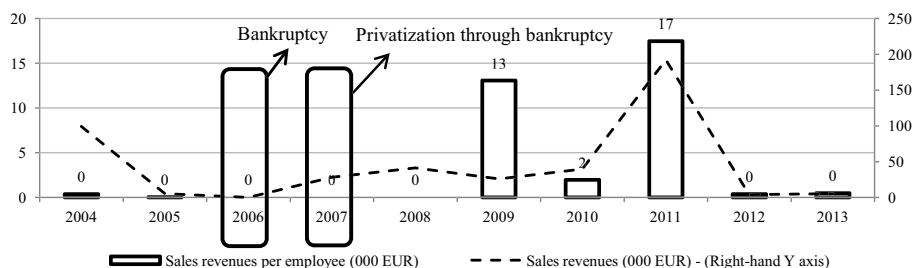
Illustration 48 Average number of employees 2004–2013



Source: Serbian Business Registers Agency

Low gross value added per employee and almost non-existent sales revenues per employee are simply the consequence of the fact that *production never restarted after privatization*. Again the indicators do not offer a worthwhile insight. The productivity indicator measured by sales revenues per employee records low values throughout the analyzed period. The average value of sales revenues per employee of companies generating the highest revenues in the sector of exploitation of ferrous, non-ferrous, precious and other metals in the 2006–2013 period totaled EUR 21,000. Gross value added generated by “Koncern Farmakom MB – Rudnik Suva Ruda” d.o.o. in the post-privatization period (2008–2011) averaged EUR 214,000, but in the last two years the average GVA was EUR 100,000. The average gross value added of companies generating the highest revenues in the sector of exploitation of ferrous, non-ferrous, precious and other metals in the 2008–2013 period totaled EUR 2.4 million.

Illustration 49 Sales revenues per employee and sales revenues 2004–2013

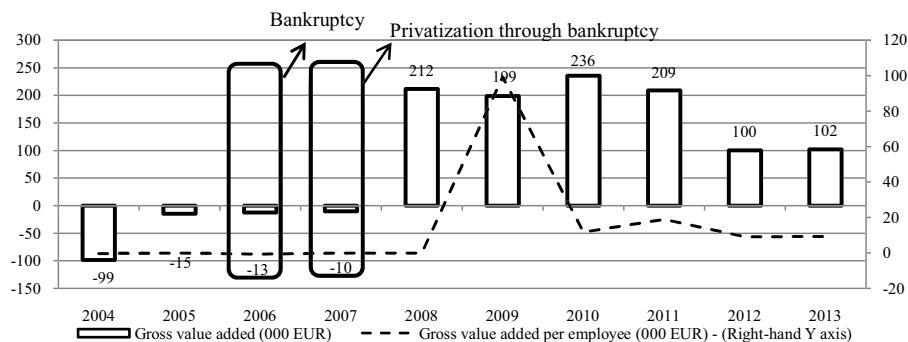


Source: Author's calculations

In the post-privatization period, own equity had a dominant share in the structure of financing sources in all the years of the analyzed period. One of the principal reasons for the small share of borrowed sources was that production did not resume in the analyzed period. A significant increase in the

Company's own equity on account of the restatement of capital in 2012 was due to the positive impact of the change to the fair equity value, i.e. the Company's ore deposits.

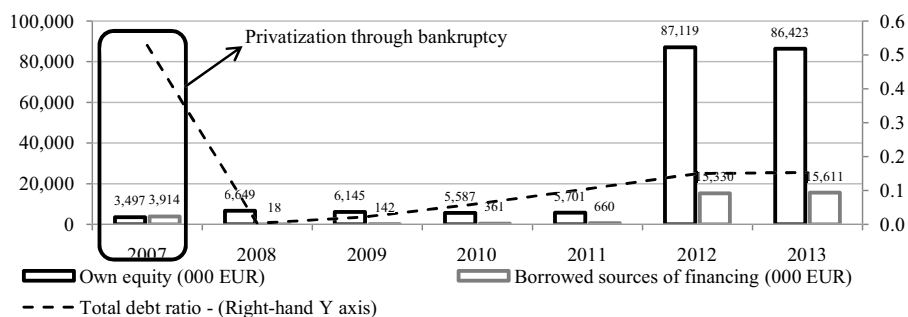
*Illustration 50 Gross value added and gross value added per employee
"Rudnik Suva Ruda" 2004–2013*



Source: Author's calculations

Thanks to the sale of the bankruptcy debtor as a legal person, *the buyer acquired "Suva Ruda" with no liabilities and with the redundancy issue already resolved*, but the privatization proved nonetheless to be a failure due to the financial difficulties of the buyer itself. Thus, the situation of the buyer was reflected in the situation of the privatized company.

Illustration 51 "Rudnik Suva Ruda" d.o.o. debt levels on Dec 31, 2008–2013



Source: Author's calculations

Financial difficulties plaguing the buyer had many different causes, but economic factors were crucial. First among them ranked the financing of investments from short-term sources with unfavorable interest rates, which was particularly conspicuous in the wake of the financial crisis outbreak. The parent company managed to replace a part of the short-term loans with the

long-term credit line via the International Financial Corporation, but the problem of financing was still not fully resolved. Another likely problem was the excessively rapid expansion of the parent company to heterogeneous business activities where its investments, particularly in the mining sector, had insufficient return on investment rates. Thirdly, the parent company suffered from poor corporate management. And finally, operating results presented in official financial statements were brought into question given that the parent company apparently disclosed profits, but could not service its debts. The future of “Suva Ruda” is relatively uncertain, particularly if we bear in mind that the parent company is bankrupt and that it used 100% of its share in the Company as collateral.

4. PRIVATIZATION IN THE METAL INDUSTRY

In this section, we will consider the case studies of the privatization of DP “Goša montaža” from Velika Plana and “Zavarivač” AD from Vranje. The companies were selected following an analysis of the privatized companies whose primary business activities were the metal construction and construction parts manufacturing. These two companies differ considerably in terms of their current statuses as well as with regard to models and methods of privatization applied to them. Whereas “Goša montaža” is operating successfully, “Zavarivač” AD has been undergoing restructuring for the third year running. The grave situation of “Zavarivač” AD is partly a consequence of its failed privatization conducted first under the Ownership Transformation Act, and then through an acquisition of the majority stake in the company by a strategic investor. On the other hand, “Goša montaža” ranks as one of the rare examples of a successfully implemented worker shareholding model as part of which the workers did not acquire their stocks for free. Instead, they joined forces to set up a consortium which purchased the majority stake in the company’s socially-owned equity at a public auction.

Prior to its privatization, “Goša montaža” business operations had been relatively stable, but its business had suffered from scores of legal property-related problems reflected, above all, in its ownership of non-registered properties and many legal disputes. In addition, up until the application of the rule on state creditors’ debt acquittance, the issue of large debts owed to banks undergoing bankruptcy proceedings had remained unresolved. The state creditors’ debt acquittance was probably crucial for the successful sale of “Goša montaža” given the questionable willingness on the part of potential buyers to take over the said debts (or, in case there had been no debt acquittance, the selling price would have been drastically lower along with an uncertain outcome with respect to the final settlement of state creditors’ claims). After the privatization, “Goša montaža” went through several cycles of growth and decline in its sales and services revenues, but over the course of the period up to and including 2013 a positive sales and services revenue trend was predominant (in 2011 alone, “Goša montaža” generated revenues to the tune of EUR 23.8 million). By 2013 inclusive, the company invested a total of about EUR 4 million in equipment, while its cumulative net profit for the 2007–2013 period amounted to over EUR 14 million, which was accompanied by an exceptionally favorable cash-flow position. On top of that, “Goša montaža” attained a satisfactory level of quality of corporate governance and reporting to investors. “Goša montaža” also conducted a responsible dividend distribution policy. In terms of the manner in which the privatiza-

tion was carried out and its outcome, as well as with regard to its characteristics, the case of “Goša montaža” is a positive exception.

Problems plaguing “Zavarivač” had come to the fore as far back as early 1990s when the company had ended up in bankruptcy due to the loss of its market share and consequent decline in the volume of its business operations. Following an enforced settlement with the creditors, the company had emerged from bankruptcy and entered privatization proceedings in late 2000 pursuant to the provisions of the Ownership Transformation Act. From 2003 to 2007, in the course of the period prior to (the second round of) privatization, “Zavarivač” had been generating only a token net operating profit along with growing debts. Given that the equipment was on average over 20 years old, the company had been in dire need of procuring new machinery, welding and transport equipment. A decision to sell the remainder of the socially-owned equity by public tender with invitations to the remaining shareholders had been a reasonable option, bearing in mind the prospect for state creditors’ debt acquittance, the need for the company to implement its own restructuring measures and the lack of funds for necessary investments for which a new (majority) owner had been needed. In addition, a public tendering procedure would allow for the imposition of specific requirements on potential bidders as well as a control of implementation to be performed by the Privatization Agency. As in the case of “Goša montaža”, there had been many non-registered real estate properties and accompanying construction-related and technical documentation had been lacking. The company had also stood to incur large liabilities on account of legal actions against it, and the problem of excessive workforce had not even been truly addressed.

After privatization in late 2008, “Zavarivač” AD experienced deterioration in its business operations coupled with a severe drop in its production and sales output volumes. Several factors were instrumental in deterioration of the company’s business. Except for external factors (the global economic crisis’ impact took its toll in the year when the buyer took over control over the company), the company suffered from many internal problems such as poor financial situation, excessive workforce and strained relations between the employees and new owners. Any recovery in “Zavarivač” AD business operations was particularly impeded by the absence of an agreement on the amount and disbursement of severance packages for the employees identified as being redundant. The stand-off culminated in a work stoppage in 2010 which was why the company failed to deliver on already signed contracts. Soon after this, the banks declared the previously granted loans due for repayment.

The buyer had secured earlier a part of the funds necessary for normalization of the company’s business operations by taking out a loan from the Development Fund of the Republic of Serbia designated for acquisition of equipment. In order to unblock the company’s account and create conditions for regular business operation, the then management, appointed by the buyer itself, used a portion of the funds from the Development Fund’s loan (contrary to its designated purpose). In February 2011, due to the company’s failure

to comply with contractual obligations, the Privatization Agency cancelled the privatization contract having previously extended the deadline for correction of irregularities in the contract's implementation. Immediately after the contract's termination, the Agency adopted a decision on restructuring in order to prevent enforcement against the company's assets as well as to carry out restructuring measures. However, "Zavarivač" failed to boost its production due to insufficient recovery of the domestic market still suffering from the impact of the crisis and internal problems.

After the 2010 cancellation of the privatization contract and the decision on restructuring, "Zavarivač" continued to accrue liabilities so that the total amount in late 2013 was EUR 13.7 million. Key problems plaguing "Zavarivač" were inadequate workforce structure, high energy consumption and high debt levels including considerable enforceable employees' claims against the company resulting from successful litigation. Over the course of restructuring, "Zavarivač" did not essentially resolve any of the problems above, while the privatization itself brought new legal and property-related challenges meaning that the only way out was bankruptcy unless measures were taken to make "Zavarivač" attractive for potential buyers.

A characteristic shared by both cases was that the management and employees of both companies had access to a large body of data and relevant information presented in respective privatization programs (probability of claims settlement, current state of assets, expected outcomes of lawsuits, etc.). "Goša montaža" employees took advantage of full, comprehensive information on the status and prospects for the subject of privatization and became owners of the company at the public auction. The employees held the view that the company would continue to operate successfully which in turn would enable them to set aside a part of the generated profit for payments of installments under the contract on sale of socially-owned "Goša montaža" equity. Asymmetry of available information also played an important role in "Zavarivač" privatization. One of the reasons for the subsequent cancellation of the contract was a discrepancy between the actual situation on one hand, and official business records and data from the tendering documentation on the other, however responsibility for this also partly lay with the buyer who failed to conduct appropriate due diligence.

When the two cases are compared by the achieved privatization objectives, DP "Goša montaža" is one of rare privatizations where the key objectives have been accomplished. Specifically, "Goša montaža" has improved its business efficiency; investments in equipment worth EUR 4 million have been made; the company has implemented an integrated management system comprising the system of quality management in compliance with relevant standards. While we assume that "Goša montaža" is regularly paying its dues at both the national and local levels, given that we have not collected data on the importance of "Goša montaža" for the local government's finances, we placed a question mark in the table below instead of a plus sign. On the other hand, the privatization of "Zavarivač" AD has only partly achieved the objec-

tives in terms of an increase in public revenues, however to a large degree, “Zavarivač” AD has managed to continue applying relevant standards.

Privatization objectives	Goša montaža	Zavarivač
Efficiency of privatized company	+	–
Increase in investments	+	–
Transfer of technologies and know-how	+	+/-
Increase in public (national and local) revenues	+	+/-
Hard budget constraint	+/?	–

The survival of “Zavarivač” AD was made possible thanks to the existence of *soft budget constraint*, i.e. accrual of liabilities to state creditors, employees and suppliers. Outstanding liabilities to state creditors at both the national and local levels continue to grow. “Zavarivač” has accumulated significant arrears on dues owed to the city. Moreover, *as of the decision on restructuring was made, the company has not paid a single dinar into the local self-government’s budget*. The amount of levied but unpaid tax on salaries and wages totaled about RSD 50 million in 2014.

Disparity between the two cases may be illustrated by comparison of projected and actual operating results. The failed privatization of “Zavarivač” AD led in aggregate, (in current values), to a operating result worse by EUR 13.5 million than the one arising from the alternative scenario of a successful privatization (had “Zavarivač” operated like “Goša montaža”) for the 2009–2013 period.

4.1. CASE STUDY – PRIVATIZATION OF DP “GOŠA MONTAŽA” VELIKA PLANA

4.1.1. Background information on “Goša montaža” AD

“Goša montaža” DP company (hereinafter referred to as the Company or “Goša montaža”) takes its origins from a Serbian-French joint stock company established in 1923.¹⁵⁰ “Goša montaža” underwent various transformation phases (of the then socially owned forms of organization for a company) and relocations of its headquarters so that as of 1982 the Company operated as a ‘business organization’ (*radna organizacija*) and then as a limited liability company headquartered in Velika Plana as part of “Goša” holding company. In late 2004, “Goša montaža” changed its form of organization once again and re-registered from a limited liability company to a socially-owned com-

¹⁵⁰ Information collected at the Company’s web site: <http://www.gosamontaza.com/> (Site visited: July 15, 2014).

pany.¹⁵¹ “Goša montaža” was *privatized by public auction in accordance with the fast-track privatization procedure in May 2006 by a consortium consisting of its employees.*

The Company’s overall assortment of products and services includes design and elaboration of workshop documentation; production of equipment and all types of steel constructions; installation, maintenance and rental of transport equipment and machinery. “Goša montaža” has two manufacturing facilities in Velika Plana and Smederevska Palanka, fully equipped to operate as independent production units, each with a complete production process. The production and services program of “Goša montaža” AD is realized through its manufacturing capacities of 600 tonnes as well as locksmith-related and welding works of 100,000 hours per month. The Company has all relevant licenses in the field of welding¹⁵² and a significant human capital – 9 out of 42 engineers have E/IWE (European/International Welding Engineer) certificates, while over 100 welders are trained to perform specific welding procedures. “Goša montaža” has 17 cranes with capacities of between 8 and 300 tonnes, as well as its own welding training center, quality assurance and quality control service which is accredited for independent non-destructive testing of materials and welds.¹⁵³

“Goša montaža” AD is operating predominantly in the energy sector and is involved in construction, maintenance and overhaul of facilities and equipment for hydroelectric and thermoelectric power plants. The Company manufactures and installs steel constructions for hydro facilities and other types of facilities, as well as equipment for mining and oil industries. “Goša montaža” is often hired as a subcontractor. In 2011, the Company established a dependent company “Goša montaža Banja Luka” d.o.o. which has not yet had significant business activities. “Goša montaža” now incorporates in its operations an integrated management system comprising ISO 9001:2008 Quality Management System, ISO 14001:2005 Environmental Management System and OHSAS 18001:2009 Health and Safety Management System. The whole process from designing through to installation complies with EN 1090-2 technical requirements for the execution of steel structures, while welding works comply with

151 Socially-owned companies which used to be a part of the holding company had to first transfer the equity. In the case of “Goša montaža”, there was 75% of socially-owned equity at the beginning of the privatization process, whereas 25% belonged to the “Goša” holding company. In June 2004, a decision was made to transfer 25% of equity so that 100% of “Goša montaža” equity became socially-owned.

152 These are DIN EN ISO 3834-2 (a certificate for welding works), DIN 18800-7 (currently being replaced by EN 1090-2), PED 97/23/EC (a certificate for manufacturing pressure vessels), a certificate for manufacturing and installation of pipelines in conformity with EN 13480-4.

153 The most important references are: the thermoelectric power plants in Obrenovac, Obilić and Kostolac; hydroelectric power plants “Đerdap” and Bajina Bašta; the “Interkontinental” hotel in Belgrade; detergent plant “Merima” Kruševac and “Sartid” blast furnaces; a business center in Munich; steel plants in Denmark, Expo Center in Moscow, etc.

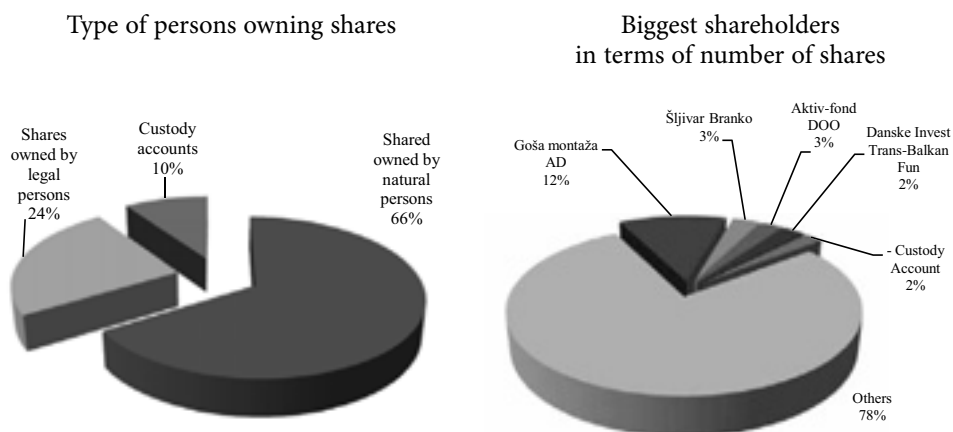
EN ISO 3834-2 and DIN 18800-7 norms. “Goša montaža” AD has necessary licenses issued by the Ministry of Environmental Protection, Mining and Spatial Planning of the Republic of Serbia.¹⁵⁴ “Goša montaža” adopted a corporate code of conduct in 2012 and discloses regularly in a transparent manner information of relevance to the Company’s shareholders.

Table 30 Background information on “Goša montaža” AD Velika Plana

Full business name:	Joint-stock Company for Manufacturing and Installation of Equipment and Facilities Goša montaža, Velika Plana
Abbreviated business name:	Goša montaža AD Velika Plana
Company code:	07264399
Registered address:	Velika Plana
Standard Industrial Classification (SIC) Code:	Metal constructions and construction parts manufacturing (2511)
Legal form:	Joint-stock company
Status:	Active company
Number of employees (2013):	633
Year of privatization:	2006

Source: Serbian Business Registers Agency

Illustration 52 Goša montaža AD Equity ownership structure on August 28, 2014



Source: Central Register of Securities of the Republic of Serbia

¹⁵⁴ Information collected at the Company’s web site: <http://www.gosamontaza.com/> (Site visited: July 15, 2014).

4.1.2. Business operations prior to privatization

From 2003 to 2005, immediately before privatization, “Goša montaža” products and services sales revenues had been recording stable but low growth rates. Sales revenues had been fairly stable averaging EUR 10.2 million. In this period, the median annual growth rate for products and services sales revenues totaled 1%, but in 2006, after the privatization, despite favorable market conditions, sales revenues dropped by 10.6%.

The said volume of products and services sales had enabled the Company to register positive operating results in the pre-privatization period, but with very low net profits. Despite a positive net operating result of EUR 780,000, in 2003 “Goša montaža” had recorded a net operating profit of only EUR 24,000 due to the write-off of long-term financial investments. In 2004, “Goša montaža” sales revenues were the same as in the previous year, however, due to an increase in the costs of materials and wages, its operating profit had declined. In 2005, thanks to a rise in sales revenues and lower operating expenses, the Company increased its operating profit. As a result of a 10.9% drop in sales revenues, the Company’s operating result in 2006 had been lower than in 2005, but given significantly higher other revenues, the Company had managed to generate the highest net operating profit in the analyzed period.¹⁵⁵

Illustration 53 Goša montaža
AD Sales revenues
2003–2006 (000 EUR)

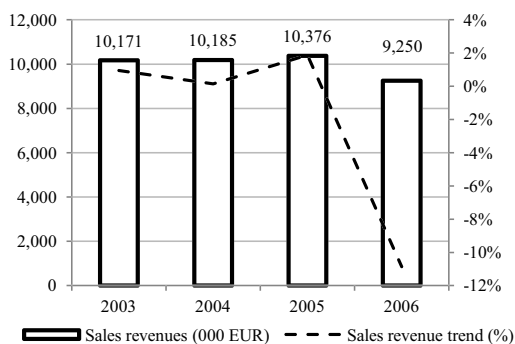
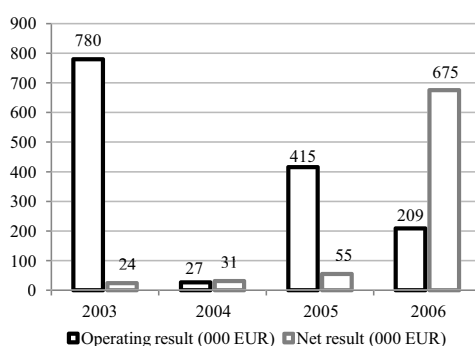


Illustration 54 Goša montaža
AD Operating & net profits
2003–2006 (000 EUR)



Source: “Goša montaža” Velika Plana Privatization Program, Serbian Privatization Agency, February 2006

In the pre-privatization period, “Goša montaža” had been grappling with several *legal property-related problems* pertaining, above all, to non-registered properties as well as dealing with a large number of legal disputes.

155 “Goša montaža” Velika Plana Privatization Program, Serbian Privatization Agency, February 2006.

In addition, up until early 2006, there had been an unresolved issue of an outstanding debt owed to “Beogradska banka” which, as a bank undergoing bankruptcy proceedings, had been under the administration of the then Agency for Deposit Insurance and Bank Rehabilitation, Bankruptcy and Liquidation. The debt originating from the 1980s, including interest on arrears, had reached the amount of USD 1.2 million (EUR 1.2 million) in late 2004. In the pre-privatization period, the Company had made the biggest investments in its fixed assets in the early 1980s and late 1990s, while the most recent investments in equipment had been realized in the early 2000s, and before that – as far back as the early 1970s and 1980s.¹⁵⁶

4.1.3. Privatization

On May 25, 2006, at a public auction, the subject of privatization – *“Goša montaža”* – was sold to a consortium consisting of 272 workers of the company as represented by the then general manager. The Company itself was privatized in a so-called *fast-track privatization by auction procedure*, i.e. except for the privatization program (disclosing detailed information on the status of assets and liabilities as well as carrying values), no additional equity valuation of the subject of privatization was presented.¹⁵⁷ According to the privatization program, the carrying value of the capital stock in late 2004 had been RSD 352.3 million, with the lower bound for carrying value totaling RSD 176.2 million (i.e. from 50% to 100% of the carrying value), while the carrying value of equity put up for sale (70% of the entire socially-owned equity) had been RSD 246.6 million.

Table 31 Estimated value of capital stock on December 31, 2004

	Carrying value	Adjusted carrying value
Capital stock (000 RSD)	251,973	352,321

Source: “Goša montaža” Privatization Program, February 2006, Serbian Privatization Agency

The discrepancy between the carrying value and the adjusted carrying value arose from a legal obligation related to state creditors’ debt “acquittance” to the tune of RSD 100.3 million. From this sum, RSD 82.2 million

¹⁵⁶ Ibid.

¹⁵⁷ A crucial difference between the fast-track and regular privatization by auction was that the company value in the fast-track procedure was to be established by applying the adjusted carrying value method, whereby loss and total liabilities (liabilities, deferred gains on account of restatement of capital, long-term provisions, and accruals and deferred income) were to be subtracted from the value of total assets. On the other hand, a regular program of privatization by auction stipulated a discounted cash flow valuation and liquidation valuation to be carried out by appraisal professionals in order to obtain a more realistic picture in the case of subjects of privatization whose equity value was negative or low relative to their assets value in accordance with the carrying valuation method.

was held by the Agency for Rehabilitation of Banks in claims against “Goša montaža” previously held by “Beogradska banka”,¹⁵⁸ while the remaining RSD 18.2 million pertained to the Tax Administration, the Solidarity Housing Development Fund and a smaller number of public utilities.¹⁵⁹ Given that the sale was effected in May 2006, the socially-owned equity value offered for sale increased to RSD 296.9 million as the restatement of estimated value was carried out by applying the monthly retail prices growth index in the period from the date of valuation to the date of announcement of the public call for auction bids.¹⁶⁰ State creditors’ “debt acquittance” was probably crucial for the sale of “Goša montaža” as the buyers would not be willing to take over the said debts or the price would be drastically lower with an uncertain outcome regarding the settlement of state creditors’ claims.

The opening price at the public auction was 10% of the estimated value of socially-owned equity, i.e. RSD 29.7 million (EUR 376,000), but the price almost quintupled to RSD 146 million (EUR 1.67 million), or about 50% of the estimated value, due the presence of another two rival bidders. As the Privatization Act provided for a more favorable treatment of domestic citizens, the buyer was allowed to pay the asking price in *six equal annual installments* of EUR 278,200.¹⁶¹ In their own words, “Goša montaža” AD employees had been preparing for the Company’s privatization for the past two

158 With the enactment of the legislation on regulation of relations between the Republic of Serbia and banks in bankruptcy on account of foreign credits and loans (“Official Gazette of the Republic of Serbia”, no. 45/05), legal entities – debtors (in this case – “Goša montaža”), whose liabilities rendered the bank in bankruptcy a debtor, i.e. original debtor or guarantor, were to be released from obligations with respect to the banks in bankruptcy (in this case – “Beogradska banka”) and incur obligations with respect to the Republic of Serbia.

159 Under the amended Privatization Act, and subsequently the Regulation on Manner and Conditions for the Subject of Privatization’s Settlement of Liabilities to Creditors (“Official Gazette of the Republic of Serbia”, no. 45/06) from 2006, state creditors of the subjects of privatization were under an obligation to provide for acquittance of debt as of December 31, 2004, and settle their claims from the proceeds generated by the sale of the subjects of privatization. The said regulation was later amended three more times (“Official Gazette of the Republic of Serbia”, nos. 108/07, 126/07 and 60/08).

160 Article 20 of the Regulation on Assets and Equity Valuation Methodology (“Official Gazette of the Republic of Serbia”, nos. 45/2001 and 45/2002) stipulated that if a public call for auction bids was announced more than 30 days after the date of assets/equity valuation, the Agency was to perform the restatement of assets/equity in accordance with this regulation. The restatement of assets/equity from paragraph 1 of this article was to be performed between the date of assets/equity valuation and the date of announcement of the public call for auction bid. The restatement of assets/equity from paragraph 1 of this article was to be performed through the application of monthly retail prices growth index in the Republic of Serbia where the retail prices growth index for the previous month was to be applied to the current month.

161 Contract on Sale of Socially-Owned Equity by Public Auction between the Privatization Agency of the Republic of Serbia and the Consortium of Natural Persons, dated May 30, 2006, available at the following address: <http://www.priv.rs/upload/company/contract/500804.PDF> (Site visited: June 29, 2014).

years.¹⁶² Given that the *consortium consisted of 272 persons*, the annual rate on average totaled slightly more than several thousand euros per consortium member.

The *sale contract contained standard contractual elements with regard to investments and social contributions* in case of the sale of the socially-owned equity by public auction. When signing the sale contract, the buyer assumed an obligation to invest in fixed assets to the tune of RSD 21.8 million (about EUR 260,000) within 12 months from the date of signing of the sale contract.¹⁶³ The buyer was also contractually obliged to accept a social program stipulating respect for all the rights of employees as specified in the individual collective agreement, a limitation on employees lay-offs for two years after the date of conclusion of the sale contract, but with an option to pay out severance packages to redundant employees to the tune of six-month's worth of average monthly gross wage or, if more favorable, EUR 250 for each full year of the workers' respective length of service, as well as a preferential treatment for employees nearing retirement and those with the status of disabled persons.¹⁶⁴

4.1.4. *Business operations after privatization*

After the privatization, "Goša montaža" AD increased its business activities which was reflected in a significant growth of products and services sales revenues relative to the pre-privatization period. Following the privatization on May 25, 2006, as soon as in 2007, the Company's management signed contracts for repair and overhaul services with "Naftna industrija Srbije" (Serbian oil company), "Elektroprivreda Srbije" and the "U.S. Steel" steel plant in Smederevo, thereby employing the entire capacities of the Company and sparking the need for new employees. Given the increasing business volumes, "Goša montaža" AD raised the salaries and wages by 20.9% of its expert services staff and skilled manual workers: around 70% of the entire workforce.¹⁶⁵

162 <http://arhiva.glas-javnosti.rs/arhiva/2006/06/29/srpski/SH06062804.shtml> (Site visited: June 21, 2014).

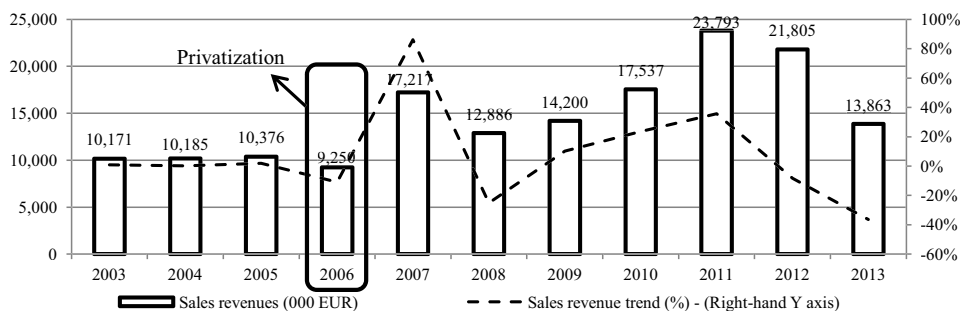
163 The contract also stipulated a total amount of investments in excess of EUR 1 million as well as that the deadline for investments might be longer than 12 months from the date of signing of the sale contract. An additional obligation was that if profit was generated at the end of accounting period, dividends for each of the two years after the conclusion of the sale contract were to be set to the tune of at least 10% of the Company's profit after tax and legal reserves. Contract on Sale of Socially-Owned Equity by Public Auction between the Privatization Agency of the Republic of Serbia and the Consortium of Natural Persons, dated May 30, 2006, available at the following address: <http://www.priv.rs/upload/company/contract/500804.PDF> (Site visited: June 29, 2014).

164 Additionally, the social program stipulated that if the subject of privatization had over 50 employees and if the need arose for termination of more than 10% of employment contracts due to technological changes, the competent organ of the privatized company was under obligation to adopt a redundancy benefits program having previously obtained the opinion of a representative trade union.

165 http://www.b92.net/biz/vesti/srbija.php?yyyy=2007&mm=06&dd=23&nav_id=252516 (Site visited: June 28, 2014).

“Goša montaža” AD continued to experience *several cycles of growth and decline* of its products and services sales revenues. In 2007, the increased level of the Company’s business activities was accompanied by a significant sales revenue growth of 86.1% annually. With the onslaught of the economic crisis in 2008, the Company’s sales revenues dropped by 25.2%. Following this slump however there was a period of accelerated growth, in which, the Company registered in the next three years an average sales revenue growth of 23.1% bringing the total sales revenues generated in 2011 up to EUR 23.8 million. Due to a significant depreciation of RSD relative to EUR in 2012, which lost 11% of its value, the Company’s sales revenues in 2012 denominated in EUR were lower by 8.4% year-on-year. In 2013, the Company recorded a slump in sales revenues by 36.4%, and this downward trend persisted in the first half of 2014.

Illustration 55 “Goša montaža” AD sales revenues 2003–2013 (000 EUR)



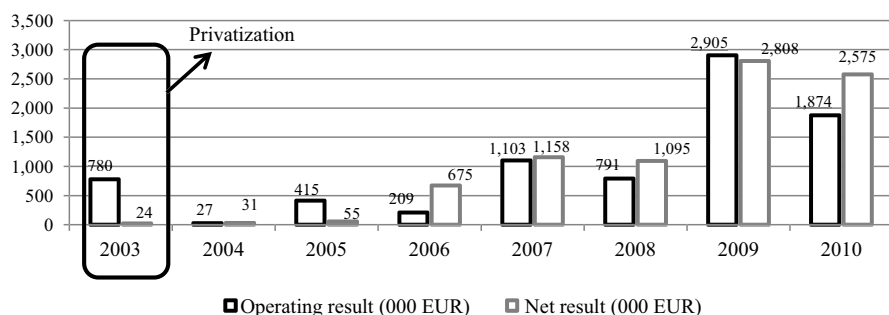
Source: “Goša montaža” Privatization Program, Velika Plana, Serbian Privatization Agency, February 2006 and Serbian Business Registers Agency

After privatization, “Goša montaža” AD continued to post positive operating and net results. The Company recorded its best results from 2009 to 2012. Due to a considerable drop in sales revenues of 25.2%, “Goša montaža” generated a lower operating profit in 2008 relative to 2007. The 2009 sales revenues growth of 10.2% and a reduction of the cost of salaries and wages by 11.2% resulted in the Company’s significantly higher operating profits year-on-year.

In the next two years, the Company’s operating profits declined to an average of EUR 1.9 million. The reason for this significant drop in operating results in 2010 and 2011 was a strong growth of the cost of materials, other operating expenses and the cost of salaries and wages which in those years were higher on average by 61.8%, 86.1% and 11.6%, respectively. In 2012, despite the fall in sales revenues denominated in EUR by 8.4%, the Company generated the biggest operating profit to the tune of EUR 3.1 million. The reason for such a operating result was a decline in the cost of materials and other operating expenses by 25.5% and 26.7%, respectively. In 2013, despite a

considerable 36.4% slump in sales revenues, the Company posted a positive operating result however this was 43.9% lower compared to the operating result in the previous year.

Illustration 56 “Goša montaža” AD operating and net results 2006–2013



Source: Serbian Business Registers Agency

Cumulative net profit in the 2007–2013 period totaled over EUR 14 million. The net operating result was in line with the operating results trend over the course of the entire analyzed period. A significant deviation from the said trend was recorded in 2010. The reason for this is a relatively high positive financial result totaling EUR 882,000 in 2010 due to high revenues on account of foreign exchange differences and interest. A similar situation, but to a lesser degree, was also registered in 2008.

The buyer, i.e. the consortium of employees, invested in late 2006 in the acquisition of equipment and assets to the tune of RSD 21.9 million (EUR 261,000), thereby fulfilling its obligation from the sale contracts vis-à-vis mandatory investments. According to the management, after the privatization and up the end of 2013 around EUR 4 million was invested in the Company.

“SIM Industry Servis” from Šabac (owned by the Italian company – SIM) was the customer with a biggest share (62.6%) in the Company’s overall outstanding receivables in late 2013, while the share of energy companies – Elektroprivreda Srbije, HE Đerdap and Naftna industrija Srbije in late 2013 – in aggregate, totaled 38.4%. In the preceding years, the biggest share of the Company’s outstanding receivables pertained to other companies in the energy sector (TE “Nikola Tesla”, TE KO Kostolac, Petrohemija, etc.). As regards the suppliers, in late 2013, “Antikor” from Belgrade, “Elektrovolt” from Valjevo and “SIM” from Sremski Karlovci had the biggest shares of 23.2%, 20.4% and 13.6%, respectively, in the Company’s overall payables.¹⁶⁶

166 Comments enclosed with 2013 financial reports “Goša montaža” AD Velika Plana, Serbian Business Registers Agency.

“Goša montaža” was recording a growth in earnings before interest, taxes, depreciation and amortization (EBITDA%) in the post-privatization period. EBIT% and EBITDA% in the 2003–2006 period these totaled 3.5% and 5.4%, respectively. After 2007, EBIT% and EBITDA% were 11.2% and 12.4%, respectively. The reason for higher profitability indicator values in the post-privatization period were increased business activity (sales revenues). When compared to the pre-privatization period, the difference is particularly noticeable in the net result indicator values trend. The average value of the said indicator from 2003 to 2006 had been 2.1%, whereas in the 2007–2013 period, it stood at 12.3%. Considerably higher values of the return-on-assets (ROA) and return-on-equity (ROE) indicators from 2007 to 2013, as opposed to the 2003–2006 period, show that “Goša montaža” AD was managing its assets and equity much more efficiently in the post-privatization period.

Table 32 “Goša montaža” AD profitability indicators 2003–2013

Year	2003	2004	2005	2006	2007	2008
EBITDA %	10.8%	1.9%	5.3%	3.5%	7.2%	7.3%
EBIT %	7.7%	0.3%	4.0%	2.3%	6.4%	6.1%
Net result %	0.2%	0.3%	0.5%	7.3%	6.7%	8.5%
ROA	0.3%	0.5%	1.0%	10.3%	13.2%	11.8%
ROE	0.5%	0.9%	1.8%	19.6%	25.9%	21.3%
Gross margin	84%	N/A	78%	82%	83%	87%
Year	2009	2010	2011	2012	2013	
EBITDA %	21.4%	11.6%	9.1%	15.5%	14.4%	
EBIT %	20.5%	10.7%	8.1%	14.3%	12.6%	
Net result %	19.8%	14.7%	7.8%	15.0%	13.6%	
ROA	28.9%	18.0%	10.4%	20.6%	13.3%	
ROE	45.2%	35.0%	23.7%	37.8%	19.0%	
Gross margin	87%	85%	80%	84%	83%	

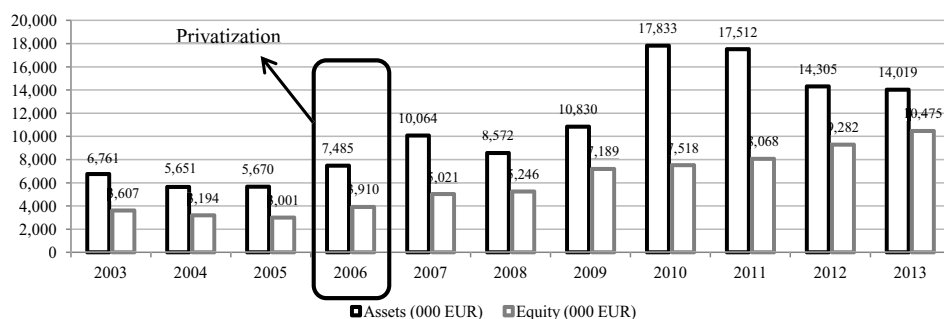
Source: Author’s calculations.

Both before and after the privatization, significant depreciations of the RSD exchange rate relative to the EUR had a large impact on the trend in the Company’s business assets value denominated in EUR.¹⁶⁷ The most important factors strongly influencing the fluctuations in “Goša montaža” AD

¹⁶⁷ In some years, RSD would lose up to 15% of its value relative to EUR.

total assets value before the privatization, i.e. in the 2003–2006 period, were declining long-term financial investments in late 2004 and the growing value of its operating assets as a result of gradually increasing volumes of the Company's business activities. In the analyzed period, the value of fixed assets was falling at an average year-on-year rate of 22.8%. In the same period, the Company's equity, denominated in EUR, was recording a drop in value up until late 2005 at a median year-on-year rate of 18.2%. In late 2006, thanks to considerably improved operating results, the Company's equity value increased by 30.3% to the EUR 3.9 million mark.

Illustration 57 “Goša montaža” AD assets and equity on December 31, 2003–2013



Source: “Goša montaža” Privatization Program, Velika Plana, Serbian Privatization Agency, February 2006 and Serbian Business Registers Agency

The value of operating assets continued to grow through to late 2010. The primary driver behind the increase in operating assets value in the said period was an increased level of business activities, i.e. a growth in the overall amount of receivables as well as the introduction and subsequent growth in the value of short-term financial investments.¹⁶⁸ “Goša montaža” AD fixed assets value increased significantly when compared to the pre-privatization period thanks to, above all, a considerable rise in the value of its industrial real estate properties, facilities and equipment. The first significant growth of fixed assets value was recorded in late 2007 due to investments in equipment carried out as stipulated in the privatization contract. Thanks to new investments, the value of fixed assets was growing up until late 2011, when it reached its maximum of EUR 3.3 million. In the following years, the share of fixed assets in the Company's total business assets have declined as there have been no new investments in fixed assets.

¹⁶⁸ For the sake of comparison, the Company's operating assets value at the end of 2010 relative to late 2006 was higher by EUR 9.1 million. After 2010, a period of gradual reduction in the operating assets value ensued due to weaker business activities of the Company, i.e. a decline in the overall amount of receivables with regard to the Company's clients and declining inventories. The Company's operating assets value stabilized in late 2013 at the level of EUR 11.2 million.

“Goša montaža” AD’s own equity was constantly increasing in all the years following privatization. The primary drivers of the Company’s own equity growth from late 2007 until the end of 2010 were the positive net operating results in the analyzed period. From 2011 until the end of 2013, in addition to positive net operating results, increasing reserves contributed to the Company’s equity growth since, as already stated earlier, a part of the funds from current net gains was to be set aside as legal reserves, whereas the remaining cash was retained as unallocated profit.

In all the years, except 2010 and 2011, “Goša montaža” posted high liquidity indicator values which highlighted an exceptionally *favorable position of the Company in liquidity terms*. Over the course of the entire analyzed period, current ratio and quick ratio were registering values at or above the theoretically optimal level of 2:1 and 1:1, respectively. In late 2010 and 2011, although these two indicators recorded lower values, the Company’s liquidity status was not jeopardized bearing in mind that the quick ratio values were above the theoretically optimal level. In the course of all the analyzed years, the Company managed to maintain a long-term financial balance, which went on to show that the Company’s long-term financial assets were entirely funded from long-term sources. A marked trend of growing net working capital showed that there were conditions in place for the maintenance of long-term liquidity.

Table 33 “Goša montaža” AD liquidity and debt indicators
on December 31, 2003–2013

Year	2003	2004	2005	2006	2007	2008
Current ratio	2.4	3.3	3.0	2.5	2.0	2.6
Quick ratio	1.8	2.7	2.5	2.1	1.9	2.4
Net working capital (000 EUR)	2,804	2,939	2,960	3,708	4,218	4,332
Year	2009	2010	2011	2012	2013	
Current ratio	2.8	1.5	1.5	2.3	3.2	
Quick ratio	2.6	1.3	1.4	2.1	2.9	
Net working capital (000 EUR)	5,928	5,194	4,795	6,310	7,728	

Source: Author’s calculations

The Company has not formally adopted a dividend distribution policy. However, given a significant share of dividends, the Company has been implementing in practice a moderate policy of paying out the dividends from its profits at the end of accounting periods in the past several years (in 2011 – 45.4%, in 2012 – 17.8% and in 2013 – 26.7% of the total profit).¹⁶⁹ As a

169 Decisions on the Company’s profit distribution for 2011, 2012 and 2013.

rule, at its annual meetings, the Company's shareholder assembly passes a decision on distribution of unallocated profits from previous years according to which a part of the funds would be typically retained within the Company as unallocated profit (retained earnings), and then as reserves, whereas the rest would be disbursed to shareholders as dividends. The total amount of dividends disbursed to shareholders on account of profits generated from 2010 to 2013 was, in aggregate, RSD 350.1 million (about EUR 3.2 million). The Company issued a total of 257,174 shares whose market capitalization in mid-August 2014 was RSD 591.5 million (about EUR 5 million), i.e. 49% of the carrying value. In the autumn of 2011, the consortium was devolved to individual persons after the last installment of the purchase price had been paid. In February 2007, "Goša montaža" shares had been made available for trading on the over-the-counter (OTC) market by single price method. As of May 2012, the Company's shares were traded in accordance with the continuous trading method, and, in March 2013, the Company was included in the Belgrade Stock Exchange Belex 15 index.¹⁷⁰

There is *no a single shareholder whose stake exceeds 5%* of the Company. However, as of 2011 the Company has been buying back its shares so that now it owns 12% of its own shares.¹⁷¹ Free float factor (FFc), a percentage of shares which are freely traded, in late June 2014 was (for Serbia) exceptionally high – 88.8%. "Goša montaža" is one of the rare companies with foreign investment funds as its shareholders. The Company has a *two-tiered management system with clearly defined responsibilities of the supervisory board and executive directors*. On top of that, in addition to a legally mandatory supervisory commission, the Company formed its internal control service. The Company has achieved *a satisfactory level of quality in terms of corporate governance and reporting to investors*.¹⁷² *A Corporate Code of Conduct was adopted in 2012*.¹⁷³ Since 2011, in its annual reports, "Goša montaža" has been publishing information on its business operations' compliance with the corporate governance principles. "Goša montaža" is regularly reporting to its shareholders, and all the materials related to shareholder assembly meetings are available on the Company's web site.

170 As opposed to the single price method where a single price is determined at which all placed trading orders are to be carried out, in the continuous trading method the prices are formed on the basis of received trading orders within +/- 20% range from the indicated price, i.e. the closing prices as set at the previous stock exchange meeting.

171 Minutes of the proceedings from the regular "Goša montaža" AD Shareholder Assembly meeting held on April 16, 2011.

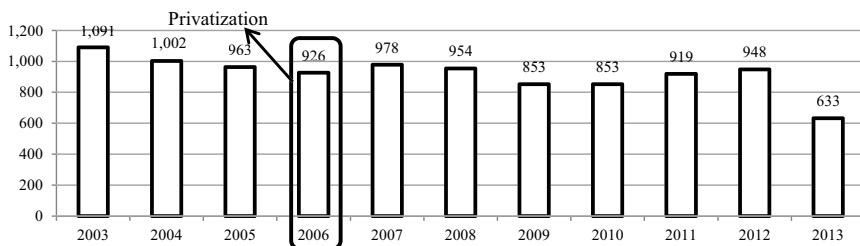
172 "Goša montaža" – Questionnaire on corporate governance practices of issuers, Belgrade Stock Exchange. The questionnaire is available at the following address: <http://www.belex.rs/data/2013/04/00081741.pdf> (Site visited: August 22, 2014).

173 Corporate Code of Conduct, "Goša montaža" joint-stock company. The Corporate Code of Conduct is available at the following address: <http://www.belex.rs/data/2012/05/00074483.pdf> (Site visited: August 22, 2014).

4.1.5. Employment and productivity

The sector of metal construction and construction parts manufacturing is characterized by *considerable employee fluctuation*, particularly with regard to specific job profiles such as installers and welders, so that any overall head count largely depends on the Company's business activity. At the time of privatization, the Company employed 906 workers. After privatization, thanks to new contracts in 2007, the average number of employees increased. In the following years, there was no need for the hiring of new workers and the workforce size was gradually decreased up until 2011. In 2012, the number of employees rose to 948, but in 2013 it dropped considerably to 633 due to decreased business activity, which was by far the lowest head count over the course of the analyzed period. Significant workforce fluctuations also had an impact on the full-time and part-time employee structure.¹⁷⁴ In the period from May 2006 to April 2011, in the course of which the Privatization Agency carried out a control of performance of contractual obligations, "Goša montaža" terminated employment contracts of a total of 588 full-time and part-time workers. In each compliance report, the Agency stated that the Company was not in breach of its contractual obligations arising from the social program. In addition, in the same period, the Company hired a total of 437 new, primarily part-time, workers.

Illustration 58 "Goša montaža" AD average number of employees by years 2003–2013



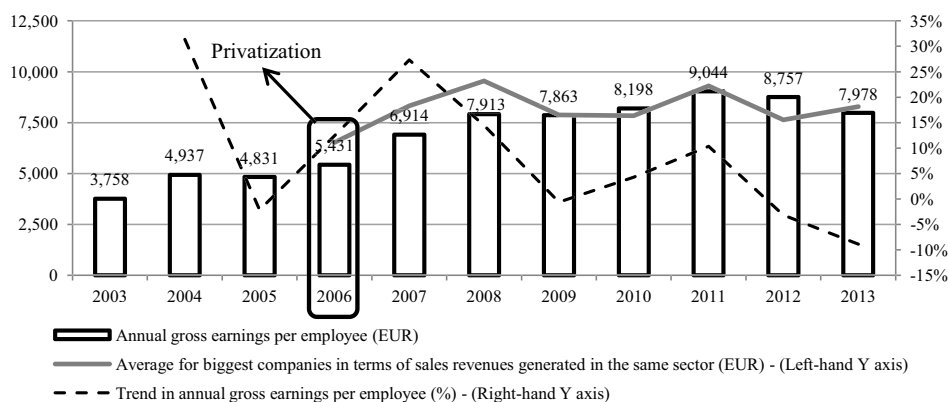
Source: "Goša montaža" Privatization Program, Velika Plana, Serbian Privatization Agency, February 2006, and Serbian Business Registers Agency

Given that this is a company typical of employees shareholding model, the question which needs to be asked is whether this has spurred the growth of salaries and wages costs. In the business expenditure structure of "Goša montaža", from 2003 to 2006, the share of the cost of salaries and wages

¹⁷⁴ On the day of the last control carried out at the Company – April 12, 2011, there were 868 employees, of whom 770 were full-time employees. The report on control of performance of contractual obligations by the subject of privatization – "Goša montaža" AD Velika Plana, dated November 15, 2006; January 24, 2007; June 26, 2007; November 23, 2007; May 8, 2008; February 12, 2010; December 10, 2010; and April 12, 2011.

averaged 48.6%, and up to 2005, there had been no significant increase of the share of these costs in the Company's operating expenses. In 2006, the share of salaries and wages in the Company's business expenditure rose to 55.3%.¹⁷⁵ From 2007 to 2013, the share of salaries and wages in operating expenses stood at on average 47.0%, but there were considerable swings over the years. The growth of the total amount of gross salaries and wages recorded a significant leap after privatization, and in 2012 it totaled about EUR 8 million. However, *the growth of gross salaries and wages per employee was commensurate with the Company's productivity indicator trend, except in 2013.*

Illustration 59 "Goša montaža" AD annual amount of gross earnings per employee by years 2003–2013 (EUR)

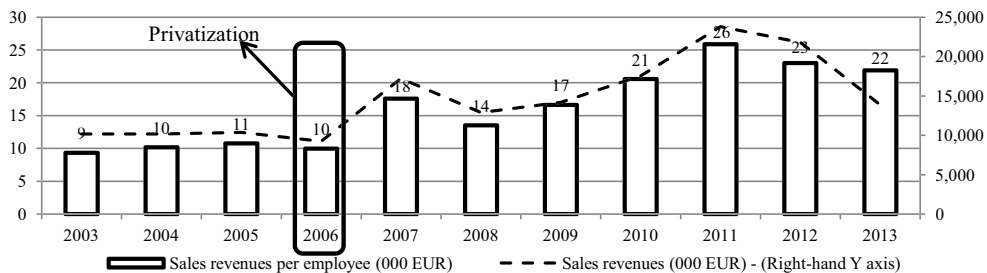


Sales revenues per employee in the post-privatization period, from 2007 until 2011, except for 2008, were conducive to both a reduction of the number of employees and products and services sales revenue growth. Sales revenues in this period grew annually by 26.1% on average, while the average number of employees in 2011 was 6% lower than the Company's head count

¹⁷⁵ In 2007, despite the annual growth of the cost of salaries and wages of 34.4%, its share in business expenditure was reduced to 41.8% due to a considerable increase in the cost of raw materials in the same year of 83.1%, and a consequently high rise in operating expenses of 77.9%. The considerable increase in the cost of materials in 2007 occurred as a result of higher business volumes. In 2008, the share of the cost of salaries and wages in overall operating expenses rose to its highest level in the analyzed period totaling 61.9%. This was the result of an annual increase in the cost of salaries and wages by 11.7% and a decline in operating expenses in 2008 by 24.7%. Relatively high shares of the cost of salaries and wages in operating expenses of 58.9% was also recorded in 2009, but in the following years it dropped to an average of 41.7%. Once again a significant increase in the cost of salaries and wages was registered in 2011, when these expenses were higher by 18.9%. In addition to the growth of employees' average salaries and wages, an increase in the workforce size in 2007 and 2011 by 5.6% and 7.7%, respectively, contributed to the rise in costs of salaries and wages.

in 2007. The 2011–2013 period was characterized by a fall in the Company's productivity due to, above all, considerably reduced business activities and, consequently, lower sales revenues. This statement is further corroborated by the fact that, despite a significant reduction in the workforce size in 2013, "Goša montaža" AD recorded sales revenues per employee indicators similar to those achieved in the previous year.

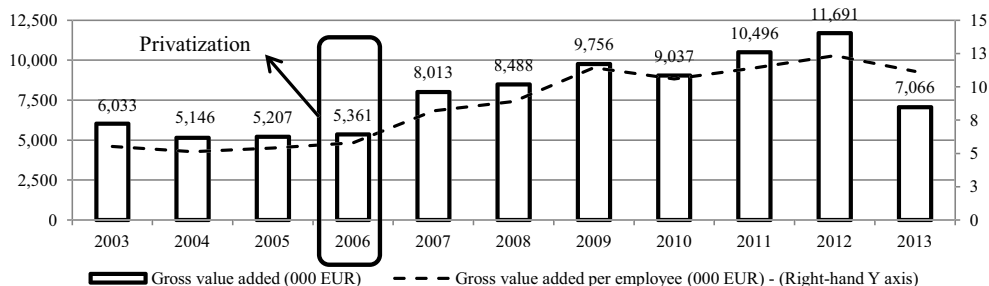
Illustration 60 "Goša montaža" AD sales revenues per employee and sales revenues 2003–2013



Source: Author's calculations

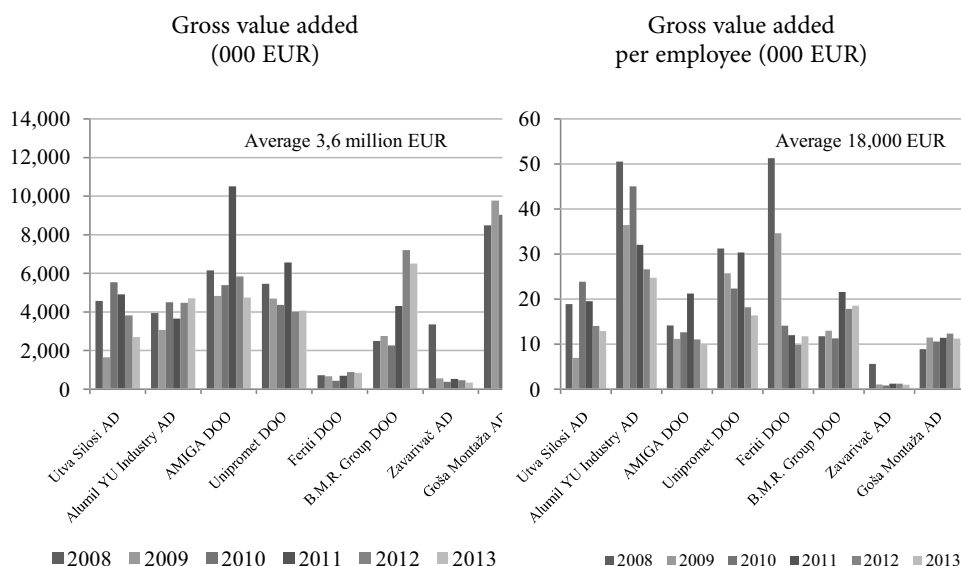
Gross value added generated by "Goša montaža" AD was constantly growing after the Company's privatization. It grew from EUR 5.4 million in 2006 to EUR 11.7 million in 2012. The principal driver behind GVA growth in the 2008–2013 period was the Company's higher levels of business activity. GVA indicator value per employee in the analyzed period was stable hovering on average at around EUR 11,000. In 2013, due to a slump in the Company's business activities, both indicators recorded considerably lower values.

Illustration 61 "Goša montaža" AD GVA and GVA per employee 2003–2013



Source: Author's calculations

Illustration 62 Gross value added and gross value added per employee for the biggest companies in terms of sales revenues in the sector of metal constructions and construction parts manufacturing 2008–2013



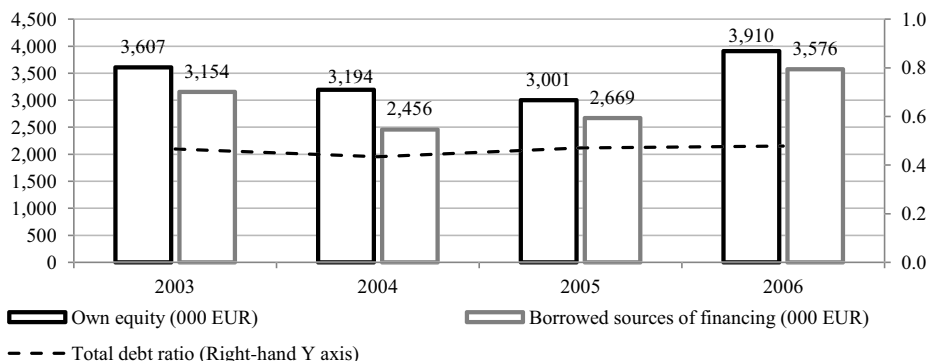
Source: Serbian Business Registers Agency

In all the years of the analyzed period, “Goša montaža” AD generated GVA above the median value for the biggest companies in terms of sales revenues in the sector of metal construction and construction parts manufacturing. However, taking into account the newly generated GVA per employee, “Goša montaža” AD was registering values below average in all the years of the analyzed period. A possible explanation for the disparity between total GVA and GVA per employee could be the Company’s insistence on preserving employees’ jobs. In addition, this disparity points to the fact that “Goša montaža” AD will most likely have to implement new business reorganization measures in the forthcoming period.

