INSIGHT INTO THE CAUSES OF THE AGROKOR CONGLOMERATE FAILURE

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Abstract: *The Agrokor Group is the largest privately-owned company in Croatia and one of the biggest employers in the surrounding economies, with thousands of heterogeneous suppliers involved in its vertically integrated system. This paper provides insight into the (hi)story of the conglomerate and its failure that caused unprecedent public turmoil. Based on the traditional postulation of internal or external factors that crucially run the show, we lean our discussion on the seminal work of John Argenti and the government's role among usual exogenous cause suspects.*

Keywords: *Agrokor, business failure, attributions / causes, management, government.*

1. INTRODUCTION

With about 60,000 employees spread over Croatia, Slovenia, Serbia, Bosnia-Herzegovina and Hungary, it would be hard to overstate the company's importance to Croatia and the surrounding region. The second part of the article briefly describes the business community growing skepticism about Agrokor's ability to service its debt liabilities and the culmination in the "perfect storm" that placed the distressed conglomerate under a reorganization regime set up by the government. Part three gives a kind of reality check, by presenting a snapshot of the financial situation after audit and revision. Starting from the deterministic and voluntarist viewpoints on business failure research, the causes of Agrokor's failure were discussed from the internal/external factors perspective in chapter four, followed by concluding considerations.

2. AGROKOR'S RISE AND FALL

The company was founded as a family-owned flower business in the 1976. In the last two decades, it grew into the largest Croatian company, spanning the Western Balkans and becoming one of largest family-owned businesses in Europe.[43] With a 95.52% share, the parent company is Adria Group Holding B.V. Netherlands, controlled by Mr. Ivica Todorić, Agrokor's founder.[44]

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[43] According to data compiled in mid-2017 by the Center for Family Business of the University of St. Gallen and the EY's Global Family Business Center of Excellence, Agrokor was ranked 222nd among the largest 500 family firms around the globe [1].
[44] He was chairman and CEO from the beginning until the opening of the emergency management procedure in April 2017, when Mr. Todorić and his management board were removed from their posts.

By the mid-1980s, Agrokor had become Yugoslavia's market leader in the flower trade, after which it expanded into the import and export of fruit and vegetables, oil crops and cereals. Among other acquisitions within the newly independent Croatia in the mid-1990s, Agrokor gained ownership of three market leaders: Zvijezda (edible oil and margarine producer), Jamnica (bottled water company) and Ledo (ice cream and frozen food manufacturer). In 1994, Agrokor acquired the Croatian grocery retailer Konzum, which was a €300m business with 200 stores. A decade later, in 2005-2007, Agrokor purchased Belje, PIK Vrbovec, Agrolaguna and Tisak – Croatia's largest or top companies in agriculture and livestock breeding, meat production, viticulture, olive growing, and tobacco retail and newsstands. On its expansive path in Croatia, virtually no acquisition opportunity was overlooked, resulting in dozens of non-core market side-projects in tourism, advertising, printing, construction and civil engineering, etc. During the same period, several acquisitions in neighboring countries were made, as well as heavy investments in overall modernization and upgrades of Agrokor's businesses.

Over the next two decades, Agrokor's retail flagship Konzum transformed into a €3bn business operating approximately 1,000 stores in three countries (Croatia, Bosnia-Herzegovina, and Serbia). Together with Serbia's Delta Group and Slovenia's Mercator, Konzum was one of three key players in the regional food and retail market. Reportedly Agrokor tried several times to merge all three companies; what is certain is that Agrokor made several unsuccessful attempts to take over Mercator, before finally striking a deal in September 2014. This was the company's most significant deal, roughly doubling the size of Agrokor's retail business. At that time, Mercator was heavily indebted (€1.1bn), struggling both financially and operationally. The total value of the takeover transaction was €544m, out of which €324m were used for the acquisition, €200m for deleveraging Mercator's financial position and €20m for Mercator's operational working capital requirements. The acquisition created the largest retailer in much of the former Yugoslavia while pressure on the margin was rising, exercised by West European retailers (Belgium's Delhaize and Germany's Schwartz group) investing in the region.

