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*Transakcje wykupów przedsiębiorstw*
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# Buy – out Transactions of Enterprises

Piotr J. Białowas\*

## ■ Introduction

The development of world economies in recent years has been influenced by the globalization, which tends to be terminologically abused in both theory and practice. Yet, it is hard to disagree with its huge role, being aware of its multifaceted character. Free movement of capital, its concentration and the ongoing process of getting a faster communication, both electronic and physical, year by year are having more and more effect on shaping the world's order. The complexity of this phenomenon may be exemplified by the correlation between the electricity demand, economic growth and environmental protection, which is in turn associated with the construction of new power plants. One of the characteristic features of the modern world, determined by the processes of globalization, is the phenomenon of acquisition of business organizations. Means of the investment is certainly the capital. Capital (in particular the cost and ease of acquisition) usually affects the design of a takeover model. The article focuses on the phenomenon which has been increasing over the last few years, namely on the share of specific capital transactions that are financed by the debt of the acquired entity. The specificity of these acquisitions is that they are characterized by a relatively high rate of return as well as they result in a deep restructuring of the acquired business, which determines their effectiveness.

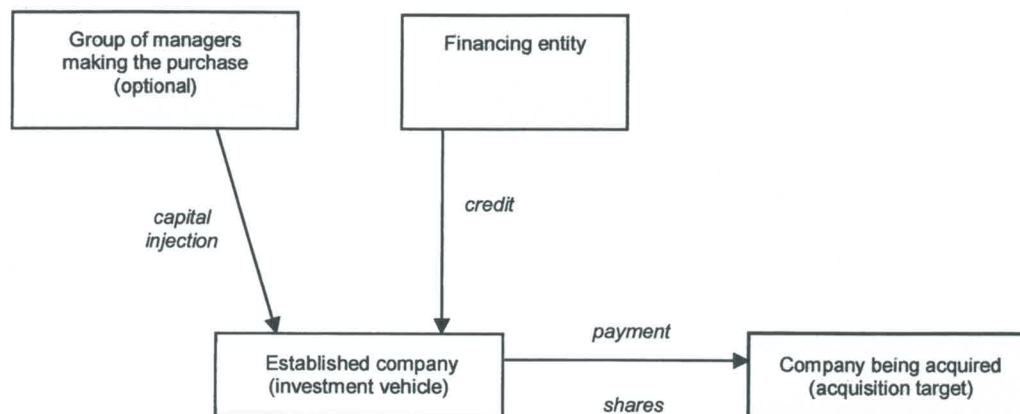
## ■ Characteristics and mechanism of leveraged buyouts

As has been mentioned in the introduction, one of the types of the company acquisitions are the buy-out transactions – very often leveraged. This technique derives from the United States. In Europe it is particularly popular in the UK. Among the buy-out techniques, different types of transactions are to be distinguished. Their definitions are often confused with each other, especially in the countries where the phenomenon is not very common, for instance in Poland. The buy-outs transactions are those that result in acquisition of a controlled stake in the company by acquiring shares from the owner. The participation of the company executives or its employees is possible. The participation of institutional entity (or several entities) is also possible. Depending on the role of foreign capital and the type of parties (participants) of the transaction, each of its sub-types is going to be highlighted and described in detail later in this article. The buyout mechanism is based on several stages. In the first stage a group of managers (in the case of the classical process of MBO)

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creates a special investment vehicle, whose task will be to acquire the company to be sold. The purchase is financed by bank loans acquired by the established company and the capital founders. Figure 1 presents the first phase of redemption.