4.1.6. Financial restructuring

The Company did not incur short-term financial liabilities, i.e. short-term liabilities, hence long-term liabilities with 42.8% and business-related liabilities with 38.3% had the biggest share in the structure of borrowed sources of financing. Total debt ratio values in the pre-privatization period, from 2003 to 2006, averaged 0.5.

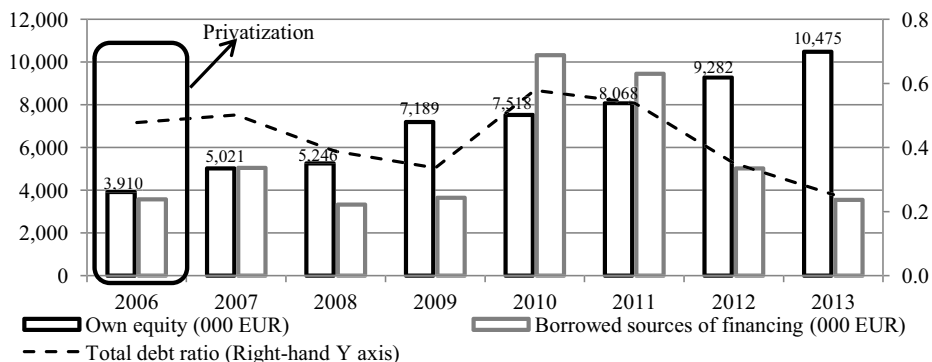
Illustration 63 “Goša montaža” AD debt levels on December 31, 2003–2006



Source: Author's calculations

After privatization, “Goša montaža” AD recorded significant debt growth in late 2010, which was due, above all, to a considerable rise in business-related liabilities. These liabilities grew from EUR 1.6 million in late 2009 to EUR 8.8 million in late 2010. In the subsequent years, the Company's total debt fell as the business-related liabilities declined. *In late 2013, “Goša montaža” AD did not have any interest-related liabilities.*

Illustration 64 “Goša montaža” AD debt levels on December 31, 2007–2013



Source: Author's calculations

4.1.7. Relationship between the company and local self-government

In the case of “Goša montaža”, we have not succeeded in obtaining the data on contributions, i.e. the Company's share of local governments' budget revenues (Velika Plana and Smederevska Palanka) in terms of local budgets' revenues generated on account of the Company's business opera-

tions.¹⁷⁶ However, given the large number of employees and relatively successful business, one may well assume that “Goša montaža” business operations have had a significant impact on the local governments’ budget.

Under the Privatization Act, a total of 14 companies were privatized in Velika Plana by public auction. Velika Plana has a somewhat higher percentage of successful privatizations by auction relative to the average since only three out of 14 privatization contracts have been cancelled. In two out of the three failed privatizations bankruptcy proceedings have been initiated. An additional eight socially-owned companies have fallen into bankruptcy after the intention to privatize them was abandoned, while two more companies remain unprivatized. In 2012, there were 7.212 employed persons in the municipality of Velika Plana, with an unemployment rate of 35.3%. This meant that “Goša montaža” was one of the key employers (but we should bear in mind that some of employees worked on the territory of the Smederevska Palanka municipality).

4.2. CASE STUDY OF “ZAVARIVAČ” AD VRANJE

4.2.1. *Background*

“Zavarivač” AD (hereinafter referred to as the Company or “Zavarivač”) was established in 1970 as a Specialist Welding Company (SZP) “Zavarivač” by a decision passed by the Municipal Assembly of Vranje. At its inception, the Company employed 23 workers and provided only welding services. In its early years, “Zavarivač” grew rapidly, hence a large increase in its workforce size and formation of so-called “accounting units” throughout the former Yugoslavia. In the 1980s, “Zavarivač” grew into a company with 1,236 employees working on projects both within the country and abroad.¹⁷⁷

“Zavarivač” business operations deteriorated in the early 1990s. Disintegration of the country, loss of markets and, consequently, shrinking business activity forced the Company into bankruptcy in 1992. Bankruptcy proceedings were conducted under the then Enforced Settlement, Bankruptcy and Liquidation Act¹⁷⁸ and completed in June 1996 by the Decision on Approval of Enforced Settlement regulating the manner in which claims against the debtor were to be settled. As part of the enforced settlement procedure, two creditors, of which one was “Jugobanka” d.d. Belgrade, converted their outstanding claims into ownership stakes in the Company. Four years on, the creditors-turned-owners withdrew from “Zavarivač” and the entire equity of the Company was registered as socially-owned.¹⁷⁹

176 We contacted the Company on several occasions in relation to this matter.

177 Information Memorandum SZP “Zavarivač” AD Vranje, Serbian Privatization Agency, September 2007.

178 “Enforced Settlement, Bankruptcy and Liquidation Act” (“SFRY Official Gazette”, no. 84/89 and “FRY Official Gazette”, nos. 37/93 and 28/96).

179 As part of the procedure, SZP “Zavarivač” changed its status from a socially-owned to a limited liability company. In February 2000, under the Contract on Change of the Com-

The “Zavarivač” *privatization was carried out in two stages*. In late 2000, *the Company started a privatization procedure under the provisions of the Ownership Transformation Act*. In the first round of “ownership transformation”, around 60% of socially-owned equity was distributed free of charge. After the first phase, there were no significant changes to the ownership structure, while trading in the Company’s shares was made possible as late as April 2007. The second round of privatization was carried out by *sale of the remaining portion of the socially-owned equity at a public tender*. The Company was eventually sold after several delays and failed attempts to do so. *“Zavarivač” AD was privatized (for the second time) in late 2008 by a consortium* consisting of the “Galeb Group” d.o.o. as the majority consortium stakeholder and another three other legal entities as well as 16 individuals. In addition to the stocks of the Share Fund, the new owners managed to acquire a part of the employees’ shares, and thus form a majority stake in the Company. The new privatization of “Zavarivač” coincided with the outbreak of the economic crisis and was plagued by many organizational and financial problems. Only two years later, the privatization contract was cancelled which brought “Zavarivač” back into the fold of the Privatization Agency. As of June 2011, the Company has been undergoing restructuring, carrying out sporadically its core business activity, but only on the domestic market and whilst incurring considerable.

“Zavarivač’s” core business activity is metal construction and construction parts manufacturing. The Company manufactures and installs steel constructions and construction parts, and it also produces heating boilers of all types. “Zavarivač” has five production-related and administrative sectors. The manufacturing process takes place at three production facilities in Vranje: a special equipment facility, at steel and aluminum locks facilities.¹⁸⁰

The Company has relatively new machinery and manufacturing facilities as well as other buildings with a surface area of over 28,000 m², and it also has the necessary welding certificates.¹⁸¹ Key problems plaguing “Zavarivač” have been inadequate workforce structure, high energy consumption and high debt levels including considerable enforceable employees’ claims against the company resulting from successful litigation.

In late 2013, “Zavarivač” was in debt in excess of EUR 13.5 million. At the time, the Company had a negative net equity and operated below the

pany’s Founder, “Interjug” d.d. withdrew from the Company and relinquished its right to compensation on account of its ownership stake in the Company, while “Jugobanka” d.d. Belgrade, pursuant to the same contract, withdrew from the Company’s ownership structure following a payment for the restated value of the bank’s stake in the Company on the date of its withdrawal.

180 The special equipment facility produces heating boilers, processing equipment and steel constructions, while the processing of sheet metal, steel profiles and pipes as well as aluminum pipes takes place at the other two facilities. Ibid.

181 The Company has DIN 18800-7 class E certificate as well as DIN EN ISO 3834-2 certificate (information collected at the Company’s web site: <http://www.zavarivac.rs/> (Site visited: September 1, 2014).

profitability threshold. Nonetheless, if the issues of outstanding debt and excessive workforce were to be resolved, given an existing and sufficient level of demand, the Company might become viable. If the conditions for normal business operations were met, and with a proviso that the debt and redundancy problems were sorted out, according to the estimates, the Company would then need an investment in equipment to the tune of about EUR 1 million as well as an additional investment worth EUR 300,000 in working capital.¹⁸² “Zavarivač” owns landed property (around 14 hectares of land in Vranje and Preševo valued at EUR 2.5 million) and facilities outside the location where it is headquartered (estimated to be worth EUR 600,000 worth). Following the decision on restructuring, no investors showed any interest in the Company. Therefore, if the debt and redundancies problems are not resolved, “Zavarivač” will most likely end up in bankruptcy.

Finally, “Zavarivač” has outstanding debts to the city. Moreover, *as of the date of the decision on restructuring, the company has not paid a single dinar into the local government’s budget*. The amount of levied but unpaid tax on salaries and wages totaled about RSD 50 million in 2014. This data effectively shows that the soft budget constraint, as a framework within which “Zavarivač” is operating, does not pertain solely to the Tax Administration and other state bodies, but is also applicable locally. In addition, the “soft budget constraint” regime persisted even after the first wave of privatization (non-payment of contributions). After the Company was provided with protection thanks to the decision on restructuring, the “soft budget constraint” became a *sine qua non* for the “Zavarivač” business operation.

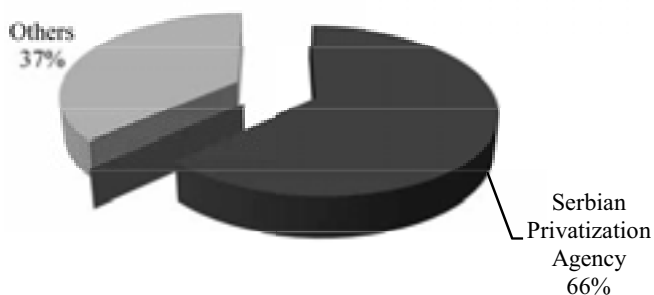
Table 34 Background information on SZP “Zavarivač”
AD Vranje – undergoing restructuring

Full business name:	Specialist Welding Company Zavarivač AD, Vranje – undergoing restructuring
Abbreviated business name:	SZP Zavarivač AD Vranje – undergoing restructuring
Company code:	07205180
Registered address:	Vranje
Standard Industrial Classification (SIC) Code:	Metal constructions and construction parts manufacturing (2511)
Legal form:	Joint-stock company
Status:	Active company
Number of employees (2013):	352
Privatization/Termination	2000 (insider privatization) and 2008 (public tender), 2011 (termination of privatization and decision on restructuring)

Source: Serbian Business Registers Agency

182 Factis Report on the Portfolio of the Privatization Agency.

Illustration 65 “Zavarivač” AD Equity ownership structure on August 28, 2014



Source: Central Securities Register

4.2.2. Business operations prior to privatization¹⁸³

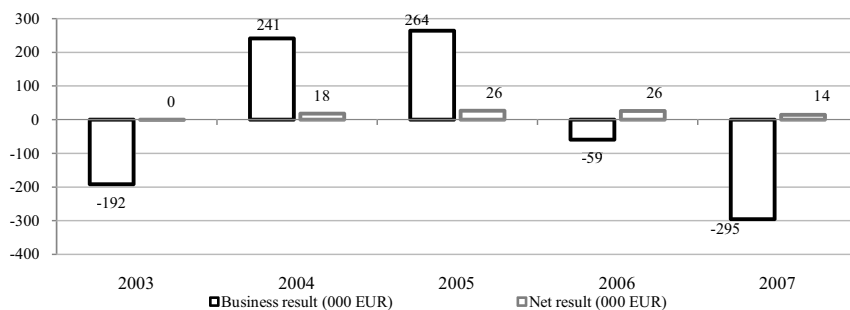
According to financial reports, in the pre-privatization period, from 2003 to 2007, “Zavarivač” had been posting a token net profit (although positive net result on average totaled only EUR 17,000 annually).¹⁸⁴ Despite significant fluctuations in operating result values in the analyzed period, “Zavarivač” has always disclosed positive net results, albeit operating results in the pre-privatization period varied considerably. In 2004 and 2005, the Company’s operating results were positive, but turned negative prior to the sale of the remaining socially-owned equity in 2007 due to an increase in the cost of materials and the cost of salaries and wages. Unlike 2004 when the Company was in the black thanks exclusively to a reduction in operating expenses,¹⁸⁵ in 2005 the Company generated profit but this was not down to growing sales. Instead, this was due to increasing revenues on account of an increase in the value of inventories of work in progress and finished products.¹⁸⁶

¹⁸³ In this segment we will limit our analysis to the period prior to privatization of the remaining socially-owned equity by public tender.

¹⁸⁴ Information Memorandum SZP “Zavarivač” AD Vranje, Serbian Privatization Agency, September 2007.

¹⁸⁵ These changes are denominated in EUR. Given significant depreciation of the RSD exchange rate with respect to EUR, the conclusions inferred from the analyzed changes denominated in RSD differ if the changes are denominated in the EUR. In RSD, the Company’s operating expenses in 2004 remained at the same level as in 2003, whereas operating revenues in the same period grew by 10.9% thanks, above all, to a significant increase in sales revenues of 13.4%.

¹⁸⁶ Disclosed business profits in 2005 were not generated by growing business activities, but resulted from an increase in the value of inventories of work in progress and finished products and services, which rose 5.9 times year-on-year and constituted 30% of the Company’s revenues in 2005. Despite the growth in products and services sales revenues in 2006 of 49.6%, due to declining revenues on account of the increase in the value of

Illustration 66 “Zavarivač” AD Operating and net results 2003–2007

Source: Information Memorandum SZP “Zavarivač” AD Vranje, Serbian Privatization Agency, September 2007

*Table 35 “Zavarivač” AD Trend
in production output volumes 2003–2006*

Product group	Unit of measurement	2003	2004	2005	2006
Steel constructions	tonne	1,695	1,680	1,800	2,800
Processing equipment	tonne	115	116	280	320
Roofing works and locks	m ²	6,000	6,500	8,000	10,000
Heating boilers	pcs	1,823	1,444	1,000	350
Services	hour	300,941	277,446	300,000	350,000

Source: Information Memorandum SZP “Zavarivač” AD Vranje, Serbian Privatization Agency, September 2007

In the pre-privatization period, “Zavarivač” recorded a growth in its production output volumes. This increase in its production output volumes reflected favorable conditions in this industry sector so that in late 2006 the Company’s production output volume was 1.5 times greater than in 2003.¹⁸⁷ The companies from the industry sector, particularly the metalworks sector, were the largest clients of “Zavarivač”. Manufacturing of steel constructions had the biggest share in the overall production output of the Company with

inventories, which dropped from EUR 1.6 million to EUR 259,000, and due to a considerable growth in the cost of materials and the cost of salaries and wages, “Zavarivač” was in the red in 2006.

187 “Zavarivač” AD business operation falls in line with the procyclical character of the industry sector. In the given period, Serbian industry production output grew by 14.8%, while the processing industry at the same period grew 16.3%.

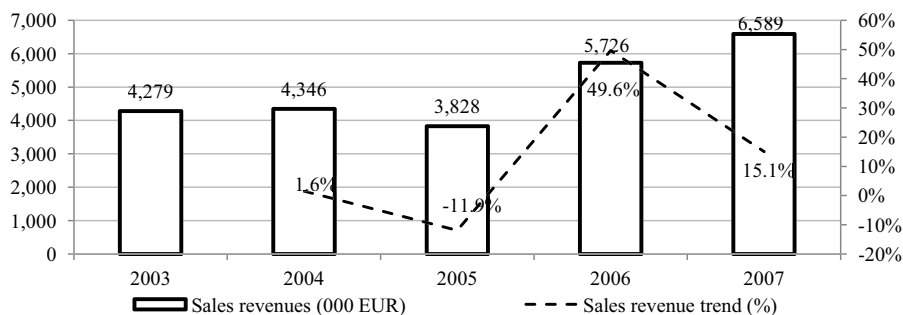
an average mark of over 50% from 2003 to 2006.¹⁸⁸ The Company's average capacity utilization rate in 2006 was 72.33%.¹⁸⁹

Table 36 "Zavarivač" AD Capacity utilization rates 2003–2006

Manufacturing facility	Unit of measurement	Installed capacity	Actual capacity	2003	2004	2005	2006
Special equipment facility (PSO)	tonne	3,000	2,500	70%	80%	90%	92%
"Čelik" facility	tonne	3,000	2,500	80%	90%	90%	95%
Aluminum locks facility	tonne	65	40	15%	20%	80%	30%

Source: Information Memorandum SZP "Zavarivač" AD Vranje, Serbian Privatization Agency, September 2007

Illustration 67 "Zavarivač" AD Sales revenues 2003–2007 (000 EUR)



Source: Information Memorandum SZP "Zavarivač" AD Vranje, Serbian Privatization Agency, September 2007

From 2003 to 2007, "Zavarivač" AD sales were growing due, above all, to an increase in foreign markets sales. In this period, the Company registered a minor drop in sales revenues (denominated in EUR) only in 2005 because of declining sales on the domestic market and significant depreciation of the RSD against the EUR.¹⁹⁰ In 2006 and 2007, the Company's sales recovered thanks, above all, to a considerable sales growth on foreign markets.¹⁹¹

188 Information Memorandum SZP "Zavarivač" AD Vranje, Serbian Privatization Agency, September 2007.

189 Ibid.

190 Median value of RSD against EUR in 2005 had been lower by 14.2%.

191 In 2006, the Company's biggest foreign customer was "Arens" Twist from Germany with over a 40% share in the Company's receivables, whereas on the domestic market "Zavarivač" had a diversified customer base so that the six biggest domestic clients held

*Table 37 “Zavarivač” AD Sales revenues
structure by markets 2003–2006 (000 EUR)*

Product group	2003	2004	2005	2006
Domestic markets	4,279	4,289	3,353	3,317
Foreign markets	0	57	475	2,409
Total	4,279	4,346	3,828	5,726

Source: Information Memorandum SZP “Zavarivač” AD Vranje, Serbian Privatization Agency, September 2007

“Zavarivač” investments in buildings/facilities were last realized in late 2000 and 2001, when a storage facility for finished products with a surface area of 470 m² was built. Most buildings owned by the Company had been erected in the late 1970s and 1980s as well as the early 1990s. The last investment in equipment was made in the period from 2004 to late 2006, however, the majority of the Company’s equipment had been acquired in the 1970s and early 1980s.¹⁹²

4.2.3. Privatization

Despite the growth in sales and capacity utilization, the lack of operational restructuring, lack of a solution to the excessive workforce problem and other measures suggested that “Zavarivač” was plagued by grave problems on the eve of the privatization. In late 2005, the Privatization Agency decided to sell the remainder of the socially-owned equity (stocks in possession of the Share Fund – 30.2% and Pension and Disability Insurance Fund (PIO) – 10%) by public tender. In late 2007, a public call for tendering bids for 40.2% of “Zavarivač” (socially-owned) shares was put out. Under the conditions stipulated in the public call, potential bidders were obliged to put in bids for all the Company’s shares, including those held by other stockholders (59.8%). After the ranking of bids, the Share Fund was to invite other stockholders to add their shares to the shares from the Share Fund portfolio. Austrian company “Palfinger Gmbh” was the only potential bidder which purchased the tendering documentation, but refrained from putting in an offer. The tender failed. We may speculate at length about the potential bidder’s reasons to back away, but the most likely explanation would be that restructuring costs would be too high given that no operational or financial restructuring had been carried

a 32% cumulative share in the overall amount of the Company’s receivables. The biggest domestic customers of the Company in 2006 were “Vlasotince” Municipal Assembly, “Jeep Comerc” Belgrade, “Alfa Plam” Vranje, “Preduzeće za puteve Vranje” (Road construction and maintenance company), “Mag Wirtgen” Belgrade and “Simplo” Vranje. (*Information Memorandum, op.cit.*)

192 Information Memorandum, op.cit.

out as a preparation for the privatization as well as that the potential bidder was reluctant to take on the risk of acquiring a minority stake.

The decision to sell the remaining socially-owned equity by public tender in conjunction with an invitation to other shareholders to participate is a reasonable option, bearing in mind the necessity of implementation of restructuring measures, as well as of new investments for which a new (majority) owner was needed. In addition, privatization provided an opportunity to reduce a portion of liabilities owed to state creditors. The reduction in liabilities was significant, but not as large as in the case of “Goša montaža”, and amounted to 21% of total Company’s liabilities, i.e. EUR 562,000, whereby the total debt would fall from EUR 2.67 million to EUR 2.11 million.

An important difference with “Zavarivač” compared to other companies in the Privatization Agency portfolio was that in the latter there was a mechanism in place to impose at least some restructuring measures (e.g. a decrease in the number of employees along with severance pay) whereas this was not the case with “Zavarivač” as a company with minority socially-owned equity. The Company, i.e. the management and the employees, had no incentive to implement the measures of operational restructuring. The purchase of such a subject of privatization always brings along a risk due to unresolved issue of redundancies, legal property-related problems and lack of both operational and financial restructuring measures.

“Zavarivač” had a significant problem with respect to property-related issues and the cost of legal disputes where it was the defendant. Many buildings were not registered and documentation on property ownership as well as building and technical documentation were also lacking. The Company was involved as a defendant in many lawsuits potentially running the risk of incurring additional liabilities of USD 460,000. At the time of privatization, some court rulings had already come into effect and the enforcement of the court rulings was delayed by the decision on restructuring.

After the first failed attempt and several extensions of deadlines for the sale the remaining socially-owned equity, the Company was finally sold on December 30, 2008, to a consortium consisting of four legal entities and 16 natural persons. The consortium and representatives of the Share Fund of the Republic of Serbia and the Privatization Agency signed the Contract on Sale of 31,066 shares owned by the Share Fund and the Pension and Disability Insurance Fund (PIO), whereby the consortium became the owner of 40.2% of “Zavarivač” AD total equity. The price per share was EUR 25.20, while the price for 40.2% of the Company’s equity was EUR 782,863.

The contract of sale stipulated the obligation of the buyer to put in an offer for all the remaining Company’s shares, given that the plan was for the Share Fund to invite, after the signing of the contract, all the remaining individual stockholders to add their shares to the shares from the Share Fund portfolio. Pursuant to the obligation mentioned above, the consortium purchased additional shares thereby becoming the majority owner (63%), out of

which “Galeb Group” d.o.o. held 52% of the Company’s equity. Overall, the consortium spent about EUR 1 million to acquire 63% of “Zavarivač” AD equity.¹⁹³ The purchase price partly reflected many risks brought by the acquisition of majority stake in such a company. Except for the stated purchase price and a statement on the purchase of all shares on offer, the third key element of the contract was unconditional acceptance of a minimum of obligations related to the social program.

New majority owner “Galeb Group” d.o.o. was established in 1977 first as a workshop in the field of electrical engineering and electronics, but then as a company selling and servicing industrial electrical tools and equipment (welding equipment, compressors, metal cutting and shaping machines). The buyer is also the biggest domestic manufacturer of fiscal cash registers and terminals for remote reading of data from fiscal devices, and it also sells railroad signaling systems and GPS systems, and is involved in recycling and processing metal and plastic packaging.¹⁹⁴ In the mid-2000s the buyer ranked among the one hundred most profitable companies in Serbia, but in the past several years it has been plagued by serious financial difficulties partly brought about by the failed privatization of “Zavarivač”.

4.2.4. *Business operations and key events after privatization*

After the privatization, the “Zavarivač” business operations drastically deteriorated. This is, above all, reflected by a constant decline in sales and manufacturing output. “Zavarivač” AD annual products and services sales revenues in 2009 slumped by 32.1%, and in 2010 by 42.4%, so that 2010 sales revenues were at the level of about 40% of the 2008 sales revenues. Following a significant production output growth in the year preceding the privatization, the production output volumes in the post-privatization period were dropping at an annual rate of 42.4% (e.g. the production output of steel constructions stood at only 15% of the output in 2007).

The first factor which was instrumental in worsening operating results was the economic crisis as *the buyer took over control of the Company in late March 2009 when the fallout from the crisis was the most severe.*¹⁹⁵ Except for the economic crisis, other reasons for the considerable decrease in production output volumes were increasingly more conspicuous internal problems within the Company such as its poor financial position, redundancy issue and poor relations between the trade unions and new owners. This conflict came to a head in April 2010, when there was no production at all due to a strike.¹⁹⁶

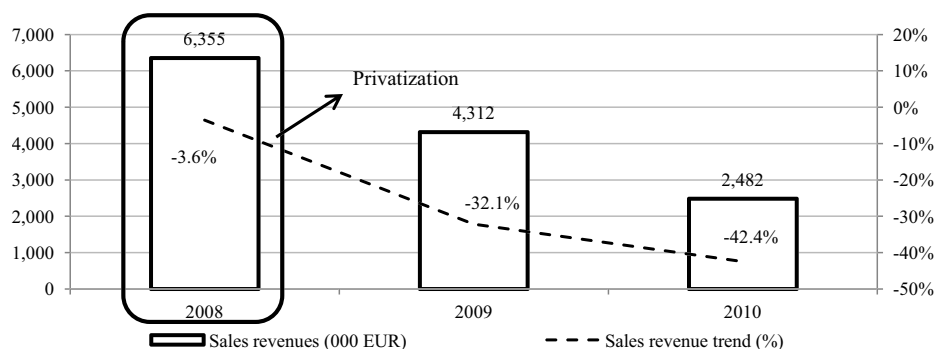
193 Interview with Mr. Veselinović, owner of “Galeb Group” d.o.o.

194 Information collected from the corporate web site of the buyer: <http://www.galeb.com/> (Site visited: June 15, 2014).

195 Industrial production in the Republic of Serbia in 2009 dropped by 13.5%, whereas the processing industry’s output declined by 18% relative to 2008 levels.

196 Report on the performance of obligations from the contract on sale of shares from the portfolio of Share Fund SZP “Zavarivač” AD Vranje by public tender, dated June 23, 2011.

Illustration 68 “Zavarivač” AD Sales revenues 2008–2010 (000 EUR)



Source: Serbian Business Registers Agency

Table 38 “Zavarivač” AD Production output volume trend for steel constructions 2007–2010 (tones)

Year	2007	2008	2009	2010
Steel constructions	4,138	3,577	1,972	616

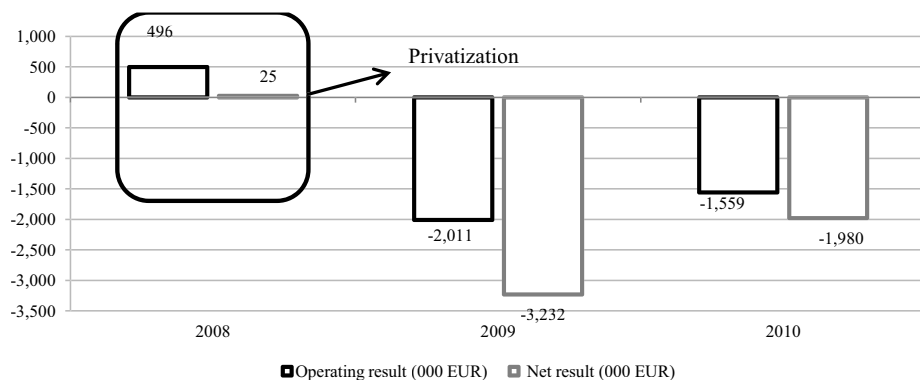
Source: Report on performance of obligations from the contract on sale of shares from the portfolio of Share Fund SZP “Zavarivač” AD Vranje by public tender, dated June 23, 2011, and brochure (teaser) Zavarivač DIL Inženjering Konsalting DOO, April 2013

Due to unfavorable market conditions and grave internal problems, the Company was recording increasingly worse operating results after the privatization so that in 2009 and 2010 “Zavarivač” posted losses of EUR 2 million and EUR 1.6 million, respectively. A significant growth in financial expenses resulting from the Company’s increasing debt and a rise in other expenses in 2009 contributed considerably to the net business loss of EUR 3.2 million. In 2010, due to high financial expenses and business loss, “Zavarivač” was in the red to the tune of EUR 2 million.

“Zavarivač” has presented an unrealistic financial situation prior to privatization. According to the buyer, soon after the takeover of “Zavarivač”, it was found that there were *significant discrepancies between the real situation of the Company and the official business records and information and data presented in the tendering documentation*.¹⁹⁷ In order to see the bigger picture, the new owner hired an independent auditor to check the accuracy of the financial reports and made key personnel changes in the Company.

197 Interview with Mr. Veselinović, owner of “Galeb Group” d.o.o.

Illustration 69 “Zavarivač” AD Operating and net results 2008–2010 (000 EUR)



Source: Serbian Business Registers Agency

The independent auditor found that the 2007 outstanding receivables pertaining to foreign customers and worth EUR 1 million could not be collected, that the Company suffered from a serious cash flow problem, and that the loans raised to finance export deals could not be serviced.¹⁹⁸ On top of that, it was established that there were deficits in inventories of unfinished and finished products. When all this was factored in, an entirely different picture of the Company's financial position and business operations prior to privatization emerged. Thus, the buyer indirectly admitted its *failure to carry out adequate due diligence procedure* as part of the preparations for the purchase of majority stake in the Company. However, we should also mention that the auditors were not as adamant in their report with regard to the correction of values pertaining to discrepancy in outstanding claims against clients.

One of the consequences of unrealistic disclosure of the Company's financial situation was a correction to the Company's 2008 operating revenues figure with respect to the entire sales revenue generated by the increase in value of inventories of work in progress and finished products of EUR 1.4 million.¹⁹⁹ According to the buyer, the independent auditor established that in 2008 “Zavarivač” AD incurred a loss of EUR 2.36 million, while the tendering documentation and the Company's business records disclosed positive operating results for 2008. In addition, it was found that *contributions*

198 Comments enclosed with adjusted financial reports are available at the following address: <http://www.auditor.rs/klijenti/zavarivac/Napomene%20uz%20korigovane%20finansijske%20izvestaje%202008.pdf> (Site visited: July 20, 2014). According to the auditor's report, inventories were overvalued by RSD 130 million, unfinished products – by RSD 11.5 million, and receivables due from abroad – about RSD 70 million.

199 Report on performance of obligations from the contract on sale of shares from the portfolio of Share Fund SZP “Zavarivač” AD Vranje by public tender, dated June 23, 2011.

and taxes on salaries and wages had not been paid for several years running, which totaled EUR 1.7 million in outstanding dues on this account.²⁰⁰ This certainly raises the issue of responsibility of individuals preparing the documentation as well as of persons in charge of business records and auditors. However, there is also the issue of whether the buyer conducted an appropriate analysis of “Zavarivač” AD business operations prior to its decision to purchase the Company.

According to the “Galeb Group” owner, it was necessary to provide EUR 4 million in order to ensure the continuity in business operations and payment of outstanding dues from the pre-privatization period. As regards technology, the situation at “Zavarivač” AD was exceptionally bad, according to the buyer, and significant investments in equipment were badly needed. At that point, the buyer’s estimate was that an additional EUR 4 million was needed to invest in equipment, working capital, social program and settlement of EUR 1.7 million in outstanding dues on account of unpaid contributions and taxes on salaries and wages before the privatization.

In order to raise a portion of the funds required, the buyer requested and was granted a loan by the Development Fund of the Republic of Serbia worth RSD 250 million (about EUR 2.4 million). This loan’s purpose was to purchase necessary equipment from the buyer itself – “Galeb Group”. Formally, the loan beneficiary was “Galeb Group”, given its better financial standing, while “Zavarivač” assets were mortgaged.²⁰¹

Having taken over the Company, the buyer discovered a significant surplus of employees as well as the fact that a small number of employees had necessary certificates required for this type of work either domestically in the country or abroad. Out of 420 persons on the Company’s payroll, among whom many were employed in the Company’s administration, only 30 workers (welders) could qualify for international certificates necessary for work abroad as well as additional 30 workers who could work in Serbia using already outdated the manual metal arc welding (or shielded metal arc welding) method. *The buyer’s estimate was that 150 employees at that point should be made redundant, which led to negotiations with trade unions on the issue of redundancies.*²⁰²

The buyer failed to reach an agreement with trade unionists on redundancies which resulted in a 2010 strike and the inability of the Company to deliver on already closed business deals. Under the privatization contract, it was not possible to enforce redundancies for a 12-month period after privatization (until July 3, 2010) unless a different agreement was reached with the Company’s representative trade union. Trade unionists proposed that the employees to be made redundant be paid severance packages to the tune of

200 Interview with Mr. Veselinović, owner of “Galeb Group” d.o.o.

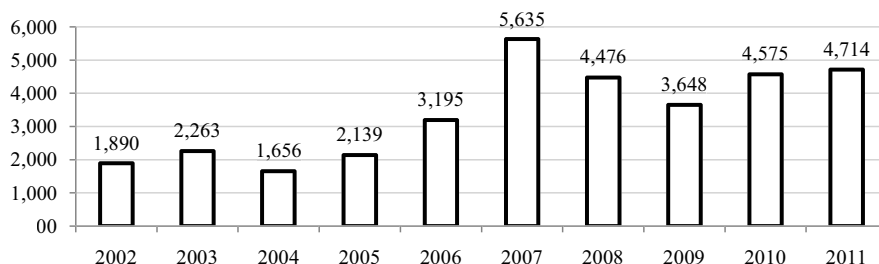
201 Ibid.

202 Ibid.

EUR 500 for each year of the given employee's length of service, pursuant to the agreement signed with the Company's management prior to privatization.²⁰³ The proposal put forth by Mr. Veselinović, the "Galeb Group" owner, was that the Company could raise EUR 2 million from banks to disburse severance pay, but this amount would provide for considerably lower severance pay than that demanded by the trade union.²⁰⁴

Later on in the negotiations, trade unionis lowered the requested amount per year for severance pays from EUR 500 to EUR 300, which, in the "Galeb Group" owner's view, was still a large expense for "Zavarivač" AD. To illustrate the point, *the amount demanded by the trade union was three times higher than the one stipulated in the state funded redundancy program.*²⁰⁵ Given the employee age structure, the cost of an average severance pay at "Zavarivač" would be above average for companies undergoing restructuring. Bearing in mind that the average age of workers was 54, the Company could not agree to such a proposal since the average total amount of the severance pay would range between EUR 6,000 and EUR 10,000.

Illustration 70 Average severance pays at companies undergoing restructuring and preparations for privatization (EUR)



Source: Author's calculations based on the Privatization Agency data

According to the buyer, the trade union was presented with the final offer of EUR 100 to EUR 130 per year of the length of service, which was above the legally required amount. Trade unions declined this offer after which the bank withdrew EUR 2 million in loan intended for redundancies. In addition, the trade union denied its consent for severance pay to be disbursed to

203 Report on the extraordinary control of performance of obligations under the contract on sale of shares from the portfolio of the Share Fund – SZP "Zavarivač" AD Vranje by public tender, dated March 1, 2010.

204 Interview with Mr. Veselinović, owner of "Galeb Group" d.o.o.

205 Amendments to the 2013 decision presented the employees with an option to get EUR 300 per year of their respective length of service. See the Decision on redundancies in the process of streamlining, restructuring and preparations for privatization ("Official Gazette of the Republic of Serbia", nos. 64/2005, 89/2006, 85/2008, 90/2008 – corr., 15/2009, 21/2010, 46/2010, 9/2011, 6/2012, 63/2013 and 21/2014)

40 workers who wanted voluntarily to leave the Company.²⁰⁶ In early 2010, about 250 workers of “Zavarivač” AD went on strike demanding the payment of outstanding wages from August 2009 onwards as well as the bridging of gaps in their respective lengths of service with respect to contributions and taxes due. The strike went on for 66 days which was why a business deal with a thermoelectric plant in Germany fell through as the strikers would not allow the equipment to leave the factory grounds. As soon as the employees went on strike, all *the banks which had previously granted loans to “Zavarivač” AD declared these credits due for full repayment.*

In order to unblock the Company’s account and create conditions for regular business operation, the then management of the Company earmarked a portion of the funds raised as a loan from the Development Fund of the Republic of Serbia. Therefore, the Development Fund loan was not used as intended, i.e. it was not used for the originally stated purposes due to the impasse reached in negotiations between the buyer and the representative trade union.²⁰⁷

Failing to reach an agreement with the trade unionists, the buyer proposed that the social program be amended so that the redundancy program could be implemented without prior consent on the part of the representative trade union. At the same time the trade union representatives requested the Privatization Agency to carry out an extraordinary inspection due non-performance of contractual obligations on the part of the buyer, which indeed was conducted on March 1, 2010.²⁰⁸ As part of its inspection, the Privatization Agency found that “Zavarivač” was not paying wages regularly, that wages were not being calculated in accordance with agreed rates, that the owner was avoiding cooperation with the trade union, that the number of employees’ working hours had been reduced on account of the “percentage of the production quota achieved” (although there was no rulebook on quotas in place, as well as many other breaches).²⁰⁹

At the time of signing of the privatization contract, “Zavarivač” AD was late with the payment of 1.5 months of wages, but on March 1, 2010, the Company owed 5 monthly wages to its employees.²¹⁰ On top of that, ac-

206 Interview with Mr. Veselinović, owner of “Galeb Group” d.o.o.

207 Ibid.

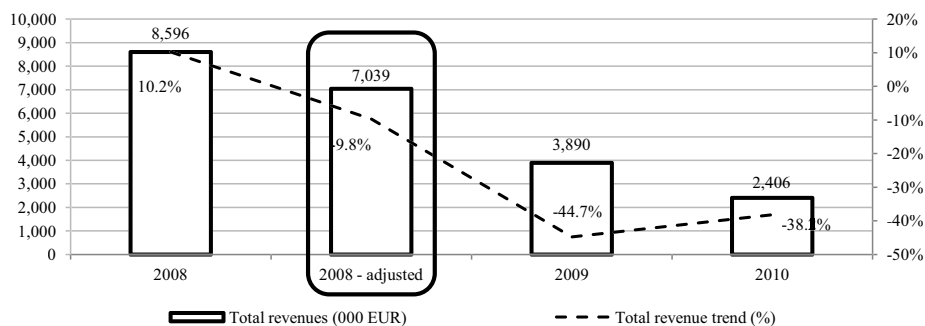
208 The Privatization Agency’s extraordinary control established, *inter alia*, that there was a suspicion of the buyer’s failure to observe the Labor Act, which was also subsequently established in the Ministry of Labor’s inspection conducted on February 19, 2010. (Report on the extraordinary control of performance of obligations from the contract on sale of shares from the portfolio of the Share Fund – SZP “Zavarivač” AD Vranje by public tender, dated March 1, 2010).

209 As of January 8, 2010, the Company paid the second half of salaries and wages for July 2009 (Report on the extraordinary control of performance of obligations from the contract on sale of shares from the portfolio of the Share Fund – SZP “Zavarivač” AD Vranje by public tender, dated March 1, 2010).

210 <http://www.gradjevinarstvo.rs/VestDetaljiURL/Galeb-grupa-odustaje-od-privatization-fabrike-Zavariva%C4%8D-iz-Vranja.aspx?ban=810&vestid=1521> (Site visited: June 24, 2012).

cording to the trade union chairman, Mr. Dodić, the owner was not paying for sick leave, travel expenses, severance packages and jubilee awards over the course of the 3-year period after the privatization, hence the employees demanded of the Privatization Agency to cancel the contract with the new owner.²¹¹ In addition, certain irregularities pertaining to the obligation to ensure continuity in the Company's business operations were established, and this, along with the problem of the payments of salaries and wages, were the grounds for the cancellation of the privatization contract.

Illustration 71 "Zavarivač" AD Total revenues 2008–2010 with adjustment for 2008 total revenue



Source: Serbian Business Registers Agency

Under the privatization contract, the buyer took on an obligation to ensure within the next 16 months from the date of privatization (by early July 2010) a continuity in the production of standard metal products, apart from machines and devices. This effectively meant that the Company was to maintain in this period (or increase) the level of total annual revenues relative to those stated in the last annual financial report prior to privatization, i.e. the 2008 P&L report.²¹² Correction to operating revenues to the tune of EUR 1.4 million, as suggested by the independent auditor, was additionally relevant as it rendered the owner's contractual obligation to ensure continuity in business operations more difficult.

"Zavarivač" AD's total revenues from 2008 onwards have been continuously declining. The 2008 income statement reported a decrease in the adjusted value of total revenues by 9.8%, as well as an average drop of 41.4% for the next two years relative to the adjusted level of 2008 revenues. In 2009 and 2010, the new owner – "Galeb Group" failed to comply with its contractual obligation to ensure a minimal continuity in "Zavarivač" AD's business operations, i.e. to maintain at least the 2008 level of total annual revenues for the

211 http://www.b92.net/biz/vesti/srbija.php?yyyy=2011&mm=02&dd=12&nav_id=492402 (Site visited June 24, 2012).

212 Report on performance of obligations from the contract on sale of shares from the Share Fund SZP "Zavarivač" AD Vranje portfolio by public tender, dated June 23, 2011.

following 16 months. Allegations about the new owner's failure to ensure a minimal continuity of the Company's business operations were subsequently corroborated by the independent auditor. According to the auditor, in 2009, in addition to the existing projects, "Zavarivač" closed business deals worth EUR 744,000 and mostly delivered on its new contractual obligations, but this would eventually prove not to be enough. On top of that, the independent auditor stated that, in this respect, the buyer was fulfilling its obligations from the privatization contract within the scope of its abilities, but under the worsening conditions caused by the global economic crisis and changing market circumstances.²¹³

The buyer received warnings on several occasions from the Privatization Agency that there was a realistic threat of its failure to comply with the contractual obligations as well as that corrections were needed in order to meet all contractual obligations. To this end, the Privatization Agency proposed amendments and addenda to the existing privatization contract in order to extend the deadlines for compliance with the contractual obligations for additional 12 months. The Agency also requested the buyer to submit the missing documentation, correct certain omissions and ensure the regular payment of salaries and wages to the employees.²¹⁴ At the same time, the owner of Šabac-based "Galeb grupa", Mr. Veselinović, said on several occasions that there was a realistic possibility of withdrawing from "Zavarivač" due to the Company's hidden losses.²¹⁵

In February 2011, the Privatization Agency cancelled the privatization contract having previously extended the deadline for correction of irregularities in the contract's implementation. Earlier, in October 2010, the Agency had established that the buyer had failed to meet all of the obligations from the contract on sale of "Zavarivač" Vranje, and set another deadline for corrections of irregularities in the contract's implementation.

The Privatization Agency also stated that the buyer failed to fulfil its obligations with regard to maintaining the continuity of the Company's business activities.²¹⁶ that, contrary to the contract's provisions, an additional six buildings of the Company were used as a collateral for a Development Fund's long-term loan, for which no prior consent had been obtained from the Privatization Agency; and that provisions regarding the submission of the audit report were not complied with.²¹⁷ Following the cancellation of the privatization contract due to non-performance of contractual obligations on the part of the buyer, the Privatization Agency passed a decision in June 2011 to start

213 Ibid.

214 Ibid.

215 <http://www.gradjevinarstvo.rs/VestDetaljiURL/Galeb-grupa-odustaje-od-privatization-fabrike-Zavariva%C4%8D-iz-Vranja.aspx?ban=810&vestid=1521> (Site visited: June 24, 2014).

216 Report on the performance of obligations from the contract on sale of shares from the Share Fund SZP "Zavarivač" AD Vranje portfolio by public tender, dated June 23, 2011.

217 Ibid.

the restructuring of “Zavarivač”. Immediately upon the announcement of the privatization contract’s cancellation, the employees went on strike again demanding the payment of outstanding wages.

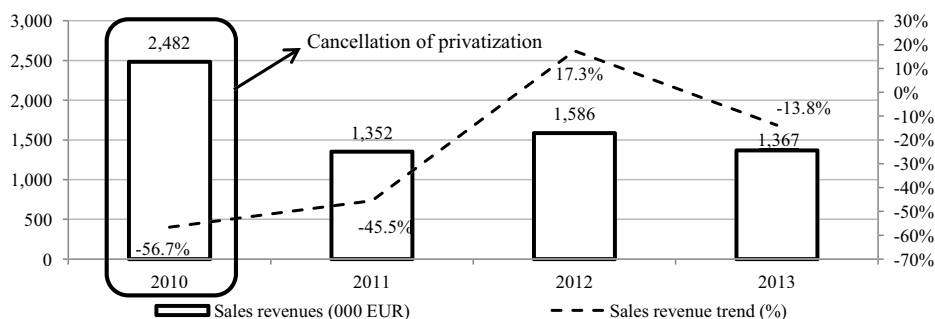
After the termination of the privatization contract, “Zavarivač” AD failed improve production output due to the impact of the economic crisis as well as the internal problems plaguing the Company with the manufacturing output for steel constructions remained at more or less the same level as in 2010. On the other hand, boiler sales increased on the domestic market, and the Company also succeeded in entering the Greek market. In 2013, the Company clinched a deal worth around EUR 800,000 based on the December 2012 contract.²¹⁸

Table 39 Production output volume trend by product groups 2010–2013

Product group	Unit of measurement	2010	2011	2012	2013
Steel constructions	tonne	616	534	677	350
Processing equipment	tonne	66	0	0	0
Boilers	pcs	0	3,383	3,874	5,156
Services	tonne	133	0	169	338

Source: Teaser Zavarivač AD DIL Inženjering Konsalting DOO from April 2013 and SZP “Zavarivač” AD Vranje – undergoing restructuring

Illustration 72 Sales revenues 2010–2013 (000 EUR)



Source: Serbian Business Registers Agency

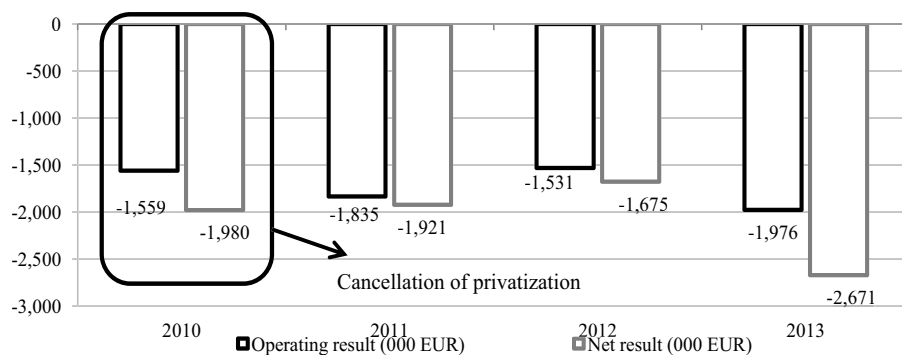
From 2011 to 2013, the Company’s sales revenues totaled on average about EUR 1.4 million, which was way below the 2010 sales revenue when the privatization contract had been cancelled. This piece of information goes to show that the Company has failed to significantly improve the sales on

218 Teaser “Zavarivač” AD, DIL Inženjering Konsalting DOO, from April 2013.

both domestic and foreign markets after the start of the restructuring process and termination of the privatization contract. However, some new forms of collaboration have been initiated.²¹⁹

In the 2010–2013 period, the Company was posting losses of on average EUR 1.7 million per year on average. In the same period, net business loss averaged EUR 2 million. Due to significant financial expenses, the 2013 net business loss considerably deviated from the average and totaled EUR 2.7 million.

Illustration 73 “Zavarivač” AD Operating and net results 2010–2013



Source: Serbian Business Registers Agency

In the 2010–2013 period, former majority owner “Galeb Group” d.o.o. had by far the biggest share in the overall amount of receivables from clients as well as the biggest share in the amount of payables to suppliers. From December 31, 2009, to August 31, 2013, the creditor with the biggest individual share by far in the total liabilities owed to suppliers was the former owner – “Galeb Group” DOO Šabac.

Table 40 Receivables structure on December 31, 2010–2013

Client	2010	2011	2012	2013*
Galeb Group” Doo Šabac	48.5%	71.7%	62.9%	45.7%
Others	51.5%	28.3%	37.1%	54.3%
Total	100%	100%	100%	100%

* Data on August 31, 2013 Source: Serbian Ministry of Economy, Profile SZP “Zavarivač” AD Vranje – undergoing restructuring

219 In 2013, the Company signed the Protocol on Business and Economic Cooperation, Joint Action and Technology Transfer with German company EWG.

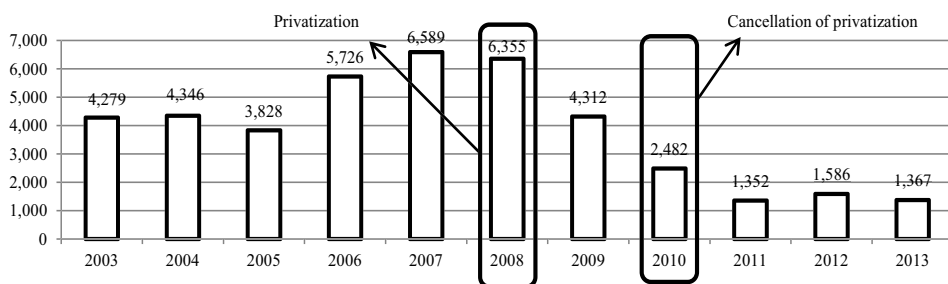
Table 41 Liabilities to suppliers on December 31, 2008–2013

Suppliers	2008	2009	2010	2011	2012	2013*
“Galeb Group” Doo Šabac	1.1%	13.6%	57.4%	62.2%	58.2%	46.0%
Others	98.9%	86.4%	42.6%	37.8%	41.8%	54.0%
Total	100%	100%	100%	100%	100%	100%

* Data on August 31, 2013 Source: Serbian Ministry of Economy, Profil SZP “Zavarivač” AD Vranje – undergoing restructuring

When observing sales revenue trends in all three periods – before and after the privatization as well as after the cancellation of the privatization contract, i.e. following the decision on restructuring, we can see that the beginning of a marked decline in sales revenues coincided with the Company’s privatization, and was followed by another slump in sales after the termination of the privatization contract by as much as 45.5%, reducing the average annual sales revenue to a mere EUR 1.4 million.²²⁰

Illustration 74 “Zavarivač” AD Sales revenues 2003–2013 (000 EUR)



Source: Information Memorandum SZP “Zavarivač” AD Vranje, Serbian Privatization Agency, September 2007, and Serbian Business Registers Agency

The 2003–2005 period was characterized by growing profitability rate indicator values followed by a two-year period of considerably lower profitability in the Company’s business operations. The reason for such a dip in profitability lay with the said declining sales revenues in 2005 and a significant rise in the cost of materials and salaries. Although the values somewhat recovered in 2008, a repeated audit of financial reports found that the Company’s operating result has been exaggerated. Considerably reduced operating revenues in 2009 occurred as a result of subsequent corrections in financial reports,

²²⁰ Subsequent corrections of omissions identified in the 2008 financial reports by an independent auditor, a slump in business activities and sales, and significant internal problems within the Company were the principal reasons for considerably lower profitability indicator values of “Zavarivač” AD.

declining business activities and sales and grave internal problems within the Company. All this was conducive to negative values for the analyzed indicators.

“Zavarivač” AD had been reporting token net operating profits until 2008, hence the net results had also had merely token values. Due to subsequent corrections of omissions in the 2008 financial reports identified by an independent auditor, and the general deterioration of business environment caused by the global economic crisis and considerable internal problems within the Company, as of 2009 “Zavarivač” AD was constantly posting negative net operating results. Token return on assets (ROA) and return on equity (ROE) in the 2003–2008 period, coupled with negative values for the analyzed indicators, pointed to the fact that the Company was not efficiently managing its business assets and equity.

Table 42 “Zavarivač” AD profitability indicators 2003–2013

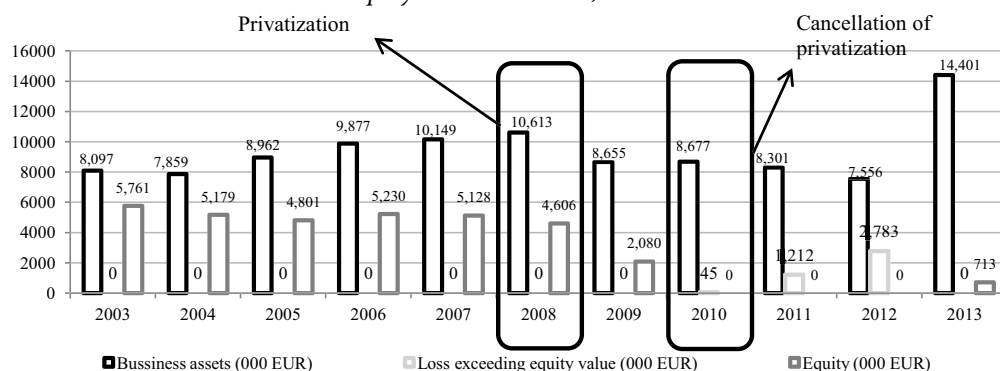
Year	2003	2004	2005	2006	2007	2008
EBITDA %	1.9%	10.4%	12.3%	2.6%	-1.1%	11.3%
EBIT %	-4.5%	5.5%	6.9%	-1.0%	-4.5%	7.8%
Net result %	0.0%	0.4%	0.7%	0.4%	0.2%	0.4%
ROA	0.0%	0.2%	0.3%	0.3%	0.1%	0.2%
ROE	0.0%	0.3%	0.5%	0.5%	0.3%	0.5%
Gross margin	57%	55%	31%	45%	N/A	40%
Year	2009	2010	2011	2012	2013	
EBITDA %	-41.6%	-52.9%	-114.5%	-81.3%	-121.6%	
EBIT %	-46.6%	-62.8%	-135.7%	-96.5%	-144.5%	
Net result %	-75.0%	-79.8%	-142.1%	-105.6%	-195.4%	
ROA	-33.5%	-22.8%	-21.1%	-16.9%	-21.6%	
ROE	-96.7%	-190.3%	–	–	-749.0%	
Gross margin	56%	47%	54%	39%	30%	

Source: Author’s calculations

From 2004 to 2008, i.e. the year of the 2nd privatization, “Zavarivač” business assets value were growing at a median annual rate of 7.9%. Following the privatization, due to subsequent corrections of omissions in the 2008 financial reports identified by an independent auditor and a considerably worse business environment as a result of the global economic crisis, the value of the Company’s total business assets in 2009 declined by 18.9%. Even

though financial reports disclosed growth in the Company's business assets value for 2010, 2011 and 2012, in reality it was non-existent. The apparent growth in the Company's total business assets value did not occur as a result of the growth in value of the Company's fixed or operating assets, but was down to the accounting disclosure of loss exceeding the Company's equity. In the course of 2013, the Company made a major acquisition of new equipment²²¹ resulting in a growing business assets value year-on-year of 39.3%.

Illustration 75 "Zavarivač" AD business assets and equity on December 31, 2003–2013



Source: Information Memorandum SZP "Zavarivač" AD Vranje, Serbian Privatization Agency, September 2007, and Serbian Business Registers Agency

Table 43 "Zavarivač" AD liquidity and debt indicators on December 31, 2003–2013

Year	2003	2004	2005	2006	2007	2008
Current ratio	1.3	1.3	1.2	1.1	1.3	1.3
Quick ratio	0.6	0.7	0.3	0.2	0.4	0.3
Net working capital (000 EUR)	740	742	729	427	1,265	1,461
Year	2009	2010	2011	2012	2013	
Current ratio	0.3	0.4	0.3	0.3	0.2	
Quick ratio	0.1	0.2	0.2	0.2	0.2	
Net working capital (000 EUR)	-4,734	-3,898	-4,783	-5,863	-8,437	

Source: Author's calculations

"Zavarivač" AD has been experiencing *major cash flow problems*. In all the analyzed years, the Company's current and quick liquidity ratio were re-

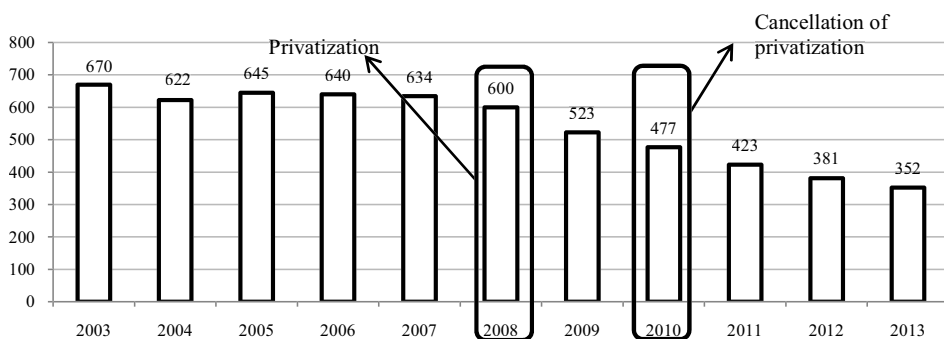
²²¹ Comments enclosed with 2013 financial reports of SZP "Zavarivač" AD Vranje – undergoing restructuring.

ording values below the optimal levels of 2:1 and 1:1 respectively. A downward trend for the said indicators was quite conspicuous, suggesting deterioration in the Company's liquidity up to the level where it was not possible anymore to meet short-term liabilities by resorting to its operating assets. As of 2009 onwards, the Company's long-term assets have not been financed entirely from long-term sources. We notice a negative trend, i.e. year after year the operating assets value has been declining whereas short-term liabilities have kept growing. Delays in payment of employees' salaries and wages is also illustrative of the Company's grave cash flow problem.

