Case-by-Case Privatization in the Russian Federation

Lessons from International Experience

Edited by
Harry G. Broadman
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Harry G. Broadman, ed.

The World Bank
Washington, D.C.
385)  
1. Privatization—Russia (Federation)—Conferences.  
2. Privatization—Russia (Federation)—Case studies—Conferences.  
3. Privatization—Case studies—Conferences.  
4. Broadman, Harry G.  
II. Series: World Bank discussion papers; 385.  
HD4215.15C37 1998  
338.947—dc21 98-21138  
CIP
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FOREWORD

Dynamic private sector development is the key to resumption of sustained growth in Russia. Since the advent of reform in 1992, the Russian authorities have made substantial strides towards creating a market economy through privatization, along with other important measures, such as deregulating prices and production, reducing subsidies, liberalizing foreign trade, and creating a market-oriented legal and institutional framework. Including leasing and lease purchase arrangements, as of January 1, 1998, Russia has privatized more than 130,000 enterprises, including 16,000 large and medium firms. Still, some key state owned enterprises (SOEs) at all levels of government have yet to be fully or partially divested.

Russia’s privatization efforts have evolved from mass vouchers, to management and employee buyouts, to “loans for shares”. Recently, the authorities have established an institutional framework for a “case-by-case” approach, with several pilot transactions underway. Case-by-case privatization, which ensures transparency and competition through the use of independent financial and other advisors, has been widely practiced in other economies, including those undergoing the transition from planning to a market system.

The World Bank has been involved in assisting several other countries implement the case-by-case approach. In 1997 the Russian authorities requested the Bank to present a workshop on the lessons of international experience in case-by-case privatization, focusing on pragmatic issues of implementation. This volume, edited by Harry Broadman, who managed the workshop, contains the principal presentations made at the workshop, supplemented by additional materials.

In publishing this volume we very much hope it proves to be of interest to policymakers in Russia and to the international community that focuses on Russian affairs and economic transition.

Michael F. Carter
Country Director for Russia
Resident Representative in Moscow
ABSTRACT

This monograph contains the proceedings of a high-level workshop on “International Experience in Case-by-Case Privatization: Lessons for the Russian Federation” that was held in St. Petersburg, Russia in July 1997. Against the backdrop of Russia’s mass voucher privatization initiative in 1993-94 and the more recent controversial “loans-for-shares” program, the workshop took place soon after the Russian authorities announced that a case-by-case privatization program would start. The case-by-case approach is especially applicable for the sale of large, economically important enterprises, where transparency and competition are crucial to successful transactions. The timing of the workshop was fortuitous because it came immediately on the heels of the $1.8 billion sale of a 25 percent plus one share stake in the telephone holding company Svyazinvest. The workshop combined “hands-on” methodological presentations and case studies. The monograph contains the core presentations made at the workshop, updated and supplemented with integrative material. The workshop was cosponsored by the Ministry of State Property (then-GKI), the Ministry of Finance and the World Bank.
CURRENCY EQUIVALENTS  
(As of July 1997)

Currency Unit = Ruble  
$1.00 = R 5,864

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

ADR - American Depository Receipt  
CAPM - Capital Asset Pricing Model  
CBC - Case by Case  
CEE - Central and Eastern Europe  
COGS - Cost of Goods Sold  
DCF - Discounted Cash Flow  
EBIT - Earnings Before Interest and Taxes  
EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization  
FSU - Former Soviet Union  
GAAP - Generally Accepted Accounting Principles  
GDP - Gross Domestic Product  
GDR - Global Depository Receipt  
GKI - Goskomimuschestvo (State Property Committee of Russia)  
IPO - Initial Public Offering  
IRR - Internal Rate of Return  
MEBOs - Management-Employee Buyouts  
MLT - Medium and Long Term Liabilities  
PE Ratio - Price/Earnings Ratio  
SAMIR - Societe Anonyme Marocaine de l'Industrie du Raffinage  
SHF - Shareholders Funds  
SOE - State-Owned Enterprise
Part One

INTRODUCTION
Chapter One

OVERVIEW

Harry G. Broadman*

Introduction

Since 1992 the Russian economy has been undergoing a massive structural transformation to a market system, with the privatization of state owned enterprises a core reform. Against the backdrop of mass voucher privatization in 1993-94 and (to a lesser extent) the establishment of new business entities, today more than 70 percent of Russia’s GDP is produced in the private sector. Given the size of the Russian economy and the inertia of central planning’s legacy, this is truly a remarkable achievement within such a short time-frame.

This progress notwithstanding, significant challenges remain in Russia’s privatization effort. Not only are there key enterprises that have yet to be fully (or even partially) privatized—including some of the largest in the economy—but the nature and methods of Russia’s privatization program have come under increased scrutiny as regards the degree to which greater transparency and competition in the privatization process can improve outcomes. The Russian authorities, keenly aware of these challenges, have been eager to learn from international experience in privatization, especially the “case-by-case” approach. Case-by-case privatization is especially applicable for the sale of large, economically important enterprises, where transparency and competition are crucial to successful transactions. The Government announced it would begin to implement such a program in 1997—initially covering four enterprises and enlarging the number in 1998 and 1999.

In order to assist the Russian authorities with the design of their case-by-case privatization program, the Bank organized a high-level workshop in St. Petersburg in July 1997 to present lessons from international experience in case-by-case privatization. The workshop was co-sponsored by the Ministry of State Property (then-GKI), the Ministry of Finance and the Bank. The timing of the workshop was fortuitous, coming immediately on the heels of the $1.8 billion sale of a 25 percent plus one share stake in the telephone holding company Svyazinvest. Partly as a result, the workshop presentations proved to be provocative. It was decided that publication and dissemination of them to a wider audience in order to encourage further policy discussion would be extremely useful. This monograph contains the core presentations made at the workshop, updated and supplemented with integrative material. A companion volume to this English version of the proceedings is being published in Russian.

* Harry Broadman is Program Team Leader and Senior Economist for Russia Operations, The World Bank
Of course, privatization is but just one structural reform objective for private sector-led growth in Russia. The realization of private sector-led growth will also necessitate efficiency gains from competition and restructuring, as well as new investment. These will depend mainly on improvements in Russia’s overall business environment. Steps in that direction include a more transparent and predictable regulatory regime, such as stronger contract and property rights enforcement; easier market entry for new businesses and removing barriers to exit for non-viable enterprises; development of the capital market; and the elimination of distortions in the tax system. At the same time, growth is also critically dependent on structural reforms beyond private sector development, among others, those that: enhance fiscal management; reform and restructure monopolistic infrastructure sectors; reform the banking sector; foster international trade and investment; reform social systems; and restructure the agriculture sector. The Government’s “Medium-Term Reform Program” was submitted to the State Duma on March 6, 1997.

By the same token, even if privatization and other needed structural reforms take root, without a sound macroeconomic environment, renewal and sustainability of Russian economic growth will be illusive. While much of 1992-1996 was marked by rapid inflation, shrinking output, rising unemployment and social hardship, following the elections in the summer of 1996 when the Russian people broadly endorsed continued progress toward a market economy under the leadership of President Yeltsin, gradual macroeconomic consolidation began to take hold in 1997. Indeed, significant if somewhat uneven macroeconomic progress was increasingly evident throughout the year. Inflation fell to 11 percent, GDP actually grew (by just under 1/2 percent) for the first time since 1992, the ruble remained relatively stable, and the current account was in surplus. However, a chronically fragile fiscal system weakened further by the fourth quarter, engendered by poor revenue collection, an increase in arrears, and weak expenditure management. The Government responded to the fiscal crisis by unveiling a Fiscal Action Plan to increase the collection of taxes and reduce federal budget expenditures, and by introducing into the state Duma a revised draft Tax Code. Implementing these fiscal measures represents a core challenge to the Government.

With a rich structural reform agenda being put in place, the beginnings of a macroeconomic turnaround, and the formation of a new reformist Government team, 1997 was a pivotal year for the Russian economy. It is against this background that the workshop on case-by-case privatization took place.

Overview

Methodological Framework. The scale of privatization that has taken place in all transition economies since the early 1990s is impressive. In John Nellis' leading presentation, he estimates that since 1990 about 60,000 large and medium enterprises, plus hundreds of thousand of small firms, have been privatized. Nellis reviews the principal methods of sale and divestiture that have been utilized in transition economies -- including management or employee buyouts (MEBOs), voucher privatization, and case-by-case sales -- and assesses the advantages
and disadvantages of each. For this assessment he uses several yardsticks, such as restructuring efficiencies, corporate governance, speed, access to capital, generation of government revenue and fairness. Which method is right for Russia? What matters most is accomplishing the change in ownership. But on the margin, the greater the transparency and competition in the transaction process the better the outcome. Nellis’ answer is: use mass or MEBO methods, as has already been done, to get the bulk of assets in private hands and cut the links between the enterprise and the state. Then apply case-by-case in a select number of special cases to get the investors, management skills, market access and especially capital that core investors bring to bear.

Building on Nellis’ presentation, Harry Broadman describes the phases of privatization that Russia has experienced since 1992. He traces the mass voucher scheme of 1993-94, to the “loans for shares” program involving the banking sector in 1995-96, to the emergence of an initial case-by-case program in 1997. Broadman specifies the principles under which the case-by-case approach has been most effectively practiced in other countries. Emphasis is given to the key role played by independent financial advisors in ensuring transparency and competition in the sales preparation processes as well as in the carrying out of the tenders themselves. Broadman then reviews the institutional and legal framework that has recently evolved in Russia making way for the case-by-case approach. The nascent framework is currently being implemented on a pilot basis, with four firms having been selected to participate in 1997. Beyond 1997, the Government has committed itself to a larger program of case-by-case privatization. Moreover, it will adhere to a common set of principles for greater transparency and competition when other privatization approaches are utilized.

The fundamental tenets and procedures of case-by-case privatization, as implemented internationally, are presented by Dick Welch. The presentation draws on the experience of Canada, Indonesia, and Lithuania (detailed case studies were presented later in the workshop and are reproduced as separate chapters below). Welch outlines the five-steps that are integral to the case-by-case approach: (i) selection of candidate enterprises, (ii) carrying out a feasibility study and developing sale options, (iii) detailing the privatization strategy, (iv) passing necessary legislation or obtaining approvals, and (v) conducting the transaction (sale). Since case-by-case sale is such a laborious and demanding process, Welch argues that it makes sense to select only the strongest firms to participate in the process. Once the candidates are selected, it is important for the government to hire independent financial (and other) advisors who can help assess in a credible fashion the commercial feasibility of the proposed transactions, the pros and cons of various sales options, and the value of the enterprise. Once the feasibility study is completed, a decision on privatization strategy must be taken, including determination of such issues as: the legal and regulatory regime which will be used; the timing of sale; resolution of employee issues; among others. The form of sale used in the case-by-case approach can take several forms: direct initial public offerings (IPOs); “third party sales” (sales to an intermediary or intermediaries); a “negotiated sale” (usually a closed bilateral transaction); or a “mixed sale” (used when the government wants a strategic buyer to bring investment and know-how to restructure the enterprise but where the government retains some of the shares to sell to others).
The role of independent advisors in case-by-case privatization is pivotal: their third-party function helps to ensure the preparation and tendering process is transparent, competitive and conducted at arms length from insider interests. In a follow-up presentation, Welch focuses on key issues with which governments must deal in hiring and using such advisors. He pinpoints the need for hiring a consortium of advisors when the sale is complex, and often one that mixes domestic and foreign personnel in order to bring to the table all relevant expertise. Not only are financial advisors needed, but also legal experts, accountants and marketing specialists. He emphasizes that in order to sharpen advisors’ incentives for delivering high quality performance through to the sale, governments would do well to not necessarily employ the same advisors in the tendering stage who were hired to carry out the pre-sale preparation work; rather competitive bidding should be utilized for both phases (where the first set of advisors is not precluded from bidding on the second stage).

Olivier Fremond’s two subsequent presentations focus more specifically on both the transaction process and valuation methodology, respectively. In the former, the core of his analysis is a comparison of structuring competitive tenders and structuring IPOs. For tenders, he traces out the critical time-path of actions, from hiring accountants and auditors to advertising the sale to selecting the winning bid. He gives great emphasis to structuring the process in such a way to ensure transparency by focusing on the quality of procedures followed, such as with respect to documentation and transfer (sale condition) provisions, rather than on the pace of implementation. On average, he argues that the overall process, from the time auditors are selected to the close of the sale, could well take at the bare minimum 30 weeks, including at least eight weeks after the tender itself is launched. The IPO process is similar, but often more structured. Typically it is shorter in duration, perhaps 20 weeks. A key issue for IPOs is determining who shall serve as the underwriter; similarly, who will take the risks for the placement of shares in the stock market. The reason why privatization through IPOs is so popular around the world is that they often allow small investors to earn very good profits in a short period of time. Of course, IPOs are effective options for case-by-case privatization only to extent that a country’s stock market is well-functioning. In many transition economies such markets are nascent.

With respect to valuation methodology, Fremond first outlines the basic terminology used in modern financial accounting and then describes several approaches for estimating the value of the enterprise to be privatized. These include (i) the “comparable transactions/comparable companies” method, which is based on the assumption that two enterprises of the same size, in the same sector and with similar balance sheet and financial results should have similar value, as measured by various common financial ratios; (ii) the discounted cash flow (DCF) method, which, unlike the “comparable transactions/comparable companies” approach is not based on historical financial results (and thus geared toward passive financial investors), but based on producing a range of estimates of the company’s prospective value across different scenarios (and thus geared toward investors interested in active
management of the firm); (iii) replacement value, which measures the cost of replacing the assets if they were suddenly lost or destroyed; and (iv) adjusted net assets, which calculates the fair market value of the assets on the firm’s balance sheets, less depreciation and liabilities. No single method is best, with the selection decision turning on the objective in question. An optimal approach is to utilize several methods in order to obtain a range of estimated values.

Over the last several years much has been learned about how governments should organize themselves to carry out case-by-case privatization effectively. John Nellis’ analysis of this issue shows that successful privatization programs have the following characteristics. First, they are located at the center of government, i.e., at a powerful position near the focus of the governmental decision-making process. Second, they have a champion, i.e., a strong individual or a set of individuals at the highest ministerial and bureaucratic levels who support them, push for them and fight the inevitable major political battles on behalf of the privatization program. Third, they have a relatively narrow set of clearly defined aims and goals. Finally, they have the capacity to develop institutional competence and experience. In practice this means that the government administrators have the capacity to hire and to supervise the private sector support services—investment bankers, lawyers, accountants and management consultants—that perform the bulk of the work on the preparation of privatization transactions.

Case Studies. Against the backdrop of the preceding methodological framework, the balance of the workshop focused on several case studies where case-by-case privatization methods had been utilized in various countries.

In presenting the case of SAMIR, the principal oil refinery of Morocco, Olivier Fremond, illustrates a sale using a combination of the IPO and strategic investor approaches. SAMIR has been in existence for approximately 35 years. It is one of the biggest companies in the country and is perceived as “blue chip” by the public. It had the following ownership structure prior to privatization: 98.82% — state; 1.12% — private investment company; and 0.06% — privatizable bank. The company was incorporated in 1959, and the privatization began in 1996, with twenty-five percent of the share capital reserved for an IPO, which was targeted preferentially at retail investors. Employee shares were offered for sale at a 15 percent discount to the IPO price through a direct sale. The remainder of the shares were reserved for a strategic investor who was to be identified through an international tender. If the strategic investor did not want to purchase all the shares still owned by the State, the remainder would be sold by means of global offering on the international markets, through a GDRs issue. The decision to conduct the IPO before the tender for the strategic investor caused some difficulties. Because industrial acquirers rarely value companies on the same basis as financial investors, significant differences in valuation occurred during the tender. Potential acquirers argued that their DCF valuations yielded results significantly lower than the stock market price. On the other hand it was politically inconceivable to agree to sell a majority stake in SAMIR to a foreign investor at a price lower than the price at which Moroccan retail investors had purchased their shares. It transpired that bidders might be willing to pay a price in excess of the IPO price if the Government agreed to
guarantee a period of protection from foreign imports. In fact, the longer the period of protection
the more they would be willing to pay. In the end, the government agreed to a seven to eight
year period of protection and launched the tender. The winner was the Corral Petroleum AB
Holding of Sweden, which paid Dh251 (US$28.72) per share for the 67.7 percent stake still
owned by the State, compared to Dh243 (US$27.80) per share for the IPO price. The losers were
Moroccan consumers who would have to pay a higher price for gasoline for the next seven to
eight years and those domestic institutional investors who were not able to participate in the
transactions. If the IPO had not been done first, this would probably not have happened.

Dick Welch presented two cases from Canada. The first concerns the sale of the
Canadian air traffic control system, the Air Navigation System (ANS). ANS was part of the
federal Department of Transport and was managed and staffed by government employees. Its
services include air traffic control, advisory services, airport status and weather. These services
were provided from seven area control centers, 55 control towers and 105 flight service stations.
In 1995, when the privatization took place, ANS employed about 6,400 people, including 2,300
air traffic controllers. When the Government first decided to examine the feasibility of
privatizing ANS in 1993, the initial reaction among some officials was that the system was not
marketable because it was running a deficit of $50 million a year. However, financial advisors
were hired and valued ANS at over $1.0 billion under several different options of sale. Once the
financial advisors had provided their valuation, the government was able to make a decision on
privatization. It decided to open negotiations with a user group -- representing the domestic
airlines and other aircraft users, the air traffic controllers and some other interests. Agreement
was reached on using the government’s financial advisor to help to establish a price for the sale
of ANS. After introduction of a new tax on foreign carriers, ANS’s financial situation improved
dramatically, and it was then decided that the initial valuation was too low. It became clear that
the purchaser could borrow more cheaply than foreseen and for a longer period of time. The
government engaged a second financial advisor to redo the valuation and advise on the aspects of
possible financing for the purchaser. The advisors repeated the valuation and concluded that
ANS was worth $2 to 3 billion. The intensive use of financial advisors was key to a successful
and remunerative sale.

