

# **Privatisation of the pharmaceutical sector – problems related to the evaluation of government programmes**

## **The pharmaceutical sector in Poland in the late 1990's**

In the second half of the 1990's the pharmaceutical market was composed of 65 state-owned enterprises, employing in total approx. 24 thousand people.

Manufacturers in the pharmaceutical industry included: 14 state owned “Polfa” plants, 10 “Herbapol” herbal medicine manufacturers, 2 science and research institutes, as well as 6 serum and vaccine manufacturers and 13 galenic preparation manufacturers.

The total number of wholesalers equalled approximately 400, including 20 former state-owned Cefarm enterprises.

The early 1990's were marked with the opening of the pharmaceuticals market in Poland. In 1990 official prices were abolished for imported medicines, in 1992 import duties were abolished for ready-made medicines. Due to the liberalization of the trade policy, about 400 companies started operating on the pharmaceutical market.

Between 1996 and 2001, the sales of medicines grew from €1,125 million to €3,581.5million in terms of value, and from 1,406 million to 1,632 million in terms of packages sold. As the prices of foreign medicines were four times higher than the prices of domestic medicines, the overall market share of foreign medicines in terms of value grew by over a half and constituted two thirds of the market. The quantitative market share of foreign medicines grew from 20.3% to 35% in that period.

The dynamically growing duty free import of ready medicines directly influenced the pharmaceutical market. In the period covered by the audit, the value of imported pharmaceutical goods grew by over 47%, whereas export decreased by over 38% in the same period.

The increase in the cost of generating income from 81% in 1996 to 90% in 2000 resulted in decreased profitability. The financial results in 2000 were lower by 43% to those obtained in 1996.

## **The government programme for the restructuring of the pharmaceutical sector**

In 1994, the Government adopted an Action programme for the restructuring of the pharmaceutical sector. The Programme set forward measures for the development of enterprises, the increase in the sales of domestic pharmaceutical products on the domestic and foreign markets, and the protection of domestic manufacturers' interests. One of the measures envisaged by the Programme was Changing the ownership structure of enterprises and institutes. It was thought that the industry would develop on condition that pharmaceutical enterprises were privatised. The aim of the privatisation was: to ensure the inflow of external sources of financing for the development, improved management, improved effectiveness of the enterprises' operation, as well as implementing the production of new medicines.

In its post-audit evaluation of the Ministry of Treasury, the NIK stated that the Action Programme's positive outcome was the effective privatisation of over 64% of manufacturers (Polfa), 40% of wholesale distribution networks (Cefarm) and 90% of the herbal medicine manufacturers (Herbapol). Thanks to the incurred investment outlay of over €378,5 million, the value of Polfa's fixed assets increased over twofold, and the production quality corresponds to the requirements of international markets. Another effect brought about by the restructuring measures was the extension of the market offer, by registering over 4,300 new pharmaceuticals and medical materials.

### **Main findings of the NIK audit**

1. In its evaluation, the NIK's stated that the rate of privatisation of medicine manufacturers (Polfa) was unsatisfactory. The privatisation process of the Polfa plants was initiated after the Polish market had been opened to importing companies, without any customs protection for Polish entities. This resulted in limited interest on the part of investors in the sector. By the end of 2000, only 9 Polfa plants had been privatised. Their total market share was 20%. Five medicine manufacturers remained state-owned.
2. In its evaluation, the NIK's stated that the privatisation process had the best outcome in four companies where the strategic investor (who purchased 80% of shares) came from within the sector. Factors taken into account included the

interest of the State Treasury, the companies, their employees as well as the state medicine policy.

3. Although privatisation by means of quoting the shares on the Warsaw Stock Exchange brought about the biggest revenue to the budget, it failed to comply with the programme requirements. The State Treasury did not have effective tools of supervision over the product operation of two of the companies

The privatisation of Polfa Łyszkowice, effectuated by the Skierniewice Voivode, did not have a favourable outcome for the State Treasury. Due to unfavourable provisions of the privatisation agreement, the German company Byk Gulden gained the opportunity of taking over, free of charge, shares of the company (owned by the State Treasury) with a nominal value of €1.