By the end of 2016, the vertically integrated conglomerate controlled the entire supply chain, with a presence in grocery and non-food retail, food production, agriculture and tourism. For the twelve-month period to the end of September, the group generated consolidated revenues of €6.4bn. However, due to increased competition and failure to reap the expected benefits from the Mercator acquisition, the toxic combination of rapid expansion, over-investment, low profitability and high-cost borrowing became indigestible. Compared to a typical ratio of three for the retail industry, Agrokor's ratio of net debt to trailing 12-month EBITDA was pending at levels more than twice that.

The avalanche of negative public news began on January 2, 2017 as Moody's Investors Service downgraded Agrokor's corporate family rating to B3 from B2 and its probability of default rating to B3-PD from B1-PD [2]. The anxiety among investors began to unfold after only two weeks, when Agrokor's bond prices began their precipitous decline.

As of September 30, 2016, Agrokor's payables were HRK 16.2bn (€2.175bn), which translates to 150 of days payables outstanding. With limited access to debt (or equity) and the deterioration of the group's operating performance, prudent management of pending debt maturities was of crucial importance. From investors to suppliers, the interested parties sought a rapid resolution of a problem that objectively needed time to be resolved in 2017. However, time was running out, and running out fast: fearing for their claims, the company's financially exhausted Croatian suppliers flocked together and called on the government to protect their rights. The company's management decided to operate in "*silenzio stampa*," not holding any press conferences or releasing statements, thus only prodding speculation about imminent collapse due to a lack of information. Considering the weakened support from suppliers, Moody's voiced the opinion that the company is no longer able to sustain its high level of trade payables. While the HRK 2.29bn (€307m) in cash and cash equivalents reported at the end of September 2016 exceeded the HRK 959m (€127m) of short-term debt, Moody's estimated that the company's liquidity would not suffice to finance a reduction in payables [3].

While Agrokor announced its intention to appoint an independent global restructuring advisor, the Croatian government apparently had other plans. Facing a political challenge, policymakers speedily and silently prepared a new piece of legislation to handle cases of financial distress in especially large enterprises. On April 6, 2017, the Croatian Parliament passed the Emergency Management Act (EMA). Besides ordinary pre-bankruptcy and bankruptcy procedures, EMA instituted a special reorganization regime for any distressed company "of systemic importance" and was expeditiously published on the same date and became effective on the next day. Although the government stated otherwise[45], the law's main purpose was obvious, and therefore the EMA is commonly referred to as "Lex Agrokor."

Mr. Todorić and his management board filed the activation of the new legislation for Agrokor on the same day the EMA went into force. Three days later, on April 10, 2017, the Commercial Court appointed the emergency trustee for the company. From that moment onward, Agrokor's owner had no influence nor did he participate whatsoever in the management of his financially troubled business empire. This point on the timeline can be marked as the end of one era in the company's life cycle and the beginning of a new subsistence[46], inviting us to discuss closer the causes of failure. Before doing so, we will give a short insight into Agrokor's revised numbers.

3. THE AUDITED AND REVISED FINANCIAL STATEMENTS

The audited financial statements of Agrokor d.d. and the consolidated financial statements of the Agrokor Group were finally released in October 2017. The audit encompassed 27 companies subject to statutory audit in Croatia, and 3 companies in Serbia and Bosnia-Herzegovina, respectively. The scope of the consolidation for 2016 consists of 80 companies, 42 of them in Croatia.

The published 2016 results and restated 2015 results after an audit performed by PricewaterhouseCoopers (PwC) revealed a gloomy picture of accounting irregularities and value adjustments, along with a deterioration in operating performance (tables 1-3). The audit results contained "significant adjustments" to Agrokor's statements from preceding periods. The total equity decrease (impairment) of the Group from FYE 2014 to FYE 2016 amounted to HRK 21.7bn, with the loss in 2016 totaling HRK -11bn. The loss in 2015 was HRK -3.6bn, as opposed to the HRK 1.2bn in profits stated by reports that were audited by Baker Tilly Croatia. PwC's adjustments in the report for 2015 emerged from reported accounting irregularities, including, *inter alia*, undisclosed liabilities of HRK 3.9bn, undisclosed operating and financial

[45] Explaining to Parliament the reasons why this bill was proposed, Croatian Prime Minister Andrej Plenković said that "*…(t)he bill on emergency receivership in systemically important companies is not a bill for Ivica Todorić, it is not 'Lex Agrokor', it is a bill whereby Croatia and the government are protecting the interests of the Croatian financial system, the economy, the workers and employees of Agrokor, family farms, suppliers and all stakeholders that are currently involved in the processes connected to that largest Croatian company*" [4].

