GRUPPO FERRUZZI: A NEW GLOBAL COMPANY

Raul Gardini, known as "il contadino" or "the farmer" in Italy, and his company Gruppo Ferruzzi, represented a new global company that had a leadership role to play in both the agricultural and chemical industries and in the interaction between the two. The Wall Street Journal (July, 1989) recognized Ferruzzi on its list of the 55 companies providing global leadership in the 1990s and as being a major player in the combined field over the next several decades. To manage this complex combination of firms, products, processes and technologies, required an ingenious structure as outlined in Exhibit 1. From this value-added chemical and value-added agroindustry, has emerged a company with a leadership role not only in these two industries, but also in engineering, construction, insurance, real estate, publishing, information services, and merchant banking.

The financial results expected in the first year of operations of the new entity (1989), in spite of a L140[1] billion trading loss had been quite strong as noted in a recent Prudential-Bache Securities analysis (October 20, 1989). The analysis of the company and selected exhibits from that analysis are set forth in Appendix A of this case. The report as noted is very optimistic about the future of the company in the near term. Raul Gardini realized that there were major trends occurring in the world and that his company was not only responding to these trends, but taking a proactive leadership role in responding to the new needs of Europe, the centrally planned economies, North America, and Asia. He realized that through his technology he could make a difference in the combined "green" products that would affect the environment, the food system, and health and nutrition. He also recognized that demands were being placed on the company by centrally planned economies of Eastern Europe to help their food and chemical industries become part of the global food and chemical system. His task was to make certain that a structure had been created that was flexible enough to be responsive to change and creative enough to provide synergies that could cause additional responsible change. He wanted to make the Prudential-Bache projections conservative rather than optimistic.

Gruppo Ferruzzi, the second largest publicly held company in Italy, was founded in Ravenna in 1947 as an agricultural trading company.[2] By 1983, it had become one of the largest agroindustrial companies in

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[1]In 1988, $US1=1,400 Italian Lira.
[2]For additional background, see "Gruppo Ferruzzi: Economics, Politics, and Ethanol," HBS Case No. 588-002, and "Montedison--1986," HBS Case No. 389-067.

Janet Shaner and Marco Sipione prepred this case under the supervision of Professor Ray A. Goldberg as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

the world, and by 1986, after the acquisition of Montedison (the leading Italian chemical company) Ferruzzi had been reviewed as a unified agribusiness-chemical world leader. Ferruzzi owned 71 facilities in the United States and had four companies listed on the New York Stock Exchange.[3] In chemicals, Ferruzzi had become the world leader in fluorine (Ausimont), in anti-cancer drugs (Erbamont), and in polypropylene and advanced plastic materials (Himont). In agribusiness, Ferruzzi had become the leader in refined lecithin, soy protein, and feed pre-mix (Central Soya), Europe's largest grain trader, the largest soybean processor, the number one starch and sugar producer, and it owned 1.8 million acres of land in Europe, the United States, Brazil and Argentina. In Italy, the company was by far the largest agricultural concern, the largest food company, the largest chemical manufacturer, the number one concrete manufacturer, and one of the biggest public works contractors. In addition, the Ferruzzi group had created a joint venture in the basic chemical sector with Enichem, the Italian government's chemical subsidiary, giving life to Enimont, the 7th largest chemical company in the world with $10 billion of sales. At the same time, Ferruzzi had maintained its position in the value added chemical sector (Himont, Ausimont, Erbamont) with $4.5 billion sales.

History of Ferruzzi

Gruppo Ferruzzi had evolved through four different phases in its four decades of existence. It started as an importer of agricultural products from Eastern Europe and the United States. During the years the trading activities grew very rapidly and Ferruzzi became a major worldwide commodities trader. Afterwards, through several large acquisitions and investments, the group became a multinational agricultural and industrial producer.

Traditionally, Italy had been a net agricultural importer, so Ferruzzi started backward integrating and built a 16-silo infrastructure to distribute grain from abroad within the country. This was the beginning of the agroindustrial complex. Trade profits funded vertical and horizontal integration. The company financed and helped build the animal feedstuffs industry for pigs and poultry, set up breeding research facilities, supported local corn production, and trained people in the use of the futures market.

By the 1960s, the company was engaged in an industrial diversification process. The company started a soybean crushing business, Soya Ravenna, and invested heavily in expanding its capacity and storage. At the same time, it started building silos and other infrastructure in New Orleans, Brazil and Argentina, its major sources of soybeans and other grains, and it started a shipbuilding and transport operation. Besides insuring dependable supply and quality, these investments gave the company an insight into local conditions and other business opportunities.

By 1975, Europe had become a major agricultural power. The CAP had been very successful and led first to community cereal self-sufficiency, and then to increasing exports. Ferruzzi's main business

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[3]Ausimont, Erbamont, Himont, and Montedison.

became importing into Italy domestic European surpluses and exporting these to the rest of the world. The company's offices and facilities expanded to London, Madrid, Paris, Brussels, and Chicago.

Also during this period, Ferruzzi bought Eridania and Beghin Say, the largest Italian and French sugar producers. Although sugar was a mature, heavily protected and subsidized industry in Europe, the company was betting on a traditional and strategic sector. The company thought that national governments were unlikely to give up self-sufficiency despite mounting costs. Besides providing steady profits, these acquisitions tied Ferruzzi to one of the largest farm networks in Europe. Sugar beets, unlike most agricultural commodities, could not be stored before processing, and thus close industry-farmer cooperation was critical in this sector.

In 1979, Serafino Ferruzzi died in a plane crash. His son, three daughters, and two son's-in-law met and decided that one of the son's-in-law, Raul Gardini, should head the operation. This decision led to a period of explosive growth.

Raul Gardini was a seemingly easy-going executive who enjoyed going out into the fields near Ravenna to talk to farmers about the season's crops. He enjoyed spending weekends on his large racing yacht, skippered by Paul Cayard, or in Venice in his large palazzo on the Grand Canal. One month a year, Gardini vacationed on his sprawling Argentinian ranch. During his ten year tenure, Ferruzzi had become the second largest private Italian company and one of the top ten agroindustrial and chemical companies in the world.

Ferruzzi's remarkable growth has been accomplished through acquisitions, primarily over the past two years. The most important was the 1987 acquisition of a controlling interest in Montedison, which more than doubled the size of the group. From a strategic perspective, the Montedison acquisition is even more significant because it should enable Ferruzzi to pursue its long-run goal of using agricultural products as renewable sources of energy and chemical feedstocks--the so-called "green chemistry."

The agroindustry group also was revamped in 1987 through the acquisitions of CPC Europe (starch) and Central Soya (soybeans). These acquisitions expanded the predominant sugar orientation of the group and fit in with the group's agro-chemical strategy.

