

Framework Plan for the Zagreb Stock Exchange, 2010-2014

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Pursuant to the tender requirements issued on December 28, 2009, the Zagreb Stock Exchange ("ZSE") has requested a short "program of work for the next 4 years" be supplied with all applications for the vacant Management Board positions. This requirement loosely translates into a request for a broad framework strategic plan ("Framework Plan"), which is provided herein, using the following assumptions and limitations:

- All information regarding the ZSE's operations, challenges, aspirations and goals used herein is gleaned from public sources.
- Given the timeframe of the tender, very little time was available to do the requisite research and to formulate this Framework Plan.
- This Framework Plan is confidential and is the property of Indium d.o.o. ("Indium"). It is provided for the exclusive purposes of potentially providing consulting services to the ZSE and/or for the hiring of Milan A. Račić as the new President of the Management Board of the ZSE. Indium reserves the right to publish or use this Framework Plan, in whole or in part, on its website (www.pureindium.com) and/or in any other forum or publication it chooses, unless otherwise agreed to between Indium and the ZSE.

A. Resource Assessment & Re-allocation (Months 1-12)

Even a casual review of the information suggests that the ZSE is not optimizing the use of its physical, human resource and technological assets. As a first step, a full review of the allocation of resources is a priority. We suggest the following steps to ascertain the current resource allocation for purposes of optimization:

1. **Service Contracts** - All service contracts with a yearly value over 120.000 Kunas would be reviewed. Those found to be of questionable value would be terminated at the lowest cost possible to the ZSE. Given the current economic climate, we would also seek to renegotiate existing contracts with those providers whose services we wish to retain.
2. **Physical Assets** – A full inventory of leased and owned property would be undertaken. All relevant agreements would be reviewed. Those agreements found to be superfluous to the ZSE’s optimal operations would be terminated, while all others would be renegotiated to more reasonable levels, where possible (given existing contractual commitments entered into by the previous management).
3. **Human Resources** – All other changes to the way the ZSE operates are incumbent on having a team which is:
 - **Cohesive**
 - **Motivated**
 - **Dedicated**
 - **Focused**
 - **Driven**
 - **Honest**

Therefore, we would undertake a full review of the ZSE’s labor force. The review would encompass staff numbers, responsibilities and compensation. The aim of the review is to ensure that the ZSE is making full use of its human resource assets at a reasonable cost.

4. **Regulatory Review** – A review of the existing regulatory framework for the ZSE’s and listing members’ functioning would be undertaken. This would be done with a view to making changes, and lobbying for changes where the regulatory framework is not within the ZSE’s purview, so as to increase transparency, liquidity and the ZSE’s market positioning.

B. Strategic Review (Months 1-4)

1. **The Past** – While the ZSE experienced undeniable growth over the past few years, so did the Croatian economy in general, so did the world economy, and most importantly, so did almost all stock exchanges. Thus, while the ZSE’s growth over the previous few years is undeniable, its *strategy* for continuing that growth and/or managing through the current economic crisis is unclear. In other words, the ZSE appeared to ride the wave of growth until the start of the current economic crisis with no plan for how to move forward.

Acquisitions & Mergers: The ZSE wisely merged with the Varaždin Stock Exchange. The management of the ZSE appears to have considered taking over various regional stock exchanges in neighbouring countries, but little headway was made in that regard. It is understood that the owners of the ZSE see the sale of the exchange to a stronger CEE exchange as their optimal exit strategy. This is probably true, but the ZSE has lost valuable time in positioning itself for a viable near-term sale and exit.

As the saying goes - "You make hay while the sun is shining", meaning that one prepares for hard times during the good times. The ZSE appears not to have done that and currently finds itself without a compelling story as to why it is a good buy for most potential purchasers.

2. **Current Positioning** - The ZSE is a product which needs to be packaged and pitched. The first step in doing that successfully is to ascertain where it fits in the marketplace. We would undertake a review of the ZSE's current positioning in the CEE market, based on volume, product mix, regulatory framework, cyclical framework, and potential market breadth and depth.

If the ZSE is just one of 15 similar local low-volume exchanges, which are basically undifferentiated, it is difficult to rationally expect a price above that to be gotten for a nominal placeholder, *i.e.*, a buyer would only acquire the ZSE for its presence in the limited Croatian market.

