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Institutional prerequisites of forming the market of mergers and acquisitions of companies in the countries of Central and Eastern Europe

Zasadnicze warunki instytucjonalne fuzji oraz akwizycji spółek w krajach Europy Środkowej i Wschodniej

Abstract

The article deals with the prerequisites of establishing, structuring and developing of the market for corporate control in the countries of Central and Eastern Europe. It also explores the reasons for activating mergers and acquisitions in this region and discusses the peculiarities involved in such processes.

Key words: *privatization, market liberalization, foreign investments, institutional changes, mergers and acquisitions, a corporate sector.*

Streszczenie

Artykuł dotyczy zasadniczych warunków tworzenia i kształtowania się oraz rozwoju rynku kontroli korporacyjnej w krajach Europy Środkowej i Wschodniej. Bada również przyczyny fuzji i przejęć w tym regionie i omawia specyfikę związanych z tym procesów.

Słowa kluczowe: *prywatyzacja, liberalizacja rynku, zagraniczne inwestycje, zmiany instytucjonalne, fuzje i akwizycje, sektor korporacyjny.*

1. Introduction

In modern conditions world markets including the emerging ones are in the process of fundamental, structural, technological and institutional changes and represent considerable potential for international corporate sector expansion. Simultaneously, in the nearest future emerging markets will be developing within the overall process of economic globalization. At the same time impact of globalization processes on competitiveness of companies is becoming increasingly considerable.

Nowadays mergers and acquisitions of companies are an integral part of the overall process of the world corporate community development. Every day at least one deal is clinched on corporate control market. Thus, it is impossible to underestimate the role and significance of business development due to such an instrument as the market of mergers and acquisitions.

2. Problem definition

In the countries of Central and Eastern Europe (CEE) corporate control market started arising after disintegration of the USSR. While shifting from the planned to market economy in the early 1990s there was initiated divestment of government property. At that time privatization in the country was implemented mainly without using the instruments of the world economy. However, at present the Ukrainian companies which went through primary accumulation of capital and redistribution of property, start realizing the necessity of international comparison of the process of forming the common institutional conditions of the market economy and their correlation with corporate level.

At the same time as one of the real alternatives from the point of view of comparability countries of Central and Eastern Europe can be analysed. Selection of the aforementioned countries in the context of their experience may be explained by several reasons. In these countries simultaneously with Ukraine there was implemented transition from the socialist economy to the market economy. This gives an opportunity to compare construction of market mechanisms and institutions as well as their influence on forming the corporate control market [1]. It is worth noting that successful applications for membership in the European Union of the countries of CEE in some cases caused accelerated development of the processes of forming market economy.

In this way investigation into experience of corporate control level transformation in the countries of Central and Eastern Europe can facilitate application of the most effective instruments of the market of mergers and acquisitions in Ukrainian companies. This can allow not only to achieve necessary goals on the corporate level but also to make a considerable contribution into the country's economic development as a whole.

It is worth noting that there is a sufficient amount of publications of American, West European and East European scientists devoted to the issue of establishing corporate markets in the countries of Central and Eastern Europe after disintegration of the USSR. The most interesting works which deserve consideration are written by such authors as J. Child, A. Czegledy, D. DePamphilis, S. Estrin, S. Foster, R. Goldberg, R. Kennedy, L. Krkoska, A. Lajoux, P. Mihalyi and M. Rock.

Meanwhile, it is necessary to state the fact that what is left uninvestigated is the issue of forming the fundamentals of corporate control markets in the countries of Central and Eastern Europe and activating corporate integration due to mergers and acquisitions.

The purpose of the article is to form the concept concerning peculiarities of the processes of mergers and acquisitions in the countries of Central and Eastern Europe as well as to find out positive experience and accumulation of macroeconomic information which will favour the process of qualitative transformation of Ukrainian corporate market.

3. Problem solution

I. Economic situation and risks in the countries of Central and Eastern Europe at the beginning of the transition period.