Ferruzzi is now consolidating its acquisitions through a restructuring program that involves rationalization, sales of noncore businesses, and debt reduction. Key steps in the restructuring have been the September 1988 merger of Montedison's financial services subsidiary, Iniziativa META, into Ferruzzi Finanziaria; selling assets such as the retail supermarket chain, Standa, and the number one detergents company, Mira Lanza; the Enimont joint venture, which links Montedison's commodity chemicals business with the state-controlled Enichem; and exchanging a 21.6% interest in the Rizzoli-Corriere della Sera publishing group for a 9.6% stake in the Milan holding company Gemina. (This company was controlled by Fiat and had significant publishing and banking interests in Italy.) In October, Ferruzzi announced plans to consolidate its insurance and property holding activities and to establish a new insurance holding company, Fondiaria Spa, which was quoted on the Milan stock exchange. In addition, a rights offering and a convertible bond offering were contemplated as part of the restructuring and were expected to raise about L550 billion. After restructuring, Ferruzzi Finanziaria earned L554 billion in 1988. For sports enthusiasts, Ferruzzi's enticement of Dan Ferry, the number one pick in last year's National Basketball Association college draft, to play for its basketball team, Messagero Roma, was a particularly important event.

Ferruzzi's shares were listed for trading on the Milan stock exchange in September 1988. Prior to that time, the company was privately held by the Ferruzzi family. The META merger was affected through an exchange of Ferruzzi shares for META shares, 64% of which were held by Montedison. Italian law prohibits cross-shareholding, and the Ferruzzi shares that Montedison received were sold to the public. The proceeds were used by Montedison to reduce debt. After the merger and public offering, the family interest in Ferruzzi was reduced to 39%.[4]

Ferruzzi Corporate Structure

Ferruzzi Finanziaria was the holding company for the businesses controlled by the Ferruzzi family and its public shareholders. Ferruzzi operated in five major sectors: agribusiness, chemicals, engineering and construction, insurance, and other operations such as real estate, publishing, information services, and merchant banking.

Agribusiness: The Ferruzzi Group was the number one European agro-industrial group with its companies Eridania, Beghin-Say, Cerestar, Central Soya, Lesieur, Koipe and Italiana Olii & Risi. Ferruzzi started in the commodity trading business and had since diversified into agricultural storage and transportation and processing. In 1985, sales in this segment were L876 billion and 100% in sugar, but Ferruzzi had diversified its operations considerably since that time. In vegetable oils (45% of 1988 sales), Ferruzzi was among the top three companies worldwide in oil seed crushing, held 20% of world soy protein market share, held 50% of refined lecithin market share, and through Central Soya, was the number one producer of pre-mixed feeds and the number two producer in the United States in animal feed. Sugar (31% of sales) was a stable, cash generating business, and Ferruzzi was Europe's largest producer holding 13% market share in Europe, 38% in Italy, and 30% in France. Ferruzzi initially entered the starch business (18% of sales) to hedge against declining sugar consumption, and by 1988 it was the number one European producer of corn and wheat starch and one of the top five worldwide. Finally, Ferruzzi had diversified into rice (6% of sales) and cattle farming. Ferruzzi also handled more than 20 million tons of grain each year, making the company the primary exporter of grains of European Community origin to countries outside the EEC, with a market share of approximately 20%. With Eridania, net sales had increased from $741 million in 1985 to $6.5 billion in 1988, and it represented the eighth largest pure food company in the world. As Ferruzzi looked to the future, it wanted to continue to diversify its

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[4]Schieneman, Gary, "Ferruzzi Finanziaria Company Report," Prudential-Bache Securities (October 20, 1989), pp. 3-4.

agribusiness interests to reduce single sector risk, complement its current products, and establish critical mass to compete in international markets.

Chemicals: Ferruzzi entered the chemical industry with its purchase of Montedison. In polypropylene through Himont, it held 20% of the world market share and controlled 60% of world capacity under license. In addition, it was in among the top five producers worldwide in polymers, among the top three in acrylic fibers, and a co-leader in Europe in fluoroelastomers. Enimont produced base chemicals including polyethylene, synthetic fibers, fertilizers, plant care products, intermediates for detergents and fine chemicals, and base petrochemicals and aromatics. This group was number seven in the world, and Ferruzzi believed the two entities could share research and development costs, rationalize production, and eliminate duplication, thus freeing resources for the development of other Montedison businesses.

Ferruzzi saw energy as a good hedge to its chemical operations, and it was involved in oil and gas exploration and production, hydroelectric power, and in retail stations in a joint venture with Shell. Ferruzzi wanted to be in this business as a hedge against oil price increases. In pharmaceuticals, Ferruzzi's Erbamont company was a world leader in anticancer drugs and was involved in antibiotics and drugs against cardio-vascular and nervous system diseases as well. Chemical sales were divided 17% in Montedison, 73% in Enimont, 7% pharmaceuticals, and 3% in energy.

Other segments: In engineering and construction, Ferruzzi was the market leader in Italy, being number one in concrete and one of the top five construction companies. In addition, it had a strong international reputation in chemical process engineering. In insurance, through its La Fondiaria subsidiary, Ferruzzi wanted to capitalize on the growing Italian demand for insuring its aging population and transfer its skills to other European markets. To complete its portfolio, Ferruzzi had interests in real estate, information technology, publishing, and the paper industry. In addition, Ferruzzi was part of a group of Italian industrial companies who had a 25% investment in the newly privatized Mediobanca, Italy's formerly government controlled merchant bank.

Future Strategies

Gardini was looking at the year 2000 with optimism. He had considered the social, economic, demographic and environmental trends, and they had prompted him to elaborate a far-reaching strategic plan. He recognized the five challenges which the group was already facing including the environment, nutrition, health and life insurance, energy, and new materials, his goal being to address these changes and improve the quality of life in the following ways.

The group's strategy to achieve these objectives involved four primary strategies:

1. Increasing and consolidating its leadership positions in its core businesses.

2. Integrating its portfolio activities by creating relationships between agroindustry and chemicals and completing the restructuring of the companies acquired in the agroindustry sector.

3. Innovating through internal research and development to create new products and materials for chemicals and pharmaceuticals as well as new uses for agroindustrial raw materials in chemical outputs.

4. Establishing critical mass to compete in international markets by expanding insurance and financial services operations internationally and strengthening its business positions in the chemical industry.

Some results had already been achieved. Regarding the environment, the Ferruzzi group was the first in the world to prepare a daily analysis of the carbon dioxide emitted and absorbed by its own activities. (The results that have surfaced have been of a greater absorption that results in a positive contribution in solving the greenhouse effect. See Exhibit 2.)

The Birth of Green Chemistry

The Ferruzzi Group was the only one in the world to know in depth both agricultural and chemical processing. The most innovative aspect regarding this "green chemistry" project was to exploit the synergies between chemicals and agribusiness. Ferruzzi's long run goal was to develop uses for agricultural raw materials (carbohydrates, vegetable oils, etc.) as substitutes for petroleum-based chemical feed stocks and as sources of energy, and the group had established a new R&D company, Ferruzzi Research and Technology (Fertec) to identify possible industrial uses of agricultural products. Ferruzzi also wanted to gain environmental advantages by developing new "clean" industrial processes. Finally, with the introduction of soy cultivation in Europe, Ferruzzi pushed towards a better use of the land through soybean crop rotation and also reduced the amount of chemical products necessary for cultivation thanks to the natural characteristics of the soy which added nitrogen to the soil. Ferruzzi's unique combination of agricultural production and industrial activities represented a strategic "asset" of great relevance in a world more and more "constrained" by environmental problems. (See Appendix B).