The NIK informed the District Public Prosecutor's office in Łowicz about a reasonable suspicion of an offence committed during the Polfa Łyszkowice privatisation process.

After the completion of the audit process, the Chamber also forwarded to the Minister of Treasury audit protocols relating to the Polfa Łyszkowice privatisation, as well as the documents delivered to the Public Prosecutor's Office, in order to initiate measures that would limit the negative impact of the privatisation agreement on the State Treasury.

While the privatisation of medicine manufacturers was generally done in consistence with the programme, the privatisation of "Cefarm" medicine wholesalers was done without any preparation whatsoever. This process was implemented by government representatives – the Voivodes. Lack of any strategy that would determine the method and aims of the privatisation contributed to the fact that the privatisation was initiated by the management of the enterprises and was subject to pressure from them. Consequently, the Cefarm privatisation involved the use of privatisation funds created by the enterprises, with no external financing. Companies, created by the employees, which took over the existing enterprises did not have sufficient assets to cover payments due for the use of State Treasury property, or sufficient investment funding. Privatisation involving the employees exclusively, with no external financing, did not ensure the implementation of any development measures in the privatised enterprises. Most Cefarm enterprises witnessed a situation in which the employees sold their shares, and capital was accumulated by people who formerly held

managerial positions in the privatised enterprise, or natural persons acting on behalf of legal entities – companies quoted on the stock exchange.

However, the most serious mistake that the NIK revealed was the lack of a coordinated sales process of the distribution network. Before the privatisation, all Cefarm wholesalers in total operated throughout the whole territory of Poland. When particular enterprises with regional range were sold separately, the network became dispersed. The NIK was of the opinion that the effect of scale was not used appropriately. As a result, some of the underinvested companies soon went bankrupt.

## **Main conclusions**

During the process of privatising these enterprises, some mistakes were committed that are typical for privatisation processes: failure to update price estimates, undervaluing the companies, failure to monitor the performance of obligations on the part of investors. Obviously, the NIK's recommendations included improving the operation of public administration in order to avoid similar irregularities in the future.

However, the NIK mainly recommended that the Minister of Treasury should draft a privatisation programme for the remaining five Polfa plants and implement it.

At the moment of completing our audit:

Polfa Tarchomin (in Warsaw) had not regulated the legal status of their land and its financials were drastically deteriorating. One of the two potential investors withdrew exactly for that reason: there were claims pertaining to the land where factory shops were located. The other investor was rejected due to intense protests on the part of the staff of the enterprise.

Polfa plants in Lublin, Grodzisk Mazowiecki and Pabianice had positive financial results. Two investors were interested in purchasing Polfa Lublin, and the Minister of Treasury held negotiations with both of them. In the remaining two companies neither the management nor the staff were interested in privatisation.

Polfa Warsaw was not interested in getting privatised either.

## **The second audit of restructuring and privatisation in the pharmaceutical sector**

In 2007 the NIK investigated the pharmaceutical sector again, paying particular attention to the actions of the Minister of Treasury towards entities that had not been

privatised. Previously, while preparing for the audit, the NIK had been informed by the Minister of Treasury that the Government had developed and adopted a new programme for the restructuring and privatisation of the pharmaceutical sector. The government has been successfully implementing it for a few years. Therefore we decided to perform the 2007 audit. The aim of the audit was to assess the effects of the government administration activity within the scope of restructuring and privatisation of entities from the pharmaceutical sector, including above all:

- the regularity of privatisation processes in enterprises within the pharmaceutical sector;
- the protection of State Treasury interests;
- the implementation of the *Strategy for the pharmaceutical industry up to 2008*, adopted by the Council of Ministers;
- the restructuring of enterprises within the pharmaceutical sector.

## **Strategy for the pharmaceutical industry up to 2005**

The government implemented the NIK's recommendation and adopted a new government programme called Strategy for the pharmaceutical industry a few months after the completion of the audit (in 2002). The Strategy for the pharmaceutical industry stated that the changes in the ownership structure of the pharmaceutical companies effectuated until that time had not brought the desired effects. Investors focused on manufacturing the existing range of medicines, using Polish companies as packaging sites and warehouses for imported medicines. Therefore, it was reasonable to create an entity, supervised by the State Treasury, which would manufacture medicines substituting imported goods and thus constitute a counterbalance for foreign companies, by being able to e.g. manufacture cheap medicines listed as subsidised medicines.