The second Canadian case Welch presents is the sale of Telesat. Telesat was established
in 1969 as a joint venture between the government and the country’s major telecommunications
carriers to develop a domestic satellite-based telecommunications system. It is the only carrier
providing domestic satellite facilities. It operates two satellites and a network of 500 earth
stations. The Canadian Radio-Television and Telecommunications Commission regulates the
firm using rate of return regulation. The government’s shares, held directly and indirectly,
amounted to 53 percent of the total. The privatization of Telesat was announced in 1991. In the
first stage, a merchant/investment bank was engaged through a competitive process as the
government’s financial advisor. Two sales options were considered for the privatization, an IPO
and a trade sale. However, the financial advisor advised the government that an IPO would be
riskier than a trade sale and would bring a substantially lower price. As a result, the government
agreed to privatize the company through a competitive trade sale. Because of the regulated nature of the business (at that time), it was stipulated that the purchaser would have to be cleared under the Canadian Competition Act. In the second stage, following the opening of the bidding, only two potential purchasers emerged. Confidentiality agreements were signed with the two, which allowed them to engage in extensive consultations with the government concerning proprietary information. In the end, the government chose the higher of the two bids. Shortly after the privatization, the Canadian government deregulated the long distance telephone market.

A summary of direct sale privatizations in Poland, Hungary, the Czech Republic and the Slovak Republic is the subject of Igor Artemiev’s presentation, which is based on a report of case studies prepared by World Bank staff. The sales took place in 1990-1992 when the legal and institutional framework for case-by-case privatization in those countries was nascent, similar to the present circumstances in Russia. The report covers 22 companies with a turnovers ranging from $4 million to $300 million. On average, the period of closing a case-by-case privatization deal within the sample was 15 months. In half the cases, negotiations were held with a single potential investor. The average sales price was about $55 million. While it is difficult to generalize across all the cases, several lessons emerge. First, there is a need for a firm’s employees to feel they have adequate representation during the privatization process; perhaps even being given a financial incentive to become shareholders. Second, for firms that have deteriorating financial conditions, time is of the essence since if such enterprises are unable to adjust quickly, spontaneous privatization and asset stripping can result. Third, property rights should be clarified to reduce the risk premium demanded by investors and thus increase receipts from sales. Fourth, environmental liabilities should be resolved as soon as possible and careful legislation passed to establish clear policies on assignment of environmental risk. Finally, only passive financial restructuring, if any, should be done prior to privatization, with most restructuring remaining the province of the new owners; governments rarely, if ever, get returns on the restructuring they do before the sale.

**Summary of Lessons.** In the final presentation, Harry Broadman and John Nellis summarize the principal lessons from international experience for implementing case-by-case privatization in Russia (and elsewhere). One critical lesson is that transparency, fairness and level playing field are of utmost importance. The privatization award process should be transparent and clear beforehand to avoid controversies, conflict of interest and corruption. Another is the need to tailor the case-by-case privatization strategy to the particular circumstances of the country and each enterprise. Although there are a number of “best practices” and generally accepted case-by-case privatization methods, only careful packaging, timing and sequencing can guarantee overall success. The accent should be on pragmatism, flexibility and willingness to try new solutions and methods. The need for support from the highest political level for the privatization process to overcome inertia and the inevitable resistance from bureaucracy and special interest groups cannot be overstated. A proper incentives structure can motivate domestic and particularly international investors to buy equities. Outside expertise should be sought. There
is a growing body of specialist experience in case-by-case privatization worldwide; local experts can be used, but governments should not hesitate to resort to services of foreign privatization experts. By the same token, privatization programs should be implemented in the framework of an overall package of mutually reinforcing economic reforms, such as macroeconomics stabilization, trade liberalization, financial sector reform, elimination of subsidies, a pro-competition policy and regulatory reform. Pre-privatization restructuring should be short-term and defensive; such restructuring should be limited to legal, financial (balance sheet) and organizational changes, which may include closures, reductions in labor or transfers of social services. Implementation of technology changes, investment of capital and major purchases should be left to the new owners, not to government agencies. Conditions attached to privatization to be kept to a minimum. Complex, elaborate undertakings will detract from the value and attractiveness of the enterprise and may undermine the deal. The regulatory environment, price controls, subsidies and other problem areas should be cleaned up before the sale. Case-by-case privatizations should not be limited by an artificially fixed timetable or deadline. However, there is a need to keep a constant pressure on the process. Sequencing several sales in a pipeline of a case-by-case privatization program according to market conditions could meet this objective. Also, not all transactions can be successful and the government might need to reject all bids and start the bidding process anew or change the method of divestiture. Public information and publicity campaigns play a critical role in case-by-case programs. Most successful privatization programs place a strong emphasis on educating the public and extensive advertising of the expected sales. Finally, maximizing sale proceeds must be balanced with other priorities. Although the privatization agency has a duty to ensure that state assets are sold for their fair market value, maximization of individual sale proceeds must be balanced with other priorities, such as broadening share ownership and promoting the levels of capital markets.

* * *

The workshop and these proceedings would not have been possible without the efforts of a wide range of people. Particular acknowledgments are owed to Alexander Braverman, First Deputy Minister, Ministry of State Property; Sergey Molozhavyi, Deputy Minister, Ministry of State Property; Elvira Nabiullina, Deputy Minister, Ministry of Economy; Andrei Filev, then-Director, International Financial Institutions Department, Ministry of Finance; and Victor Pankraschenko, Director General, Russian Privatization Center. In addition several of my colleagues from the World Bank greatly assisted in the workshop’s organization and planning, including Michelle Mancesidor, Oleg Petrov, Elena Shtykanova, Dick Welch and Olga Stchesnovich. Finally, assistance from Michelle Mancesidor, Oleg Petrov and Sandy Craig is gratefully acknowledged in the final editing of these proceedings. The workshop was partially supported by a Japanese PHRD (Policy and Human Resources Development Fund) grant.
Part Two

METHODOLOGICAL FRAMEWORK
Chapter Two

PRIVATIZATION IN TRANSITION ECONOMIES: AN UPDATE

John Nellis *

Introduction

In this presentation I will focus on three questions:

How much has been privatized in the transition countries of Central and Eastern Europe (CEE) and the former Soviet Union (FSU)? (Equally important, what has not yet been privatized; what remains to be divested?)

What methods of sale or divestiture have been used? and

What are the advantages and disadvantages of the various privatization methods employed? In particular, which methods have best led to enterprise restructuring; that is, which type of privatization best promotes changes in the companies that make them more competitive and likely to survive and thrive?

What Has Been Privatized?

The amount of privatization that has taken place in the last seven years in transition economies is very large, indeed amazingly large. In the period 1980 to 1991, in non-transition economies of the world, the World Bank calculated that some 6,800 privatizations1 of large and medium firms took place (excluding the former East Germany). In November of 1995 I tried to calculate the number of medium and large firms privatized in CEE and the FSU and concluded as follows: Looking only at cases in 15 transition countries where reliable numbers were available at the end of 1994, an estimated 30,740 firms had changed ownership.2 (The numbers referred to majority sales of medium and large firms.) If one adds the special case of Germany, with its additional 14,500 medium and large firm privatizations through the end of 1994 by the famous

* John Nellis is Senior Manager, Private Sector Development Department, The World Bank

1 The 6,800 number is found in World Bank, Privatization: Lessons of Experience, 1992. We define "privatization" to mean a transfer of ownership such that a majority of the shares or equity in an enterprise passes from state or public ownership into private hands.

2 The 15 countries are: Bulgaria, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, FYR Macedonia, Moldova, Mongolia, Poland, Romania, Russia, Slovak Republic and Slovenia. Reluctance to include dubious data probably led to an underestimation of the total.
Treuhandanstalt, then the total number of firms divested in just these 16 countries exceeded 45,300—6.6 times the total in the rest of the world, in about 1/2 the time.

Of course the process did not stop in 1995; in many countries, such as Latvia, Ukraine and Romania, the period after 1995 has been a time of greatly increased privatization activity. This means the totals are doubtless much higher today, probably close to 60,000 privatized large and medium companies, or more. In addition, one has to mention the many hundreds of thousands of small business units and objects privatized—at least 75 thousand in Russia alone; 22 thousand in the Czech Republic, 33 thousand in Ukraine—and the explosive growth of new private firms and activities. It can be seen that an incredibly large and rapid shift of ownership has taken place, and that in many transition states the bulk of economic activity is now in private hands.3

---

Figure 2.1: The Private Sector Has Grown Rapidly

<table>
<thead>
<tr>
<th>Group</th>
<th>Country</th>
<th>Private Sector Output as a Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1</td>
<td>Poland</td>
<td>[Graph showing growth]</td>
</tr>
<tr>
<td></td>
<td>Slovakia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hungary</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Croatia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>FYR Macedonia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Czech Republic</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Slovak Republic</td>
<td></td>
</tr>
<tr>
<td>Group 2</td>
<td>Estonia</td>
<td>[Graph showing growth]</td>
</tr>
<tr>
<td></td>
<td>Lithuania</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bulgaria</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Latvia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Albania</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Romania</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mongolia</td>
<td></td>
</tr>
<tr>
<td>Group 3</td>
<td>Kyrgyz Republic</td>
<td>[Graph showing growth]</td>
</tr>
<tr>
<td></td>
<td>Russia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Moldova</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Armenia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Georgia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Kazakhstan</td>
<td></td>
</tr>
<tr>
<td>Group 4</td>
<td>Uzbekistan</td>
<td>[Graph showing growth, xxx 1995]</td>
</tr>
<tr>
<td></td>
<td>Ukraine</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belarus</td>
<td>[Graph showing growth, 1990]</td>
</tr>
<tr>
<td></td>
<td>Azerbaijan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tajikistan</td>
<td>[Graph showing growth]</td>
</tr>
<tr>
<td></td>
<td>Turkmenistan</td>
<td></td>
</tr>
<tr>
<td>East Asia</td>
<td>Vietnam nonstate</td>
<td>[Graph showing growth]</td>
</tr>
<tr>
<td></td>
<td>China</td>
<td></td>
</tr>
<tr>
<td></td>
<td>China nonstate</td>
<td></td>
</tr>
</tbody>
</table>

Nonetheless, despite this impressive pace and scope of privatization, in almost every transition state there is still a great deal left to privatize. The World Bank calculated that as of the end of 1995, in seven transition countries for which we had data, an average of about 25 percent of the number of enterprises remained in state hands. In five of these countries an average of 35 percent of the value of the enterprise sector as a whole remained publicly owned. Why is this the case? First, because some countries set aside certain firms or sectors as “strategic” or vital to national security and did not sell them, or at least did not sell them in the first wave of mass privatization programs that so many of these states adopted (for example, in the Czech Republic, Slovak Republic, Lithuania, Mongolia, Kazakhstan and Russia). This left the state with a large portfolio of publicly owned firms that remain to be privatized. There may be as many as 10 thousand unprivatized or minority privatized medium and large industrial firms in Russia today. Many of them are in bad shape, unable to raise capital and surviving at a much reduced rate of production. (Though this may also describe the privatized firms; a subject we will return to).

Second, many countries have government property funds or other state owned entities retaining significant percentages of shares in many or even most privatized companies. In some cases these are majority stakes. Economic wisdom and bureaucratic hindsight suggest that states would have been better off selling all the companies as fast as possible, and selling all the shares in companies privatized as fast as possible. But often this has not been done. The question then arises, what is to be done with these companies and shares? We will come back to this issue.

**Methods of Divestiture**

The principal privatization techniques adopted have been:

- **Management buyouts or management and employee buyouts (often called MEBOs).** In these, employees and managers in the firm being divested are given the opportunity—sometimes in an open competition as in Czech Republic or Estonia, sometimes without competition as in Russia, sometimes in a competition but with advantages for insiders (such as lower price, or special credit arrangements), as in Latvia and many other countries. Russia’s first phase mass privatization program was called a voucher program but was actually something of a MEBO scheme with a voucher program attached to it. MEBOs are being used extensively in Romania, in Slovakia’s second phase

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4 The seven were: Czech Republic, Estonia, Hungary, Lithuania, Mongolia, Poland and Russia; take away the last two for the second figure on percentage of value retained.

5 Some privatizing countries—the United Kingdom, Mexico and Argentina—held back shares in selected privatizations (usually in the large infrastructure firms) in the hopes that the new private core investor would drive up value, allowing government to sell its remaining shares at a steep premium. In some cases this tactic worked, and in a couple of instances it worked spectacularly. But most observers see the opposite trend in transition economies; that is, government retained shares tend to lose much of their value over time. The consensus is that transition governments are better off disposing quickly of all, or as much as possible of their shares.
of privatization, and both Slovenian and Latvian privatizations have mainly ended up as MEBOs.

- The second main method is what we call "equal access voucher privatization." This approach gives the public at large the opportunity to obtain shares in companies (or in investment funds) by exchanging vouchers, distributed to them at low or no cost by the government. "Equal access" means that all citizens have the same opportunities and buying power from their vouchers. Neither insiders nor any other group gets special claim on the assets. Czech Republic's first privatization effort followed this approach; and similar schemes of this sort were tried in countries as diverse as Lithuania, Mongolia and Albania.

- The third method, and the subject of this seminar, is case-by-case sales of various types; by negotiated trade sales (used in Hungary), by tender, by bunching companies in a multi-enterprise tender (used in Germany, Estonia, Latvia), and by holding a public offering for the shares of a company undergoing privatization (i.e., Poland and again Hungary). All these methods can be seen on the following diagram:

<table>
<thead>
<tr>
<th>Country</th>
<th>Sales to Outside Owners</th>
<th>Management Employee buyouts</th>
<th>Equal-access voucher privatization</th>
<th>Restitution</th>
<th>Other</th>
<th>Still in state hands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>32</td>
<td>0</td>
<td>22</td>
<td>9</td>
<td>28</td>
<td>10</td>
</tr>
<tr>
<td>Value of firms</td>
<td>5</td>
<td>0</td>
<td>50</td>
<td>2</td>
<td>3</td>
<td>40</td>
</tr>
<tr>
<td>Estonia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>64</td>
<td>30</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Value of firms</td>
<td>60</td>
<td>12</td>
<td>3</td>
<td>10</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>Hungary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>67</td>
<td>13</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>17</td>
</tr>
<tr>
<td>Value of firms</td>
<td>34</td>
<td>3</td>
<td>0</td>
<td>5</td>
<td>7</td>
<td>51</td>
</tr>
<tr>
<td>Lithuania</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>&lt;1</td>
<td>3-5</td>
<td>65-70</td>
<td>0</td>
<td>0</td>
<td>25-30</td>
</tr>
<tr>
<td>Value of firms</td>
<td>&lt;1</td>
<td>3-5</td>
<td>50-60</td>
<td>0</td>
<td>0</td>
<td>45-35</td>
</tr>
<tr>
<td>Mongolia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>0</td>
<td>0</td>
<td>70</td>
<td>0</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td>Value of firms</td>
<td>0</td>
<td>0</td>
<td>55</td>
<td>0</td>
<td>0</td>
<td>45</td>
</tr>
<tr>
<td>Poland</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>3</td>
<td>15</td>
<td>6</td>
<td>0</td>
<td>17</td>
<td>59</td>
</tr>
<tr>
<td>Russia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms</td>
<td>0</td>
<td>55</td>
<td>11</td>
<td>0</td>
<td>0</td>
<td>34</td>
</tr>
</tbody>
</table>

Which Method Works Best?

Which of these methods works best? As can be seen from the table below, it depends on which of the potential goals of privatization you are attempting to maximize.

<table>
<thead>
<tr>
<th>Method</th>
<th>Better corporate governance</th>
<th>Better access to capital and skills</th>
<th>More government revenue</th>
<th>Greater fairness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale to outside owners</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Management-employee buyout</td>
<td>-</td>
<td>+</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Equal-access voucher privatization</td>
<td>?</td>
<td>+</td>
<td>?</td>
<td>-</td>
</tr>
<tr>
<td>Spontaneous privatization</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>


As you see, there is no perfect method of privatization. Each approach has advantages and disadvantages, according to the objectives being sought. However, in our chart, only one method—direct sales to an external purchaser, that is, the case-by-case method—achieves 3 pluses. The rest of this seminar is designed to tell you why this is the case.

The crucial issue is which method best induces restructuring? That is, which privatization method most encourages firms to compete and succeed in the market? I start with a general observation: "restructuring appears to progress at a more rapid pace in countries that have privatized large firms more rapidly." We see there is a general association between privatization, especially rapid privatization, and successful restructuring.6

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7 Restructuring means in essence (from easier to harder steps): labor shedding, cost cutting, increasing ratios of exports to sales, and obtaining new investments or otherwise making major changes in technology and production lines.
The evidence is strong that selling a majority stake to a core, experienced investor, often but not necessarily a foreign investor, produces very good restructuring results. A study of privatized firms in Poland, for example, shows that "gross profitability to sales has increased the most in those enterprises that were privatized with the help of a strategic investor..."8

Almost all firms in transition countries have to restructure (and are restructuring) in one way or another to survive. But the harder, deeper restructuring steps and especially gaining access to new investment capital, are more often taken in foreign owned privatized firms than in firms taken over by insiders (or remaining as SOEs).9 This is not surprising, these are the investors with money and experience. One would expect them to do better, and they do. The problem is that there are so few of them, so few experienced, cash-rich investors (domestic or foreign) in transition countries who will come in and rescue these firms.