The health challenge was being faced through Erbamont and Antibioticos the pharmaceutical companies of the Ferruzzi Group and was directed toward the development and production of new products against some of the worst human diseases plaguing our world such as tumors, cardiovascular diseases and the nervous system, and infections. Erbamont, already a world leader in the anti-tumor products, was preparing for the future with 1,500 researchers and L220 billion of investments for 1989.

Through La Fondiaria, the insurance company, the Group was trying to respond to the problems caused by the aging of the population through a private social security system.

The exploitment of clean energy sources (through another Group company, SELM, which produces hydroelectric energy), the study of new technology for pollution-free cultivation and for feeding the growing world population, and the research of new material complete the activities of the Ferruzzi Group to achieve the goals given by the five challenges.

In addition to its environmental products, Ferruzzi was expanding its international operations with other ventures such as a joint venture between Enimont, Montedison, Occidental Petroleum and Marubeni to build the largest petrochemical complex in the world in the Soviet Union and an agreement to develop 500,000 hectares in the Ukraine. In addition, Ferruzzi was assisting in developing the agricultural infrastructure in the Soviet Union.

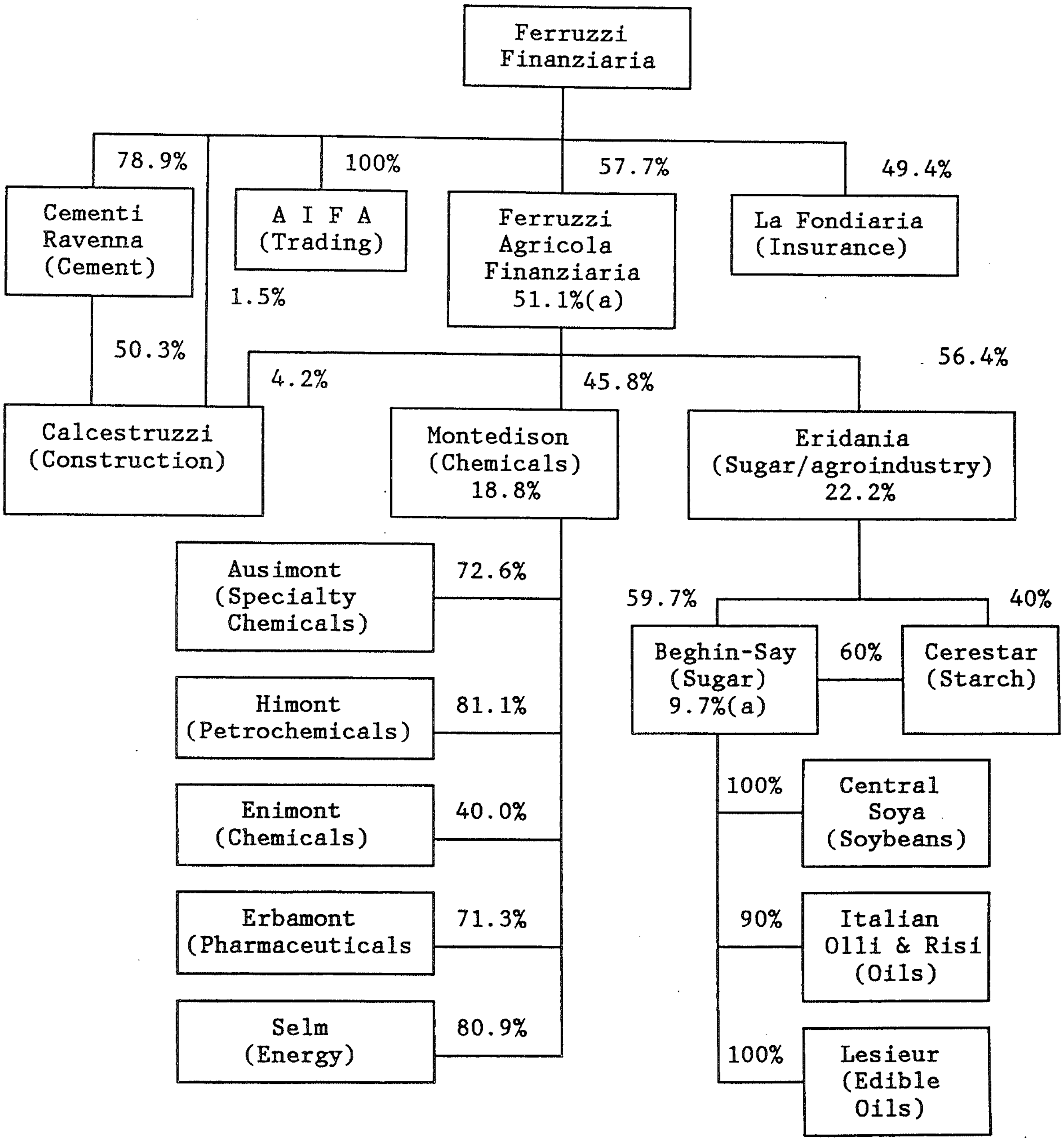
Conclusion

The strategy adopted by Mr. Gardini and Gruppo Ferruzzi had received great interest from the stock market. Montedison's and Eridania's listed stocks were among the largest gainers in the period from January 4, 1988 to October 31, 1989 (Exhibit 3). Mr. Gardini had to maintain this momentum by building the appropriate corporate structure to capture all of the synergies contained in his vision.

Exhibit 1

GRUPPO FERRUZZI: A NEW GLOBAL COMPANY

Ferruzzi Finanziaria
Organization

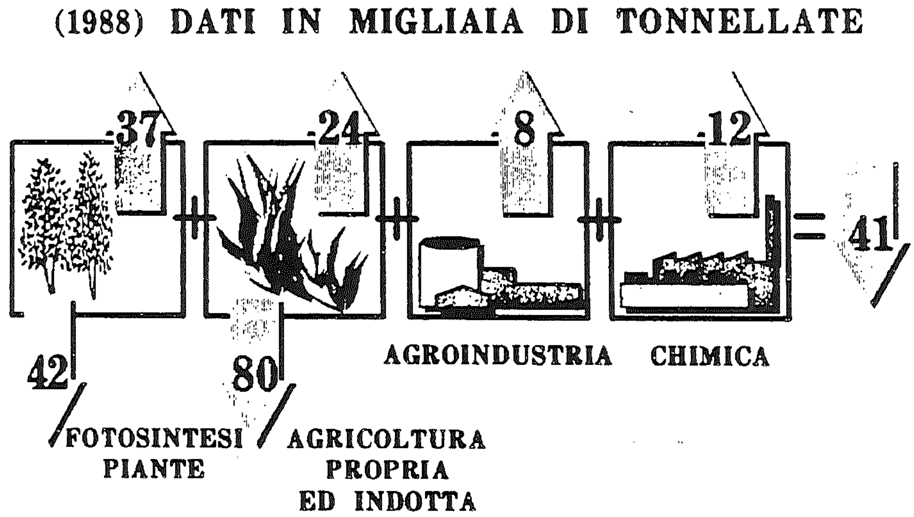


Source: Prudential Bache Securities, October 20, 1989
(a)Ferruzzi beneficial interest in group earnings