The principal element of the Strategy was the Plan of restructuring and privatisation of the pharmaceutical sector, whose implementation was to meet the assumed aims:

- social (providing the availability of cheap medicines, counteracting unemployment),
- strategic (creating a strong, competitive capital group with a national range),
- reinforcing the development of the capital market by privatising the restructured holding on the Warsaw Stock Exchange),
- financial (making savings for the state budget due to implementing a sound policy of subsidising medicines, decreasing the unfavourable balance on the current turnover account, in order to favour Polish manufacturers)

- developmental (preparing the pharmaceutical sector to meet the demands of competition related to entering the EU, gaining new markets for the sale of Polish medicines).

In order to achieve these aims, state-owned entities within the pharmaceutical sector were to undergo restructuring and privatisation. However, as it was demonstrated by the previous audit, the entities that had not been privatised were still in a poor economic and financial condition and it proved impossible to find a potential investor.

The NIK investigated the way the new programme was constructed and whether the difficulties with its implementation were foreseeable.

The NIK concluded that the aims of the Programme for the restructuring and privatization of the pharmaceutical sector were inconsistent – implementing some of them made it impossible to implement some other aims of the Programme. Social aims were inconsistent with financial aims – it was practically impossible to implement the aim of ensuring common availability of cheap medicines while assuming tangible savings for the state budget. Social aims were also inconsistent with strategic and developmental aims. The created state-owned capital group was supposed to manufacture cheaper products than those provided by foreign entities operating on the Polish pharmaceutical market, push such entities out from the Polish market and successfully compete against them on the eastern markets. Still, no cost reductions were foreseen related to possible cuts in employment – it was assumed that the number of jobs was going to be maintained. The plan indicated the need to incur extra costs related to the adjustment to requirements resulting from entering the European Union. This involved relatively higher manufacturing costs. In the NIK's assessment, the authors of the Strategy also failed to take into consideration the fact that the capital group was to be composed of entities which had previously proved impossible to be privatised, including entities that suffered a difficult economic situation and had generated high losses in the previous years.

The NIK also found measures taken by the Minister of to be unreliable. The Minister of Treasury failed to analyse the feasibility of the concept of creating the holding, or to analyse the composition of the consolidated group. Although the government programme indicated various methods of consolidation, it was the duty of the Minister of Treasury to conduct an analysis in order to determine the most effective method of consolidation and selection of the consolidated entities. As our audit revealed, the concept of a holding was

adopted. The holding included four entities manufacturing pharmaceuticals, two of which were in a very poor financial condition.

The Minister of Treasury failed to take into consideration the remarks and opinions forwarded to him by other ministers.

The Minister of Finance pointed out that there were no legal grounds for creating a centralized holding. The President of the National Bank of Poland was of the opinion that the programme did not give answers as to the methods (and mechanisms) used to achieve the aims of the programme. The authors of the project wanted to create a holding based on the “equality of the consolidated entities”, even though these entities varied in terms of their financial results. Moreover, their financial results, financial condition and managerial potential seemed too weak for them to play the role of an actual leader in financial consolidation.

Other members of the government pointed to the lack of sufficiently strong arguments in favour of consolidating the pharmaceutical sector. There was a threat that the weaker companies could have a negative impact on the value of the whole group. The main aim of restructuring the pharmaceutical sector should be to raise the profitability of manufacturing pharmaceuticals in Poland, as opposed to social or political and economic aims.

## **Implementation of the programme**

Difficulties in the implementation of the faulty programme lead to a situation in which four years were wasted in the process of restructuring and privatisation of enterprises. The Minister did manage to create a holding called the Polish Pharmaceutical Holding SA (PHF SA), but other measures were implemented sluggishly.