8 C. A. Bogdanowicz-Bindert & Jan Czekaj, "Poland, Privatisation--Past Experience and Future Perspectives," unpublished draft, Warsaw, April, 1997, p. 35.

9 EBRD, Transition Report: 1995, p. 135. Note also that new "greenfields," or de novo firms, often do better than any privatized firm, regardless of their ownership structure.
**Figure 2.3: Some Transition Economies Have Proved Much More Attractive to Foreign Investment**

<table>
<thead>
<tr>
<th>Group 1</th>
<th>Percentage of 1994 GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>6,459 millions of dollars</td>
</tr>
<tr>
<td>Slovenia</td>
<td>438</td>
</tr>
<tr>
<td>Hungary</td>
<td>10,634</td>
</tr>
<tr>
<td>Croatia</td>
<td>n.a.</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>36</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>3,996</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>483</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Group 2</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>646</td>
</tr>
<tr>
<td>Lithuania</td>
<td>73</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>397</td>
</tr>
<tr>
<td>Latvia</td>
<td>323</td>
</tr>
<tr>
<td>Albania</td>
<td>186</td>
</tr>
<tr>
<td>Romania</td>
<td>1,101</td>
</tr>
<tr>
<td>Mongolia</td>
<td>38</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Group 3</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Kyrgyz Republic</td>
<td>25</td>
</tr>
<tr>
<td>Russia</td>
<td>3,900</td>
</tr>
<tr>
<td>Moldova</td>
<td>86</td>
</tr>
<tr>
<td>Armenia</td>
<td>10</td>
</tr>
<tr>
<td>Georgia</td>
<td>n.a.</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>719</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Group 4</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Uzbekistan</td>
<td>250</td>
</tr>
<tr>
<td>Ukraine</td>
<td>950</td>
</tr>
<tr>
<td>Belarus</td>
<td>52</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>110</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>25</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

**East Asia**

| Vietnam                              | 351                    |
| China                                | 121,704                |

A rough estimate is that from 10 to 15 percent of all enterprises up for privatization in transition economies will prove attractive to core investors (and that number may be on the high side). One conclusion from this is that transition countries are going to have to rely mainly on themselves, on their own policies, on their own capital, on their own managers to do much of the essential work of restructuring. But the fact of the matter is that few countries have succeeded in using case-by-case methods to effect a large number of sales.

However, while the firms sold case-by-case may be relatively few in number, they will generally be the larger or even the largest and most economically important firms in the country.

Thus, case-by-case sales are very significant. Partly because of the financial magnitude of the sales, partly because of the key goods and services provided by these firms, and partly because of the signals sent to the market and the investment community by these sales.

I return to my main question: which sales technique is best for restructuring? In their most recent paper Pohl, Anderson, Claessens and Djankov\textsuperscript{10} looked at 1992-1995 performance information for 6,300 firms in seven transition economies (Russia is, unfortunately, not in the group). They concluded that there was not much difference in post-sale performance between firms sold to insiders and those privatized through case-by-case sales. The important thing was change of ownership. They argued that the sales method used was of secondary, indeed minor importance. They state: "privatization is the key to restructuring.....on average, a firm that has been privatized for four years will increase productivity three to five times more than a similar firm that is still in state ownership."\textsuperscript{11}

I must admit I have my doubts that this conclusion holds true for Russia. In Russia, mass privatization has taken place, but budgets did not sufficiently “harden” for some time, nor are markets as competitive as in some of the Eastern European countries. The result is that restructuring in the many Russian privatized firms lacking a strategic investor has so far been very slow, relatively modest in size and (at least up to 1995) hard to distinguish from that taking place in SOEs.\textsuperscript{12} To compound the problem, the Russian mass privatization scheme resulted in enterprise insiders possessing, on average, 2/3 of the shares in each of the 16,000 firms divested in the voucher auctions. Nineteen percent of adult Russians working in firms got 56 percent of equity in divested firms; 81 percent of citizens having only vouchers got only 15 percent of equity.

\textsuperscript{10} Pohl \textit{et al.}, \textit{op. cit.} (1997), p.v.

\textsuperscript{11} Pohl \textit{et al.}, \textit{op. cit.} (1997), p. v.

Figure 2.4: Russia: Capital Structure of Privatized Firms

On average:

- Workers: 45%
- Managers: 15%
- Funds: 12.5%
- Individuals: 12.5%
- State: 15%

Percent of Shares


Many think, and hope, that we are not yet seeing major changes in Russian privatized firms simply because not enough time has passed, and that in the coming months and years the positive effects of private ownership will become more apparent and easily provable. We see in other transition countries that the longer the firm has been private the better it performs. It is likely this will prove to be the case in Russia as well.

But what the record clearly shows is that privatization is necessary for transition to take place, succeed and endure. Transition countries that have tried to avoid, delay and make painless privatization have usually just made things worse for themselves (for example, in Bulgaria). Which method is right for Russia? The answer is both, that is, use mass or MEBO methods, as has already been done, to get the bulk of assets in private hands and cut the links between the enterprise and the state. Then apply case-by-case in a select number of special cases to get the investors, management skills, market access and especially capital that core investors bring to bear.
Chapter Three

THE EMERGENCE OF CASE-BY-CASE PRIVATIZATION IN RUSSIA:
PRINCIPLES AND INSTITUTIONS

Harry G. Broadman*

This presentation summarizes briefly the evolution of the various methods of privatization utilized in Russia since 1992; the principles undergirding the move to case-by-case privatization; and the emerging Russian institutional framework for case-by-case privatization.

Phases of Privatization in Russia

In 1993-94, under the *voucher* mass privatization program, the Government transferred, either completely or partially, over two-thirds of all large- and medium-sized enterprises and over 80 percent of all small enterprises to private ownership, including minority stakes in most of Russia’s largest enterprises. The voucher program gave substantial benefits to the insiders of the firms.

In the second stage of privatization (1995-96), the Government sold share packages in several thousand more enterprises for cash. It also transferred controlling shares in a few of the largest and most attractive enterprises in trust to Russian banks in exchange for loans—the so-called *loans-for-shares* scheme. The lack of transparency in the way these latter privatizations were carried out has raised serious concerns about equity, concentration of market power, and corporate governance. Moreover, because the processes utilized were insufficiently competitive, government revenues from the transactions were substantially reduced.

In late 1996, the Government announced a third stage of privatization based on a *case-by-case* approach. This privatization initiative began in 1997 and is initially to last for three years. It is targeted at large enterprises and can involve a combination of transaction methods, including use of strategic investors, competitive tenders and auctions, and initial public offerings (IPOs), although to date no large Russian enterprise has been successfully privatized on a case-by-case basis through an IPO.

* Harry Broadman is Program Team Leader and Senior Economist for Russia Operations, The World Bank

More generally, in 1997 the Government committed itself to carry out future privatizations using transparent and competitive procedures. As a step towards that objective, in mid-1997 the Government completed two of the largest privatizations since 1995: the $820 million sale of a 40 percent stake in Tyumen Oil and $1.8 billion sale of a 25 percent plus one share stake in the telephone holding company Svyazinvest. While these transactions appear to have been more transparent and competitive than earlier privatizations, putting in place a fully transparent and competitive privatization regime in Russia remains a formidable challenge.

In 1997 the Government reported that the private sector accounts for 70 percent of GDP, 75 percent of manufacturing enterprises and more than 80 percent of the workforce. At the beginning of 1997 foreigners owned less than 2 percent of Russia's medium-sized and large enterprises. However, in the largest 100 companies, foreign participation amounted to 12 percent.

As of 1 January 1998 more than 130,000 enterprises had been privatized in Russia, of which 3,100 changed their form of ownership in 1997. In 1996 the number of privatized enterprises was around 5,000, while in 1995 it was 10,000. There are currently 29,000 federally-owned enterprises and institutions and the total number of fully state-owned enterprises was reduced to 88,000 in mid-1997 from 205,000 in 1992.

In 1997 the state earned 18,078 trillion rubles (in 1997 figures) on sales of stock in privatized companies, while the budgeted revenues were 6.5 trillion rubles. Ninety percent of 1997’s revenue was earned on privatization of 11 corporations. The State Property Ministry and Russian Federal Property Fund’s budgeted revenue for 1998 is 9,525 mn rubles (in 1998 rbls).

**Principles for Transparent and Competitive Privatization in Russia**

A priority objective in the enterprise sector is to revitalize privatization with a credible privatization program that is based on the principles of transparency, openness and competition. Despite the extent of Russia’s earlier privatization initiatives in transferring assets to private ownership, the state remains, by far, the largest property owner, and the federal government continues to retain majority ownership or control in many large enterprises. This underlines the importance—both in strategic and fiscal revenue terms—of implementing the future privatizations in a sound manner.

Privatizing these remaining assets—and doing so using **competitive and transparent** procedures—is necessary so as:

- to *increase efficiency in use of the assets* by improving enterprise management and corporate governance, enhancing restructuring incentives, and locking in hard budget constraints.
Under competitive privatization procedures, the winning bidders are more likely to be those who can best manage the assets—and thus produce the highest value added for the economy.

- **to send a signal to both domestic and foreign investors** that Russia’s business environment is open, competitive, and investor-friendly, and that private sector development is market-driven. Transparent privatization militates against insider deals and sends the signal that regulatory and other similar decisions in Russia are made predominantly on commercial, economic grounds.

- **to promote domestic support for overall market reforms** and to demonstrate to the Russian population that privatization can be open and fair. The Russian public has been extremely disenchanted with many of the transactions in the past few years that have transferred assets to a select group of insiders at give-away prices.

- **to raise substantial budget revenues.** Cross-country experience shows that competitive and transparent privatizations could generate billions of dollars in needed fiscal revenue over the next several years.

The process by which privatizations are carried out has important ramifications for the efficiency of resource allocation, further investment from domestic and foreign sources, public support for reform, and budget revenues. Thus future privatization procedures—especially for the largest companies—should adhere to the following principles:

- **The design of each transaction should be tailored** to the enterprise’s and purchaser’s specific situation—this is the hallmark of the “case-by-case” approach. The transactions should be done in the context of an overall privatization process that is well planned and executed in conformity with international investment practices and capital market standards.

- **Transactions should be transparent and competitive** to ensure equal access by all potential investors, including foreign participants. Reputable and experienced independent financial advisors are critical to safeguard the integrity of the process; their involvement is integral to the case-by-case framework that has been established (see below).

- Maximum restructuring efficiency and financial returns to the government from a sale will likely come by **utilizing outside, strategic investors** who can bring renewed commitment and fresh ideas to the business.

**Russia’s Institutional Framework for Case-by-Case Privatization**

To meet these objectives in the case-by-case privatization program, the Government issued two resolutions -- Government Resolutions No. 363 of April 1, 1997 and No. 564-R of May 12, 1997 -- specifying rules and implementation procedures for such privatizations. The
resolutions require the case-by-case privatizations to be fully open and competitive (including through equal and open access to domestic and foreign buyers), and using openly and competitively selected financial advisors. The privatization processes themselves will also be widely advertised domestically and internationally. Enterprises will be valued at market prices or, if they are not traded, based on international business valuation procedures.

The Government selected four pilot companies for an initial case-by-case privatization program beginning in 1997 under the principles outlined in the resolutions, and appointed tender committees for these privatizations under GKI Directive No. 356-r of May 15, 1997. By November 1997 the financial advisors had been selected for three of the four cases, and it is planned that beginning in the spring of 1998 the tender committees will issue the tenders for the sales

Beyond the pilot 4-firm project, the Government has committed to implementing future privatizations on the basis of a common framework of principles and procedures that ensures transparency, openness and competition. Bidding procedures will encourage all interested parties to participate; privatizations will be widely advertised, including internationally where this could attract additional qualified buyers; when employed, financial advisers will be reputable, and engaged through a transparent, competitive process; conflicts of interest will be avoided; and bid evaluations will be carried out objectively.

The methods for carrying out future privatizations will be "commercial competitive bidding", and "auctions" or "specialized auctions" as defined in law, including "On Privatizing State Property and on the Principles of Privatizing Municipal Property in the Russian Federation", which was adopted by the State Duma on 24th June, 1997 (the "Privatization Law"). The new law provides a legal basis for privatization, which since 1992 has proceeded entirely by presidential decrees and government resolutions. According to the law, each year a new privatization program has to be passed along with the budget. Major new provisions of the law are related to management of the state shareholding in privatized companies, the rights of workers' collectives in future privatizations and ensuring greater transparency of the privatization process. The law eliminates most insider privileges during privatization and sets out procedures for determining more realistic market valuations of assets on sale.

In accordance with the Privatization Law, in August, 1997 the Government submitted to the State Duma the "State Program of Privatization in the Russian Federation" ("State Privatization Program"), which identifies two lists: (i) 33 state enterprises held in federal property and subject to reorganization into open joint stock companies and privatization beginning in 1998; and (ii) 27 open joint stock companies whose federally held shares are subject to sale beginning in 1998. Not counting the four pilot case-by-case transactions initiated in 1997, at least a quarter of the enterprises which are on the lists (i) and (ii) above, and which will experience continuation of privatization measures initiated in 1997 or initiation of such measures in 1998, will be privatized through "case-by-case" transactions as defined by Government
Resolutions 363 and 564-R of 1997 (involving in particular the engagement of financial advisers as early as possible in the process), and building on any experience from the four pilots. Privatization of the eight largest companies on the lists, as measured by their assets, will be privatized in accordance with the case-by-case institutional framework. The Government will take all reasonable steps to ensure State Duma deliberation on the State Privatization Program, and to facilitate its passage. Should the State Duma not approve the legislation in a timely fashion, the Government will take all necessary and feasible steps in conformity with the legislation in force to enable the privatizations referred to in (i) and (ii) above to proceed in 1998-99 in accordance with the approaches defined above.

To increase the scope of privatization, a Presidential Decree will be issued in 1998 that reduces the list of “strategic” enterprises under Government Resolution 949 of September 18, 1995 barred from any privatization, by either domestic or foreign investors. The enterprises to be removed from the “strategic list” shall include enterprises in at least the following sectors: chemicals and petrochemicals; medical equipment, health and drugs; light industry and cosmetics; iron and steel; air transport; sea and river transport; grain storage and processing; transport construction; petroleum; civilian research; machine tools and machines; power generation; construction and building materials; coal; industrial freezers; industrial fuel storage. Subsequently in 1998, the enterprises removed from the list shall be subject to privatization.

The Government is also committed to ensure that foreign investors have equivalent access to privatization tenders and auctions as domestic investors. To that end, the Russian Federal Property Fund and the Ministry of State Property will ensure that, at least 45 working days prior to the auction or tender of the enterprises included in the State Privatization Program and the privatization of other enterprises where the starting price exceeds US$50 million, individual advertisements for the sales shall be placed in widely read international publications.
Chapter Four

FUNDAMENTALS OF CASE-BY-CASE PRIVATIZATION

Dick Welch*

Introduction

This presentation is based on my experience as a senior Canadian government official in the privatization program at the Department of Finance, where I worked for a number of years before coming to the World Bank. We generated about C$10 billion in revenues from our privatization sales over 10 years. The Canadian program involved sales of the national airline, national railway, much of the telecommunications business—all using case-by-case methods. I will also draw lessons from my experience in the Lithuanian and Indonesian privatization programs. Lithuania has followed a privatization strategy similar, in some ways, to the Russian one: first, mass (voucher) privatization, then cash sales and now they are starting a case-by-case program. Indonesia, as Russia, has a very rich resource base but, it has been able to attract substantial foreign investment and funds to government through privatizing state firms in infrastructure and mining.

Advantages of the Case-By-Case Approach

The case-by-case approach has been widely used outside transition economies. It has a number of advantages over other methods. The heart of this approach is that each privatization is handled as a distinct process and that allows the government to resolve various policy issues that arise when privatizing larger companies. For example, in the telecommunications sector there are specific regulatory issues that must be resolved before the sale to receive the full price from the sale. There are questions for example, on how to deal with employees, how to deal with foreigners’ participation and other issues. Therefore, only the case-by-case approach, doing one deal at a time, allows the government to resolve all the policy issues and, thus, maximize the selling price.

Other advantages of the case-by-case approach include greater opportunities to obtain much needed foreign capital, managerial and technological knowledge and better access to the world market for companies. This presentation examines the five-step process for case-by-case privatizations and the four main sales options: public share offer (IPO), trade (third party) sale, negotiated sale and mixed sale.

* Dick Welch is Private Sector Development Specialist, Private Sector Development Department, The World Bank
**Steps in Case-By-Case Privatization**

Case-by-case privatization has five steps: i) selection of candidates, ii) feasibility study and developing sale options, iii) privatization plan, iv) passing necessary legislation or obtaining approvals, v) and the transaction (sale).

**Step One: Selection of Privatization Candidates.** This is not necessarily an easy task. What can be generally recommended is that the government should look at most or all of its state-owned enterprises as possible case-by-case privatization candidates and only then choose those which are commercial, marketable and do not have overwhelming policy reasons to be kept in government. Those firms that are not marketable for a variety of reasons should be dropped. This is a much better approach than first compiling a huge list of enterprises not subject to privatization and then seeing what is left for case-by-case. For example, in Canada only a few enterprises from a large list of SOEs were considered to be of strategic importance, such as, broadcasting, and thus not privatizable. There must be a process of identifying the right privatization candidates. Since case-by-case sale can be a laborious and demanding process, it makes sense to select only the best ones. Another principle is to select more candidates than you think you can sell because often circumstances change and you may not be able to proceed to sell all the candidates you have chosen. Therefore it is advisable to have a pipeline of privatization candidates that can be moved into the sale process as required.