In the late 1970s quite a few countries of CEE started developing different adoption programs. Such a step with planned economy can be explained, as an endeavor to retain consumption on the necessary level for constant decrease in production efficiency. The volume of medium-term and long-term crediting in the countries of CEE and the USSR from 1976 to 1980 annually averaged US$ 1.2 billion, from 1981 to 1985 about US$ 1.8 billion and from 1986 to 1990 it accounted for about US$ 5 billion per annum [2]. As a result the countries of Central and Eastern Europe, except Czechoslovakia and Romania, approached the transition period with big state indebtedness and announced default [7].

The transition period changed the situation in the region drastically. Capital flow came from western countries and was aimed at protection and support of economic and political changes. At that time private capital bided its time since state and commercial risks were very high in the region. Gross domestic product (GDP) had been decreasing in the countries of CEE by the period from 1993 to 1994 but in the CIS it had been decreasing by 1997. In 1992 inflation rate was less than 100% only in six countries of CEE [4].

At this stage the main aim was to adjust the countries with the transition economy (as a whole they accounted for 3% of the volume of the world economy with population that accounted for 7% of the world population in the late 1980s) in accordance with the world economy.

To achieve this goal and to increase effectiveness and efficiency it was necessary to change the structure of private property and the mechanism of corporate management as well as to change legislation and government regulation in favour of liberalization of trade, prices and forms of economic activity. The transition period assumed creation of conditions for macroeconomic stability, change of the role of the state and methods of state regulation implementation, reforms in all spheres of activity including the financial one as well as creation of new financial institutions.

Among the main constituents of the transition process there can be formulated the following ones:

1. Liberalization. It is a liberation process of majority of prices so that they can be defined by free markets and the process of decreasing the trade barriers which broke off the connection with price structure in the countries with the market economy all over the world.
2. Macroeconomic stability. First of all, this is a process with the help of which after initial rapid increase of inflation rate following liberalization and pressed demand liberation, inflation is becoming controlled and decreases with the course of time.
3. Reorganization and privatization. It is the process of creating a viable financial sector and reforming enterprises in these countries so that they can produce goods which can be sold on free markets and this is the process of transferring them into private ownership.
4. Legal and institutional reforms. These reforms are necessary for reorientation of the role of the state in these countries, establishment of law and order as well as application of the appropriate policy of competition support [4, 6].

It was supposed that liberalization and stabilization of macroeconomics could be implemented rather quickly, so could be privatization of small enterprises. At the later stage of the transition period there would be intensified privatization of large enterprises as well as legal and institutional reforms which took more time.

Endeavours of national governments to achieve balance between recommendations and requirements of western countries, financial institutions and private investors taking into consideration specific character of conditions in one or another country of Central and Eastern Europe led to appearance of a great number of various programs of the transition period, privatization programs and other political initiatives which set goals of acceleration of overcoming the transition period and economic restructuring. However, one should agree that to launch market price mechanisms it was necessary to embark on liberalization and macroeconomic stability in spite of economic difficulties that could be created by them. There was an opinion that privation would be temporary and less severe than in case the process stretched in time.

Thus, transition to the market economy in majority of the countries started with fast price liberation from their artificially low level that immediately led to rapid rise of inflation rate correcting the prices.

In addition to increase in inflation rate, transition to the market economy was followed by one more shock: at the beginning of the transition period in all the countries of Central and Eastern Europe production decreased on average by 40% [4].

The results of researching this phenomenon afford the ground for assumptions stating that rigid macroeconomic policy, which was applied to restrain inflation, caused comparatively moderate initial production cutback. And 'disorganization' which is associated with such shocks as disintegration of the Council for Mutual Economic Assistance (CMEA) played an important role. Disorganization means rupture of production links, particularly in materials and intermediate production resources supply, which led to collapse of centralized planning and dismantlement of production conglomerates with vertical structure which were working under the old system. This rupture led to production decline [8].

In the search for explanation why in different countries the character of collapse was different, as a rule, they refer to “unfavorable primary conditions” in some countries. It is conditioned by the fact that at the beginning of transition the countries had different characteristics and in quite a few of them these distinctive features complicated the task of retaining the economic activity on the prior level. It is not surprising that the countries with more unfavourable primary conditions experienced more dramatic production cutback.

One of the main factors of further production revival was success in inflation rate decrease. The countries that restrained inflation quickly and retained this success managed to restore production growth faster which was even more considerable.