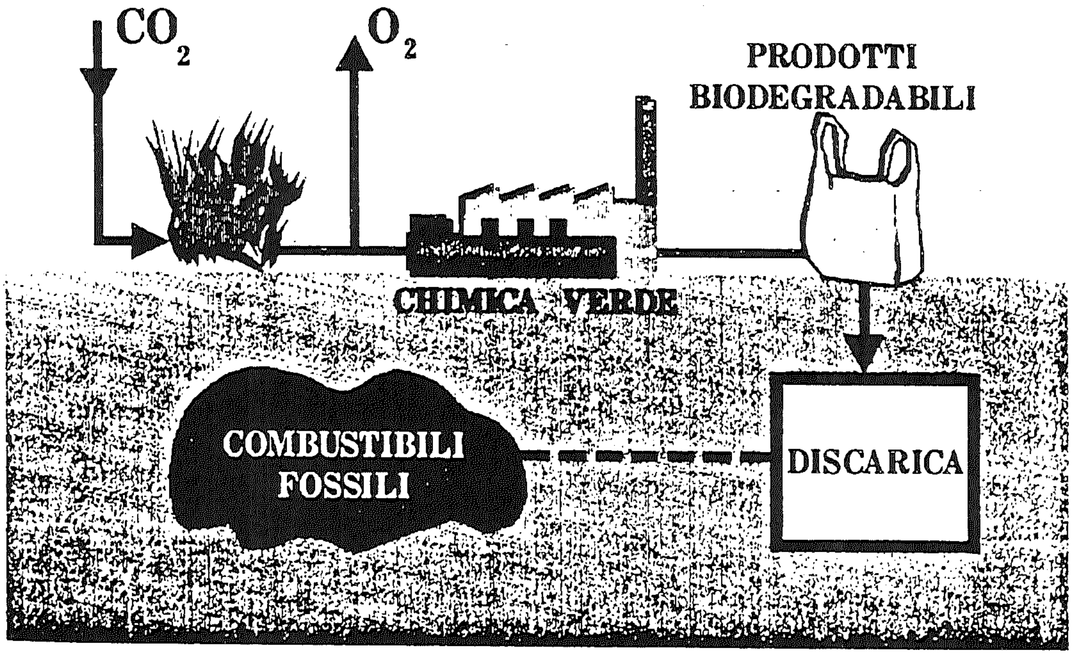
Exhibit 2

GRUPPO FERRUZZI: A NEW GLOBAL COMPANY

Daily Balance of Worldwide CO_2 Activities of Ferruzzi Group



The Implementation of Green Chemistry



Source: Company records

Exhibit 3

GRUPPO FERRUZZI: A NEW GLOBAL COMPANY

Stock Performance of the Top 10 Worldwide Chemical Companies
from January 4, 1988 to October 31, 1989

Company	Stock Price % Change
1. Montedison	+60,4
2. Ciba-Geigy	+47,5
3. Rhone-Poulenc	+39,4
4. Du Pont	+31,6
5. Basf	+15,3
6. Bayer	+13,9
7. Union Carbide	+13,8
8. Hoechst	+12,1
9. Dow Chemicals	+ 7,1
10. ICI	- 0,1

Stock Performance of the Top 10 Worldwide Food Companies
from January 4, 1988 to October 31, 1989

Company	Stock Price % Change
1. Eridania	+128,6
2. Philip Morris	+100,0
3. Taiyo Fishery	+ 92,7
4. Conagra	+ 59,6
5. Archer Daniels Midland	+ 41,2
6. Unilever	+ 34,8
7. Occidental Petroleum	+ 14,4
8. Dalgety	+ 12,5
9. Nestle	+ 4,6
10. RJR Nabisco	Noncalculable

Source: Company records

APPENDIX A

Prudential-Bache
Securities

Ferruzzi Finanziaria

Company Report

Ferfin (L2,891)--Milan
Rating: 3-2

Gary S. Schieneman, CPA (New York) 212-214-5022

Shares Are Attractive Despite Current Setbacks

October 20, 1989

Ferruzzi's shares are currently (October 20) trading at L2,891, approximately equal to the price established at the end of the first month of the stock's flotation a year ago. The shares had gained 20% in 1989, reaching a high of L3,488 on August 31. These gains were reversed in September and October, in part reflecting the general market decline during that period, capped off by the 7.1% decline in the Milan market on October 16.

Ferruzzi shares have substantially underperformed the market since they began trading. Even at the August 31 high, the share performance was 20% below the market. The underperformance was accentuated in September, due in part to the adverse effects of the company's alleged attempt to corner the soybean market and resulting trading losses. The decline in the Ferruzzi share price during September was double the decline in the market, which also has pulled back from an August 31 high. The shares were down even more in October compared with the market as uncertainties concerning the company continued. Because of these uncertainties, we rate the shares a hold near-term. But we believe the soybean problem will be resolved and profits should increase significantly in 1990. Based on the current depressed price, and our belief that the Milan market will resume its climb in 1990, the shares are an attractive long-term buy.

The Soybean Hitch: 1989--The Good Year That Almost Was

Ferruzzi's acquisitions paid off in 1988. The group reported 1988 net income of L554 billion, an increase of L474 billion, or 592% over 1987. A large part of the increase was due to the 1988 META merger and to extraordinary gains on disposals of businesses. After eliminating the effect of these transactions, earnings before extraordinary gains totaled L157 billion, up 24% from the prior year.

We had expected a better performance in 1989, but soybean trading losses have changed that. Ferruzzi has announced that it expects to report a L140 billion ($100 million) loss from trading activities in 1989. This loss is related, but not restricted to, Ferruzzi's alleged attempt to corner the soybean market and the Chicago Board of Trade's order that Ferruzzi close its July position. Because of this loss, we expect 1989 profit before extraordinary items to drop to L50 billion, 65% below the prior year.

EARNINGS

Ferruzzi reported 1988 net income of L554 billion versus L80 billion in 1987, an increase of 592%. These earnings are not comparable however, because of the META merger and the initial consolidation of Montedison in 1988. In Table 1 we have restated 1987 to allow year-over-year comparisons. Even after restatement, 1988 net income was up 230%.

Table 1
Ferruzzi Finanziaria
Comparative Income Statements
(Billions of Lire)

	1987			Interim
	Reported	Restated (a)	1988	1989 (d)
Revenues	5,881	19,740	24,865	8,500
Operating profit	461	1,506	2,339	540
Net interest expense	(358)	(1,009)	(1,463)	
Equity in affiliates	130	111	27	
Other income (b)	555	917	1,230	
Income before tax	788	1,525	2,133	
Income tax expense	(207)	(504)	(770)	
	581	1,021	1,363	
Minority interest	(501)	(853)	(809)	
Net income	80	168	554	192
U.S. $ millions (c)	57	120	396	137

(a) Restatement comprises:

Montedison consolidation--Ferruzzi consolidated Montedison for the first time in 1988. Despite owning less than a majority of the voting shares (46%), Ferruzzi has effective control of Montedison, which is the basis for consolidation. In 1987, Montedison was accounted for on an equity basis. To provide comparability, we restated the 1987 income statement to consolidate Montedison. This had no effect on net income but changed line items in the income statement.