The privatization decision will depend on the priorities of the government and what results it expects to achieve from its privatization program. For example, the overriding goal of the Canadian privatization program was to sell state-owned companies that had no clear public purpose while maximizing receipts from sale.

The government can use a policy test to establish what should be privatized and what should remain in government hands. For example, the Canadian policy test is to establish whether an SOE’s function is “central” to government by analyzing the need for government ownership or direct delivery of the SOE’s service or product. If a SOE does not meet this test, it becomes a privatization candidate or a candidate for shutdown.

Once the identification process has been completed and a list of candidates selected, a review is usually undertaken, with ministers and senior officials, to decide which SOEs will move onto the second step of the process—the feasibility study.

**Step Two: Feasibility Study and Sales Options.** Once the candidates are selected, it is important to hire financial advisors who will help determine which candidates are marketable, what the sales options are and the value of the enterprise. When the Canadian Government was deciding on privatization method for its satellite telecom company, it was inclined to do an initial public offering (IPO) but the financial advisor’s view was that, although an IPO would be possible, it would bring a lot more revenue to sell to a third party (as a trade sale) which, in the
end, was the method used. The government will also need to appoint its team of officials who will be responsible for the sale. The financial advisor will work closely with this government team and the privatizing candidate, and the advisor will develop several options on how to sell the company. The feasibility analysis will include an examination of the following:

- the economic performance and efficiency of the SOE, its profitability and its potential; (This will involve a review of the firm’s financial and operational results and forecasts)
- the internal structure and management of the firm;
- the need to corporatize the firm prior to privatization;
- the need for restructuring and rationalization; (Restructuring should be limited to: financial (balance sheet) and labor issues, which may include reductions in labor or transfers of social services. Implementation of technology changes, substantial investment of capital and major purchases should be left to the new owners, not to government agencies. Financial advisors will usually be able to recommend what is the minimum restructuring that is needed to maximize chances of successful sale.)
- the environmental aspects of the privatization, including past and future pollution, and the need, if not already in place, to establish environmental legislation or regulation;
- the market situation in which the enterprise should be working, particularly with an evaluation of whether any existing monopoly should be broken up or preserved;
- the characteristics, concerns and requirements of potential buyers and investors;
- the valuation of the firm and the timing and method of privatization, i.e., the privatization options;
- the policy issues that need to be resolved before moving to privatization; and (For example, what regulation, if any, is required, what level of foreign participation is acceptable and what role will the employees play in the privatization.)
- any restrictions on sale (For example, government shares, golden shares or special terms and conditions.)

The final step in the advisor’s assignment is the valuation of the SOE to give a price range within which the company can be sold. If there are two options for sale, the advisors will give two price ranges. Usually, at the end of this feasibility stage, the advisors will produce a report laying out what the sales options are and what the sales timing should be (whether the
company should be sold now or later) and what the value range is. This will allow senior
government officials and ministers to decide whether they want to proceed, how and how fast.

Valuation of the SOE is of paramount importance and is aimed at establishing a likely
sale price for the enterprise. In Western market economies, the current practice is to base
valuation on discounted cash flow projections of future earnings and comparisons of like firms’
market prices when sold through trade or negotiated sales or their stock market valuations, if
publicly traded. Replacement value and book value are less satisfactory measures of value.
Book value is meaningless in privatization sales, being based on historical costs, and replacement
value may be much higher than the company could be sold for.

**Step Three: Privatization Plan.** Once the feasibility study is completed, a decision on
whether and how to proceed to sell can be taken. To proceed, a privatization plan is required. It
will include the steps for resolving outstanding policy issues:

- the regulatory regime which will be used;

- the details on the timing and method of sale;

- the resolution of employee issues; and
  (Such as share ownership plans, pension and benefit issues, downsizing provisions and
  protection of employees)

- the process for choosing financial advisors and sales agents for the sale.
  (These may be the same advisors who prepared the feasibility study.)

**Step Four: Passing Necessary Legislation and Getting Approvals.** This needs to be
done prior to the sale. The necessary approvals should be obtained and the policy issues resolved
before the sale starts. As much as possible, the sale should be removed from the political
process.

**Step Five: Transaction (Sale).** Initial Public Offerings (IPOs) are normally used for
large, attractive and (at least potentially) profitable SOEs. IPOs can be used to sell shares both
to domestic and foreign buyers. Developing and transition countries’ IPOs are normally in the
form of American or Global Depository Receipts (ADRs or GDRs). IPOs can be structured to
give a preference to small individual investors that allows government to widen share ownership
and strengthen capital markets. In the UK, IPOs were used widely whereas in Canada only the
largest companies were sold through public offerings while the majority of firms were sold to
third parties through trade sales.

Trade, or third party, sales involve a sale of some or all of shares to some third party,
which can be another company or a consortium of companies or a person (domestic or foreign).
It is extremely important to use here an open bidding process (auctions) because it allows the government to get the best price, provides maximum transparency and, thus, protects government officials from accusations of special interest in the deal.

A negotiated sale is the least transparent and, as there is only one buyer, it is difficult to achieve the highest price. Negotiated sales are used in two cases. First, if after an open bidding process there is only one qualified buyer interested, it is necessary to negotiate with that buyer. Likewise, when there is only one obvious buyer and it therefore does not make sense to organize competitive bidding. In Canada, for example, there was the case of the air navigation system where it was decided to sell the system to a user owned company. The sale was extremely successful but it took a long time to negotiate a mutually acceptable price and conditions. Otherwise, the process resembles a trade sale.

Mixed sales are used when the government wants a strategic buyer to bring investment and know-how to restructure the company but still would like to keep some of the shares to sell domestically or abroad to have the shares widely distributed among the citizens or small institutional investors. Normally, after a trade sale of controlling interest the performance improves quickly and the government can earn large revenues by undertaking a public share offering. This technique is successfully used in many developing economies since it serves simultaneously a variety of purposes: economic, financial, social and political. It provides strong owners-good corporate governance, the possibility to maximize revenues and investment, political support to the entire privatization and market reform program and social cohesion as mixed sales strengthen the middle class and promote popular capitalism.

Lessons Learned

- **Transparency and openness.** The first principle is that the privatization process must be transparent and open. If it is not transparent the government will not know if all who would have participated and possibly paid a higher price will have done so. If the process is not open and transparent, the government will be very vulnerable to various accusations of sweet-heart deals with the winners at fire-sale prices. Finally, investors are discouraged by opaque sales processes and many will not participate in them.

- **Value for assets.** The second principle is that the government has to receive a value for its assets in order not to compromise the privatization program.

- **Level playing field.** All the participants must be treated fairly. If the process is not fair, those who wanted to pay the highest price may not participate because they will perceive their chances of winning a bid as compromised. Participation in bidding process in case-by-case privatization involves high preparation costs: accounting, legal, consulting, management costs, and a potential buyer will only submit a bid if he feels that the process is fair, open and deserves the time and money that has to be spent.
• *Pre-sale restructuring and investment should be minimized.* Buyers will decide how to do it best. The government should do the absolute minimum necessary to get the sale done. Some financial restructuring is warranted before sale as well labor restructuring because it is easier for the government than for the buyer to deal with redundant labor.

• *Public information campaign is critical.* Successful programs have always relied on public support which requires active efforts on the part of the privatization agency to explain the purposes of the program to the broader public, the benefits to the people, economy and privatizing enterprises as well as provide extensive information on the course of implementation of the privatization program.
Chapter Five

HIRING AND USING ADVISORS

Dick Welch\textsuperscript{*}

What Are Financial Advisors?

Investment or merchant banks are usually used as financial advisors for bigger privatizations. They sell a firm’s shares through share flotations, third party trade sales, negotiated sales or mixed sales. Other advisors are also used in privatization such as, legal advisors, auditors and various technical advisors. Government may use a consortium of financial and other advisors instead of a single financial advisor. It is important to decide in advance whether the government wants to hire its advisors separately or as a consortium. There is an advantage to hiring a consortium, as the head of the consortium will be responsible for managing all the advisors as a team. Whereas, if they are hired separately, they will have to be managed individually which may be the more expensive and time consuming option, particularly if government officials do not have experience in this area. Both a foreign and domestic advisor are required if the government wants to sell shares in an SOE both domestically and abroad.

If the transaction is limited in size and is unlikely to attract much international interest, business consulting firms may suffice as financial advisors. However, even big six accounting and consulting firms have limited experience selling significant companies in comparison with merchant banks.

Why Are Financial Advisors Needed?

Government will need financial advisors in case-by-case privatizations to value the enterprise and to advise the government on the timing and method of sale. The financial advisor will also advise on sales options. Advisors will establish the price (usually a price range) that the government could receive for the enterprise. The advisors may provide several valuations based on different sales methods, for example, whether sale is through a stock flotation (IPO) or through a trade sale.

Once the Government has decided when and how to privatize, it will require a financial advisor and sales agent to undertake the sale. Then a financial advisor and sales agent will help design the privatization sales plan and will plan and undertake the sale, in cooperation with Government officials. When a privatization moves to the sales stage through an IPO, a syndicate of investment or merchant banks will be formed to sell the shares in the SOE. The government will need to appoint a firm as a lead manager for the syndicate to manage the sale process.

\textsuperscript{*} Dick Welch is Private Sector Development Specialist, Private Sector Development Department, The World Bank
Financial advisors and sales agents will also advise on the costs and benefits to government of the policy framework for the privatization, that is, nature and term of any monopoly, restrictions on non-resident participation, regulatory regime, effects of value of environmental problems, etc. Financial advisors and sales agents will also advise government officials on all commercial aspects leading up to the sale and will manage the bidding process or undertake the public offering of shares.

**Why Are Other Advisors Needed?**

Other professional advisors are also necessary in the privatization process. Lawyers will be required to manage the due diligence process, advise government on the legal aspects of the privatization draft and draw up confidentiality and sales agreements. Accountants and auditors may be needed to undertake audits before the sale and industry technical experts and specialists may be required as well.

The companies being privatized will normally require an audit before the sale. Generally, the financial advisors should start their work before the audit and they should guide this process as they will know what kind of audit is required for the sales process.

**Should the Government Use the Same Financial Advisor for Both Stages of Privatization?**

Privatization literature often questions whether the same financial advisory firm that advised the government during the early stages of the privatization process should undertake the sale of the enterprise. The argument against using the same advisor is that there is a conflict of interest inherent in advising on whether and how to privatize an enterprise and on the actual sale of that enterprise.

However, the best advisory firms are often reluctant to undertake the advisory role if they cannot participate in the sale, which is usually the more profitable assignment. Moreover, the mandate of the investment bank responsible for the placement may be structured in such a manner that the higher the effective sales price, the higher will be the compensation to the bank. Therefore, it is in the interest of the financial advisor and sales agent to maximize proceeds. Finally, if the financial advisors have done a good job on the initial advisory, the government will probably want them to complete the sale, as they already understand the company’s specifics, the method of sale they proposed and have a commitment to the valuation they made.

A way to manage this issue is to tender for both the initial financial advisory and the sales agent advisory but not restrict the winner of the first from participating in or winning the second.

Alternately, the government can bind the advisor to a two-stage assignment: a) feasibility study and b) sales process. In the advisory contract there will be a clause allowing the government the option of changing the advisor through the cancellation of the contract after the
first assignment. This will give the government an exit at the first stage if it is not content with the advisor.

Foreign Advisors

In transitional and developing economies, the government will probably want to use a consortium of domestic and foreign advisors. Where the Government expects participation by foreign investors, foreign capital sources or where it will sell shares on international markets, the Government will need to hire foreign financial advisors. These advisors can and should work with the domestic advisors who will address the more local issues. The government should not be shy about hiring foreign advisors, particularly for the larger privatizations.

Tenders for Financial Advisors

It is extremely important that governments engage advisors through a competitive bidding process. This secures the best advisors for each particular sale and best possible price for the advisory services.

However, given the specialist nature of the advisory service, government officials may wish to use a «short list», limited to those firms that have the experience and marketing capacity necessary for the privatization. The list, as a rule of thumb, should have eight to ten companies on it to avoid too few bidders if some companies should decide to combine to bid or a number should be uninterested in bidding. Interested firms would then make written submissions against broad terms of reference drawn up by the government. Face-to-face interviews with key officials of the best two or three of the firms would then follow.

In submitting their proposals in the tender process, financial advisors should be asked to be as inventive as possible. They should explain to the government how they would undertake the sale based on the information in the TOR and other sources. This will force them to do some independent research and they quite often come up with impressive ideas. It is also good practice to include a draft contract in the initial invitation package and indicate that this is the contract the government intends to use. This will help reduce the amount of negotiations with the winning advisory firm.
Chapter Six

THE TRANSACTION PROCESS

Olivier Frémont*

Methods of Sale

What are the main methods of privatization? Let us rank them in order of decreasing State participation. First, come management contracts. In this case the State continues to own the company while the management is entrusted to a private operator who receives a fee in exchange for his services. The profits or losses generated by the operations belong to the State. Next come leases, where the operator partakes in the profits of the enterprise, and further down the line, concessions whereby a private operator assumes responsibility for investments in the company and pays a concession fee to the State.

Further down the list, the debt-equity swap is one way of privatizing. A bank or other creditor may agree to swap its debt into equity, thereby diluting the State’s participation or it may decide to sell the equity to a strategic investor.

Privatization by capitalization has been developed by the Bolivians. It entails first doubling the capital of the company by issuing new shares reserved for a strategic investor. After the capital increase, the shares owned by the State are used in part to fund the pension funds and the rest is sold to private investors through a public offering.

This brings us to the next two methods. The first method is the international tender, sometimes called third party sales. The second method is the Initial Public Offering (IPO) or public offering, whereby privatizable shares are sold via the stock market. If the company is being listed on the stock exchange for the very first time, it is an IPO. If the shares are already quoted on the exchange, it is a Public Offer.

But before we discuss these two methods let us continue to review the different privatization methods. Next to tenders, come private placements or negotiated (direct) sales. In this case the privatizable shares are sold without competition but on the basis of direct negotiations with a prospective buyer. Direct sales do not maximize proceeds and are therefore only used when there is just one obvious buyer and no other way to sell the shares.

*Olivier Frémont is Senior Private Sector Development Specialist, Private Sector Department, The World Bank
Then there are *management/employee buy-outs (MEBO)* and *liquidation*. Although MEBOs are not considered to be very successful in Russia, they may achieve good results provided that the new owners have their personal wealth at stake. There has to be a realistic threat of bankruptcy to focus the mind and force rationalization.

Finally, there come *mixed sales* which may combine tender, public offering and possibly direct sale/MEBO. In mixed sales, several transactions are carried out in sequence. The optimum way is first to sell a stake through a tender to a core shareholder. Once the company as a going concern is secured, or "anchored" in reliable hands, the residual shares may then be sold to the public via the stock market. At the same time, a direct sale can be used to sell shares to the employees of the company on a preferential basis. Let us now focus on tenders and IPOs.

**Structuring Tenders**

**Critical Path.** The period of implementing a case-by-case (CBC) privatization tender can be illustrated by the following timetable called "critical path". On the diagram 30 weeks are spent from the time of the selection of auditors to the announcement of the results.

<table>
<thead>
<tr>
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<th>weeks</th>
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<tbody>
<tr>
<td>Select auditors</td>
<td>1-2</td>
</tr>
<tr>
<td>Carry out audit</td>
<td>3</td>
</tr>
<tr>
<td>Select financial advisor</td>
<td>4</td>
</tr>
<tr>
<td>Valuation exercise</td>
<td>5</td>
</tr>
<tr>
<td>Finalize transaction structure</td>
<td>6</td>
</tr>
<tr>
<td>Draft tender documents</td>
<td>7</td>
</tr>
<tr>
<td>Identify potential bidders</td>
<td>8</td>
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<tr>
<td>Advertising</td>
<td>9</td>
</tr>
<tr>
<td>Launch tender</td>
<td>10</td>
</tr>
<tr>
<td>Negotiations with bidders</td>
<td>11</td>
</tr>
<tr>
<td>Select winner</td>
<td>12-30</td>
</tr>
</tbody>
</table>

Source: author

The first task is to select the auditors and then begin the audit. Simultaneously or immediately following the selection of auditors, comes the selection of the financial advisor. This is done so that the latter has a chance to guide the auditing process. The financial advisor undertakes the valuation exercise. Generally, the method of sale is of critical importance to the value of a company. Indeed it may be different depending on whether it is sold by tender or by IPO. A valuation exercise includes a period of "due diligence" during which the financial advisor becomes familiar with the company and verifies that all the information he has received is accurate and that no significant fact was omitted which might have an adverse impact on the value of the company. The financial advisor visits the company, gets acquainted with its
management, the facilities, the financial records and the management accounts so that he can
prepare an information memorandum, carry out the valuation and ultimately respond to questions
from potential investors.

Although the decision to sell the company by means of a tender may be determined early
on in the process, other transaction issues such as, how much is to be sold by tender and at what
price and with which conditions, represent an on-going dialogue between the advisor and the
seller. As the valuation is being carried out, simultaneously tender documentation is finalized as
well as the final structure of the deal. In addition, a short list of potential buyers is compiled by
the financial advisor and approved by the seller.

The right financial advisor should have good sectoral experience. He should already have
closed deals in the same sector as the privatizable company. He should know the senior
management of potential buyers intimately and be able to talk to them easily. Some official
advertising in the international financial press may help but the real motivation will come from
the financial advisor carrying out some direct, proactive marketing, contacting potential buyers,
making sure their senior management knows about the investment opportunity, prompting
questions and answers, and providing all the documentation requested by them.