4.2.5. Employment

We have already analyzed in the previous section the issue of redundancies as well as the problems arising from the dispute between the buyer and the trade union resulting in termination of the Company's business operations. In the pre-privatization period, "Zavarivač" had not essentially reduced its head count. The annual number of employees in the 2003–2007 period had been on average 642. *After 2008 and the second round of privatization, the Company's workforce size was significantly decreasing.* Following the privatization, the average number of employees dropped from 600 (527 full-time and 73 part-time employees) in late 2008 to 477 at the end of 2010, when the privatization contract was cancelled. The Company's head count continued to fall by 42 workers a year on average even after 2010.

Illustration 76 "Zavarivač" AD average number of employees by years 2003–2013

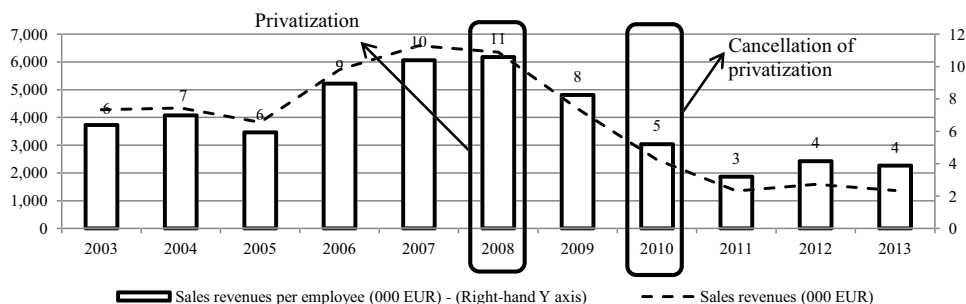


Source: Information Memorandum SZP "Zavarivač" AD Vranje, Serbian Privatization Agency, September 2007, and Serbian Business Registers Agency

In the post-privatization period, the Company's productivity was declining due to organizational problems within the Company itself and a slump in demand brought about by the economic crisis. The main driver behind the Company's productivity growth, measured by sales revenues per employee from 2003 to 2007, had been the sales revenues growth, above all, on foreign markets. From 2008 and through to 2011, given a significant drop in demand

as a result of the world economic crisis and grave organizational problems, productivity measured by sales revenues per employee plummeted. Thereafter, the value of the analyzed indicator stabilized at a very low level.

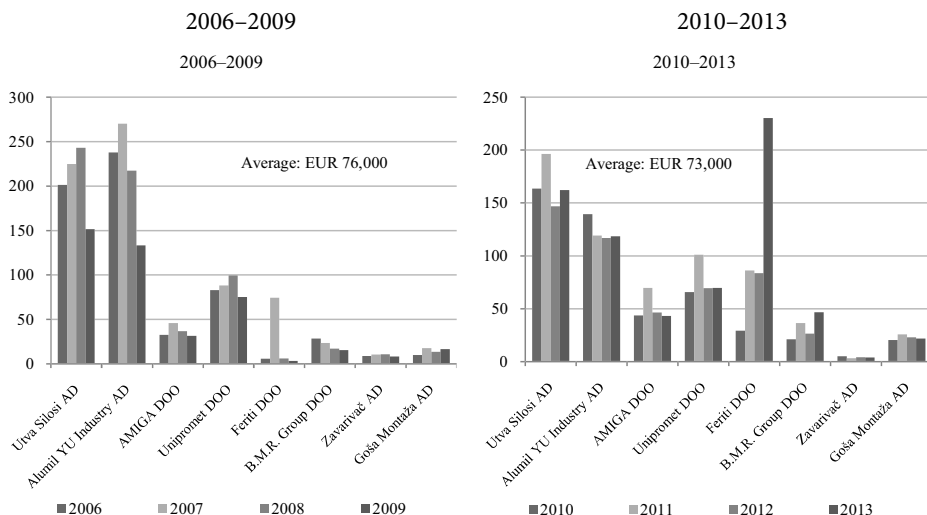
Illustration 77 “Zavarivač” AD sales revenues per employee and sales revenues 2003–2013



Source: Author's calculations

In comparison to the companies posting the highest sales revenues per employee in the sector of metal constructions and construction parts manufacturing, “Zavarivač” AD was registering values well below the average of EUR 75,000 in the 2006–2013 period.

Illustration 78 Sales revenues per employee for largest companies in the sector of metal constructions and construction parts manufacturing



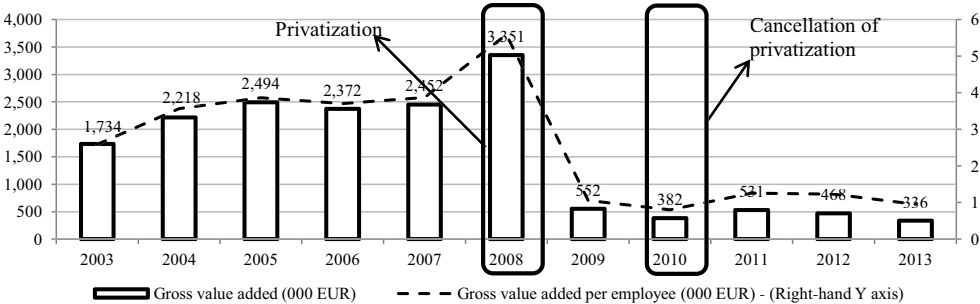
Source: Serbian Business Registers Agency

Gross value added generated by “Zavarivač” AD was constantly falling from the privatization onwards, from EUR 3.3 million in 2008 GVA to an

average of EUR 454,000 per year from 2009 to 2013. The main reason for a nose-dive in the Company’s GVA were subsequent corrections of errors (made while compiling 2008’s financial reports) were proposed by an independent auditor: a drop in demand and business activity of the Company due to the global economic crisis and grave organizational problems within the Company such as a significant surplus of employees, clashes with the trade union and workers’ strikes.

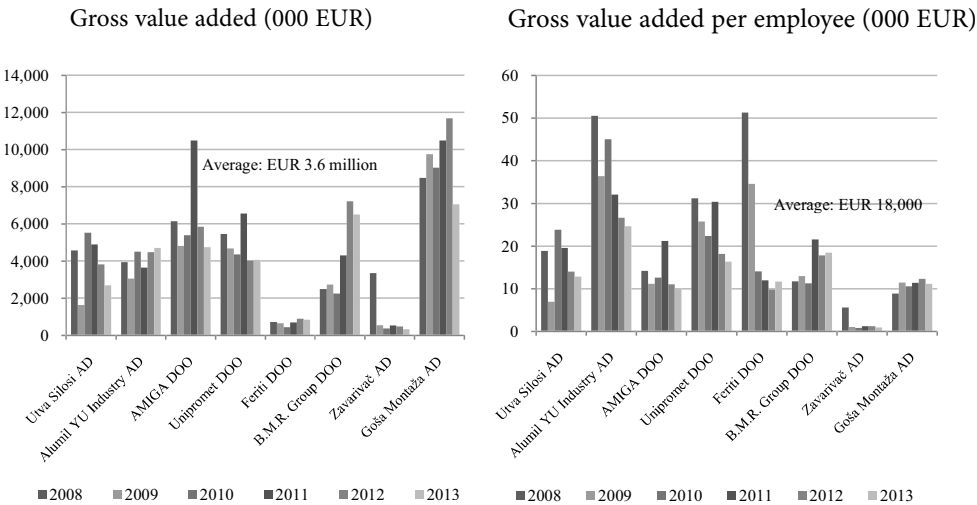
In all the analyzed years, the Company was generating a gross value added well below the median value for the biggest companies in the sector of metal construction and construction parts manufacturing.

Illustration 79 “Zavarivač” AD gross value added and gross value added per employee 2003–2013



Source: Author’s calculations

Illustration 80 GVA and GVA per employee for biggest companies in terms of actual sales revenues in the sector of metal constructions and construction parts manufacturing 2008–2013



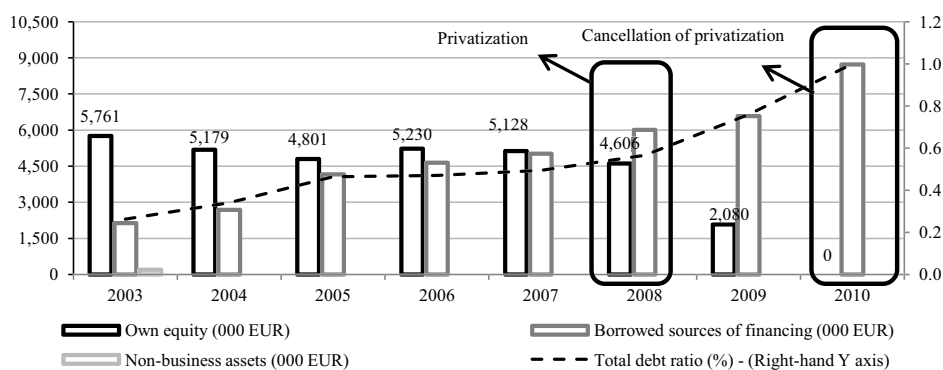
Source: Serbian Business Registers Agency

4.2.6. Financial restructuring

In the pre-privatization period, the Company increased its debt levels. The acquittance of debt by state creditors for outstanding claims by late 2004 solved only partially the debt problem. The Company's debt ratio had been gradually rising until late 2005 when the first significant upsurge in overall debt was recorded (the total amount of liabilities leapt from EUR 2.7 million to EUR 4.2 million). At the end of 2006, the liabilities (after the acquittance of debt by state creditors) totaled EUR 3.85 million, of which about a million pertained to short-term loans from commercial banks. The loans had been raised by pledging the Company's key assets as collateral so that at present all the significant assets are mortgaged. In addition to the increase in liabilities related to short-term loans, the liabilities to suppliers as well as the liabilities on account of unpaid wages to employees also rose. The Company continued increasing its debt until the end of the analyzed period so that in late 2010 the entire business operations of the Company were being financed from borrowed sources.

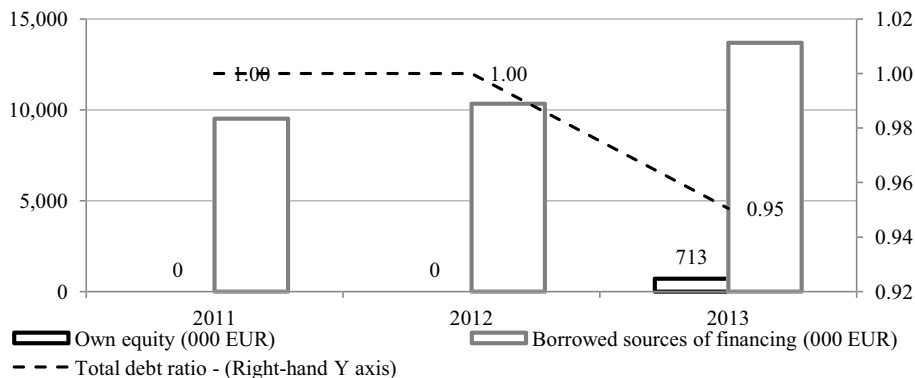
From 2003 to 2009, the Company's short-term liabilities had an average share of 90% in the overall structure of borrowed sources of financing. By late 2008, business-related liabilities made up about 60% of the total short-term liabilities, but in late 2009 this percentage dropped to 32.6% due to a considerable increase in liabilities related to short-term loans and unpaid workers' wages. The growing trend in short-term financial liabilities and liabilities related to unpaid wages persisted in the subsequent years.

Illustration 81 "Zavarivač" AD Debt levels on December 31, 2003–2010



Source: Author's calculations

Illustration 82 “Zavarivač” AD debt levels 2011–2013

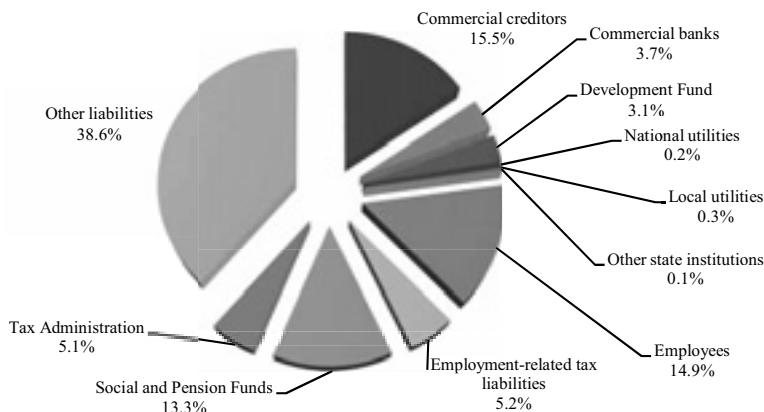


Source: Author's calculations

Apart from 2006, the Company's equity was falling in value year after year, and particularly so in late 2009 and 2010, after which the Company was posting losses exceeding the value of its own equity. In 2010, the Company's loss exceeding its equity totaled EUR 45,000; in 2011 – EUR 1.2 million; and in late 2012 – EUR 2.8 million.

Since late 2010, “Zavarivač” AD was recording significant long-term liabilities growth. In 2010, loan-related liabilities increased to EUR 2.6 million from the late 2009 level of only EUR 67,000. From 2011 to 2013 the average value of the Company's total long-term liabilities amounted to EUR 2.5 million constituting an average share of 30% in the Company's structure of borrowed sources of financing.

After the cancellation of the privatization contract in 2010, “Zavarivač” continued piling up its liabilities. In late 2013 the total liabilities reached the EUR 13.7 million mark (RSD 1.57 billion). The share of short-term liabilities was 80%, whereas long-term liabilities pertained to the funds provided by “Galeb Group” that were approved on account of the Development Fund loan entailing a mortgage on “Zavarivač” assets. The Company's survival during the restructuring was partly financed through short-term loans granted by the Serbian Export Credit and Insurance Agency and the Development Fund so that the liabilities on this account in late 2013 totaled EUR 564,000. “Zavarivač” also accrued its liabilities on account of unpaid wages. In 2013 alone, this portion of liabilities increased by over EUR 1 million reaching a total of EUR 4.7 million. Finally, the Company's liabilities to suppliers were growing at somewhat slower pace and totaled EUR 2.4 million.

Illustration 83 Liabilities structure end 2013

Source: Privatization Agency

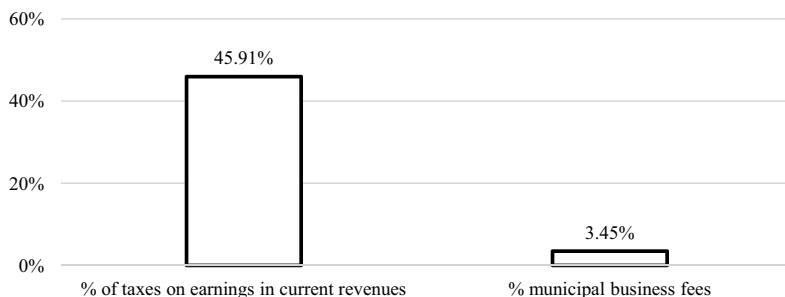
Given the diversified structure of the Company's creditors and other possible obstructions (holdout problem) it will be very difficult to come up with a viable re-organization plan which could be adopted, even with prior consent of the state creditors.

4.2.7. Relationship between the company and local self-government

Vranje is one of the biggest cities in South Serbia and the center of the Pčinja District. In Vranje, by the end of 2012, 12 companies had been privatized, out of which, in addition to "Zavarivač", another five companies had their privatization contracts cancelled. Ten socially-owned or previously privatized companies are undergoing bankruptcy proceedings, while another 7 companies have not yet been privatized. The total number of the unemployed in 2012 was 8.700, while the unemployment rate stood at 30.3%.

The net financial result of the municipality in 2012 was in the red. The share of salaries and wages tax income in the municipal current revenues was 46%, which exceeded the national average. The share of municipal fees levied on businesses in the municipal current revenues totaled 3.5%, which went to show that the local government imposed a significant burden on local businesses.

Illustration 84 Share of taxes on wages and municipal business fees in current revenues of the City of Vranje



IMPACT ON DIRECT REVENUES OF THE CITY OF VRANJE

The table below shows the cumulative share of paid tax on land, tax on property of legal persons, special environmental protection fees, municipal business sign display fees and construction land usage fees in the total actual direct revenues. The table also shows that “Zavarivač” is not paying its dues. As of the moment when the Company’s restructuring process started, the City of Vranje has not collected a single dinar in terms of its direct revenues from “Zavarivač” (the average annual amount of dues in aggregate to be paid by “Zavarivač” to the municipality is around RSD 4.7 million) resulting in an ever increasing debt owed to the local government.

Table 44 Company’s share in total direct revenues of the City of Vranje

Description	2009	2010	2011	2012	2013
Direct revenues – actual (000 RSD)	328,044	438,262	399,848	447,447	472,144
Zavarivač AD undergoing restructuring (RSD)	2,098	3,256	7,932,951	0	0
Share in direct revenues (%)	0.64%	0.74%	1.98%	0.00%	0.00%

In terms of the public direct revenues structure as of August 31, 2013, inclusive, the biggest portion of outstanding dues owed by SZP “Zavarivač” AD Vranje (undergoing restructuring) to the City of Vranje pertained to unpaid construction land development fees to the tune of RSD 22.2 million (EUR 194,000). The Company also had a significant outstanding tax-related debt due to its failure to pay property taxes totaling RSD 9.98 million (EUR 84,000)²²².

²²² Serbian Ministry of Economy, Company Profile SZP “Zavarivač” AD Vranje – undergoing restructuring.

Table 45 Company's dues to the City of Vranje (000 EUR)

Direct public revenue	Aug 31, 2013
Property tax	86
Construction land development fee	194
Municipal business sign display fee	26
Environmental protection fee	16
Other	3
Total	325

Source: Serbian Ministry of Economy, Profile SZP "Zavarivač" AD Vranje – undergoing restructuring

IMPACT ON CEDED REVENUES OF LOCAL GOVERNMENT

The table below shows the share of paid contributions and taxes on salaries and wages in the total amount of ceded revenues. Obviously, "Zavarivač" has not been discharging its tax-related liabilities (the amount of unpaid contributions and taxes on salaries and wages in 2014 totaled about RSD 50 million) so that the impact of the Company's dues on ceded revenues of the City of Vranje has been negligible.

Table 46 The Company's share in total ceded revenues of the City of Vranje

Year	2009	2010	2011	2012	2013
Ceded revenues – actual (000 RSD)	533,420	522,739	683,173	1,058,139	1,039,744
Zavarivac AD (000 RSD)	758	2,419	0	0	80
Share in ceded revenues (%)	0.14%	0.46%	0.00%	0.00%	0.00%

PUBLIC UTILITIES DUES (AND DUES OWED TO OTHER LOCAL PUBLIC UTILITIES)

"Zavarivač" is mostly supplied with water by the municipal water supply public utility company, however, occasionally the water from four wells located on the factory grounds are used as service water and for factory grounds maintenance. Waste water is discharged into the city's sewer system. "The biggest public utility-related debt of Zavarivač" is owed to the Development and Construction Directorate of the City of Vranje.

Table 47 “Zavarivač” AD Dues to local utilities (000 RSD)

Year	2008		2009		2010	
	payable	receivable	payable	receivable	payable	receivable
JP Vodovod (water supply and sewage)	2,394	1,885	1,263	1,482	691	698
JP KOMRAD (waste disposal)	1,749	282	773	1,603	872	1,214
JP Direkcija za razvoj i izgradnju (Development and Construction Directorate)	2,028	0	2,706	2,098	2,405	0
Total	6,171	2,167	4,742	5,183	3,969	1,912
Year	2011		2012		2013	
	payable	receivable	payable	receivable	payable	receivable
JP Vodovod (water supply and sewage)	469	117	763	847	581	108
JP KOMRAD (waste disposal)	73		133			
JP Direkcija za razvoj i izgradnju (Development and Construction Directorate)	3,437	0	3,343		4,327	0
Total	3,979	117	4,239	847	4,908	108

The largest outstanding liabilities owed to local utilities, public utilities and institutions as of August 31, 2013, are presented in the table below.

Table 48 “Zavarivač” AD dues to public utilities and institutions (000 EUR)

Year	2008	2009	2010	2011	2012	August2013
Vranje Health Care Center	4	8	12	7	8	10
ED Jugoistok DOO Vranje, Vranje	27	65	50	107	17	15
JP Vodovod Vranje	9	3	3	6	5	8
District Heating Plant Niš	1	2	2	-2	3	3
Real Estate Cadaster Vranje	0	0	3	3	2	2
Public Health Institute Vranje	3	3	0	1	2	2
Total	44	81	69	121	36	40

Source: Serbian Ministry of Economy, Profil SZP “Zavarivač” AD Vranje – under-going restructuring

4.3. WHAT IF ANALYSIS

As part of a “What If” analysis, a projection of assumed trends for values of individual positions in the profit and loss account of “Zavarivač” AD Vranje was made in order to quantify the impact of the counterfactual (positive) outcomes in the “Zavarivač” AD Vranje privatization. Given the limited access to available data the quantification of this scenario comprises assumed business operations of the Company up to the level of operating results.

The following assumptions were made for the purpose of projections of assumed values for operating revenues, expenditure and operating result of “Zavarivač” AD:

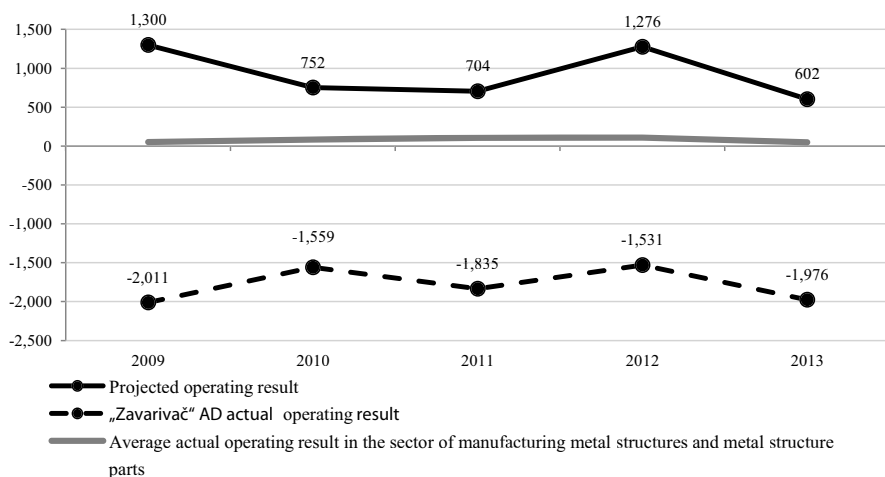
- 1) The basic premise is that an alternative buyer taking over a majority ownership stake in “Zavarivač” AD would implement all aspects of the business policy which were applied by the buyer of “Goša montaža” AD, as a company which continued to operate relatively successfully. All specific characteristics of business operations typical of “Zavarivač” AD have not been taken into account, instead the starting point is that specific business traits of “Goša montaža” AD are also applicable to “Zavarivač” AD. In addition, we assume that market conditions in which “Goša montaža” AD operates apply to the business environment of “Zavarivač” AD.
- 2) The year zero for projecting assumed values for operating revenues, expenditure and final operating results is 2008, the privatization year for “Zavarivač” AD.
- 3) The baseline for projections of trends in assumed values for “Zavarivač” AD operating revenues and expenses are the fluctuations of the historical values for operating revenues and expenses recorded in business operations of “Goša montaža” AD, as an example of a successful privatization, for the 2009–2013 period.
- 4) Given the subsequently identified omissions in the process of compiling 2008 financial reports, as established by an independent auditor who, consequently, proposed appropriate corrections to the business revenue figures, these corrections were taken into account while conducting this counterfactual analysis. The adjustments suggested pertained, *inter alia*, to the corrections of increases in value of inventories of work in progress and finished products in the balance sheet to the tune of EUR 1.4 million.
- 5) The baseline for projections of “Zavarivač” AD’s assumed sales revenue values are historical data for fluctuating rates of revenues generated by “Goša montaža” AD sales of products and services in the 2009–2013 period.
- 6) The baseline for projections of assumed values of a) revenues from own use of products, services and merchandise, b) changes in value

of inventories of work in progress and finished products, and c) other operating revenues is the historical share of the above revenue categories in “Goša montaža” AD’s sales revenues in the 2009–2013 period.

- 7) The baseline for projections of assumed values for expenses as part of business expenditure, i.e. a) purchase costs of goods sold, b) costs of raw materials, c) costs of salaries, fringe benefits and other personal expenses, and d) other operating expenses, is the historical share of the above expenses in “Goša montaža” AD’s sales revenues in the 2009–2013 period.
- 8) Due to lack of adequate data, an approximation of trends in values of the costs of depreciation and provisions has been made. With the approximation of the costs of depreciation and provisions, historical data for the rate of changes to the value of the costs of depreciation and provisions for “Goša montaža” AD in the 2009–2013 period have been used.

Results stemming from the alternative scenario for “Zavarivač” AD’s privatization are presented in the table below. Based on the projections of assumed values for operating results, “Zavarivač” AD would be generating profits above average in the sector of metal construction and construction parts manufacturing in all the analyzed years.

*Illustration 85 Alternative scenario for a successful
“Zavarivač” AD privatization – Overview of projected and actual
operating results in 2009–2013 (EUR 000)*



Source: Author’s calculations

Based on comparisons between the projected and actual operating results, taking into account the assumptions above, the failed privatization of “Zavarivač” AD led

in aggregate, in current values, to an operating result worse by EUR 13.5 million than the one arising from the alternative scenario of a successful privatization for the 2009–2013 period.

Table 49 “Zavarivač” AD projected assumed values of operating revenues, expenses and operating results 2009–2013 (000 EUR)

Year	2009	2010	2011	2012	2013
Projected operating revenues	7,044	8,746	12,010	10,807	6,883
Sales revenues	7,002	8,648	11,733	10,753	6,836
Revenues from own use of products, services and merchandise	0	0	246	0	16
Increase in value of inventories of work in progress and finished products	0	0	0	0	0
Decrease in value of inventories of work in progress and finished products	0	0	0	0	0
Other operating revenues	42	98	30	54	31
Projected operating expenditure	5,745	7,994	11,305	9,531	6,281
Purchase cost of goods sold	0	0	0	0	0
Raw material and consumables used	891	1,327	2,318	1,728	1,186
Cost of salaries and wages	3,307	3,448	4,098	4,094	2,490
Costs of depreciation and provisions	196	254	360	389	385
Other operating expenses	1,351	2,965	4,529	3,321	2,219
Projected operating result	1,300	752	704	1,276	602
Actual operating result of “Zavarivač” AD	-2,011	-1,559	-1,835	-1,531	-1,976
Actual average operating result in manufacturing of metal constructions and construction parts	53	82	105	110	49

Source: Author's calculations

5. PRIVATIZATION IN THE PHARMACEUTICAL INDUSTRY

In this section, we will consider the case studies of the privatization of two companies in the pharmaceutical sector – “Zdravlje” AD from Leskovac and “Jugoremedija” AD from Zrenjanin. In the pre-privatization period, in terms of market shares, “Zdravlje” AD was a significantly bigger player relative to “Jugoremedija” AD, however, these two companies, which ranked fourth and fifth, respectively, on the domestic market, were overall much smaller than their larger competitors.²²³ Privatization proceedings, restructuring measures and subsequent consequences for business operations of these two companies, as well as for local governments, had contrary outcomes. Whilst “Zdravlje” AD managed to continue operating in unfavorable market circumstances, “Jugoremedija” AD ended up mired in bankruptcy proceedings with uncertain prospects for a resumption of its business operations, and is one of the most often cited examples of controversial privatizations from the list of so-called “list of 24 *disputed privatizations*”.²²⁴

The “Zdravlje” AD privatization procedure started in the 1990s, but at the inception of a new legal framework in 2001, the Company had less than 2% of its shares owned by the employees. In October 2002, 70% of the socially-owned equity of “Zdravlje” AD was sold by public tender for a relatively small amount of EUR 3.5 million relative to its estimated value on the day of sale. The Company’s sale failed to attract significant interest of strategic investors, hence only one potential (and eventually the actual) buyer put in a bid – the Icelandic company “Pharmaco hf”. The low sale price was the consequence of not only weak interest on the part of potential buyers but also the amount of expenses required to fund the social program.

The Company had invested over EUR 31 million in the development of its production-related operations in Serbia by 2008, thus successfully ful-

223 In case of “Zdravlje” AD and “Jugoremedija” AD, the selection of these two companies was based on preliminary analyses of privatizations and the market structure presented in Annex 1.

224 The list of 24 disputed privatizations also features cases which have nothing to do with actual privatizations. The cases of contentious privatizations specifically pertain to the proceedings carried out through the application of different laws. The European Union also insists on resolving the issue of disputed privatizations. See the European Parliament’s Resolution, March 29, 2012, available at the following address: <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2012-0114&language=EN&ring=B7-2012-0188> (Site visited: July 4, 2012).

filling its obligations from the privatization contract. New investments were made even after the fulfillment of all the obligations related to the privatization contract totaling EUR 50 million in aggregate.

“Zdravlje” reduced drastically its staff so that the total number of employees in 2013 was at only 19% of the entire workforce of late 2000. The expenditure resulting from the “Zdravlje” social program reached EUR 24.76 million, which ranked “Zdravlje” among the companies with biggest social programs in absolute terms.²²⁵ In addition to the social program, the privatization contract offered many incentives to employees (minority shareholders) intended to alleviate the impact of redundancies. Following the privatization, the Company implemented a series of measures as part of its operational restructuring and advancement of the quality of the production process, and focused its business operation on the manufacturing of human drugs.

As of 2008, “Zdravlje” AD’s operating results were weaker, but one should take into account that this sector was hit particularly hard by the liquidity crisis from 2008 to 2013 whose cause, except for the economic crisis, was the state’s inability to regularly service outstanding liabilities of the National Health Insurance Fund to suppliers of drugs and other pharmaceutical products.²²⁶ Since the change in ownership of the buyer, “Zdravlje” AD today is a part of the globally integrated pharmaceutical company “Actavis” plc focused on developing, manufacturing and commercializing, above all, generic drugs, and represents one of 35 manufacturing and distribution centers of the “Actavis” company. The “Zdravlje” privatization should be analyzed in comparison to other companies in the pharmaceutical sector. The question to ask would be what would have happened to “Zdravlje” AD if there had been operational restructuring measures implemented by the Company and improvement in the quality of manufacturing, which was what happened after privatization.

225 The “Zdravlje” social program ranked fourth, following closely behind the social programs of “DIN” Niš and cement plants in Beočin and Novi Popovac, respectively. For an overview of social programs of the companies sold by public tender, see Kecman-Šušnjar, A. “Effects of privatization of companies of strategic importance for the Serbian economy”, PhD Thesis, Faculty of Economics, University of Belgrade (2012).

226 Operating results of pharmaceutical companies are greatly affected by an extensive state regulation of the drug market. This is reflected, above all, in the regulated prices of pharmaceutical products, which, as a rule, are depressed, i.e. below real market prices. Such a policy is intended to ensure sufficient quantities of drugs for the National Health Insurance Fund, which, despite the cap on prices, has not been regularly discharging its liabilities with respect to suppliers. This effectively has a crucial impact on business operations in the sector since a lion’s share of pharmaceutical companies’ income is generated through the sales of medications on the National Health Insurance Fund’s restricted list of reimbursed drugs. Another aspect to the state regulation pertains to drug marketing. Due to the ample space that a detailed analysis of the state regulation of pharmaceutical companies would require, it will not be included in this study.

The chain of events in the case of “Jugoremedija” AD privatization was extremely convoluted. “Jugoremedija” is one of the rare companies which, having already been privatized under the Ownership Transformation Act, was privatized “again” by sale of the remaining (state-owned) shares; after which a capital increase was carried out. It was not long before the contract was cancelled, followed by a gradual but insubstantial recovery of the Company, but ultimately to bankruptcy proceedings in which “Jugoremedija” has remained entangled to date after a failed effort to adopt of the reorganization plan.

From the very beginning, “Jugoremedija” privatization had been embroiled in a myriad of problems. The privatization under the Ownership Transformation Act had created two groups of owners with mutually opposed objectives. On one hand, were employees whose goal was to keep their jobs, and, on the other, the “Share Fund of the Republic of Serbia”, citizens who became shareholders under the provisions of the law, and former employees, whose primary objective was maximization of the share price. Following the second round of privatization in late 2002, a Macedonian pharmaceutical company, “Jaka 80”, owned by Jovica “Nini” Stefanović became the biggest shareholder of “Jugoremedija”.

Suspensions of the validity of the privatization abounded soon after the sale of the state-owned minority stake in the Company. Most often cited problems were: a failure on the part of the buyer to present a bank guarantee; preventing minority shareholders to be appropriately represented in the shareholder assembly; the manner in which the capital increase had been carried out; acquisitions of other companies, etc. The discontent of employees resulted in a work stoppage, and subsequently the cancellation of the contract, after which the minority shareholders took over the management of the Company. The new management faced many problems, including inadequate inventories of raw materials, suspended application of GMP (good manufacturing practices) standards, insufficient level of maintenance of equipment and manufacturing facilities and damage inflicted on “Jugoremedija” due to bloated invoices for procurement of raw materials required for drug production, etc.

The ensuing investigation confirmed suspicions of possibly unscrupulous and illegal business transactions under the previous management, which was reflected in the marked “principal-principal problem” in the operation of “Jugoremedija” in that period. This implied that the then “Jaka 80” owner brushed aside the rights of other shareholders and the profits to which they were entitled in order to maximize his own personal gain. All this indicated poor corporate governance practices at “Jugoremedija” in this period. Even though initial results pointed to a recovery in business operations, the actual recovery has never taken place. Changes in regulations requiring drug producers to meet the conditions necessary for the GMP certificate and a

decision of the new management to launch a new investment cycle in order to comply with the GMP standards in drug production, altered market circumstances and the state policy of drug prices reduction deteriorated further the situation of “Jugoremedija”.

Lacking its own funds, most of the funds needed for investments came from borrowed sources of financing under unfavorable conditions, while a smaller portion of the funds required was generated through the sale of “Jugoremedija” ownership stakes in other companies. Mobilized resources were not sufficient however as this did not include antibiotics and ampoule production. In order to obtain the GMP certificate “Jugoremedija” management decided to transfer the antibiotics production from the existing plant to another legal entity – “Penpharm” d.o.o. which was owned by “Jugoremedija” and a number of its shareholders.

A disruption of the manufacturing process in 2009 due to: an overhaul of the facilities; registration of foreign pharmaceutical companies’ drugs on the RZZO list of reimbursed drugs (resulting in the loss of a significant portion of the market for “Jugoremedija”); problems arising from the failure to settle contractual financial liabilities to the licensing partner “Sanofi-Aventis”; and the state’s drug prices reduction policy further aggravated already dire situation of “Jugoremedija”. After the 2007 cancellation of the privatization contract, the state has never participated in the management of “Jugoremedija” despite the fact that it was the biggest individual shareholder, through the Share Fund and the Pension and Disability Insurance Fund, with an ownership stake of 42%. Such a lack of interest on the part of the state created problems for the normal business operations of “Jugoremedija” since some important decisions could not be made without the presence and consent of the biggest minority shareholder, i.e. the state.

The state’s disinterestedness in “Jugoremedija” affairs represents an example of poor corporate governance practices and further illustrates the point that the state has never been interested in setting clear rules for business operations, participating in corporate governance in its capacity as either a minority or a majority shareholder or establishing clear rules and goals for corporate management (nor developing a criteria for evaluation of all of the above). As the state was absent from corporate management in the said companies, these companies were left in the hands of the existing management structures and run in accordance with their business principles. An additional example of persisting poor corporate governance practices at “Jugoremedija” was the conflict between the state and “Jugoremedija” management, which was a *“principal-principal problem”* of sorts, that is to say a clash between the two estranged camps of shareholders.

A new blow to “Jugoremedija” occurred when a new management appointed by employees was accused of abuses. Piling up of business losses and significant financial and other expenses resulted in an accumulation of losses

year after year. Seriously disrupted financial balance and, eventually, total accumulated losses exceeding its equity value were conducive to the initiation of bankruptcy proceedings against “Jugoremedija” in late 2012.

When we compare these two cases by the achieved privatization objectives, despite some limited results, the *Zdravlje* privatization accomplished **most stated goals**. Namely, “Zdravlje” AD increased its business efficiency and made an investment in equipment worth EUR 50 million. This company implemented an integrated management system based on a quality management system and underlying relevant standards. “Zdravlje” regularly pays its dues at both national and local levels. As we were not able gather data on the significance of “Jugoremedija” for local finances, we have a question mark instead of a plus sign in the table below. On the other hand, “Jugoremedija” privatization achieved only partially the goals related to the increase in public revenues (thanks to the sale of shares owned by the state).

Privatization objectives	Zdravlje	Jugoremedija
Efficiency of privatized company	+	–
Increase in investments	+	–
Transfer of technologies and know-how	+	–
Increase in public (national and local) revenues	+/-	+/-
Hard budget constraint	+	–

The impact of the two privatizations on local governments is significant. *The City of Zrenjanin is one of the local governments with the most privatized companies*. Out of 58 privatizations, 8 contracts have been cancelled, whilst 14 socially-owned or previously privatized companies are undergoing bankruptcy proceedings, including “Jugoremedija” AD.²²⁷ In spite of the figures stated above, in comparison to other local self-governments, the City of Zrenjanin has secured better results. This is particularly conspicuous if we compare it to Leskovac. **Out of a total of 38 privatized socially-owned companies in Leskovac, privatization contracts have been cancelled in as many as 23 cases**, whilst 35 socially-owned or previously privatized companies are undergoing bankruptcy proceedings. In this context, “Zdravlje” AD’s privatization resulting in the continuation of this company’s business operation is especially important for Leskovac in fiscal terms. To illustrate the point, “Zdravlje” AD accounted for as much as 13% of ceded revenues generated by

227 One should bear in mind that this data may feature companies which were taken into account twice. Namely, it is possible that the contract was cancelled first after which the bankruptcy proceedings ensued. In addition, it is possible that a company was not even privatized, i.e. instead of the sale of the company, the bankruptcy proceedings were immediately initiated.

the City of Leskovac. Today this share is considerably lower due to a reduction in the number of employees, but it still significant and hovers between 4% and 5%. Another important piece of data illustrating the importance of “Zdravlje” AD is the 19.8% share of pharmaceutical industry in the gross value added on the territory of the City of Leskovac. On the other hand, the share of the pharmaceutical industry in the gross value added on the territory of the City of Zrenjanin is negligible.

It is possible to illustrate the difference between the two cases by comparing projected and actual operating results. The failed privatization of “Jugoremedija” AD produced a operating result, in cumulative current values, EUR 13.4 million worse than the result from an alternative successful privatization scenario (if “Jugoremedija” had operated like “Zdravlje”) for the 2003–2013 period. This discrepancy is even more conspicuous for the 2007–2013 period, when the operating result in aggregate in the alternative scenario was EUR 31.6 million higher than the actual operating result of “Jugoremedija” AD in the said period.

5.1. CASE STUDY – PRIVATIZATION OF “ZDRAVLJE” AD, LESKOVAC

5.1.1. *Background information*

“Zdravlje” AD (hereinafter referred to as the Company or “Zdravlje”) with its headquarters in Leskovac, was established as a socially owned enterprise in 1953. The company’s core business is the production of pharmaceuticals. This company belongs to the group of big local producers of pharmaceuticals. Production takes place in the industrial zone of the city of Leskovac on an area of 22 acres.

After the privatization that was carried out in November 2002 via public tender, “Pharmaco hf” had become majority owner of “Zdravlje”, an Icelandic pharmaceutical company that at a time shown ambition to become one of the leading producers of generic drugs. The buyer changed the name in May 2004, and continued to operate under the name “Actavis”. In November 2012, pharmaceutical company “Watson Pharmaceutical” had taken over “Actavis Group”, which integral part was also “Zdravlje” AD, this led to the newly formed company establishing itself as the third largest pharmaceutical company in the production of generic drugs that continued its operations under the joint name “Actavis”.²²⁸ At start of 2013, subsidiary company “Actavis Holding CEE B.V.” had executed the purchase of the rest of the shares from minority shareholders, thus becoming the sole owner of “Zdravlje” AD.

Prior to the privatization process, along with drugs for human consumption, “Zdravlje” had produced drugs for the use in veterinary medicine, tubes

228 <http://www.bloomberg.com/article/2013-01-24/axguA68J5eDo.html> (Site visited on August 28, 2014).

and dosages, cosmetics and medical devices, even fruit and vegetables processing. After the privatization, the Company focused its operations towards human drugs, but the scope of produce covered almost all significant therapeutic classes, along with OTC (over-the-counter) products, i.e. drugs that are being issued without prescription, herbal drugs and dietary products, followed by medical devices, most important being dialyzers and vein-arterial kits. The parent company Actavis Holding CEE B.V. is the only owner of Zdravlje AD.

Table 50 Background information on “Zdravlje” AD Leskovac

Full Business Name:	Pharmaceutical – chemical industry Zdravlje AD
Abbreviated name:	Zdravlje AD
Company code:	07204817
Registered address:	Leskovac
Standard Industrial Classification (SIC) Code:	Production of pharmaceuticals (2120)
Legal form:	Limited liability company
Status:	Active company
Number of employees (2013):	391
Year of privatization:	2002

Source: Serbian Business Registers Agency

5.1.2. Business operations prior to privatization of “Zdravlje” AD

From the 1970s to the period prior to privatization process, business activities of the Company can be roughly divided into three phases. In the first period, from 1976 to 1985, “Zdravlje” expanded its scope and production range, while three quarters of the production was placed on the markets of more than 40 countries. Economic stagnation had marked the second phase, starting from 1986 to 1996.²²⁹ “Ownership transformation” was launched in this phase, so in 1991, “Zdravlje” was transformed from public company to limited liability company.

In the period from 1996 to 2002, business activities were faced with great turbulences. In 1997, sales revenues amounted to EUR 43.1 million, but were followed by a decline in operating results.²³⁰ The value of the sales of “Zdrav-

²²⁹ Detailed background information about the Company is available on the corporate web site: <http://www.actavis.rs/sr/AboutUs/ActavisSerbia/istorijatdo2000.htm> (Site visited on August 25, 2014)

²³⁰ At the time, “Zdravlje” designed and built a plant for pharmaceutical raw materials and refined chemicals. In the same period of time, the company launched production of con-

lje” AD marked a significant decline to 44,6% in the course of 1999 (from EUR 37.6 million to EUR 20.8 million) as an aftermath of war conflicts, macroeconomic instability and the freezing of prices of drugs on local markets.²³¹ Despite a decline in sales, “Zdravlje” still recorded an operating profit, but net results were negative due to high financial and other expenses (write-off of receivables, short term financial placements and part of the inventory).²³² In 2000, sales expressed in EUR reached half of the amount generated in 1998, but despite high financial and other expenses, “Zdravlje” AD recorded positive operating and net results. In 2001, sales revenues recorded high growth amounting to 75.1%, while the Company generated operating profit in the amount of EUR 11.3 million. However, the trend of high negative financial and other expenses continued, so net profit was significantly lower (EUR 3.7 million). The third phase ended with the change of the legal status in 2002, when limited liability company was transformed into a joint stock company named “Pharmaceutical chemical industry Zdravlje AD Leskovac”.²³³ At that point, within the equity ownership structure, shareholders equity had amounted to only around 2%, while the remainder referred to the socially owned capital.²³⁴

tact lenses “Boston Envision” and an arrangement was renewed with the company “Polymer Technology Corporation”, based in the U.S.A.

231 Due to recorded hyperinflation, as well as major devaluation of dinar’s exchange rate during 2000, followed by later depreciation of the exchange rate in 2001, there are significant discrepancies when we consider tendencies of the changes in balance sheet items of the Company expressed in dinars and in the amounts denominated in EUR. Considered in EUR currency, “Zdravlje” had marked the decline of sales revenues expressed in EUR in 2000 amounting to 11,8%, while considered in RSD currency, the Company had generated sales revenues growth on annual level amounting to 81,8%. Bearing in mind that physical volume of the production of “Zdravlje” in 2000 had decreased for the average 27,5%, sales revenues growth expressed in the national currency had been generated exclusively as the consequence of hyperinflation.

232 Ibid.

233 Comments enclosed with financial reports of FHI Zdravlje AD for 2013.

234 Although the case study includes the analysis of operating activities pertaining to privatization in the time frame of two years prior to privatization until today, it should be noted that the companies in the field of the pharmaceutical industry belonged to the group of around 1.500 companies that in the earlier stages had commenced the process of ownership transformation. Around two thirds of the total number of pharmaceutical companies had commenced the privatization process using internal shareholding as a role model, which was the only possibility due to the then valid legal provisions in the field of privatization. Privatization of pharmaceutical companies, and all other companies for that matter, had been significantly accelerated in the course of 1993, thanks to hyperinflation. Due to the lack of provisions pertaining to revaluation of debt caused with inflation, numerous companies in the former FRY were fully privatized. After gaining prices stability at the beginning of 1994, and due to the changes of legal provisions that annulled inflationary gains of the citizens and based on which revaluation of all procedures of the ownership changes were conducted, the privatization process completed thus far was practically annulled. In case of “Zdravlje”, it is about the mentioned 2% of share and 98%

Illustration 86 “Zdravlje” AD Sales revenues in 1999–2001 (EUR 000)

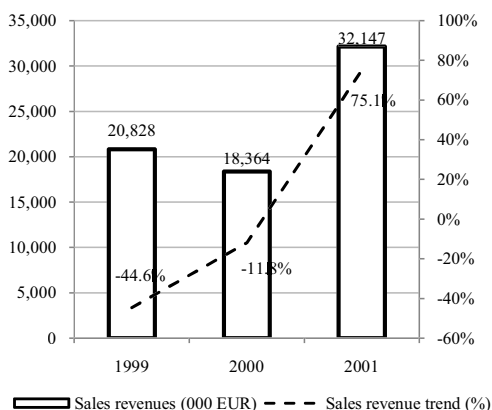
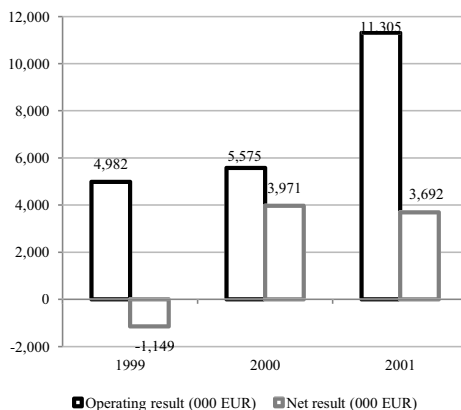


Illustration 87 “Zdravlje” AD Operating and net results 1999–2001 (EUR 000)



Source: “Zdravlje” company profile, Serbian Privatization Agency

“Zdravlje” AD placed the majority of its products through wholesale distribution channels on the local market, while the minority part amounting to a total of 20% was sold via retail distribution channels.²³⁵ The Company exported part of its products, with Bosnia-Herzegovina, Macedonia, Bulgaria, Russian Federation and Iraq representing its largest export markets. The oligopolistic structure is one of the main features of Serbian pharmaceutical market (the four biggest companies had 90% of the market share). At the moment of privatization, “Zdravlje” had a share of 12.8%, however, most significant products of the Company had from 40% to 60% of the market share. In the years preceding privatization, significant growth on the market of Serbian pharmaceuticals was expected owing to an increasing income per capita and the fact that expenses for pharmaceutical were three times lower than in Croatia.

Prior to the privatization process in 2001, “Zdravlje” had disposed of a production range of around 160 products. The company’s share of pharma-

of socially owned capital, so the Company had operated in joint ownership. Considering the structure of capital, only “Galenika” AD presented an exception from the rule as with 75% of total equity it was placed in state ownership (owned by National Health Insurance Fund).

235 The larger part of the production during the reporting period was designed for the local market, especially throughout the course of 1998 and 1999, when sales implementation share on the local market amounted to the average 92.3%. During 2000, the export of the products of “Zdravlje” AD increased, primarily as a result of very low export rates in previous years, so it amounted to 16.2% of the total sales of the Company. (*Company profile Zdravlje, Serbian Privatization Agency*). In 2001, as a result of launching the work of the plant of raw materials and refined chemicals, as well as with renewing earlier launched production of contact lenses “Boston Envision”, “Zdravlje” records significantly larger sales revenues compared to the previous years.

ceutical products in overall sales had amounted to 75%. Generic drugs had acquired the dominant share in sales, while 22 licensed products had been less significant. Out of the total generated human drugs sales of the Company in 2001, 86% referred to generic drugs.²³⁶ The position of the Company was especially strong in the market niches of gastrointestinal and respiratory drugs with 50% and 34% market share respectively. "Zdravlje" AD had accomplished significant market share also when it came to the market niches of drugs for pregnant women (26%), blood disorders (23%) and metabolism and diet regulation (18%).

The National Health Insurance Fund was the most significant individual client of "Zdravlje" AD Leskovac in 2001 purchasing 70% of the company's human drugs.²³⁷ In this period, local producers had significant advantage in the practice in acquiring generic drugs on the part of the Republic Institute, but it was expected that foreign companies would, after a certain period of time, be treated in the same way, meaning that the share of domestic producers on the drug market would be reduced.

As for property and legal relations, the right to use these was registered in the city with building land in favor of the Company given that it was not possible to acquire ownership over the building land. Facilities in the production complex amounted to 39.968 m³ of the total area.²³⁸ These buildings were mostly constructed during the 1970s and as was the case with the majority of former socially owned companies, they acquired no use permit. Apart from Leskovac, "Zdravlje" had production facilities in other city municipalities (production of syringes for single use in Medveđa, production of aluminum tubes and dosages in Lebane and production of contact lenses in Krupanj). The Company also dealt with the production that had no direct relation with pharmaceutical industry (with fruit, vegetables and dietary soups processing within the Company, based in Bosilegrad).

Concerning other property, "Zdravlje" had a significant share in several companies of the financial sector ("Dunav Insurance Company" – 4,5%, "AIK Bank" – 4,5%, "Kulska banka" – 9,5%) and majority share ("Zdravlje Trade") and a minority share ("Slavijamed") in wholesale drugstores. At the point of sale, "Zdravlje" possessed several trademarks and patents (158 registered on

236 Most vital licenses of the Company were acquired from "Boehringer Ingelheim" and there was an agreement with the biggest company of generic production "Teva". "Zdravlje Leskovac" had an active program of drug development, focused on the development of new generic drugs. Two drugs resulted from this program during 2001: "Karvilex" and "Alphapres", both from the field of cardiovascular medicine.

237 Information memorandum "Zdravlje Leskovac", July 2002, Privatization Agency.

238 At the moment of privatization, the Company used significant property including the use permit registered on the following immovable property: industrial complex in Leskovac, of total area amounting to 212.226 m², plant in Zdeglov, of total area 25.014 m², plant in Gadzari, of total area 10.200 m², plant in Bosilegrad, of total area 17,600 m², two representative offices in Belgrade of a total area of 616 m² and 453 m² respectively, as well as several business facilities in Leskovac.

the national level, 36 international trademarks; 10 valid national patents and 13 patent applications, out of which 7 were registered in international PCT system, Patent Cooperation Treaty). Patents referred to the procedures of getting pharmaceutical raw materials, but also to the product formulation.²³⁹

5.1.3. Privatization of “Zdravlje” AD

The Company was privatized by public tender. According to its characteristics, we can place “Zdravlje” in the group of tender privatizations in which foreign investors (multinational companies as a rule) were interested in taking over market share or natural resources, which was primarily the case in the fields of tobacco, pharmaceuticals and the industry of construction materials, i.e. sectors with an oligopolistic market structure. As a rule, heavy investments and generous social welfare programs accompanied mentioned privatizations.²⁴⁰

A public invitation to tender was published in midJune 2002, with the deadline for submitting bids the end of September 2002. Privatization adviser in the case study of “Zdravlje” was “Nomura International plc”.²⁴¹ In the procedure of the privatization preparation, the adviser contacted leading pharmaceutical companies, but according to the allegations in the Information Memorandum, they showed no interest in the Company, while the European Bank for Reconstruction and Development (EBRD) and International Financial Corporation (IFC) on the other hand had expressed willingness to secure financing to the Company after the privatization, nevertheless, only one potential buyer, Icelandic pharmaceutical company “Pharmaco hf”, had submitted an offer.²⁴² The buyer had implemented business development policy through organic growth and through the acquisitions of other pharmaceutical companies.²⁴³

239 A drug that has acquired patent protection for its healing substance is fully protected and represents an original drug. After the expiry of such patent, the drug becomes generic. Moreover, generic can be innovative (innovative generic) and then we have supergenerics, biogenerics and specialties, which could also be patent protected.

240 V. Zec. M. “Privatization-concepts, operationalization and open issues”, Fokus, October 2010. CLDS, Belgrade, 23. For comparing agreed and implemented investment in those cases, see Kecman, A. “Effects of privatization of the companies strategically vital for Serbian economy”, PhD thesis, Faculty of Economics, University of Belgrade, (September, 2012), 143–144 (available at: <https://fedorabg.bg.ac.rs/fedora/get/o:6251/bdef:Content/get>).

241 The selected advisor had in preparing privatization documentation (teasers, analyses of market valuation and other papers) engaged several legal, accounting and other advisors). The contract on engaging the privatization adviser is available at <http://www.priv.rs/upload/company/contract/501794.PDF> (Site visited on July 12, 2014)

242 <http://www.priv.rs/Agencija+za+privatizaciju/477/Otvorene+ponude+za+Zdravlje%2C+Leskovac.shtml> (Site visited on July 12, 2014)

243 It should be noted that it was expected that in the previous period, due to the expiry of certain patents, some of the valuable drugs of the leading manufacturers would be

“Zdravlje” was privatized in November 2002, after which “Pharmaco hf”²⁴⁴ became its majority owner. The transaction price for 70% of the socially owned equity (68.63% of total equity) amounted to only EUR 3.5 million.²⁴⁵ The estimated value of the socially owned equity stated in the contract had amounted to RSD 553.3 million (around EUR 9.3 million), while according to financial reports, total equity value in 2001 had reached RSD 2.311,5 million (around EUR 38.7 million), while RSD 2.028,2 million (around EUR 34 million) pertained to the effect of restatement of capital.²⁴⁶

Apart from the social program, the sales agreement offered a range of incentives to the employees (minority shareholders) in order to depreciate the problem of solving the issue of staff surplus. The buyer was committed that in the case employees sell their shares that after the sale amounted to something more than 15% of total issued shares, they would not pay less than EUR 2 million. With this, employees were guaranteed significantly higher price per share compared to what the state got in the process of selling socially owned equity.

The incentive for the employees and the management of “Zdravlje” in order to obtain their support for the sale was represented in the contract provision on the obligation of the buyer to sell shares of commercial banks, and to give that generated income in the form of reduced taxes and costs to the employees divided in proportion with distributed free shares.²⁴⁷ Moreover, the buyer had made commitment via the contract that in the case of generating profit in the end of accounting period, it will determine and pay dividend to the shareholders for every fiscal year after the day of fulfilling its stipulation to the amount of at least 10% net profit.²⁴⁸ The buyer had in accordance with sales contract paid to the shareholders part of the profit that “Zdravlje” AD generated during 2006 and 2007 in the form of dividends.²⁴⁹

taken over by a significant number of generic producers on the market. Such expectations had caused significant shifts on the market. See <http://www.businessweek.com/stories/2005-10-12/online-extra-no-dot-23-actavis-group> (Site visited on July 29, 2014)

244 The transaction Agreement is available at <http://www.priv.rs/upload/company/contract/505048.PDF> (Site visited on July 12, 2014)

245 By comparison, “Hemofarm” was sold to the German pharmaceutical company “Stada” for around EUR 475 million.

246 The contract’s coming into force was conditioned with making a decision on confirming core equity on the part of the Leskovac based Commercial Court. The capital evaluation of “Zdravlje” had caused protests of the minority shareholders: <http://www.antikorupcija-savet.gov.rs/radio-televizija-i-stampa/cid1037-1261/blic-plodovi-najbolje-privatizacije-na-svetu>

247 This is an unusual contract provision, and it is also questionable why the sale was not conducted in the preparation process for privatization through the stock exchange.

248 The contract of sale and purchase of social capital via public tender between FHI “Zdravlje” AD Leskovac, Serbian Privatization Agency and “Pharmaco” HF, dated December 20, 2002.

249 Report on buyer’s compliance with obligations from the contract on the sale of equity of the company “Zdravlje” Leskovac dated April 10, 2008, Serbian Privatization Agency.