The failure of the consolidation process resulted from lack of action or delayed action on the part of the Minister of Treasury. The Minister surrendered to the pressure from the management boards and trade unions of the PHF SA daughter companies, who were reluctant to see the entities consolidated. The entity created for the purpose of the consolidation – PHF SA had limited influence over the companies despite being their majority shareholder. The Minister of Treasury was late to forward to PHF SA tools necessary to perform shareholder’s supervision, i.e. appointing most of the supervisory board members in the daughter companies and introducing relevant changes to the statutes of these companies. This made it difficult to adopt resolutions that would enable the consolidation. The Minister of Treasury did not react to signals from PHF SA referring to the necessary changes in the consolidation concept (a

concern instead of a holding). This state brought about the existence of an entity that generated only costs – between 2004 and 2006 PHF SA, which was not actually operational, incurred expenses of €3 million. These costs were covered from the dividends of the daughter companies, previously directed to the state budget.

## **Restructuring of the entities**

Lack of action or insufficient restructuring measures in the pharmaceutical sector entities remaining under the supervision of the state treasury caused the deterioration of their economic and financial condition, decrease in profitability and competitiveness. Despite the relatively low effectiveness of human resources in the entities involved in the consolidation, no employment restructuring measures were introduced, and the Social Contract that was concluded made this process even more difficult. Social contracts guaranteed all the staff job security for the period of 10 years, with no deterioration of working conditions, a salary increase every year, free transport to work and the obligation to obtain a written consent from the trade unions to perform any restructuring measures. The need to incur significant costs in order to adjust to EU requirements made it necessary for the companies in the sector to limit investment outlays as well as research and development funding. As a result of this, none or fewer new medicines were introduced to the manufacturing process. This made it impossible to meet the target sales revenues and contributed to further deterioration of the financial results. The companies also failed to limit their operational costs by completing the property restructuring and effectuating organizational changes. Their economic situation was worsened even further by concluding unfavourable commercial contracts.

## **Privatisation**

The privatisation of PHF SA never took place, due to the failure of the consolidation process. The privatisation of Polfa plants not involved in the consolidation and the supervision of the Ministry of Treasury over the performance of contractual obligations under privatisation contracts were implemented correctly. Share packages were purchased by investors within the sector.

However, the privatisation measures towards the remaining entities, including distribution enterprises, were inept. Similarly to the findings of the previous audit, it was revealed that the privatisation was not coordinated by particular supervision bodies (the Minister of Treasury and the Voivodes). In most cases, the privatisation processes resulted from the initiative and pressure on the part of the enterprises' managerial bodies and

employees. The dominant mode was direct privatisation by way of bringing the enterprise as contribution in kind to the company. Still, no capital gains were ensured and, at the same time, all influence was lost over the management and the influence over supervising the created companies was limited. The causes of failed privatisation processes included:

- lack of necessary restructuring measures or insufficient scope of such measures,
- weak measures or lack of measures on the part of the management bodies,
- lack of arrangements between the founding body, the bodies of the enterprise and trade unions as to the selection of privatisation mode, or
- unregulated legal status of the enterprise's properties.

## Summary

The NIK usually issues a positive evaluation of the Minister who has implemented its request. It was also the case this time. On completing the first audit, the NIK came to the conclusion that the old restructuring and privatisation programme was no longer up to date. Therefore, the NIK suggested updating it or creating a new programme taking into consideration the situation within the sector. And the Minister implemented this request. Only, was it possible to evaluate his actions positively and conclude that the NIK's recommendation was implemented? In our opinion, it was not. Another question arises – was the conclusion correct? Here, the answer is not so simple any more. This creates a dilemma as to how specific the NIK's conclusions should be. Should we only point to the directions of the desired solutions, or should we give detailed advice and thus do the work of the audited entity in terms of operational management? This problem has remained with us since the audit was completed. Another one also appeared: what would be the best conclusion to present after the second audit? The natural thing was to suggest that the Minister should develop a new programme. But what will happen if he develops this one inappropriately as well?

This time we were more specific. The main conclusion from our audit was that the Council of Ministers should take a decision on the entities consolidated within PHF SA: select the method of consolidation or refrain from the consolidation altogether.

The Minister of Treasury informed us that such a decision had been taken. The holding is to be dissolved and the particular entities will be privatised separately. Another programme has been drafted which multiplied the concept included in the first programme.

Six years have passed, immense costs have been incurred to cover the operation of the holding and the restructuring opportunity has been wasted.

Perhaps we shall perform another audit in a few years' time.