Once this is done, the tender is launched. A two-month duration for a tender is the
absolute minimum; three months is preferred. Then the tender is closed, short negotiations with
the bidders follow and the winner is quickly selected. The quicker the selection process, the less
suspicions there will be about the lack of transparency which is the most discrediting thing in the
investment community. Transparency should be observed all the way through under any
circumstances.

**Documentation.** The following documents usually accompany a sale by tender:

- *Confidentiality agreement.* Potential bidders should confirm that any information received
  by them will only be used in the context of formulating an investment decision and not for
  commercial purposes.

- *Information memorandum.* This document outlines the activities, history, competition,
  ownership structure, and financial performance of the company over the last three to five
  years.

- *Questionnaire on potential acquirers.* The seller must ensure that bidders are reputable,
  technically competent, have sufficient funds to effect the purchase of the privatizable
  company, and that they are not in bankruptcy.

- *Draft Sales and Purchase Agreement.* The terms and conditions of the sale should be
  prepared in advance and submitted to potential acquirers at the time they receive the
information memorandum. An important lesson in CBC tenders is that sellers should insist on negotiating on the basis of their own legal documents, rather than the purchaser's. This is important because having control of the drafting of legally binding documents reduces the chances that the final agreement does not reflect what was agreed upon during negotiations.

- **Access to data room.** In addition to the documents outlined above, for those parties who have demonstrated that they are bona fide "would be" investors, access to "data room" and the management of the company is granted. As its name indicates, "data room" is a room in which confidential information on the company is gathered. Potential bidders who visit the room may take as many notes as they wish from the documents made available to them but they cannot copy them or take them outside of the room because the information made available to bidders is likely to be valuable to competitors. It is important to limit access to data room only to those who are most likely to bid for the company.

**Transfers.** Governments often impose conditions for the sale of their privatizable companies. Outlined below are some standard clauses often used by governments to ensure that their political objectives are fulfilled besides the maximization of proceeds.

- **Consortium versus single buyer.** Strategic stakes can either be sold to a single core investor who would bring capital and know how or to a consortium consisting of a core investor allied with a series of institutional investors. If the strategic investor is likely to be a foreigner, the consortium approach may render the privatization politically more acceptable by insisting that the foreign investor allies himself with a group of domestic institutional investors. At the same time, the foreign investor is often reassured by the presence in the share capital of the privatized company of powerful domestic investors who agree to delegate management to him and enter into a shareholders' agreement with him.

- **Minimum and/or maximum number of shares per investor.** In order to ensure that the ownership structures of consortia are well balanced post privatization, governments sometimes stipulate that no investors can purchase more than a certain maximum number of shares within the consortium or, alternatively, no less than a minimum number of shares.

- **Restriction on nationality (positive or negative).** Restrictions on nationality can also be imposed. For example, governments may insist that there be at least one foreign investor in the consortium or inversely, that domestic investors be included in the consortium.

- **Minimum price.** Sometimes governments post a minimum price for the shares of the company they want to privatize below which bids will not be deemed acceptable. This approach is not recommended because the minimum price may prevent the market from functioning freely by deterring potential bidders to participate in the sale process if they
deem the minimum price to be too high. Instead of a minimum price, it is better to have a reserve price which is not disclosed to potential bidders but which may allow the government to call off the sale if bids are below the reserve price.

- **Lock-in clause.** In order to ensure that privatized companies are secured as going concerns in the next few years following their privatization, governments often seek to stabilize the ownership structure of the companies by introducing "lock-in" clauses that prevent the new owner(s) from reselling their shares before the expiration of a certain period of time, typically between eighteen months and five years.

- **Sale-back agreement.** These agreements are meant to ensure that national investors have the possibility to participate in the upside of privatization. They consist of a commitment by the strategic investor(s) to resell part of their shares on the domestic stock market after a fixed period of time which may vary between six months to several years.

- **Golden shares.** Invented by the British, these types of shares allow governments to retain some say in the future of the company once the privatization operation is completed. Typically, a golden share allows the government to veto any extraordinary decision such as a change of control in the ownership structure, a change in the focus of operations, or a major sale of assets.

**Other specific undertakings:**

- Investments commitments.

- Employment preservation.

- "Kiss and beware of rocket scientists" principle. All the options described above are useful tools to ensure that privatization takes place in the context of the overall political objectives of the government. However, caution should be exercised when using them. To maximize chances of success, sales should be structured as simply as possible. The more complicated the sale structure, the less the market is allowed to function freely, and the less the chances of success. Beware of complicated transaction structures. Privatization is not nuclear physics.

**Structuring IPOs**

**Critical path.** The critical path of an IPO is similar to that of the tender but the selection process of the financial advisor and lead manager of the issue is much more structured. This process is known as a beauty contest. Investment banks compete for this role. The financial advisor prepares the valuation and provides advice to the seller about the price at which the shares should be offered to the public. In the British tradition it is also responsible for the
preparation of the prospectus which will be distributed to all parties interested in subscribing to the issue. In the American tradition which is more legalistic, the prospectus is done by a law firm or with strong involvement of lawyers. A prospectus is an important document. It provides potential investors with all the necessary information to formulate an investment decision.

While this exercise takes place, the placement syndicate is put in place with a lead manager at its top and the members of the syndicate underneath. The seller signs a placement contract with the lead manager who in turn signs placement contracts with the members of the syndicate. In addition, the communication campaign must be organized. The communication advisor should be selected in a competitive process and sufficient time should be allowed for the preparation of the TV and radio advertisements, the billboards, the newspaper etc.

For institutional investors, special marketing efforts called road shows are usually undertaken. Once the prospectus is ready and distributed through banks branches and all other points of subscription, the placement syndicate is in place, and the road shows completed, then the subscription period can open. Experience shows that subscription periods do not need to be kept open for very long. A week to ten days is usually enough. Once the subscription period is closed, the subscriptions must be centralized, prior to the government carrying out the final allocation on a per person basis. Once this is completed, there follows a press conference and the first quotation. It is important that the last three take place on the same day.

| Figure 6.2: Critical Path in Structuring IPOs |
|----|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| weeks |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 |
| Beauty contest | | | | | | | | | | | | | | | | | | |
| Valuation | | | | | | | | | | | | | | | | | | |
| Prospectus | | | | | | | | | | | | | | | | | | |
| Placement syndicate | | | | | | | | | | | | | | | | | | |
| Select advertisement | | | | | | | | | | | | | | | | | | |
| Communication | | | | | | | | | | | | | | | | | | |
| Road show | | | | | | | | | | | | | | | | | | |
| Subscription period | | | | | | | | | | | | | | | | | | |
| Centralization | | | | | | | | | | | | | | | | | | |
| Allocation | | | | | | | | | | | | | | | | | | |
| Press conference | | | | | | | | | | | | | | | | | | |
| First quotation | | | | | | | | | | | | | | | | | | |

Source: author
Structuring the Issue. As in tenders, IPOs can be structured in a variety of ways:

- **Underwriting versus best effort.** An important issue is who takes the risk of not being able to place the shares. If the placement is done on a best effort basis, the shares which have not been placed with private investors return to the government. The latter receives only the proceeds related to the shares actually sold to private investors. If on the other hand the placement is underwritten, then it is the underwriter who takes the risk of not being able to place the shares in the market. Whatever happens the government is certain to receive the total anticipated revenue from the sale. In the UK, underwriting costs typically 1% of the issue. In the United States, this cost can be somewhat greater. In Russia, where risks would be perceived as significant by underwriters, it might cost as much as 3-5% of the issue and some issues might not be underwritten at all.

- **Pre-marketing/bookbuilding.** The cost of underwriting may be significantly reduced by using the so-called pre-marketing (bookbuilding) method. In this case the appetite of the market for the issue is tested by requesting non-binding expressions of interest from institutional investors based on a lower price and an upper price. General public interest can also be tested by recording purchase orders from the retail networks of high street banks. These indications give placing agents a very broad idea of the existing demand for the shares about to be offered for sale. As a result this exercise may significantly reduce the risks and price of underwriting. This issue is so important that it would warrant a separate seminar exclusively devoted to public placement techniques, underwriting etc.

- **Size adjustment.** In case of oversubscription, the seller may decide to increase the size of the issue. Also, in the case of undersubscription the issue may be downsized.

- **Retail investors/institutional tranches.** Broadening share ownership is often a political objective of privatizing governments. To demonstrate their political will, they give preference to retail investors in their privatization IPOs. To fulfill this objective they structure their issues with two separate tranches, one reserved for retail investors, the other for institutional investors. Typically, in industrialized countries, retail tranches represent 60 percent of the total size of the issue. In emerging markets, retail tranches of domestic IPOs can represent as much as 70 percent of the issue.

- **Subscription rules.** Usually a minimum and maximum number of shares per retail subscriber is fixed by privatizing governments. This rule is used to avoid that the lion share of an issue be taken up by a small minority of high-net-worth individuals. On the other hand, no limitation is usually imposed on institutional investors.
Placement syndicate. The schematic diagram below represents the structure of a placement syndicate. At the top, the Global Coordinator is in charge of advising the issuer and coordinating the issue. For large offerings, there would typically be a syndicate for the institutional tranche and a separate one for the retail investors. Each would be managed by one or several lead managers. When there are more than one lead managers, they are called Joint Lead Managers. Then come the Co-Lead Managers and finally the junior members of the placement syndicate.

Allotment

- Allotment. Once the subscription period is closed and all orders have been consolidated into a single order book, the next task consists of allotting shares to individuals and institutions. For political, ethical, or historical reasons, governments sometimes seek to encourage the development of a population of shareholders. In order to fulfill their political objective, governments start the allotment process by serving all retail investors with the minimum number of shares. The residual shares, if any, are then distributed on a pro rata basis. Allotments are generally discretionary for institutional investors. It is also important to eliminate multiple applications.

- Claw-back/Flow-through. If the retail tranche is oversubscribed, the claw-back technique allows the issuer to reduce the institutional tranche by a maximum amount fixed in
advance. If the one tranche is undersubscribed, the shares may be allotted to the other tranche. This is called a flow-through.

**Price Stabilization.** The reason why privatization IPOs are so popular around the world, is that they often allow small investors to earn very good profits in a short period of time. The diagram below illustrates the typical share price behavior of a privatization IPO. If the issue price is $100, in the next few days following the primary issue the price may go up to $120-130. This is because the issue was priced “generously” by the government in the primary market and institutional investors who believe that the shares are still relatively cheap and who have not been served in the primary issue as many shares as they wanted, buy in the secondary market. This makes the share price increase.

As the price increases, there are some investors, in particular the small retail investors, who decide to sell their shares and quickly crystallize a capital gain. But for some time the buyers out number the sellers and the share price continues to rise. Then comes the time when institutional investors stop buying while the retail investors continue to sell. The share price starts falling. The process of selling shares in the immediate aftermath of a primary issue is called “flow back”. Stabilization techniques can be used to prevent the share price from going or staying below the issue price. The best known technique is called a “green shoe”.

![Figure 6.4: Price Stabilization](image)

Source: author
A green-shoe is an over allotment facility. Here is how it works: An issuer wants to sell 100 shares via the stock market. He gives 85 shares to his underwriter, keeps 15 in stock (the greenshoe), and gives his underwriter an option to buy the greenshoe in part or in whole, at the issue price. Typically, the call option has a limited life span of two weeks after the end of the subscription period. During the placement period, the underwriter endeavours to place 100 shares in the market, even though he only has 85. In other words, he over-allots the shares. Say he placed 100 instead of 85. Then, depending on the behaviour of share price in the secondary market, the underwriter will follow one course of action or another. If the shares price stays above the issue price, the underwriter simply exercises his greenshoe and serves the 15 shares he did not have to his customers. On the other hand, if the share price goes below the issue price, he does not exercise his greenshoe; instead he buys the 15 shares he needs in the secondary market. In doing so, he mops up the excess supply and contributes to stabilizing the share price.

Costs. Apart from fees to auditors and lawyers, IPOs cost issuers the following generic fees:

- a praecipium to the Global Coordinator of the placement syndicate and lead manager of the issue;
- a placement fee to members of the syndicate on a pro rata basis of the shares placed by each member;
- a stock exchange fee for the listing of the company on the exchange;
- a fee to the Stock Exchange Commission for getting the prospectus approved;
- communication fees: fixed fee for creation, space on television and radio, film-making; and finally
- printing costs.
Total cost may be from 4 to 8 percent of the issue price. All the fees are paid from the gross proceeds of the transaction.

<table>
<thead>
<tr>
<th>Figure 6.5: Cost Structure</th>
</tr>
</thead>
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<tr>
<td>Audit</td>
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<td>Legal advisor</td>
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<td>Praecipium</td>
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<td>Placement fee</td>
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<td>Stock exchange fee</td>
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<tr>
<td>Visa prospectus</td>
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<td>Communication</td>
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<td>Printing</td>
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Source: author
Chapter Seven

VALUATION METHODOLOGY

Olivier Frémond*

Definitions

Before reviewing valuation techniques, we need to define a few basic elements of terminology. At the end of each financial year a company prepares its financial statements. They consist of a profit and loss (P&L) statement, a balance sheet, and a cash flow statement. If the company is to be offered for sale to international investors, it is important that these statements be prepared according to the Generally Accepted Accounting Principles (GAAP) in the United States or the United Kingdom. This is because these two countries have become the norm for financial accounts worldwide.

By the end of its financial year, a company has generated an annual revenue or turnover, and incurred some expenses in the form of direct and indirect costs. After the cost of goods sold (COGS) is deducted from the turnover, we obtain the first indicator of profitability of a company, the EBITDA, or Earnings Before Interest, Taxes, Depreciation and Amortization, also known as the gross cash flow; this number can be expressed in absolute or relative terms, as a percentage of turnover. Subtract depreciation and amortization from the EBITDA, and we derive the famous EBIT, or Earnings Before Interest and Tax. Then, by removing interest payments and taxes from the EBIT, we get the Net Profit figure.

These parameters are the most basic financial indicators which allow comparison between companies of the same sector.

Let’s now look at the other side of financial accounts, the balance sheet. Think of a balance sheet as a snapshot of a company’s finances at a given point in time. Let’s look at its components. As shown in the table below, the company’s assets are on the left hand side and its shareholders’ funds and liabilities on the right hand side. This is called T-accounting. The company’s assets consist of fixed assets such as land, buildings and equipment, and current assets such as stocks and receivables. Shareholders’ funds consist of the company’s share capital plus reserves plus retained earnings; liabilities are broken down to current and long-term liabilities. Total assets must equal total shareholders’ funds and liabilities.

* Olivier Frémond is Senior Private Sector Development Specialist, Private Sector Department, The World Bank
We are now equipped to analyze financial accounts and value companies. But before doing so, we need to define one more fundamental concept: the market capitalization of a company. It is its stock exchange value. To calculate it one multiplies the share price quoted on the Stock Exchange board by the total number of shares in issue.

With these basic tools in hand, we can concentrate on valuation methodologies. First, we will discuss the techniques known as comparable transactions and comparable companies. Then
we will focus on the discounted cash flow valuation method. We will also briefly discuss the replacement value and adjusted net assets methods of valuation.

**Comparable Transactions And Comparable Companies**

The comparable transactions and comparable companies methods of valuation are based on the fundamental assumption that two companies of the same size, in the same sector, with a similar balance sheet and similar financial results should have a similar value. The distinction between comparable companies and transactions is introduced because, when a transaction takes place, acquirers often pay a premium over the current market value of the company in order to acquire control of its cash flow.

Comparison is important for determining market values because valuation is not an exact science; it is more of an art than a science. One very effective way of getting close to the market value of a company is to identify a sample of similar companies in the same sector with comparable prospects for growth. Within this sampling, we can look at their market values in relative terms, by means of a series of ratios between their market capitalization or the transactions values of a control block of their share capital, and their financial results. These ratios can then be applied to analyze the financial results of the company we want to value.

There are four principal ratios, used in combination, to value companies. They are: Price/Earnings or PE ratio, the EBIT ratio, the EBITDA ratio, and the Turnover ratio.

**The PE Ratio.** This ratio compares the market value of a company with its net earnings, either historical or prospective. Consider a company quoted on a stock exchange. Its PE ratio is the result of its market capitalization divided by its net profit figure for the previous year, or if projections are available, for the current year. A PE ratio is the equivalent of a multiple of net earnings, or in other words, it is the number of years necessary to reach pay back for an investment, assuming that the company will continue to generate the same results over the interval. So, for example, if a company generated 10 dollars per share in profits last year and its share price is $100, it will take you ten years to recoup your investment if you buy the shares, assuming that the company continues to generate the same profits in the future. Let’s say, for example, that you plan to implement an IPO of a pulp and paper company and you want to determine what your issue price should be. One way of estimating this price is to look at the PE ratio of a series of comparable quoted pulp and paper companies. Taking the average of these PEs and multiplying this number by the latest net profit figure of your own pulp and paper company, will give you an estimate of its total market value, and dividing this figure by the total number of shares in issue will give the issue price per share. As you can see, this is a very useful benchmark for valuing the companies.

**The EBIT Multiple.** The calculation of the EBIT multiple is similar to the PE ratio. But remember from our earlier discussion that the EBIT is a measure of the financial performance of
a company before interest payments and tax. Take, for example, two companies in the same sector, similar in all respect, with the same profit and loss statement and the same total assets, except that one has no debt on its balance sheet while the other has some. Their net profit figures will be different. But their EBIT should be similar. In other words, the EBIT measures the operating profit of a company independently of the financial structure of its balance sheet. This means that when you multiply a company's EBIT by its appropriate EBIT multiple, you get the market value of its total assets. To arrive at the market value of the company's shareholders' funds, one must subtract the long term liabilities from the value of the total assets. In the professional jargon, we say that the EBIT multiple is "above the line" while the PE ratio is "below the line".