The relatively low price paid for the company is due to low interest at the moment of privatization, but primarily due to the price of the social welfare program that the buyer calculated into the total cost that needs to be paid.²⁵⁰ The crucial problem primarily pertained to the surplus of employees. At the moment of privatization, “Zdravlje” had more than 2.100 employees, which included estimated huge surplus. Within this context, the age structure of the employees was especially unfavorable, given that from a total number of employees, i.e. from 2.135, only 17% of them, or precisely 362 fully employed persons were less than 35 year old.²⁵¹ Social welfare programs contained a large number of measures, while the total sum of the social welfare programs depended on several factors. The buyer had made a commitment in the sales contract in the part pertaining to social welfare program to keep the existent system of salaries, the bonus agenda in accordance with performance, as well as other benefits and social rights of the employees, along with adhering to the collective contracts for at least five years from the day of privatization. The buyer made a commitment to maintain all presently employed staff members for a period of at least three years, unless another deal with the unions concerning ways of reducing the number of employees could not be made in the meantime. Severance payments, in case of voluntary termination of working contract were also subject to negotiations with unions. The contract anticipated salary increases (not less than 5%), as well as training and retraining programs adjusted to the union’s needs amounting no less than EUR 170.000 on annual level, for the period of five years.²⁵² In the case of “Zdravlje”, data based on the social welfare program put its cost at EUR 24.76 million, making it the company with the biggest social welfare program.²⁵³ According to the contract, the investment plan for a five year period amounted to EUR 20 million.

250 Using of the other two criteria (social welfare and investment programs) in the process of selecting the best offer was the subject of criticism. Mijatović notes that the state had realized in 2003 that low prices are the consequence of generous welfare programs, so tender obligations of guaranteeing employment for the period of the next three to five year were cancelled, while the state took over social welfare programs. See. Mijatović, B. “Privatization of actual sector” in “Four years of transition”, B. Begović, B. Mijatović editor., CLDS, Belgrade, 2005.

251 Company profile Zdravlje, Serbian Privatization Agency.

252 Social welfare program contained other measures as well. For example, the buyer had committed to implement at the earliest convenience the housing program with the goal of constructing and selling certain number of houses and apartments to the employees in accordance with financial assistance agenda. The scope of such program should be higher than EUR 250.000 annually, or five apartments (of the average area amounting to 70 square meters) to be built in the next five year period. (The contract of sale and purchase of social capital via public tender between FHI “Zdravlje” AD Leskovac, Serbian Privatization Agency and “Pharmaco” HF, dated December 20, 2002).

253 Social welfare program of “Zdravlje” is according to its size ranked fourth, right after social welfare programs of “DIN” Nis and cement plants in Beočin and Novi Popovac. For the review of social welfare programs of the companies sold via public tender, see Kecman-Šušnjar, A. (2012).

5.1.4. Business operations and key events after privatization

Upon privatization, “Pharmaco” implemented significant investments. *In the course of 2004, the buyer had invested EUR 6.9 million into new production equipment*, plant adaptation, installation of an up-to-date IT system and quality control.

Table 51 Buyer’s investment dynamics in “Zdravlje” AD 2003–2006

Estimated	Invested	Estimated	Invested	Estimated	Invested	Estimated	Invested	Estimated	Invested
2003		2004		2005		2006		Total	
3,200	3,410	6,900	7,112	5,600	5,978	2,100	7,900	17,800	24,400

Source: Report on buyer’s compliance with obligations from the contract on sale of the equity of the company “Zdravlje” Leskovac AD, dated April 10, 2008, Serbian Privatization Agency

At the same time, in accordance with the organizational structure of the “Actavis Group” for the Balkan region, starting with December 1, 2004, “Zdravlje” became one of major “Actavis” production facilities in Leskovac while a new regional representative office was established in Belgrade.²⁵⁴ During 2005, the first stage of the adaptation of the business unit “Pharmacy” and the reconstruction of storage facilities took place, so at the end of 2006, the buyer had invested a total amount of EUR 15.8 million into “Zdravlje” AD.

Production volume of “Zdravlje” AD in the period from 2004 to 2006 recorded a slight growth trend, while the reduction in production of some manufacturing lines was compensated by the increase in the production of other production lines.

Table 52 Production output of “Zdravlje” AD Leskovac 2004–2006 (number of items)

Product group	unit	Year		
		2004	2005	2006
Pharmacy	item	455,805,924	455,785,075	503,359,229
Drug	item	7,211,398	1,499,649	413,576
Para-pharmacy	item	57,617,919	65,365,176	39,755,765

254 Corporate website “Zdravlje” AD Leskovac, <http://www.actavis.rs> (Site visited on July 12, 2014).

Product group	unit	Year		
		2004	2005	2006
Chemistry	item	1,050,815	1,761,193	1,351,308
Total	item	521,686,056	524,411,093	544,879,878

Source: Report on buyer's compliance with obligations from the contract on sale of the equity of "Zdravlje" AD Leskovac dated March 07, 2007, Serbian Privatization Agency

After privatization, "Zdravlje" AD conducted a number of operational restructuring measures. In 2007, "Zdravlje" was granted a certificate on the system of health and safety at work – OHSAS 18001 and a certificate for quality in accordance to ISO 9001: 2001 standard. In the same year, adaptation of the Pharmacy was finished, and the second phase of adaptation immediately followed. Adaptation of the Microbiological Laboratory under the highest GLP standards was also underway. In 2007, "Zdravlje" taken a leading position within "Actavis Group". After the inspection of the Danish Drugs Agency in 2008, the Company was granted with its first official EU GMP certificate and it also passed the inspection of the Serbian Ministry of Health for GMP certification. A vital business goal of the Company had been achieved with the acquisition of these certificates, which in turn enabled it to enter into the European and international markets. In the course of the same year, the project of adapting production facility for manufacturing and packaging of Drugs in Business unit 1 Pharmacy was also finalized. Up until the end of 2008, the buyer had invested over EUR 31 million in the development of its production operations in Serbia, with which implementation of the obligations from the privatization contract were successfully achieved.

After acquiring the EU GMP certificate, "Zdravlje Actavis" started exporting to the markets of Denmark and France. The Danish Drug Agency had conducted a new inspection of the production facilities in Leskovac during 2009, and again reported that "Zdravlje Actavis", (except for "Glimepirid"), fulfills EU GMP standards for production and packaging. After getting an EU GMP certificate, the first millions of "Glimepirid" pills were placed on the Danish market, while the Company got a license for putting into circulation this oral hypoglycemic on the French market. In 2010, another investment into the new Facility of liquid forms had been finalized in accordance with the contemporary GMP standards and the latest regulatory requirements. In the course of March 2010, "SGS" carried out the first regular supervisory assessment for HACCP Codex Alimentarius Guideline and GMP Codex Alimentarius, when the implementation of the quality management system was confirmed without any inconsistency.²⁵⁵

255 Ibid.

After privatization process, the Company focused its business activities on human drugs, whereas prior to privatization, apart from drugs for human consumption, “Zdravlje” AD produced drugs for veterinary purposes, tubes and dosages, cosmetics and medical devices, and even dealt with the fruit and vegetables processing. “Zdravlje” AD had stopped producing PVC gloves in 2004 and aluminum tubes and aerosol dosages in 2006. The buyer closed the facilities of plastic syringes in Medveđa, the aluminum tubes and dosages in Lebane, while in case of the facility for dried fruit and vegetables in Bosilegrad, with contract on donation, “Zdravlje” AD transferred the right of using the land (as well as unregistered ownership right on the objects and ownership right for the use of equipment to the Municipality of Bosilegrad).²⁵⁶ Given that the facility was not used for performing core business of the Company, the Agency considered that the buyer didn’t need to acquire prior consent of the Agency. According to the findings of Privatization Agency, in the course of its investigations, it was determined that contract provisions on the ban of selling, transferring or estranging significant property was respected, meaning that as of 2006, 2.92% of the permanent assets were alienated, out of allowed permissible 5%.

New investments followed after implementing obligations from the privatization contract. At the end of 2010, the Company “Actavis” had invested EUR 500.000 into the new storage facility in Leskovac, exclusively designed for storing pharmaceutical products for the Serbian market. In the same year, after detailed checking of all GMP relevant segments in company’s business dealings, that were subject to standards and requirements of the pharmaceutical regulation, the Danish Drugs Inspection Agency “DKMA” confirmed that “Zdravlje” met all standards of good production practice for the EU markets, and it was granted a recommendation for the extension of EU GMP Certificate. During August 2013, “Zdravlje Actavis” had successfully implemented investment into opening new a production facility for the production of drugs to be used in the treating of Parkinson’s disease, in which the full cycle of production would be covered, from measurement, granulation, via tableting and filming, to primary and secondary packaging.²⁵⁷ The total investment of “Actavis” into “Zdravlje” since 2003 now exceeded EUR 50 million.

After privatization, the employees, i.e. the small shareholders acquired a total number of 95.708 shares, out of which 82.984 came from the free distribution for which, some EUR 24 per share was guaranteed to them based on the contract. In the first period, some shareholders decided to sell their shares for the price slightly higher than this that was guaranteed in the contract, while the shareholders that didn’t do this were better off, as the price during 2007 rose to EUR 200 per share. However, this period ended with another cost reduction of shares due to bad business dealings of “Zdravlje”, so the price under which the majority owner had bought off shares, after the legal framework for

256 Report on buyer’s compliance with obligations from the contract on sale of the equity of the company “Zdravlje” Leskovac dated April 10, 2008, Serbian Privatization Agency.

257 Ibid.

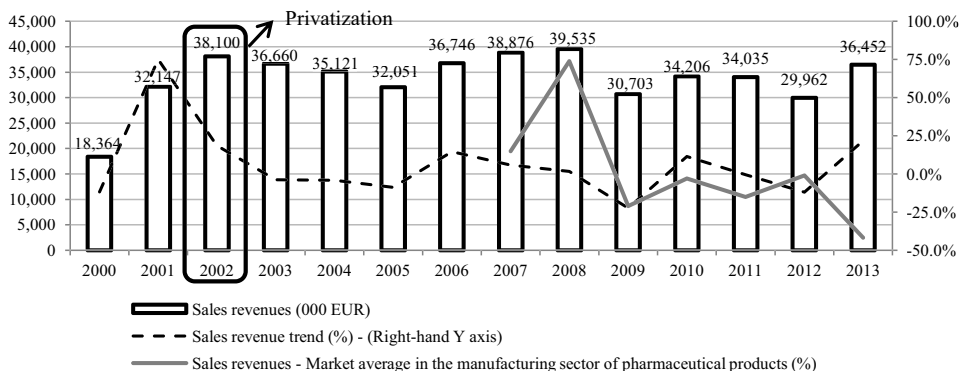
compulsory share acquisition was fulfilled at start of January (more than 90% of issued shares), had amounted to RSD 5.327 (around EUR 47.6 EUR).²⁵⁸

In April 2013, “Actavis” had become 100% owner of “Zdravlje”. Based on the report of the Central Registry of Securities, compulsory repurchase of stock was fully finalized in a way that all minority shareholders’ shares were booked to “Actavis”.

After privatization, with certain fluctuations, “Zdravlje” maintained sales revenues at a level similar to the one prior to privatization. The period from 2002 to 2008 was marked with favorable market conjecture, during which “Zdravlje” had undergone two stages. In the period from 2002 to 2005, “Zdravlje” AD recorded sales decline in the EUR currency, primarily due to significant depreciation of the value of RSD compared to the EUR. In the national currency, the Company had recorded sales growth in all the years of analyzed period under the average annual rate of 9%. In the period from 2005 to 2008, “Zdravlje” recorded stable sales revenue growth, expressed in EUR, with the average annual rate of 7.4%. The main reason due to which “Zdravlje” had recorded sales revenue growth in this period was stable growth of the physical volume of production and growth of total business activities.

In the 2008–2013 period, there were markedly negative trends on the market – a consequence of the world economic crisis and general cash-flow problems in the pharmaceutical sector in Serbia. The main driving force behind the cases of bankruptcy within the country in the mentioned period was that the State was unable to regularly meet the obligations that National Health Insurance Fund had towards the suppliers of drugs and other pharmaceutical products. Such a situation on the market negatively affected the sales revenue trend of the Company, that after a sudden decline in 2009 amounting to 22.3%, it still hasn’t managed to return to the level generated in 2008.

Illustration 88 “Zdravlje” AD Leskovac sales revenues 2000–2013 (EUR 000)

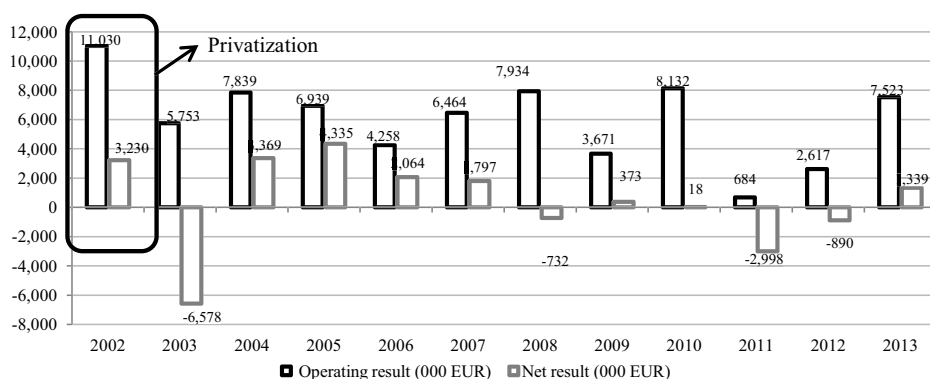


Source: Serbian Business Registers Agency, “Zdravlje” company profile and Serbian Privatization Agency

258 Notice on compulsory share acquisition available at <http://www.crhov.rs/?obavestenjeID=f7e5cb5a-e1d7-4c02-a6cb-bf532d392235> (Site visited on July 20, 2014)

In the first post-privatization year, “Zdravlje” recorded a net loss in the amount of EUR 6.6 million due an increase of 57% in salary costs and other expenses (from EUR 4.6 million to EUR 15.4 million). Depreciation of the RSD represents the main reason for the reduction of operating results the Company recorded in 2005. Viewed from the national currency perspective, Company had recorded approximately the same operating profit in 2004 and 2005. In 2006, a significant increase of the costs related to staff salaries that were 52.1% higher on the annual level, represents the main reason why the Company achieved lower operating results compared to the two previous years. Opposed to the recorded revenue growth trend ending with 2008, in 2009, due to the world economic crisis and the crisis of liquidity in the pharmaceutical sector, “Zdravlje” AD recorded significantly lower sales revenues, meaning also that the result on the business level was significantly lower. A sudden increase in the cost of materials in 2011, amounting to 73.2% and maintaining high level of costs during 2012, significantly affected the weak business performance of the Company. According to the data from financial reports, the sudden increase of sales revenues had significantly affected better results of “Zdravlje AD” in 2013, so the Company had overcome difficulties caused by the economic crisis and the liquidity problems in the pharmaceutical field.

Illustration 89 “Zdravlje” AD operating results and net results 2002–2013 (EUR 000)



Source: “Zdravlje” company profile and Serbian Privatization Agency

Average financial expenses of “Zdravlje AD” in the period from 2004 to 2007 amounted to around EUR 2.7 million, reaching the level of EUR 6.2 million in 2008 (which was the main cause of the Company’s recording net business loss in 2008). *High levels of financial expenses* were one of the main factors that affected the Company’s poor net results during 2009 and 2010. Weaker operating results 2011 and 2012, together with high level of financial and other expenses were main drivers of the negative net results during

2011 and 2012. In 2013, “Zdravlje” recorded positive growth of the operating results, while after registering net losses for two years, the Company again recorded positive net results amounting to EUR 1.34 million.

“Zdravlje” AD recorded significantly better profitability in the period following 2008, compared to the period prior to world economic crisis. The opening of new production facilities, increased business activity and sales revenues, were the main reasons due to which “Zdravlje” had recorded significant increase in profit values prior to deducting value added tax and interest rate (EBIT%) as well as EBITDA% in 2001, while the values of the mentioned indicators maintained the same high level in the next years. In 2003, due to the significant growth of salaries and other expenses, “Zdravlje” recorded a negative net result and consequently negative values of ROA (return on assets) and ROE (return on equity) indicators.

High double-digit values of profit prior to deduction of taxes and interest rates (EBIT%) and income prior to deducting taxes, interest rates and depreciation (EBITDA%) were maintained in the next few years, which indicated good results of business dealings and relatively high operating profitability of “Zdravlje”. Mentioned indicators in 2011 and 2012 record unusually low values primarily due to significantly higher expenses of materials compared to sales revenue growth. In 2013, “Zdravlje” AD again records double-digit rates of analyzed indicators, primarily due to significant sales revenue growth.

The Company had recorded negative net results during 2008, 2011 and 2012, while in the other years, the rate of the net result recorded positive values. In the same year, the Company had marked negative return on assets (ROA) and return on equity (ROE) and a more expressed trend of decreasing indicators of ROA and ROE is present. The trend of decreasing values was recorded within the indicators of the gross production margin, which was reduced to the level of 57.7% in 2013 compared to 75% in 2008.

Table 53 “Zdravlje” AD Leskovac profitability indicators 2000–2013

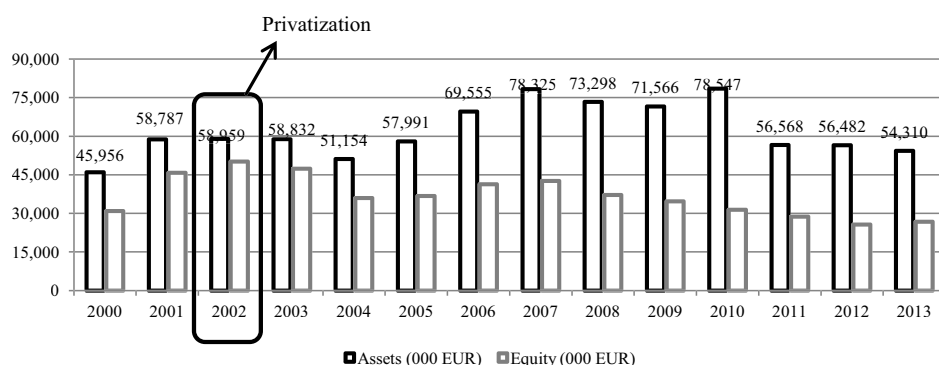
Year	2000	2001	2002	2003	2004	2005	2006
EBITDA %	38.4%	42.9%	36.2%	22.6%	28.6%	28.4%	18.3%
EBIT %	30.4%	35.2%	28.9%	15.7%	22.3%	21.6%	11.6%
Net result %	21.6%	11.5%	8.5%	-17.9%	9.6%	13.5%	5.6%
ROA	10.2%	7.0%	5.5%	-11.2%	6.1%	7.9%	3.2%
ROE	15.4%	9.6%	6.7%	-13.5%	8.1%	11.9%	5.3%
Gross margin	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Year	2007	2008	2009	2010	2011	2012	2013
EBITDA %	24.0%	27.9%	21.1%	31.4%	9.6%	16.4%	26.9%
EBIT %	16.6%	20.1%	12.0%	23.8%	2.0%	8.7%	20.6%
Net result %	4.6%	-1.9%	1.2%	0.1%	-8.8%	-3.0%	3.7%
ROA	2.4%	-1.0%	0.5%	0.0%	-4.4%	-1.6%	2.4%
ROE	4.3%	-1.8%	1.0%	0.1%	-10.0%	-3.3%	5.1%
Gross margin	N/A	75.0%	71.7%	68.2%	47.4%	53.4%	57.7%

Source: Author's calculations

After the initial significant growth of the value of total assets, reduction of the same value followed, which turned the value of assets of “Zdravlje” to the level that the Company had prior to privatization. The main generator of the rise of the value of business assets of “Zdravlje” AD was the growth in property values, facilities, equipment and biological assets and account receivables, due to significant investments into the fixed assets and greater business activities of the Company. In the period 2004–2007, an explicit trend of growth of the value of total business assets was evident. The value of property, facilities and the equipment, along with biological assets in the aforementioned period had grown under an average year-on-year rate amounting to 13.9%, as a result of investments into core assets on the part of the new owner. The value of trade receivables in the same period had grown under an average year-on-year rate amounting to 18.1%, due to increased business activity of the Company. *Due to significant write-off of outdated receivables on the local market, the value of the total business assets in the end of 2011 is significantly reduced.*

Illustration 90 “Zdravlje” AD assets and equity on December 31, 2000–2013



Source: Serbian Business Registers Agency, “Zdravlje” company profile and Serbian Privatization Agency

As there was no increase in core capital, the changes in the value of the equity of “Zdravlje” AD ensued as a result of overall business activities of the Company, as well as the result of adjusting the fair values of fixed assets. Although “Zdravlje” hadn’t improved operating results, i.e. the value of the equity and assets compared to the period prior to privatization, the aforementioned results should be regarded in the context of overall the pharmaceutical field, which will be dealt with in the next section.

“Zdravlje” AD had achieved a satisfactory score of the liquidity indicators and hadn’t had major problems with liquidity. In the period after 2009, there is a trend of decreasing the value of the current and quick ration under theoretically optimal levels but despite this, the Company hadn’t experienced any major problems with liquidity. In the course of the whole reported period, “Zdravlje” had managed to establish a long-term financial balance, i.e. long-term assets of the Company were fully financed from long-term sources. High values of net working capital show that there were realistic conditions for maintaining permanent liquidity.

Table 54 “Zdravlje” AD liquidity indicators on December 31, 2000–2013

Year	2000	2001	2002	2003	2004	2005	2006
Current ratio	0.8	1.3	2.8	3.6	4.2	4.7	3.4
Quick ratio	0.5	0.7	1.5	2.5	3.0	3.6	2.5
Net working capital (000 EUR)	-2.803	3.112	9.005	12.102	15.825	19.604	20.692
Cash conversion cycle	202	84	177	256	307	353	345
Year	2007	2008	2009	2010	2011	2012	2013
Current ratio	2.4	2.4	2.4	1.9	2.0	1.8	1.7
Quick ratio	1.8	1.9	1.9	1.5	1.4	1.3	1.3
Net working capital (000 EUR)	19.975	20.382	21.707	21.904	13.359	12.087	11.152
Cash conversion cycle	336	310	385	356	239	172	121

Source: Author’s calculations

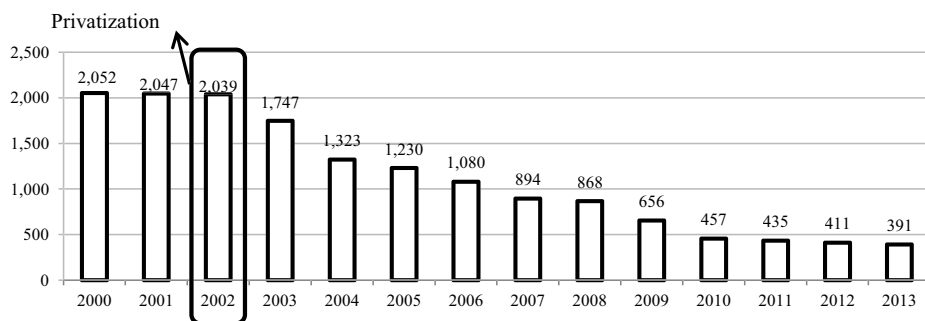
The average duration of the cash cycle of “Zdravlje” was significantly longer compared to the average market duration within the field of production of pharmaceutical compositions which for the period 2007–2013 amounts to approximately 182 days. Value indicators of the duration of the cash cycle of “Zdravlje” AD show that the need for additional financial sources with the aim of financing business cycles was significantly more prominent compared to the market average. The main reason for the rather high of cash

conversion cycle is the inability and significant difficulty in collecting receivables from the state institutions and big pharmaceutical wholesalers.

5.1.5. Employment

A crucial problem of “Zdravlje” AD was reflected in the surplus of employees. A reduction of the number of employees in “Zdravlje” AD was conducted gradually, so the number of the staff was reduced year on year. In the period from 01.02.2006 to 31.01.2007, there were no forced layoffs, but 216 employees left the Company voluntarily. All employees were paid severance pays ranging from EUR 350–700 per every year of service.²⁵⁹ The average number of employees was reduced from 2,052 in 2000, to 391 staff members in 2013. *The number of employees in 2013 represents only 19% compared to the number of employees at the end of 2000.*

Illustration 91 “Zdravlje” AD average number of employees per year 2000–2013



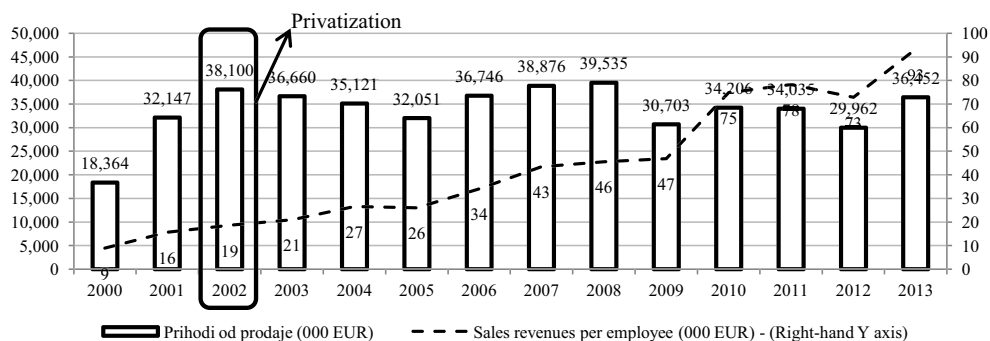
Source: Serbian Business Registers Agency, “Zdravlje” company profile and Serbian Privatization Agency

The above mentioned groups of employees that showed an interest were offered the possibility to become suppliers to their former company through the establishment of new commercial companies and by transferring certain activities to such established companies. It happened that during 2006, based on this, 45 employees had transferred to three companies that carry out services by maintaining factory grounds and offering catering services for “Zdravlje” AD. With one business company formed in this way, an agreement was signed in 2006 on taking over the Cosmetics facility with Company “Z Cosmetics”, which was formed by some twenty former employees of “Zdravlje”.²⁶⁰

259 In the 2007–2008 period, 47 employees left “Zdravlje” AD by mutual agreement with the payment of severance that were agreed with the employees to which union representatives had no objections. In 2007, there were 9 newly employed full time workers. (Reports on buyer’s compliance with obligations from the contract on sale of the equity of the company “Zdravlje” Leskovac dated March 7, 2007 and April 10, 2008, Serbian Privatization Agency.)

260 SIEPA “Investments”, number 8, September 2009.

Illustration 92 “Zdravlje” AD sales revenues and sales revenues per employee 2000–2013



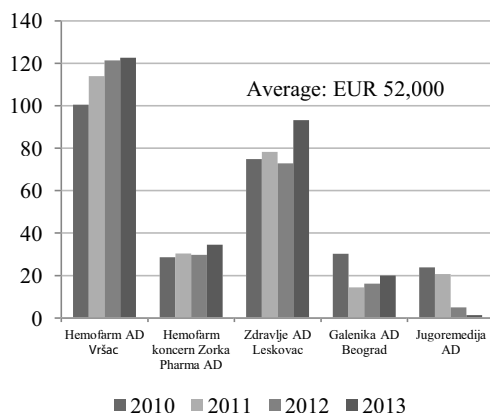
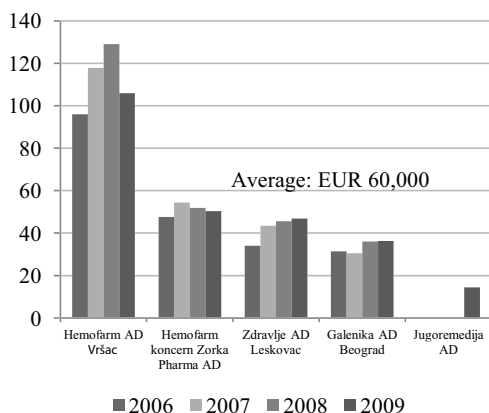
Source: Author's calculations

A trend of sales revenue growth was noticeable in all the reported years. An increase of sales revenue per employee was created primarily as a result of a significant reduction of the number of employees in all the reported years, and partly due to sales revenue growth in certain years. Reviewing sales revenues per employee with the biggest drug producers in Serbia, “Zdravlje” AD recorded above average values for the period from 2010 to 2013 (an average EUR 52,000). Moreover, it is indicative that companies that are in foreign ownership (“Hemofarm” AD and “Zdravlje” AD) record higher and above average values compared to the companies that are in local (state or private) ownership (“Galenika” and “Jugoremedija”).

Illustration 93 “Zdravlje” AD Sales revenue per employee for the biggest companies in terms of actual sales revenues in the manufacturing sector of pharmaceutical products

2006–2009

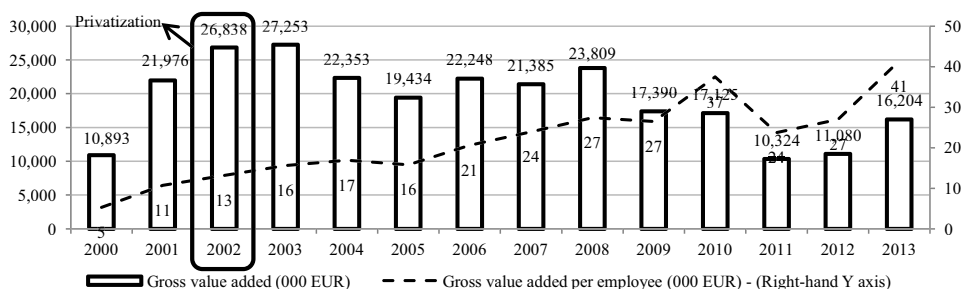
2010–2013



Source: Serbian Business Registers Agency

Newly generated GVA of “Zdravlje” declines in the period after 2008. An average gross value added (GVA) of “Zdravlje” AD in the period from 2002–2008 had amounted to EUR 23.3 million, while in the period after 2008, an average gross value added of “Zdravlje” AD amounted to EUR 14.4 million. A significant drop in GVA in 2011 was conspicuous, which was a consequence of poorer operating results; due to the significant rise in the cost of materials.

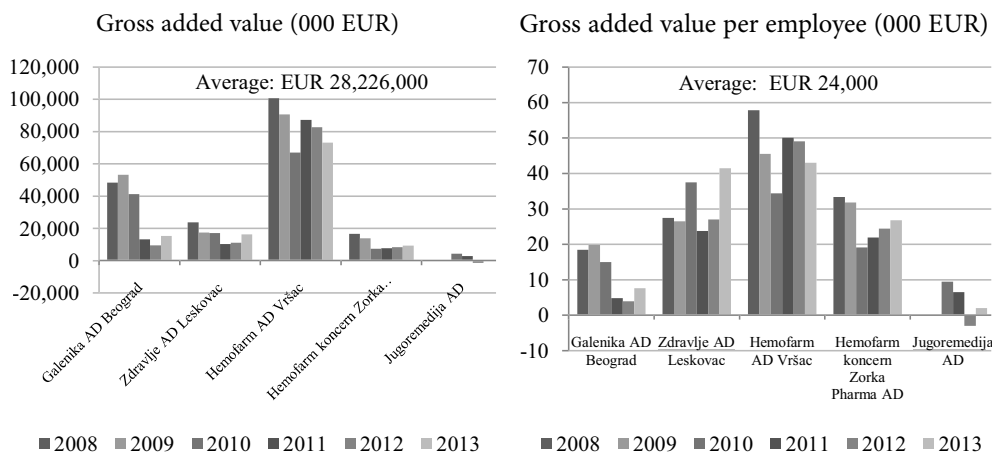
Illustration 94 “Zdravlje” AD GVA and GVA per employee 2000–2013



Source: Author's calculations

“Zdravlje” followed up on the general decreasing trend of the GVA sector, but it is the only Company that records a rise of the GVA per employee. In the reported period, gross added value of the biggest companies in terms of actual sales revenues in the sector of pharmaceutical compositions manufacturing registers a downturn. Generated gross added value of the biggest companies in terms of actual sales revenues in the sector of pharmaceuticals manufacturing in the period 2008–2013, amounted on average to EUR 28.2 million, while the gross added value per employee in the same period amounted to EUR 24,000.

Illustration 95 Gross added value and gross added value per employee of the biggest companies in terms of actual sales revenues in the sector of pharmaceuticals manufacturing 2008–2013

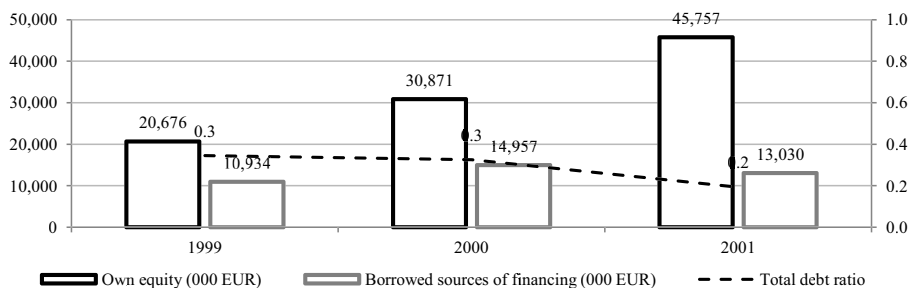


Source: Serbian Business Registers Agency

5.1.6. Financial restructuring

In the years prior to privatization, “Zdravlje” AD had a relatively low debt level. In case of “Zdravlje”, there is no data on registered mortgages on loans at the point of privatization.

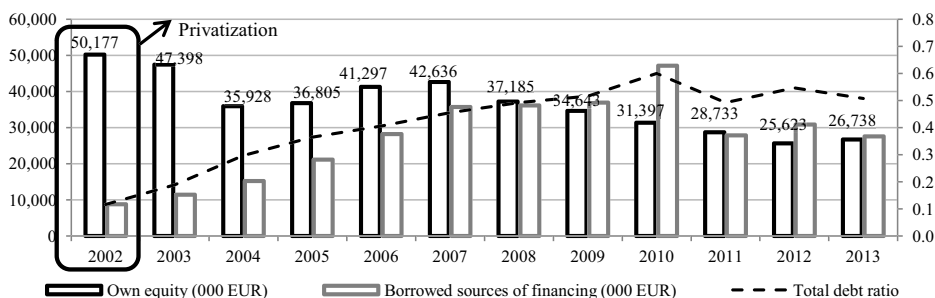
Illustration 96 “Zdravlje” AD debt levels on December 31, 1999–2001



Source: Author's calculations

In the post-privatization period, “Zdravlje” records an average total debt level. There was no capital increase of the Company after privatization, so the changes of the values of their own equity were the result of the business activity of the Company and adjustments in terms of fair values of the fixed assets. The value of the borrowed sources of financing had followed trend of value of the equity, except at the end of 2010, when an unusual rise of its value of 27.7% was registered at a year-on-year level. At the end of 2010, a significant rise in the level of borrowed sources of financing was mainly affected by the growth of long-term liabilities on the year-on-year level of 67%. A significant increase in interest-bearing liabilities of the Company was generated in the period from 2005 to 2007, which mainly refers to the long-term loans from the affiliated company of the Buyer “Actavis BV” from the Netherlands.²⁶¹

Illustration 97 “Zdravlje” AD debt levels on December 31, 2002–2013



Source: Author's calculations

261 Report on buyer's compliance with obligations from the contract on sale of the equity of the company “Zdravlje” Leskovac dated April 10, 2008, Serbian Privatization Agency

5.1.7. Relationship between the company and local government

Sixty-eight companies from the territory of the municipality of Leskovac were listed in the Privatization Agency's portfolio. Out of that number, 47 companies were sold by public auction while only two were sold by public tender. The cancellation of contracts followed in 23 cases, while in 51 cases, state owned or formerly privatized companies ended up in bankruptcy. In this context, the privatization process of "Zdravlje" AD, that allowed continuous business activities, is of special fiscal significance to the city of Leskovac.

In late 2012, the unemployment rate in Leskovac was at an exceptionally high 47.3%, meaning that there were 22,812 unemployed and 25,400 employed workers in the city. The reduction of the number of employees in "Zdravlje" significantly affected the rise in the unemployment percentage rate. In addition, the significance of "Zdravlje" for the city of Leskovac reflects in the fact that the gross added value of the pharmaceutical industry within manufacturing industry is decisively the highest, while manufacturing industry is still the key sector of the city of Leskovac with a 60% of the share in GVA of this municipality.²⁶²

IMPACT ON LOCAL GOVERNMENT DIRECT REVENUES

The table shows the total share of payments of "Zdravlje" AD based on direct revenues of local self-government in the total amount of RSD 81.5 million and part of debt based on the interest rates of almost RSD 3.5 million. Bearing in mind that those liabilities were not regular, as well as due to the interest rates that were generated by the discrepancies between liabilities and payments, on December 31, 2013, "Zdravlje" AD Leskovac was indebted to a total amount of RSD 5.2 million. However, by mid-2014, the debt was reduced to RSD 1.9 million. The biggest part of the debt was generated as an obligation to pay the construction land usage fee in the course of taking over competencies of administering local revenues on the part of the cities and municipalities. "Zdravlje" AD share in the paid direct local public revenues is very high and it ranges from 3.29% in 2010 as much as 4.80% in 2009. Such a high share shows the significance of "Zdravlje" AD for the City of Leskovac.

Table 55 Company share in total direct revenues of the City of Leskovac

Year	2008	2009	2010	2011	2012	2013
Direct revenues–actual (000 RSD)	226,269	276,754	361,086	359,605	321,378	387,959
Zdravlje AD (000 RSD)	10,290	13,275	11,867	13,518	14,933	17,625
Share in direct revenues (%)	4.55%	4.80%	3.29%	3.76%	4.65%	4.54%

Source: "Zdravlje" AD

262 "Regional Atlas of Serbia 2012", Belgrade, 2013.

IMPACT ON LOCAL GOVERNMENT CEDED REVENUES

The table shows the “Zdravlje” AD share of paid income taxes and other ceded revenues in aggregate with respect to the total ceded revenues of the City of Leskovac in the analyzed period. The table shows that in **2008, the “Zdravlje” AD share in the ceded revenues was as high as 13.28%**. The reason for this is surely the number of employees and average amount of salaries. This means that **the Company, on its own, generated one eighth part of the ceded revenues of Leskovac at that point**. This exceptionally high contribution to the Leskovac budget in ceded revenues remained stable up to 2011. Implementation of tax reform is noticeable in 2012 and 2013, when the mentioned contribution amounted to 4.63% i.e. 4.34% respectively, which is on the level of direct revenues of “Zdravlje” in the total actual direct revenues of Leskovac. In the analyzed period, total income tax to salaries amounted to RSD 379.441.232, which is an average share of 7.51% in the analyzed period and in the fiscal terms, indicating the significant dependence of the local budget on a single company.

Table 56 Company's share in total ceded revenues of the City of Leskovac

Year	2008	2009	2010	2011	2012	2013
Ceded revenues – actual (000 RSD)	608,553	577,756	608,885	795,125	1,270,041	1,194,530
Zdravlje AD (000 RSD)	80,817	70,297	57,220	60,454	58,854	51,799
Share in ceded revenues (%)	13.28%	12.17%	9.40%	7.60%	4.63%	4.34%

Source: Zdravlje AD

PUBLIC UTILITIES DUES (AND OTHER LOCAL UTILITIES)

“Zdravlje” AD regularly pays dues to public utility services, i.e. to companies that are entrusted with the services of waste disposal. In the monitored period 2008–2013, “Zdravlje” AD had regularly paid its dues for the water supply and waste water drainage to JKP “Vodovod Leskovac”. The total amount paid in this period for the above utilities amounts to RSD 77 million. The services of waste disposal in Leskovac were provided by the company “Porr-Werner & Weber”. According to analytic records of the Company, in the analyzed period, “Zdravlje” AD has paid for these services a total amount of RSD 20.1 million. On the basis of presented data, it is obvious that in the 2008–2013 period, “Zdravlje” paid a total amount of RSD 98 million to the public utilities on the territory of the City of Leskovac.

Table 57 “Zdravlje” AD dues to public utility services (000 RSD)

Public Utility	2008		2009		2010	
	payable	receivable	payable	receivable	payable	receivable
JKP vodovod Leskovac (water supply and sewage)	12,580	12,198	12,115	12,071	13,985	15,227
Porr-Werner& Weber (waste disposal)	3,070	2,848	3,005	2,779	3,059	3,602
Total	15,651	15,046	15,120	14,850	17,044	18,829
Public Utility	2011		2012		2013	
	payable	receivable	payable	receivable	payable	receivable
JKP Vodovod Leskovac (water supply and sewage)			13,578	13,581	11,118	11,106
Porr-Werner& Weber (waste disposal)	4,128	3,588	3,650	3,650	3,650	3,654
Total	18,196	16,455	17,228	17,240	14,768	14,760

Source: “Zdravlje” AD

5.2. CASE STUDY – PRIVATIZATION OF “JUGOREMEDIJA” AD ZRENJANIN

5.2.1. Background

“Jugoremedija” (hereinafter: the Company) is a company established more than fifty years ago. The first pharmaceutical plant in Zrenjanin was opened in 1961 through a licensing arrangement with the German pharmaceutical company “Hoechst AG” (presently “Sanofi-Aventis”) and was engaged in producing active ingredients for medicinal products. In 1973 the company was named “Jugoremedija”, and the same year a joint venture contract was signed between IPK “Servo Mihalj”, “Hoechst”, and “Jugoremedija”. The cooperation with “Hoechst” led to enlarging the assortment of products and growth of production and enabled “Jugoremedija” at that time to have modern production facilities in compliance with GMP and GCLP standards. This resulted in an export expansion of Jugoremedija, exporting to the markets of the USSR, Romania, Czechoslovakia, Belgium, Austria and the Netherlands. The contract was extended in 1984 for a period of fifteen years. All production, packaging, warehousing and other activities (including the registered seat of the company) are located in Zrenjanin.

The majority of the Company’s products were generic versions of original drug products. “Jugoremedija” was present with its products in the

markets for the following therapeutical fields: digestive tract and metabolism diseases (Baralgetas, Daonil, etc.), respiratory (Amynophillinium), cardiovascular (Lasix, Trental, Lopion, Enalapril, etc.), skin and infective diseases, and analgesics (Cliacil, Tolycar, Nirypan, etc.). The Company had a broad assortment of generic drug products with about **120 different drug products** in varying dosages and pharmaceutical forms. “Jugoremedija” was also owner of the licenses for most drug products which it produced, with the exception of 5 drug products which were produced under license by “Aventis”. “Jugoremedija” had an ISO 9001 quality certificate and environmental protection certificate ISO 14001, and was in the process of receiving the certificate for ISO 18001.²⁶³

As for its market, “Jugoremedija” was **focused on the national market** where it sold most of its products, almost exclusively through wholesale distribution channels. **A great number of drug products produced by “Jugoremedija” were included on the “positive lists” of the National Health Insurance Fund**, whereby the sale thereof was subsidized. “Jugoremedija” had 41 drug products on the A List (prescription drug products), 15 on the A1 List (alternative to prescription drug products), and 29 on the B List (over-the-counter medicinal products). Foreign markets in which “Jugoremedija” operated included Russia, former Soviet republics (Ukraine, Belarus, Georgia, Armenia, Moldova, Azerbaijan, and Kazakhstan) and the markets of all former Yugoslav republics.

The case of privatization of “Jugoremedija” is included in the list “24 contentious procedures” (mostly privatization procedures). The privatization process of “Jugoremedija” was highly complex, and it is fair to say that “Jugoremedija” is (if not unique) among the rare companies which has gone through all models and methods of privatization. After the first round of privatization undertaken according to the Ownership Transformation Act, there followed a second round of privatization by auction sale of stake in equity of “Jugoremedija” owned by the state (the Share Fund).

“Jugoremedija” at the time of privatization was organized as a limited liability company, therefore the sale of “Jugoremedija” was the sale of stake in the Company owned by the “Share Fund of the Republic of Serbia”, and not the sale of the Company’s equity as such. For this reason the sale of 42% of the capital of “Jugoremedija” was implemented through an off-the-floor auction.²⁶⁴ The Privatization Agency drafted the auction documents, organized the auc-

263 Teaser “Jugoremedija”; Opportunity to invest in the pharmaceutical sector in Serbia – sale of majority package of shares of AD Jugoremedija, Privatization Agency, Masters Finance and PKF Accountants & Business Advisers, December 2010

264 The previous ownership transformation of “Jugoremedija” was verified by the Ministry of Economy and Ownership Transformation. The Decision number 583/98-1-15/2.9.1998 verified the capital in the mixed ownership of “Jugoremedija” and changed the organizational form of “Jugoremedija” from socially-owned enterprise to limited liability company into stakes and remaining social capital. According to the Ownership Transformation Act of 1997, the Ministry of Economy and Privatization, the successor of the

tion and selected the most favorable bidder: the company “Jaka 80” from Macedonia. After the sale of the state owned stake (not shares!) there was a **capital increase**, which created a division between the minority share-holders and a majority ownership was formed. This period too was short-lived and the **capital increase was reversed**. After small shareholders took over the control of the Company, in cooperation with the Ministry of Economy and the Privatization Agency, a **tender sale was attempted**, with the price being the only criterion, **but it failed**. Finally, after an unsuccessful privatization attempt, bankruptcy proceedings were initiated during which creditors filed the **reorganization plan**. The Commercial Court in Zrenjanin, at the end of December 2012, made a ruling to open the bankruptcy proceedings, at the motion of different creditors (secured creditors “Hypo Alpe Adria Bank” and “Europharm” from the Czech Republic), due to the debtor’s lasting inability to pay matured claims. The Restructuring Plan was adopted, so the assets of “Jugoremedija” are currently leased for use to the company “Union-medic” d.o.o. from Novi Sad.

Currently, “Jugoremedija” AD is undergoing bankruptcy and has three subsidiaries: HI “Luxol” AD Zrenjanin (with 74.8% share in share capital), “Jugoremedija – com in liquidation” d.o.o. Zrenjanin, and 100% share in the capital of “Remevita Nova” d.o.o. Zrenjanin). Through its subsidiaries, “Jugoremedija” has been engaged in producing cosmetic products.²⁶⁵

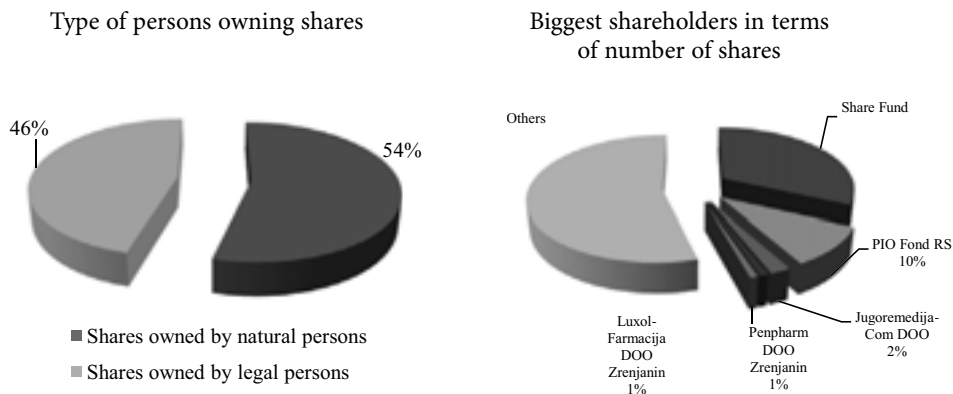
Table 58 Background information on “Jugoremedija” AD Zrenjanin – undergoing bankruptcy

Full business name:	Jugoremedija pharmaceutical company, Zrenjanin – undergoing bankruptcy
Abbreviated name:	“Jugoremedija AD Zrenjanin – under bankruptcy”
Registry number	08000034
Registered address:	Zrenjanin
Standard Industrial Classification (SIC) Code:	Production of pharmaceutical products (2120)
Organizational form:	Joint-stock company
Status:	Company undergoing bankruptcy
Number of employees (2013)	33
Year of privatization:	2001/2002

Source: Serbian Business Registers Agency

preceding ministry, confirmed the earlier decisions by its decision number 1262-1/2000-22/21.09.2001.

265 Remevita, d.o.o. Plant for Production of Medicinal Products was established in 1996, by “Jugoremedija” and “Sanitarije” from Novi Sad, with the objective to produce human medicinal products and para-pharmaceuticals for the national and foreign markets. “Remevita” is located in the location of “Jugoremedija” in Zrenjanin.

Illustration 98 Equity ownership structure as of 28 August 2014

Source: Central Register of Securities of the Republic of Serbia

5.2.2. Privatization

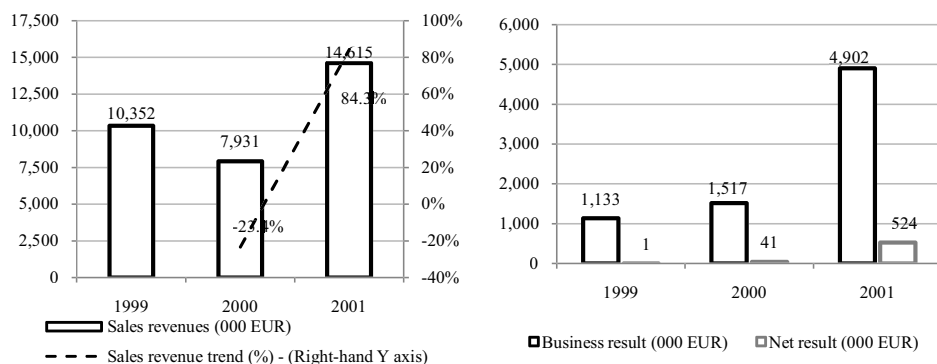
Privatization of “Jugoremedija” (hereinafter: the Company or “Jugoremedija”) started in 2001, at which time, in accordance with the Ownership Transformation Act, 58%²⁶⁶ of the stake in the equity capital in the Company was distributed free of charge to physical persons employed in the Company at that time or in the past. However, the ownership structure of “Jugoremedija”, after the said privatization, included physical persons who were never employed by Jugoremedija. This led to creating two groups of owners with completely diverse interests within the privatized part of “Jugoremedija”. Those employed at the time were striving to preserve their jobs, while the price of shares for them was of secondary importance. On the other hand, the Share Fund of the Republic of Serbia, or the physical persons who became owners thanks to the provisions of the Ownership Transformation Act, as former employees of “Jugoremedija”, were striving to achieve the maximum price from the sale of their shares.

In the period before privatization, from 1999 to 2001, due to the war conflicts, international sanctions and macroeconomic instability, “Jugoremedija” suffered a decline in sales of 23.4% in 2000. Already the following year, after the political changes and the revocation of international sanctions, “Jugoremedija” increased its sales expressed in EUR by 84.3%. In the same time period, “Jugoremedija” is experience positive operating results of business activity and a symbolic value of net profits resulting from operations. In 2001, thanks to a considerable growth of sales revenues and to a lesser degree thanks to income based on an increased inventory, “Jugoremedija” was

²⁶⁶ Teaser “Jugoremedija”, Opportunity to invest in the pharmaceutical sector in Serbia – sale of majority package of shares of AD Jugoremedija, Privatization Agency, Masters Finance and PKF Accountants & Business Advisers, December 2010.

operating with a much higher operating and net profit compared to the two preceding years.

Illustration 99 “Jugoremedija” AD Sales revenues, operating and net results 1999–2001 (000 EUR)



Source: Serbian Business Registers Agency

At the end of 2002, by purchasing 41.93% shares from the Share Fund of the Republic of Serbia, the Macedonian pharmaceutical and cosmetics company “Jaka 80” from Radoviš, became the new co-owner of “Jugoremedija”. This company purchased at the auction for RSD 959.5 million (EUR 15.5 million) a share of the equity of “Jugoremedija” of 41.93%. The acquiring company AD “Jaka 80” was established in 1980, and since 1996 it had changed its organizational form and became a joint stock company. It sold about 60% of its production on the Macedonian market and exported the remaining portion to the markets of Serbia and Bosnia and Herzegovina.²⁶⁷ According to the “Report on Jugoremedija” by the Anti-Corruption Council, “Jaka 80” in 2002 generated net operating profits of EUR 1.9 million.²⁶⁸ The same year, “Jugoremedija” generated net operating profit of EUR 909 thousand.²⁶⁹

Since at the time of the privatization “Jugoremedija” was organized as a limited liability company and since the subject of sale was a stake in the capital of the Company and not the share capital, the sale was performed off the stock-exchange floor. The Privatization Agency prepared the auction

267 <http://www.jaka80.com.mk/> (Site visited: August 27, 2014)..

268 Report on Jugoremedija, Anti-Corruption Council of the Republic of Serbia, 2004.

269 “Jaka 80” at the time of privatization of “Jugoremedija” was in majority ownership of Mr Jovica Stefanović – Nini, who known to the Serbian public due to the scandal that followed after the privatization of “Srbolek” in 2005, due to suspicions that he caused damage to this pharmaceutical company amounting to more than EUR 5 million EUR. Otherwise, even before this time, Jovica Stefanović – Nini was linked to, and on a number of occasions suspected of, abuse of office and abuse of powers in business. http://www.b92.net/info/vesti/index.php?yyyy=2012&mm=11&dd=07&nav_category=16&nav_id=658271 (Site visited: June 15, 2014).

documents and organized the auction and selected the most favorable bidder. Since the subject of sale was a stake in the capital of “Jugoremedija” owned by the “Share Fund of the Republic of Serbia”, the Contract on Sale and the Investment Contract were signed between the Share Fund (not the Privatization Agency, which performed all the sale related steps) and the buyer. **The Share Fund and the buyer “Jaka 80” after the auction signed two contracts: the Contract on Sale of stake in ownership and the Investment Contract.** The Contract on Sale of ownership stake of 41.93% was signed the same day the auction was held. Apart from paying the sale price the Buyer undertook to invest in “Jugoremedija” RSD 360 million in cash or other material assets in the form of a fully paid capital increase within 30 months of the day when all conditions are met, which would enable it to register its increased stake and to authorize the participation of all other members of the company in accordance with the law. The contract also stated that in view of its obligation to invest the buyer shall provide an unconditional bank guarantee.

The Share Fund accepted to sign the contract without requesting the bank guarantee, thus changing the conditions of the auction sale and the provisions of the principal contract. After acquiring the biggest individual minority ownership stake in “Jugoremedija”, the buyer “Jaka 80” at the time of signing the sales contract did not provide the bank guarantee, due to which there was no onset of the date of fulfillment of conditions. The party of the investment contract – the Share Fund – since the very beginning did not object to the way in which the contract was implemented, and accepted to sign it without requesting the bank guarantee, thus changing the auction sale conditions and provisions of the principal sales contract. In the process of control of contract implementation, the Share Fund stated that the contract is fully implemented.²⁷⁰

After the privatization was revoked, the management of the company which took over the management of “Jugoremedija” indicated a series of mistakes made in the privatization procedure. Among other things, as stated in the “Report on Jugoremedija” by the Anti-Corruption Council, minority shareholders were not informed that the state was selling its stake in “Jugoremedija”, while there were indications that the value of capital and consequently the sales price were underestimated, since they did not take into consideration the stock of finished products the value of which was EUR 11.5 million.^{271, 272}

270 Report on Jugoremedija, Anti-Corruption Council of the Republic of Serbia, 2004.

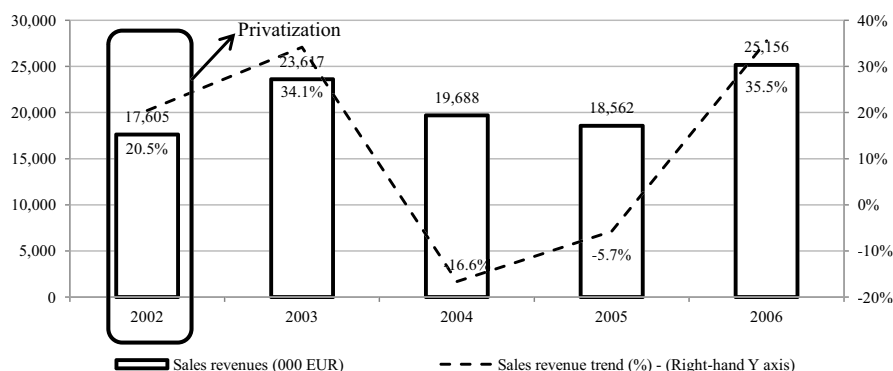
271 http://www.b92.net/info/vesti/pregled_stampe.php?yyyy=2012&mm=10&dd=26&nav_id=655178 (Site visited: June 15, 2014).

272 The Anti-Corruption Council came to the same conclusion and stated in its Report on “Jugoremedija” that such inventories were not even included in the balance sheets of “Jugoremedija”. (Report on Jugoremedija, Anti-Corruption Council of the Republic of Serbia, 2004).

5.2.3. *Busines operations and key events after the privatization*

After the privatization, “Jugoremedija” increased its sales relative to 2002, the year in which privatization happened. After taking over “Jugoremedija”, the buyer “Jaka 80” settled the previous debt or portion of debt of “Jugoremedija” to “Aventis” amounting to EUR 496 thousand. After privatization “Jugoremedija” increased its production and sales of “Jugoremedija” products, both in the national market and in the markets of former Soviet republics.²⁷³ In 2003 “Jugoremedija” changed its organizational form and from a limited liability company was transformed into a shareholders’ company.²⁷⁴ During the same year, due to increased business activity, “Jugoremedija” employed an additional 90 workers. The Company had reduced sales, expressed in EUR, during 2004 and 2005, but even so, the sales revenues were greater than the sales revenues in 2002. Sales revenues of “Jugoremedija” in 2004 were reduced due to frequent strikes of employees, stopping of production, and during a certain period of time only minimum operating processes were maintained. During 2005, in RSD, “Jugoremedija” saw an increase in sales revenues of 7.6%, but when expressed in EUR, due to significant depreciation of the RSD exchange rate relative to EUR in 2005, sales revenues of the Company were lower by 5.7%.

