A BIG CRISIS GENERATING A BIG OPPORTUNITY

How the collapse of Agrokor Group may result in several interesting investment targets

21 June 2018

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INTRODUCTION

Background

- In 2017 rumours started appearing that the Agrokor Group (hereinafter 'Agrokor', or 'Group'), one of the largest enterprises in South East Europe, was in serious financial distress.
- The rumours were quickly followed by a total collapse of Agrokor's finances, prompting the Croatian government to enact a special law for protecting companies with systemic risk to the national economy, the so-called 'Lex Agrokor', which shielded the Group from any legal or financial liability towards its creditors for a period of 1 year.
- The law also appointed a Court selected Administrator to manage the Group, similarly to a bankruptcy related appointee, only in this case Agrokor did not declare bankruptcy – at least not yet.
- There is a consensus among experts that Agrokor will not survive in its current shape and form, which opens up several interesting investment opportunities for selected companies within the Group.
- This report aims to shed some light into these investment opportunities to potential investors, by providing insights into the Agrokor situation and some of its 'crown jewels' in terms of companies that could be considered attractive investments.
- Information in this report has been collected using open source intelligence (OSINT), as well as human intelligence (HUMINT) with great proximity to the subject matter. Our internal analytical team conducted a comprehensive assessment of all collected intelligence – the summary of which is condensed in this document.

Timeline of key events

1976 — 1. Founded as a small 'mom & pop' flower shop. Gradually spreads into import & export of cereals, fruits and veggies, but still maintains an SME status.

1989 — 2. Converts company status to a joint stock company, Ivica Todorić (UBO until last year) starts building political capital to fuel subsequent expansion.

1995 — 3. Agrokor starts buying state-owned food and retail companies, in transactions riddled with red flags and rumours of corruption.

2014 — 4. Agrokor acquires Mercator (major competitor) at an overvalued price. Transaction heavily financed by expensive debt – typical high yield leverage buyout

2016 — 5. The Group's cash flow position (which was bad to begin with) further deteriorates. Management and auditors deploy "creative accounting" to hide losses.

2017 — 6. Agrokor implodes, Government executes a de-facto bailout, although de-iure it's called a "Special Administration Procedure". More on next slide.

- The Agrokor Group was/is a combination of a typical vertically-integrated FMCG company and a regional conglomerate that includes non-core businesses, such as health care, IT, real estate, tourism, etc.
- Such over-diversification, coupled with nepotism stemming from the family ownership, resulted in huge inefficiencies. Adding to it an aggressive expansion strategy, financed by expensive high-yield debt, led to the imminent collapse of the Group.

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RED FLAGS

Allegations of insider trading and corruption

- In March of 2017, representatives of the US-based hedge fund, Knighthead Capital, meet with Mr Ante Ramljak, at the time an independent financial advisor. A week later, the Government passes Lex Agrokor through Parliament, while Ramljak is appointed as the Government's Special Administrator assigned to manage Agrokor during the restructuring process.
- Concurrently, Knighthead buys a big chunk (50%+) of Agrokor's bonds, which, considering the financial distress the Group was in at the time, were trading at large discounts (approx. 30 cents on the dollar, probably even cheaper). As a bond holder, Knighthead was not considered a senior creditor in the 'pecking order' of Agrokor's lenders.
- A couple of months later, several lenders and bond holders (led by Knighthead, see table on the right) participate in a EUR 1bn loan facility to Agrokor. These lenders are given super seniority in the creditors' pecking order. This seniority is retroactively applied to the nominal value of the bonds, which they purchased at huge discounts months earlier.
- This transaction was enabled by the provisions of Lex Agrokor. Thomas Wagner, Knighthead's co-founder even admitted in public that they've decided on the investment after consultations with the Government. The main red flag here is the question whether Knighthead had insider information about the provisions of Lex Agrokor, before making its investments? Why did Knighthead meet with Ramljak weeks before it was announced that he (Ramljak) would not only be the Special Administrator of Agrokor, but also influence the main provisions in the Law (i.e. Lex Agrokor)?
- Russian-based Sberbank, one of the largest creditors of Agrokor (over a EUR 1bn in loans) heavily objected the 'roll-up', even questioned the legality of it, despite the provisions in Lex Agrokor. Rumours started surfacing the entire transaction and the Lex Agrokor was created in order to favour Knighthead, which made the investment (allegedly) with insider knowledge from Ramljak, who influenced the provisions in the Law.