**The EBITDA Multiple or Gross Cash Flow Multiple.** The sole difference between the EBITDA multiple and the EBIT multiple is that the former is calculated before depreciation and amortization. Again, take two companies in the same sector, similar in all respects except that one company has invested a lot in fixed assets to prepare for its future growth while the other has not. The one that has made a lot of investments will have a greater EBITDA than the one that has not invested as much. Therefore, the EBITDA is a more accurate measure of the financial performance of a company. This is why financiers prefer to look at the EBITDA than the EBIT.

**The Turnover Ratio.** Like the EBITDA and EBIT multiple, the turnover ratio is "above the line," it yields a value of the total assets of the company, from which the balance sheet liabilities must be deducted to obtain the value of the equity.

**Discounted Cash Flow (DCF) Valuation**

The comparable transactions and comparable companies methods that we have just discussed are particularly useful for financial investors, that is, people who are interested in the future dividends stream of companies in which they invest and who do not take an active part in their management. They focus, on historical financial results or anticipated results in the near term and leave the management to strategic investors, typically industrial investors. Industrial investors are more concerned about the future financial results of their companies. Because they control management, they also control the cash flow of their companies. For these two reasons, industrial acquirers tend to focus on the discounted cash flow (DCF) method of valuation rather than comparable transactions and comparable companies.

Conceptually, the DCF method is simple. It involves estimating the future free cash flows of a company over a medium to long term horizon, then applying a discount factor to these projections and sometimes adding on a terminal value. The total funded debt on the balance sheet of the company is then subtracted to obtain the net present value of the company's equity. However, in practice a DCF valuation requires the preparation of a fairly sophisticated computer model capable of running sensitivity analysis and sound judgment in the selection of the input data and of the discount rate.
Let's now review briefly each component of the DCF model. Free cash flow is defined as net profit plus interest payments, plus depreciation, minus future capital expenditures, minus the variation in working capital, that is the difference between accounts receivable and stocks, and accounts payable.

A free cash flow is the real cash balance left in the bank account of the company at the end of the financial year. Note that we add back the interest expenses to the net profit figure. This
is because it is easier to subtract the total funded debt from the net present value of the assets to calculate the net present value of the equity. Therefore, we use the “unleveraged” cash flow, or a cash flow “above the line” - to use an expression we are already familiar with.

These calculations must be repeated every year within the projected horizon. Of course, as one moves away from the present, the visibility of the future financial performance of the company diminishes. Visibility for the nearest twelve months of operations is usually fairly good, but anything beyond this requires educated guesses. Natural resources companies tend to be valued by projecting their future cash flows ad infinitum while for companies in cyclical industries, cash flow projections tend to be limited to a five to seven years horizon. After that horizon, the formula of terminal value is applied to calculate the residual value of the company. We will discuss how this value is calculated later on.

Once the cash flow projections are ready, the results must be discounted using an appropriate discount rate. Discounting is a way of taking into account the risk associated with potential investments. Projections are only just that. There is a risk that they will not be fulfilled. Of course, the higher the discount rate the lower the value of the company. The discount rate depends on the perception of the country’s political risk, on the intrinsic risk of the industry to which the company belongs, and on the specific costs of equity and of debt of the company being valued.

\[
\text{DISCOUNT RATE} = \text{POST TAX COST OF DEBT} \times \text{DEBT/EQUITY RATIO} + \text{COST OF EQUITY} \times (1-\text{DEBT/EQUITY RATIO}) + \text{POLITICAL RISK PREMIUM}
\]

Let’s look at each of the elements that make up a discount rate. Starting with the last one, the political risk, let me give you the Russian example. Russia is still perceived as a risky country. Because of this perception of risk, the discount rates used to value Russian companies are high; as a result, Russian companies are often valued as much as 20 times less than comparable companies from the European Union. The more transparency, openness, and political stability investors perceive, the lower the risk premium they will demand and the higher price they will be prepared to pay for Russian companies.
Cost of Debt. The cost of debt is calculated by taking an average interest rate charged to the company by its banks on its loans multiplied by one minus the corporate tax rate. This adjustment is made because interest expenses are generally offsettable for corporate tax calculations. This calculation is quite easy.

\[ K = D \times (1 - T) \]

where

- \( K_D \) = COST OF DEBT;
- \( I \) = INTEREST RATE; and
- \( T \) = TAX RATE

Cost of Equity. The cost of equity is more complicated to calculate. To derive it one uses the Capital Asset Pricing model whose basic formula is set out below. We could spend several hours discussing this model but let me explain what it says in simple terms. Basically, the model asserts that the cost of equity for a corporation equals the risk free rate, that is the rate of interest paid by the government on its Treasury notes, plus a certain factor called Beta, times the expected market risk premium for the company itself as well as the industry in which the company operates.

\[ K = R_C + F \times [E(R_M) - R_F] \]

where

- \( K_C \) = COST OF EQUITY;
- \( R_F \) = RISK FREE RATE;
- \( B = BETA OF SECURITIES; \) and
- \( E(R_M) - R_F = EXPECTED MARKET RISK PREMIUM \)

The Beta factor is the most difficult variable to estimate, particularly in emerging markets. It measures the volatility of the company’s equity. If the company is not quoted,
comparisons must be made with similar quoted companies, sometimes from different countries. The problem is that the less homogeneous the sample of comparable companies, the less meaningful the calculation of the beta is.

One last word on this subject. Most investors who use the DCF method of valuation think in terms of Internal Rate of Return (IRR). An Internal Rate of Return is the discount rate at which the stream of revenue must be discounted so that the sum of earnings, such as dividends or retained earnings and the proceeds from divestitures if the investor harvests his investment at some later date, minus the acquisition price, equals zero. In the case of a DCF the stream of expense and revenue starts with an expense, the cash outlay for the purchase of the company; then it consists of the projected yearly net cash flows of the company plus the terminal value. The discount rate at which this stream of cash outlay/revenue equals zero is called the internal rate of return. Companies often use the IRR as a hurdle rate. In other words, if the IRR is below a certain number, the investment proposal is discarded.

**Terminal Value.** There are two ways of calculating a terminal value. The first method is based on taking the last cash flow of the projections, then discounting this figure using the discount rate \((r)\) used to discount the cash flow projections, adjusted by an amount equal to the average growth rate of the last two cash flows \((g)\), to the power \(n+1\).

The second method represents a market-based approach. The terminal value is calculated by multiplying the EBITDA of the last projected year by the average EBITDA multiple of comparable quoted companies, and by dividing this figure by the discount rate to the power \(n\).
FIRST METHOD:

\[ T_V^{N+1} = \frac{CF_N}{(R-G)} \]

where

- \( T_V \) = TERMINAL VALUE
- \( CF_N \) = PROJECTED CASH FLOW IN YEAR \( N \)
- \( R \) = DISCOUNT RATE
- \( G \) = AVERAGE GROWTH RATE OF LAST CASH FLOWS

SECOND METHOD:

\[ T_V^N = \frac{(EBITDA_N \times M)}{R^N} \]

where

- \( T_V \) = TERMINAL VALUE
- \( EBITDA_N \) = PROJECTED EARNINGS BEFORE INTEREST, TAX, DEPRECIATION AND AMORTIZATION IN YEAR \( N \)
- \( M \) = AVERAGE VALUATION MULTIPLE OF COMPARABLE QUOTED COMPANIES
- \( R^N \) = DISCOUNT RATE TO THE POWER \( N \)

Replacement Value And Adjusted Net Assets

The last two methods of valuation are rarely used by acquirers. Most of the time buyers discard them as irrelevant because these methods do not provide a measure of yield of the proposed investment. Unfortunately sellers tend to focus on them. This can create serious difficulties during negotiations.

1. **The Replacement Value Method** measures what it would cost to replace the assets if they were suddenly lost or destroyed.

2. **The Adjusted Net Assets** method calculates the fair market value of the assets on the company’s balance sheet, taking account of the depreciation and tear and wear of the assets, and then subtracts from this number the company’s liabilities.

\[ \text{ADJUSTED NET ASSETS} = \text{FAIR MARKET VALUE OF ASSETS} - \text{LIABILITIES} \]
To conclude our discussion, the table below presents the result of a recent valuation exercise for a refinery in an emerging market. Let us look at the results of the different methods. The DCF method gave a range of values comprised between $340 million and $690 million. The comparable transactions method gave variable results depending on which multiples were used: financial multiples gave a bracket of $595 million to $710 million, while the use of operational multiples resulted in a range of $85 million to $260 million. The comparable companies method gave a lower value range than the comparable transactions. The value of the company came out between $540 million to $650 million. The adjusted net assets method resulted in the value of $390 million (which is low) and the replacement value method gave $975 million, way above the other results. In the end, the financial advisor to the privatizing government estimated the value of the company to be between $450 and 650 million.

**Valuation Summary**

<table>
<thead>
<tr>
<th>Valuation Method</th>
<th>Equity value for 100% of Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>DCF</td>
<td>$340 - $690</td>
</tr>
<tr>
<td>Comparable transactions</td>
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</tr>
<tr>
<td>financial multiples</td>
<td>$595 - $710</td>
</tr>
<tr>
<td>operational multiples</td>
<td>$85 - $260</td>
</tr>
<tr>
<td>Comparable companies</td>
<td>$540 - $650</td>
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<tr>
<td>Adjusted net assets</td>
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<td>Replacement value</td>
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Source: author
Chapter Eight

ORGANIZING GOVERNMENT FOR PRIVATIZATION

John Nellis*

Introduction

Over the last ten years we have learned a great deal about how governments best organize themselves to carry out privatization. We have learned that case-by-case privatization in particular poses heavy administrative and managerial demands on the government as a seller.

In terms of their organization, successful privatization programs have the following characteristics:

- First, they are located at the center of government, i.e. at a powerful position near the focus of the governmental decision-making process.
- Second, they have a champion, i.e. a strong individual or a set of individuals at the highest ministerial and bureaucratic levels who support them, push for them and fight the inevitable major political battles on behalf of the privatization program.
- Third, they have a relatively narrow set of clearly defined aims and goals.
- Finally, they have the capacity to develop institutional competence and experience. In practice this means that the government administrators have the capacity to hire and to supervise private sector support services—investment bankers, lawyers, accountants and management consultants—because the bulk of the work on the preparation of privatization deals is carried out, not by government bureaucrats who have little experience in these matters, but rather by private sector professionals.

Central Location

Why should privatization programs be placed at the center of government? There are several reasons:

First, privatization is always and everywhere an intensely political process. It generates opposition from a large number of actors within the bureaucracy and in the society (labor unions, nationalist parties etc.) Central location of the program in the Prime Minister’s Office, in the Presidential Office, in the Ministry of Finance or some separate powerful ministry (as has been

* John Nellis is Senior Manager, Private Sector Development Department, The World Bank
the case in several successful privatization programs) places it in the position where it can, if not overwhelm opposition, at least do battle with opponents on equal footing. Thus, the chances are maximized that political and bureaucratic resistance can be more easily overcome with some degree of effectiveness.

Second, privatization programs are usually part of a larger economic reform program, such as a structural adjustment package, and they need to be coordinated with the overall macroeconomic policy. Therefore, there needs to be a close relationship between privatization authorities, the Ministry of Finance and the Central Bank officials, and this can be best achieved by use of a central position.

Third, privatization has a wide-spread impact affecting line ministries, the business community, labor, local government, consumers and “civil society” hence it has wide-spread political repercussions. Often it is absolutely necessary for senior officials and ministers to intervene to resolve issues.

Finally, there is hardly a country in the world where a privatization program was immediately welcomed by the society as a whole. All required a considerable amount of discussion, negotiation and compromise. A central location and strong political leadership are indispensable for this to take place.

**Clearly Defined Aims and Goals and Centralized Authority**

Privatization programs need clear aims and goals. These can be laid out in policy statements, law, decrees or instructions to officials. Lack of clear goals leads to confusion; confusion leads to delays or poor transactions. Privatization affects a wide range of interests; clear goals permit rational trade-offs.

Clarity is best achieved when there is centralization of privatization authority. However, a pronounced tendency can be seen all over the transition economies to divide this responsibility among a number of state agencies. The Russian situation is quite typical. Part of the responsibility lies in the GKI, another part in the State Property Fund, some responsibility is delegated to key ministries and to top it off there are regional authorities at the republic, oblast and municipal level who also take some part in the privatization decision-making process.

One can understand the reasons for this dispersion of authority; the size of the country, the fragility of the transitional political process, the need to reward different stakeholders both geographically and politically, all led to the situation which currently exists in Russia. However, the fact is that this division of responsibility is very costly when it comes to the case-by-case method, which is difficult to implement even with a highly centralized administrative mechanism. Diffuse, overlapping and conflicting responsibilities will make this process
especially complicated. This is not an insurmountable obstacle but one which has to be squarely addressed in order to achieve good results in case-by-case privatization.

Develop Institutional Competence and Experience

Privatization of state firms is a complex task. It requires commercial and policy skills not usually found in government. Successful programs have staffed privatization agencies with people skilled in commercial, financial and business matters, usually drawing them from the private sector. The need to develop institutional competence also militates for the establishment of one privatization body for case-by-case privatization. It can build experience over time by carrying out a number of privatizations.

International Experience

International experience confirms that most successful privatization programs are situated in the center of government. Canada ran its most successful privatization program from the central Department of Finance. New Zealand and the UK ran their programs from the Treasury Department. In any case, all successful programs require strong political and bureaucratic support and direction. This sort of support is usually most available in the center of government.

In Canada three different organizational forms were tried for administering the privatization program in the period from 1985 to 1997. The first organizational structure was characterized by the domination of line ministries who were running privatization under the guidance of a Monitoring Group at the Treasury Board. This scheme was not successful at all; this Monitoring Group was not able to control the process. Some of the ministries would not proceed with their privatizations. Even worse, others would proceed without sufficient knowledge of what they were doing. Finally, the program came to a halt because of a scandal. The main reason for the failure of this organizational model was the lack of centralized control of the process.

The second organization for privatization created a separate Department with its own Minister. That worked reasonably well because of the central control of the privatization process. The line ministries were expected to cooperate with the Privatization Department and thus the second requirement for a successful program—the concentration of the privatization function—was met. However, the first condition was missing; this agency was not attached to the center of decision-making and had a relatively weak Minister. Therefore, it was difficult to move the privatization program through the government process.

After a couple years the privatization function was reorganized for the third time and moved to the Ministry of Finance. This had several advantages. First, it was possible to bring a small group of professionals into the Finance Ministry who knew how to carry out the privatization process. Second, privatization was placed as close to the center of government as
possible in Canada. The Department of Finance is the second most powerful ministry in the country. This worked extremely well; over one third of all sales during the ten year program were done during the three years when privatization was run from the Finance Department or under the control of the Ministry of Finance.

So the lesson is to have a very small group of highly professional people within government with a powerful Minister representing the interests of privatization.

In Morocco there have been three institutions involved in privatization. First, there is a Ministry of Privatization directly under the Prime Minister. Second, there is a Valuation Authority directly appointed by the King of Morocco and made up of seven independent individuals who alone are entitled to fix the value of companies to be privatized. Finally, there is a Transfer Commission whose function is to provide guidance and advice to the Ministry of Privatization on the transaction structure.

The Ministry of Privatization had overall responsibility for the program. It was staffed with a very small group (about ten people) of government officials and a number of private sector professionals, dealing with audit, valuation and placement. The prime role of the Ministry was to manage a group of private consultants, manage the timetable and make sure that private operators were meeting the deadlines and complying with the privatization legislation of the Kingdom of Morocco. This has worked quite well.

Conclusions - What To Do

To conclude, let us discuss the positive and negative international experience in institutional arrangements for case-by-case privatization. First of all, the privatization decision-making process must be at the center of government and responsibility for it must be assigned to a powerful Minister or other influential governmental leader.

Second, the decision making function of the privatization process should be focused in one place and not broken up among several ministries and agencies.

Third, the privatization agency needs to be staffed with top-rate officials who have the experience and training in commercial and financial matters and who have the ability to negotiate, to monitor and to enforce the substantial number of contracts with the private sector that will be necessary to carry out privatization campaigns. Very often these people will come from the private sector.

Finally, privatization agencies should be provided with adequate funding so that the substantial number of advisors needed (both domestic and foreign) can be hired and the best and brightest in the public service can be retained in the agency for a sufficient period of time to gain the necessary experience.
Conclusions - What Not To Do

Unfortunately, some privatization "don’ts" have taken place in Russia already. For example, the principle of not splitting the privatization function among a number of different agencies, ministries and commissions has not been observed in Russia.

A second lesson is not to give the decision making function in privatization to the branch or line ministries who tend to be defenders of their own bureaucratic domains and not take a national perspective. This has proven a serious problem in several transition economies.

Thirdly, one should not let the SOEs privatize themselves. The SOE management is in a conflict of interest situation in such a case. They also do not take a national perspective and look after their own very narrow interests, or special interest of their enterprise or their sector and devote little or no attention to any conception of national or public interest.
Part Three

CASE STUDIES
Chapter Nine

PRIVATIZATION OF SAMIR
THE PRINCIPAL REFINERY OF THE KINGDOM OF MOROCCO,
1995-97

Olivier Frémont

Introduction

Like many developing countries, the Kingdom of Morocco has recognized that the privatization process is critical to the economic development of the country. Before starting the process, the Moroccan Government spent approximately four years creating the necessary framework for privatization, including the privatization law and the institutions necessary for administering the program. Finally, in 1993, divestiture began.

According to the newly created privatization law, companies can be privatized in one of three ways: i) fixed price Initial Public Offers (IPOs), ii) tenders, and iii) private placements; hybrid transactions which combine the three methods can also be used. Employees of privatizable companies can, at the discretion of the privatization minister, be offered the option to purchase 10 percent of the capital of their company (or 20 percent of the privatizable tranche, whichever is the lowest), at a 15 percent discount to the IPO price or the effective sale price to the strategic investor.