Illustration 100 “Jugoremedija” AD Sales revenues 2002–2006 (000 EUR)



Source: Serbian Business Registers Agency and <http://www.jugoremedija.co.yu>

According to the statement of the then general manager, in this period of time “Jugoremedija” had registered 50 new products and increased its sales in both the national and export market. It was also expected that “Jugoremedija”

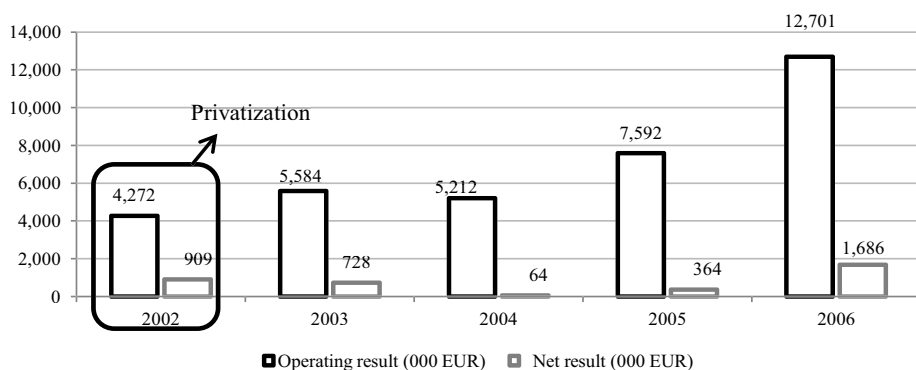
273 Share Fund of the Republic of Serbia, <http://web.archive.org/web/20031020105430/http://www.share-fund.co.yu/sr/vestprivatizacija.htm> (Site visited: August 27, 2014).

274 Old web site of Jugoremedija can be accessed http://web.archive.org/web/20041029092042/http://www.jugoremedija.co.yu/Jugoremedija/onama_istorijat.htm (Site visited: August 27, 2014).

would register an additional 12 new products and increase its market share by 4 percentage points. There were also plans that dividends would be paid to shareholders in the amount of RSD 48 million (approximately EUR 580 thousand). In the meantime, “Jugoremedija” became majority owner of the Zrenjanin based factory of cosmetics and home chemical products “Luksol”, the factory of confectionery products “Medela” from Vrbas, and “Vetprom” from Novi Sad.

Until 2007, when the contract was terminated, according to financial statements, “Jugoremedija” continually operated with a profit and generated net operating profits. “Jugoremedija” generated operating profits mostly due to the growth of sales revenues.²⁷⁵ The greatest operating profit was generated in 2006, thanks to a considerable growth of sales revenues, which increased at an annual rate of 35.5%. Due to the considerable growth of Company expenditures which, in 2006 were 2.3 times higher than in 2002²⁷⁶ and due to the high negative operating results otherwise²⁷⁷, “Jugoremedija” had significantly lower values of net profits relative to profits from operations.

Illustration 101 “Jugoremedija” AD operating and net results 2002–2006 (000 EUR)



Source: Serbian Business Registers Agency and <http://www.jugoremedija.co.yu>

The business operations of “Jugoremedija” in the years following privatization were often linked to numerous charges for illegal operations, law suits and criminal reports by small shareholders, strikes and other forms of trade union action, as well as criminal charges by the Buyer. At the beginning, the cooperation between the shareholders was good, the employees/sharehold-

²⁷⁵ In the period from 2003 to 2006, Company sales revenues, expressed in RSD, grew at the annual rate of 20.5%, while in EUR the average rate was lower at 11.8%.

²⁷⁶ Financial expenditures of “Jugoremedija” in 2006 were EUR 2.3 million, compared to EUR 820 thousand in 2002. The increase of financial expenditure of the Company resulted from short-term loans.

²⁷⁷ The average value of the remaining negative operating result of the Company in the period from 2003 to 2006 was EUR 5.8 million.

ers accepted the sale of shares to “Jaka 80” as a good business move, trusting state authorities and the new co-owner. However, problems began when “Jaka 80”, as owner of the biggest individual package of shares (41.93%), according to some allegations, started to violate the rights of minority shareholders.

According to allegations in the “Report on Jugoremedija” by the Anti-Corruption Council, the then management of “Jugoremedija” convened shareholders’ general assembly meetings without ensuring adequate conditions for minority shareholders to be adequately represented. According to allegations in the above report, an example of the most drastic violation of rights of minority shareholders by “Jaka 80” was related to the manner in which capital increase of “Jugoremedija” was performed during the year 2003.²⁷⁸ Namely, instead of the capital increase that the buyer undertook the terms of the sales contract,²⁷⁹ “Jaka 80” implemented the capital increase through debt to equity conversion under the debt that at that time “Jugoremedija” had towards “Jaka 80” to the tune of RSD 260 million (about EUR 4 million)²⁸⁰ which was converted into an equity stake of the Buyer in “Jugoremedija”. Through this additional capital increase “Jaka 80” became the majority owner of “Jugoremedija” with a stake of 61.02% of capital.²⁸¹

Despite all legal weaknesses, according to the allegations of the Anti-Corruption Council, the then management of “Jugoremedija” signed a debt-to-equity conversion agreement with “Jaka 80”, and enforced a decision on a special issue– of-shares based on the debt to equity conversion (conditional increase of basic capital). Based on this documentation, the Commercial Court in Zrenjanin in 2003 inscribed “Jaka 80” as owner of 61.02% of equity.²⁸² It was exactly this debt-to-equity conversion that was one of the reasons why the dissatisfied minority shareholders initiated a series of law suits.

At the beginning of 2004 the protest of employees – shareholders intensified and became radical. By the end of December 2003 more than 200

278 Report on Jugoremedija, Anti-Corruption Council of the Republic of Serbia, 2004.

279 Additional capital increase of “Jugoremedija”, according to obligations stated in the sales contract, was to be done based on conversion of Buyers assets intended for the mandatory level of investments in cash or other material assets in a total amount of RSD 360 million converted into equity share of the Buyer in “Jugoremedija”.

280 <http://www.vreme.com/cms/view.php?id=387234> (Site visited: August 22, 2014).

281 Additionally, the Anti-Corruption Council in its “Report on Jugoremedija” states that the decision on additional capital increase by debt-to-equity conversion that “Jugoremedija” owed at that time to “Jaka 80” was not made by the General Shareholders’ Assembly, and it was not allowed under the contract signed with the Share Fund of the Republic of Serbia. (Report on Jugoremedija, Anti-Corruption Council of the Republic of Serbia, 2004).

282 Additional suspicions regarding the legality of the capital increase as it was performed will results from the statement of the then deputy president of the Shareholders’ Assembly of “Jugoremedija”. Namely, she claimed that Jaka 80” through its management in “Jugoremedija” just prior to the said additional capital increase unnecessarily took loans in the name of “Jugoremedija” from “Jaka 80”, and procured great quantities of raw materials for medicinal product “Viziren” which, in her words, was not selling well in the market. Report on Jugoremedija, Anti-Corruption Council of the Republic of Serbia, 2004)

employees of “Jugoremedija” started a general strike, they were dissatisfied with the amount of monthly salaries which, despite increased production, were frozen at the level from September 2002, and by the situation regarding the collective agreement.²⁸³ The General Manager of “Jugoremedija” and the majority owner at the beginning of January 2004 took over control of “Jugoremedija” and prevented all employees participating in the strike from entering the factory grounds.²⁸⁴ Afterwards, under the decision of the then management, many employees who participated in the strike were laid off, which resulted in reducing the overall number of employees. The strike ended when the management of “Jugoremedija” accepted to adopt the previously suspended collective agreement, to increase the total amount of salaries by 12 %, and to cancel the decisions laying off trade union activists. Due to the failure to comply with the part of that agreement ending the previous strike, on 11 May 2004, a group of employees gathered around the “trade union” began a new general strike. Due to the strike of employees in 2004, “Jugoremedija” stopped production for almost three months, but the then management managed to maintain minimum operating processes during the strike, which they were required to do by the national labor inspectorate.

The dispute regarding the additional capital increase of “Jugoremedija” intensified in February 2004, when small shareholders filed a case before the Commercial Court in Zrenjanin due, as they stated, to untrue data contained in the documentation based on which increase of capital was implemented in “Jugoremedija”, violating the then prevailing laws.²⁸⁵ The Commercial Court in Zrenjanin in April the same year made a ruling rejecting the claim of small shareholders as inadmissible, as the then prevailing Company Act allowed only shareholders with at least 10% of shares in a company to challenge decisions of the shareholders’ company.²⁸⁶

The requests of minority shareholders for supervision and protection measures to be undertaken due, as they alleged, to violation of the sales contract, caused in May 2004 there to be reactions by the Ministry of Economy which, in the process of supervision, ordered the Share Fund to initiate procedures for termination of both contracts signed with “Jaka 80” and undertake also other measures to protect the assets of the Company, due to violation of the Privatization Act. In the first response to the news of the request of the Ministry of Economy to the Share Fund to terminate both contracts signed with “Jaka 80”, the then director of “Jugoremedija” claimed that the Share Fund can only initiate court proceedings but cannot cancel the sales contract. Shortly afterwards, the Share Fund made a decision whereby it unilaterally cancelled the sales contract with the Macedonian company “Jaka 80”

283 http://www.b92.net/info/vesti/index.php?yyyy=2004&mm=01&dd=04&nav_category=9&nav_id=129177.

284 Ibid.

285 Ibid.

286 Ibid.

on the sale of 41.93 % shares of “Jugoremedija”.²⁸⁷ The Share Fund also made a decision also to unilaterally cancel the Investment Contract signed on 2 October 2002, since “Jaka 80” failed to provide the necessary bank guarantees.

According to allegations from the “Report on Jugoremedija” by the Anti-Corruption Council, as long as two years after the signing of the Sales Contract, the Buyer “Jaka 80” did not provide bank guarantees nor did it make the necessary investment as obliged by the Sales Contract. Also, according to the allegations of the same source, the documents of the Share Fund include a letter by “Jaka 80” requesting not to provide the bank guarantee, since the fees related to providing such a guarantee were excessively high, stating also that they retain their obligation to invest.²⁸⁸ The legal representative of the company “Jaka 80” stated that “Jaka 80” in May 2003 requested the Share Fund and the Privatization Agency to provide information on how to make payment for the guarantee and for the list of banks whose guarantees are acceptable, but that the company never received such information nor the list of banks. Soon after the decision was made to unilaterally cancel the contract by the Share Fund, the then management of “Jugoremedija” publicly disclosed information that the Share Fund in December 2003 submitted minutes to the Ministry of Economy and Privatization stating that all items of the investment contract with the Macedonian company “Jaka 80” have been fulfilled.²⁸⁹

After receiving the ruling of the Commercial Court in Zrenjanin of 26 April rejecting the claim of minority shareholders as inadmissible, the minority shareholders filed a claim to the Higher Commercial Court in Belgrade. The Higher Commercial Court in Belgrade on 25 June 2004 made a ruling confirming the previous ruling made by the Commercial Court in Zrenjanin, rejecting the claim of minority shareholders. Additionally, in the same year the National Labor Inspection Service declared the general strike in “Jugoremedija” illegal. After the Higher Commercial Court in Belgrade ruled confirming the previous ruling of the Commercial Court in Zrenjanin, minority shareholders on 28 June 2004 filed to the Supreme Court a petition for a review of proceedings,²⁹⁰ which subsequently returned this case to the first-case instance to re-adjudicate.²⁹¹ After these rulings, the workers on strike

287 http://www.b92.net/info/vesti/index.php?yyyy=2004&mm=06&dd=29&nav_category=9&nav_id=144680 (Site visited: September 14, 2014)..

288 Report on Jugoremedija, Verica Barać, Anti-Corruption Council of the Republic of Serbia, 2004.

289 The then owner and management of “Jugoremedija” in responding to the pressure exerted upon them, on 9 June 2004 filed criminal charges against former Economic Minister Dragan Maršićanin, the President of the Anti-Corruption Council Verica Barać, the Deputy Minister of the Economy Zora Simović, and the President of the Commission for Securities Mira Prokopijević, because through irresponsible statements regarding the privatization of “Jugoremedija” they inflicted damage to the company and that “Jaka 80” shall claimed for compensation of damages caused to Jugoremedija.

290 Anti-Corruption Council of the Republic of Serbia, 2004. Report on Jugoremedija.

291 http://www.b92.net/info/vesti/index.php?yyyy=2006&mm=05&dd=25&nav_id=198712 (Site visited: September 14, 2014).

in “Jugoremedija” expelled the general director, who subsequently, on 9 July, after 50 days of absence, returned to his post with the assistance of the police, the judge and the court enforcement officer of the court in Zrenjanin, based on the ruling of the Basic Court.²⁹²

After all of these events, the Department of the Interior in Zrenjanin on 17 July 2004 filed criminal charges against the then general director of “Jugoremedija” Mr. Radovanović and his assistant Mr. Marković due to suspicions that they have abused their office and counterfeited official documents. Mr. Radovanović was accused that he has ensured for the Macedonian company “Jaka 80” illegal pecuniary benefit amounting to RSD 7.2 million and is suspected that in the business ledgers he counterfeited data on increase of capital of “Jugoremedija”. The second accused Mr. Zlatko Marković was suspected of having taken for himself the benefit of daily allowances for traveling abroad totaling RSD 4.1 million.²⁹³

Subsequently, the Commercial Court in Belgrade by its ruling, reversing the privatization of “Jugoremedija”, rejected the claim of shareholders’ company “Jaka 80” requesting nullity of contract for investment signed between “Jaka 80” and the Serbian Share Fund. Following such a claim by “Jaka 80”, the Serbian Share Fund filed a counter claim in June 2006, which was granted by the Commercial Court in Belgrade and a ruling was made to cancel the Contract on Sale of “Jugoremedija”. Minority shareholders of “Jugoremedija” joined the above counter claim by the Share Fund.²⁹⁴

The result of the Commercial Court in Belgrade’s final ruling of January 2007 was the cancellation of the contract on sale of the ownership stake, while the ruling of the Higher Commercial Court in Belgrade confirmed the earlier ruling of the Commercial Court in Zrenjanin regarding the nullity of the capital increase by debt conversion.²⁹⁵

According to the statements of the new management, at the time of the taking over of “Jugoremedija” by employees in March 2007, the production had stopped, the power supply and the technological steam supply had been disconnected, the Company had high debts to employees, suppliers and state authorities, the stock of raw materials was insufficient, the implementation of GMP standards had stopped, and the level of maintenance of equipment and the system was inadequate. The previous management had not made payments for certain obligations since 2002, such as taxes, contributions to the Pension and Disability Fund, neither had they made payments to certain suppliers, and this was tolerated by the state throughout this period. On the

292 <http://www.vreme.com/cms/view.php?id=387234>.

293 http://transparentnost.org.rs/ts_mediji/stampa/2004/JUL_2004/1807-04.html (Site visited: September 15, 2014).

294 <http://mondo.rs/a27014/Info/Drustvo/Ponistena-privatizacija-Jugoremedije.html> (Site visited: September 16, 2014)..

295 Plan for restructuring of Jugoremedija AD undergoing bankruptcy Zrenjanin, Hypo-Alpe-Adria Bank AD and Blue Rose Fund DOO.

other hand, according to the same sources, the new management was faced with threats by the Tax Administration that it would initiate bankruptcy over “Jugoremedija” unless it settled all debts to it. Equally, certain suppliers did not have any understanding concerning the problems faced by “Jugoremedija” resulting from poor privatization.²⁹⁶

According to statements from the new management appointed by employees, the key cause of the crisis that “Jugoremedija” was undergoing in 2007 was the fact that for many years the preceding management was getting out of the company the free assets that the Company generated during almost 5 years under the preceding management.²⁹⁷ Specifically, there were suspicions that the previous owner got assets out of “Jugoremedija” through acquisitions of companies that had nothing to do with the pharmaceutical industry (“Medela”, and “Luksol”) and through doing business with other legal entities owned by Mr. Stefanović²⁹⁸. Additionally, they considered that instead of such practice, the profit generated by “Jugoremedija” should have been used to settle accumulated debts to employees, suppliers and the state.²⁹⁹

Such suspicions that the previous owner was getting assets out of “Jugoremedija”, were additionally corroborated by the findings of the Department of Criminal Police. At the beginning of November 2012, in the campaign of the task force of the Department of Criminal Police, the police brought in for questioning the previous owner and the former general director of “Jugoremedija” (owner of companies “Jaka 80” in Macedonia and “MD Nini” in Niš), as well as the former manager in charge organizational, economic and legal operations of the pharmaceutical plant “Jugoremedija” and the director of the company “Nini”. They were suspected that by abuse of office to the detriment of “Jugoremedija” they ensured for the owner to gain illegally about EUR 7.5 million.³⁰⁰

The method of this abuse, according to the findings of the Department of Criminal Police, consisted of submitting significantly inflated invoices for the procurement of raw materials for production of medicinal products which companies owned by the owner of “Jugoremedija” “MD Nini” and “Jaka 80” from Macedonia submitted to “Jugoremedija”. These companies procured raw

296 Interview with the President of the Managing Board of “Jugoremedija”, Zdravko Deurić, (available at www.jugoremedija.rs).

297 Teaser “Jugoremedija”, Opportunity to invest in the pharmaceutical sector in Serbia – sale of majority package of shares of AD Jugoremedija, Privatization Agency, Masters Finance and PKF Accountants & Business Advisers, December 2010.

298 The Anti-Corruption Council also warned of indications that there was money laundering in “Jugoremedija”. The Council stated that warnings of money laundering in the case of “Jugoremedija” were also put forward by the Republic of Macedonia State Anti-Corruption Commission.

299 The response of “Jugoremedija” AD Zrenjanin to the text “The case of the official of the Anti-Corruption Agency” (Novi magazin Nr. 58 of 7 June 2012, p. 39–41), Jugoremedija, <http://www.uciteljneznalica.org/item-Odgovor%20Jugoremedije%20fabrike%20lekova%20AD%20Zrenjanin%20n-371.htm> (Site visited: August 27, 2014)..

300 <http://www.rts.rs/page/stories/sr/story/135/Hronika/1206572/Hap%C5%A1enje+u+afერი+%22Jugoremedija%22.html?email>. (Site visited: August 27, 2014).

materials directly from manufacturers in India, Italy, Germany and Switzerland and subsequently sold them to “Jugoremedija” at considerably higher prices.³⁰¹

As stated by the new management of “Jugoremedija” it was exactly the practice of avoiding purchasing raw materials for medicinal products from “Aventis”, which “Jugoremedija” was obliged to do under the contract, that was yet another example of unconscientious business practice by the preceding management. Such business practice led to jeopardizing further cooperation with “Aventis”. The same source stated that due to the violating of contractual obligations, “Aventis” claimed from “Jugoremedija” to pay compensation totaling EUR 1.8 million asking also for them to withdraw from the market and destroy all medicinal products manufactured after the expiration of the license rights. However, after a meeting and a deal with “Aventis” closed in Paris, such a result was avoided. According to this agreement the new management of “Jugoremedija” undertook to pay damages to “Aventis” and continue the cooperation. Additionally, as stated by the new management, the previous management lost all standards and certificates and the permit to export to Russia.³⁰²

The financial difficulties of “Jugoremedija” were accompanied by other problems as well. The government had earlier, through new legislative solutions and the Law on Medicinal Products and Medical Devices (“The Official Gazette of the Republic of Serbia” Nr. 84 of 24.07.2004), regarding the permits for manufacture of medicinal products for the first time defined deadlines for implementation of guidelines of good manufacturing practice (under GMP standards). The Law introduced a transition period of five years for harmonization with positive pharmaceutical regulations, which meant that manufacturers in this period had to ensure adequate conditions and equip-

301 “According to the findings of the Department of Criminal Police, the suspect had in the period from March 2006 to February 2007 been inflating invoices for raw materials used in the production of medicinal products by “Jugoremedija” issued by company “Jaka 80” from Radoviš, which company procured the same raw material originating from India at the price which was 70 times lower than the price invoiced to “Jugoremedija”. There were also findings that the company “MD Nini” used the same method in procuring raw materials from foreign suppliers from India, Germany and Italy at prices that were 50 times lower than the price invoiced to “Jugoremedija”. The same source states that “Jugoremedija” made advance payments for raw materials to the Macedonian company “Jaka 80”, and that such raw materials had never been delivered to “Jugoremedija”. This debt of “Jaka 80” to “Jugoremedija”, was returned by “Jaka 80” by delivering two tonnes of raw materials which, according to allegations of the Criminal Police, were not at all needed by “Jugoremedija” while they were also invoiced at prices far higher than original. Such inflated invoices, according to the allegations of the Department of Criminal Police, resulted in Jovica Stefanović Nini acquiring illegal gain to his companies “Jaka 80” and “MD Nini” at the detriment of “Jugoremedija” totaling RSD 590 million, or about EUR 7.5 million in the period from March 2006 to February 2007. <http://www.rts.rs/page/stories/sr/story/135/Hronika/1206572/Hap%C5%A1enje+u+aferi+%22Jugoremedija%22.html?email=yes> (Site visited: August 28, 2014).

302 “Jugoremedija – where and how to move on”, <http://www.republika.co.rs/414-415/13.html> (Site visited: August 27, 2014).

ment for production of pharmaceutical products. Additional amendments to the said Law extended this deadline until the end of 2010.

In order to comply with the legal obligation and create conditions for normal operation and development of “Jugoremedija”, and considering the fact that there had been no investments in “Jugoremedija” for more than twenty years, the new management of the Company decided to invest about EUR 10 million in reconstructing the facilities for solid and semi-solid forms and packaging and warehousing units. The new management of the Company concluded that it was not possible to rehabilitate all production facilities and, bearing in mind that about 60% of all registered medicinal products produced by “Jugoremedija” are tablets, they started reconstruction of the facility for solid and semi-solid forms and the packaging and warehousing units. The cost of the investment was about EUR 10 million,³⁰³ and it was done in order to ensure conditions in “Jugoremedija” to sufficient to be granted European GMP standards. Lacking its own capital, most of the money needed for investment was borrowed under unfavorable financial conditions, while a minor part was generated through the sale of stakes of “Jugoremedija” in companies “Medela” and “Vetprom”.³⁰⁴ The reconstruction of the existing facilities and fulfillment of the criteria for GMP certificate was an imperative for the new management, because otherwise “Jugoremedija” could no longer produce medicinal products.

During the year 2009 reconstruction works were being completed in the facilities for solid and semi-solid forms and the packaging and warehousing units to be in compliance with GMP standards, so that the biggest facilities of Jugoremedija did not operate during this period of reconstruction. “Jugoremedija” in the meantime managed to ensure a sufficient level of stocks, and the sale thereof was planned in order to ensure regular salaries for employees during the reconstruction period. At the beginning of 2010, the investment of Jugoremedija was activated, specifically an investment in equipment amounting to EUR 1.4 million and in construction works amounting to EUR 5.8 million. However, this was not sufficient because this project did not cover the production of ampoules and antibiotics.

The completed investments in equipment and construction works were not sufficient to meet all the legal requirements for smooth continuation of production and the Ministry of Health of the Republic of Serbia made a decision to stop production of antibiotics in “Jugoremedija” until it was moved into a different location.

In order to have the GMP certificate “Jugoremedija” had to remove the production of betalactane antibiotics from the existing plant, due to which demand the new management of “Jugoremedija” decided to build a new

303 Comments enclosed with financial statements of Jugoremedija AD Zrenjanin undergo bankruptcy, 2013.

304 Interview with the president of the Managing Board of “Jugoremedija”, Jugoremedija AD, www.jugoremedija.rs

plant for production of antibiotics. The idea was that the facilities of the new plant should be built within the newly established company “Luxol farmacija” d.o.o, whose founders were 46 workers-shareholders of “Jugoremedija” including the acting general director of “Jugoremedija”. The founders of “Luxol farmacija” d.o.o. founded the company with the equity invested by employees-shareholders in the form of their shares in “Jugoremedija”. After which they provided funds for the purchasing of land in the industrial zone “Jugoistok – Ečka” in Zrenjanin totaling EUR 83 thousand, plus about EUR 300 thousand as initial capital for the construction of the storage, office buildings and other facilities.³⁰⁵ Antibiotics were produced also within another newly established company – “Penpharm” d.o.o, owned by “Luxol farmacija” d.o.o. with a stake of 70.98% and “Jugoremedija” AD with a stake of 29.2%.³⁰⁶ Into this company (“Penpharm” d.o.o) the company “Luxol farmacija” d.o.o. invested facilities and land, while “Jugoremedija” AD invested about 30 years old equipment and licenses for the production of medicinal products. Through this joint investment it was intended that “Jugoremedija” AD and “Luxol farmacija” d.o.o. would jointly produce antibiotics. In March 2011 “Jugoremedija” ensured all the necessary requirements for the certificate of good manufacturing practice (GMP).

Despite the initial positive indications, what followed was another decline in the operations of the Company due to the excessive debt level of “Jugoremedija” and also due to the loss of market share. In 2007, the year when the previous privatization was cancelled, “Jugoremedija” generated sales revenues totaling EUR 11.4 million which is less than a half of the sales revenues generated in 2003, when such revenues stood at EUR 24 million.³⁰⁷ As stated by the new management of “Jugoremedija”, the reason for such plummeting of sales was the state in which the company “Jugoremedija” was in after it was taken over by the employees in 2007.³⁰⁸ Soon after the change of management, there were the first positive indications pointing to the some chance of recovery of the company and its exiting the crisis. The new management of “Jugoremedija” managed to win back markets that had been lost in the meantime and they also signed a contract for USD 4.5 million for production and export of ampoules into Russia, Ukraine, Belarus, and Kazakhstan.³⁰⁹ Another factor that contributed to recovery of sales of “Jugoremedija” in 2008

305 <http://www.naslovi.net/2010-12-10/b92/radnici-jugoremedije-grade-fabriku/2179913> (Site visited: August 29, 2014).

306 Serbian Business Registers Agency, data on co-owners of “Penpharm” d.o.o. (Registry number: 20695218)

307 Serbian Business Registers Agency.

308 New management of the Company when coming to office was faced with stopped production, disconnected power and technological steam supply, high debts to employees, suppliers and the state, inadequate stock of raw materials, revocation of GMP standards, insufficient level of maintenance of equipment and production system.

309 “Jugoremedija – where and how to move on”, <http://www.republika.co.rs/414-415/13.html> (Site visited: August 30, 2014).

was the growth of the physical scope of production which in 2008 was greater by an annual level of 82%.

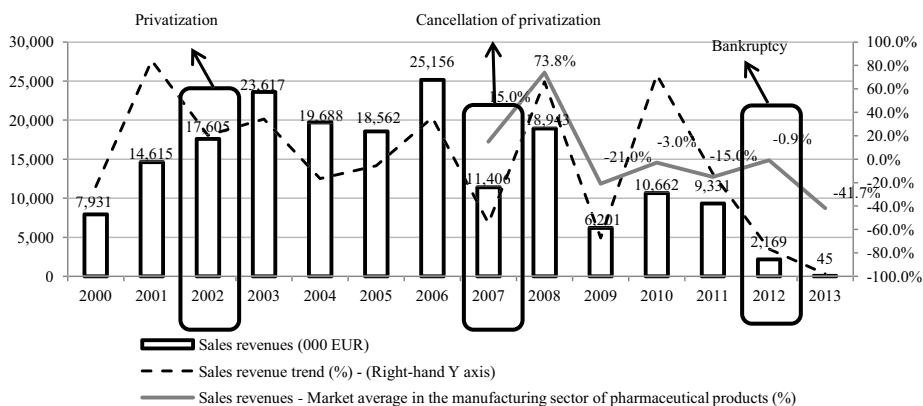
Table 59 Production output volume 2007–2013

Unit	Volume						
	2007	2008	2009	2010	2011	2012	2013
Boxes	8,414,236	15,273,768	6,340,656	N/A	6,131,703	831,697	0

Source: Privatization Agency of the Republic of Serbia and the Profile of Jugoremedija AD Zrenjanin

Although the new management managed to increase sales revenues in the following year to EUR 19 million, the new deterioration of business happened due to excessive debt level and the inability of the Company to increase or at least maintain level of sales that it had before 2007.

Illustration 102 “Jugoremedija” AD sales revenues 2000–2013 (000 EUR)



Source: Serbian Business Registers Agency. Study on Consolidation of the Pharmaceutical Industry in Yugoslavia, 2001 and <http://www.jugoremedija.co.yu>

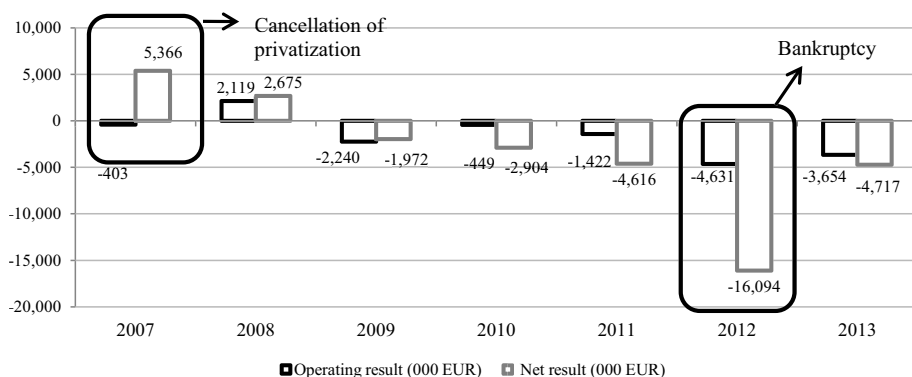
The sales revenues in 2009 were significantly lower than in 2008, due to the fact that *production had to be stopped in order to undertake an overhaul in order to receive the GMP certificate*. The then management expected that after the overhaul that sales revenues in 2010 would be about EUR 25 million. They also expected that during the following two years, thanks to the modernization of the facility for liquid forms and the displacement of the plant for production of β -lactam antibiotics, “Jugoremedija” would have sales totaling EUR 40 million.³¹⁰ The initial sales results during the first quarter of

310 Teaser – sale of majority package of shares of AD Jugoremedija Zrenjanin, December 2010.

2010 indicated that the management plans for 2010 would be achieved, as the sales in the first quarter alone amounted to EUR 4.5 million. However, by the end of 2010 “Jugoremedija” had sales revenues of only EUR 10.7 million.³¹¹

Since 2010 the circumstances regarding sales of “Jugoremedija” were much more difficult due to the entry of medicinal products by foreign pharmaceutical companies and their inclusion on the positive list of the National Health Insurance Fund, whereby “Jugoremedija” lost about 50% of the market. On top of the loss of market, reduced sales revenues were a consequence of the policy pursued by the National Health Insurance Fund to reduce the prices of drugs.³¹² An additional aggravating fact which contributed to weak sales of “Jugoremedija” was the lost lawsuit against “Jugohemija” regarding the part of ownership in “Jugoremedija”, that “Jugohemija” had at a certain point in time. “Jugoremedija” had to pay damages to “Jugohemija” totaling EUR 4.5 million, which “Jugoremedija” paid through finished products (drugs). “Jugohemija” subsequently placed the drugs in the market at lower, discounted prices, which resulted in an additional drop of market share and sales by “Jugoremedija”.³¹³ Already by the end of 2011, as stated by the representative of the association of shareholders of “Jugoremedija 3”, *due to failure to settle contractual financial obligations towards the license partner “Sanofi – Aventis”, “Jugoremedija” lost the right to produce and distribute products which made up 80% of the domestic sale of drugs.*³¹⁴

Illustration 103 “Jugoremedija” AD operating and net results 2007–2013 (000 EUR)



Source: Serbian Business Registers Agency

311 Ibid.

312 <http://www.naslovi.net/2011-05-13/danas/prica-o-revoluciji-u-jugoremediji/2534674> (Site visited: August 29, 2014).

313 http://www.b92.net/info/vesti/pregled_stampe.php?yyyy=2012&mm=10&dd=26&nav_id=655178 (Site visited: August 29, 2014)..

314 <http://www.naslovi.net/2011-11-10/dnevnik/suvlasnici-nezadovoljni-upravom/2946422>.

“Jugoremedija” suffered operating losses in 2007 primarily due to a significant decrease of sales revenues of 54.7%. However due to a significant increase of other revenues of the Company, which grew from EUR 2.8 million to EUR 11.7 million, “Jugoremedija” operated with a net operating profit in 2007. It was only in 2008 that Jugoremedija had positive net results during the period from 2007 to 2013, and this was thanks to growth of production and recovery that happened during that year. In all other years “Jugoremedija” operated with losses which were a result of lower sales, stopping of production in 2009 for overhaul purposes in order to gain the GMP license, and due to the inability to regain its market position and level of sales that the Company had in the period before 2007. The reason why “Jugoremedija” was not successful in achieving positive operating results was partly the loss of market and partly high interest expensens resulting from excessive borrowing of the Company. This led to net operating loss and the inability to ensure adequate working capital.

It was the sudden increase of financial expenditures and the subsequent sudden increase of other expenditures, along with the business losses, that were the key reasons why “Jugoremedija” was operating with net losses from business operations from 2009 to 2013. The sudden increase of financial expenditures first occurred in 2008, when it increased at an annual level by 3.7 times, or from EUR 675 thousand in 2007 to EUR 3.2 million in 2008. The financial result from operations in all the years under review was negative. A greater negative financial result of “Jugoremedija” in the period after termination of privatization was a consequence of significant borrowing by “Jugoremedija” based on long-term and short-term loans in order to finance the overhaul of the existing plant and ensure the GMP certificate and working capital.³¹⁵

The sudden increase of expenditures of “Jugoremedija” was recorded during 2011 and 2012 due to significant depreciation of claims and short-term investments and due to the writing off of a portion of stocks.³¹⁶ Consequently to the aforementioned increase of other expenditures, other operating results of the Company were negative in 2011 and 2012 and totaled EUR 1,5 million and EUR 7.1 million respectively.³¹⁷ The seriousness of the situation in “Jugoremedija” is also illustrated by the reports of the independent auditor for the years 2010 and 2011 indicating a significant over-valuation of working assets in the financial statements (stocks that had expired, bad debts, etc.), accompanied at the same time by an under-valuation of obligations, or specifically no reservations were being made for disputes of significant values

315 In the period from 2002 to 2007 the negative financial results of “Jugoremedija” were on average EUR 1.1 million, and in the period from 2008 to 2012 averaged EUR 2.1 million.

316 Other expenditures of “Jugoremedija” in 2011 at an annual level were greater by 3.9 times and reached the level of EUR 2 million. In 2012 other expenditures at annual level was greater by 2.9 times and reached EUR 7.7 million. In comparison, the value of other expenditures of “Jugoremedija” in 2010 was EUR 401,000.

317 For comparison, the average value of other results from business operations of “Jugoremedija” from 2002 to 2006 were also negative and amounted to EUR 5 million.

(the lost lawsuit under the claim by “Sanofi – Aventis” d.o.o. Belgrade) due to which the auditor gave his qualified opinion with a reservation regarding the validity of presented financial statements for the years 2010 and 2011.³¹⁸

Due to poor operating results “Jugoremedija” was faced with a liquidity crises which was manifested, among other things, in the late payment of salaries to employees. As of October 2011, employees in “Jugoremedija” had not received salaries for three months, which caused dissatisfaction, especially among a portion of the employees who were members of the trade union UGS “Nezavisnost”. The reasons for failure to pay salaries stated by the acting general director Mr. Deurić were that the funds available were directed to procurement of raw materials for production and in difficulties in sales due to the uneasy situation in the market of medicinal products caused by late payments of the National Health Insurance Fund for prescription drugs.³¹⁹ Mr. Deurić also stated that due to general lack of liquidity the wholesalers were late in settling payments for delivered products and they owed “Jugoremedija” around RSD 11 million.³²⁰ The representatives of the trade union UGS “Nezavisnost”, in contrast with the majority independent trade union, did not accept the explanations put forward by the director that the Company was in a dire situation. The dire financial situation of “Jugoremedija” was further confirmed by the fact that during July 2011 the Ministry of Economy and Regional Development was approached by the German company “Sanofi–Aventis”, with whom “Jugoremedija” was cooperating, notifying it that the Zrenjanin pharmaceutical company in the last three years was not living up to its financial obligations – debts.³²¹

Due to the collapsing financial situation of “Jugoremedija”, *the management on several occasions asked the government for assistance*, as it was the biggest individual minority shareholder of the Company with 42% of shares. The Ministry of Economy and Regional Development together with the Ministry of Health in July 2011 had a meeting with representatives of the management and trade unions of “Jugoremedija”. The representatives of the Ministry expressed readiness to have the state, as the biggest individual shareholder, actively engaged in management bodies. It was the opinion of the representatives of the Ministry that one of the reasons why “Jugoremedija” was in a difficult financial position was that the management was not capable off running the Company, so that the banks as creditors were no longer ready to continue lending.³²² It was obvious that at this period of time there was a

318 Plan of Reorganization Jugoremedija AD in bankruptcy Zrenjanin, submitted by Hypo-Alpe-Adria Bank AD and Blue Rose Fund DOO.

319 <http://www.naslovi.net/2011-10-06/dnevnik/sirovine-pojele-plate-u-jugoremediji/2914099> (Site visited: August 22, 2014).

320 <http://www.naslovi.net/2011-10-11/danas/kasne-plate-u-jugoremediji/2870153> (Site visited: August 22, 2014)

321 <http://www.naslovi.net/2011-08-21/dnevnik/pogresna-terapija-u-jugoremediji/2754804> (Site visited: August 22, 2014).

322 Ibid.

conflict between the acting general director of “Jugoremedija” Mr. Deurić and the Ministry of Economy and Regional Development, and the director said repeatedly that he has no trust in the state as a partner.³²³

After the privatization was terminated in 2007 the state did not participate in the management of “Jugoremedija” although it was the biggest individual minority shareholder. This is substantiated by the fact that the general assembly of shareholders in August 2011 was not attended by any representative of the state, despite the fact that it owned 42% of its capital. Such *absence of its representatives, or proxies of the state, also created serious difficulties in the functioning of “Jugoremedija”*. The above general assembly, due to the absence of representatives of the state, could not have the two thirds majority needed for the adoption of the proposals of the Managing Board.³²⁴ This proposal, which could not be adopted, was about rescheduling obligations of “Jugoremedija” under loans from the “Vojvodina Development Bank” and the “Hypo Alpe-Adria” bank and mortgaging property for the purposes of the intended rescheduling.³²⁵

Poor operating results of “Jugoremedija” resulted from a number of causes. On the one hand, the state with its policy of reducing prices for medicinal products contained in the positive list of the National Health Insurance Funds contributed to it (Lasix ampoules, Aminofilin retard ampoules), the irregular payment to suppliers by health institutions, difficulties in getting loan guarantees, inability to collect receivables from wholesalers suffering from lack of liquidity and favoring imports over domestic production of medicinal products.³²⁶ On the other hand, poor operating results were additionally a consequence of the business policies of the Company to continue manufacturing medicinal products despite their production being non-profitable. The Director of the National Health Insurance Fund stated that the debt of the Fund to

323 <http://www.naslovi.net/2010-12-12/dnevnik/stigla-dozvola-za-luksol-farmaciju/2185056> (Site visited: August 22, 2014).

324 The Share Fund which in the name of the state had 31.96% of capital of “Jugoremedija” (the Pension Insurance Fund had 9.97%), did not send their representatives, due to which it was assumed that the Share Fund was against adopting the proposal of the Managing Board.

325 <http://www.naslovi.net/2011-08-21/dnevnik/pogresna-terapija-u-jugoremediji/2754804> (Site visited: August 22, 2014).

326 This is further substantiated by the fact that the National Health Insurance Fund (RZZO) in February 2011 signed with manufacturers of drugs a protocol stipulating that pharmaceutical companies shall reduce their claims for drugs to the Fund by 10% in order to thus ensure reliable supply of the market. The Protocol with RZZO was signed by the “leading pharmaceutical companies present in the Serbian market. The agreement under the Protocol applied directly to drugs from the List A and A1, while the drugs from List B would be governed by the same principle, but through public procurement procedures which are to be carried out by health care institutions. For comparison purposes, as of end of 2010, “Jugoremedija” had in the prevailing positive lists 41 medicinal products in the List A, 15 in the List A1 and 29 in the List B. (Teaser “Jugoremedija”, *Opportunity to invest in the pharmaceutical sector in Serbia – sale of majority package of shares of AD Jugoremedija, Privatization Agency, Masters Finance and PKF Accountants & Business Advisers, December 2010*).

pharmacies had been accumulated over a number of years and at the end of 2010 it had soared to more than RSD 14 billion, adding that such a situation threatened to jeopardize the stability of the national health care system.³²⁷

At the beginning of 2011 the state together with small shareholders attempted once again through tenders to find the good buyer – a strategic partner for “Jugoremedija”. The Privatization Agency in February 2011 published a public call for tender for the sale of 92.87% of the capital in “Jugoremedija”. The tender offered for sale 3.46 million shares of “Jugoremedija” at the nominal value of RSD 1,000 per share, and the minimum price of the package of shares was EUR 51.9 million, or EUR 15 per share. The Share Fund was the owner of 31.95% of shares, the Pension Fund 9.96% and 50.94% of shares of “Jugoremedija” were owned by individual shareholders and deposited in the account of securities. Small shareholders responded in November 2010 to the call of the Share Fund to join their shares. The condition that bidders had to fulfill in order to participate in the tender was to be engaged in the production of pharmaceuticals over the past five business years and to have had in the last year income of at least EUR 30 million.³²⁸

Previously, the small shareholders, as majority shareholders of “Jugoremedija”, managed during 2009 to reach an agreement with the Ministry of Economy regarding the new model of privatization of the Company, although initially the Ministry did not have an understanding for the plans of small shareholders. The ambition of the small shareholders was to have “Jugoremedija” sold under tender, which is to say in a procedure in which the price is not the sole parameter for the selection of the most favorable bidder, but rather to look for a strategic partner. The additional dispute between small shareholders and the Ministry arose regarding the deadline within which the new privatization was supposed to happen. Small shareholders did not want the sale to begin before the reconstruction of facilities were completed in order to ensure compliance for GMP standards, while the idea of the Ministry was to transfer the obligation for transformation to the future owner. Finally, the approach of small shareholders to accept to wait with the sale until the reconstruction of the production facilities was completed before any sale. An agreement was also reached with the Ministry of Economy to act jointly with the small shareholders under the tender whereby the state would sell its 42% of shares together with small shareholders.³²⁹

In May 2011 the tender commission which was in charge of the tendering procedure for the sale of 92.8% of the registered capital of “Jugoremedija” declared that the tender had failed. The Commission stated that by the dead-

327 <http://www.naslovi.net/2011-02-18/emportal/rzzo-i-farmaceutske-kompanije-potpisale-protokol-video/2344000> (Site visited: August 22, 2014).

328 <http://www.naslovi.net/2011-02-14/biznis-novine/prodaje-se-jugoremedija/2334454> (Site visited: August 22, 2014).

329 Interview with the President of the Managing Board of “Jugoremedija”, Zdravko Deurić, Jugoremedija AD.

line for the submission of bids, 22 April 2011, no bids had been received for purchasing the capital of “Jugoremedija”, and that no request for the purchasing of the tender documents had been received in the stipulated time.³³⁰

Two weeks after the unsuccessful tender attempt, according to a statement by a member of the Managing Board, the shares of “Jugoremedija” were to be available for trading in the Stock-Exchange based on the agreement between the management and the Share Fund. The management of “Jugoremedija” requested that the state should not sell its package of shares independently of the small shareholders, in order to avoid mistakes from the previous privatization.³³¹ On the first day of trading in shares of “Jugoremedija” the opening price per share was RSD 500. After several days the price of shares dropped to RSD 333 per share, and on 27 June only one share was sold at the price of RSD 309. This gave rise to serious concerns among the four thousand small shareholders and 450 employees of the plant who were hoping to get at least EUR 10 per share.³³²

Employees – shareholders of “Jugoremedija” who were dissatisfied with the performance of the management at the end of 2011 formed an association of shareholders “Jugoremedija 3”. The reason for the formation of the new association of shareholders was, in their words, to try with the local self-government and the state institutions to find a solution for the problems of “Jugoremedija”, as the company after the terminated privatization was in a much better position compared to 2011. During 2011 the account of “Jugoremedija” was blocked for more than 100 days, and the Company was not paying taxes or contributions and were late with payment of salaries, with frequent disconnections of telephones, energy supply and gas³³³. Due to outstanding contractual financial obligations to its licensing partner “Sanofi – Aventis”, “Jugoremedija” lost the right to produce and distribute products making up 80% of its domestic sale of medicinal products.³³⁴

At this point “Jugoremedija” was shaken by a new scandal. Due to suspicions that they had abused their office and caused damage to the Company “Jugoremedija” of about EUR 600,000 the Department of Criminal Police in cooperation with the Higher Public Prosecution Office in Zrenjanin at the

330 <http://www.naslovi.net/2011-05-15/biznis-novine/neuspeo-tender-za-prodaju-zrenjaninske-jugoremedije/2540551> (Site visited: August 22, 2014).

331 <http://www.naslovi.net/2011-05-23/danas/objedinjavanje-akcija-glavni-cilj/2556227> (Site visited: August 22, 2014).

332 <http://www.naslovi.net/2011-07-06/magyarszo/lose-vesti-sa-berze/2655185> (Site visited: August 22, 2014).

333 <http://www.naslovi.net/2011-11-14/dnevnik/javna-diskreditacija-posle-kritika/2955361> (Site visited: August 22, 2014).

334 The statement by the association of shareholders “Jugoremedija 3” states that during the preceding three years there had been interest by serious pharmaceutical companies for the acquisition of “Jugoremedija”, but such interested companies did not manage to reach a deal with the management regarding the conditions of sale (<http://www.naslovi.net/2011-11-10/dnevnik/suvlasnici-nezadovoljni-upravom/2946422>).

beginning of August 2012 arrested the acting general director and a number of his associates. They were arrested under suspicion that they had – at the time of founding the Company “Penfarm” d.o.o., through a valuation of land and shares of “Jugoremedija”, which was higher than the market value, as well as by counterfeited and unsigned valuation report for the value of the license for medicinal products (which was valued at lower than the market price) – created benefits to the company “Luksol farmacija” to the amount of RSD 55,396,100 and thus caused damage to company “Jugoremedija”.³³⁵

Excessive debts of “Jugoremedija”, the loss of the market and the plummeting of sales led to the final collapse of “Jugoremedija”, against which bankruptcy proceedings were instituted at the end of 2012. Permanent business losses, high financial expenditures and other expenditures, resulting primarily from overly depreciated claims and short-term investments and writing off of a portion of stocks,³³⁶ resulted in accumulated losses year after year and in recording losses exceeding equity capital. As of 31 December 2012 “Jugoremedija” no longer had any major uncollected claims, nor cash or other short-term assets, which seriously jeopardized the financial balance and liquidity of the company. The recorded loss exceeded the equity at the end of 2012, totaling EUR 9 million, the lack of liquidity and insolvency of the company were sufficient grounds for the bankruptcy proceedings to be initiated over “Jugoremedija” at the end of 2012.

Table 60 “Jugoremedija” AD profitability indicators 2000–2013

Year	2000	2001	2002	2003	2004	2005	2006
EBITDA %	25,5%	39,5%	28,3%	26,2%	32,1%	46,2%	54,6%
EBIT %	19,1%	33,5%	24,3%	23,6%	26,5%	40,9%	50,5%
Net result %	0,5%	3,6%	5,2%	3,1%	0,3%	2,0%	6,7%
ROA	0,4%	3,8%	5,5%	3,1%	0,2%	1,2%	5,8%
ROE	0,8%	6,8%	9,1%	5,5%	0,4%	2,5%	10,8%
Gross margin	N/A	N/A	N/A	N/A	N/A	N/A	N/A

335 According to statements by the police the value of land that in “Penfarm” d.o.o. by “Luksol farmacija” was valued much higher than the market value of such land. Also, the value of shares of “Jugoremedija” owned by “Luksol farmacija” was presented in amounts exceeding several times their actual value, while the transfer of full rights for renewal and registration of medicinal products “Clijacil” and “Tolika” from the company “Jugoremedija” AD to the company “Penfarm” d.o.o. was presented in an amount several times lower than actual. (<http://www.politika.rs/rubrike/Hronika/Cetiri-osobe-lisene-slobode-zbog-Jugoremedije.lt.html>; Site visited: August 29, 2012).

336 Comments enclosed with financial statements of Jugoremedija AD Zrenjanin under bankruptcy for 2011 and 2012.

Year	2007	2008	2009	2010	2011	2012	2013
EBITDA %	5,4%	16,3%	-19,8%	7,8%	-6,9%	-180,6%	-474,9%
EBIT %	-3,5%	11,2%	-36,1%	-4,2%	-15,2%	-213,5%	-8135,7%
Net result %	47,0%	14,1%	-31,8%	-27,2%	-49,5%	-742,1%	-10500,9%
ROA	15,7%	7,6%	-5,8%	-8,9%	-15,4%	-58,0%	-17,4%
ROE	29,4%	13,7%	-11,0%	-20,8%	-48,3%	-437,4%	–
Gross margin	N/A	N/A	N/A	54,5%	55,1%	56,2%	-263,8%

Source: Author's calculation

Since we have had a detailed look at the events that affected the business operations of the Company, we can now go back to analyzing the financial position of the period under review. After termination of privatization in 2007 the operation of “Jugoremedija” AD was not profitable. The reason for the high value of profitability indicators of “Jugoremedija” AD until the year 2006 was the significant growth of sales revenues and the consequent relatively high levels of operating results as indicated by the earnings before interest and taxes (EBIT%) and the rate of operating profits before amortization (EBITDA%). The sudden downfall of profitability indicators of “Jugoremedija” AD started after 2006, due to its crisis in business, stopping of production in order to undertake an overhaul in 2009, loss of markets and inability to recover after restarting production. From 2010 to 2012 the average gross production margin of the Company was 55.3%.

The key generator of growth of value of business assets in the period since the end of 2000 to the end of 2007 was the growth of the value of inventories of the Company. The total business assets of “Jugoremedija” grew continually since the end of 2000 to the end of 2007, with the exception of the end of 2005, growing at the average year to year rate of 12.9%. The key generator of growth of the value of business assets of the Company in this period was the growth of working assets of the Company.³³⁷ As of the end of 2007 the total value of working assets of the Company was EUR 25.4 million, relative to EUR 9.5 million at the end of 2002, the year of the privatization. Within the working assets the greatest growth was recorded with respect to inventories, which at the end of 2007 totaled EUR 17.4 million in contrast with EUR 6.2 million at the end of 2002.³³⁸ Within the structure of working assets in the period since the end of 2002 until the end of 2007, inventories had an average share of 70.0%, while trade receivables had an average share of

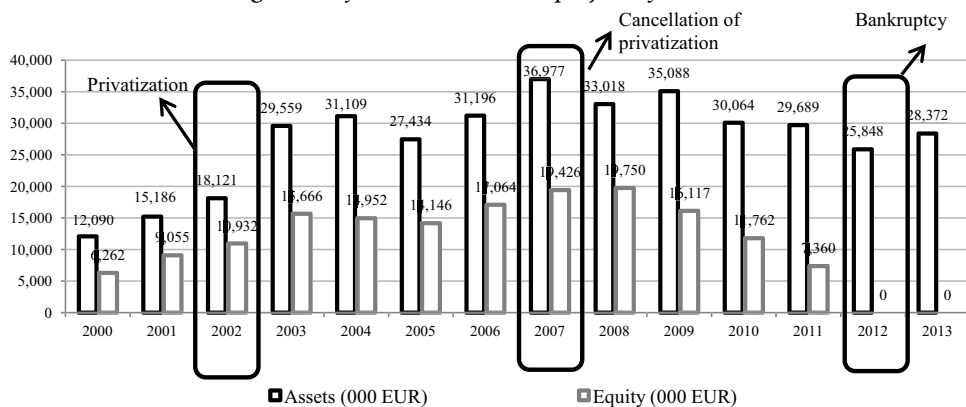
³³⁷ The average year-to-year rate of growth of value of working assets in the period under review was 23.2%.

³³⁸ The most significant growth of value of inventories was recorded at the end of 2006 and 2007, when their value increased on average by 65.6%.

23.3%.³³⁹ “Jugoremedija” recorded the first significant business investments at the end of 2006 in the amount of EUR 2.1 million while at the end of 2007 the corresponding value was EUR 381 thousand.

The first significant increase of value of permanent assets of “Jugoremedija” was recorded at the end of 2003, when it reached EUR 14.4 million.³⁴⁰ In RSD the value of permanent assets of “Jugoremedija” was growing until the end of 2005, thanks to investments of the Company in non-tangible assets and the growth of long-term financial investments. As stated by the then director, the key generator of the growth of non-tangible assets and long-term financial investments of the company were the registration of new products and acquisitions of majority stakes in companies “Luksol”, “Medela” and “Vetprom”. In subsequent years, the value of permanent assets of “Jugoremedija” was declining, closing with the end of 2008, due to reduced value of non-tangible assets and long-term financial investments.³⁴¹ At the end of 2007 the value of permanent assets of “Jugoremedija” totaled EUR 11.4 million and was by EUR 2.8 million higher relative to its value at the end of 2002.

Illustration 104 “Jugoremedija” AD assets and equity as of 31 December, 2000–2013



Source: Serbian Business Registers Agency and the Study on Consolidation of the Pharmaceutical Industry in Yugoslavia, 2001

From 2007 to 2012 the value of total business assets was in constant decline, with the exception of the end of 2009, which recorded an increase in value of 6.3% solely thanks to the increased value of real property, plant and

339 The average value of trade receivables from 2000 to 2007 was EUR 3.1 million.

340 At the end of 2002 assets of “Jugoremedija” totaled EUR 8.6 million.

341 One of the key reasons for reduced value of long-term financial investments is the exit of “Jugoremedija” from ownership in companies “Medela” and “Vetprom”. The reason why the new management decided to sell the stakes in the above companies was the lack of human resources to cover the management issues related to these companies, as well as financial reasons, because this sale secured a portion of funds needed for the reconstruction of facilities in order to get the GMP certificate.

facilities and biological agents of 40.0%.³⁴² The key reason for the reducing value of total assets of “Jugoremedija” in the period after 2007 was the sudden reduction of the value of inventories. A considerable growth of the value of permanent assets of “Jugoremedija” was recorded at the end of 2008 and end of 2009, as a result of “Jugoremedija” investing in reconstruction of the facilities for solid and semi-solid forms and the packaging and warehousing units in line with GMP standards. The value of non-current assets of “Jugoremedija” at year to year level at the end of 2008 was greater by 22.7%, and at the end of 2009 by 37.8%. At the end of 2012, when bankruptcy proceedings were instituted in “Jugoremedija”, the value of working assets of the Company was EUR 3.1 million, of which the inventory represented EUR 1.9 million and the value of permanent assets of the Company was EUR 13.7 million a figure practically fully consisting of real property, facilities and equipment and biological agents.

“Jugoremedija” AD in the period after termination of privatization had a pronounced problem of liquidity in its operations. The current ratio and the quick ratio of the Company in all years under review were below the theoretically optimum level of 2:1 and 1:1 respectively. There was a constant trend of dropping of the said indicators, which pointed to the worsening of liquidity of the Company to the level at which it was no longer possible for working assets to cover short-term liabilities. The companies were not fully financed from long-term sources. In the period after termination of privatization, there was a negative trend for the said indicators (net working capital). The significant worsening of liquidity of “Jugoremedija” after 2009 is further substantiated by the fact that there were delays in the payment of (even minimum) salaries, that the account of the Company was blocked, the failure to pay overhead expenditures which resulted in interim disconnections from power and gas supply and disconnection of telephone lines and the loss of rights to produce and distribute products due to the failure to meet the financial obligations to the license partner “Sanofi – Aventis”.

Table 61 “Jugoremedija” AD liquidity indicators as of 31 December, 2000–2013

Year	2000	2001	2002	2003	2004	2005	2006
Current ratio	1.2	1.4	1.7	1.2	0.9	0.9	1.3
Quick ratio	0.6	0.3	0.6	0.3	0.3	0.3	0.3
Net working capital (EUR)	878	1,896	3,919	2,042	-1,862	-1,567	3,980
Duration of cash cycle	N/A	175	113	184	135	-217	229

342 As of end of 2009, the value of permanent assets of “Jugoremedija” was EUR 19.4 million, of which real property and equipment and biological agents accounted for EUR 17.7 million.

