SPOTLIGHT ON VALUE

economic and market ideas and how they may benefit our investors

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German banks have grown vastly more critical of their business customers - we look at the problems of Babcock Borsig, Fairchild Dornier and DorintGruppe ……

German banks were expecting a windfall from selling off their shareholdings in industry following that change in the law on capital gains tax which came into effect in January of this year. More than 50% of German equity is tied up cross-shareholdings which has often resulted in inertia, whether it be a refusal to invest, to venture into unfamiliar fields, to seek out new markets, or to stir up poor managements or oust leaders who are failing their businesses. It was widely expected that the banks would be relatively quick off the mark to start the process of selling their shareholdings. Indeed, that was one of the main aims of the change in the law : to invigorate equity trading and to bolster the returns on capital invested by using market mechanisms to re-assign capital to more profitable uses. However, the markets have not offered the banks a particularly good climate in which to undertake any of this.

Instead of a windfall from unloading corporate stakes, the German universal banks have been faced with a wave of domestic business insolvencies. This may be one of many factors driving the banks to be decidedly cautious in their support of businesses that have

hit financial difficulties. Where once the government could be fairly sure that the banks would go along with it in a drive to turn a failing company round, and between government subsidies and banking finance, companies in trouble could hope for the funding to tide them over the difficult times, now the banks are increasingly saying no.

It does not help that, in the wake of corporate scandals in the US such as Enron and WorldCom, investors and analysts everywhere have become warier than ever. It does not help that the financial markets are constantly on the look-out for the next Enron wherever it may be. Several of the euro zone’s biggest companies are among the weakest European enterprises, including household names like Deutsche Telekom, France Telecom, ABB and Ericsson, or heavy industrial companies such as Alcatel, the electronics group, Alstom, the engineering company and chemicals producer Rhodia. Faced with higher debt and weaker revenue growth, a number of these companies could be open to merger or acquisitions that might then boost their standing. Many have uncertain credibility because investors fear a lack of transparency over their finances and find their management style opaque. There is currently a crisis of confidence which is greatly exacerbating any problems a company may have to a far greater degree than normal.

The German government is responding to this by calling for the federal supervisory authorities to be given increased powers. Jörg-Otto Spiller is an SPD expert on finance policy and also the designated president of BAFin, the federal body responsible for supervision of the financial services industry. Spiller is arguing for BAFin to have greater scope for examining the work of auditors. Opposition parties are also calling for greater protection of investors, with Matthias Wissmann, the economic policy expert for the CDU, pressing for an end to any company being able to serve both in an advisory capacity and as an auditor. Spiller has emphasised the point that more and more ordinary people in Germany are investing in equities or in equity-based funds to finance their retirement and such investments must not be put at risk by balance-sheet chicanery.

When two major German companies have had to put themselves into the hands of an insolvency administrator, this may already seem to be a case of too little and too late. It is notable in the cases of Fairchild Dornier and Babcock Borsig, just as in the earlier cases of KirchMedia and Philipp Holzmann, that the government or regional (Laender) government sought to find some kind of rescue package for these companies and that it was the harder line taken by their banks that finally brought about their demises.

There were intensive efforts by the German and the Bavarian governments to save Fairchild Dornier, Germany's last wholly German plane maker. The company's flagship 728/928 programme for a 70-seater regional jet was a high-profile project carrying a lot of national pride, but this was left high and dry when its partners, the Canadian firm Bombardier Inc. pulled out of talks. Fairchild has so far invested one billion euros in it and, of course, the programme has yet to generate any revenue. So the insolvency administrator, Eberhard Braun, now has the job of finding a buyer if possible for the 728/928 programme while hiving off the ''operationally profitable'' aircraft-components assembly activities and finding a buyer for that. The MAN AG unit Man-Technologie may be interested. The Italian Alenia Aeronautica SpA, part of the Finmeccanica conglomerate, which originally showed an interest in the 728/928 programme, have backed out, saying that it could not take over the project on its own and had not found a partner. In spite of this, the Bavarian government has not completely given up hopes of preventing the break-up of Fairchild Dornier. Otto Wiesheu, the Bavarian Economics Minister, said he had opened talks with the European Aeronautics, Defense and Space Company (EADS). EADS had already said it wanted to take on some of the employees of Fairchild Dornier; Wiesheu wants to convince EADS that it would benefit by taking on the Fairchild Dornier company structures as well.