[46] Agrokor creditors reached a „going concern" settlement, in October 2018 confirmed by the High Commercial Court. Over the forthcoming settlement implementation period, all companies will continue with their operations and the business activities will be transferred to a new holding entity whose ownership structure will consist entirely of (past) creditors.

expenses from 2010 to 2015 (HRK 2.2bn) and improper classification of cash and cash equivalents (HRK 2.1bn).

The accentuated accounting irregularities that compelled the swinging equity adjustment (figure 1) were derived from (I) the non-disclosure of operating and financial expenses in the P&L account, inappropriate classification of borrowings as equity, inappropriate classification of receivables from loans as cash and cash equivalents, the non-consolidation of an Agrokor subsidiary (AdriaticaNet); (II) value adjustments of intangible and tangible assets and inventories; as well as (III) other effects on equity in 2015 and 2016 e.g. equity adjustments resulting from the reclassification of operating leases into financial leases and the increase of costs and drop in revenues in 2016.

Table 1: The Agrokor Group's consolidated P&L statement for 2016 and 2015

in €000, FYE	**2016**	***2015****
Revenue	5,630,783	5,985,884
Sale of services	459,379	242,114
Other income	19,139	25,707
	6,109,301	**6,253,705**
Changes in inventories of finished goods and work in progress	34,516	-22,285
Cost of materials and goods sold	4,283,812	4.453,162
Cost of services	665,909	544,297
Staff costs	630,064	616,109
Depreciation and amortization	584,029	446,328
Other costs	908,568	304,011
Sale of properties, net	16,999	6,974
	7,123,897	**6,348,597**
Financial income	97,946	101,149
Financial expenses	562,235	433,705
	-464,289	**-332,557**
Share of loss of associates	**1,055**	**-518**
LOSS BEFORE TAX	-1,477,829	-427,967
Taxation	-16,104	43,961
LOSS FOR THE YEAR	**-1,461,725**	**-471,928**
Attributable to:		
Equity holders of the parent	-1,337,319	-497,034
Non-controlling interests	-124,405	25,105

Note: * PwC's restated data for FYE 2015. HRK/€ exchange rate: 31 Dec.
Source: Author's work, based on [5].

Table 2: The Agrokor Group's consolidated balance sheet for 2016 and 2015

in 000 EUR, FYE	**2016**	**2015***
ASSETS		
NON-CURRENT ASSETS		
Property, plant and equipment	3,297,920	3,271,196
Investment property	31,829	29,201
Intangible assets	167,043	450,965
Biological assets	56,559	56,531
Investments in associates using the equity method	36,476	22,897
Other non-current financial assets	284,471	421,025
Deferred tax assets	26,362	21,169
TOTAL NON-CURRENT ASSETS	**3,900,660**	**4.272.985**
CURRENT ASSETS		
Inventories	697,436	829,210
Biological assets	43,430	47,226
Assets held for sale	16,257	236,991
Loans and deposits	111,518	215,304
Accounts receivable	457,701	804,977
Recourse receivable	62,010	148,722
Other current assets	161,802	186,093
Cash and cash equivalents	73,697	78,198
TOTAL CURRENT ASSETS	**1,623,851**	**2,546,722**
TOTAL ASSETS	**5,524,510**	**6,819,706**
EQUITY AND LIABILITIES		
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT		
Share capital	23,833	23,592
Reserves	-2,392,817	-989,007
	-2,368,984	**-965,415**
NON-CONTROLLING INTERESTS	**445,971**	**581,862**
TOTAL EQUITY	**-1,923,013**	**-383,553**
LIABILITIES		
NON-CURRENT LIABILITIES		
Borrowings	3,585,228	3,223,535
Provisions	58,394	78,550
Deferred tax liability	78,488	135,809
Other non-current liabilities	37,528	50
TOTAL NON-CURRENT LIABILITIES	**3,759,638**	**3,437,944**
CURRENT LIABILITIES		
Accounts payable	1,402,450	1,324,147
Bills of exchange and recourse liabilities	227,365	251,230
Income tax payable	12,374	16,965
Borrowings	1,718,074	1,880,935
Liabilities due to shareholders for dividends	-	437
Other current liabilities	327,622	291,601
TOTAL CURRENT LIABILITIES	**3,687,885**	**3,765,315**
TOTAL LIABILITIES	**7,447,523**	**7,203,259**
TOTAL EQUITY AND LIABILITIES	**5,524,510**	**6,819,706**