META Merger--Effective January 1, 1988, the Montedison services operations conducted through the 63.3% owned subsidiary Iniziativa META Spa were spun off and merged into Ferruzzi. The transaction, accomplished by an exchange of shares, was treated as a pooling of interests by Ferruzzi. The company did not restate prior year's financial statements as is customary with a pooling. We restated 1987 to give effect to the merger, which increased reported net income by L88 billion.

(b) Other income--principally gains on sales of assets.

(c) U.S. $1.00 = L1,400

(d) Only interim details released.

The company reported net income of L192 billion for the first half of 1989. Although Ferruzzi did not disclose details, we believe that most of this relates to an extraordinary gain reported by Montedison following a transfer of assets to the Enimont venture. We estimate that income before this extraordinary gain was L32 billion for the first half of 1989, which is in line with our full year estimate.

The soybean losses reflect a highly aggressive trading stance taken by Ferruzzi, which we understand was taken without the knowledge and approval of Ferruzzi top management. We also understand that the company has no formal internal MIS at the group level, and the losses did not surface until the Chicago Board of Trade action. The company discloses very little information about their trading activities, which are carried at equity in its consolidated financial statements.

Given the number of major acquisitions over the past two years, it is ironic that the trading losses occurred in the oldest of Ferruzzi's businesses. Undoubtedly management attention was focused on the acquisitions and restructuring activities underway. Also, one must consider that until a few years ago, Ferruzzi was a relatively obscure family-controlled group and may not have required the management infrastructure and financial controls that are part of a major international group. The soybean lesson is that this is no longer possible.

Ferruzzi has named a new head of its trading operations, and has indicated a shift in trading strategy. In the future, trading will be tied in more closely with the company's agroindustry sector and presumably will be undertaken primarily for hedging. This should mean no more $100 million surprises, but also lower trading profits in the future.

Focus On Enimont And Not Soybeans

Had it not been for soybeans, 1989 would be a very good year. We estimate that excluding trading losses, 1989 profit before extraordinary items could increase 60% over 1988, primarily because of Enimont.

The Montedison joint venture with ENI and the formation of Enimont is the centerpiece of Ferruzzi's restructuring program. Enimont's size (more than double Montedison's commodity chemical business) is expected to provide greater market penetration and economies of scale than were available to Montedison alone. The Enimont venture will also improve Ferruzzi's balance sheet because L3.7 trillion of debt was transferred by Montedison to Enimont at January 1, 1989. Because of Enimont, we expect Ferruzzi's earnings from the chemical sector to increase by almost 60% in 1989 despite the present down-cycle in chemicals. This includes savings in interest expense attributable to the transfer of debt.

1990 Should Demonstrate Ferruzzi's Strength

We look for 1990 profit before extraordinary items to total L225 billion, an increase of 43% over 1988. Although Enimont should continue to provide restructuring benefits, we see no improvement in chemical sector earnings in 1990 compared with 1989 as continuing weakness in chemicals should offset these gains. Rather, Ferruzzi's non-chemical sectors should become relatively more important contributors to earnings during this phase of the chemical cycle.

Profits Higher On A U.S. GAAP Basis

We estimate that profits before extraordinary items would have been L15 billion higher in 1988 if U.S. GAAP had been used to prepare the financial statements. This difference should increase in 1989 because of Enimont.

Ferruzzi And 1992

The Ferruzzi group is well-positioned to compete in Europe post-1992.

- Montedison/Enimont (chemicals) is a European leader in 10 basic businesses, and a world leader in the polypropylene market.

- Eridania/Beghin-Say (agroindustry) has 13% of the European sugar market, and would benefit if production quotas are established on an EC-wide rather than country basis. The group is also a European leader in the starch sector, with a market share of approximately 35%, and has a significant presence in the vegetable oil market.

- La Fondiaria (insurance) is poised to capitalize on the development of a European insurance industry. This could involve ventures outside Italy, such as the 25% stake that the company recently acquired in Volksfuersorge, Germany's second largest life insurance company. The planned restructuring of La Fondiaria could lead to other similar ventures. Alternatively, the relative underdevelopment and growth potential of the Italian insurance market compared to other EC countries could make La Fondiaria an attractive takeover candidate.

The Agricola Conundrum

As mentioned earlier, Ferruzzi's shares have substantially underperformed the market. Part of this can be attributed to the soybean losses, but there are more fundamental reasons. First, lackluster earnings reported by insurance companies has hurt this large segment of the Milan market. La Fondiaria comprises about 30% of Ferruzzi's core earnings. Second, Ferruzzi's gearing is high--the debt to equity ratio was 3.2 to 1 at December 31, 1988. Third, the minority interest is huge--more than double shareholders' equity at the end of the year.

We believe that many of these negatives should turn around. Given the outlook for the European insurance industry, the poor insurance earnings story should be temporary. We project that Ferruzzi's debt will decrease significantly in 1989-90 as restructuring plans are implemented. Even at the inflated 1988 debt levels, Ferruzzi's cash flow (defined as income before depreciation, interest and tax) was 3.4 times interest expense. That leaves minority interest, which is explained in part by another holding company, Ferruzzi Agricola Finanziaria.

Agricola is a publicly-held company owned 57% by Ferruzzi. Prior to Ferruzzi going public in October 1988, Agricola was the group's principal holding company. Agricola was the vehicle through which Ferruzzi obtained its 45.8% interest in Montedison, and through which the 56.4% interest in the agroindustry group under Eridania was developed. Agricola retains nominal control of these companies. Because of the large minority interest in Agricola, there is a pyramiding of minorities and a lot of dilution at the Ferruzzi level.

Agricola is different from Ferruzzi in several respects. First, Agricola's investments are limited to Ferruzzi's industrial activities, i.e., Montedison and the Eridania/Beghin-Say group. Ferruzzi, on the other hand, has direct control of the group's insurance, trading, engineering and construction activities. Given the insurance sector's current lackluster market performance, and the soybean losses, Agricola is seen by many as the more attractive investment. We believe this should change as the down cycle in chemicals makes the broader Ferruzzi portfolio more attractive. More important, Agricola is not a company with substance. Decisions affecting the group are taken at the Ferruzzi level, and it is at this level that the Ferruzzi family's investment is held.

We believe that two holding companies are one too many. A buyout of the Agricola minority interest would cost L840 billion at current prices, and would have added approximately L70 billion to Ferruzzi's 1988 net income. Given the current debt reduction program, we would not expect to see this happen any time soon. However, it is our opinion that Ferruzzi's restructuring will not be completed until the Agricola issue is resolved.

Gains On Asset Sales Are Major Part Of 1988 And 1989 Interim Net Income

Ferruzzi's consolidated earnings presented in Table 1 are difficult to understand. There are very substantial minority interests in the operating entities, and the large gains on sales of assets are better reflected as extraordinary items. Also, important segments, including insurance, commodity trading, and Enimont, are carried on an equity basis.