Year	2007	2008	2009	2010	2011	2012	2013
Current ratio	1.5	1.7	1.3	1.0	0.9	0.1	0.1
Quick ratio	0.4	0.3	0.2	0.1	0.1	0.0	0.0
Net working capital (EUR)	8,760	7,606	3,039	16	-1,511	-22,717	-23,599
Duration of cash cycle	516	193	984	481	534	2,643	–

Source: Author's calculations

In all years under review, with the exception of 2005, there has been a need to additionally finance the business cycle of “Jugoremedija” from borrowed sources of financing. The average duration of the cash cycle for “Jugoremedija” AD was significantly longer relative to the average for the market of pharmaceutical production which, in the period 2007–2013, averaged 182 days. The indicators for the duration of the cash flow of “Jugoremedija” AD show that there was a more pronounced need for additional sources of financing compared to the market average. The key reason for such rather high values of this indicator in the case of “Jugoremedija” and for the market itself was the inability or strong difficulties in collecting receivables from state institutions and major wholesalers.

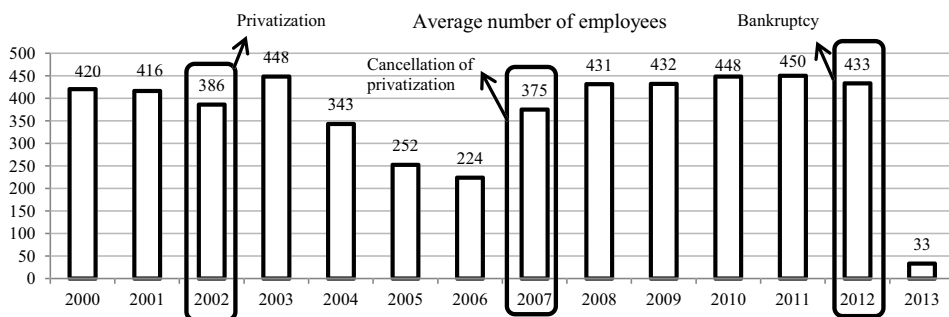
5.2.4. Employment and productivity

The average number of employees in “Jugoremedija” after the privatization was significantly reduced up to 2006, and this was especially pronounced in 2004, when the average number of employees was reduced by 105 workers. The main reason for the significant reduction of the average number of employees at the end of 2004 was the laying off of a great number of workers who were on strike at the time.³⁴³ Significant new employment was recorded in 2007, when privatization was terminated, and when the average number of employees was increased by 151. The new management appointed by the employees, decided after the termination of privatization to return to work all workers that were laid off by the preceding management. For those employees who were re-employed all obligations had been settled for the period in which they were not employed.³⁴⁴ For the period 2009–2012 the average number of employees was 441. After bankruptcy was instituted this number was significantly reduced to 33. As of the day when bankruptcy proceedings began in Jugoremedija AD, which is as of end of December 2012, the total number of employees was 391.

343 <http://www.novosti.rs/vesti/naslovna/aktuelno.69.html:161577-Otpusteno-78-radnika>.

344 Interview with the president of the Managing Board of “Jugoremedija”, Mr. Zdravko Deurić, Jugoremedija AD, www.jugoremedija.rs.

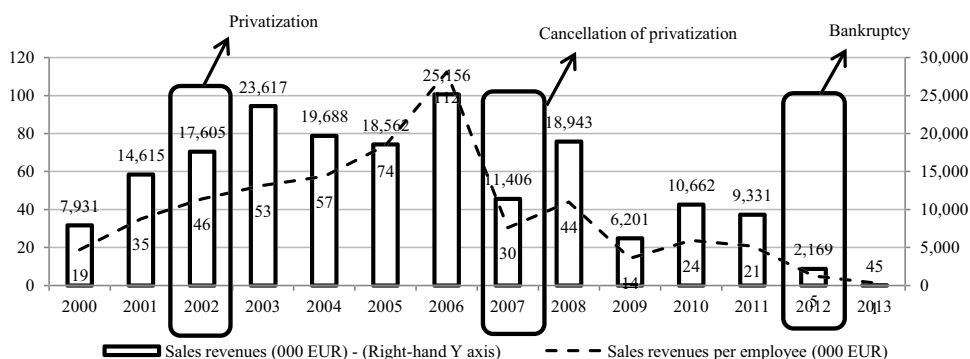
*Illustration 105 “Jugoremedija” AD Average
number of employees 2000–2013*



Source: Serbian Business Registers Agency

Revenue per employee in “Jugoremedija” AD in the period 2002 to 2006 grew significantly in parallel with the growth of sales revenue and reduction of the number of employees. After 2006, due to a significant reduction of the sales revenues and the increase of the number of employees in 2007 this indicator was significantly reduced compared to the period until 2006. In 2008, after employees took over control of the Company and thanks to sales recovery, the value of this indicator grew. Already the following year, 2009, due to the stopping of production in order to reconstruct the facilities and the related significantly reduced sales revenue, the indicator under review is again plummeted. The increase in the value of sales revenue per employee was again growing in 2010, after which due to continued decrease of sales and the subsequent bankruptcy proceedings, the indicator dropped to its lowest values compared to all years under review.

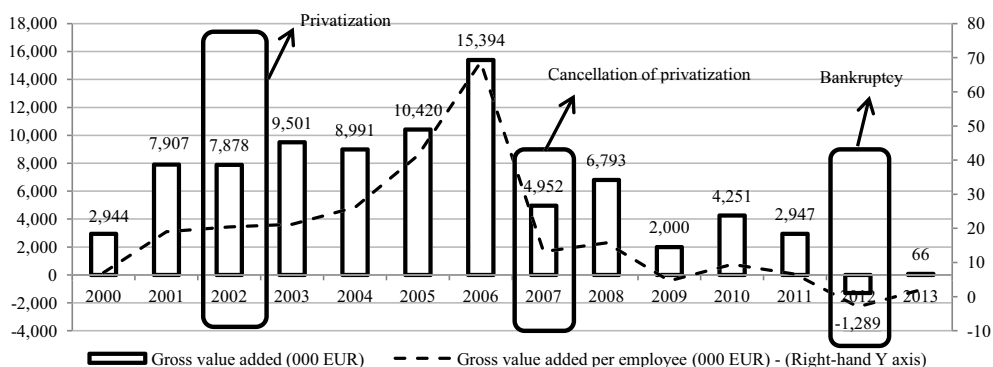
*Illustration 106 “Jugoremedija” AD Sales
revenue per employee and sales revenue 2000–2013*



Source: Serbian Business Registers Agency

With respect to the sales revenue per employee for the major manufacturers of drugs in Serbia, company “Jugoremedija” recorded the lowest levels of this indicator, which were at the same time significantly below the average level for these five companies. The gross value added generated per employee in “Jugoremedija” is fully in line with the trends of changes in sales revenues per employee. Until 2006, “Jugoremedija” recorded growth of generated gross value added, after which, due to the significant worsening of operations and drop of sales revenue, the Company recorded a significant reduction of generated net value added. An increase in the generated gross value added was recorded again in 2008 and 2010, thanks to better operating results relative to preceding years. In 2012, as a result of significant losses in the operating result, the significant level of financial expenditures and other expenditures, “Jugoremedija” recorded negative gross value added.

Illustration 107 “Jugoremedija” AD GVA and GVA per employee 2000–2013

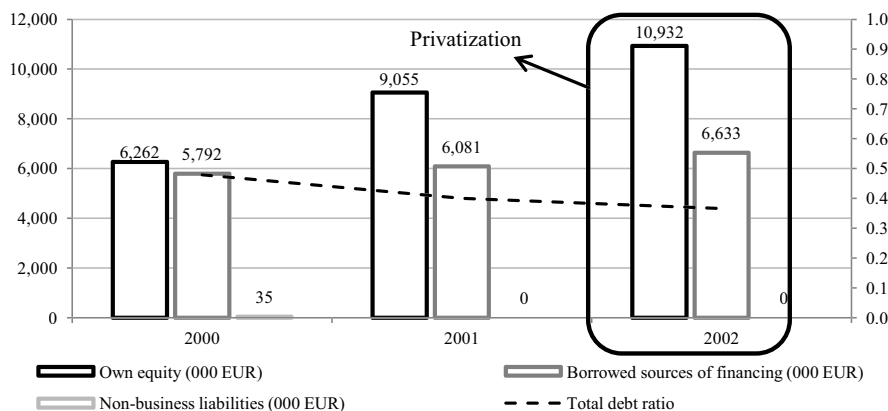


Source: Serbian Business Registers Agency

In all the years under review “Jugoremedija” AD generated GVA which was significantly below the average for the largest companies in the pharmaceutical sector. The GVA generated in the period 2008 – 2013 averaged EUR 28.2 million, while the average gross value added per employee was EUR 24 thousand.

5.2.5. Financial restructuring

In the period since the end of 2000 until the end of 2002, when “Jugoremedija” was privatized, there was a strong growing trend of the Company’s equity, resulting from a capital increase by EUR 2 million and by establishment of revaluation reserves of EUR 2.2 million at the end of 2000. The total debt level of the Company was stable at the level of 0.4.

Illustration 108 “Jugoremedija” AD debt levels as of 31 December, 2000–2002

Source: Author's calculation

Until the termination of privatization the total debt level of “Jugoremedija” stood at a relatively stable level. Long-term liabilities of “Jugoremedija” had a decreasing trend, dropping 3.2% on average annually. Within short-term liabilities of “Jugoremedija” the greatest growth was recorded in liabilities from business operations, which grew at an annual rate of 80%, thus increasing from EUR 5.5 million at the end of 2002 to EUR 13.9 million at the end of 2007.³⁴⁵ “Jugoremedija” in this period regularly settled its obligations resulting from business operations of the Company, whereby such obligations significantly increased compared to the level in the year when “Jugoremedija” was privatized. In the period since the end of 2002 until the end of 2007, the first increase of short-term financial obligations³⁴⁶ of “Jugoremedija” was recorded at the end of 2003, when the Company incurred short-term loans of EUR 3.6 million. After this increase, such obligations until end of 2005 dropped to EUR 431 thousand. Another increase of such obligations was recorded at the end of 2006, when short-term financial obligations amounted to EUR 2.6 million, and finally at the end of the following year, when privatization was terminated, the short-term obligations of “Jugoremedija” totaled EUR 1.1 million.

The period of business operations of “Jugoremedija” until the end of 2009 was characterized by a significant increase of the total debt level under short-term and long-term loans. The sudden increase of the total debt level occurred near the end of 2009 based on short-term and long-term loans needed to finance the overhaul of existing plant and equipment in order to provide sufficient levels of working capital to normalize operations. The major portion of investments in permanent assets totaling about EUR 10 mil-

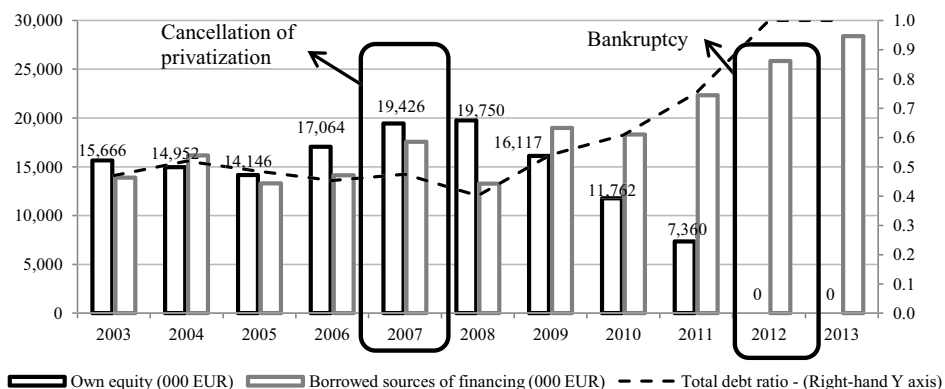
345 From late 2002 to the end of 2007, out of total liabilities, “Jugoremedija” liabilities from business operations on average accounted for a share of 80%, short-term financial liabilities had a share of 10.7%, and other short-term obligations a share of 6.5%.

346 At the end of 2002 “Jugoremedija” did not record any short-term financial obligations.

lion³⁴⁷, which was to enable Jugoremedija acquire European GMP standards, was financed by the Company from borrowed sources of financing under unfavorable conditions. Apart from this, loans were used to ensure sufficient volumes of raw materials and thus smooth business operations.³⁴⁸

“Jugoremedija” recorded uninterrupted increase of long-term obligations since the end of 2008 until the end of 2011, with the exception of the end of 2010. During this period, on year to year basis, *long-term obligations of the Company were greater by 1.1 times and grew from EUR 887 thousand at the end of 2007 to EUR 9.5 million at the end of 2011*. The trend of strong growth of short-term obligations began at the end of 2008 and ended at the end of 2010. During this period, on an annual basis, short-term financial obligations grew on average by 97.5%. Thus, the *value of short-term financial obligations grew from EUR 1.1 million at end of 2007 to EUR 5.8 million at end of 2010*. At end of 2012, when bankruptcy proceedings were instituted in “Jugoremedija”, short-term financial obligations totaled EUR 12.7 which covered all matured long-term and short-term interest accrual obligations of the Company.

Illustration 109 “Jugoremedija” AD Debt levels end year, 2003–2013



Source: Author's calculations

Since the end of 2007 until the end of 2012 there is a strong trend of reduced value of obligations from operations, which dropped from EUR 13.9 million at end of 2007 to EUR 7.6 million at end of 2012. At end of 2011 other short-term obligations of “Jugoremedija” amounted to EUR 2.3 million, while the value of other short-term obligations at end of 2007 stood at EUR 196 thousand. At the end of 2012 the value of other short-term obligations of “Jugoremedija” was EUR 5.3 million, the same as at end of 2011, primarily referring to obligations for unpaid salaries and matured unpaid obligations for interest and costs of financing.

347 Note to financial statements of Jugoremedija AD Zrenjanin under bankruptcy, 2013.

348 Privatization Agency of the Republic of Serbia, Teaser – Sale of majority package of shares of AD Jugoremedija Zrenjanin, December 2010.

Of the total liabilities in the period from the end of 2002 to the end of 2007, the average share of short-term obligations was 42.2%, while the average share of long-term obligations was 3.4%. The period from the end of 2008 to the end of 2011 was marked by an increase of the share of long-term obligations in total liabilities. At the end of 2011 long-term liabilities accounted for 31.8% of total liabilities of “Jugoremedija” while short-term ones accounted for 43.4%.

Since late 2007, when privatization was terminated, there had been a strong trend of reducing the value of own capital of “Jugoremedija” AD all the way to the point where the Company no longer had any own capital. Since the end of 2008 records show a considerable plummeting of the value of own capital of the Company’s own capital as a consequence of poor operating results and subsequent losses from current operations. Permanent losses at business level, a considerable level of financial expenditures and other expenditures resulted in accumulating losses year on year and recording losses exceeding the value of own capital at the end of 2012 and 2013 amounting to EUR 9.1 million and EUR 13.6 million respectively.

The key causes which had led “Jugoremedija” to bankruptcy were the changed market conditions, loss of market share and decrease of sales, but the primary cause was excessive borrowing. All of these caused liquidity issues and the Company could no longer service its debts. The Commercial Court in Zrenjanin, at the motion of creditor “Hypo-Alpe-Adria-Bank” AD Belgrade made a ruling to initiate preliminary bankruptcy proceedings.³⁴⁹ After the bankruptcy proceedings were initiated the bankruptcy administrator estimated the value of listed assets which, according to the report at the day of initiating bankruptcy (December 27th 2012) totaled EUR 19.2 million. Total liabilities of the bankruptcy debtor to creditors based on the Decision on the list of identified and rejected claims made by the bankruptcy administrator amounted to EUR 32.2 million.³⁵⁰

Table 62 Liquidation value of business assets and liabilities of the bankruptcy debtor owed to creditors as of December 27, 2012 (000 EUR)

	Dec 27, 2012
Real property, plant and equipment	16,480
Stakes and shares in other entities	449
Claims	1,075
Inventories	1,212

349 Reorganization plan for Jugoremedija AD in bankruptcy Zrenjanin, Hypo-Alpe-Adria Bank AD and Blue Rose Fund DOO

350 Ibid.

	Dec 27, 2012
Total business assets	19,217
Total liabilities of the bankruptcy debtor	32,248
Balance	-13,031

Source: Restructuring plan for Jugoremedija AD in bankruptcy Zrenjanin, Hypo-Alpe-Adria Bank AD and Blue Rose Fund DOO

In 2014 a new valuation was undertaken of the assets of “Jugoremedija” AD, at the order of the Commercial Court in Zrenjanin. This valuation showed that total assets of “Jugoremedija” AD in bankruptcy were assessed at EUR 68 million, the reason for the much higher valuation compared to the one from the end of 2012 being the investments of about EUR 12 million made in order to ensure national GMP for the manufacturing of tablets.³⁵¹

5.2.6. Relationship between the company and local government

Zrenjanin has a population of about 140 thousand and is one of the key economic centers of Vojvodina and of the major agro-industrial centers of Serbia. The dominant economic sectors are food production and processing, the textile and chemical industries, energy generation, construction and transport. Given its favorable geographical position, 75km from Belgrade and 50km from Novi Sad, as well as good links by Zrenjanin regional roads to international motorways E75 (46km) and E70 (65km), the town is presently perceived to be among most attractive investment locations in Serbia. *The town of Zrenjanin is a local self-government with some of the highest number of privatized companies.* Of the total of 58 privatizations 8 privatization contracts have been terminated, while 14 socially-owned or privatized companies are undergoing bankruptcy, among them Jugoremedija AD.³⁵²

COMPANY LIABILITIES TO LOCAL GOVERNMENT

As of 27 December 2012, when bankruptcy proceedings were initiated over “Jugoremedija” AD, and on the basis of information from the Restructuring Plan for “Jugoremedija” AD in bankruptcy, the Company had total liabilities to the town of Zrenjanin of EUR 116.9 thousand. Of this amount, EUR 13.7 thousand was owed to the town as second rank creditor and EUR 103.2 thousand as third rank creditor.³⁵³

351 <http://www.politika.rs/rubrike/Ekonomija/Jugoremedija-vrednija-od-dugova.lt.html> (Site visited: August 2, 2014).

352 Note that the above data may include also companies counted twice. Namely, it is possible that there was first the termination of the contract and consequently the bankruptcy proceedings were initiated. It is also possible that the company is not privatized, meaning that instead being up for sale it went directly into bankruptcy.

353 Reorganization Plan for Jugoremedija AD.

On the basis of the Restructuring Plan for “Jugoremedija” AD in bankruptcy, as of 27 December 2012, the company “Jugoremedija” AD in bankruptcy had liabilities to “The Institute for Health Protection” amounting to EUR 52.3 thousand, the public utility company JP “Directorate for Construction and Urban Planning of the Town of Zrenjanin” amounting to EUR 136.4 thousand, and to the public utility company “Cleaning and Parks Zrenjanin” amounting to EUR 28.7 thousand. All of these entities had the same status as third-rank creditors.³⁵⁴

5.3. WHAT IF ANALYSIS

As part of a “What If” analysis, a projection of assumed trends for values of individual positions in the profit and loss account of “Jugoremedija” AD was made in order to illustrate and quantify the impact of one of the possible alternative positive outcomes in the “Jugoremedija” AD privatization. Given the limited access to available data and the intention to present as faithfully as possible one of the possible alternative scenarios for the privatization of “Jugoremedija” AD, the quantification of this scenario comprises assumed business operations of the Company up to the level of operating results.

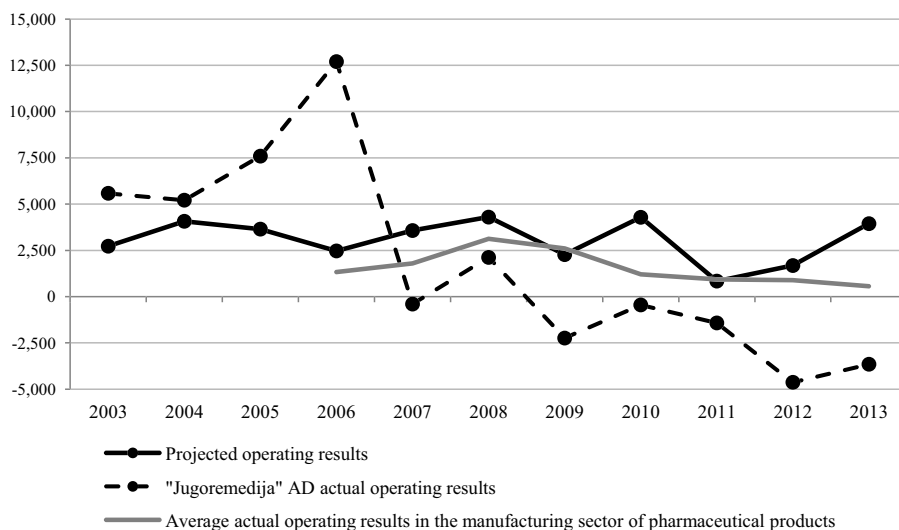
The following assumptions have been made for the purpose of projecting of assumed values for operating revenues, expenditure and net results of “Jugoremedija” AD:

- 1) The basic premise is that an alternative buyer taking over a majority ownership stake in “Jugoremedija” AD would implement all aspects of the business policy which were applied by the buyer of “Zdravlje” AD, as a company which continued to operate relatively successfully. All specific characteristics of business operations typical of “Jugoremedija” AD have not been taken into account, instead the starting point is that specific business traits of “Zdravlje” AD are also applicable to “Jugoremedija” AD. In addition, we assume that market conditions in which “Zdravlje” AD operates apply to the business environment of “Jugoremedija” AD.
- 2) The year zero for projecting assumed values for operating revenues, expenditure and final operating results is 2002, the year when the sale of the remaining socially-owned equity of “Jugoremedija” AD was carried out.
- 3) The baseline for projections of trends in assumed values for “Jugoremedija” AD operating revenues and expenses are the fluctuations of the historical values for operating revenues and expenses recorded in business operations of “Zdravlje” AD, as an example of a successful privatization, for the 2003–2013 period.
- 4) The baseline for projections of “Jugoremedija” AD assumed sales revenue values to be historical data for “Zdravlje” AD sales of products and services in the 2003–2013 period.

- 5) The baseline for projections of assumed values of a) revenues from own use of products, services and merchandise, b) changes in value of inventories, and c) other operating revenues is a historical share of the above revenue categories in "Zdravlje" AD sales revenues in the 2003–2013 period.
- 6) The baseline for projections of assumed values for expenses as part of business expenditure, i.e. a) purchase costs of goods sold, b) costs of raw materials, c) costs of salaries, fringe benefits and other personal expenses, and d) other operating expenses, is historical share of the above expenses in "Zdravlje" AD sales revenues in the 2003–2013 period.
- 7) Due to lack of adequate data, an approximation of trends in values of the costs of depreciation and provisions has been made. With the approximation of the costs of depreciation and provisions, historical data for the rate of changes to the value of the costs of depreciation and provisions for "Zdravlje" AD in the 2003–2013 period have been used.

Results arising from the impact of one of the possible alternative scenarios for "Jugoremedija" AD privatization are presented in the illustration below. The main conclusion to be inferred from the applied projections of one of the possible alternative privatization outcomes is that if this were the case, "Jugoremedija" AD would be posting much better operating results. In all the analyzed years, "Jugoremedija" AD recorded positive operating results which, except for 2011, were significantly better than average in the manufacturing sector of pharmaceutical products (Table 11).

Illustration 110 Alternative scenario for successful "Jugoremedija" privatization – Overview of projected and actual operating results in 2003–2013 period (EUR 000)



Source: Author's calculation

On the basis of comparison between the projected and actual operating results, taking into account the assumptions above, the failed privatization of “Jugoremedija” AD was conducive in aggregate, in current values, to a operating result worse by EUR 13.4 million than the one from the alternative scenario for a successful privatization in the 2003–2013 period.

Table 63 “Jugoremedija” AD projected assumed values of operating revenues, expenses and operating results 2003–2013 (000 EUR)

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Projected operating revenues	16,766	16,454	14,979	17,129	18,331	18,864	14,527	15,805	15,474	14,274	17,039
Sales revenues	16,939	16,228	14,810	16,979	17,963	18,268	14,187	15,805	15,726	13,844	16,843
Revenues from own use of products, services and merchandise	0	0	0	8	1	0	0	9	96	7	7
Increase in value of inventories of work in progress and finished products	272	173	136	106	309	392	272	0	0	312	112
Decrease in value of inventories of work in progress and finished products	451	0	0	0	0	0	0	89	644	0	0
Other operating revenues	5	52	34	36	57	203	67	80	295	111	77
Projected operating expenditure	14,041	12,382	11,332	14,660	14,759	14,567	12,258	11,519	14,635	12,595	13,095
Purchase cost of goods sold	73	48	9	381	1,532	1,504	1,647	1,911	1,515	2,059	1,691
Raw material and consumables used	4,012	4,183	4,280	4,531	4,434	4,047	3,394	4,218	7,385	5,463	6,364
Cost of salaries and wages	7,750	5,233	4,697	7,050	5,490	5,821	4,919	2,862	3,158	2,758	2,872
Costs of depreciation and provisions	657	570	560	636	742	801	727	671	664	596	593
Other operating expenses	1,550	2,349	1,786	2,062	2,562	2,394	1,571	1,858	1,914	1,719	1,574
Projected operating result	2,725	4,071	3,648	2,469	3,571	4,297	2,269	4,286	839	1,679	3,943
“Jugoremedija” actual operating results	5,584	5,212	7,592	12,701	-403	2,119	-2,240	-449	-1,422	-4,631	-3,654
Actual average operating results in the pharmaceutical sector	N/A	N/A	N/A	1,334	1,792	3,130	2,601	1,200	932	891	561

Source: Author's calculations

6. PRIVATIZATION IN AGRICULTURE

Privatization of agricultural companies is one of the most often criticized segments of the privatization process. Prior to a review of the two case studies and their respective impact on local governments, it is necessary to look into a specific legal framework and circumstances under which the privatization of agricultural companies unfolded.³⁵⁵ Except for the issues typical of other sectors, the privatization of agricultural companies grappled with problems arising from, above all, loosely worded regulations on state-owned agricultural land.³⁵⁶ On one hand, the privatization was carried out with minor difficulties in cases where the land was socially-owned, but, on the other hand, major problems would crop up for the most part in cases where the companies to be privatized had both state- and socially owned plots of land at their disposal whose respective status was regulated by several different laws.³⁵⁷ In privatizations of state-owned agricultural companies, the state-owned land utilized by the privatized companies was not subject to privatization along with the socially-owned equity of the subject of privatization. In most cases, a part of the land would be state-owned and another part of the land would be socially-owned, hence it was necessary to mark out the boundaries between the former and the latter.

In practice, privatized agricultural companies were still utilizing state-owned agricultural land.³⁵⁸ The criticism which may be levelled at the legal

355 In this section, we are restricting our discussion solely to key aspects, disregarding in the process many historical circumstances resulting in specific ownership structures of both agricultural companies and agricultural land.

356 State-owned agricultural land is for the most part located in the Province of Vojvodina, as is the case in both case studies.

357 Under the provisions of the Socially-Owned Agricultural Land Conversion to Other Types of Ownership Act, socially-owned agricultural land acquired by a legal person under the Agrarian Reform Act and regulations on agricultural land nationalization is in effect state-owned. On the other hand, socially-owned agricultural land acquired by a natural person through a legal transaction as a production-related asset constitutes the socially-owned equity of the given company. For more information about the causes, see Begović, B. B. Mijatović, D. Hiber, "Land Privatization in Serbia", CLDS, Belgrade (2006).

358 The importance of the problem with immovable assets is conspicuous in the examples of DPP "Banatski Despotovac" and DPP "Mala Bosna" which were utilizing large areas of land ("Banatski Despotovac" – total surface area of 2,051ha; "Mala Bosna" –660ha). "Banatski Despotovac" managed to convert it to privately-owned land, as well as to convert a portion of the agricultural land to construction land, whereas "Mala Bosna" was partly left with the registered right of use and partly succeeded in registering its right of ownership.

framework is that *the privatization of land was not carried out in parallel to the privatization of companies* as this would otherwise have reinforced legal certainty, rendered higher prices for the subjects of privatization and also precluded some problems arising after the privatization. Buyers of agricultural companies with state-owned land would turn to local governments with requests for lease of the land. Therefore the relations between local governments and potential (and eventually actual) buyers were very important for the outcome of any given privatization. However, legal uncertainty as well as uncertainty over the future lease in combination with a possibility for domestic natural persons to purchase the subjects of privatization in installments contributed to the adverse selection of buyers.

The fates of two agricultural companies after the implemented privatization procedures were markedly different.³⁵⁹ Whereas “Banatski Despotovac” continued to operate successfully after the privatization with sizeable investments, “Mala Bosna” ended up in a restructuring procedure following the privatization contract’s cancellation. Due to loan-related debts owed to banks, both companies mortgaged significant portions of their immovable assets wherein the “Mala Bosna” privatization revealed many weaknesses of the privatization process: the lack of a mechanism for prevention of money laundering, the use of the subject of privatization as collateral, links between domestic banks and buyers, the manner in which controls are carried out, as well as many other issues in the actual implementation.

Prior to privatization, “Mala Bosna” had been recording relatively low sales revenues and the disclosed profit had been the consequence of an increase in the value of inventories of unfinished and finished products. In late May 2007, “Mala Bosna” was privatized by a consortium of natural persons against whom criminal proceedings were subsequently brought, but, taking advantage of a legal provision, these natural persons soon ceded the company to a new owner. The Company’s post-privatization period was characterized by *obscure and opaque ownership relations*. In early 2009, “under the Assignment Contract” and with the Privatization Agency’s consent, 70% of the company’s shares were transferred to another natural person who in turn entrusted the management board chairman with the actual management of the Company. At the time, the Management Board chairman was the owner who performed management-related functions in several mutually related legal entities (the companies with which “Mala Bosna” would be doing business the most), but against whom criminal proceedings would also be subsequently brought.³⁶⁰

359 These are the companies operating in the sector of grains, legumes and oilseed crops growing. This sector’s market structure is highly diversified. In 2006 and 2007, the eight biggest primary producers of grain had an average share of 7.7% in aggregate. A slight tendency towards market consolidation marked the following years so that in the 2008–2012 period the share of the eight biggest primary producers of grain totaled, in aggregate, an average of 10.9%, and then 14.9% in 2013.

360 In early July 2011, criminal charges were brought against the “Mala Bosna” management board chairman, in his capacity as the responsible person at “Mala Bosna” AD, on sus-

In the first year after the privatization, “Mala Bosna” posted modest sales revenues, but in 2009 its sales revenues skyrocketed to 49 times larger actual sales volume relative to the privatization year. The growth was achieved thanks, above all, to the sales of mercantile wheat borrowed from the National Commodity Reserves Directorate, and not through the sales of wheat from own inventories, i.e. the sales of own products. Despite the contract on mercantile wheat loan, the Company managed to sell only two thirds of borrowed wheat. Soon after that “Mala Bosna” sales revenues went into a free-fall reaching the point of illiquidity and its accounts were frequently blocked. The average gross trade margin in 2009 was negative (-0.3%) indicating that the average wheat sale price was below the average purchase price of borrowed wheat. The period prior to privatization, from 2004 to 2006, was marked by relatively low indebtedness. After privatization, as of 2007, there was a sharp upward spiral in debt to the point where the Company had no equity of its own. A growth in financial expenses, i.e. expenditure related to interest on significant debts incurred in 2010, was the reason why the Company registered a substantial net business loss to the tune of EUR 3.6 million.

“Mala Bosna” is a typical example of using a privatized company as a collateral to raise loans for the benefit of a related legal entity or to acquire another company. In such cases, often after the first installment or after two or three years of the privatization, the contract is cancelled and the Company returns into the fold of the Privatization Agency. Parallel to levying a burden on the assets, actual transfers of assets to another legal person also takes place. Such *Ponzi schemes* are typically related to groups which have come into existence through acquisitions of several companies in the privatization process as was the case with “Mala Bosna”.³⁶¹

However, for a company to be used in such a manner, willingness on the part of banks and other financial institutions to grant loans and credit lines to such a company is a prerequisite. The case of “Mala Bosna” points to a connection between certain banks and some privatizations. As a rule, these are domestic banks (private or state-owned) among which many have ended up in bankruptcy in the past several years. Misappropriation of loans and many other instances of abuse occurred precisely within this triangle consisting of domestic banks, subjects of privatization and related legal entities. In the case of “Mala Bosna”, the Company was granted several loans by “Agrobanka”, the Serbian Export Credit and Insurance Agency (AOFI) and other commercial banks. However, the loans were not used solely by “Mala Bosna” but, above all, by legal persons associated with the “Mala Bosna” management board chairman. “Mala Bosna” had substantial claims against these companies. “Mala Bosna” claims against “Azohem”, according to the “Azohem” prepackaged plan of reorganization, totaled RSD 80 million and were placed in Class

picion of having inflicted damage to the agricultural holding of “Mala Bosna” and its minority shareholders in excess of RSD 228.3 million.

361 Vujačić. I and J. Petrović Vujačić, “Privatization in Serbia – Results and Institutional Failures” *Economic Annals*, Volume LVI, No. 191 / October – December 2011, 100.

III of unsecured/bankruptcy creditors' claims stipulating a 90% write-off. Claims against "Azotara" from Subotica which, according to the reorganization plan prepared in advance, totaled RSD 172 million and were also ranked as Class III (i.e. bankruptcy) creditors' claims stipulating a 90% write-off.

While carrying out its controls the Privatization Agency extended deadlines for the buyer to comply with its obligations under the contract on sale of the subject of privatization as many as 16 times. Finally, on account of violations of contractual obligations, in May 2010, the Privatization Agency cancelled the privatization contract and filed a request with the Serbian Ministry of Interior for a probe into the circumstances of accruing debts on the part of the subject of privatization. While performing regular controls, the Privatization Agency warned on several occasions the owners of "Mala Bosna" AD that the continuity in carrying out the core business activity was undermined. The Agency also demanded termination of the contracts whereby "Mala Bosna" was a guarantor of loans raised by legal entities associated with the "Mala Bosna" management board chairman, as well as implementation of other measures stipulated in the privatization contract. Apparently, the Agency could not resolve the issue of the negative selection of buyers through its controls (above all due to the established favorable options whereby natural persons were enabled to purchase socially-owned equity of the subject of privatization in installments). On top of that, given a large number of already cancelled contracts and the economic crisis, the Agency was often extending the deadlines and, instead of cancelling contracts, it was repeatedly warning the buyers to comply with their contractual obligations.

At the initiative of the City of Subotica, small shareholders and trade unions, a motion was filed with the Privatization Agency requesting the restructuring of "Mala Bosna" AD in order to create conditions for normal business operations. In July 2010, the Agency granted the motion. Today, "Mala Bosna" has about 438 hectares of arable land and other types of agricultural land, but these are relatively fragmented plots without irrigation. In late 2013, "Mala Bosna" had two times fewer employees than before the privatization. As a consequence of unpaid loans raised for the benefit of legal entities associated with the Company's management board chairman, "Mala Bosna" is heavily in debt with "Agrobanka", (a domestic bank itself undergoing bankruptcy proceedings), as its biggest creditor (over RSDD 400 million), followed by the Serbian Export Credit and Insurance Agency, "NLB banka" and another commercial creditor.

DPP "Banatski Despotovac" business operations prior to its privatization had been recording results similar to those of "Mala Bosna" in the pre-privatization period. Over the course of three years before privatization, "Mala Bosna" sales were relatively stable at about EUR 1.2 million on average following an initial growth. In the same period, DPP "Banatski Despotovac" had been recording a constant decline in its operating results as well as net operating results. The Company was sold at a public auction in December 2003. The contract of sale represents a typical example of a purchase in installments coupled with mandatory investment and social programs.

After privatization, “Banatski Despotovac” sales revenues were growing relative to the pre-privatization period. In all the analyzed years, “Banatski Despotovac” AD was posting positive business and net results, apart from in 2005. The biggest buyer of “Banatski Despotovac” AD products in the 2011–2013 period was a related legal entity. The Company was registering higher average profitability indicator values in 2000–2003 compared to the post-privatization period.

Investments in fixed assets were the primary drivers behind “Banatski Despotovac” AD’s growth in total business equity value, as well as the positive impact stemming from the change to its fair equity value. and the. In all the analyzed years, “Banatski Despotovac” AD was registering high liquidity indicator values pointing to the fact this was an exceptionally high-liquidity company.

“Banatski Despotovac” AD’s low overall indebtedness characterized the pre-privatization period, from 2000 to 2002. After privatization, the Company’s total debt ratio was relatively stable until late 2012 when, due a sudden growth of debt on account of loans raised to fund the investments in fixed assets, the Company recorded a substantial increase of debt levels. Finally, from the privatization onwards, there was a marked trend in the reduction in the number of employees until 2007 inclusive, when the head count stabilized at an average of 50.

If we compare the two cases by the achieved privatization objectives, the DPP “Banatski Despotovac” privatization has succeeding in fulfilling most of the key privatization objectives. Specifically, “Banatski Despotovac” has increased its business efficiency; investments in equipment have been made; and the Company has been regularly paying its tax-related liabilities at both national and local levels. On the other hand, in the case of “Mala Bosna” none of these objectives have been accomplished.

The share of “Banatski Despotovac” in direct revenues of the City of Zrenjanin was low, but it was commensurate with the size of the Company and its place in the local economy, ranging from between 0.04% in 2008 and 2009 and 0.11% in 2013, so that its actual share more than doubled over this period. “Banatski Despotovac” AD’s fiscal contribution to the budget of the City of Zrenjanin in terms of ceded public revenues is stable with a 0.11% share. “Banatski Despotovac” AD is regularly pays its dues to public utilities in Zrenjanin.

Privatization objectives	Mala Bosna	Banatski Despotovac
Efficiency of privatized company	–	+
Increase in investments	–	+
Transfer of technologies and know-how	–	–
Increase in public (national and local) revenues	–	+
Hard budget constraint	–	+

6.1. CASE STUDY – PRIVATIZATION OF DPP “BANATSKI DESPOTOVAC” PRIVATIZATION

6.1.1. *Background*

“Banatski Despotovac” AD (hereinafter referred to as “the Company” or “Banatski Despotovac”) from the namesake town was established in 1946 as a cooperative. As of 1971, it was operating as part of “Poljoprivredno dobro”, the then as a subsidiary of the “Servo Mihalj” company from Zrenjanin. In 1990, it was transformed into a socially-owned agricultural company “Banatski Despotovac”. In its capacity as socially-owned company, “Banatski Despotovac” was operating until late 2003 when it was privatized. Miloško Erić from Odžaci became the majority owner.

After the privatization, “Banatski Despotovac” changed its legal form to a joint-stock company. Prior to privatization, “Banatski Despotovac” AD had 2,051 hectares of agricultural land, of which 1,225 hectares were owned by the Company (mostly classified as Grade 3 and, to a lesser extent, Grade 2 agricultural land), whereas the rest was owned by the state.³⁶² In late 2013, the Company had in its possession 1,264 hectares as well as a lease on about 31 hectares of state-owned land.³⁶³ The land is somewhat rugged which complicates its cultivation, but also affects the profitability of a potential irrigation system project. The Company is exclusively involved in crop growing (seed wheat and mercantile wheat, seed corn and mercantile corn, sunflower and sugar beet) and runs a farm chemical store.

Table 64 Background information on “Banatski Despotovac” AD

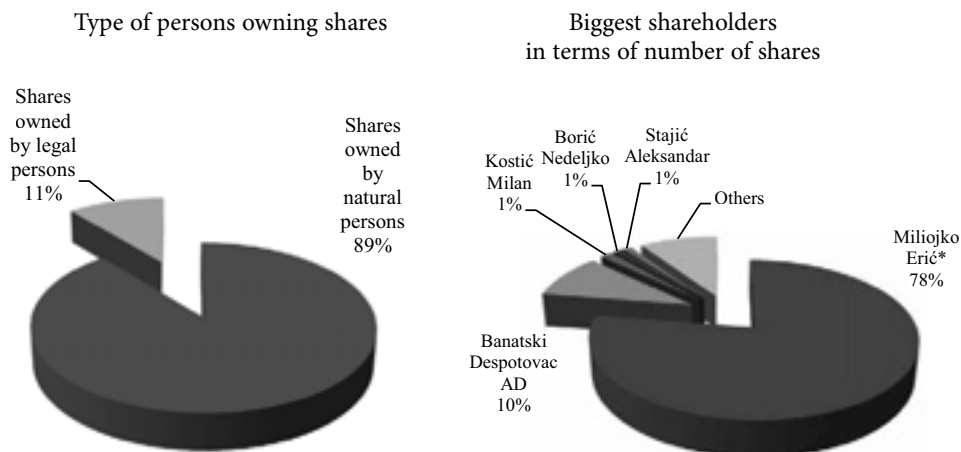
Full business name:	AD Banatski Despotovac, Banatski Despotovac
Abbreviated business name:	AD Banatski Despotovac
Company code:	08035512
Registered address:	Zrenjanin
Standard Industrial Classification (SIC) Code:	Growing of grains (except for rice), leguminous and oilseed crops (0111)
Legal form:	Joint-stock company
Status:	Active company
Number of employees 2013):	43
Year of privatization:	2003

Source: Serbian Business Registers Agency

³⁶² Report on control of performance of contractual obligations, dated September 28, 2004, Privatization Agency.

³⁶³ Presented figures were taken from the information sheet on the issuer of securities, dated March 19, 2014, available at the following address: <http://www.belex.rs/trgovanje/informator/BNDS> (Site visited: September 12, 2014).

Illustration 111 “Banatski Despotovac” DPP Equity ownership structure as of 28 August 2014



Source: Central Register of Securities of the Republic of Serbia

* By August 28, 2014 inclusive, on the basis of the Decision of the Securities Commission no. 6/0-17-390/21-13, dated July 1, 2013, shareholder Milojko Erić's right of vote with respect to 96,477 issuer's shares, comprising 73.2% of the Company's total issued shares, was placed under a temporary suspension.

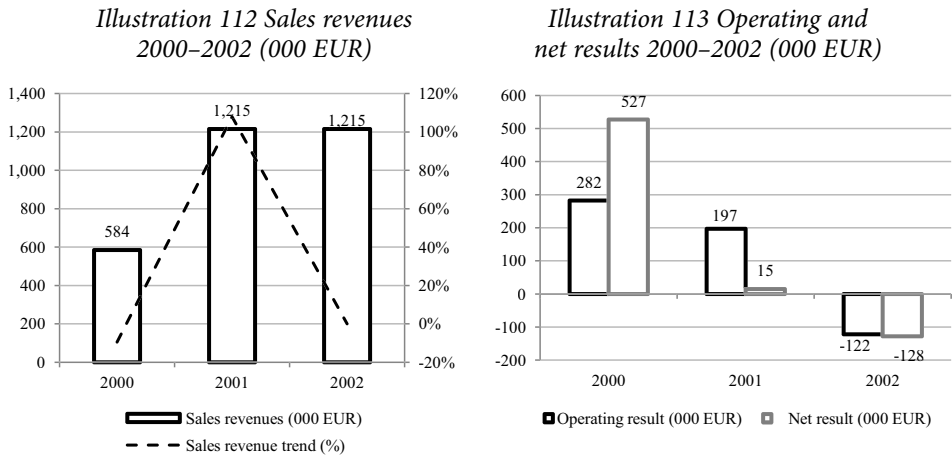
6.1.2. Business operations prior to privatization

Two years before the privatization, the Company had been generating annual revenues of EUR 1.2 million. After an initial sales revenue growth of 107.9% in 2001, the Company had approximately the same sales revenues in 2002. The principal reason for the 2001 significant sales revenue growth was a 61% rise in production output volume and an increase in the sales of its products and goods on the domestic market.³⁶⁴

Over the course of three years preceding the privatization, the Company had been recording a constant decline in business and net results denominated in EUR. Following a positive operating result in 2000, the Company was posting increasingly worse results so that in 2002 its incurred losses totaled EUR 122,000.³⁶⁵

³⁶⁴ DPP “Banatski Despotovac” Privatization Program, Banatski Despotovac, dated November 6, 2003, Privatization Agency.

³⁶⁵ The main reason for poor results was a 93.3% increase in operating expenses relative to 2000 (from EUR 704,000 in 2000 to EUR 1.4 million in 2002). Over the same period, operating revenues rose significantly from EUR 986,000 to EUR 1.2 million. Other high expenses also contributed to the Company's negative net result.



Source: DPP “Banatski Despotovac” Privatization Program, Banatski Despotovac, Privatization Agency

The late 1960s and early 1970s had been the last time that investments in DPP “Banatski Despotovac” facilities had been made. The average age of equipment was 9 years, while most investments in assets were realized in early 1970s and in the eighties.³⁶⁶ The Company had 38 tractors, with 11 of them being older than 25 years and another 12 were over 15 years old. The situation with the rest of agricultural machinery owned by the subject of privatization was similar. The most important purchase of a piece of farm machinery prior to the privatization was the acquisition of a combine harvester. The Company did not have a silo, nor irrigation system on its land.

The Company was using 2,051 hectares of agricultural land, out of which 1,225 hectares were owned by the Company, while the remaining portion was state-owned. Meadows and reed-covered areas made up a part of the Company’s agricultural land, while most of it fell into Grade 2 and Grade 3 farming land category, and to a lesser degree – Grade 4.

In the pre-privatization period, the Company had had a diversified production output. It had been growing corn and seed wheat, but a portion of farmland had been used for production of sugar beet, brewers’ grits, soybeans and sunflower while meadows had been used to grow alfalfa. The Company had registered a significant production output growth in the pre-privatization period (partly as a consequence of the low starting point) so that in 2001 it had produced 2,349 tonnes of corn, 1,699 tonnes of seed wheat, and 733 tonnes of sugar beet.

366 DPP “Banatski Despotovac” Privatization Program, Banatski Despotovac, dated November 6, 2003, Privatization Agency.

6.1.3. DPP “Banatski Despotovac” privatization

DPP “Banatski Despotovac” was privatized by public auction in December 2003.³⁶⁷ Given that the Company was privatized in a fast-track auction procedure, the basis for setting the price of Company’s equity was the adjusted carrying value.³⁶⁸ The auction starting price was RSD 16.4 million (about EUR 240,000), but eventually the majority stake in socially-owned equity was sold for RSD 81 million (about EUR 1.2 million). The buyer, a natural person from Odžaci – Milojko Erić, assumed the obligation to pay the total sales price in six equal annual installments.³⁶⁹

Table 65 Adjusted carrying value of DPP “Banatski Despotovac” equity

	Dec 31, 2002	
	RSD (000)	EUR (000)
Total equity	107,548	1,748
Socially-owned / State-owned	107,548	1,748
Private	0	0
Equity offered for sale	75,284	1,224
Equity designated for free-of-charge distribution	32,264	524

Source: DPP “Banatski Despotovac” Privatization Program, Banatski Despotovac, Serbian Privatization Agency

The sale contract is a typical example of the purchase of a company in installments coupled with investment and social programs. The buyer took on a contractual obligation to invest RSD 12.6 million (about EUR 184,000) in fixed assets of the subject of privatization, i.e. DPP “Banatski Despotovac”, within 12 months from the date of signing the contract. Under the contract’s provisions, if the total investment was worth over EUR 1 million, the deadline might be extended beyond 12 months. In addition, the buyer also incurred an obligation to allocate dividends for each of 2 years after the signing of the contract to the tune of at least 10% of the profit made by the subject of privatization, after tax and legal reserves, if profit was generated at the end of the accounting period.

The buyer took on an obligation to accept a standard social program in case of the sale of socially-owned equity by public auction. Under the contract, the buyer incurred an obligation to respect all the rights of employees as laid out in the individual collective agreement, as well as other general bylaws of the Company. Additionally, the buyer took on an obligation not to lay off em-

³⁶⁷ Serbian Privatization Agency.

³⁶⁸ For more information on the fast-track privatization by auction proceedings, see DP “Goša Montaža” privatization case study.

³⁶⁹ Contract on sale of socially-owned equity by public auction, dated December 24, 2003, available at the following address:

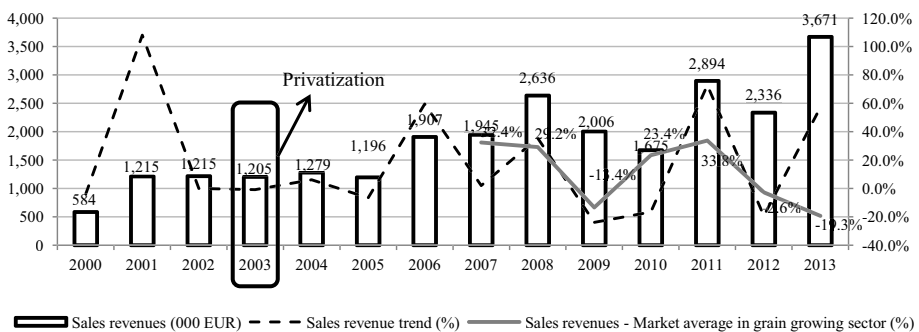
employees as redundant workers within 1 year from the date of signing of the sale contract. However, if a need for such layoffs arose, the buyer could do so provided that the consortium designated severance packages for every redundant worker in the amount of median gross earnings of such an employee over the six-month period preceding the month in which the employee was laid off (or a severance pay prescribed by the Labor Act if more favorable for the buyer).³⁷⁰

In addition, the social program stipulated that if the Company had over 50 full-time employees on its payroll and if a need arose to terminate employment contracts of more than 10% of the total workforce on account of technological changes, a competent organ of the privatized firm would be under obligation to adopt a redundancy program subject to obtaining a representative trade union's opinion on the proposal.³⁷¹

6.1.4. Business operations after privatization

Following the privatization carried out in late 2003, “Banatski Despotovac” registered sales revenues growth. In 2013, sales revenues tripled relative to the privatization year. While the growth trend was obvious, fluctuations in revenue levels occurred in the years when the production output volumes dropped.³⁷² On average, in the 2008–2013 period, the share of sale of products in the Company's overall sales revenues totaled 70.7%. In 2013, the sales revenues structure changed significantly as revenues from the sale of products and services fell below a 50% share so that the total sales revenues growth in the last year was achieved thanks to the sales of other entities' products and resale. From 2007 to 2013, the Company was generating sales revenues above the market average in the sector of growing grain, legumes and oilseed crops.

Illustration 114 “Banatski Despotovac” AD sales revenues 2000–2013 (000 EUR)



Source: Program privatization DPP “Banatski Despotovac”, Banatski Despotovac, dated November 6, 2003, Serbian Privatization Agency and Serbian Business Registers Agency

³⁷⁰ Ibid.

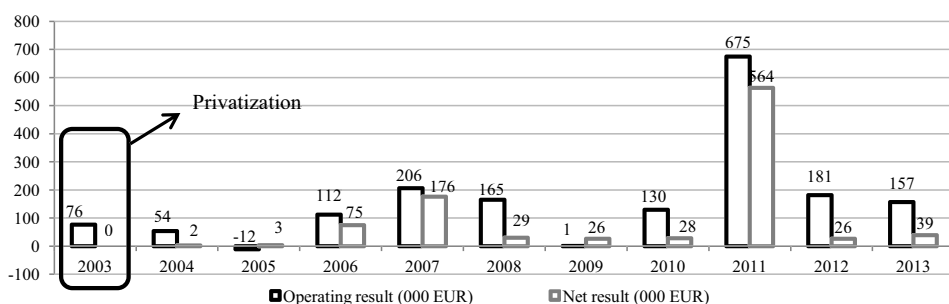
³⁷¹ Contract on sale of socially-owned equity by public auction between the Serbian Privatization Agency and Miloško Erić, Novi Sad, dated December 24, 2003.

³⁷² The average annual growth rate of sales revenues over the 2003–2008 period was 16.0%, but in the subsequent two years sales revenues were declined at an annual rate of 20.2%.

According to the majority owner, in 2012 “Banatski Despotovac” was cultivating 1,500 hectares of farming land, out of which 1,225 hectares was owned by the Company, while the rest was under lease.³⁷³ The Company was achieving significantly higher yields per hectare in comparison to the national average.³⁷⁴

After privatization, “Banatski Despotovac” AD was recording positive net operating results (except in 2005 when a minimal loss of EUR 12,000 was incurred). The average operating result in the 2003–2010 period totaled EUR 91,000. In 2011, thanks to a significant 72.8% sales revenue growth, “Banatski Despotovac” AD achieved the best operating result in the analyzed period. Given an increase in debt levels, financial expenses had a significant impact on the net result trends.³⁷⁵

Illustration 115 “Banatski Despotovac” AD operating and net results 2003–2013 (000 EUR)



Source: Serbian Business Registers Agency

The buyer successfully fulfilled his investment-related obligations. Pursuant to the sale contract, in late 2004, the buyer discharged his obligation to invest in “Banatski Despotovac” AD fixed assets to the tune of RSD 12.6 million (around EUR 184,000).³⁷⁶ Having complied with the contractual

373 <http://www.zrenjanin.rs/1-63-0-2133/Gradonacelnik-obisao-radove-u-Banatskom-Despotovcu> (Site visited: September 11, 2014).

374 In 2008, the Company’s wheat yield per hectare was 6.7 tonnes, whereas the national average was 4.8 tonnes per hectare.

375 A significant rise in financial expenses was recorded in 2008, when the annual financial expenditure grew by 85.1%, surging from EUR 44,000 to EUR 80,000. In the following two years, the Company’s financial expenses hovered around the average of EUR 53,000. A new upsurge in financial expenses occurred in 2011, when they rose by 88.1% reaching the level of EUR 102,000. In the subsequent years, financial expenses remained at approximately the same level as in 2011. The principal reason for the upswing in financial expenditure was the rising cost of debt. In 2005, 2007 and 2009, “Banatski Despotovac” AD was posting positive operating results to the tune of EUR 48,000 on average. In all other years, the Company ended up in the red, where the 2012 negative operating result of EUR 112,000 stood out in particular.

376 Report on control of performance of contractual obligations, dated February 20, 2009, Privatization Agency.

obligations, the Company stepped up further its investments among which the biggest was the investment in 15,000-tonne silos whose construction was completed in 2012. The investment was worth about EUR 2 million.³⁷⁷ Even though “Banatski Despotovac” AD was in the black in 2004 and 2005, dividends and employee bonuses were not paid due to the accrued losses from previous years of RSD 7.8 million (EUR 113,900).³⁷⁸

The most important client and the biggest supplier of the Company is a related legal entity. On December 31 of 2011, 2012 and 2013, respectively, the biggest client and the biggest supplier of “Banatski Despotovac” AD was the “Signal” transport company from Odžaci, whose owner was also the owner of “Banatski Despotovac”. This effectively meant that transfer prices might have a significant role in the Company’s business operation, but the debtor stated that they were set in the same manner as for other clients.³⁷⁹ According to available financial statements, “Signal”, the related business entity, has been operating successfully, and in 2013 alone it generated net profit of RSD 216.4 million (EUR 1.9 million). Amongst other things, this is one of the important differences in comparison to the case of “Mala Bosna” where all the related entities were plagued by financial difficulties.

However, “Banatski Despotovac” AD had been registering higher profitability indicator values in 2000–2003 relative to the post-privatization period. The average profitability indicator value before interest, taxes, depreciation and amortization (EBITDA %) from 2004 to 2013 amounted to 13.1%, whereas in the 2000–2002 period it was at the 27.8% mark. The average profitability rate (EBIT %) in the 2004–2013 period was 6.9%, whereas from 2000 to 2002 it stood at 18.2%.

“Mala Bosna” AD Profitability indicators 2004–2013

Year	2000	2001	2002	2003	2004	2005	2006
EBITDA %	58.0%	24.9%	0.6%	16.4%	12.5%	7.1%	13.5%
EBIT %	48.3%	16.2%	-10.1%	6.3%	4.2%	-1.0%	5.9%
Net result %	50.2%	1.2%	-10.6%	0.0%	0.2%	0.3%	3.9%
ROA	22.2%	0.8%	-5.5%	0.0%	0.1%	0.2%	3.4%
ROE	23.5%	0.9%	-6.2%	0.0%	0.1%	0.2%	4.4%
Gross margin	31%	54%	55%	N/A	N/A	N/A	N/A

377 <http://www.zrenjanin.rs/1-63-0-2133/Gradonacelnik-obisao-radove-u-Banatskom-Despotovcu> (Site visited: September 11, 2014).

378 Report on control of performance of contractual obligations, November 27, 2007, Privatization Agency .

379 Annual business report of “Banatski Despotovac” joint-stock company for 2011, 2012 and 2013.

Year	2007	2008	2009	2010	2011	2012	2013
EBITDA %	19.3%	13.6%	5.8%	13.3%	26.1%	10.9%	9.2%
EBIT %	10.6%	6.3%	0.0%	7.7%	23.3%	7.8%	4.3%
Net result %	9.0%	1.1%	1.3%	1.7%	19.5%	1.1%	1.1%
ROA	7.1%	1.1%	1.1%	1.1%	20.0%	0.6%	0.6%
ROE	9.2%	1.5%	1.3%	1.5%	27.4%	0.9%	1.2%
Gross margin	N/A	47%	44%	50%	60%	42%	44%

Source: Author's calculations

The Company's net result rate was positive in all the post-privatization years, and in the 2004–2013 period it was 3.9%. The Company recorded a significant deviation from the average net result rate indicator value in 2011 when the said indicator value totaled 19.5%. Return on assets (ROA) and return on equity (ROE) indicators had low, but positive values in all the post-privatization years, with the exception of 2011 when significantly higher indicator values were registered relative to average indicator values. The reason for considerably higher profitability indicator values in 2011 compared to other years was a significant growth in the Company's sales revenues.