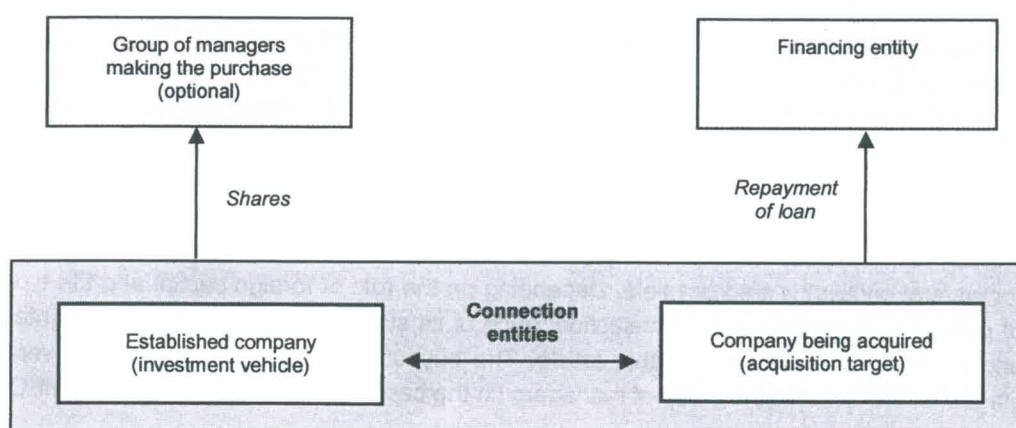
■ **Figure 1.** The first stage of a management buyout



Source: Own work.

The next stage of taking control of the company is to combine the established company (the investment vehicle) and the acquired company (the project). As a result of the merger, the shares of the combined entity (due to the increase in share capital / capital) are transferred to the shareholder / shareholder of the company (an investment vehicle), as shown in Figure 2.

■ **Figure 2.** The second phase of a management buyout transaction.



Source: Own work.

One should loan obligation in addition, the ability to generate therefore, depends on the possibility of rapid In practice there above is carried distinguishes between (Article 492 § 1 (Article 492 § 1 incorporation of company retains case, all the rules event of a merger a new company succession. This In particular, it participating in the land registers etc. Transfer of rights a financial institution month from the merger, the correct type of connection party company.

#### ■ Types and n

There are buyout acknowledged leveraged buy-out (buy-out), the management buyout a majority of the purchase of so far, who are employee buyout (buy-in management). Additionally, in managers. In the encountered. T



One should note that after the combination of entities the new entity takes over the loan obligation investment vehicle (de facto not having the possibility of its repayment). In addition, the combined company (the original company) due to its core business has the ability to generate cash to service the debt. The economic efficiency in the next stages, therefore, depends on factors such as the attractiveness of the target company and the possibility of rapid growth of its value. Total purchase ends when the debt is repayed. In practice there are transactions that last a few years. Merger of the entities described above is carried out in accordance with the regime of the Commercial Code, which distinguishes between the two types of mergers. First one is called a fusion per Incorporation (Article 492 § 1 point 1 of the Commercial Companies Code) and the merger per Union (Article 492 § 1 item 2 of the Commercial Companies Code). Merger by acquisition is the incorporation of a company's assets by another company. As a result, the incorporating company retains business continuity, and the incorporated one ceases to exist. In this case, all the rules and acts of corporate of the incorporated company still apply. In the event of a merger by the merger, a combined company will cease to exist, and in its place a new company is created, that will take over their property on the basis of general succession. This is based on the Article 494 of the Commercial Companies Code. In particular, it concerns the permits and licenses that were obtained by the entities participating in the merger. Moreover, the passage of rights disclosed in the registers and land registers ex lege, subrogation disclosure is at the request of the newly formed entity. Transfer of rights in the form of permits and licenses that granted to a company, which is a financial institution, is limited in that the entity granting authority may object within one month from the date of announcement of the merger. It should be noted that in case of the merger, the company is terminated by the liquidation. A new company, regardless of the type of connection, becomes a party to all legal relationships that were previously existing party company.

#### ■ Types and models of leveraged buyouts

There are buyouts different types of transactions to be distinguished. Among the most acknowledged there are : the LBO transactions - the so-called leveraged buyouts (called leveraged buy-out), the MBO transactions - the above mentioned MBO (called management buy-out), the LMBO operations - leveraged management buyouts (called leveraged management buy-out), EBO (employee buyout) - a transaction involving the redemption of a majority of stake by the employees of the company, MBI (management buy-in) – the purchase of a majority stake of the company by people not connected with the company so far, who are going to manage the purchased company ; the MEBO (management & employee buyout) - the combination of MBO and EBO transactions and, finally, the BIMBO (buy-in management buyout) - the combination of the MBOs and MBI transactions.