Minority interest has a particularly significant effect on extraordinary items. In 1987, the company's French subsidiary Beghin-Say reported a gain of L242 billion from sale of a half interest in a paper subsidiary, Kaysersberg. This gain comprised 26% of "other income" in the restated 1987 financial statements in Table 1. After tax and minority interest, this gain contributed only L17 billion to Ferruzzi's net income.

In 1988, Ferruzzi sold the Standa retail business acquired in the META merger at a profit of L503 billion before tax. Standa was 100% owned by Ferruzzi so there was no minority interest in the profit, and the entire amount is part of Ferruzzi's net income. After tax, the Standa gain comprised approximately 50% of Ferruzzi's net income.

In 1989, extraordinary gains are even more significant. Montedison recognized a gain of L1.5 trillion (L850 billion after tax) on the transfer of assets to Enimont on January 1, 1989. After minority interest, Ferruzzi's share of this gain is L160 billion, which comprises 83.3% of first half 1989 income.

The effect of extraordinary gains after tax and minority interest is summarized below.

Table 2
Ferruzzi Finanziaria
Reclassified Income Statement
(Billions of Lire)

	1987	1988	Interim 1989
Profit before extraordinary gains	127	157	32
Extraordinary gains	41	397	160
Net income	168	554	192

Segment Contribution

In Table 3 we detail actual and projected contributions to Ferruzzi profit (after tax and minority interest) by major business segment. Ferruzzi's beneficial interest in the earnings of each segment is based on shareholdings at December 31, 1988. The extraordinary gains apply to sales of assets and businesses. The 1989 extraordinary gain reflects Ferruzzi's share of the Montedison gain on assets transferred to Enimont, and the gain on the transfer of publishing assets to Gemina. We have not attempted an estimate of 1990 extraordinary gains, but given Ferruzzi's track record and current restructuring program, such gains could be considerable.

Because of the soybean trading losses, 1989 profits before extraordinary items are estimated to be 65% lower than in 1988. The soybean losses distorted what would have otherwise been a very good year in which all major segments other than trading are expected to increase earnings. This should carryover into 1990. Despite continuing weaknesses in chemical markets, we estimate that profits before extraordinary items should be more than 3 times higher in 1990 than in 1989, and 40% above the more comparable 1988.

Table 3
Ferruzzi Segment Earnings
(Billions of Lire)

	Ferruzzi Interest (%)	1987*	1988	1989E	1990E
Segment					
Montedison/Enimont	18.8	46	66	100	100
Agroindustry	22.2	35	20	25	30
Trading	100.0	24	35	(140)	20
Insurance	50.0	48	49	55	60
Construction & Engineering	56.0	17	22	25	25
Segment contribution		170	192	65	235
Holding company					
Goodwill amortization		(53)	(60)	(60)	(60)
Other net		10	25	45	45
Profit before extraordinary gains		127	157	50	220
Extraordinary gains		41	397	290	**
Net income		168	554	340	220

Based on separate company financial statements and Prudential-Bache estimates.
* Restated.
** Estimate not possible.

Montedison Is The Key To Future Earnings Growth

Ferruzzi's 18.8% beneficial interest in Montedison was the single most important contributor to profit before extraordinary items in 1988, and should increase in importance in coming years. The 1988 increase in Ferruzzi's share of Montedison's profits reflects strong demand for petrochemicals and plastics, plus the first full year consolidation of Himont.

The following data shows how significant Montedison was in relation to Ferruzzi's 1988 consolidated results.

Montedison
Selected 1988 Operating Data

	Lire Billions	% of Ferruzzi Consolidated
Revenues	14,122	56.8%
Operating profit	1,812	77.5
Interest expense	765	52.3
Profit before extraordinary gains	351*	
Net income	630	46.2**

* Not reported by company, Prudential-Bache estimate.
**Before minority interest.

For the first six months of 1989, Montedison reported net income before extraordinary items of L252 billion. We estimate full year 1989 earnings could total L525 billion. Ferruzzi's interest in these earnings would be L100 billion, up 51% from 1988. This very large increase is due to the Enimont joint venture, and includes an estimated reduction in interest expense attributable to a transfer of L3.7 trillion of debt by Montedison to Enimont. The benefits from Enimont should be offset in part by substantially lower petrochemicals (Himont) earnings--reported first half 1989 operating income was 37% below 1988, and we expect this trend to continue for the full year. Earnings from Montedison's pharmaceutical segment (Erbamont) should also be lower in 1989--first half 1989 income was down 14% from 1988.

We expect Montedison's 1990 earnings to be about the same as in 1989. A further drop in Himont earnings and the adverse effect of softening European petrochemical prices should be offset by further restructuring benefits to be achieved by Enimont.

On July 31, 1989, Montedison proposed to acquire the remaining minority interest in Himont (19%) and Erbamont (28%) for cash plus warrants to purchase additional Montedison shares. While the initial proposal has been rejected, we believe these buyouts, if they occur, should have no significant effect on Montedison earnings in 1989 and 1990. Increases in Montedison's share of earnings from these subsidiaries would be offset by higher interest costs on debt incurred to finance the acquisition.

Agroindustry Earnings Diminish In Importance

The improvement in Montedison's earnings has reduced the relative importance of the agroindustrial sector's contribution to Ferruzzi's profitability. As shown in Table 3, agroindustry earnings comprised 27% of profit before extraordinary items in 1987. This contribution should fall to about 13% in 1990.

The agroindustry segment is not small. Eridania and Beghin-Say are European leaders in the production of sugar, and Cerestar is a leader in the European starch sector, with about 35% of the market. Central Soya is a major U.S. producer of concentrated soy protein and refined lecithin. Consolidated revenues for 1988 totalled L8.5 trillion and operating income was L441 billion. But these companies are relatively small in comparison with Montedison. Also, there are significant minority interests which dilute the impact of this sector on consolidated earnings. Ferruzzi's beneficial interest in Eridania, the agro-industry holding company, is 22.2%. But the group's interest in Beghin-Say, the principal operating company, is much lower at 9.7%.

Agroindustry (Eridania Consolidated)
Selected 1988 Operating Data

	Lire Billions	% of Ferruzzi
Revenues	8,459	34.0
Operating profit	441	18.8
Interest expense	241	16.5
Net income	115	8.4*

*Before minority interest.

Agroindustry revenues nearly doubled in 1988 compared to the prior year, reflecting the acquisitions of Cerestar and Lesieur, and the first full-year consolidation of Central Soya. Despite the rise in revenues, operating income was unchanged from 1987. Increases from acquisitions were offset by deconsolidation of the paper business and a decrease in sugar profits. Net income in 1988 was down 40% from the prior year. This was due to higher interest expense applicable to debt incurred to finance the acquisitions, an increase in the effective tax rate (1987's effective rate was abnormally low because of capital gains taxed at special rates) and a decrease in gains on sales of assets, offset in part by equity in affiliate earnings.

We estimate that operating profit will increase by 10% in 1989 and 15% in 1990. This reflects expected improvements in starch pricing and restructuring benefits. Central Soya's profit should also improve from 1988's level, which was adversely affected by the U.S. drought.