LENDER	EUR m	LENDER cont'd.	EUR m
Knighthead	200.00	Whitebox	9.59
VTB	181.49	CIS	7.59
Zagrebacka/Unicredit	180.00	Triarii Capital	7.48
Monarch	110.80	Whitefort Capital	5.48
Erste&Steiermarkische	39.86	BrokerCreditService	3.79
VR Capital	38.20	EG Fixed Income Fund	3.79
York Capital	27.38	Silver Point	2.02
CQS/BIWA	21.23	Merrill Lynch	2.00
Goldman Sachs	19.39	Banque Pictet & Cie	1.90
Jefferies	15.99	SC Lowy	1.21
Lonestar	14.76	J.P. Morgan	1.00
Altera	13.28	Trinity Investments	1.00
Cowell&Lee	12.50	A 1 Shipping Enterprise	0.80
Marble Ridge	12.50	Segetia Fund	0.50
Stonehill	12.10	First Gateway	0.20
Ironshield	12.00	Wolfgang Abfalterer	0.20

- In early 2018 Ramljak was forced to resign from his position as Agrokor's Special Administrator on allegations of corruption. Investigative journalists uncovered that he hired his former company to serve as an advisor to Agrokor, paying them huge consultant fees. Ramljak defended his position with the claim that he needed people on the inside who he can trust. However, the general public saw this as a clear conflict of interest, and he was forced to resign. In addition to this major conflict of interest issue, Ramljak's management team was also accused of lavish overspending using their company credit cards. In a situation when hundreds even thousands of people are either losing their jobs, or fearing for their jobs, such behaviour was deemed as highly unethical.

Local suppliers – a political 'hot potato'

- By 10 July 2018 the Special Administrator (Mr Fabris Peruško, who replaced Ramljak) and his management team have to agree on a wide ranging settlement with Agrokor's Temporary Council of Creditors, which includes bondholders (led by Knighthead), lenders (led by Sberbank) and suppliers.
- One of the critical issues will be the local suppliers which are heavily exposed to Agrokor. If they have to write off a large chunk of their receivables from Agrokor, there is a high chance of many of them going bankrupt, leading to mass layoffs, even causing political instability. These suppliers are relatively low in the creditors' pecking order, making this a major problem for the Government, which is still in control, at least technically.

Residual risk

- Sberbank has seized Agrokor's assets in Serbia and Slovenia. This includes the retail companies (Mercator in Slovenia and Idea in Serbia). Agrokor is contesting this lawsuit. The long term fate of these assets remains unclear.
- A plethora of cross company guarantees, whereby one company within the Group pledged assets for guaranteeing a loan for another company within the Group. Disentangling these liabilities would require serious efforts in any due diligence process.

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SCENARIOS

1. DEBT-TO-EQUITY SWAP
Probability: medium to high

- This scenario assumes the Group's largest creditors probably taking a haircut on their claims towards Agrokor and subsequently converting their debt holdings into Agrokor's shares.
- Considering that the largest creditors are financial firms (banks and funds), they would assume a sale of the Group's companies to recoup their money, as they are probably not interested in managing Agrokor's companies in the long run.
- The most difficult issue of the D/E swap would be to reconcile the interest (and claims) of the foreign lenders (e.g. Knighthead and Sberbank) with that of local suppliers.