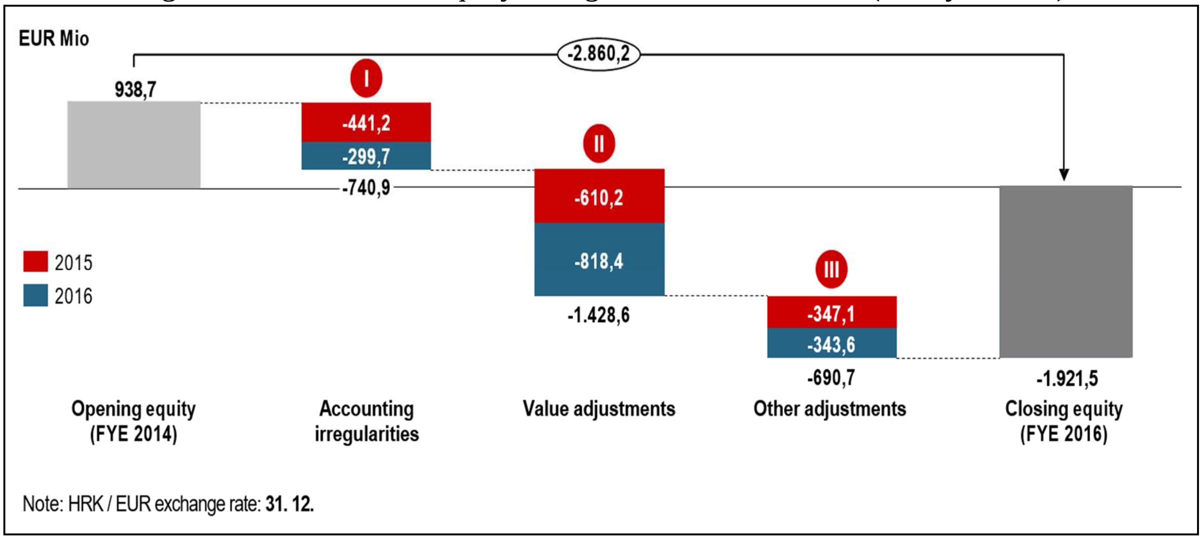
Note: * PwC's restated data for FYE 2015. HRK/€ exchange rate: 31 Dec.
Source: Author's work, based on [5].

Table 3: Overview of Agrokor's leverage ratios for 2016 and restated 2015

	2016	**2015**
Total debt/adjusted EBITDA	-16.1x	6.2x
Net debt/adjusted EBITDA	-15.8x	5.5x
Adjusted EBITDA/interest expense	-0.7x	1.8x
Total debt/equity	-2.9x	3.4x
Cash/short-term debt	0.0x	0.4x

Source: Author's work, based on [5], [6].

Figure 1: Consolidated equity change from 2014 to 2016 (in €, year-end)



Source: Author's work based on [5].

4. ATTRIBUTIONS/CAUSES OF FAILURE

Our (brief) discussion of failure causes is based on the typical postulation of external or internal factors that crucially run the show. From seminal works dating some four decades back, it is deeply rooted into today's deterministic and voluntarist school of thoughts [7].

In Agrokor's specific case, the auditor's findings together with the indicated lack of corporate governance[47] suggest that the deterministic perspective of business failure has no firm foothold. Among "usual suspects" in external failure causes, viz. economic change, competitive change, government constraints, social and technological change [9] we cannot find plausible evidence of exogenous factors, except for the possibility of government's influence. Since the business story of Agrokor fits fairy well into the crony capitalism picture [10], it is not difficult to imagine that a company can grow to systemic "importance" by political protection or favoritism. If the company's crown outgrows the government, a system of patronage can indeed arise, with the business(man) having the upper hand in political and/or economic issues of interest. From the business(man) perspective, the government's change of attitude (i.e. withdrawal from such embranchment) could be considered as an external force of overturn. The