TRADING

Ferruzzi's commodity trading companies, 100%-owned, earned L35 billion in 1988. This was L11 billion above 1987 due mainly to net interest income. Operating income was L29 billion, versus L26 billion in 1987. Ferruzzi is a leading world trader and a principal exporter of EC agricultural products. The trading companies also supply Ferruzzi's agroindustry sector with a significant amount of raw materials. Ferruzzi accounts for its trading companies on an equity basis in its consolidated financial statements.

The 1989 losses incurred in Soybean trading have been described earlier in this report. We do not expect these losses to continue in 1990, although profits should be somewhat lower than in prior years.

INSURANCE

La Fondiaria, 49%-owned by Ferruzzi, is Italy's third largest non-life insurer, and fourth largest life insurer. La Fondiaria's consolidated net income of L98 billion was unchanged from prior year net income. Premiums increased by 13.4% but they were offset by higher claims and an increase in commissions and other direct expenses. An increase in minority interests also reduced consolidated net income.

The Italian insurance market is expected to grow faster than Italy's economy, and we assumed a 10% growth in insurance earnings in 1989 (Italy's gross domestic product is anticipated to grow 3.5% in 1989 and in 1990).

We believe the insurance earnings are understated because of conservative Italian accounting practices. As explained later in this report, use of U.S. GAAP could increase these earnings by almost 40%. More important, share prices of Italian insurance companies tend to be based on asset valuation--not earnings. La Fondiaria's shares are currently trading at a P/E multiple of 45, which reflects significant amounts of unrealized appreciation in assets carried at the lower of cost or market in La Fondiaria's balance sheet. The high insurance multiple is the principal reason why Ferruzzi's shares have a current P/E of 25.1 based on trailing 1988 income before extraordinary items.

CONSTRUCTION AND ENGINEERING

Ferruzzi, through its subsidiary Calcestruzzi, is the leading producer of concrete in Italy and has a significant presence in foreign markets. The group also provides engineering services, concentrating on agriculturally related projects in Italy and abroad.

RESTRUCTURING

The Ferruzzi group has undergone significant restructuring over the past two years.

Major Acquisitions and Dispositions

Company	Year	Acquiring (Selling Company)
Acquisitions:		
Montedison	1986-7	Ferruzzi--45% of voting shares acquired
Central Soya	1987	Eridania/Beghin-Say
CPC Europe (Industrial Div.)	1987	Eridania/Beghin-Say
Lesieur	1988	Eridania/Beghin-Say
Volksfuersorge	1988	La Fondiaria--25% interest acquired
Antibiotics S.A.	1987	Montedison
Selm/Shell venture	1987	Montedison
Himont	1987	Montedison increased ownership to 81% from 38%
Dispositions:		
Standa	1988	Ferruzzi
Beresford	1987	Eridania/Beghin-Say
Kaysersberg	1987	Eridania/Beghin-Say--50% sold
Paperterie Corbehem	1988	Eridania/Beghin-Say--50% sold
Mira Lanza	1987	Montedison
Heuga	1988	Montedison

META Merger

Effective January 1, 1988, Montedison's services operations, conducted through its 64%-owned subsidiary Iniziativa META, were merged into Ferruzzi. The transaction was accomplished by an exchange of shares and accounted for by Ferruzzi as a pooling of interests. The principal assets received by Ferruzzi were META's 50% interest in La Fondiaria and Standa, a major Italian retailer.

As mentioned earlier, the merger had a major impact on 1988 earnings. La Fondiaria contributed L49 billion to Ferruzzi's 1988 earnings, and it is the largest contributor to segment earnings after Montedison. As part of Montedison, La Fondiaria's contribution to Ferruzzi's earnings would have been only L6 billion because of minority interests. Standa was sold in 1988 for L969 billion. Ferruzzi recognized an after-tax gain of L270 billion on the sale, which comprised about 50% of 1988 net income.

Enimont

Effective January 1, 1989, ENI, Italy's state energy company, combined all of ENI's chemical business (held by its subsidiary Enichem) with Montedison's commodity chemical, fiber, and a portion of its energy business in a new company called Enimont. Each participant initially held a 50% interest in the joint venture. This interest is now 40% following the public offering of Enimont shares in September 1989.

Enimont is the centerpiece of Ferruzzi's restructuring. The objective is to create an Italian chemical company that can compete in the Europe of 1992 as well as worldwide. Enimont projects 1989 revenues of L16 trillion. The opening balance sheet at January 1, 1989 shows total assets of L19.4 trillion and shareholders' equity of L3.4 trillion. These amounts immediately place Enimont among the world's top ten chemical companies. However, unlike its competitors that have significant non-chemical activities, Enimont is a pure chemical company.

The public offering, which was heavily oversubscribed, has generated great interest in Enimont. The Italian consensus is that Enimont should report net income of about L1.0 trillion in 1989. We have reduced this by 10% given the current and expected continuing weakness in the petrochemical market. Montedison's share of these earnings, which will be recognized on an equity basis, should be about L420 billion. *This is about equal to Montedison's 1988 net income before extraordinary items* and does not include earnings contributed by Montedison's remaining businesses (Himont, Ausimont, Erbamont and SELM).

The Enimont rationale is that together, ENI and Montedison can achieve a critical mass in size and technology, resulting in a formidable world competitor. The increased size will also permit economies of scale and lower operating costs. Part of the savings will come from integration of facilities and improved logistics. Additional cost savings should come from combining R&D and marketing functions.

Enimont expects to save about L500 billion a year when the pieces are finally put together. The L1.2 trillion proceeds from the public offering will be applied against debt, which totalled L6.9 trillion at April 30, 1989. This will add to the savings by reducing annual interest expense by about L95 billion after tax.

Some cost savings will be realized in 1989, principally from manpower and debt reduction. 1990 should see far greater savings, which we believe will offset any negative effects from expected continued weakness in chemical prices.

Montedison Tax Deferral. The assets Montedison transferred to Enimont were at agreed values that exceeded Montedison's book value by L3 trillion. This excess is a gain to Montedison and it is subject to Italian tax. The Italian government had agreed to deferral of 75% of the tax payable on the gain until the gain is realized through sale or use of the written up assets. Montedison applied for this tax treatment as a condition for proceeding with the venture.

The European Community Commission overruled this tax concession as a prohibited state subsidy, and the Italian House of Deputies subsequently failed to ratify the agreement. The eventual outcome cannot be determined at this time but we do not believe that the Enimont venture will be terminated, even if the tax deferral were invalidated.

We believe that Montedison eventually will seek control of Enimont. According to the joint venture agreement, in three years (January 1992) Montedison will have the right, during a 90-day period, to augment its stake in Enimont by contributing additional chemical assets to the venture. Himont is the likely Montedison contribution. ENI would then have 150 days to accept or reject the Montedison offer. If ENI accepts, Montedison becomes the controlling shareholder. If ENI rejects the offer, it must either buy out Montedison's stake or offer to sell up to 15% of its interest in Enimont to Montedison (again, Montedison is the controlling shareholder).

If Montedison decides not to augment its stake in the venture at the end of the three years, the Enimont joint venture automatically will run for another three years. At the end of that term, a new agreement would be negotiated.