2. BANKRUPTCY
Probability: medium

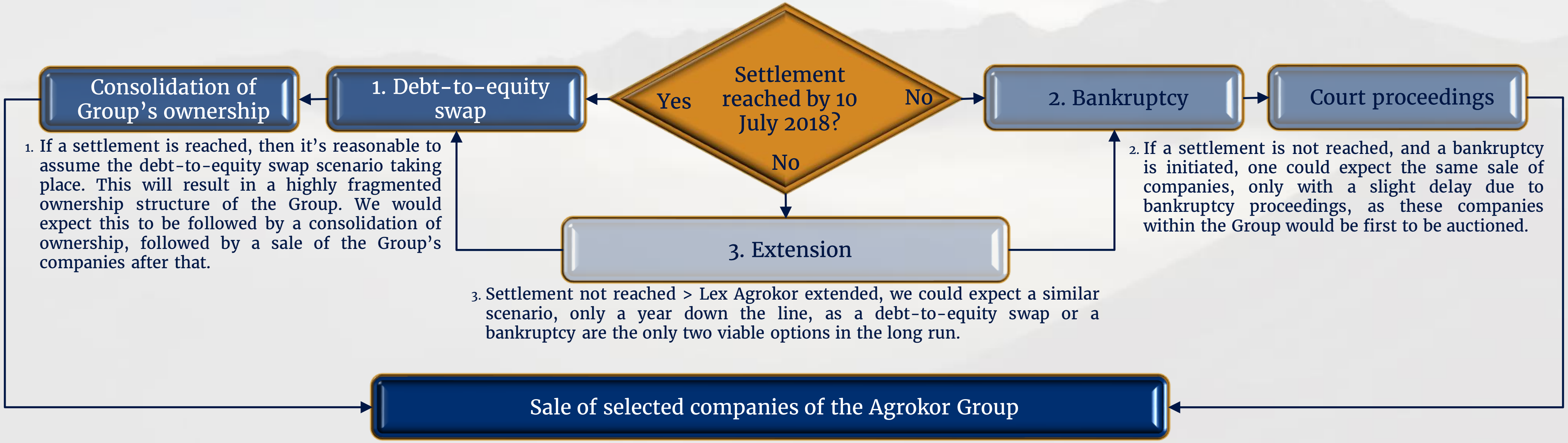
- This scenario assumes that Croatian bankruptcy laws would have to be changed in order to allow certain parts of the Group to declare bankruptcy, while other can continue to operate, because under the current legislation, if Agrokor goes bankrupt, probably no company in it would survive.
- Companies that are operationally viable could be given the opportunity to renegotiate their debt with their creditors – such an arrangement enabling them to survive.
- Less indebted companies (e.g. Ledo, Jamnica) could avoid bankruptcy, while Konzum and Mercator would probably go under.

3. EXTENSION
Probability: medium to low

- If a satisfactory solution is not found by the 10 July 2018, the Government could extend the Special Administration Act ('Lex Agrokor') for another year
- This "kicking the can down the road" option might be politically least risky, and hence the Government might be more inclined to follow it.
- However, the risk of total collapse of Agrokor is also present. No one knows at what rate the Group is burning cash, and when it will stop functioning entirely.
- A disorderly bankruptcy is then a possibility, which might create mass layoff, social unrest, fall of the Government, etc.

How might all the scenarios play out?

- All scenarios would most likely result in a sale of the most valuable companies within the Agrokor Group – the difference being in its timing, as shown in the diagram below:



1. If a settlement is reached, then it's reasonable to assume the debt-to-equity swap scenario taking place. This will result in a highly fragmented ownership structure of the Group. We would expect this to be followed by a consolidation of ownership, followed by a sale of the Group's companies after that.
2. If a settlement is not reached, and a bankruptcy is initiated, one could expect the same sale of companies, only with a slight delay due to bankruptcy proceedings, as these companies within the Group would be first to be auctioned.
3. Settlement not reached > Lex Agrokor extended, we could expect a similar scenario, only a year down the line, as a debt-to-equity swap or a bankruptcy are the only two viable options in the long run.

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SCENARIOS CONT'D.

Early signs of a debt-to-equity settlement

- Unconfirmed but reliable intelligence sources point out to a possible outline of a settlement, which seems to be acceptable to all the members of the Temporary Creditors Council and the Government. The main aspects of the settlement are listed below.
- A new company is to be formed, whereby the assets of the old Group will be transferred to this new holding company. The total valuation of the new company is estimated at EUR 2.6b.
- The Russian banks, Sberbank and VTB will end up owning little less than 50% of the equity of the new Agrokor. Sberbank will probably end up with approx. 30%, and VTB 14%. Although this stake is just shy of a controlling stake, the Russian banks will still be the most influential stakeholder group in the new Agrokor.
- The second largest shareholder group could be the bondholders, led by Knighthead Capital Management. They will end up not only receiving the previously mentioned 'roll-up' loans back with interest, but also convert their prior bond holdings into equity of between 23% and 25%, with Knighthead only owning 10%-12%.