[47] Although probably not without biases, the extraordinary trustee testifies dramatically in his adress to the Parliamentary Committee on the Economy that he „*…found a situation of complete chaos and a lack of basic standards of good corporate governance. For instance, Management Board sessions were not being held. At Agrokor there were no minutes containing an agenda or decisions made and which all Management Board Members would have voted for. This was not existent at Agrokor. All decisions were made by only one man based on his personal assessment, although this is a complex system of more than 160 companies.*" [8]

government's decision of leaving the troubled firm's accountable parties to bear the costs of failure is definitely a game changer, but since European rules apply in Croatia for quite a while, the argument sounds pretty convincing that this decision is only about unravelling the risk(s) of failure in an acceptable manner. From that perspective, regardless what some stakeholders (e.g. business owners or creditors) expect in such situations as appropriate government behavior, unfulfilled (bailout) expectations will hardly be judged as failure causes.

For insight from the voluntarist perspective, we lean on the Argenti's A score [11], [12], [13], one of the most notable qualitative models of corporate failure prediction. The A score suggests that defects and mistakes that may lead to serious troubles (i.e. management weaknesses which originate from autocratic behavior, high share of debt capital), which were present in the Agrokor Group even before 2014 (table 4).

Table 4: The A score for Agrokor in 2014

2014 (Year end)	**Y/N**	**Agrokor score**	**Argenti score**
1. DEFECTS			
CEO-autocrat	**Y**	8	8
Chairman of the board is CEO as well	**Y**	4	4
Board inactivity	**Y**	2	2
Internal contradictions inside the board	**N**	0	2
Weak financial director	**N**	0	2
Lack of professional middle and lower managers	**N**	0	1
Accounting system downsides:	**N**	0	
Absence of budget control	**N**	0	3
Absence of cash flow forecast	**N**	0	3
Absence of the system of managerial accounting of expenses	**N**	0	3
Slow reaction to changes (appearance of new products, technologies, markets, labour organization methods, etc.)	**N**	0	15
Total score		**14**	**43**
2. MISTAKES			
Too high share of debt capital	**Y**	15	15
Lack of working capital (excessively fast growth of the business)	**N**	0	15
Big project (financial sustainability)	**N**	0	15
Total score		**15**	**45**
3. SYMPTOMS			
Deterioration of financial indicators	**N**	0	3
Usage of „creative accounting“	**N**	0	3
Non-financial signs of troubles (product quality decrease, team environment deterioration, market share decline)	**N**	0	3
Final symptoms of the crisis (legal claims, scandals, resignations)	**N**	0	3
Total score		**0**	**12**
A-SCORE		**29**	**100**

Source: Author's work.

The acquisition of Mercator accelerated the show up of working capital shortage, another contribution to the particularly relevant mistake section of Argenti's model. Thus, the A score indicated a score of 12 or more in defects and 30 in mistakes for several years before the final collapse. In Argenti's view, failure is a sequential process towards the ultimate demise of the company, stemming primary from management defects converting into mistakes and lastly becoming visible as symptoms of failure. Out of his causes and symptoms of corporate failure, poor management (one-man rule, non-participative board of directors, unbalanced top management), defective accounting information, excessive gearing, uncomfortable financial ratios, creative accounting and management's denial of circumstances can be observed in Agrokor's case. Furthermore, the large number of acquisitions and heavy investments in modernization and upgrades indicate that the „Big Projects" (in which costs and time are underestimated and revenue is overestimated) could also be named.[48]

5. CONCLUSION

We epitomize our conclusion into Argenti's analogy about ships and their captains: "*If a ship is in good condition and the captain is competent it is almost impossible for it to be sunk by a wave or a succession of waves. Even if there is a storm, the competent captain will have heard the weather forecast and taken whatever measures are needed. Only a freak storm for which inadequate notice has been given will sink the ship*". [49]

The condition of the ship is of course mostly the captain's responsibility and even good ships can sink due to strange storms that develop under highly unusual and unlikely circumstances. In Agrokor's case, hints that trouble was ahead were evident for some time (years). The final storm itself was obviously quite weird. Therefore, aside from internal failure causes, external factors look very appealing for deeper and further research. The role of the Croatian government seems to be particularly promising for exploration.

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[48] Conditionally though, due to hindsight bias and lack of credible historical data.

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