By 1995, the Privatization Ministry in the Kingdom of Morocco was under pressure from the government to move the privatization process forward more quickly. The government was counting on promised revenues for its fiscal budget. Unfortunately, the Ministry was experiencing delays from the time consuming valuation exercises and audits and therefore, was unable to bring companies to market as quickly as anticipated. In addition, in anticipation of larger stock market transactions compared with the previous IPOs, it was anxious to estimate the overall absorption capacity of the domestic market for shares of companies privatized through the local stock market.

These two issues—the delay in the completion of audits and valuation exercises, and the desire to gauge the absorption capacity of the domestic market—led the Ministry of Privatization to come up with an ingenious solution. It decided to issue exchangeable privatization bonds. These bonds are essentially Treasury Notes, instruments issued by the Government with capitalized interest until December 31, 1998 at which time the buyers receive a bullet payment.

* Olivier Frémont is Senior Private Sector Development Specialist, Private Sector Department, The World Bank
There are two additional features of these bonds. First, they are exchangeable for shares of any company privatized via the stock market; and second, the bearers of these bonds are given a “first order priority” over cash subscribers. The “first order priority” advantage is valuable given the history of over-subscribed privatization issues in the Kingdom of Morocco.

The exchangeable privatization bonds essentially bought the Privatization Minister, Mr. Abderrahman Saaidi, some much needed time during which the audit and valuation process could be completed appropriately. By the time the bonds had been placed in the market, the audit and valuation of SAMIR were completed and the company was the first in the privatization pipeline.

**SAMIR Corporate Profile**

The company, Société Anonyme Marocaine de l’Industrie du Raffinage (“SAMIR”), is the principal refinery in the Kingdom of Morocco. SAMIR has been in existence for approximately 35 years. It is one of the biggest companies in the country and is perceived as “blue chip” by the public. It had the following ownership structure prior to privatization: 98.82% — State, 1.12% — private investment company and 0.06% — privatizable bank. The company was incorporated in 1959 (for 99 years). It had a production capacity of 6,250,000 tonnes per year (rather small by world standards), 1,190 employees and an 80% market share.

**SAMIR FINANCES IN 1995**

- Total Assets: US$647 million
- Share Capital: US$118 million consisting of 20,641,500 shares of $5.7 each
- Shareholders' funds: US$125 million
- MLT liabilities: US$8 million
- Net Profit: US$52 million
- Cash Flow: US$66.6 million
- Trade Protection: Yes
- Investment requirements: US$300 million

**Objectives for Privatization**

The Government of the Kingdom of Morocco was anxious to accelerate the pace of the privatization program. The Ministry of Privatization and the Finance Ministry were keen on exchanging privatization bonds to cancel the debt obligation of the Treasury. This brought SAMIR to the market as soon as the audit and valuation exercises were completed. The specific
objectives of transferring the ownership of SAMIR to the private sector were to: (i) attract foreign capital, (ii) promote the transfer of technology and know-how into the company, (iii) broaden share ownership, and, if possible, (iv) use the privatization transaction to put corporate Morocco “on the international map”.

The privatization of SAMIR began in 1996. The desire to cancel a substantial part of the exchangeable privatization bonds together with the concern that the tender process for a strategic investor would take considerable time, led the Privatization Ministry to decide to IPO the company first, then to seek a strategic investor by an open tender.

The Transaction

Twenty-five percent of the share capital was reserved for the IPO which was targeted preferentially at retail investors. In case of oversubscription the Ministry retained the right to increase the size of the issue to 30 percent; 3 percent was reserved for employees. Employee shares were offered for sale at a 15 percent discount to the IPO price through a direct sale. The remainder of the shares were reserved for a strategic investor who was to be identified through an international tender. If the strategic investor did not want to purchase all the shares still owned by the State, the remainder would be sold by means of global offering on the international markets, through a GDRs issue.

The IPO of SAMIR came within two months of the exchangeable bond issue. The 25 percent minority offered for sale was worth US$147.5 million. The size of the issue was fixed to take account of the amount of privatization exchangeable bonds in circulation. The issue was structured in two tranches, one for retail investors (70 percent) and the other for institutional investors (30 percent), with a clawback clause to reduce the institutional tranche by as much as 50 percent if the retail tranche was oversubscribed. Subscription rules included a minimum and a maximum number of shares per retail subscriber and the allotment rules consisted of serving small investors first, then the large subscribers on a pro-rata basis.

For the IPO, the company was valued at $600 million or 11.5 times the 1995 net earnings. The comparable transactions method of valuation yielded a range comprised between 11 and 16 times net earnings; and the comparable company method, a range between 8 and 15 times net earnings. So on a PE ratio basis, the issue was relatively generously priced. However, the multiple of book value was unusually high at 4.8 times book, indicating that the value might be too high for strategic investors who would focus on the discounted cash flow method of valuation. Nevertheless, the $600 million price tag was maintained. However, the price per share based on the market value of the company was deemed too high to attract small investors, because of the relatively small number of shares in issue. To render the issue more attractive to small investors it was decided to incorporate the reserves into capital and to reduce the nominal value of the shares from Dh100 (US$11.44) to Dh50 (US$5.72) per share. This allowed to bring the issue price down to $27.8 per share or Dh243 per share.
The issue was oversubscribed 1.2 times. In order to serve the shares to the cash subscribers (after serving the exchangeable bond subscribers in full), the size of the issue was increased to 30 percent. In the secondary market, the share price gained 25 percent in the days following the IPO. There were 35,336 cash subscriber and 24,000 bond subscribers. All subscribers received some shares and the number of cash subscribers was reduced to eliminate multiple applications. All bond subscribers were served. In terms of the number of shares allotted, however, the outcome was somewhat different. Cash subscribers requested 5.6 million shares and received only 819,000 shares while the bond subscribers received 100 percent of the shares they requested.

![Figure 9.1: Placement Statistics: Number of Subscribers](image)

Source: author

![Figure 9.2: Placement Statistics: Number of Shares](image)

Source: author
In terms of categories of subscribers, retail investors received most of the issue: 82.0 percent for the bond subscribers and 85 percent for the cash subscribers were retail investors. Among the institutional subscribers, the mutual funds which were only coming into existence and remained thinly capitalized, received 4.9 percent; other institutional investors between 10.6 percent and 13.1 percent, depending on whether they were cash subscribers or bond subscribers.

The decision to conduct the IPO before the tender for the strategic investor caused some difficulties. Industrial acquirers rarely value companies on the same basis as financial investors. The latter focus on historical financial results whereas the former look at future cash flow. Significant differences in valuation occurred during the tender. Potential acquirers argued that their DCF valuations yielded results significantly lower than the stock market price. On the other hand it was politically inconceivable to agree to sell a majority stake in SAMIR to a foreign investor at a price lower than the price at which Moroccan retail investors had purchased their shares. It was difficult to reconcile approaches. The Ministry of Privatization could not launch the tender until differences were reconciled. As the tender was delayed rumors started circulating in the market that that the Ministry of Privatization had difficulties identifying a strategic investor for SAMIR. The share price dropped. There emerged a real danger that the share price would drop below the issue price. Confidence in the whole privatization program would then have been at risk.

The financial advisor retained by the Ministry of Privatization initially approached 80 potential acquirers to solicit expressions of interest. Fifteen of them were retained as serious candidates. They were provided with an information memorandum, were allowed access to the data room and to management. In addition they were requested to answer a prequalification questionnaire including an indicative value for the company under certain conditions.
The government hoped to bring a number of parties into a consortium, including domestic institutional investors. It wanted to retain the right to finalize the participants in the winning consortia. Each potential bidder was requested to submit a negative list of parties that they would not want to join in a consortium. Unfortunately, the pre-qualification questionnaire proved difficult to fulfill. All the bidders despite expressions of interest refused to suggest even approximate values. The government was in a difficult situation, there was a fragile stock market price and the risk that the highest price in the tender would be lower than the IPO price.

It transpired that bidders might be willing to pay a price in excess of the IPO price if the Government agreed to guarantee a period of protection from foreign imports. In fact, the longer the period of protection the more they would be willing to pay. In the end the government agreed to a seven to eight year period of protection and launched the tender. The winner was the Corral Petroleum AB Holding of Sweden, which paid Dh251 (US$28.72) per share for the 67.7 percent stake still owned by the State, compared to Dh243 (US$27.80) per share for the IPO price. The losers were Moroccan consumers who would have to pay a higher price for gasoline for the next seven to eight years and those domestic institutional investors who were not able to participate in the transactions. If the IPO had not been done first, this would probably not have happened. However, overall the SAMIR privatization was quite successful although it carries some important lessons for practitioners in other countries.

Lessons Learned

The following lessons could be drawn from the SAMIR case:

- Use valuation method appropriate for method of sale: DCF should be used for a tender and financial multiples for an IPO.
- Use realistic discount rates in DCF: in the SAMIR case the discount rate was too low.
- Favor retail investors in IPOs: it is politically advantageous and makes privatization more sustainable.
- Remain flexible: ability to quickly adapt to changing circumstances is necessary in order to get out of critical situations.
- Don’t IPO before strategic sale: the stock market price may fall as a result.
- Don’t separate valuation from placement: in this case it resulted in overvaluation.
- Don’t increase the size of issue unless oversubscribed by at least 2 times because the initial surge in prices may be delusive.
- Don't disclose bidders identities because they collude.

<table>
<thead>
<tr>
<th>LESSONS LEARNED I: DO's...</th>
<th>LESSONS LEARNED II: DON'Ts...</th>
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<tr>
<td>1. Use valuation method appropriate for method of sale.</td>
<td>1. Don’t IPO before strategic sale.</td>
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<td>2. Use realistic discount rates in DCF.</td>
<td>2. Don’t separate valuation from placement.</td>
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<td>3. Favor retail investors in IPOs.</td>
<td>3. Don’t increase size of issue unless oversubscribed at least 2 times.</td>
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<tr>
<td>4. Remain flexible.</td>
<td>4. Don’t disclose bidders identities.</td>
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PRESS RELEASE: THE RESULTS OF SAMIR PRIVATIZATION

The Ministry of Privatization and State Enterprises concluded Morocco's largest privatization to date by selling the hard core of the main oil refinery SAMIR.

The successful sale met all objectives concerning the size of the required investment, the impact of the sale on the financial markets, and the strategic role of the two companies in the Moroccan economy.

A first tranche of 30% of SAMIR was sold on the Casablanca bourse by IPO in March 1996. That tranche targeted small shareholders. It was followed by a worker tranche in June 1996.

The Ministry named two banks as advisers in placing the hard core: Salomon Brothers and the Banque Commercial du Maroc through its subsidiary Attijari Finances. The banks first sounded out 77 potential investors for reactions to the proposed sale. Later, tender documents were sent to interested investors. The tender deadline was set for 28 April 1997.

The Transfer Commission, presided by the Minister of Privatization and State Enterprises, in the presence of the Ministry's advisory banks and legal counsel met on 29 April 1997. It ruled that the winning bid was that submitted by Corral Petroleum Holdings AB of Sweden.

Corral's total bid was 3,508,360,281 DH for 67.7% of SAMIR's capital [13,977,531 shares at 251 DH per share]. It should be noted that the SAMIR price exceeds the 243 DH minimum price set by the Valuation Authority.

At Corral's request, the State will retain a small stake in the firm for a short period not to exceed one year. The stake is set at 6.77%. At the end of that period, Corral will buy the State's remaining shares.

In addition to the purchase price, Corral's development plan provides for investments of 3.87 billion DH over the next five years. Corral will also keep current employment levels and guarantees adequate market supply conditions.

Throughout the transparent transfer process, the Ministry sought to take account of sector-specific conditions, to boost competition, to look for the highest bidder, and to watch out for the interests of the small shareholders.

Corral's international prestige and its experience in petroleum exploration, production, refining, and distribution will introduce a new, dynamic element into Morocco's petroleum sector.
Chapter Ten

PRIVATIZATION OF CANADA’S AIR TRAFFIC CONTROL SYSTEM

Dick Welch*

Introduction

This case is important because it shows how to select and use advisors. The privatization took place over a two year period ending in 1995.

Description of the System

The Canadian government’s air traffic control system (ANS) was not corporatized, was part of the federal Department of Transport and was managed and staffed by government employees. The ANS is one of the two main infrastructure components that supports the operation of aircraft flights. The other is airports. ANS services include air traffic control, advisory services, airport status and weather. The Canadian ANS provides these services from seven area control centers, 55 control towers and 105 flight service stations. In 1995 ANS employed about 6,400 people, including 2,300 air traffic controllers.

Finances

Annual expenditures were about $850 million, including capital costs. Net book value was over $2 billion. Revenues came from the Air Transport Tax (ATT) which was paid by passengers on airline tickets. ATT revenues were about $700 million per year. An additional $50 million annually came from fees for air traffic services over the North Atlantic. Over-flight charges were introduced on foreign carriers’ operations over Canada in 1995. This initially raised another $150 million annually.

When the Government decided to examine the feasibility of privatizing ANS in 1993, the first reaction amongst some officials was that the system was not marketable because at the time it was running a deficit of $50 million a year. However, financial advisors were hired who valued ANS at over $1.0 billion under several different options of sale.

* Dick Welch is Private Sector Development Specialist, Private Sector Development Department, The World Bank
Rationale for Commercialization

A government owned and operated ANS was seen to have the following drawbacks:

- users were not fully paying for services received;
- management, subject to public service rules and regulations, was seen to be inflexible and not commercial in its approach;
- the system was seen to be over-staffed;
- equipment procurement was felt to be open to political interference leading to costly and time consuming capital projects; and
- there was a concern that the system could not continue to count on the government for its capital investment needs.

In 1992, the Government Commission on National Passenger Transportation recommended that ANS be converted to a Crown (state) corporation or sold to a private corporation owned by users. About the same time, the government was approached by a stakeholder group representing users expressing dissatisfaction with the ANS and recommending that it be put on a commercial footing and run as a business.

Commercialization Decision

Once the financial advisors had provided their valuation and analysis of options for sale, the government was able to make a decision on privatization. It decided to open negotiations with a user group (representing the domestic airlines and other aircraft users, the air traffic controllers and some other interests). Agreement was reached on using the government's financial advisor to help to establish a price for the sale of ANS.

This was the basis on which negotiations with the future buyer were started in the spring of 1995. Negotiations were very difficult and they lasted for a year. Both sides depended heavily on their respective financial and legal advisors to negotiate the terms and conditions of sale.

Government Principles for the Sale of ANS

The negotiations incorporated series of requirements that the government made public. The first requirement was to sell the air navigation system at fair market value. The second requirement was that the buyer would pay cash up front and the third condition was that the Canadian Government would not give any debt guarantees. Also, the government would
establish a non-intrusive economic regulatory regime, lay out pricing principles, and provide the successor company with monopoly protection, all in legislation. The Government was also prepared to set up a special, non-intrusive regulatory body since the air navigation system was a natural monopoly. Finally, the government also established a set of principles for the sale. The purchaser would:

- preserve and promote aviation safety;
- improve the efficiency of the system;
- provide access to all users;
- provide services to remote communities;
- respect international obligations; and
- operate at full cost recovery in a fully commercial manner.

**Hiring A New Advisor**

After introduction of the new tax on foreign carriers, ANS's financial situation improved dramatically, it was then decided that the initial valuation was too low. It became clear that the purchaser could borrow more cheaply than foreseen and for a longer period of time. The government engaged a second financial advisor, Goldman Sachs from the US, to work with the Canadian advisor to redo the valuation and advise on the aspects of possible US financing for the purchaser. The advisors repeated the valuation and concluded that ANS was worth $2 to 3 billion under the new circumstances of improved financial results and easier financing. After considerable negotiation, an offer of $1.7 billion for ANS was made to the government and was accepted.

**Conclusion**

ANS is now a private company and the government has no further ownership role. Several lessons emerge from the privatization. The first was that the asset had a much greater value than many government officials at first imagined. The second is that the intensive use of financial advisors was key to a successful and remunerative sale. The second advisor was taken on when financial circumstances changed and advice was required on foreign (US) debt markets.
Chapter Eleven

TELESAT CANADA: A THIRD PARTY SALE
Dick Welch

Introduction

Telesat Canada was established in 1969 as a joint venture between the government and Canada’s major telecommunications carriers. (Most Canadian telecommunications carriers are investor-owned.) Its mission was to develop a domestic satellite-based telecommunications system. It is the only carrier providing domestic satellite facilities. It operates two satellites and a network of 500 earth stations and, in 1992, it launched two new telecommunications satellites, the Anik E2 and Anik E1. It is also the only Canadian carrier providing basic telecommunications facilities to northern communities and to remote regions in Canada.

Corporate Profile

Telesat’s major shareholders were the government of Canada with 3,225,000 shares held directly and indirectly or 53 percent of the total and the Canadian telephone companies with 2,535,000 shares or 41.6 percent of the total. Telesat accounted for about one percent of total Canadian telecommunication industry revenues in 1992. The company had 877 employees with 672 located at the head office in Ottawa and the remainder in regional offices. The Canadian Radio-Television and Telecommunications Commission (CRTC) regulates the firm using rate of return regulation.

Telesat’s Business Profile

Telesat’s business was providing telecommunication services through the use of its satellites:

- Broadcasting Services: Transmitted television programming for the major television broadcasters;
- Telephone Back-Up Services: Provided satellite based back-up capacity to the major public telephone companies;
- Private Business Network: Through its business network Telesat provided electronic banking, credit card verification, airline and travel reservations, retail inventory management, videoconferencing and business television;

* Dick Welch is Private Sector Development Specialist, Private Sector Development Department, The World Bank
- Transmission Services: Transmitted movies from one point to multi-point and direct-to-home and direct-to-cable services, etc., and

- International Services: Offered consulting services on the design, procurement, launch and operation of satellites and satellite-based telecommunications systems to international clients.