Even at the last minute for Babcock Borsig, hopes were raised because the federal and state governments agreed to increase their guarantees to 430 million euros, more than half the total deemed necessary, of which the federal government was prepared to cover 200 million euros. It was the banks, particularly WestLB, a

major shareholder in Babcock Borsig, which refused to play the part hoped for by Wolfgang Clement, the governor of the NordRhein-Westfalen state. Clement defended efforts to drum up a total of 800 million euros to save Babcock Borsig on the grounds that thousands of jobs were at stake, and it is still hoped that the Oberhausen-based maker of heavy equipment, power, water and waste-disposal plants as well as merchant and naval ships, which employs some 22,000 people, can be restructured with the closing down of unprofitable units so that the rest of the company can continue in business. A question mark hangs over how far this is possible. The business consultancy Roland Berger has been called in but four out of Babcock's six creditors had rejected Roland Berger's rescue plans and the main reason for their rejection was that new risks at the company were being discovered almost daily. None of this is very surprising, given that Klaus Lederer, then the chief executive, sold off the best-performing part of the company, Howaldtswerke Deutsche Werft (HDW), and then left to take over the helm of HDW. HDW is the world's largest producer of conventional submarines. Note this was covered in an earlier Spotlight on Value.

Another impending crisis involves Dorint AG, the largest hotel group in Germany. Dr Herbert Ebertz of Ebertz&Partner (E&P), DorintGruppe's chief shareholder and chairman of the supervisory board, has drawn the group into serious mire. Ebertz only recently took over this position at Dorint, taking on an empire of 87 hotels and a 6,300 workforce. This empire is the result of a massive expansion programme undertaken since 1997 which included the opening of 40 new hotels during that period. Dorint has not only been buying up luxury properties such as the Camp de Mar gold resort on the Spanish island of Majorca and the Four Seasons castle hotel in Berlin, but also paying over the odds for them. For the 54-room Four Seasons Dorint paid 1.85 million euros or 34,085 euros per room when the industry estimates that the going rate for a luxury hotel is 16,000 euros per room. This kind of deal alone would be enough to raise an eyebrow or two amongst Dorint's bankmanagers but Ebertz has muddied the waters in other ways, too. E&P obtained a loan of 20 million euros from five banks at the end of June. The money is to be used to help E&P and Dorint to survive a liquidity crisis. As collateral for the loan,

Ebertz used his shareholding in Dorint. This upset Dresdner Bank, Dorint’s principal bank, who cut off Dorint’s credit line and wrote to the group demanding the ‘‘settlement of Dorint’s claims of around 11 million euros against Dr. Ebertz’’. Dorint replaced Dresdner Bank with the Deutsche Post unit, Postbank. In the wake of all this Dorint has posted 2001 losses of 6.4 million euros after profits of 1.2 million euros the previous year. The company is blaming the downturn in the hotel business. Dr. Ebertz is resigning from his position as chairman of the supervisory board.

The further unravelling of the ‘‘Rheinish Stakeholderism’’ ?

Gerhard Schröder, the German Chancellor, had put severe pressure on the banks to agree to a rescue package for Babcock Borsig. Regional governments do no less, as these examples show. Once upon a time Schröder would have found the banks more compliant with his wishes. But the banks are now taking a much harder line than ever they used to do and government guarantees are no longer swaying the issue. Far from finding a windfall of profits from the sale of crossholdings, banks are being faced with the risk, in a few cases, of having to stand firm against demands for finance even when the danger is that the company is pushed into bankruptcy. And the complex network of crossholdings in Germany means that many companies may take a knock as a result of the few.

Watch this space later this week, for a more detailed update on some of the companies

mentioned in this report !