By way of analogy, Konzum (Plus) and Sonik have taken over dozens of small generic mini supermarkets in many small towns throughout Croatia. Most were not purchased or rebranded because of their stellar performance. Rather, they were taken over in order to build the Konzum Plus and Sonik brand and their perceived breadth. In times of plenty, like in the period from 2003-2008, it was possible to make a plausible argument that each of these hardly-profitable mini markets deserved somewhat of a premium price as they would help the parent company build its network breadth, and thus their valuations (built on expectations of constant price appreciation). However, in these more sober times, such an argument is not plausible, and many of these mini markets are currently being taken over just to put them out of their unprofitable misery, and the prices reflect that fact.

It is possible to gain superior pricing on undifferentiated products in a hot market, where speculative premiums based on irrational growth expectations are readily paid. However, the ZSE does not currently find itself in such a speculative CEE or European stock market environment and it is highly unlikely that we will see anything like it in the near term.

C. Product Development (Months 1-48)

The ZSE must differentiate itself above the placeholder crowd. In summary, the ZSE must be better, faster, and more profitable than competing exchanges. **The only way that this can be achieved is the through following approach:**

1. **Transparency** – The ZSE cannot be the largest market in the CEE, but it can be the most transparent one. Transparency is a case where small exchange size can be a comparative advantage for the ZSE. The relatively limited and manageable number of listed securities makes regulatory compliance easier. The best approach would be to work with HANFA, the HNB and the Ministry of Finance with an aim to fine-tune the regulatory environment in order to ensure transparent, consistent and honest reporting by its listed issuers. Then, enforce, enforce, and enforce (!) that regulatory environment.

The ZSE should emulate the HNB in terms of its market positioning and branding. The HNB currently enjoys an enviable local and international reputation as an honest broker when it comes to monetary policy. It tells the news like it is – the good, the bad and the ugly. This is the only way to generate long term credibility. The ZSE must strive to emulate this model of behaviour in the stock environment. Why is this critical? It is critical because the ZSE cannot be the largest exchange in the CEE, but it can be the most transparent, honest and even-

handed one which adds intangible as well as real value to the exchange and makes it an attractive purchase for future buyers.

Given recent political events in Croatia, particularly those linked to identifying and stamping out corruption at the highest levels, it is highly likely that all moves by the ZSE towards greater transparency would receive support from the Croatian government, the EU, the USA, the media, most listed companies, and most importantly, from investors.

2. **Liquidity** – The ZSE, like similar exchanges in the region, is choked by a lack of liquidity. The trading systems, the reporting systems, the accounting systems, and even the compliance systems need a minimum volume of trading to absorb the requisite costs and to provide for a reasonable return. At current low trading volumes, the ZSE, like all similarly-sized exchanges, is vulnerable to price manipulation, or at least the perception of manipulation. Whether this manipulation is real or perceived, it drives away trading. In addition, every case of late reporting, non-reporting, or false reporting which goes unpunished drives another nail in the liquidity coffin. On the other hand, real efforts to increase transparency and honesty in the functioning of the exchange builds credibility, and over time, trading volume. Building credibility must be a long-term goal as it takes years to cultivate.
3. **New Products** – Before developing and introducing new products to its marketplace, the ZSE should talk to potential buyers to ascertain what aspects of your operations they would want to see further or newly developed. The ZSE cannot just be a “Mini Me” of the Vienna, Warsaw, or any other larger market. It simply cannot compete. It needs to find a specialty niche at which it can excel. This niche must be profitable, but not large enough to warrant the larger exchanges developing their own markets. The best place to find out about such markets is to approach the larger exchanges with the aim of a knowledge exchange. The larger exchanges know what they can and cannot do well. Because of its size, the ZSE is non-threatening to the larger markets, thus they are more apt to want to share their experiences and ideas. The critical requirement to gaining their help is to know how to talk to them and to gain their trust. Fluency in an international language (such as English) is not the only requirement for this endeavor to be successful - knowledge of English is expected and is really a basic requirement. More importantly, however, is carriage – knowing how to speak to them in a style that resonates among an *international* business community.

