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Sava Transformation Chronicle (B)

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

Kronika preobrazbe Save (B)

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

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The early spring of 1996 brought more clarity to the dilemmas facing Sava management. The JV contract with Continental had expired at the end of 1995. While the Continental management made symbolic improvements to their offer aimed at bringing the position of the two companies closer, it was obvious that, due to prior acquisition of the Czech company Barum, it lacked real interest in strengthening the cooperation with Sava. Therefore, the proposed concessions were minor, giving no strategic potential to the extended JV. With the standalone position seen as close to non-sustainable by the majority of the core management team, Sava management, supported by IFC expert John Clarke, decided to put all of their efforts behind closing a favorable deal with Goodyear. Getting there, however, proved to be a "long and winding road", the prospects of a better future remaining elusive. In the meantime, Sava had to get ready for all the adverse effects of cutting off the relationship with Continental, before the positive effects of the new partnership would kick in.

Setting initial negotiation positions

The members of the Sava management team, which was in 1995 still led by Viljem Žener, during 1995 agreed on the need to find solution for the expiring JV contract, but were not ready to agree on what the solution was. Franc Balanč, Finance Director of Sava and likely the most strategically oriented member of the team insisted on engaging external advisors who could help the team that had no experience in international M&As. Three of them proved to be instrumental: John Clarke, an IFC expert with a strong track record in international financial deals, Marko Fajfar, a Slovenian M&A expert, and a German corporate lawyer, Matthias Blaum.

The negotiations with Goodyear were started upon suggestion of Clarke. He arranged the first visit of that time head of Goodyear in Europe, Bill Sharp, taking place in March 1995. Sharp was received by the whole Sava management team. Since the JV with Continental was still active, the company visit was organized discretely, and the involvement of the part of the team directly related to JV operations was minimized. It was important, however, that Sharp got direct evidence of fairly advanced production technology Sava was using, which immediately raised his interest in using Sava as a low cost manufacturing site for Goodyear in Europe, lack of which was one of the clear weaknesses of the company. Furthermore, Sava was attractive because of its strength in markets wherein Goodyear was largely not present (partially due also to the domination of Sava), as well as market growth od Sava brand all over Europe, Middle East and parts of northern Africa.

That visit had open doors for further discussions. A numerous team of Goodyear experts visited Sava in July 1995, performing detailed examination of Sava's technological competences and market position. Their initial conclusions were favorable, since they saw the combination of Goodyear's technological strength and Sava's production efficiency and low cost manufacturing platform as a winning proposal for market success in Europe.

Understanding Sava's cost structure remained Goodyear focal interest in the subsequent discussions. Another visit followed in December 1995, with 20 experts from both tire and engineered products areas, led by Sharp and Clark Sprang, Senior Vice-President for Business Development, who was to become Goodyear's chief negotiator in charge of preparing the deal with Sava. The delegation presented detailed cost analyses of sample products, which could be manufactured in Sava, serving as the basis for a very rudimentary business plan proposal. That also included an initial idea of the engineered products portfolio of interest for Goodyear, which was critical for Sava to understand which parts of its business would be sold to Goodyear and which would remain in Sava.

A cordial letter with Christmas greetings, which Sprang sent to Bohorič in December 1995, indicated positive impressions obtained during the visit and asked Bohorič to arrange for

Goodyear CEO meeting with the President of Republic of Slovenia, Mr. Janez Drnovšek, during his visit to Sava in January 1996.

At the same time, internal memos prepared by the members of Sava negotiating team clearly indicated many open issues and potentially demanding consequences of the deal. If part of product lines would remain with Sava, it would require sharing infrastructure or relocating part of the production. Although relocating the production of any of the future units would clearly be costly, and thus an inferior option, coming to a good solution for infrastructure sharing was far from easy. Many pieces of infrastructure, such as rubber mixing or energy generation and usage, were important part of the core processes, with high influence on quality and cost. Others, such as catering, security, medical services, building maintenance or parking, were necessary part of an industrial site, but setting the scope of their usage and a fair split of cost sharing in many cases were seen as a source of friction among the involved parties.

It was also becoming clear that Goodyear saw Sava organization as overly complex and its overheads as grossly oversized. Sava team came to the estimate of at least 750 employees to be made redundant in case of the deal! On top of that, Goodyear was using management tools (such as product costing systems) which were completely new to Sava and required their team to learn them fast in order to understand the logic behind Goodyear's negotiating position and be able to come with convincing counter-proposals.

The long march

The visit by the CEO and the board members of Goodyear in early 1996 signaled the real possibility that Goodyear's investment in Sava could well become the largest FDI in Slovenian history.