This agreement gives Montedison a three year call option on Enimont, and the decision to exercise will probably depend on the success of the restructuring. Raul Gardini, Chairman of Montedison and Ferruzzi, stated at Montedison's annual meeting in June that he will indeed try to assume control of Enimont. If he is successful, he would merge Enimont into Montedison; a coup for Montedison and Ferruzzi. The Ferruzzi Group would control a vastly larger chemical company at minimal additional cost.

Reduction In Interest Expense

Ferruzzi's consolidated net debt totaled L10.9 trillion at the end of 1988 (L9.9 trillion net of the Eridania sugar inventory, which is essentially cash under the European quota system). The debt to equity ratio was 3.2 to 1 at December 31, 1988. From a shareholders' funds perspective, (equity plus minority interest) gearing was about 100%.

Consolidated interest expense was L1,463 billion in 1988. This amount includes L87 billion of expense on notes receivable discounted. These receivables were part of the proceeds from the sales of Standa and Mira Lanza. Excluding this discount, 1988 interest expense was L1,376 billion. The effective rate on average debt outstanding in 1988 was 11.2%, which is comparable to the prior year. Ferruzzi's cash flow--defined as earnings before depreciation, interest and tax--was 3.4 times consolidated 1988 interest expense.

As indicated in Table 5, Ferruzzi's interest expense is expected to decrease by L373 billion in 1989 and an additional L100 billion in 1990. After tax and minority interest this will increase Ferruzzi's net income L72 billion in 1989 and L11 billion in 1990. The decrease in interest is due to debt reduction and the one-time discounting of receivables in 1988.

Table 5
Debt Reduction
(Billions of Lire)

				Decrease	
Debt (at December 31)	1988	1989E	1990E	1989E	1990E
Montedison	6,007	2,152	1,652		
Eridania	2,795	2,795	2,795		
Ferruzzi	2,143	2,143	2,143		
Consolidated	10,945	7,090	6,590		
Enimont (a)	____	1,880	1,610		
Total	10,945	8,970	8,200	(1,975)	(770)
Interest expense					
Montedison	765	250	190		
Eridania	241	240	240		
Ferruzzi	457	370 (b)	370		
Consolidated	1,463	860	800		
Enimont (a)	____	230	190		
Total	1,463	1,090	990	(373)	(100)
Increase in Ferruzzi net income (c)					
Debt reduction.				32	11
Discount				40	—
				72	11

(E) Prudential-Bache estimates.
(a) Montedison estimated share of Enimont debt and related interest expenses.
(b) Assumed reduction equal to 1988 discount on notes receivable.
(c) Estimated decrease in interest expense net of tax and minority interest.

Debt reduction is a key aspect of Ferruzzi's restructuring. In Table 5, we assumed that the only significant reductions would occur at the Montedison level. This relates to proceeds from sale of Ferruzzi shares acquired in the META merger (L1.4 trillion was applied in October 1988) and the Enimont transfer (L3.7 trillion). Montedison's share of Enimont debt and related interest expense accounted for on an equity basis is netted against the assumed savings in Table 5.

We assumed no debt reduction at the Eridania and Ferruzzi level in 1989-90. The interest savings projected in Table 5 would increase to the extent that additional debt is retired. We also have not included additional Montedison debt that would result from the proposed buyout of the Himont/Erbamont minority interests. This could increase Montedison debt by some L1.4 trillion, but we believe the effect on 1989 and 1990 net income would be nil as higher interest expense is offset by increased earnings applicable to the acquisition.

Comparative Balance Sheet

In Table 6, we have restated 1987 to reflect the META merger and to consolidate Montedison.

Table 6
Ferruzzi Finanziaria
Consolidated Balance Sheet
(Lire Billions)

	1987 Reported	1987 Restated*	1988
Assets			
Cash and marketable securities	633	4,658	4,224
Receivables	1,243	3,540	5,285
Inventories	2,177	4,589	4,528
Other	724	2,774	2,507
Total current assets	4,777	15,561	16,544
Investments	1,829	3,291	2,707
Fixed assets--gross	4,224	13,867	13,939
Accumulated depreciation	(1,686)	(4,226)	(4,881)
	2,538	9,641	9,058
Oil and gas concessions		1,037	993
Goodwill	1,630	6,317	5,244
Other assets	82	676	574
Total assets	10,856	36,523	35,120
Liabilities and Shareholders' Equity			
Current debt (bank & amount due on L/T debt)	2,765	8,804	8,166
Accounts payable and accrued liabilities	2,385	7,999	6,793
Total current liabilities	5,150	16,803	14,959
Long-term debt	2,457	10,246	9,033
Other liabilities	281	554	1,298
Total liabilities	7,888	27,603	25,290
Minority interest	2,293	6,311	6,740
Shareholders' equity	675	2,609	3,090
Total	10,856	36,523	35,120

*Restated for META merger and Montedison consolidation.

APPENDIX B

Green Chemistry Applications

Biodegradable Plastics: Ferruzzi wanted to combine the skills of its Cerestar starch processing operations with the plastics skills contained in Montedison and Enimont. One problem Ferruzzi faced was that the cost to produce biodegradable plastics was 10-20% higher than that for regular plastics, and changes in petrochemical feedstock prices would impact the consumer's willingness to purchase the new product. In this sector, Ferruzzi was competing with the American commodity processor Archer-Daniels-Midland (ADM) (1988 sales and income of $6.8 billion and $353 million) as well as chemical manufacturers such as Hoechst and ICI who were developing recyclable plastic technologies. Although production was costly for the present, new technologies or costs to dispose of waste could change the economics of production.

Ethanol: Low corn and grain prices combined with the need to reduce lead pollutants made ethanol attractive, and governments were encouraging the development of this lead-free gasoline. Low oil prices, competition from methanol (a lead substitute derived from natural gas which ENI produced), competition from gasoline producing oil companies, and resistance by car manufacturers to redesigning engines to accommodate the change discouraged production and made it uneconomical without government subsidies. The European Community had already turned down one proposal to subsidize ethanol, but it was reconsidering the proposal following moves in the United States to adopt clean fuels.

Lubricants and Phosphate Free Detergents: Natural oils combined with detergents dissolved dirt while creating a more degradable product. In addition, these detergents required only one-fifth of the energy to produce compared to traditional detergents. The German company Henkel, the fourth largest chemical company in Germany and a worldwide player (1988 sales of $5.8 million and net income of $192 million), was Ferruzzi's major competitor in this segment.

Clean Production Processes: Ferruzzi planned to invest $700 million to reduce sulphur oxide emissions in its Italian plants, and it was developing new fertilizers which stayed in the soil longer to retain its nitrogen content.

Under the current economic situation, production of these environmental products was uneconomical. To achieve its objectives, Ferruzzi needed an increase in consumer prices or it might have to work with the government to develop incentives or tariffs to make the business profitable. In addition, as it developed these products, Ferruzzi had to decide how to enter the market--as a producer of the end product or as a supplier of the intermediate product. The final producer might be a plastics or gasoline manufacturer, both of which were contained in Montedison.