Although for economic growth recovery it appeared to be necessary to strive for inflation rate decrease, it was insufficient. The key role in maintaining steady economic growth was played by structural reforms which facilitated private sector growth. In the countries where structural reforms started early and were conducted firmly there appeared production chains which withstood disorganization existing in the early years of transition to the market [8].

Transition to the market economy required considerable financial resources to facilitate redistribution of capital investment in productive economic sectors, modernize obsolete equipment, strengthen state infrastructure and provide finance to emerging firms. According to research by many economists, one of the main roles for economic development of the countries of Central and Eastern Europe was played by foreign investments. In accordance with statistic data, international capital flows were increasing from year to year in 1990s. Private capital started reaching CEE gradually. For six years from 1991 to 1996 private international capital flows increased ten times [5].

This proves positive changes in the economies of the countries as a consequence of stabilization measures and structural reforms, in particular, legal safeguards of investment as well as privatization process.

Per se, privatization can be referred to at the early stage of beginning of corporate mergers and acquisitions in the countries of Central and Eastern Europe. Later on ownership changes and consolidation of assets occurred, i.e. characteristics inherent in the merger (acquisition) process of the company. Specificity of this process consists in the fact that the privatization process at the early stages differed by its instruments from the methods of mergers and acquisitions being developed by the world practice.

II. Privatization in the countries of Central and Eastern Europe in the early 1990s.

As it was noted above there was highly estimated necessity of accelerated implementation of liberalization and stabilization of corporate relations and ownership in the countries of Central and Eastern Europe. Nevertheless, as to large enterprises privatization, there were arguments whether to transfer state property into the private sector quickly or to adopt a more gradual approach.

Advocates of fast privatization demanded elimination of the state property by distributing the property to the citizens, for instance with the help of vouchers which gave their owners the right and means to acquire public companies offered for sale. They were driven by the sense of justice and desire to provide common people with some economic share. Besides, they realized the necessity to take advantage of the opportunity given to privatization before government bureaucracy regrouped and started counteracting this process.

Others suggested an idea of gradual decrease in public enterprises share by appearance of new private firms in the economy. They supported privatization of enterprises by means of selling the assets to those who most likely would strive for improving the results of the enterprises' activity. Besides, they emphasized the necessity to introduce 'tight budget constraints' for enterprises to force out those which made persistent loss retaining more profitable enterprises for attraction of investors. Hungary approached privatization using this gradual way and it appeared to be more appropriate for real reorganization of enterprises [3].

In comparison to this, experience showed some drawbacks of fast privatization method. For example, in Czech Republic property transferred to millions of common citizens at the first stage of fast privatization was sold off by those who received it and everything ended up consolidating in the investment funds. But real reorganization of enterprises was not fulfilled because either the investment funds lacked the capital for their development or they were controlled by state banks which did not introduce tight budget constraints. Bad results of economic growth in Czech Republic in the late 1990s in comparison to other countries of Central and Eastern Europe can be partly explained by ineffective reform of the enterprises [9].

Generally speaking, experience of the countries of CEE gives ground to the idea that privatized enterprises tend to implement restructuring faster and work better than the similar ones left in the ownership of the state, but only provided that some additional conditions are met. These conditions include tight budget constraints and competition, effective corporate management regulations as well as an efficient legal system and rights of ownership.

In contrast to ambiguous experience concerning privatization of large companies, small business privatization was, on the whole, quite successful and completed in all the countries of Central and Eastern Europe.

In spite of ambiguous appraisal of privatization taking place in the countries with the transition economy, it is worth noting that it is the privatization process that was one of the key factors of attracting foreign capital to the group of the countries in question.

According to the data from research carried out by the World Bank, from 1990 to 1994 foreign capital share directed at privatization accounted for 67% of the total volume of foreign investment. The biggest volume of investment was received by Hungary, Poland and Czechoslovakia which were the first countries to implement privatization. At that time economic growth in Western Europe and proximity of the countries of Central and Eastern Europe favoured private capital expansion [8].