- An interesting observation made by some well acquitted experts is that some of the bondholders are already in negotiations with the larger new shareholders over the sale of their equity stakes in the new holding company. This is not surprising considering that most of the bondholders were never long term strategic investors in the first place.
- The larger suppliers would jointly end up owning approx. 6%-8%, slightly over the estimated share of the smaller local suppliers who would convert part of their receivables into an equity stake estimated at 4%-6%, and also collect some of their receivables in cash. The main aspect of this part of the settlement is that the local suppliers seem to be satisfied with the offer on the table, which means that, if the settlement is not dramatically changed, we will not witness the feared social unrest on the streets.

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MAIN TARGETS

KONZUM

- The largest FMCG retailer in the region, operating 700+ food retail stores and 60+ toiletries stores, in Croatia, Slovenia, Serbia and Bosnia and Herzegovina;
- Market share of 30% and total retail space over 340,000 m2;
- Main competitors Kaufland, Lidl and Spar;

Jamnica

- Largest producer of bottled mineral water;
- Owns subsidiaries in the same sector across the region;
- Company originally founded in 1828 with a long tradition;
- Focused on only a handful of related products, not overstretching its portfolio;

ledo

- Leading local and regional producer of ice cream and frozen foods;
- Dominant market position, despite the difficulties, with 90% market share in ice cream;

pik

- One of the largest meat production, meat processing plant and delicatessen products in the region;
- More than 70 years of tradition in meat production;

ZVIJEZDA

- One of the leading producers of cooking oil (vegetable, olive, etc.), vinegar, mayo, picked and canned foods etc;
- Almost a century of oil production;

- These companies were all formerly state owned, acquired by Agrokor during the privatization schemes, subsequently restructured after substantial investment by Agrokor in its production facilities, turning them into product leaders in their respective sub-sectors.

Key Financials

Konzum:

in EUR m	2015	2016	%
Revenue	1,418	1,410	-0.6%
EBITDA	-248	-153	38.4%

Jamnica:

in EUR m	2015	2016	%
Revenue	356	366	3%
EBITDA	37	-34	-194%

Ledo:

in EUR m	2015	2016	%
Revenue	304	302	-0.4%
EBITDA	42	-28	-168%

PIK:

in EUR m	2015	2016	%
Revenue	295	291	-1.3%
EBITDA	14	1	-94%

Zvijezda:

in EUR m	2015	2016	%
Revenue	122	120	-1.6%
EBITDA	4.08	-0.02	-100%

Advantages

- The largest retail outreach and market share in the region, despite the recent drops in both as it had to close 100+ stores last year. However, these were loss making stores;

- As with all companies within the Group, they all have very strong brands, recognized both locally and regionally, with a high degree of consumer loyalty;
- Plants, production facilities and processes are of high quality as all of these companies have invested heavily in modernization during the last few years;
- All companies have a decent share of exports in their revenue structure, with considerable growth potential for their exports, provided alternative distribution channels are found;

Risks

- Residual legal and financial risk from creditors, unless the Settlement (see page 3) stipulates that the assets would be switched to completely new legal entities, without the liabilities;

- Considerable legal risk, as Sberbank is seizing the assets of these companies outside of Croatia, where they (and Agrokor as a whole) do not enjoy legal protection of Lex Agrokor, as they do in Croatia;
- These companies served as guarantors for numerous loans to the Group, to each other and to other companies within the Group;
- The key staff is leaving, and the companies are undergoing severe human resource drain of high quality cadre;
- The majority of the Company's products are being distributed by the Konzum retail chain. New owners would have to find new distribution chains.

Other potentially interesting targets

- Private health care clinic: AVIVA POLIKLINIKA
- IT company (CRM, B2B): m>Start
- E-commerce company: abrakadabra
- Various real estate and tourism companies

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