Additionally, in the LMBO transaction there may be more other entities apart from managers. In the theory and practice the two models of the LMBO transaction can be encountered. They are presented in Table 1.



■ **Table 1.** Characteristics of the Anglo-Saxon model and the French model in the leveraged management buy-out transaction.

Models of LMBO (leveraged management buy-out)	
Anglo-Saxon model	French model
<p>The action consists of the following steps.</p> <ol style="list-style-type: none"> <li>1. The first stage focuses on the amassing of capital by the management company, which is the subject of acquisition and making contacts with potential institutional investors, such as commercial companies, investment funds, venture capital companies, etc. The consequence of determining the stakeholder groups is the establishment of a new company - a financial holding.</li> <li>2. The second stage focuses on meeting the appropriate level of capital for future transactions (bank loans, issuance of shares or bonds of the created financial holding). A characteristic feature is that the value of the loans is usually a multiple of the equity holding.</li> <li>3. In the last stage the merger of the acquired company financial holding company takes place. As a result of the merger a new company is formed. It has taken over free enterprise funds. They are usually used to repay the part of the liabilities incurred for the acquisition. Over the following years, the company repays the loans with interest.</li> </ol>	<p>The model is similar to the Anglo-Saxon one. The difference is that the company - a holding company, is formed jointly by employees, managers and selected institutional investors. Characteristic are the strict limitations on rules concerning its creation. Only managers and employees who have worked at least one year are allowed to create it; they should have at least 51% of the vote (up to 49% may belong to institutional investors), and none of them can obtain a majority stake of 51%.</p> <p>After having created a holding company, the managers with staff and institutional investors borrow money to finance their transaction. After having collected the adequate capital, a merger of the holding and the "acquired" company may take place. In practice it happens very rarely. The most common procedure is the acquisition of the company by the newly created holding company. This occurs in 80% of cases.</p>

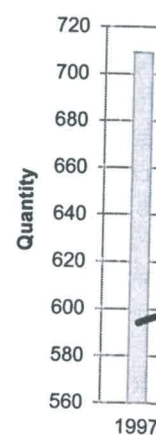
Source: Szczepankowski P., *Fuzje i przejęcia*, PWN, Warszawa, 2000, s. 99-107 oraz Zając C., *Spółeczne i organizacyjne problemy fuzji i przejęć przedsiębiorstw*, Wydawnictwo AE we Wrocławiu, Wrocław, 2005, s. 53.

Attention should be drawn to the fact that the leveraged management buyouts are based on the two key elements. They are: high managerial skills that enable the development of the market and increasing its value after the merger or acquisition, as well as functioning of the leverage arising from borrowing. Any actions associated with this type of acquisition are certainly preceded by a detailed financial analysis. For external stakeholders (investors, lenders and banks) a management team is a very important element. It should also be the guarantor of its effective organizational and financial restructuring due to having the most information about the company activities. The high financial leverage in this type of transaction means very high debt to equity ratio - debt reaches up to 90% of the sale of the company. It should be borne in mind that such transactions are successful only in case of the increase in the value of the entity in the next few years. Since the risk of transactions is relatively high, investors expect high rates of return of up to as much as 40% per year. There are many examples of successful completion of such transactions. The American company Gibbon Greeting Cards is a good example. It was acquired by the staff for the amount of \$ 81 million. After one year of this operation the company sold 17% of shares for the amount of \$ 45 million. After this period, the enterprise value was three times greater. Attention should be paid also to the fact that in addition to the competence