Financial Profile

The company’s revenues were derived from leasing satellite capacity to major television broadcasting companies, Canadian telephone companies and numerous smaller firms that provided specialized value-added telecommunications services. Telesat also earned revenues through the provision of voice, data and imaging services to businesses in direct competition with Unitel, a long distance carrier, the telephone companies and enhanced telecommunications service providers.

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<td>Preferred</td>
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Profit & Loss

| Operating Revenue | 146.5 | 177.8 |
| Operating Expenses | 124.8 | 138.8 |
| Net Earnings (After Tax) | 23.0 | 30.5 |

Source: author

Privatization Decision

The privatization of Telesat was announced in the 1991 Canadian Budget. Wood Gundy, a Canadian merchant/investment bank, was engaged through a competitive process as the government’s financial advisor. Valuation, resolution of policy issues and privatization options were taken to the government and a privatization plan was approved. Two sales options were considered for the privatization, an IPO and a trade sale. However, Wood Gundy advised that an IPO would be riskier than a trade sale and would bring a substantially lower price. As a result, the government agreed to privatize the company through a trade sale. Legislation to allow sale was passed at the end of 1991.
The Sale Process: Stage I

In January 1992 the government announced that it would sell Telesat through an open bidding process using Wood Gundy as financial advisors/sales agent. The same month, an information memorandum was provided to selected potential buyers. The government’s 53 percent share of Telesat -- a control block -- was offered for sale, subject to two key provisos: i) the purchaser would have to be Canadian; and ii) the sale would be subject to the approval of the Director of the Competition Bureau, the administrator of the *Canadian Competition Act*. The government stated that its decision on a buyer would be based on the “best overall offer”. This was understood by the business community, on the basis of past sales, to be the best cash price. Bidders were given 30 days to submit non-binding expressions of interest.

The Sale Process: Stage II

The sale moved to its second stage in February 1992. Confidentiality agreements were signed with two interested purchasers, confidential information memorandums were provided, a data room was established at Telesat and officials from the two interested purchasers visited the company and held discussions with Telesat’s top management. In early March, binding offers were submitted by the two bidders. Both had been pre-cleared under the *Competition Act* (as is allowed under this legislation). The government chose the higher of the two bids, $154 million Can., which was made by a consortium of telephone companies. Closing took place in April 1992. Shortly after the privatization of Telesat the Government of Canada deregulated the long distance telephone market. More recently, the deregulation of the local telephone market has been announced. Telesat has undergone a number of significant changes as a fully private company. A significant reduction in the staff of Telesat has occurred and Telesat has withdrawn from unprofitable activities in competitive markets.

Conclusion

The Telesat Privatization shows that a successful privatization can be undertaken and the public interest protected where the utility is properly regulated and competitive issues are addressed. It also illustrates the need for competent and experienced financial advisors who, in the case of Telesat, were able to advise the government on the differences in value between the two sales options and undertake a successful sale in a difficult sales situation - where only two bidders were interested in the company.
Chapter Twelve

CASE-BY-CASE PRIVATIZATION EXPERIENCE IN CENTRAL AND EASTERN EUROPE

Igor Artemiev

Introduction

This presentation looks at the experience of Central and Eastern Europe (CEE) on the basis of a study undertaken on trade sale privatizations in Poland, Hungary, the Czech Republic and the Slovak Republic.¹

The sales in this study took place in 1990-1992, when there was still an underdeveloped legal and institutional framework for case-by-case privatization. This experience is interesting for Russia since it is now entering the stage where a similar privatization model is to be used. The study involves 22 companies with a total turnover from $4 million to $300 million, i.e. companies of medium size by Russian standards. The study sheds light on the issues of efficiency of case-by-case privatization, namely, whether the value of hiring financial advisors is worth the price paid in terms of receipts from privatization and other quantitative indicators of sales outcomes.

Overview of Results

Trade sales were an important component of privatization in Hungary and Poland, and to a lesser degree in the Czech and Slovak Republics. Out of 6,000 large and medium-size privatized state enterprises, about 1,300 were sold to strategic investors, many of them on a case-by-case basis. Critics argued that trade sales were cumbersome, slow and expensive; proponents believed that they were the best way to ensure substantial budget receipts and investments, as well as restructuring.

The average period of closing a case-by-case deal was 15 months. On average, one deal cost 30 person-months of consulting services and brought $55 million in revenue, out of which $32 million were budget receipts and the rest was to be invested into enterprises themselves.

¹ Igor Artemiev is Senior Private Sector Development Specialist, Private Sector Development Department, The World Bank

What was the result of these deals? Many efforts were undertaken to engage investors in the process, but their overall activity was rather low. In half of the cases, negotiations were held with a single potential investor. The experience with 22 case-by-case privatizations in CEE shows that only in four cases there was a real competition and in 15 cases the same company was chosen as was proposed by the privatizing enterprise managers.

Policy Lessons

Let us now discuss the issues that arose in the case-by-case privatizations in these countries and the lessons which can be drawn.

First of all, a privatizing company’s workforce should feel some sense of “ownership” in the privatization plan. On the other hand, giving the workforce a veto right may paralyze the privatization process. In Poland and Hungary, the labor force had to give its agreement, while in the Czech and Slovak Republics such agreement was not necessary. Some financial incentives may be necessary to stimulate the interest of the employees but are not sufficient. For example, in Poland, in two of the six cases, employees bought their shares and only when the investor offered to immediately buy them at double the price. Therefore, other measures are needed to speed up the privatization process. For example, Hungary passed a law which required that all state enterprises initiate their privatization. The lesson here is let the employees have a voice but without a veto right and give them a financial incentive to support the privatization.

Another issue is the state of the financial situation of the privatizing enterprises. Most of these 22 enterprises were in good financial shape; but during the 15 months of preparation for privatization their financial balance worsened. This can be explained by the fact that the managers had their hands tied and could not take necessary actions when external conditions sharply deteriorated after the collapse of the Soviet bloc and resulted in the loss of major export markets. So by the time of privatization deal closing, six enterprises were on the verge of bankruptcy. The lesson here is that the speed factor sometimes may be more important than price considerations, especially if the financial condition is rapidly deteriorating and enterprises are unable to adjust quickly or if there is spontaneous privatization and assets stripping.

The third issue is the lack of openness as far as financial disclosure is concerned, such as on bad debt to third parties. Harmonization of accounting rules with international accounting standards (IAS) will reduce the risk premium that foreign investors demand and thus facilitate their participation in privatization. When accounting risks are high, this reduces the efficiency of case-by-case transactions. The lesson: improve access to and quality of financial information available to potential investors.

Another issue concerns unclear property rights, in particular, rights to land and other immovable property. The lack of clarity of property rights to the land on which privatized
companies are located creates substantial problems for investors and greatly reduces the value of enterprises during case-by-case privatization. The problem of restitution is not relevant for Russia as it is not provided for in the Russian Federation Constitution. But the problem of federalism as regards privatization responsibility and property is very serious. The lesson: clarify property rights to reduce the risk premium demanded by investors and thus increase receipts from sales.

The next issue is environmental aspects of privatization deals, such as obligations on future protection and on restoring the environment after damage has occurred. Transaction expenses should include environmental impact assessment costs, especially if a foreign investor is sought and if a potentially environmentally hazardous object is on sale. Currently, Russian legislation does not provide for compensation for environmental damages which happen after privatization. This creates additional risk for foreign investors who want to know beforehand what compensation if any they will have to pay. These issues have to be resolved as soon as possible and careful legislation passed to establish clear policies on assignment of environmental risk.

Another issue is the residual shares left in state hands. In five cases out of the 22 sales under consideration, all 100 percent of the shares available for sale were sold to a strategic investor. Soon after the sale, strategic investors increased their share by buying equity from the employees, the population at large and the State. Three investors threatened to walk away if they were not permitted to buy all the shares. The lesson is, governments should permit strategic investors to buy a majority stake.

The last issue concerns valuation of the shares. Substantial resources were spent on professional auditors, who were hired to do valuation based on international standards. These valuations actually helped increase the selling price on average by 20 percent of the book value. A simple conclusion can be drawn here: valuation should be market-based and in line with international best practice.
Part Four

SUMMARY OF LESSONS
Chapter Thirteen

MAJOR LESSONS FROM INTERNATIONAL EXPERIENCE

Harry Broadman* and John Nellis**

The lessons from the sample of case studies just presented are summarized in Box 1. More generally, we present in this chapter the main lessons from case-by-case privatization worldwide.

<table>
<thead>
<tr>
<th>Box 1: Principal Lessons from the Case Studies</th>
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<tr>
<td>• Valuation is only as good as the data going into the equation. In the Air Navigation System case it was shown that changes in the revenue structure and a decision to open the bidding process to parties from outside Canada led to the need for a second valuation and almost doubled the initial price. Valuation is essential because it provides comfort and political cover to the selling agent but it must be treated as a flexible instrument.</td>
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<tr>
<td>• Enterprises which seem unprivatizable at the outset can be profitably privatized with the use of committed ownership and innovative financial engineering as in the case of Air Navigation System.</td>
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<td>• A strategic investor should be found first to sell at least a core or dominant stake. Only then turn to other methods of sale aimed at diffusing ownership.</td>
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<tr>
<td>• It is desirable before privatization to establish clear property rights and clear legal owners through corporatization as quickly as possible, especially in CBC deals.</td>
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<tr>
<td>• There needs to be good accounting under international standards before privatization.</td>
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<tr>
<td>• Openness, transparency and enhancing competition reinforce greatly the chances of success: the more open the process, the more bidders will participate, and the higher the price that can be received from the sale. This is why outsiders should be actively involved.</td>
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<td>• Case-by-case privatization candidates are normally attractive firms which can interest both strategic and portfolio investors. Poor quality firms should not be used, especially at the beginning of a sales program, since the costs of hiring advisors may not be recuperated. Good firms should be sold first to raise the appetites of investors and only then should unattractive companies be considered for CBC privatization. A CBC program should always start from a success story which will breed more success.</td>
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<td>• There have to be incentives for advisors to maximize the revenue from the sale and there should be a framework for replacing advisors if necessary.</td>
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<td>• Pre-privatization restructuring should be minimized and should never involve major capital expenditures. The most effective ways to raise the value of company before the sale are by changing the management and reducing the labor force.</td>
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* Harry Broadman is Program Team Leader and Senior Economist for Russia Operations, The World Bank

** John Nellis is Senior Manager, Private Sector Development Department, The World Bank
• **Tailor the case-by-case strategy to particular circumstances.** The first lesson to be learned from the privatization experience in other countries is *the need to tailor the case-by-case privatization strategy to the particular circumstances of the country and each enterprise*. Although there are a number of “best practices” and generally accepted privatization methods, only careful packaging, timing and sequencing can guarantee overall success. The accent should be on pragmatism, flexibility and willingness to try new solutions and methods.

• **Strong political support and leadership are vital for success.** The second lesson concerns *the need for support from the highest political level* for the privatization process to overcome inertia and the inevitable resistance from bureaucracy and special interest groups. Implementation should be entrusted to pragmatic individuals with political clout, no vested interest in the status quo, and who have access to world-class technical competence. The privatization arm of government should report to a senior minister and is often given special status.

• **Fears of lack of investor interest in privatization are generally exaggerated.** The third lesson concerns *the perceived shortage of interested foreign and domestic investors*. Heavy over-subscription of share offerings in Britain, Latin America and Africa (Nigeria, Senegal) took many by surprise. The level of informal savings and capital flight in developing and transition economies is usually underestimated. Proper incentives structure can motivate domestic and international investors to buy equities.

• **Transparency, fairness and level playing field are of utmost importance.** The fourth lesson concerns *the need for transparency in the case-by-case privatization process*. Asset valuation procedures have to be carried out by third party experts and be realistic, fair and consistently applied, as do procedures for calling for bids and evaluating offers. The implementing agency should take the necessary time and effort to ensure that the privatization process is well thought out, planned and executed. Widespread publicity campaigns help ensure that the maximum number of potential investors are aware of the opportunities. In trade sales, it is important to include the contract terms as part of the bidding documents to prevent undesirable changes during post-award negotiations. The privatization award process should be transparent and clear beforehand to avoid corruption and controversies.

• **Outside expertise should be sought.** The fifth lesson concerns the *need to make full use of specialist consultants*. There is a growing body of specialist experience in privatization worldwide. Local experts can be used, but governments should not hesitate to resort to services of foreign privatization experts. Investment banks, consulting firms, environmental experts, accountants and lawyers are necessary participants in case-by-case programs. *Institutional failure*, inability of the government to manage the process because of lack of qualified staff, has slowed and undermined many privatization programs.
• **Related structural reforms should keep abreast with privatization.** Privatization programs should be implemented in the framework of an overall package of mutually reinforcing economic reforms, such as macroeconomics stabilization, trade liberalization, financial sector reform, elimination of subsidies, a pro-competition policy and regulatory reform. Privatization alone is unsustainable and unable to restructure the economy if other reforms are lagging.

• **Necessary pre-privatization restructuring should be limited, short-term and defensive.** Restructuring should be limited to legal, financial (balance sheet) and organizational changes, which may include closures, reductions in labor or transfers of social services. In fact, it is preferable that government undertake necessary labor restructuring prior to privatizing a SOE. Implementation of technology changes, investment of capital and major purchases should be left to the new owners, not to government agencies.

• **Privatization programs should be proactive with strong incentives for foreign investors.** Competition among governments for investors in privatized assets is fierce. Without a conscious, consistent and aggressive policy to attract foreign investors, privatization programs may fall short on the revenue side or turn away investors who could provide market access, the latest technology and management expertise. It is critical to reassure investors that the State will not use its political power or any residual share or “golden share” in such a way that will jeopardize the company’s ability to maximize profits and efficiency.

• **Privatization in tranches or through a mixed sale may help maximize government receipts.** The speed of “digestion” of shares in emerging markets is usually rather slow and sale through several tranches may be necessary to attract maximum number of individual and institutional investors, both at home and abroad. The use of a mixed sale can help satisfy both domestic and foreign demand to the fullest extent possible and also solve the issue of corporate governance through the introduction of a strong, controlling shareholder.

• **Governments should limit the conditions attached to privatization to a minimum.** Complex, elaborate undertakings will detract from the value and attractiveness of the enterprise and may undermine the deal. The regulatory environment, price controls, subsidies and other problem areas should be cleaned up before the sale.

• **Case-by-case privatizations should not be limited by an artificially fixed timetable or deadline.** However, there is a need to keep a constant pressure on the process. Sequencing several sales in a pipeline of a case-by-case privatization program according to market conditions could meet this objective. Also, not all transactions can be successful and the government might need to reject all bids and start the bidding process anew or change the method of divestiture.
• **Public information and publicity campaigns play a critical role in case-by-case programs.** Most successful privatization programs placed a strong emphasis on educating the public and extensive advertising of the expected sales.

• **Private monopoly may be worse than a public monopoly.** Privatization of so-called "natural" monopolies should be preceded or immediately followed by a pro-competitive restructuring of the industry and *accompanied* by a clear regulatory regime with credible enforcement means and incentives.

• **Maximizing sale proceeds must be balanced with other priorities.** Although the privatization agency has a duty to ensure that state assets are sold for their fair market value, maximization of individual sale proceeds must be balanced with other priorities, such as broadening share ownership and promoting the levels of capital markets.
List of Core Participants

CASE-BY-CASE PRIVATIZATION WORKSHOP
SPONSORED BY THE WORLD BANK
NEVSKY PALACE HOTEL, ST. PETERSBURG, JULY 27-28, 1997

MINISTRY OF STATE PROPERTY

Mr. Alexander A. BRAVERMAN
First Deputy Minister

Mr. Sergey V. MOLOZHAVYI
Deputy Minister

Mr. Zumrud H. RUSTAMOVA
Department Head

Mr. Igor I. SHUVALOV
Department Head

Mr. Aleksey V. EMELYANOV
Deputy Department Head

Mr. Vladimir N. SEMERIKOV
Deputy Department Head

MINISTRY OF FINANCE

Mr. Andrei A. FILEV
Head
Department on International Finance Institutions

RUSSIAN PRIVATIZATION CENTER

Mr. Victor N. PANKRASCHENKO
General Director

Mr. Mikhail O. ERMOLOV
Deputy General Director
Procurement Department
Mr. Serguey A. ELEKOEV  
Department Chief

RUSSIAN FEDERAL PROPERTY FUND

Ms. Marina V. CHEKUROVA  
Deputy Chairman

MINISTRY OF ECONOMY

Ms. Elvira S. NABIULLINA  
Deputy Minister

Mr. Aleksandr I. VOYTENKO  
Deputy Department Head

STATE ANTI-MONOPOLY COMMITTEE

Ms. Inna V. OVCHINNIKOVA  
Assistant to First Deputy Chairman

Mr. Sergey F. KOTOV  
Deputy Division Chief

WORLD BANK

Harry BROADMAN  
Program Team Leader and Senior Economist for Russia Operations  
Europe and Central Asia Region

John NELLIS  
Senior Manager  
Private Sector Development Department

Olivier FREMOND  
Senior Private Sector Development Specialist  
Private Sector Development Department
Igor ARTEMIEV  
Senior Private Sector Development Specialist  
Private Sector Development Department

Dick WELCH  
Private Sector Development Specialist  
Private Sector Development Department

Elena SHTYKANOVA  
Operations Officer  
World Bank Moscow Office
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