Besides economic potential of the region low production costs inherent at the moment of privatization start were also attractive for western investors. However, it should be noted that impressive volume of direct investment in these years can be explained by several large contracts in the countries of Central and Eastern Europe. That is why while from 1994 to 1995 there could be noticed direct investment growth particularly due to tax concessions during privatization for foreign investors in Hungary and to acquisition of Czech SPT Telecom by Telsource as well as big deals in Romania and Bulgaria, in 1996 there was decrease in direct foreign investment because of revocation of the concessions in Hungary, adoption of the privatization program prohibiting direct participation of foreign investors in privatization in Slovakia as well as slowdown of economic growth in the countries of Western Europe [4,11].

Not diminishing the role of all the factors that influenced the privatization process in the countries of CEE, it should be noted that the main incentive was the change of government regulations and the legal base which began to protect foreign investors' interests and ensure implementation of foreign investors' rights, particularly repatriation of profits, protection against deterioration in investment legislation, nationalization prevention and accordance of tax concessions. Thus, practically in all the countries, there were created special economic zones providing exemption from income tax completely or in part and an opportunity to use accelerated depreciation methods. For example, in Slovakia an investor was exempted from income tax over the period of ten years. In Hungary the government stimulated creation of industrial parks for such companies as Ffextronicx, IBM, Jabil Circuit and Philips [10].

In the mid 1990s three countries of Central and Eastern Europe leading in attracting direct foreign investments were Czech, Poland and Hungary. Thus, according to the data of the European Bank for Reconstruction and Development at the end of 1997 in Hungary companies under control of foreign companies amounted to 60% of production output and more than 20% of workplaces [1].

For the countries of Central and Eastern Europe privatization was considered to be a way of attracting direct investment that could be directed at reforming and restructuring, creating new jobs and production modernization. On the enterprise level privatization provided transparency of financial reporting as well as adjusting production and management processes in accordance with the western standards. These processes were the determinative for private capital influx and development of corporate management market mechanisms.

The privatization process in the countries of CEE gradually grew to such an extent that mergers and acquisitions proper, inherent in the economies of West European countries, started developing also in the countries with the transition economy. At the same time, legislation standardization and economic growth brought the countries of Central and Eastern Europe closer to their aim, namely entering the European Union.

In May 2004 eight countries of CEE and Baltic States entered the European Union. Undoubtedly, the European Union accession is aiming at leading the countries of Central and Eastern Europe to the level of development of western countries in all spheres of the state's life activity; as a result, there will continue further legislation changes providing more attractive conditions for investments in the economy of these countries. However, this process will be implemented gradually, and to achieve the aims of our analysis of mergers and acquisitions of the companies in Central and Eastern Europe it has been crucially important to show economic and political prerequisites for rapid boom on the corporate control market.

Thus, according to the data of the annual research concerning the corporate control market of the countries of Central and Eastern Europe, carried out by the consulting company KPMG and the research company Dealogic, the market of mergers and acquisitions of the countries of CEE has been growing intensively since the late 1990s. From 1997 to 2000 the growth amounted for over 80% per year in volume and increased from US$ 2.2 billion in 1997 to US $ 16.9 billion in 2009. Meanwhile, it is worth noting that the number of transactions increased from 96 in 1997 to 1045 transactions in 2009 [12]. Such rapid growth on the corporate control market in the countries of Central and Eastern Europe was, on the one hand, maintained by the growth of the world corporate control market and, on the other hand, it testified to stabilization and progress of macroeconomic growth in the countries of this region.

4. Conclusion

Having analyzed the peculiarities of economic growth of the countries of Central and Eastern Europe, we should emphasize once again that, as a consequence of the lack of examples of transforming the planned economy into the market one in western countries, the countries of the region had to learn from their own mistakes. The endeavour of fast transition from the planned economy to the market one required the same fast implementation of the mass privatization process. The initial aim and cause of implementing mass privatization set by the governments of the region's countries were economic recovery and adjustment of the broken production links that corresponded to the wish of private owners to provide competitiveness and restoration of profitability of the received enterprise.

Nevertheless, just those structural and institutional changes in the region at the transition stage and mass privatization lay the foundation and formed corporate control market peculiarities in the countries of Central and Eastern Europe, as well as allowed to integrate national corporate control models in the European corporate model successfully.

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