By March 1996 key stakeholders of Slovenian politics and business, orchestrated by Bohorič, came to the consensus that Sava should take the next steps making the deal possible. Given many interests involved this was not a small achievement and it served as a proof of Bohorič's political prowess.

Based on the available data Mr. Fajfar prepared two separate extensive reports for the needs of the management team, one on the situation related to Continental and the other related to Goodyear, which also included the description of necessary steps that had to be taken in order to close the deal. The report on Continental was clear: the partner had no strategic interest in Sava's development and would present a wrong choice. The report also indicated that some members of Sava management team were "uncritically loyal" to the long-standing relationship. The report on Goodyear was highly positive, but it also indicated that relationship with Continental had to be legally clarified before Goodyear would make any firm commitment. Preventing the transfer of proprietary Continental technology, acquired over the years, to Goodyear, was identified as one of the potentially critical stumbling blocks.

Bohorič decided to send a harsh-worded letter to Continental CEO, in order to get the final offer on possible future cooperation, as well as to clarify the alternatives. The final meeting with Continental took place in Frankfurt. Although the JV contract had already expired, Continental still owned equity share in Sava and, at least formally, it was also kept as an open option to solidify the negotiation positon towards Goodyear. Sava management wanted to make the terms of the Continental exit from company ownership clear.

Given existing frictions in the Sava management team, Bohorič had to organize management team meeting and formalize the conclusions. An internal ten-page document, drafting all key elements of the situation at hand, was distributed to twelve members of the extended management team for review. Finally, on March 26, 1996, all members of the core management team supported the decision to drop the partnership with Continental in favor of the one with Goodyear. Several team members were charged with preparing emergency financial, marketing and sales plans to be able to bridge the gap following the end of sales of Sava products through Continental sales network. Another huge topic looming was the switch of technology, since according to the JV contract Sava would have to stop using Continental production technology, the backbone of its tire manufacturing process, in the very moment it engaged with another partner.

With the formal management team decision in favor of partnership with Goodyear out of the way, Bohorič could take the next move, which proved to have unforeseeable long-term consequences: change the ownership structure.

Until April 1996, Sava had several groups of owners with very diverse interest: four funds controlled by Slovenian Government on behalf of the Slovenian state as the owner (46%) Continental (28%), employees and retirees (16%) and small investors (10% in total). The Government had decided to exit the ownership, selling its share to institutional investors. That marked the start of the new era of Sava as a joint stock company, with governance bodies realigned to reflect it. Bohorič lobbied with the institutional investors to create the ownership structure favorable for the company, as well as to set a friendly Supervisory Board[1] consisting of 14 members (unusually large for that time Slovenian standards). Finally, he was appointed as the first President of the newly composed Management Board. He also got the open mandate to lead further negotiations with Goodyear. Obviously, institutional investors had speculated that the deal with Goodyear would enhance the value of Sava, more than justifying their investment.

With the negotiations seemingly entering the final stage in August 1996, a number of open issues worried Sava Management Board. Despite positive tone of discussions, Sava had not received a binding offer or even an indication that it would be at an acceptable level. The position of some influential stakeholders (such as unions) remained unclear. Sava was interested in keeping statutory control over the new JV, which would require 25%+ ownership stake, but it was not clear whether Goodyear was ready to accept it. Many important "technical details" were still open, too, such as final structure of engineered products portfolio to remain in Sava, sharing of the infrastructure needed for manufacturing units of both parties, transfer pricing policy or the ownership of Sava brand.

The proposal received from Goodyear in late August 1996 was a big disappointment for Sava. John Clarke was in particular critical, citing lack of strategy and clear goals. Goodyear presented the future cash-flows used for price calculation as lower than the ones in previous years, and the only driver of future profit increase was the decrease of labor costs. Clarke even suggested he would review once again the "status quo" option, in which Sava would remain standalone, using technology support from Vredestein.

The discussions were continued in autumn, with a major breakthrough achieved during the visit of Sava's managers to Akron in September. It appeared that Goodyear team appreciated direct, no-nonsense style of their counterparts, as well as their obvious expertise. Significant part of the conclusions reached in that meeting found their place in the final JV contract, solving some of the most delicate technical issues like formal split of the production facilities or details on technological processes. As a result, the parties agreed to keep three manufacturing units at the Labore factory site: Tires, Goodyear Engineered Products Europe

[1] According to that time Slovenian legislation, two-tier governance system was in place following the German model: in large companies General Assembly appointed 2/3 of the Supervisory Board members and 1/3 were employee representatives. Supervisory Board then appointed the whole Management Board in charge of daily operations of the company.

and Sava-Tech (the latter comprising all of the Sava engineered products portfolio that were not transferred to Goodyear). All the infrastructural costs were to be divided among the three legal entities according to a detailed shared services contract.