D. The Impediments to a Quick & Profitable Exit (timeframe N/A)

The possible sale of the ZSE, in whole or in part, at a reasonable price is not likely to happen in the very near future. It could happen quickly, but it is unlikely. As a responsible and profit-oriented organization the ZSE must prepare for the probable, not the hopeful. Such a sale or strategic investment is most likely to happen in the period from 18-48 months. As much as the shareholders of the exchange appear to want a quick exit, it probably will not happen for the following two reasons.

1. **Groundwork Not Completed** - The groundwork for preparing the ZSE for profitable sale should have started a minimum of 5 years ago. Preparing a product such as an exchange for market is not an overnight proposition, but is the result of deliberate, sustained and meticulous strategy and execution. Although various positioning strategies for the ZSE were discussed, none were implemented.
2. **Weakness of Possible Purchasers** – Most of the talked-about purchasers of the ZSE, and most exchanges in general, are just coming out of their worst years in history in terms of performance. Exchanges around the world are currently in stabilization mode. They have stemmed the tide of drastically declining revenues and are reviewing their future growth options. The sale of the ZSE to some of these exchanges faces several hurdles unrelated to

the way the ZSE operates, including: the lack of a clearly defined and agreed growth strategy, the lack of financing, and the fact that Croatia is a secondary market in terms of size and growth potential.

E. Making a Profitable Exit (Months 1-48)

There is no point in lamenting the opportunities missed in previous years. The goal of this Framework Plan and the job of running the ZSE is to turn the exchange around. As stated earlier, this cannot be done overnight, but it can be done.

1. **The Sales Process Starts on Day 1** - Although we have stated that it is likely that it will take 18-48 months to successfully sell or merge the ZSE with a strategic investor, this will not happen unless the sales process starts on Day 1. The Resource Re-allocation, the Strategic Review and the Product Development are all geared towards repackaging the ZSE for sale and this process must start from Day 1 and continue until the sales proceeds hit the shareholders' accounts.
2. **Profitability** - The Resource Assessment & Re-allocation efforts we discussed in Section A are designed to make the ZSE a leaner and more efficient organization. In the end, in selling the ZSE as a product, we are selling profits – past, current and future. Everything that the ZSE has done well in the past, must be done better. Everything that the ZSE has *not* done well in the past, must be fixed or discarded. The ZSE will find an attractive buyer if it is profitable in the long-term. By virtue of its size, it can't make the biggest profits in the industry. However, steady ROI and ROE are very desirable in today's investing world and will always attract a suitor.
3. **Target Audience** – The ZSE has done a fairly good job of communicating with the Croatian business community and its media players. It is commendable that the exchange has all documents available in English on the website – a rarity within the Croatian corporate community. However the ZSE impresses its own family with this, so to speak. Foreign buyers will demand more from the exchange. Communication will be improved though greater transparency.

If the ZSE is to find a foreign buyer or strategic investor who is willing to pay top price, it must make itself not only attractive but also available. Instituting the changes advocated by this Framework Plan will make the ZSE more attractive but it must also avail itself to potential buyers through positive media attention and active contribution within business markets where its potential buyers reside and operate.

Getting consistent, and good, press in foreign marketplaces is made difficult by Croatia's small economic footprint and its foreignness. These are challenges faced by many smaller countries and businesses in larger media marketplaces. However, they can be overcome if one has a good story to tell (profitability and growth) and can tell it well. Telling the story well to a larger, richer and more sophisticated target audience requires the following:

- Fluency in the lingua franca of international business – English – or of the specific target language
- A very good understanding of the target audience's strengths and weaknesses, hot-button issues (how do press them or avoid pressing them, as the case may be)
- A very good understanding of how the target audience processes and analyzes information
- Most importantly, an understanding of how the target audience makes decisions

F. The Keys to Success

In many ways, a small country, or a small business, or a small exchange, must know its larger partners, acquirers, and/or competitors better than they know themselves in order to overcome the disparities of wealth, power and stage time. Instituting the advice of this Framework Plan, including an intelligent communications policy, will make the ZSE into a profitable organization in the long-term, whether the ultimate goal is to sell to a foreign buyer or not. While the previous leadership missed the boat in terms of preparing the ZSE for the current economic crisis, let alone sale to a foreign buyer, all is not lost. By increasing transparency, liquidity and developing a brand for itself, (a niche in which it can excel), the ZSE could someday serve as the exemplar for other similar low-volume exchanges.