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■ **Figure 3.** T

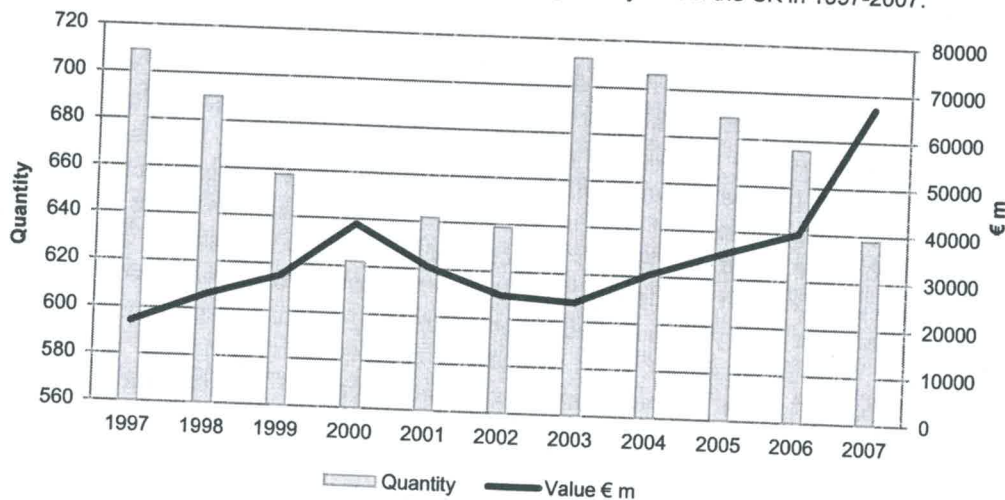


Source: CMBORI

of the management of the acquiring entity, the type and condition of the company, which is going to be the subject of takeover, is relevant in assessment of the project success. One type of risk of the project will accompany the innovative companies, and the other one in case of operating in less developed markets. The financial structure of the company before the acquisition and its financial ratios are also of particular importance. There are companies being acquired as a result of the LMBO transaction, which possess a financial liquidity surplus and the share in the assets of a several dozen percent. Of course, these subjects are perfect targets of the LMBO transactions due to the fact that one can reduce the debt with the cash available immediately after the transfer. Referring to the LBO transaction in Polish conditions it should be noted that the market for leveraged buyouts is in the infancy of development. The biggest buyout LBO type in Poland was the sale of the Aster City Cable Cable by the British private equity firm Hicks, Muse, Tate and Furst (under its present name Lion Capital) to another private equity firm - Mid Europa Partners for € 1.6 billion zł. The value of this transaction was twofold higher than the overall market in the previous year.

Apart from the degree of leverage, as has been already stated, the MBO transactions are particularly attractive in the UK. In recent years their share in all the mergers and acquisitions (M & A) remains high, representing about 60% in terms of both volume and value. In other Western European countries the interest in the MBO transactions is highly varied. It is due to the different levels of financial markets development, diversified regulations and different degrees of intensity of privatization processes. The following charts no. 3 and 4 reveal the number and value of the buy-ins and the buy-outs transactions over the years 1997 - 2007 in the UK and the Continental Europe.

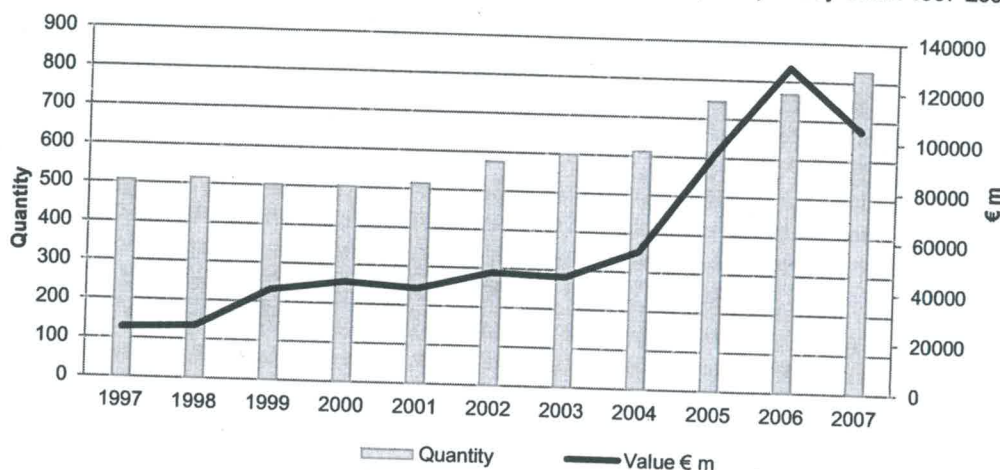
■ Figure 3. The number and value of transactions Buy-In/Buy-Out in the UK in 1997-2007.