Investment in plant and equipment was the principal reason why "Banatski Despotovac" AD had a growth in overall business assets value, while the positive impact of the change to fair equity value and positive net operating results were the key drivers behind the growth of equity.³⁸⁰ The average value of "Banatski Despotovac" AD total assets in the 2004–2011 period totaled EUR 2.5 million. A conspicuous increase in the Company's total business assets value of 70% was recorded in late 2012, when the value of overall business assets grew from EUR 3.2 million to EUR 5.4 million.

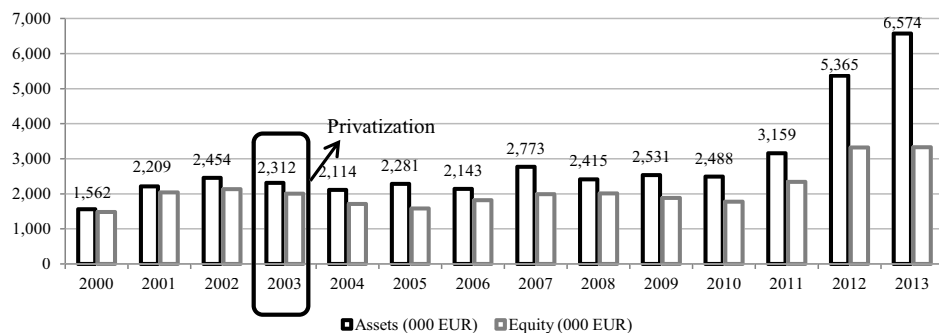
An increase in the fair value of land, purchase of additional agricultural land and investments in fixed assets (investments in silos and flat-floor storage)³⁸¹ were cited as the main reason for a significant growth in total assets value in late 2012. As of December 31, 2013, the Company's total assets value was higher by 23% year on year, due to, above all, the introduction of new equipment, i.e. the silo and flat-floor storage.³⁸²

380 Note that the primary reason for opinion with reservation in the Company's financial reports audit is the inability to assess the fair value of land so that these positions do not reflect the values in accordance with the international accounting standard MRS-16.

381 Comments enclosed with financial reports for 2012, "Banatski Despotovac" AD.

382 Ibid.

*Illustration 116 “Banatski Despotovac” AD
assets and equity on Dec 31, 2000–2013*



Source: DPP “Banatski Despotovac” Privatization Program, Banatski Despotovac, dated November 6, 2003, Serbian Privatization Agency and Serbian Business Registers Agency

From late 2004 until the end of 2011, the key drivers behind the growth in “Banatski Despotovac” own equity were the effects of restatement of capital thanks to the positive impact of the change to the fair value of assets (particularly in 2012 and 2013) and a positive net operating result in the said period, i.e. the retention of net operating profit within the Company as unallocated profit.

In all the analyzed years, “Banatski Despotovac” AD recorded high liquidity indicator values. Over the course of the analyzed period, from 2000 to 2013, “Banatski Despotovac” AD was registering values of general and quick ratios above the theoretically optimal level. The Company managed to establish a long-term financial balance which was why a part of short-term funds came from long-term sources. There was a positive trend with the said indicator (net working capital), i.e. year on year there was stronger growth of operating assets value than the growth of short-term liabilities. A marked upward trend in the value of net working capital went on to show that the Company was capable of maintaining permanent liquidity.

The Company is still operating as a joint-stock company, while the takeover of minority shareholders’ stakes in the firm is under way. Company shares had been traded sporadically until mid-2007 when larger transactions were recorded. Through related entities acting as proxies the majority owner intended to take over the stocks of minority shareholders in late 2012, but the idea was later abandoned.³⁸³ The Securities Commission imposed on the majority owner a temporary ban on the right of vote to 96,477 shares of the issuer, which constituted 73.2% of all the issued shares. After this, the Company made a decision to acquire its own shares, and purchased 12,626

383 Notice of the intent to take over shares is available at the following address: <http://www.belex.rs/data/2012/12/00080761.pdf> (Site visited: September 11, 2014).

ordinary shares at a price of RSD 2,500 each, which was 9.58% of all the registered ordinary shares.³⁸⁴

Table 66 “Banatski Despotovac” AD liquidity indicators on Dec 31, 2000–2013

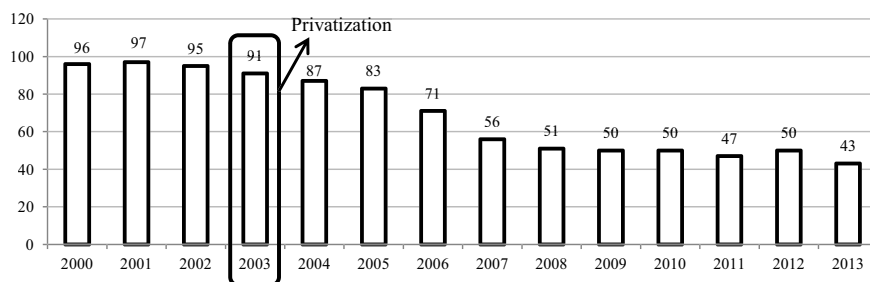
Year	2000	2001	2002	2003	2004	2005	2006
Current ratio	8.0	5.3	4.8	5.1	3.1	2.0	6.2
Quick ratio	1.0	1.2	1.3	5.1	1.5	0.6	2.7
Net working capital (000 EUR)	489	718	639	768	682	483	654
Year	2007	2008	2009	2010	2011	2012	2013
Current ratio	2.5	3.5	2.3	2.0	4.2	1.8	1.8
Quick ratio	1.2	1.3	1.3	1.2	3.1	0.8	1.2
Net working capital (000 EUR)	816	750	774	742	1.635	765	1.096

Source: Author’s calculations

6.1.5. Employment and productivity

Following privatization, the Company’s workforce was shrinking until late 2007. After the privatization, by the end of 2007, a total of 35 employees left “Banatski Despotovac” AD, of whom 31 were made redundant.³⁸⁵ As of 2008, the Company had a relatively stable employee numbers (about 50). Another significant reduction in the number of employees was registered in 2013 when, amongst others, the then general manager resigned.

Illustration 117 “Banatski Despotovac” AD
average number of employees per year 2000–2013



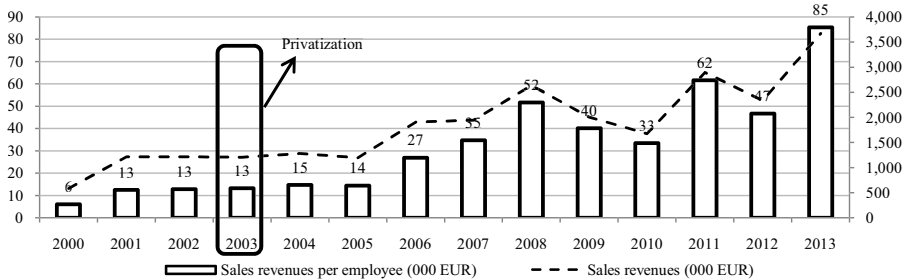
Source: DPP “Banatski Despotovac” Privatization Program, Banatski Despotovac, Privatization Agency and Business Registers Agency

384 Report on acquisition of own shares is available at the following address: <http://www.belex.rs/data/2014/03/00087259.pdf> (Site visited: Sep 14, 2014).

385 Reports on control of performance of contractual obligations, dated 28 Sep 2004, 27 Nov 2007, 22 Feb 2008, 20 Feb 2009 and 9 Jan 2009, respectively, Privatization Agency.

Sales revenues per employee figures were posting high growth rates after privatization. Given that the Company's number of employees was relatively stable, the said indicator values trend depended exclusively on the Company's sales revenue trend.

Illustration 118 "Banatski Despotovac" AD sales revenues per employee and sales revenues 2000–2013

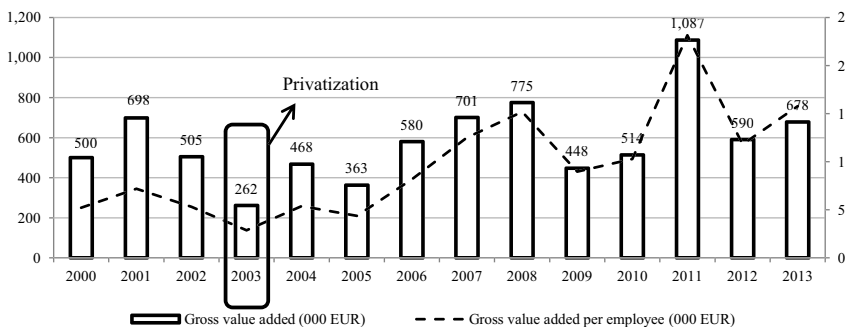


Source: Author's calculations

However, over the course of the entire analyzed period, "Banatski Despotovac" AD was recording values which were considerably below the average values registered by the biggest companies in terms of actual sales revenues in the sector of growing grain (except for rice), leguminous and oilseed crops. The average sales revenue per employee indicator value for the biggest companies in the grain growing sector in the 2006–2009 period totaled EUR 429,000, and from 2010 to 2013 – EUR 574,000.

"Banatski Despotovac" AD gross value added had been declining from 2000 to 2003. After the privatization, as the business was growing, the Company's gross value added was also growing. In 2011, due to a significant rise in sales revenues at an annual rate of 72.8% and, consequently, better operating results, "Banatski Despotovac" AD generated the biggest gross value added relative to all the previous years. Since the number of employees as of 2007 was relatively stable, the gross value added per employee indicator depended exclusively on the generated gross value added trend.

Illustration 119 "Banatski Despotovac" AD GVA and GVA per employee 2000–2013

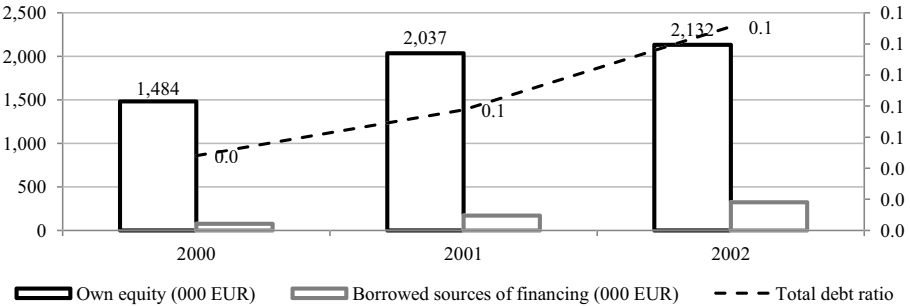


Source: Author's calculations

6.1.6. Financial restructuring – indebtedness (debtor-creditor relations)

The pre-privatization period, from 2000 to 2002, was characterized by the Company’s low levels of debt.

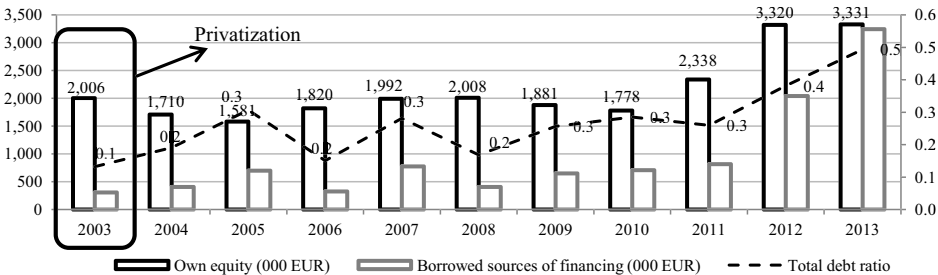
Illustration 120 “Banatski Despotovac” AD debt levels on Dec 31, 2000–2002



Source: Author’s calculations

Following privatization, the Company’s total debt ratio was relatively low until late 2012. In the course of 2012, overall debt levels suddenly surged upwards due to loans raised to fund investments in the Company’s fixed assets. Total long-term loan liabilities at the end of 2013 amounted to RSD 204.6 million. In 2012, the Company was granted a long-term loan of EUR 1 million for the purchase of equipment, and then in 2013 – another two long-term loans by two commercial banks to the tune of EUR 759,000 in aggregate for the purchase of machinery, maintenance of liquidity and financing operating assets. The Company pledged about 320 ha of its agricultural land as a collateral for the loans, but a related legal entity’s guarantee was also provided.³⁸⁶ Given the sudden rise in debt, problems might have occurred in the case of the Company being unable to service maturing liabilities.

Illustration 121 “Banatski Despotovac” AD debt levels 2003–2013



Source: Author’s calculations

386 Comments enclosed with 2013 financial report, available at the following address: http://fi.apr.gov.rs/fi_Dokumenta/61011805.tif (Site visited: September 12, 2014).

The key difference, in comparison to “Mala Bosna”, is the use of loans as designated for the purchase of equipment, i.e. the improvement of production and service-related capacities of “Banatski Despotovac” AD, instead of pledging the assets of the subject of privatization as a collateral in order to provide cash for related legal entities. In addition, it is indicative that no long-term loans have been granted to the Company by those banks undergoing bankruptcy proceedings. Positive net operating results as well as the restatement of capital based on the change to fair equity value have contributed to equity value growth.

6.1.7. The relationship between the company and local government

As we have already looked into the privatization in Zrenjanin through the case study of “Jugoremedija”, we may state that the privatization of “Banatski Despotovac” represents an opposing example. Zrenjanin is one of local governments with the largest number of privatized companies. Out of a total of 58 companies, 8 contracts have been cancelled, while 17 socially-owned or previously privatized companies are undergoing bankruptcy proceedings, including “Jugoremedija” AD, whereas another 3 companies have still not been privatized.³⁸⁷

The importance of the analyzed company is best reflected in its social responsibility towards the local community, particularly Banatski Despotovac, the place where this company is headquartered. “Banatski Despotovac” AD is a major donor and stakeholder in many social activities and projects of importance for the life of local residents, such as winter cleaning of snow, sponsorships of sporting and cultural events, as well as activities of pensioners and religious communities.

IMPACT ON LOCAL SELF-GOVERNMENT DIRECT REVENUES

The table below shows the company’s cumulative share, in terms of taxes on land and property of legal entities, environmental protection fee and business sign display fee, in the total direct revenues of the City of Zrenjanin. This share is relatively low, but it is commensurate with the Company’s size and its place in the structure of Zrenjanin’s economy. The overall amount of the city’s direct revenues generated by the Company in 2009–2013 totaled RSD 2.2 million; exceeding the amount of due liabilities in the analyzed period. All the analytical cards kept by the City of Zrenjanin’s tax administration in its records, on December 21, 2013, corroborated the fact that the Company was regularly paying its dues.

³⁸⁷ One should bear in mind that this data may feature companies which have been taken into account twice. Namely, it is possible that first a contract has been cancelled and then bankruptcy proceedings brought against the same company. In addition, it is possible that a company has not even been privatized, i.e. that bankruptcy proceedings have been initiated instead of sale of the given company.

The relative share of “Banatski Despotovac” AD payments in the total direct revenues of the City of Zrenjanin ranged between 0.04% in 2008 and 2009 and 0.11% in 2013. An unambiguous conclusion might be inferred that the Company’s contribution grew even though simultaneously total direct revenues grew by 40.40%. The average share of the Company in the City’s direct revenues in all the analyzed years was 0.06%. A particularly important characteristic was the regularity of payments of local taxes and fees which provided for accurate projections of revenues, i.e. better predictability of revenues for the local government’s budgeting.

Table 67 Company’s share in total direct revenues of the City of Zrenjanin

DESCRIPTION	2008	2009	2010	2011	2012	2013
Actual direct revenues (000 RSD)	–	574,383	583,957	649,604	815,782	806,435
Banatski Despotovac AD (RSD)	–	246	248	383	406	878
Share in direct revenues (%)	–	0.04%	0.04%	0.06%	0.05%	0.11%

Source: Banatski Despotovac AD

IMPACT ON LOCAL SELF-GOVERNMENT CEDED REVENUES

The table below shows the Company’s share of paid wage taxes in aggregate, specifically the part levied by the local government under the Local Government Financing Act, relative to the overall ceded revenues of the City of Zrenjanin in the analyzed period. According to the data in the table, “Banatski Despotovac” AD fiscal contribution to the Zrenjanin budget was stable at around 0.11% share in total ceded revenues. In 2012, the share rose to 0.13%, which resulted in an increase in the average share in the analyzed period from initial 0.11% to 0.12%. This was an important result bearing in mind the changes to the Local Self-Government Financing Act which, as of October 2011, increased local budgets’ share in the collected wage taxes from 40% to 80%, while the share of the analyzed company remained at the same level. In the analyzed period, the total amount of wage taxes paid was RSD 13,405,674, where the budget of the City of Zrenjanin received RSD 7,883,674.

Table 68 Company’s share in total ceded revenues of the City of Zrenjanin

Year	2009	2010	2011	2012	2013
Actual ceded revenues (RSD)	893,043	914,082	1,201,051	1,886,221	1,764,140
Banatski Despotovac AD (RSD)	1,000	1,025	1,358	2,543	1,956
Share in ceded revenues (%)	0.11%	0.11%	0.11%	0.13%	0.11%

Source: Banatski Despotovac AD

PUBLIC UTILITIES DUES

“Banatski Despotovac” was regularly paying its dues to public utilities in Zrenjanin for water supplied and waste water drainage services. Some analytical cards in the public utilities’ records showed payments for utility services effected before the actual issuance of invoices for a given period. In 2011 and 2012, JKP “Vodovod i kanalizacija Zrenjanin” invoiced RSD 504,059 to the Company, and “Banatski Despotovac” AD paid RSD 504,083. This public utility did not issue invoices in 2013 and it lacked data for the 2008–2010 period due to the change of software. JKP “Čistoća i zelenilo Zrenjanin” was providing waste disposal services. This utility’s invoices to the Company in the 2008–2013 period totaled RSD 83,605, whereas the payments in aggregate amounted to RSD 83,313.

Table 69 Public utilities dues

Public Utility	2008		2009		2010	
	payable	receivable	payable	receivable	payable	receivable
JKP Vodovod i kanalizacija Zrenjanin (water supply and sewage disposal)	Due to change of software, no data for these years					
JKP Čistoća i zelenilo Zrenjanin (waste disposal)	60,224	60,224	3,255	3,255	3,493	3,202
TOTAL	60,224	60,224	3,255	3,255	3,493	3,202
Public Utility	2011		2012		2013	
	payable	receivable	payable	receivable	payable	receivable
JKP Vodovod i kanalizacija Zrenjanin (water supply and sewage)	257,512	257,512	246,547	246,571	not invoiced	
JKP Čistoća i zelenilo Zrenjanin (waste disposal)	5,572	5,572	5,443	5,443	5,618	5,618
TOTAL	263,084	263,084	251,990	252,014	5,618	5,618

6.2. CASE STUDY OF DP MALA BOSNA PRIVATIZATION

6.2.1. Background information on DP “Mala Bosna”

“Mala Bosna” AD (hereinafter referred to as the Company or “Mala Bosna”) is classified as a small company based in Mala Bosna in the vicinity of Subotica whose core activity is primary agricultural production, above all, the growing of mercantile wheat, mercantile corn, sunflower and soybean, as well as other field crops to a lesser degree. The Company was established in 1952, and after several changes to its legal status it was registered as a socially-owned company in 1997. The Company went into privatization as a 100% socially-owned firm under the Privatization Act. An initiative to launch the privatization process was brought in January 2003. DP “Mala Bosna” was privatized four years later, in May 2007, through the sale of 70% of socially-owned equity by public auction. At the time of privatization, the Company had low sales revenues and about 30 employees. Prior to privatization, “Mala Bosna” had been using over 660 hectares of agricultural land, out of which 166 hectares had been owned by the state, while 496 hectares had been socially owned, classified for the most part as Grade 2 and Grade 3 farming land and situated almost entirely on the territory of one cadastral municipality.

The privatization of “Mala Bosna” fell into a group of privatizations which caught the eye of the public at large as they were *associated with money laundering, “tunneling” of the Company’s assets and other illegal actions*. The buyer was a consortium of domestic natural persons gathered around Višnja Jerković.³⁸⁸ As the changes to the Privatization Act provided for assignment of the contract³⁸⁹, the buyer took advantage of this opportunity and concluded in November 2008 a contract whereby contractual obligations were assigned to another natural person (assignee). Following several controls carried out by the Privatization Agency, the privatization contract was cancelled in May 2010 on account of the failure to maintain business operations. Immediately after the termination of the privatization contract, in July 2010, in order to provide for resumption of business operations and protection from creditors a decision on restructuring was passed, and the Company has been undergoing restructuring for the past four years. “Mala Bosna” is severely indebted, and its biggest creditors are “Agrobanka, undergoing bankruptcy”, “NLB” bank and another commercial creditor, hence a conclusion is to be inferred that the Company is worse off now with respect to debtor-creditor relations than it was prior to privatization.

388 This is a group of natural persons with several privatization contracts cancelled by the Privatization Agency, among whom there are several facing criminal proceedings.

389 The provision allowing assignment was introduced in Article 41 of the Privatization Act (“Official Gazette of the Republic of Serbia” nos. 38/01, 18/03, 45/05 and 123/07). The reason for the introduction of assignment provision was, above all, to prevent the return of already privatized companies into the fold of the Privatization Agency.

In this case study we have attempted to outline the key aspects of tunneling in simple terms.³⁹⁰ Tunneling is typically defined as the transfer of assets and profits out of firms for the benefit of those persons who control their operations. In this specific case, it was done by incurring debts burdening the assets of the subject of privatization for the benefit of other related persons. In theory, tunneling in countries undergoing transition was often associated with a slow-paced privatization process in the event of direct sale that played into the hands of general managers of state (socially-owned) companies as they would gradually transfer business operations to their newly established companies, or in case of voucher privatization, i.e. privatization with diversified ownership, where the management of a privatized company would have similar incentives for tunneling at the expense of shareholders. A specific trait of the Serbian privatization model is the tunneling after the actual privatization carried out by the owners with a controlling stake in the firms themselves. This could be partly explained by a possibility to purchase a company in installments in the privatization process. Given that no full payment of the purchase price has been made, the new owner is incentivized to take as much valuable assets as possible out of the firm before the 'strategic' cancellation of privatization contract. The owner's intent to purchase the firm's assets, and not only the company which in many instances had poor market prospects (as the assets themselves were more valuable than the company as a whole), played a crucial role with regard to incentives for tunneling. Of course, a prerequisite for tunneling is the absence of meaningful sanctions against such actions.

Today "Mala Bosna" has about 438 hectares of arable land and other farming land, but these are mostly fragmented plots without irrigation systems. In late 2013, the Company employed half the number of workers it had had before privatization (17). Given that the privatization contract has been terminated, the cumulative ownership stake of the Privatization Agency and the Share Fund of the Republic of Serbia totals as much as 82%.

Table 70 Background information on "Mala Bosna" AD Subotica

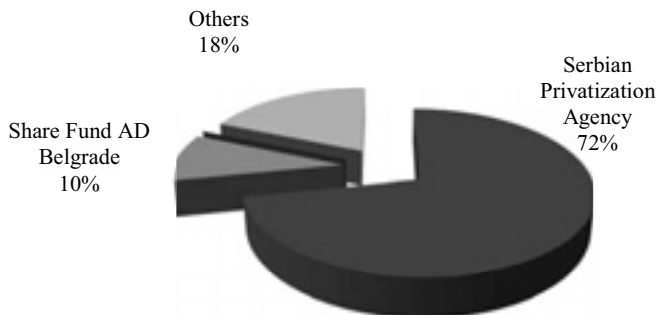
Full business name:	AD Mala Bosna – undergoing restructuring
Abbreviated business name:	AD Mala Bosna – undergoing restructuring
Company code:	08236526
Registered address:	Subotica
Standard Industrial Classification (SIC) Code:	Growing grains (except rice), legumes and oilseed crops (0111)
Legal form:	Joint-stock company

390 For more information on tunneling, see Johnson, S. et al "Tunneling", *American Economic Review*, Vol.90(2): 22–27. On similar experiences of other countries undergoing transition, see e.g. Atanasov, V. (2005). How much value can blockholders tunnel? Evidence from the Bulgarian mass privatization auctions. *Journal of Financial Economics*, 76(1), 191–234.

Status:	Active company
Number of employees (2013):	17
Year of privatization:	2007

Source: Serbian Business Registers Agency

Illustration 122 Equity ownership structure on August 28, 2014



Source: Serbian Central Securities Register

6.2.2. Business operations prior to privatization

In the 2004–2006 period preceding the privatization, DP “Mala Bosna” had been generating low sales revenues of only EUR 309,000. A more significant deviation from the average sales revenue had been recorded in 2006, above all, due to a low starting point, when a growth of 54.2% had been registered amounting to the sales level of EUR 386,000. DP “Mala Bosna” realized its entire sales on the domestic market.³⁹¹

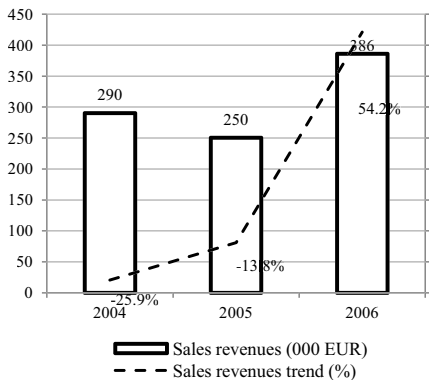
The Company had been operating poorly before the privatization. Despite posting profit, such a result had not been the consequence of actual business operation but, above all, *creative accounting*. Namely, the Company did not make operating profit in 2005 and 2006 thanks to a growth in sales, but on account of disclosure of profits from the increase in value of inventories of finished and unfinished products. The principal reason for a negative operating result in 2004, just like in the previous years, were low sales levels.³⁹² In all the other years of the analyzed period, DP “Mala Bosna” was generating operating profits, but this was down to disclosure of revenues from an *increase in the value of inventories* of work in progress and finished products instead of rising sales revenues. Revenues from the increase in the value

391 DP Mala Bosna Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency.

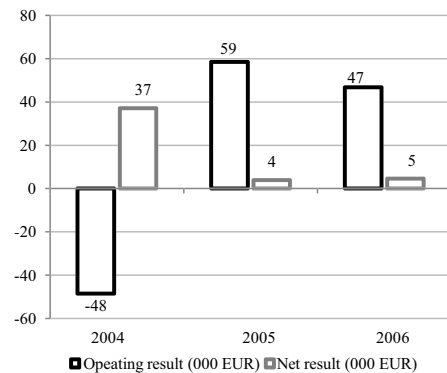
392 Ibid.

of inventories in 2005 and 2006 averaged about EUR 162,000, i.e. a half of the average sales revenues in this period. Operating profits in 2005 and 2006 were made despite a significant increase in the costs of materials and wages. In 2005, raw material and consumables used rose by 58.1%, and remained at approximately the same level in 2006, while the annual costs of salaries and wages in these two years were 27% higher on average. The Company's net profits in the analyzed period were considerably lower than operating profits due to negative financial results.

*Illustration 123 Sales revenues
2004–2006 (000 EUR)*



*Illustration 124 Operating and
net results 2004–2006 (000 EUR)*



Source: DP Mala Bosna Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency

While equipment parts were being replaced (the level of written-off equipment was about 60%), the last investments in facilities prior to privatization had been made in the 1960s and 1970s.³⁹³ A combine harvester, purchased by the Company on a loan secured by this piece of equipment as collateral (as part of preparations for the pending privatization) made up over half of the entire value of the Company's equipment.

Prior to privatization, the Company had been using over 660 hectares of agricultural land, out of which 166 hectares had been owned by the state, while 496 hectares had been socially owned, classified for the most part as Grade 2 and Grade 3 farming land and situated almost entirely on the territory of one cadastral municipality. The Company was a registered holder of the rights of use. On top of that, according to the data from the Privatization Program, the Company also took an additional 40–50 hectares under lease so that a total of about 700 hectares was under cultivation annually. The Company had a very *simple organizational structure* with two segments – production and commercial/accounting units. Two thirds of the Company's employees were unqualified workers. In terms of age structure, workers over 50 years of age constituted a predominant part of the workforce.

393 Ibid.

6.2.3. Privatization

DP “Mala Bosna” was *privatized at a public auction* on May 28, 2007, at the starting price of RSD 160 million (about EUR 2 million), by a consortium headed by Višnja Jerković. Given that the subject of sale at the public auction was a 70% stake in the socially-owned equity of “Mala Bosna” AD, the remaining portion of 30% of the socially-owned equity was to be distributed among the Company’s employees. In late 2004, “Mala Bosna” AD equity valuation ranged between RSD 189.2 million (EUR 2.4 million) and RSD 283.8 million (EUR 3.6 million). The lower bound of the Company’s socially-owned equity value range was 132.4 million (EUR 1.7 million), whereas the upper bound of the socially-owned equity value range stood at RSD 198.7 million (EUR 2.5 million).³⁹⁴ In this regard, the actual purchase price fell within the given valuation range. However, one should bear in mind that this was a sale in installments, hence the buyer could easily cease regularly paying the installments due.

Table 71 Estimated total equity value of “Mala Bosna” AD on December 31, 2004

	Carrying value	Lower bounds for equity value (DCF valuation method)	Upper bounds for equity value (DCF valuation method)	Liquidation equity value
Total equity (000 EUR)	1,258	-192	-207	2,998

Source: DP “Mala Bosna” Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency

The contract featured standard requirements vis-à-vis the buyer and stipulated a minimum level of investments in fixed assets designated for the Company’s core activity.³⁹⁵ The consortium took on a contractual obligation to invest within 12 months from the signing of the sale contract RSD 7.7 million (about EUR 97,000) in “Mala Bosna” AD assets. Under the contract’s provisions, the buyer also incurred an obligation to pay out dividends if the Company were to make profit at the end of the accounting period, i.e. to allocate dividends for each of 2 years after the conclusion of the sale contract to the tune of at least 10% of the profit generated by the Company after taxes and legal reserves.³⁹⁶

³⁹⁴ The estimated DCF (Discounted Cash Flow method) values of “Mala Bosna” AD total equity on December 31, 2004, was negative, upper and lower bounds of the total equity value range were set on the basis of liquidation value of total equity, i.e. the lower bound for equity value was set at 80% of the liquidation equity value, while the upper bound for equity value was set at 120% of the liquidation equity value (see DP Mala Bosna Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency).

³⁹⁵ Contract on sale of socially-owned equity by public auction between the Serbian Privatization Agency and a consortium of natural persons, dated June 1, 2007.

³⁹⁶ Ibid.

Under the contract, the buyer also assumed an obligation to accept a social program, i.e. to respect all the rights of employees as laid out in the individual collective agreement, as well as other general bylaws of the Company. Additionally, the buyer took on an obligation not to lay off the employees as redundant workers within 1 year from the date of signing the sale contract.

However, if a need for such layoffs arose, the buyer could do so provided that the consortium designated severance packages for every redundant worker to the tune of the average gross earnings of such an employee over the six-month period preceding the month in which the employee was laid off, or a severance pay prescribed by the Labor Act if more favorable for the buyer.³⁹⁷ In addition, the social program stipulated that if the Company had over 50 full-time employees on its payroll and if a need arose to terminate employment contracts of more than 10% of the total workforce on account of technological changes, a competent organ of the privatized firm would be under obligation to adopt a redundancy program subject to obtaining a representative trade union's opinion on the proposal.³⁹⁸

The post-privatization period was characterized by unclear and changeable ownership relations. DP "Mala Bosna" was privatized at a public auction on May 28, 2007, by a consortium with Mrs. Višnja Jerković at its helm. Next year already the buyer was late with payment of the second installment, and then in early 2009, 70% of "Mala Bosna" shares were transferred from Mrs. Jerković, under the so-called Assignment Agreement and with prior consent of the Privatization Agency, to another natural person – Đorđe Đukanović.³⁹⁹ At the shareholder assembly meeting of "Mala Bosna", held on February 24, 2009, Mr. Mališanović, Mr. Njegić and Mrs. Zelić were appointed as legal representatives of the Company.⁴⁰⁰ According to "Mala Bosna" AD employees, the Company's new owner assigned all the management rights to Mr. Mališanović, the management board chairman.⁴⁰¹ At this point, Mr. Mališanović was also the owner or held managerial positions at the following companies: "Peđa Komerc" d.o.o. Subotica, "Azotara" d.o.o. Subotica, "Azohem" d.o.o. Subotica, "Panvita – Nova Brazda" AD, "MP Kluz Tisa" d.o.o. Subotica, "Agro PNB" d.o.o, "Graničar" AD and "Most HID".⁴⁰²

397 Ibid.

398 Ibid.

399 <http://www.yueco.rs/vest/ekonomija/poljoprivrednici-ele-da-kupe-malu-bosnu> (Site visited: August 1, 2014).

400 Report on control of performance of contractual obligations, dated May 15, 2009, Serbian Privatization Agency.

401 <http://vesti.krstarica.com/ekonomija/agencija-raskinula-ugovor-o-prodaji-preduzeca-mala-bosna/> (Site visited: August 1, 2014).

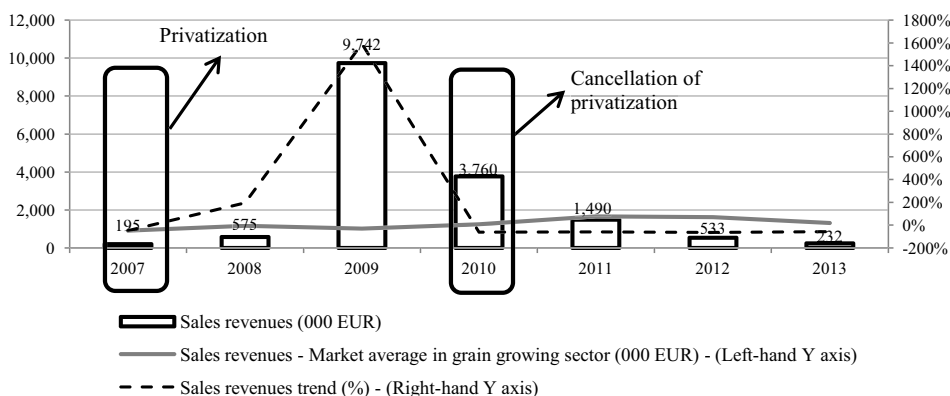
402 Report on business operations of AD "Mala Bosna" – undergoing restructuring, Mala Bosna, 2011.

6.2.4. Overview of business operations and key events after privatization

Following the mid-2007 privatization, DP “Mala Bosna” recorded modest sales revenues in 2007 and 2008. Actual sales revenues were significantly below the market average in the grain growing sector. In 2009, “Mala Bosna” AD generated considerably higher sales revenues relative to 2008 thanks exclusively to a contract concluded with the National Commodity Reserves Directorate to borrow mercantile wheat. Namely, the Company’s sales revenues surged upwards from EUR 575,000 in 2008 to as much as EUR 9.7 million in 2009. For the sake of comparison, the average sales revenues in the sector of grain growing in 2009 in the Republic of Serbia was EUR 1 million. The surge in 2009 sales revenues occurred as a result of the contract on mercantile wheat loan concluded with the National Commodity Reserves Directorate. In the same year, “Mala Bosna” AD increased its own production, but the revenues generated from sales of own products were well below par in comparison to the revenues realized through sales of borrowed wheat.

As of 2009, instead of 700 hectares, the Company was now cultivating 2,000 hectares of farming land having taken out a lease on additional plots of land. Except for sales of wheat, the Company generated a smaller portion of its revenues through fertilizer sales on the domestic market.⁴⁰³

Illustration 125 “Mala Bosna” AD sales revenues 2007–2013 (000 EUR)



Source: Serbian Business Registers Agency

Despite the contract on mercantile wheat loan intended to generate sales on foreign markets, the Company managed to sell only two thirds of the borrowed wheat. Under the contract between the Company as a borrower and the National Commodity Reserves Directorate, a loan of 35,000 tonnes of mercantile wheat worth RSD 404.6 million (about EUR 4.3 million) was granted with the proviso that this commodity be exclusively sold on foreign

403 Compliance Report, December 9, 2009.

markets.⁴⁰⁴ The Company made the majority of its 2009 total sales revenues worth EUR 9.7 million by sales of borrowed wheat. By the end of 2009, “Mala Bosna” AD managed to sell only two thirds of wheat on loan from the National Commodity Reserves Directorate.⁴⁰⁵

The wheat loan contract was signed without prior consent of the shareholder assembly, which was contrary to the provisions of the Company Act of the Republic of Serbia in effect at the time of the signing. Bearing in mind the Company’s debt burden which at that point was 4 times higher than the value of the Company’s fixed assets, under the then Company Act of the Republic of Serbia, the decision to close the wheat loan contract with the National Commodity Reserves Directorate should have been preceded by a decision of the shareholder assembly giving approval for the loan. At the time when a control of compliance with contractual obligations was carried out by the Privatization Agency, i.e. on September 14, 2009, the Company did not present proof that such a decision existed, hence the wheat loan contract had been apparently signed without prior consent of the shareholder assembly, which was contrary to the provisions contained within the Company Act of the Republic of Serbia.⁴⁰⁶ However, when the next control was carried out by the Privatization Agency on December 9, 2009, the management of “Mala Bosna” AD presented to the Agency’s representatives the said decision of “Mala Bosna” shareholder assembly, dated December 5, 2009, noting that some shareholders had announced that they would exercise the right to which dissenting shareholders were entitled and request the Company to buy out their shares.⁴⁰⁷

Frequent instances of blocking of the Company’s account, and consequently the inability to normalize its business operations, was one of the main reasons for the steady downward spiral in sales revenues. After 2009, “Mala Bosna” AD sales revenues were steadily declining at an average annual rate of 60.6%. The Company recorded sales revenues above the market average in the grain growing sector only one more time – in 2010. There were two reasons for a slump in sales revenues; the first reason was the high sales revenue mark in 2009, which was achieved largely thanks to the sales of borrowed wheat, could not be reached again in 2010 exclusively through sales of own wheat from the Company’s inventories.

The second reason were frequent instances of the blocking of the Company’s banking accounts as a result of the Company’s inability to service its outstanding dues. These actions considerably impeded the Company’s business operations in the following years. According to the records of the Creditworthiness Center of the National Bank of Serbia, the Company experienced several instances of months-long blocking of its accounts. Within a year-long

404 Compliance Report, September 14, 2009.

405 Compliance Report, December 9, 2009 Serbian Privatization Agency.

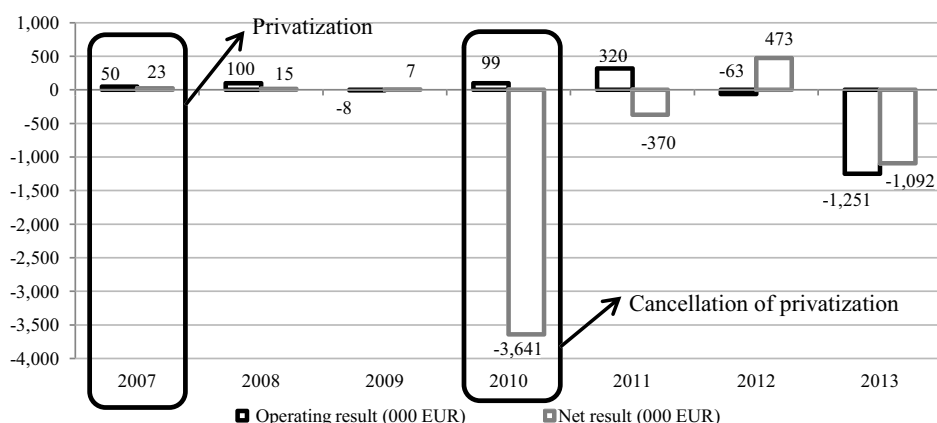
406 Compliance Report, December 14, 2009, Serbian Privatization Agency .

407 Compliance Report December 9, 2009, Serbian Privatization Agency.

period, until April 30, 2010, inclusive, “Mala Bosna” had its account blocked for 160 days on end.⁴⁰⁸ After the decision on restructuring, the Company was protected, i.e. its accounts were no longer blocked.

In addition to a significant contribution of the sales of goods, (but not the Company’s own products) to the overall sales revenues of “Mala Bosna” AD, disclosed revenues from an increase in the value of inventories as well as income from its own use of products and services also played a role in the growth of the Company’s operating revenues in 2007 and 2008. Business operations of “Mala Bosna” AD from 2007 to 2011, with the exception of 2009, were characterized by very low operating profits, which, on average, amounted to EUR 112,000. Operating profits in 2007 and 2008 were generated for the most part thanks to an increase in the value of inventories of work in progress and finished products, as well as their own use of products, merchandise and/or services. In aggregate, these revenues in 2007 and 2008 made up an average of 65% of the Company’s total operating revenues.

*Illustration 126 “Mala Bosna” AD business
and net results 2007–2013 (000 EUR)*



Source: Serbian Business Registers Agency

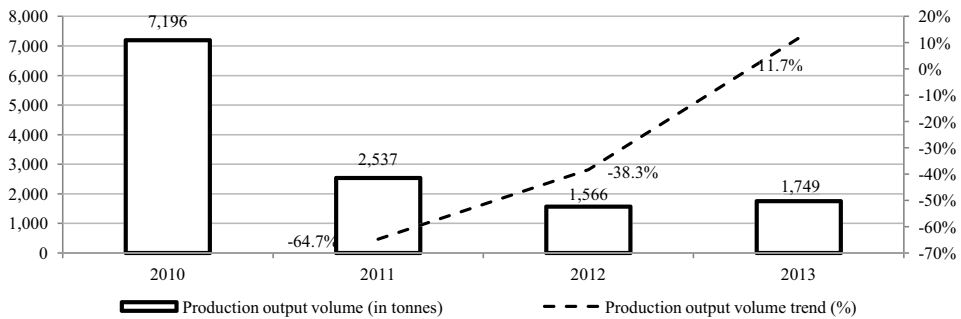
A sudden rise in the cost of goods sold in 2009 was the primary reason for the Company’s business loss in 2009 despite significant sales revenues growth. The cost of goods sold soared from EUR 33,000 in 2008 to EUR 8.4 million in 2009 mostly due to the signing of a contract with the National Commodity Reserves Directorate to borrow wheat for sale on foreign markets, but also on account of an increase in the cost of other goods sold.

In 2010 and 2011, “Mala Bosna” AD yielded profits, above all, thanks to a considerable reduction in the cost of goods sold. These expenses dropped from EUR 8.4 million in 2009 to EUR 3.1 million in 2010 only to be further

408 Compliance Report, May 4, 2010, Serbian Privatization Agency.

cut to EUR 212,000 in 2011. This severe slump in business activities was the principal reason for the Company's business losses in 2012 and 2013, respectively, which was further corroborated by a drop in production output volumes, except in 2013. From 2011 until 2013, production output volumes were very low.

Illustration 127 "Mala Bosna" AD production output volume 2010–2013 (in tonnes)



Source: Serbian Ministry of Economy

A considerable growth in financial expenses, i.e. interest-related expenses arising from incurring a large debt in 2010, was conducive, above all, to the Company's net business loss of EUR 3.6 million. The Company's financial expenses soared from EUR 111,000 in 2009 to EUR 1.6 million in 2010. Profits made in 2007⁴⁰⁹ and 2008⁴¹⁰ were used to cover the losses from previous years. Over the course of 2008, the Company's new owners managed to meet their contractual obligation to invest in equipment and assets to the tune of RSD 7.7 million (about EUR 94,000).⁴¹¹

While performing regular controls, the Privatization Agency warned on several occasions the owners of "Mala Bosna" AD that the continuity in carrying out the core business activity was being undermined. The Agency came to such conclusions despite the significant 2009 sales revenue growth because it was generated through sales of borrowed wheat accruing liabilities in the process, and not as a result of sales of its own wheat. The Agency held a view that if "Mala Bosna" could not return the borrowed wheat severe disruptions might occur in the Company's business operations.⁴¹²

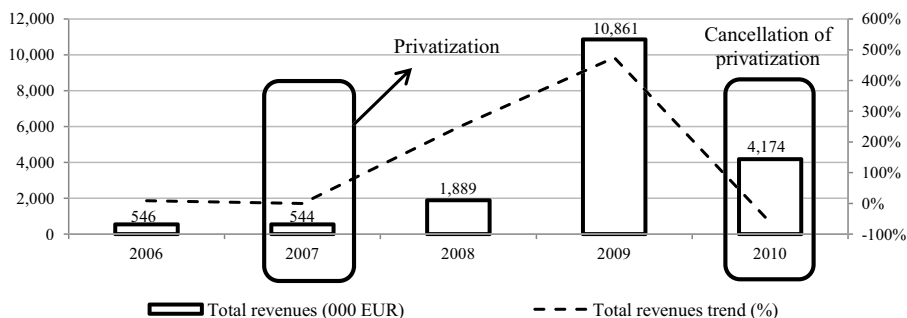
409 Compliance Report July 10, 2008, Serbian Privatization Agency.

410 Compliance Report May 15, 2009, Serbian Privatization Agency.

411 Compliance Report July 10, 2008, Serbian Privatization Agency.

412 Compliance Report May 4, 2010, Serbian Privatization Agency.

Illustration 128 “Mala Bosna” AD total revenues 2006–2010 (000 EUR)



Source: Serbian Business Registers Agency

On account of the breach of contractual obligations, *in 2010 the Privatization Agency cancelled the privatization contract* and filed a request with the Serbian Ministry of Interior for a probe into the circumstances of “Mala Bosna” AD’s accrual of debts with respect to the National Commodity Reserves Directorate. Due to a failure in the performance of contractual obligations regarding the maintenance of core business activity as well as a violation of labor regulations governing the payments of wages and due taxes and contributions levied on employees’ earnings for December 2009 and first four months of 2010, the Privatization Agency requested the Ministry of Interior probe into the circumstances of “Mala Bosna” AD incurring debt vis-à-vis the Serbian Commodity Reserves Directorate.⁴¹³ At the initiative of the City of Subotica, small shareholders and trade unions, a motion was filed with the Privatization Agency requesting the restructuring of “Mala Bosna” AD in order to create conditions for normal business operations. On July 5, 2010, the Agency granted the motion.⁴¹⁴

In early July 2011, the police brought criminal charges against Mr. Mališanović on suspicion of inflicting damage in his capacity as the responsible person to “Mala Bosna” agricultural holdings and its minority shareholders worth over RSD 228.3 million. Police allegations specified that Mr. Mališanović, in his capacity as the responsible person at “Mala Bosna” AD, was transferring money to the related companies associated with himself – “Peđa komerc”, “Azotara” and “Azohem” – on the basis of loan contracts over the course of 2009 and 2010. Thus, according to police estimates, “Mala

413 Ibid.

414 The Decision is available at the Privatization Agency’s web site: <http://www.priv.rs/Agencija+za+privatizaciju/8329/Odluka+o+restrukturiranju++subjekta+privatizacije+Akcionarsko+društvo+Mala+Bosna+Mala+Bosna,+Edvarda+Kardelja+1.shtml> (Site visited: August 1, 2014). For more information on the initiative, see interview with Ištvan Hudi, vice-president of the Serbian Confederation of Autonomous Trade Unions – Subotica branch at: <https://www.youtube.com/watch?v=U3RdKTXU9pc> (Site visited: August 1, 2014).

Bosna” and its minority shareholders sustained losses worth over RSD 228.3 million.⁴¹⁵

The new management board of “Mala Bosna” published a “Report on Contentious Transactions of ‘Mala Bosna’ AD, Mala Bosna” detailing disputed transactions of the Company for the duration of the previous management board’s term in office with Mr. Mališanović at its helm. Amongst other things, the report charged “Agrobanka” AD Belgrade with failing to revoke its guarantee to “Mala Bosna” AD for wheat on loan from the National Commodity Reserves Directorate. The report also alleged that “Agrobanka” AD Belgrade knew or must have known about “Mala Bosna” AD’s failure to discharge its obligations with regard to the National Commodity Reserves Directorate, which was what the guarantee was provided for. In addition, allegations went on to specify that guarantee instruments provided by “Azotara” i “Azohem”, (the companies owned by Mr. Mališanović), were not used, but exclusively “Mala Bosna” AD guarantee instruments.⁴¹⁶

Table 72 Relative share of receivables owed by individual customers in cumulative receivables of “Mala Bosna” AD, end year, 2008–2013

Clients	2008	2009	2010	2011	2012	2013
PIK Zemun	–	–	–	20.3%	17.8%	42.5%
Azohem DOO	–	3.4%	36.5%	–	20.0%	–
Dragan Markovic AD	–	–	–	45.9%	17.0%	–
Azotara DOO	–	71.3%	44.7%	–	–	–
Vojvodina AD – undergoing restructuring	–	–	–	13.6%	12.0%	28.6%
Peda Komerc	–	16.8%	7.3%	–	–	
Other buyers	100%	8.5%	11.6%	20.2%	45.2%	28.9%

Source: Serbian Ministry of Economy, Profile “Mala Bosna” AD – undergoing restructuring

Up until the termination of the privatization contract, the biggest customers and suppliers of “Mala Bosna” AD were legal persons mutually related through ownership relations or managerial positions held by Peđa Mališanović at that point in these companies (“Azohem” d.o.o. Subotica, “Azotara” d.o.o. Subotica, “Panvita – Nova Brazda” AD, “Graničar” AD and others). After the adoption of the decision on restructuring, the main clients were other companies undergoing restructuring process. This was an interesting finding be-

415 <http://www.ekapija.com/website/sr/page/617797/Kako-je-Agrobanka-ojadila-Malu-Bosnu-?> (Site visited: August 1, 2014).

416 Ibid.

cause it brought into question the ability of “Mala Bosna” AD to do business with companies in the private sector. Both in the post-privatization period and after the termination of the privatization contract and the passage of the decision on restructuring, three customers had a predominant share in the Company’s total amount of outstanding receivables in the 2008–2013 period, and their cumulative share in overall claims totaled 90%.

The situation was similar with liabilities owed to suppliers both in terms of the characteristics of commercial creditors and with regard to the dominant share of a small number of creditors in the overall liabilities owed to suppliers. Yet again, after the cancellation of the contract, key creditors which were legal persons related to Mr. Mališanović were replaced by the companies undergoing restructuring. An overview of the biggest suppliers of “Mala Bosna” AD and their shares in the total outstanding payables to the suppliers is presented below in the table.

Table 73 Relative share of payables owed to individual suppliers in cumulative payables of “Mala Bosna” AD owed to suppliers – end year, 2008–2013

Supplier	2008	2009	2010	2011	2012	2013
Azohem DOO	62.0%	61.5%	9.5%	–	–	–
Azotara DOO	13.3%	–	18.5%	–	–	–
Uljarice Bačka DOO	21.8%	9.0%		10.0%	34.8%	29.0%
Panvita – Nova Brazda AD	–	–	31.5%	–	–	–
Plima Pek Kruševac	–	–	10.0%	63.5%	–	–
Graničar AD	–	–		5.2%	18.2%	15.2%
Other suppliers	2.9%	29.5%	30.6%	21.3%	47.0%	

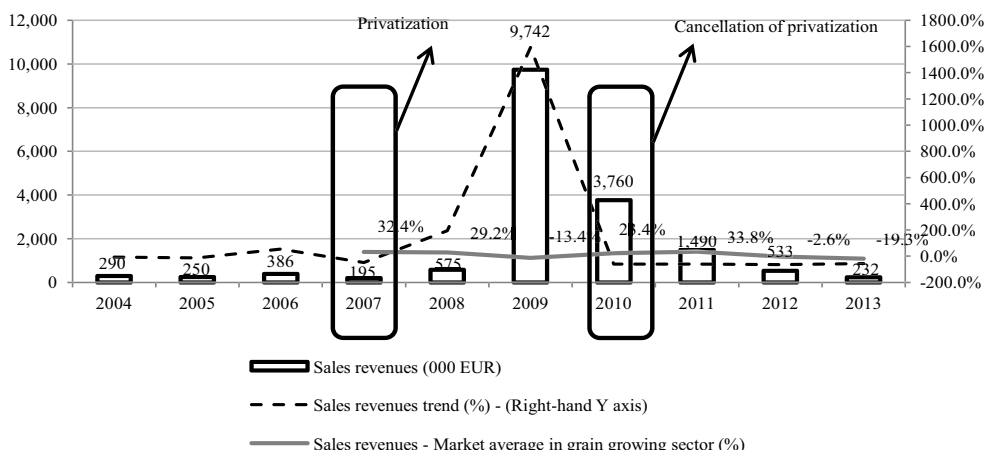
Source: Serbian Ministry of Economy, Profile “Mala Bosna” AD – undergoing restructuring

“Mala Bosna” AD profitability indicator values until 2008 do not paint an accurate picture of the Company’s profitability given that the revenues which were not generated through sales of the Company’s own products constituted the biggest or dominant portion of “Mala Bosna” AD operating revenues in the given period. However, for the sake of comparison with other case studies, we will present key indicators based on available financial figures.

In the pre-privatization period, from 2004 to 2006, and for two years after the privatization, “Mala Bosna” sales revenues were relatively low and averaged EUR 340,000. In 2009, “Mala Bosna” AD recorded a significant spike in sales in 2009 which was so large that the sales revenues skyrocketed to 49 times greater actual sales volume relative to 2007, i.e. the privatization year. The Company produced such extraordinary sales gains thanks, above all, to

the sale of wheat on loan from the National Commodity Reserves Directorate, rather than through sale of own wheat from its inventories. In the following years, the Company was registering a steady decline in sales revenues at an annual rate of 60.6%, due to, above all, a slump in business activities caused by cash flow problems and frequent blocking of the Company's business account. In the 2007–2013 period, the Company recorded a sales revenue growth above the market average solely in 2008 and 2009.

Illustration 129 "Mala Bosna" AD Sales revenues 2004–2013 (000 EUR)



Source: DP Mala Bosna Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency and Serbian Business Registers Agency

"Mala Bosna" AD was registering significantly higher profitability rate indicator values up until 2008. However, higher EBITDA% and EBIT% values in the pre-privatization period were not the result of a higher level of the Company's business activities based on larger sales volumes but were due to an increase in the value of inventories of unfinished and finished products. In the 2004–2007 period, these revenues made up an average of 42.6% of the Company's operating revenues. A considerable portion of revenues which did not result from sales were also recorded in 2008, when their share in the Company's total sales revenues amounted to 67.4%. Given that the revenues which were not generated from the sales of products constituted a significant – and in some years dominant – share in the overall operating revenues of "Mala Bosna" AD, the values of analyzed profitability indicators in the 2004–2008 period could provide reliable information on the Company's profitability. In the period after 2008, the main factors with the biggest impact on the trend in values of both indicators (EBITDA and EBIT) were a significant increase in the cost of goods sold in 2009 and increasingly diminishing sales revenues.

Table 74 “Mala Bosna” AD Profitability indicators 2004–2013

Year	2004	2005	2006	2007	2008
EBITDA %	2.1%	39.4%	20.7%	40.5%	22.5%
EBIT %	-16.7%	23.4%	12.1%	25.6%	17.4%
Net result %	12.8%	1.6%	1.2%	11.7%	2.6%
ROA	1.5%	0.3%	0.3%	1.2%	0.7%
ROE	1.8%	0.3%	0.4%	1.8%	1.2%
Gross margin	59%	N/A	N/A	N/A	-36.7%
Year	2009	2010	2011	2012	2013
EBITDA %	0.3%	4.4%	27.6%	0.5%	-144.2%
EBIT %	-0.1%	2.6%	21.5%	-11.8%	-539.4%
Net result %	0.1%	-96.8%	-24.8%	88.7%	-470.9%
ROA	0.1%	-39.1%	-3.6%	5.4%	-12.5%
ROE	0.6%	-627.1%	–	–	–
Gross margin	30.5%	47.8%	82.6%	59.6%	3.6%

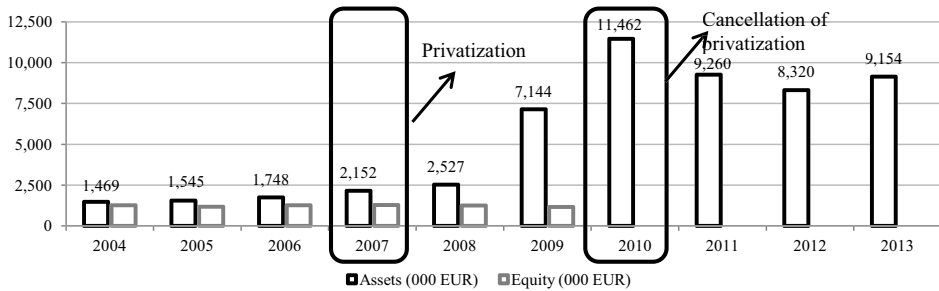
Source: Author’s calculations

Values of net result indicators were higher on average in the pre-privatization period, from 2004 to 2007, rather than in the period after 2007. A sudden drop in sales revenues, negative operating results and higher financial expenses were the principal factors influencing the trend in net result indicator values between 2010 and 2013.⁴¹⁷ Trends in the values of return on assets (ROA) and return on equity (ROE) indicators showed that “Mala Bosna” AD was managing its assets and equity more efficiently in the pre-privatization period than after the privatization. A sudden drop in ROA indicator value in 2010 was the consequence of the Company’s growing debt, and consequently high financial expenses and net operating loss of the Company. “Mala Bosna” AD generated relatively high gross production margin values on average in all the analyzed years, with the exception of 2008. In 2009, the Company generated most of its sales revenues through the sales of wheat on loan, i.e. the sales of goods. The average gross trade margin in 2009 was negative and

⁴¹⁷ Exceptionally low sales revenues and relatively high revenues generated through an increase in the value of inventories of unfinished and finished products were conducive to higher net result values in 2007 in comparison to the average. Due to a significant growth in financial interest-related expenses arising from growing indebtedness of the Company as well as other expenses in 2010, and consequently high net operating loss, a negative net result was registered in 2010.

totaled -0.3% , indicating that the average sale price of wheat, (which was for the most part borrowed from the National Commodity Reserves Directorate) was actually lower than the purchase price of borrowed wheat.