Goodyear's decision to close its plant in Greece in early autumn 1996 without prior notice threatened the negotiation process. Sava had strong employee representation in its Supervisory Board. When unions learned about the developments in Thessaloniki, they questioned the trustfulness of Goodyear and asked the management to obtain formal assurance that something similar would not happen to them. As a result, Goodyear sent European GM, as well as production and HR managers to explain the situation and calm down the unions.

Remaining issues were resolved with increased speed, allowing the parties to set the basic principles of JV as well as key sales and profit targets for the first five years. Goodyear opted for soft approach to labor optimization, valuing employee motivation more than fast cost reduction. Although the initial valuation was rejected by Sava as too low, the parties stayed committed to come to a mutually acceptable deal.

Bohorič was working on three fronts. He was representing Sava towards Goodyear, but he left most of the work to Clarke, Fajfar and his colleagues from Sava Management Board. He spent much more time ensuring the lasting support of the external stakeholders (which seemed the easier task) and calming down the internal frictions, with some of the old-time managers (including several sitting on the Supervisory Board) reluctant to accept change of partnership and some others resisting changes because of likely loss of influence. That was in particular true for the influential Accounting and Planning function, which was used to run the company from behind the scene and had huge problems to adjust to Goodyear transparent style.

With Clarke and Fajfar preparing critical documents such as 8-year business plan and detailed evaluation of all issues that remained open in previous negotiations, Sava moved forward to close the negotiations. Clarke was particularly forceful, pushing both Sava experts to prepare better for the negotiations, and Goodyear side to accept his views on company valuation, using all the expertise he had as IFC Senior Investment Officer. When Sava managers failed to produce the counteroffer he asked for, he prepared it himself.

Several more rounds of negotiations were needed in spring 1997 to resolve all the open issues. Finally, on May 12, 1997 Goodyear issued the formal Letter of Intent, which Sava signed four days later. All the contracts were finished by the end of 1997.

The result

Sava and Goodyear agreed to invest into two new companies, as presented in Figure 1.

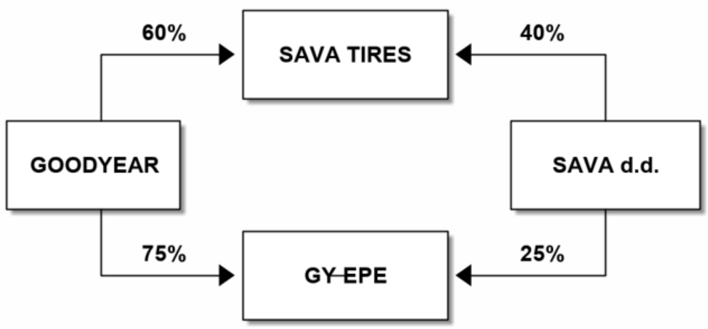

Figure 1: Ownership structure of newly formed companies

Goodyear – Engineered Products Europe started operations on January 1, 1998, while Sava Tires started on July 1, 1998. Goodyear paid 100 million US$ for its share in Sava Tires, with the 4-year option to buy out the remaining 40% of Sava shares. The price for 75% of shares in EPE was 12.5 million US$, with the same buy-out conditions.

What now

After more than two and a half years of negotiations, the partners could enjoy the successful closure of the deal. However, that just opened the new round of important challenges.

Goodyear faced the challenge of bringing in the new technologies and making the companies fully viable within its global organization. Although soft approach used during the negotiations seemed to be beneficial for gaining the initial trust of the employees and local management, it was also clear that both companies had to undergo significant changes in order to raise their competitiveness and remain sustainable. Goodyear managers were warned that Slovenian culture was status-quo oriented and that implementing changes could prove to be very difficult. Goodyear decided to put its European CFO, Richard Johnson, in charge of making things happen in Slovenia.

Sava Management Board had seemingly nicer challenge: receiving more than 110 million US$ (with additional 70 million US$ expected within the next four years) for the assets transferred to the JV companies, Sava was suddenly sitting on significant amount of cash. It also remained in possession of several engineered products programs, some of which were seen as having solid developmental potential. Clearly, the management was eager to come with interesting investment proposals, since otherwise it could expect the owners, Slovenian (private) institutional investors, to take the money out of the company as extraordinary profits. With Janez Bohorič strongly in command, Sava could be certain to persuade the owners to follow the strategy of the management. The question was, however, what should that strategy be: investing into remaining rubber programs, buying some related businesses, going after unrelated diversification or even forming Sava's own investment fund and engaging financial professionals to run it?

Sava Transformation Chronicle

Teaching Note

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

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

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

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

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

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

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

The preparation may be structured around the following questions:

Case A:

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

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

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

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

Case B:

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

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

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

Case C:

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

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

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

Case D:

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

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