Source: CMBOR/Barclays Private Equity/Deloitte & Touche



■ Figure 4. The number and value of transactions in Continental Europe Buy-In/Buy-Out in 1997-2007.



Źródło: CMBOR/Barclays Private Equity/Deloitte & Touche

Analyzing the process of the MBO buyout it can be seen that the intensity of this phenomenon also depends on the assessment of the attractiveness of alternative investments. For instance, the decline in interest in such MBO acquisitions in the United Kingdom a few years ago strongly attracted investors' interest in the new technologies sector entities, which gave hope to the very high rates of return on capital employed. The decline in the number of mergers and acquisitions (classical M & A transactions), in turn, may cause an increase in the number of the MBO transactions owing to the decreasing valuations of companies in this period. A very important factor in the development process are the MBO acquisitions tax regulations. An example of a country in which there has been a significant wave of growth in this type of transactions, as a result of the liberalization of the tax burden in the case of capital income from operations, was Ireland. Also in Germany in recent years there has been changes in regulations and taxes, which increased the interest in the MBO transactions to such extent that Germany in 2003 occupied the second place in Europe in terms of executed buyout firms transactions.

Trying to relate the level of the European buyout market situation to the situation in Poland it should be noted that Poland is a country where such transactions are a highly controversial phenomenon. No detailed analyzes of the transactions are carried out. It has been estimated that each year in Poland several dozen buy-out transactions are conducted. One should note that many of them are carried out without publicity, for example as a result of the withdrawal of the Western companies from the market, which have not reached the planned level of revenue in Poland. In this case, the Western companies are getting rid of their subsidiaries located in Poland for its managers. A measure of the low growth of this market in Poland may be comparing the value of transactions in the UK to the level of revenues from privatization in Poland. In 2005, the value of buyout transactions in the UK amounted to about 131 billion, comparing to the revenues from privatization in

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Poland reaching 5 billion and then, in 2012- less than 10 billion, which represents respectively 3% and 6% of the transactions carried out in England. Polish companies repurchases, in particular leveraged transactions using sophisticated financial engineering are usually seen as a desire to get rich quickly by unethical investors. They are not considered as a tool of improving the efficiency of the company. There are many examples of transactions in Poland, which have not been carried out due to the phenomenon of 'playing safe' by banks which co-finance of the buy-out transaction. An example of a project that has failed is the purchase of a controlled stake of the FM Famur SA (a company which operates in the production, sale and repair of a combined cutter-loader market) from the National Investment Fund (NIF). The Famur Investor, established for this purpose the managerial-employee company, signed a conditional agreement to sell the NFI shares worth about 38 million. Funds for this purpose were to come from a bank loan, which was to be secured by the purchased shares. The withdrawal of the banks from the transaction resulted in failure to meet the terms of a preliminary agreement with the NFI. The same cause was the reason of failure to acquire of a package the 33% shares of the Bumar Fablok SA by the Fablok - the joint-stock employee company from one of the National Investment Funds for 6 million PLN<sup>1</sup>.

#### ■ The organizational effects and limitations of the buy-out transactions.

As has been mentioned earlier, the effective buyout of the company takes place in the presence of specific factors, both on the side of the acquired company - which is a takeover target, and on the side of the environment (investor and provider of capital). These factors may include the following elements:

1. Trust in the financing entity's transaction, resulting in a lower cost of capital. In practice, the access to capital is determined by various factors, such as willingness to enter new foreign markets and, therefore, financing the foreign investment by a bank or investment fund from the same country as the acquirer. An example of such a transaction was the acquisition of JELFA SA, a joint stock company, by the Lithuanian JELFA Polish legal entity SANITAS Ltd. with a share capital of EUR 50 thousand zł, related party capital of AB SANITAS LITHUANIA - the SANITAS Sp. z o.o. (Ltd.) served as an investment vehicle.
2. An inefficiently managed company that is a takeover target, which is susceptible to the restructuring process. In practice this may mean, for example, a possibility of carrying out the restructuring of fixed costs as a result of voluntary redundancy program, a combination of functions and consolidation of entities if the purpose of the acquisition is a holding company. A favorable factor, according to the new investor, is also an inefficient management of fixed assets, which after having been inventoried can be realized. Another example is the solution of financial reserves as a result of not fulfillment of the conditions that would justify their formation and which were not reflected in the valuation of the company.