Illustration 130 “Mala Bosna” AD assets and equity on December 31, 2004–2013



Source: DP Mala Bosna Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency and Serbian Business Registers Agency

The main driver behind the growth of “Mala Bosna” AD business assets value in late 2009 and 2010 was the growth in the total amount of receivables with respect to clients, short-term financial investments and an increase in the value of the Company’s inventories. The most significant growth in the total business assets of “Mala Bosna” AD was recorded in the post-privatization period, in late 2009 and 2010. The total business assets value of the Company in late 2009 increased year-on-year by a factor of 1.8. The total amount of outstanding receivables from customers in late 2009 was EUR 2.4 million, whereas at the end of the previous year – only EUR 24,000. In late 2009, the Company disclosed short-term financial investments to the tune of EUR 1.5 million. The Company’s inventories grew due to wheat on loan from the National Commodity Reserves Directorate given that the Company only managed to sell only two thirds by late 2009.⁴¹⁸ In late 2010, the Company’s total business assets value stood at EUR 11.4 million; exceeding by 60% the total business assets value of the Company at the end of 2009.⁴¹⁹

At the end of 2011, the overall business assets value dropped by 20% relative to late 2010, and totaled EUR 9.2 million. A reduction in the Company’s total business assets value was due to a decrease in the value of inventories by 81.5%, as well as a drop in the total amount of receivables and short-term financial investments by 90.0% and 95.5%, respectively. In late 2013, the value

418 Report on control of performance of contractual obligations, dated May 4, 2010, Serbian Privatization Agency.

419 Receivables and short-term financial investments of the Company in late 2010 were higher year-on-year by 43.8% and 36.3%, respectively. In late 2010, the Company’s outstanding receivables amounted to EUR 3.4 million, while short-term financial investments totaled EUR 2.1 million. In late 2010, the Company’s inventories increased by 10.5% totaling EUR 2.1 million.

of total business assets grew by 10% as a result of an increase in the value of fixed assets which was down to a rise in the value of agricultural land following adjustments to its current market value.⁴²⁰

A decrease in the value of inventories, a total amount of receivables and short-term financial investments in late 2011 occurred as a result of deficits, inability to establish the existence of certain inventories, adjustments to the value of inventories and offsetting a portion of receivables by payables owed to the same legal entities. In late 2011, the Company's inventories decreased due to the stated deficits in inventories of materials, adjustments to the value of inventories and devaluing of inventories as a consequence of inability to establish the existence of specific goods at individual storage facilities owned by "Azotara" d.o.o., "Peđa Komerc" d.o.o. and "Azohem" d.o.o. as well as a failure to present evidence of the fate of goods stored in other warehouses with which "Mala Bosna" AD was collaborating. Indirect write-offs of non-payable claims to the tune of RSD 98.1 million (EUR 937,700) were cited as reasons for the decline in the total amount of the Company's receivables in late 2011. The remaining claims were further cut through offsetting a significant portion of the Company's receivables by its liabilities to "Azotara" d.o.o., "Azohem" DOO, "Peđa Komerc" d.o.o., "Azotara Subotica" d.o.o. and the Institute for Field Crops and "Panvita – Nova Brazda" AD. While drafting the 2011 financial report, an assessment was made that the claims arising from borrowings to commercial entities related in terms of ownership and management to Peđa Mališanić did not meet the requirements needed to be declared a part of "Mala Bosna" AD assets. This was why the said claims, resulting from previous borrowings and reduced by a portion which could be offset by liabilities owed to the same legal entities were written off. "Graničar" Gakovo AD and "Vojvodina" AD, as companies undergoing restructuring, were exempted in this respect.⁴²¹

In addition, there were many illogical aspects to the business operations of "Mala Bosna" AD with respect to its dealings with its biggest clients⁴²² – "Azotara" d.o.o., "Azohem" d.o.o. and "Peđa Komerc" d.o.o., owned by Mr. Mališanić, who was at the same time "Mala Bosna" AD management board chairman.⁴²³ The motive for the sale of 1,300 tonnes of mercantile wheat in

420 Comments enclosed with 2013 financial reports, "Mala Bosna" AD – undergoing restructuring.

421 Business operation report for 2011, "Mala Bosna" AD – undergoing restructuring.

422 "Mala Bosna" AD biggest clients in late 2009 and 2010 were "Azotara" DOO, "Azohem" DOO and "Peđa Komerc" DOO. "Mala Bosna" AD claims against these three companies constituted a 91.5% share in the Company's total amount of receivables from clients in late 2009, and 88.4% at the end of 2010. Total claims of "Mala Bosna" AD against the three companies mentioned above amounted to RSD 199.6 million (EUR 2.1 million) in 2009, and RSD 309.4 million (EUR 2.9 million) in 2010. In this period, the owner of all three companies listed above was Peđa Mališanić, who was at the same time "Mala Bosna" AD management board chairman.

423 Serbian Ministry of Economy, "Mala Bosna" AD – undergoing restructuring – Company profile.

2009 to “Azotara” d.o.o., eight days before the expiry of deadline for returning the borrowed wheat to the National Commodity Reserves Directorate, was unclear. In a control of business dealings with “Azohem” d.o.o. carried out later on, in it was established that in fact no transaction of goods took place as specified in an invoice worth RSD 119.9 million (about EUR 1.1 million).⁴²⁴

The Company’s short-term financial investments pertained almost entirely to financial borrowings to companies associated with Peđa Mališanić in terms of either ownership relations or management positions held by Peđa Mališanić at the time in these commercial entities. “Mala Bosna” AD’s short-term financial investments pertained almost entirely to financial loans to “Peđa Komerc” d.o.o. Subotica, “Azotara” d.o.o. Subotica, “Azohem” d.o.o. Subotica, “Panvita – Nova Brazda” AD and “MP Kluz Tisa” d.o.o. Subotica. As of May 4, 2010, the overall amount of loans granted by “Mala Bosna” AD to the companies listed above totaled RSD 217.8 million⁴²⁵ (about EUR 2.1 million).⁴²⁶ On top of that, loans were also granted to other companies: “Agro PNB” d.o.o., “Graničar” AD, “Most HID” and “Vojvodina” AD – undergoing restructuring. All the above-mentioned companies receiving loans, except for “Vojvodina” AD – undergoing restructuring, were related legal entities in terms of ownership status or managerial positions held, at the time, by Mr. Mališanić.⁴²⁷

Cash loaned by “Mala Bosna” AD to companies associated with Mr. Mališanić through ownership relations or management positions was acquired by the Company in the form of loans raised in the name and for the benefit of “Mala Bosna” AD. Pecuniary funds procured in such a manner would be typically transferred in their entirety on the same day to business accounts of the related commercial entities.⁴²⁸ To this end, contracts on interest-free loans without any security would be drawn up, whereas, at the same time, “Mala Bosna” AD had an obligation to pay interest on its loans to the creditor banks.⁴²⁹

In accounting terms, the principal driver behind the company’s equity value growth from late 2004 until the end of 2009 was the positive net operating result in the said period, i.e. retention of generated net profits within the Company as unallocated gains. An additional factor which, to a lesser degree, had an impact on the Company’s equity value growth in late 2008 was the decision on capital increase on the basis of mandatory investment worth

424 Business operation report for 2011, “Mala Bosna” AD – undergoing restructuring.

425 The total amount was allocated as follows: “Peđa Komerc” DOO – RSD 87.8 million (about EUR 833,000); “Azotara” DOO Subotica – RSD 32.6 million (about EUR 309,000); and “Azohem” DOO – RSD 72.3 million (about EUR 685,000).

426 Report on control of performance of contractual obligations, dated December 9, 2009, Serbian Privatization Agency.

427 Report on business operations for 2011, “Mala Bosna” AD – undergoing restructuring.

428 “Peđa Komerc” d.o.o. Subotica, “Azotara” d.o.o. Subotica, “Azohem” d.o.o. Subotica, “Panvita – Nova brazda” AD and “MP Kluz Tisa” d.o.o. Subotica, Agro PNB” d.o.o., “Graničar” AD and “Most HID”.

429 Report on business operations for 2011, “Mala Bosna” AD – undergoing restructuring.

RSD 7.7 million (about EUR 94,000). On the same day, a decision was made to release ordinary shares of the second issue in order to carry out the capital increase.⁴³⁰ However, the use of the subject of privatization as a vehicle for raising loans for the benefit of commercial entities related to the owner forced the Company to disclose a loss in 2010 which was greater than its equity value; as a consequence of the Company's growing debts and inability to service its outstanding debts.

Over the course of the analyzed period, "Mala Bosna" AD was experiencing severe cash flow problems, which culminated in frequent blocking of its business account due to the Company's failure to settle its liabilities to creditors as well as its inability to regularly pay wages to its employees. In the course of the entire analyzed period, from 2004 until 2013, "Mala Bosna" AD was recording values of current ratio and quick ratio indicators below the theoretically optimal levels of 2:1 and 1:1, respectively. As of 2010, both indicator values were declining conspicuously, which in turn pointed to a continuing deterioration of the Company's liquidity. In all the analyzed years, the Company failed to establish a long-term financial balance indicating that long-term assets were not fully financed from long-term sources. There was a marked negative trend in this indicator values (net working capital), i.e. year after year the value of operating assets was shrinking whereas short-term liabilities were growing up to the point where it was not possible anymore to offset short-term liabilities by operating assets.

The conspicuous trend of ever-decreasing net working capital values suggested that the Company was not capable of maintaining permanent liquidity. The liquidity issue would culminate in frequent blocking of the Company's bank account and failure to pay wages to its employees.

*Table 75 "Mala Bosna" AD liquidity and debt indicators
on December 31, 2004–2013*

Year	2004	2005	2006	2007	2008
Current ratio	0.5	0.9	1.0	1.0	1.0
Quick ratio	0.1	0.0	0.1	0.1	0.0
Net working capital (000 EUR)	-85	-38	-6	17	48
Year	2009	2010	2011	2012	2013
Current ratio	1.1	0.7	0.1	0.2	0.1
Quick ratio	0.7	0.5	0.1	0.1	0.1
Net working capital (000 EUR)	410	-3,776	-8,176	-7,054	-7,281

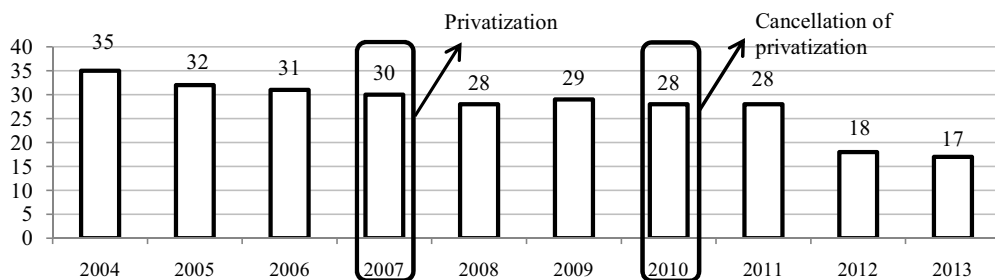
Source: Author's calculations

430 Report on control of performance of contractual obligations, dated July 10, 2008, Serbian Privatization Agency.

6.2.5. Employment and productivity

The average number of employees at “Mala Bosna” AD had been relatively low and stable until 2011. The Company’s head count in the 2006–2013 period had stood at 27. After the privatization of “Mala Bosna” AD, new owners did not lay off employees as part of redundancy program. From 2007 until the last year in which a control of compliance with the contractual obligations was carried out by the Serbian Privatization Agency, on May 4, 2010, a total of eleven (11) employees left the Company on the basis of voluntary termination of their employment contracts, retirement or notices of dismissal served by the employer. At the same time, the Company employed an additional 9 workers.⁴³¹ Following the cancellation of the contract, a number of employees left the Company having received severance pays financed from the “Transition Fund”.⁴³²

Illustration 131 “Mala Bosna” AD average number of employees by years 2004–2013



Source: DP Mala Bosna Privatization Program, Mala Bosna, dated December 31, 2004, Serbian Privatization Agency and Serbian Business Registers Agency

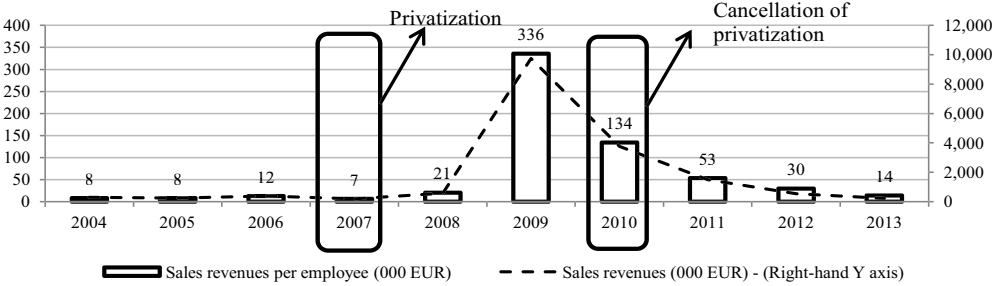
Productivity of “Mala Bosna” AD measured by sales revenues per employee was relatively low and averaged below EUR 10,000. A significant rise in the Company’s productivity, as measured by this indicator, was registered in 2009 due to a considerable increase in sales revenues stemming from the sales of wheat borrowed from the National Commodity Reserves, and not

431 Reports on control of performance of contractual obligations, dated July 10, 2008; May 15, 2009; September 14, 2009; December 9, 2009; March 5, 2010; and May 4, 2010; Serbian Privatization Agency.

432 The Transition fund is just the name of a position in the budget of the Republic of Serbia used to finance severance pay-offs in accordance with the Decision on establishing social programs for employees whose employment is terminated as part of the process of company restructuring, preparations for privatization, bankruptcy and liquidation (“Official Gazette of the Republic of Serbia”, nos. 64/2005, 89/2006, 85/2008, 90/2008 – corr., 15/2009, 21/2010, 46/2010, 9/2011, 6/2012, 63/2013 and 21/2014) which has been changed many times.

as a result of sales of its own wheat from its inventories. In the subsequent years, due to a slump in the sales revenues at an annual rate of 60.6%, the said indicator value was falling proportionally. Given that “Mala Bosna” AD employee numbers were relatively stable over the course of the entire analyzed period, the sales revenue trend was the main driver of growth and the reason for the subsequent decline in the Company’s productivity measured by sales revenues per employee.

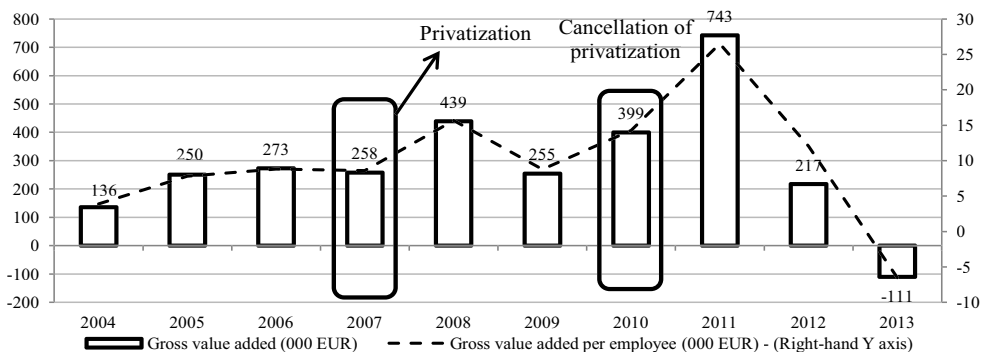
Illustration 132 “Mala Bosna” AD sales revenues per employee and sales revenues 2004–2013



Source: Author’s calculations

“Mala Bosna” AD sales revenues per employee indicator values were below the average for the biggest companies in terms of actual sales revenues in the sector of growing grains (except rice), leguminous and oilseed crops for the duration of the entire analyzed period. This discrepancy was less noticeable in the course of 2009 for the reasons stated above. The sales revenues per employee indicator value for the biggest companies in the sector of growing grains (except rice), leguminous and oilseed crops totaled EUR 429,000 on average between 2006 and 2009, but rose to EUR 574,000 in the 2010–2013 period.

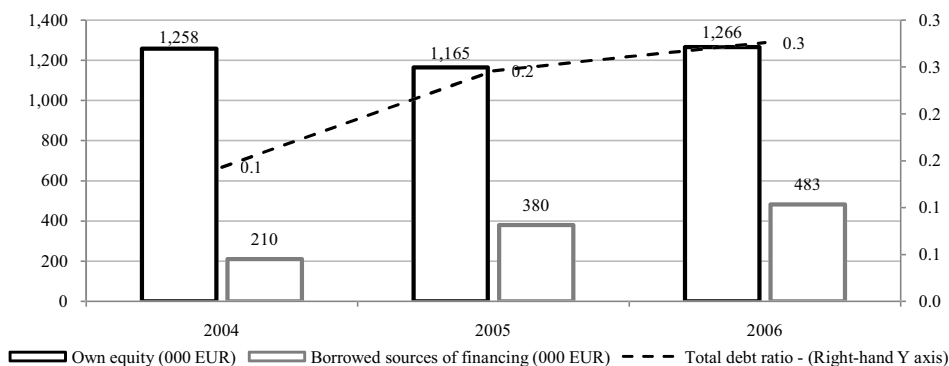
Gross value added of the Company undergoing restructuring was negative. In all the years of the analyzed period, Mala Bosna” AD generated gross value added which was considerably below the median value for the biggest companies in terms of sales revenues in the sector of growing grains (except rice), leguminous and oilseed crops. Gross value added generated by the biggest companies in the sector of growing grains (except rice), leguminous and oilseed crops in the 2008–2013 period totaled EUR 2 million on average, while the gross value added per employee in the same period was EUR 48,000. After 2011, due to cash flow problems, frequent blocks of the Company’s account and poor operating results, the gross value added generated by “Mala Bosna” AD was sharply falling; reaching a point where it became negative.

Illustration 133 Gross value added and gross value added per employee 2004–2013

Source: Author's calculations

6.2.6. Financial restructuring – indebtedness (debtor-creditor relations)

The period prior to privatization, from 2004 to 2006, was marked by relatively low indebtedness and relatively stable own equity levels. In the said period, values of borrowed sources of financing in absolute terms were growing at an annual rate of 53% and this, in its entirety, pertained to the growth of interest-related liabilities of the Company, i.e. growing liabilities due to short- and long-term loans raised by the Company. In addition, the degree of overall indebtedness of the Company rose from 0.1 to 0.3. As part of its preparations for the privatization, the Company was incurring debts in order to purchase necessary equipment.

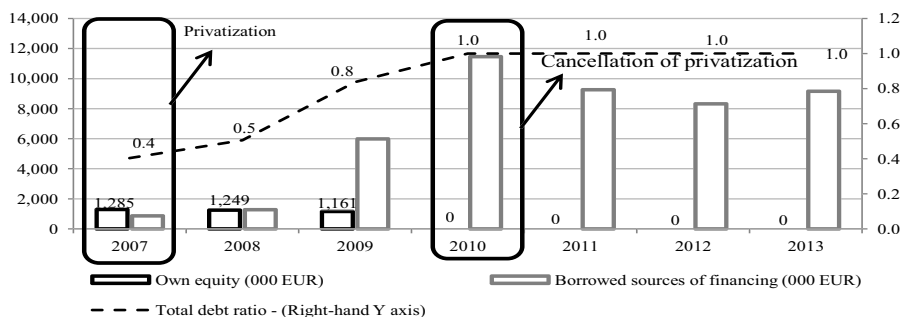
Illustration 134 “Mala Bosna” AD debt levels on December 31, 2004–2006

Source: Author's calculations

After privatization, as of 2007, there was a sharp upward spiral in debt to the point where “Mala Bosna” AD had no equity of its own. In this respect, “Mala Bosna” is a typical example of using a privatized company as a collat-

eral to raise loans for the benefit of a related legal entity or to acquire another company. In such cases, often after the first installment or two or three years after the privatization, the contract is cancelled and the Company returns into the fold of the Privatization Agency. Parallel to levying a burden on the assets, actual transfers of assets to another legal person also takes place. Such Ponzi schemes are typically related to groups which have come into existence through acquisitions of several companies in the privatization process as is the case with “Mala Bosna”.⁴³³

Illustration 135 “Mala Bosna” AD debt levels on December 31, 2007–2013



Source: Author's calculations

In 2009 a marked trend of growing debt started to develop. In May 2009, the Company concluded a contract to borrow 35,000 tonnes of mercantile wheat worth RSD 404.6 million (about EUR 4.3 million). A guarantee of “Agrobanka” AD from Belgrade was enclosed with the contract as surety. The deadline for returning the borrowed wheat was the end of 2009. “Mala Bosna” AD did not succeed in returning the borrowed wheat within the set deadline which resulted in the blocking of the Company’s account. In order to resume normal business operations, in late 2009 “Mala Bosna” AD signed a contract with “NLB” banka AD Belgrade on a loan worth EUR 500,000 and in early 2010 a loan contract with “Agrobanka” AD Belgrade worth RSD 230 million (about 2.4 million EUR). In addition, the Company had taken out a loan earlier in 2009 from “Findomestic Bank” AD Belgrade to the tune of RSD 40 million RSD (about EUR 450,000), as well as another one from the Serbian Export Credit and Insurance Agency to the extent of EUR 250,000.⁴³⁴

In April 2010, the Company signed a contract with “Agrobanka” AD Belgrade on taking over 18,000 tonnes of mercantile wheat at the price of RSD 11 per kg (EUR 0.1) as a way to discharge a part of the Company’s liabilities

433 Vujačić. I and J. Petrović Vujačić, “Privatization in Serbia – Results and Institutional Failures” *Economic Annals*, Volume LVI, No. 191 / October – December 2011, 100.

434 Compliance Report, March 5, 2010, Serbian Privatization Agency.

to the bank on the basis of previously granted security. After the signing of the contract, the total debt of “Mala Bosna” AD to “Agrobanka” AD Belgrade was reduced from RSD 429.7 million (about EUR 4.2 million) to RSD 198 million (EUR 1.9 million).⁴³⁵ However, the Company’s current level of indebtedness is unsustainable, i.e. without substantial financial restructuring the only way out is bankruptcy through insolvency.

And yet, for “Mala Bosna” AD to be deployed in such a way, a prerequisite would be the willingness of banks and other financial institutions to grant loans to such a firm. The case of “Mala Bosna” points to a connection between some banks and certain privatizations. As a rule, these are domestic banks (either private or state-owned) among which many have ended up in bankruptcy themselves in the past years. It is precisely within this triangle of domestic banks, subjects of privatization and connected entities that unappropriated use of credits and a series of other abuses have occurred. However, the loans were not used solely by “Mala Bosna” but, above all, by legal persons associated with the “Mala Bosna” management board chairman. “Mala Bosna” had substantial claims against these companies. “Mala Bosna” claims against “Azohem”, according to the “Azohem” prepackaged plan (*unapred pripremljeni plan reorganizacije*), totaled RSD 80 million and were placed in class of unsecured/bankruptcy creditors’ claims stipulating 90% write-off. Claims against “Azotara” from Subotica which, according to the prepackaged plan, totaled RSD 172 million and were also ranked as Class III (i.e. bankruptcy) creditors’ claims stipulating 90% write-off.

6.2.7. *Relationship between the company and local self-government*

The Company itself is based in the namesake village of Mala Bosna, in the vicinity of Subotica. The Company’s location is favorable in terms of, above all, infrastructure and connections. As the second largest city on the territory of the Autonomous Province of Vojvodina, Subotica is the most important industrial center of northern Vojvodina, i.e. the Northern Bačka region.⁴³⁶ Dominant economic activities are agriculture, food production and food processing, the electrical industry, metal and chemical industries and the services sector. A total of 76 companies have been privatized in Subotica, and the percentage of cancelled contracts is relatively low – 20% (i.e. 16 companies). As many as 65 companies have been sold by public auction, and another three by public tender. Bankruptcy proceedings have been brought at the remaining eight companies. Seven companies remain unprivatized, but a significant number of companies (14) have ended up in bankruptcy.⁴³⁷ “Mala Bosna” is the only company on the territory of the City of

435 Compliance Report, May 4, 2010, Serbian Privatization Agency.

436 <http://www.suboticainvest.com> (Site visited: August 1, 2014).

437 This number pertains only to companies sold in accordance with the 2001 privatization model.

Subotica which is currently undergoing a restructuring process. However, given its size, “Mala Bosna” does not play a significant role in contributing to the Subotica budget.

As we could not collect the data on “Mala Bosna” liabilities with respect to the local self-government, the following table provides an overview of the Company’s dues according to the available data as of August 31, 2013.

*Table 76 “Mala Bosna” AD liabilities
to local self-government as of August 31, 2013*

	000 RSD	000 EUR
Property-tax-related liabilities – agricultural land	675	6
Property tax (except on land) for legal person	26	0
Environmental protection and improvement fee	17	0
Municipal business display sign fee	2	0
Construction land usage fee	-2,081	-18
Waste water drainage fee – Vode Vojvodine	-2,088	-18

Source: “Mala Bosna” AD ID, Serbian Ministry of Economy

6.3. WHAT IF ANALYSIS

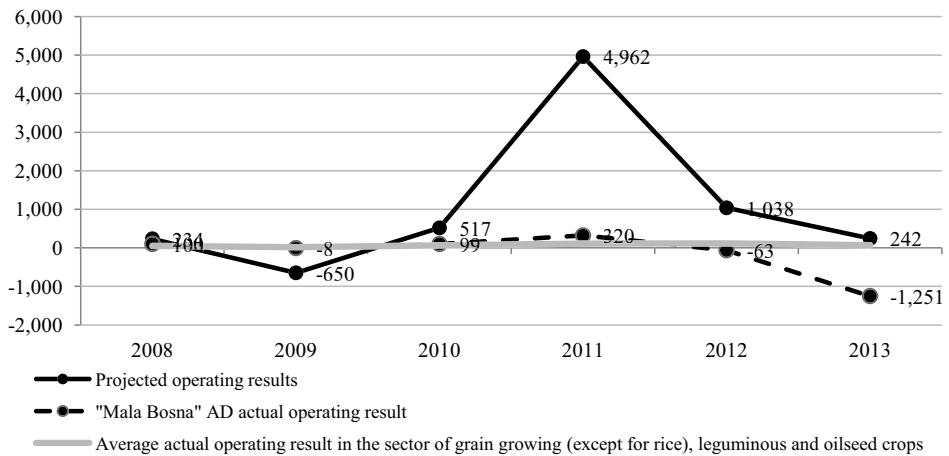
As part of a “What If” analysis, a projection of assumed trends for items in the profit and loss account of “Mala Bosna” AD was made in order to illustrate and quantify the impact of the counterfactual scenario i.e. possible alternative positive privatization outcomes. Given the limited access to available data the following assumptions were made for the purpose of projections of assumed values for operating revenues, expenditure and operating result of “Mala Bosna” AD:

- 1) The basic premise is that an alternative buyer taking over a majority ownership stake in “Mala Bosna” AD would implement all aspects of the business policy which were applied by the buyer of “Banatski Despotovac” AD, as a company which continued to operate relatively successfully. All specific characteristics of business operations typical of “Mala Bosna” AD have not been taken into account, instead the starting point is that specific business traits of “Banatski Despotovac” AD are also applicable to “Mala Bosna” AD. In addition, we assume that market conditions in which “Banatski Despotovac” AD operates apply to the business environment of “Mala Bosna” AD.

- 2) The year zero for projecting assumed values for operating revenues, expenditure and final operating results is 2007, the privatization year for “Mala Bosna” AD.
- 3) The baseline for projections of trends in assumed values for “Mala Bosna” AD operating revenues and expenses are the fluctuations of the historical values for operating revenues and expenses recorded in business operations of “Banatski Despotovac” AD, as an example of a successful privatization, for the 2008–2013 period.
- 4) The baseline for projections of “Mala Bosna” AD’s assumed sales revenue values are historical data for “Banatski Despotovac” AD’s sales of products and services in the 2008–2013 period.
- 5) The baseline for projections of a) revenues from own use of products, services and merchandise, b) changes in value of inventories, and c) other operating revenues is the historical share of the above revenue categories in “Banatski Despotovac” AD sales revenues in the 2008–2013 period.
- 6) The baseline for projections of assumed values for expenses as part of business expenditure, i.e. a) purchase costs of goods sold, b) costs of raw materials, c) costs of salaries, fringe benefits and other personal expenses, and d) other operating expenses, is the historical share of the above expenses in “Banatski Despotovac” AD sales revenues in the 2008–2013 period.
- 7) Due to lack of adequate data, an approximation of trends in values of the costs of depreciation and provisions has been made. With the approximation of the costs of depreciation and provisions, historical data for the rate of changes to the value of the costs of depreciation and provisions for “Banatski Despotovac” AD in the 2008–2013 period has been used.

The main conclusion to be inferred from the applied projections of one of the possible alternative privatization outcomes is that “Mala Bosna” AD would be registering much better operating results. The principal reason why “Mala Bosna” AD’s actual operating result in 2010 exceeded the projection for the same year was that, in addition to the sales of its own products, the Company generated revenues from the sales of goods. This pertained to the sales of wheat borrowed from the National Commodity Reserves, which was not included in the alternative scenario of “Mala Bosna” AD’s successful privatization. Based on projections of assumed operating result values, “Mala Bosna” AD would be making operating profits above the average in the sector in all the analyzed years apart from 2009.

Illustration 136 Alternative scenario for “Mala Bosna” privatization – Overview of projected and actual operating results in 2003–2013 period (EUR 000)



Source: Author's calculations

The difference between the two cases may be well illustrated with a comparison of projected and actual operating results. The “Mala Bosna” AD failed privatization, in cumulative current values, produced a EUR 5.5 million worse operating result than the one presented in the alternative scenario privatization case (if “Mala Bosna” AD had operated like “Banatski Despotovac”) in the 2008–2013 period.

Table 77 “Mala Bosna” AD projected assumed values of operating revenues, expenses and operating results 2008–2013 (000 EUR)

Year	2008	2009	2010	2011	2012	2013
Projected operating revenues	22,322	16,337	13,759	22,191	20,653	31,379
Sales revenues	21,180	16,119	13,455	23,252	18,773	29,498
Revenues from own use of products, services and merchandise	0	0	66	108	0	0
Increase in f inventories of work in progress and finished products	2,709	17	446	0	1,468	1,300
Decrease in inventories of work in progress and finished products	1,961	120	523	1,521	0	0
Other operating revenues	393	321	316	352	412	581

Year	2008	2009	2010	2011	2012	2013
Projected operating expenses	22,089	16,987	13,242	17,229	19,615	31,137
Purchase cost of goods sold	4,157	4,367	2,651	4,480	6,909	15,382
Raw material and consumables used	8,971	6,750	5,441	7,453	6,744	7,815
Cost of salaries and wages	3,332	2,638	2,327	2,628	2,661	2,664
Depreciation, amortization and provisions	2,643	1,591	1,266	1,115	1,009	2,458
Other operating expenses	2,986	1,642	1,557	1,553	2,292	2,819
Projected operating result	234	-650	517	4,962	1,038	242
“Mala Bosna” actual operating results	100	-8	99	320	-63	-1,251
Actual average operating results in the sector	49	15	61	110	113	69

Source: Author's calculations

7. CONCLUSIONS

In this section we will consider possible solutions to the key problems contained in privatization, and we will highlight a potential role of local self-governments and public utilities in the privatizations which are already under way as well as the remaining ones. Given that the newly adopted Privatization Act came into effect just before this study, and bearing in mind that it would not be realistic to expect changes to the law any time soon, the recommendations have been formulated with a view, above all, to resolving the problems which have not been overcome by the adoption of the new Privatization Act⁴³⁸. These recommendations concern the issue of construction land, the role of local self-governments in bankruptcies, redundancies, privatization of public enterprises and the business environment.

7.1. PROBLEM OF CONSTRUCTION LAND – CONVERSION FOR A FEE

One of the key unresolved issues with respect to the rights of privatized companies, i.e. their owners, is as follows: Will the state recognize – and under which conditions – the right of ownership to the construction land to which, at the time of privatization, they acquired the broadest possible scope of the right – the right of use, that was conducive to the right of construction? This issue came to the fore when a Decision of the Constitutional Court IUz-68/2013, dated October 10, 2013,⁴³⁹ rendered the provision in Article 103, para. 1, of the Planning and Construction Act⁴⁴⁰ null and void, thus effectively precluding further conversion of the right of use into the right of own-

438 In principle, there was no need for comprehensive changes and an entirely new legal framework as this would slow down and protract the completion of privatization, but even the existing framework, with minor changes, provided for flexible solutions, above all, through bankruptcy proceedings whereby, thanks to non-existence of liabilities, the companies featured in the Privatization Agency's portfolio would be rendered more attractive. The new framework envisaged solutions to the problem of excessive debt in cases where state entities constituted the majority of creditors, and it partly solved the problem of "soft budget constraint" with the proviso that the deadlines for the completion of privatization were observed. However, the new framework has not yet essentially resolved two crucial problems in the Privatization Agency's portfolio – legal property-related issues (land) and a mechanism for dealing with redundancies.

439 Decision of the Constitutional Court no. IUz-68/2013, dated October 10, 2013 ("Official Gazette of the Republic of Serbia", no. 98 dated November 8, 2013).

440 Planning and Construction Act ("Official Gazette of the Republic of Serbia", no. 72/09, 81/09, 64/10, 24/11, 121/12, 42/13, 50/13, 54/13 and 98/13)

ership to construction land. Given that the investors were denied the right of construction based on their right of use by way of legal changes to the land ownership regime which, at the same time, allowed the conversion of such a right into the right of ownership for a fee, the said Constitutional Court's ruling rendered the whole concept pointless, whilst any investments in the construction land were *de facto* blocked.

Experiences from the privatization process show that, in many cases, investors have decided to purchase the subject of privatization precisely because of the valuable construction land in its possession. Whilst the public may well criticize the moral aspect to such privatizations, particularly if the investor's exclusive motive is the acquisition of expensive construction land, we should be aware that such a motive was not illegal at the time of privatization, and that it did not become illegal later on. Another important issue is related to what part of the privatization price pertains to the value of construction land, i.e. how much investors have paid for the construction land in each individual privatization. An answer to the question might well point to a fair solution to this already pressing problem as further delays preclude investments in large plots of construction land. The users of such land are incurring losses, but local governments are also at the receiving end as they would be otherwise able to charge fees for land development and subsequently collect property tax. In addition, investors might raise an objection that such a decades-long blockade of valuable construction land is forcing the subjects of privatization into bankruptcy, which in turn raises the issue of the state's responsibility for the fate of these companies, i.e. investments.

To see better the bigger picture, we will highlight below the legal treatment of the construction land, the views of the Constitutional Court on this issue, as well as possible solutions to this important problem. Article 88, para. 1, of the Constitution of the Republic of Serbia stipulates that the utilization and management of privately-owned agricultural land, forest land and urban construction land is free. Article 86 guarantees equal treatment of all types of ownership – private, cooperative and public. The new ownership concept excludes construction land from the provisions regulating assets in public use (Article 87) which may only be state-owned. Thus, the legal concept according to which the right to use construction land is a subsidiary right, transferable exclusively in conjunction with the buildings on it, has been abandoned.

The previous concept from the 1990 Constitution (Article 60) stipulated that construction land was state- or socially-owned, thereby placing it in the same category as natural resources and assets of general interest. Such a concept was already abandoned in the 1992 Constitution of the Socialist Federative Republic of Yugoslavia (SFRY), which stipulated in Article 73, para. 4, that urban construction land might be privately-owned or have other types of ownership in accordance with the law. However, even the 2003 Planning and Construction Act failed to solve this problem. Instead, this piece of legislation "timidly" introduced a part of undeveloped construction land in legal

transactions by specifying in Article 84 that the previous owner, his/her legal heir as well as persons to whom the previous owner had transferred the right of use were entitled to the right of use to undeveloped construction land, as well as that this right was subject to legal transactions. Whilst the Constitution does not unequivocally stipulate the legal grounds for a transfer of construction land from the state to natural and legal persons, a targeted interpretation of Article 87 of the Constitution provides for a conclusion that the privatization of construction land may solely be carried out in accordance with the law. Under Article 1 of the Planning and Construction Act, this specific piece of legislation regulates, *inter alia*, the use of construction land, hence this law is precisely the right place for resolving the issue of conversion of the right of use to ownership right. This is exactly how Articles 100–102 of the law regulate fee-exempt conversion, whereas Articles 103–108 regulate conversion for a fee.

However, the said legal solution to the conversion for a fee was rendered pointless by the Decision of the Constitutional Court IUz-68/2013, dated October 10, 2013, which found its non-compliance with the Constitution, hence abolishing the provision in Article 103, para. 1, of the Planning and Construction Act which read as follows: “The cost of acquiring the right of use to construction land comprises, under this law, total revalued cost of equity, i.e. assets, paid in the privatization procedure, or total revalued cost of assets or part of assets of a company or other legal person in bankruptcy or enforcement proceedings, as well as other real costs.” The Constitutional Court held a view that such a provision, which provided for a favorable option for privatized companies or buyers of assets or a part of assets in privatization, bankruptcy or enforcement proceedings with respect to the fee for conversion of these persons’ right to use construction land into the ownership right, violated the constitutional principle of the unity of legal order, requiring that the fundamental principles and legal institutes which regulated in a systemic fashion an area of social relationships be adhered to in separate laws, unless the systemic law expressly stipulated a possibility to regulate these matters in a different manner. Specifically, the Constitutional Court was of the opinion that such a provision violated the underlying principles of the Privatization Act, according to which the subject of privatization was state- or socially-owned equity, as well as that such a favorable option with respect to the conversion fee did not represent a legally and constitutionally acceptable measure in public interest – to allow repurposing of the construction land by way of construction of facilities and its rational use – since such a favorable option constituted an excessive burden for the community as a whole and the beneficiaries of restitution in particular.

On the other hand, in its Decision IUz-74/10, dated September 9, 2010,⁴⁴¹ the Constitutional Court took a clear view that the provision accord-

441 Decision of the Constitutional court no. IUz-74/2010 (“Official Gazette of the Republic of Serbia”, no. 64 dated September 10, 2010).

ing to which the right of use of undeveloped state-owned construction land would cease to exist *ex lege* if the conversion of this right into the ownership right did not take place within the prescribed one-year deadline, regardless of whether the holder of the right to conversion applied for conversion or not. This Constitutional Court's ruling implies that it is the obligation of the institution implementing the law to enable the beneficiary of the right to conversion to exercise its legal right.

We are fully aware of the problem for the legislator caused by the Decision of the Constitutional Court IUz-68/2013, but our view is that such a ruling does not abolish the legislator's obligation to find a fair solution to the issue of conversion of the construction land acquired in the privatization procedure, as well as in the bankruptcy and enforcement proceedings. There are several ways in which the issue of conversion may be resolved. 1) Full abolition of the conversion fee. Such a legal solution has been suggested by both foreign and domestic investors. They agree that in the privatization proceedings, as well as in the bankruptcy and enforcement proceedings, they have purchased the company's equity, not the assets, but they go on to say that the equity valuations have also encompassed immovable assets whose value is, of course, dependent on the location, i.e. the land where the assets are located. When they considered their respective offering prices, i.e. their bids for a company's equity, the value of construction land was of high significance. In this respect, from the viewpoint of fairness, in their view, the obligation to pay any fees for the conversion of the right of use into the ownership right is disputable. 2) Prohibition of conversion of the right of use into the ownership right in case of privatized companies. The view held by citizen associations representing restitution interests is that the acquisition of the ownership right to construction land by the privatized companies should not be allowed. However, in case the conversion is allowed, then a fee equal to the full market price of the given plot of land should be charged. They believe that such a solution complies with the ruling of the Constitutional Court IUz-68/2013, dated October 10, 2013, cited above. 3) Conversion of the right of use for privatized companies into the right of ownership for a fair fee. The option to allow conversion for a "fair fee" enjoys popular support. However, this option entails that no quick ready-made fixes are to be applied, but that a fee is to be calculated for each individual case, which would effectively mean that the court would set the fee in most cases.

Obviously, each of the listed solutions has its weaknesses and strengths, but one should bear in mind that the situation which inhibits investments in large areas of the most valuable construction land is the most costly for Serbia. The most important investors – international companies are not expanding their manufacturing facilities because they cannot build on the land to which they have the right of use, hence investments are diverted to other markets. On the other hand, investors suffering from material problems are prevented from investing with their strategic partners in construction on that land, which takes their companies into bankruptcies in the long run.

The passage of time in itself will not solve the problems that have been “piling up” on construction land for decades due to a variety of ownership regimes on that land over time; disparate entries in the land register (private, state-owned, socially-owned, and then again state-owned); different rights established to this land (the right of use on developed construction land, unrealized rights of construction on undeveloped construction land). Such a state of play has given rise to diametrically opposed interests of all those who claim the right to this land on various grounds – from “old” owners who were deprived of their right by confiscation or nationalization, to building cooperatives which had been granted the right to build on undeveloped construction land, but for decades have failed to exercise it, to users of developed and undeveloped construction land who gained the right by purchasing companies’ equities in privatization, bankruptcy and enforcement proceedings.

A very detailed 2006 study by CLDS suggested that the options for a solution to this problem would not change. The study identified the same options for privatization of construction land which are still available today: restitution; giving away land to existing users (fee-exempt conversion), public sale of available land at market prices; sale of construction land to existing users at a discount price due to the assumption that a part of the price was paid through the purchase of property or construction land development fee which was paid when obtaining a building permit (conversion for a fee, with a discount); and, finally, time-limited lease on the land.⁴⁴²

An analysis of the options listed in this study clearly shows that free-of-charge conversion was and has remained the most effective solution as it is conducive to the fastest and cheapest establishment of the property regime (privatization) that will result in the fastest investment on that land, and consequently economic growth. In the meantime, the weakness of this solution has persisted given that the same objection cited in the study still stands. Namely, such a solution is unfair to “old” owners and it does not generate budget revenue. “Sale of construction land to existing users at simulated market prices”, as an option recognized in the study as fair, raised back then a number of issues regarding the model for setting a market price and payment options, which are still valid today. In addition, nothing has changed either in relation to the then nine identified different cases involving construction land and all the dilemmas typical of those cases.⁴⁴³

442 Begović, B. et al. “Privatization of state-owned land in Serbia”, CLDS, Belgrade (2006), 51–59.

443 Ibid. 59 – 70. The study features an overview of nine possible cases in practice: 1) land with roads, streets and parks, i.e. public areas, and land with public buildings, i.e. buildings owned by the state, which is not designated for privatization; 2) construction land which has never been developed; 3) land with a private building of a former land owner or his/her legal heir; 4) construction land (above all in the central parts of a city) designated for urban reconstruction; 5) land with buildings which have never been the property of a former land owner but are privately owned; 6) land with buildings which the land owner has sold voluntarily and are privately owned; 7) construction land with build-

What we may conclude is that the problems in relation to the privatization of construction land will not go away over time, but only become more complicated, which is why it is necessary to resolve this problem urgently. In order to solve this issue and allow construction on these vast areas of “locked” construction land as soon as possible, three obvious solutions are to be considered:

- to re-establish the right of construction on the basis of the right of use on construction land⁴⁴⁴, and not to implement the fee-exempt conversion of the right of use to the ownership right until after a certain degree of development of the given plot of land is reached. This would account for the free-of-charge conversion bearing in mind that the user has paid the land development fee and incurred other expenses, thus equating the status of these users to the status of users of developed land who are entitled to free-of-charge conversion; or
- to allow conversion of the right of use to the ownership right without a fee, irrespective of whether the construction land is developed or undeveloped, and regardless of how the right of use has been established in favor of the beneficiary of the right to conversion; or
- to prescribe that conversion is to be carried out for a fee, but with a reduction in percentage points of the market price by way of introducing a legal assumption that a part of the price for the land has already been paid as part of the payment of privatization price – given that that the right of use at the time of privatization had a market value. If the conversion is allowed for a fee, it is necessary to provide for a possibility of payment in installments or deferred payment as the conversion will not take place if investors have no interest and ability to sustain its expenses.

Taking into account the Decision of the Constitutional Court IUz-74/2010, one should point out that the second and third option also run the risk of being declared unconstitutional, whereas the first is the most along the lines of previous rulings by the Constitutional Court. When analyzing the problem of construction land privatization, particularly in cases where a subject of privatization is entitled to the use of land, we have to remind ourselves of how such a problem with agricultural land was solved. Namely, in priva-

ings which have never been the property of the former land owner and are now state- or socially-owned and designated for privatization; 8) construction land with buildings which the former owner has sold voluntarily and are state- or socially-owned and designated for privatization; and 9) construction land with buildings which were the property of former land owner, but have been nationalized or expropriated.

444 Such a solution follows in the footsteps of the Decision of the Constitutional Court IUz-74/2010 (“Official Gazette of the Republic of Serbia”, no. 64, dated September 10, 2010), and it is not contrary to the Decision of the Constitutional Court IUz-68/2013, dated October 10, 2013 (“Official Gazette of the Republic of Serbia”, no. 98, dated November 8, 2013).

tization proceedings the land owned by the state and cooperatives was not transferred as part of the privatization process. State-owned agricultural land would be leased until the issue of restitution was resolved. However, socially-owned agricultural land, i.e. land acquired earlier by the subject of privatization as part of its business operations would be transferred in the privatization procedure and entered in the land register as the private property of the subject of privatization. Whilst mistakes have been made with land register entries on this account rendering such entries overall inconsistent (as noted in the case studies of privatizations of “Banatski Despotovac” AD and “Mala Bosna” AD), this solution has not been disputed in practice. However, these principles are not applicable in their entirety to the construction land because the problems related to it are much more complex.

7.2. ROLE OF LOCAL GOVERNMENT IN BANKRUPTCIES AND “HARD” BUDGET CONSTRAINT

The interest of local governments is for the resources of the companies undergoing privatization to be put to effective use as soon as possible. Case studies show that one of the consequences of failed privatizations is the accumulation of debts owed to local self-governments and public utilities. As a rule, the attitude of local governments in such cases was passive. This is why, as a rule, local governments and public utilities are bankruptcy (i.e. unsecured) creditors with a very low levels of settlement of outstanding debts in case of bankruptcies. Nonetheless, relative to the missed opportunity to create a new taxpayer and user of utility services by sale of bankruptcy debtors as legal entities (or their assets), the low rate of settlement of outstanding debts is a less significant consequence of delays in initiating bankruptcy proceedings.

Given that the changes to the Bankruptcy Act (Article 59) limited the amount of advance payment to RSD 50,000 for legal persons classified as micro and small companies, local governments should be more active and advance expenses of bankruptcy proceedings.⁴⁴⁵ This also applies to larger bankruptcy debtors as the same article in the Bankruptcy Act stipulates that the advance payment is to be considered as an expense of the bankruptcy proceedings, hence it takes priority in payments from the bankruptcy estate. In such cases, given the existence of a significant bankruptcy estate, typically the repayment takes place. An additional reason for a proactive approach on the part of local governments is the manner in which Article 80 of the new

445 Bankruptcy Act (“Official Gazette of the Republic of Serbia”, nos. 104/2009, 99/2011 – second law, 71/2012 – Decision of the Constitutional Court and 83/2014). In case studies of individual privatizations, the municipality of Vladičin Han made an advance payment in the “FOPA” case at the time when no one knew if the company would be struck from the businesses register due to the lack of interest.

Privatization Act has been formulated, providing for a possibility (not an obligation) that the Privatization Agency file a motion to initiate proceeding if one of the following requirements has been met: failure to carry out business activities over a period longer than 6 months; lack of interest in privatization; there have been no employees over a period longer than 6 months; a decision on the model and method of privatization has not been made; in the case that a program has not been adopted due to lack of consent on the part of creditors; or for other bankruptcy-related reasons stipulated in the Bankruptcy Act.

Deadlines and incentives are such that the initiation of bankruptcy proceedings may be protracted, thereby increasing the expenses incurred by local governments on account of keeping such bankruptcy debtors alive. However, the role of local governments should not solely be restricted to the initiation of the proceedings. Local governments and public utilities should also take on an active role for the duration of the proceedings. If possible, it would be desirable for representatives of public utilities to participate in the creditor committee's proceedings. Since the Bankruptcy Act stipulates that bankruptcy creditors are eligible to sit on the committee, regardless of the amount of their respective claims, as well as that a creditor may propose itself or another bankruptcy creditor as a committee member, there are no legal obstacles to such possibility. Given that, in practice, a typical characteristic of the creditor committee is passivity, (along with a lack of willingness on the part of creditors to join the committee), local governments may thus influence indirectly the speed at which the bankruptcy proceedings unfold, but also protect better their interests (e.g. by filing objections to the work of bankruptcy administrators with a bankruptcy judge).

As the public utilities cannot suspend the provision of utility services on account of unpaid bills from the period prior to the submission of a motion for initiation of bankruptcy proceedings, under Article 64 of the Bankruptcy Act, they may only seek to ensure that the legal provisions stipulating the regular payment of current dues be observed. This, however, gives public utilities, and indirectly the local governments, a significant negotiating power. When the utilities estimate that the time is right, particularly in the case of bankruptcy, they should immediately file a request in writing with the bankruptcy judge for depositing the bankruptcy debtor's funds designated to ensure the payment of utility services. Unless there are prospects for adoption of a restructuring plan, the utilities should apply a hard budget constraint and suspend the provision of utility services to the bankruptcy debtor failing to regularly pay for already provided utility services. Thus an incentive is created for both the bankruptcy administrator and other stakeholders to speed up and complete the proceedings.

In case of restructuring plans, local governments may demand the formation of a separate group of creditors with priority claims based on pub-

lic revenues (but which do not fall into the first priority class). This would empower such a group of creditors to exert much stronger influence on the possibility of the plan adoption. However, this recommendation will have no effect in case of restructuring of companies which are currently in the Privatization Agency's portfolio. The new Privatization Act has introduced the conditional debt write-off as a measure for preparation and debt relief for the subject of privatization whereby state creditors assume an obligation to write off the subject of the privatization's debt as of December 31, 2013. The debt write-off mechanism is applied solely if the sale of company's equity has been effected or if a contract on capital increase pertaining to the subject of privatization has been concluded. Given the quality of companies featured in the portfolio, as well as a relatively small share of local governments in the overall debt (especially in the event of a cancelled privatization), local governments may not expect significant repayment in most cases. Finally, local governments may promote alternatives to the bankruptcy proceedings (mutually agreed financial restructuring). When considering the role of local governments in bankruptcy proceedings, one should bear in mind that each sale of significant assets or the bankruptcy debtor itself is a brownfield investment in the local community whereby unutilized or partially utilized resources (such as land and equipment) are put to more efficient use.

7.3. RESOLVING THE ISSUE OF EXCESSIVE WORKFORCE – “TRANSITION FUND” AND SOLIDARITY FUND

With respect to the surplus of employees, two situations tend to occur: 1) when it is necessary to reduce the number of workers prior to privatization or bankruptcy, and 2) when it is possible to ensure settlement of dues to the employees as part of the bankruptcy proceedings. The former scenario arises in companies which can be privatized, but before the privatization the problem of redundancies must be resolved, or in companies where the outstanding dues to workers need to be settled prior to bankruptcy proceedings on account of their regional importance or for other reasons. The latter scenario comes to the fore in the case of the inevitability of pending bankruptcy proceedings.

In order to ensure that the problem of surplus employees in companies listed in the Privatization Agency's portfolio is resolved without disruption, it is necessary to **adjust the** Decision on establishing the Program for resolving redundancies in the process of rationalization, restructuring and preparation for privatization and increase the budget allocation to the Transition Fund, which, according to the budget revision proposal, totals RSD 2.8 billion (about EUR 23.5 million), which is not enough to solve the problem of redundancies in companies undergoing restructuring, thereby bringing into

question the whole procedure of public call for investors. For the sake of comparison, in 2011 the fund had around EUR 50 million allocated to it.

The program itself should not be voluntary and it should be time-limited because, in the past, employees would withdraw their previously given consent due to excessively protracted approval procedures. Severance packages paid out from the Transition Fund cannot resolve long-term problems as the workers who have lost their jobs typically use their severance pays to meet everyday needs instead of investing in efforts to find a new job, become employed or acquire new qualifications. A possible solution is to tie a part of the severance package to specific measures of active policy on the labor market. However, this begs the question to what an extent such measures would indeed increase the likelihood of employment for this group of workers. Be that as it may, such a measure is not possible in case of employees' voluntary consent to receive severance pay from the Transition Fund.

Amendments and addenda to the Labor Act in the part regulating the employees' claims in case of bankruptcy proceedings have ushered in such a procedure (the preclusive deadline for submitting the decision establishing the right to claims in bankruptcy proceedings to the Solidarity Fund has been extended from 15 to 45 days).⁴⁴⁶ Nonetheless, these changes have not resolved the issue of financing the Solidarity Fund. In addition to these changes, given the expected number of bankruptcy proceedings in socially-owned companies, it is necessary to increase the budget allocation to the Solidarity Fund. An alternative would be to consider amending Article 138 of the Labor Act since the latest changes to the Labor Act have failed to enable the Fund to use the money for the same purposes in the following year instead of returning the remaining funds to the budget at the end of the current year. Moreover, it is possible to consider further simplification of the procedure in case of submission of the documentation substantiating the claim (Article 141 of the Labor Act). As individual local governments in whose local communities larger companies undergoing restructuring are operating will face an additional rise in unemployment, it is necessary to carry out as soon as possible labor market active policy measures as soon as possible.

7.4. PRIVATIZATION AND LOCAL PUBLIC ENTERPRISES

The new Privatization Act specifies that the subject of privatizations are socially-owned i.e. public equities and assets of companies and other legal persons, including public enterprises and public equities in shares or stakes. Therefore, the law also applies to public enterprises such as public utilities.

446 Labor Act ("Official Gazette of the Republic of Serbia", nos. 24/2005, 61/2005, 54/2009, 32/2013 and 75/2014).

It is not realistic to expect the application of privatization procedures to a larger degree in the domain of public utilities in the Republic of Serbia. However, bearing in mind the necessity of public utility restructuring and that 1) spinning off non-core business activities (e.g. travel agencies, security services, vehicle maintenance, etc.), 2) spinning off certain activities supporting the company's business (e.g. utility meter reading, road surface maintenance, technical project design preparations, etc.) or 3) sale of certain assets – will occur in some public utilities privatization remains one of the options. Privatization of *non-core* (ancillary) activities of public utilities is a realistic (and desirable) option.⁴⁴⁷

Parts of the company involved in spun-off activities (the activities which support the provision of utility services) should be approached very cautiously. A contractual arrangement with a company to be formed by spinning off from an existing public utility might be at first concluded without prior public competition but thereafter with the highest bidder. The duration of the contract should depend on the given activity or required assets. In the initial period, newly formed companies could be subsidiaries of public utilities, but the eventual outcome could be privatization of these companies. Be that as it may, the privatization of ancillary activities within public utilities should be approached in a way that avoids the repetition of mistakes identified in the privatization of socially-owned companies thus far. This implies prior settlement of legal asset-related issues, excessive workforce and liabilities, i.e. creditor-debtor relations, issues, as well as prevention of adverse selection.

7.5. BUSINESS ENVIRONMENT

A favorable business environment is crucial when making a decision to invest in the case of both privatizations and new greenfield investments. Whereas many components of the business environment for local governments are exogenous, i.e. set at the national level or determined by external circumstances, some very important factors are endogenous i.e. local governments have a crucial influence on them. Whilst many municipalities have improved their respective business environments, there are numerous possibilities for further improvement. One of the key factors locally are construction land fees, but also other fees such as the locally levied business sign display fees on business premises. Whereas construction land fees represent a considerable source of revenue for municipalities, revenues generated from other municipal fees are not particularly important for municipal budgets, moreover, these fees are often set in an arbitrary fashion. Further elimination of parafiscal levies at the municipal level may significantly cut the cost of doing business locally, particularly in case of micro and small companies. There are

447 For more information on possible options, see World Bank, 2014, *Serbia - Municipal public finance review: Options for efficiency gains*, Washington, D.C. : World Bank Group.

many other factors with an impact on the success of privatization which are directly or partly under the control of local governments such as the state of infrastructure or the quality of utility services.

Case studies clearly show that the role of a reputable investor – capable of transferring technology, carrying out operational restructuring measures and investing in equipment – is crucial for the success of privatization. Such investors are responsive to incentives and a favorable business environment is essential if they are to make a decision to invest.

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