<sup>1</sup> Więclawski R., Aranżacja finansowania dla wykupów menedżerskich, „Nasz Rynek Kapitałowy”, nr 2/2004, s. 64.



3. A highly competent management team, which consists of actors of change. The knowledge of the financial management and process re-engineering is particularly important.

Certainly, the above factors are only synthetic elements determining obtaining the projected profitability of the acquisition. Next to them, a number of macro and micro-economic factors may be enumerated, such as the current situation on the capital markets or even the real estate market situation, intended for possible release after the acquisition of unnecessary assets. Attention should be paid to the restructuring of the acquired company, which is a crucial stage in the acquisition process.

Trying to identify the transaction limit buy-out, attention should be drawn to the frequent difficulty of funding opportunities. Especially in recent years, a highly cautious approach of banking entities is to be observed. In general, carrying out a leveraged buyouts transaction is not easy, especially in the Polish conditions. One of the most significant barriers are provisions of article 345 of the Commercial Companies Code, which prohibit a public limited company from lending or security, as well as prohibit the financing of the purchase or acquisition of shares issued by it, this provision does not apply to limited liability companies. Hence, in leveraged transactions a company of such organizational and legal form is used. The provision of the article 345 of the Code of Commercial Companies tend to be mentioned as a potential barrier for companies - investment vehicles (SPV). If we establish a company with a minimum capital only with the purpose of acquiring, the only assets of the 'investment vehicle' company are the shares of the acquired company. investment vehicle. On the liabilities side, we have all of the obligations in relation to the entities that are the sources of funding. Relating to the next step, which is a combination of entities, again the issue of article 345 entries in the Commercial Companies Code (the acquired company is usually a public company) based on the article 494 of the Commercial Companies Code. It indicates that the acquiring company, in our case the SPV company, gains all the rights and obligations of the acquired company. One of the procedural restrictions of the efficiency of the process is also the article 509 of the Commercial Companies Code, which protects the corporate rights of minority shareholders in the form of merger resolutions without a remedy. This, combined with a relatively long time of waiting for a call recording by registration courts in Poland, may be a factor inhibiting the process. The latter elements, however, are specific to each reorganization process in which there are changes in the share capital requiring registration in the National Court.

To conclude, the leveraged buyouts transactions are certainly at the higher level of complexity compared to the traditional processes of mergers and acquisitions. They are very often accompanied by a desire to quickly achieve a certain return on invested capital in terms of value incomparable to any investment alternative with no desire to engage in long-term development of the acquired company. The author believes this may lead (and it often does) to "spiral squeezing" of companies by financial investors. In the successive stages there are high, but smaller and smaller levels of return on invested capital generated for them. It is associated with limited possibilities of restructuring the company. The popularity

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of this type of transactions will certainly increase due to the growing pressure to increase return on investment and profitability of the business in every sector of the economy, which seems to be an inseparable part of the contemporary world and the increasing role of capital markets.

### ■ Summary

The article presents the problem of management buy – outs as specific ways to take over the company. Division of types is presented with particular emphasis on leveraged management buy – outs. Presented legal restrictions of the transaction.

### ■ Streszczenie

W artykule przedstawiono zagadnienie wykupów menedżerskich jako specyficznych sposobów przejęcia przedsiębiorstwa. Przedstawiony został podział rodzajów wykupów ze szczególnym uwzględnieniem lewarowych wykupów menedżerskich. Przedstawiono prawne ograniczenia transakcji.

**Keywords:** merger, acquisitions, buy – outs, leveraged buy – outs, legal aspects

**Słowa kluczowe:** fuzja, przejęcia, wykupy, wykupy lewarowane, regulacje prawne,