RECOMMENDATION ON PRIVATIZATION PROGRAM

REPUBLIC OF THE PHILIPPINES

REPORT BY

THE FIRST BOSTON CORPORATION

CENTER FOR PRIVATIZATION
1750 New York Avenue, N.W.
Washington, D.C. 20006

Project No. 13

July 1986

Prepared for the
BUREAU FOR PRIVATE ENTERPRISE
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

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Macro/Micro Economic Analyses
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Strategic Planning
Taxation

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A. Executive Summary

1. This report is the result of a 2 week visit in the Philippines with Ministers, various Government officials and private sector leaders. The visit was coordinated and sponsored by the U.S. Agency for International Development (U.S. AID) Mission in Manila and the Private Enterprise Bureau of the U.S. AID.

2. The recommendations of this report apply primarily to the privatization of going concerns or Companies and not to the liquidation of assets such as land and machinery.

3. To undertake the privatization process, the Government should establish a divestiture unit. The unit will comprise a staff and an executive director. The staff, consisting of 10 local professionals, would be responsible for marketing the Companies but will not have any management or operational responsibilities of the Companies it is marketing. An executive director whom the Government has appointed to carry out the privatization mandate will head the unit. A board, chaired by the executive director, and consisting of highly respected Government officials and private sector figures, would approve or disapprove all privatization transactions negotiated by the unit.

4. The unit will receive the assistance of an outside adviser experienced in the privatization of Companies in financial difficulty and of Companies often requiring financial or corporate restructuring. The adviser would provide and guide the unit on the following areas:

- Recruiting and Training the Unit Staff
- Providing Information and Data Management
- Valuing Going Concerns
- Preparing Sales Memorandum
- Advising on Financial and Corporate Restructuring
- Setting up Data Room
- Preparing Potential Buyer List
- Distributing Information
- Developing Bids and Negotiating
- Designing the Transaction
- Providing Fairness Statements
- Advising on General Pitfalls in Marketing the Companies

5. The Government should not create holding companies or funds. The divestiture facility should under no circumstances be formed as a corporation or para-statal organization of independent ownership and or of indefinate life. Emphasis on centralization, simplicity, flexibility and speed will be the keys to success.

6. To the extent that Companies are rehabilitated, the Government should only undertake financial or corporate restructurings. As a general rule, the cost of rehabilitation of physical assets, both in terms of money and time spent will not be recovered in the sale.

B. Introduction

First Boston International has been invited by the U.S. Agency for International Development through the Center for Privatization to report on the design and execution of a privatization project for the Government of the Philippines ("the Government"). This report emphasizes the areas which we feel are critical for the success of the privatization effort and is the result of a 2 week visit with various Government officials and members from the corporate, legal and accounting communities.

It is inappropriate to give a very detailed and definitive plan given our relatively short visit and the complexities of the issues involved. However, our trip confirmed that the experiences and the lessons we have gained as the adviser for privatizations in countries such as Spain, Canada, Italy, Colombia, Chile, United Kingdom and Costa Rica are applicable to the privatization issues facing the Government.

Based on these experiences and based on the meetings we held in Manila, in our view, it is critical that the vehicle through which the privatization is carried out is characterized by flexibilty, simplicity and political support. To this extent we recommend a structure which places emphasis on efficiency and pragmatism. We suggest that the Government form a small privatization unit staffed by qualified local professionals and headed by a director who has the full support of the Government to carry out the mandate.

The special circumstances of this privatization project should be emphasized. It includes Companies in financial difficulty in an environment in which the local capital market base is relatively small and the international capital markets are difficult to access.

C. Reasons for Privatization

The Government may have many reasons for privatizing the state chartered companies and certain companies that have come into the ownership of the Government due to default on loans and other reasons (together the "Companies"). During our meetings the Government presented some or these reasons. They are, to:

1. Return to the private sector those Companies that was never meant to be under Government control but came into Government receivership due to defaults and other difficult circumstances.

2. Avoid the continuing drain on the budget caused by loss makers.

3. Generate greater dynamism in the economy, which will provide greater wealth and employment.

4. Increase the capital revenues for the Government.

5. Signal the Government's belief in and wish to encourage the private sector.

6. Encourage wider share ownership of major Philippine Companies and help develop a local capital market.

7. Alleviate foreign debt problems caused by the heavy foreign debt servicing requirements of many Philippine Companies.

The relative importance to the Government of these factors will in some degree influence the weighting given to the different target purchasers and thus to methods of disposal.

D. View Regarding Potential Purchasers

Because many Companies are difficult to divest, the Government should in principle entertain all categories of solid and reputable buyers including foreign corporations and individuals. All reasonable options should be left open. Some of the major reasons for this recommendation are:

1. Although the reflow of flight capital is one of the aims of the Government, at least in the short-term, individual Filipinos may not have sufficient disposable income to facilitate the privatization of major Companies.

2. If Filipino investors know that foreign competition exists, the proceeds realized on sales are likely to be significantly higher than if it is known that foreign buyers are not allowed to bid.

3. There are some indications of interest in portfolio investment by foreign nationals. However, investment on a major scale will take time and will need to be under pinned by an economic and monetary policy which has been seen, for some time, to be both stable and encouraging to investment.

Consequently, it is our impression that for any large scale privatization to be possible, investment by foreign companies will be an essential and major ingredient in the process. Such companies will also bring other advantages, including, access to and knowledge of markets worldwide and large scale integration in production, marketing and distribution. By including foreign investors, the privatization process can also foster exports. Recent studies of industrial exports in Brazil and Mexico indicate that 50% of the expansion in manufactured exports in the last decade was attributable to multinational corporations.

We understand that there is some support for enforcing a minimum of 60% local participation for most ventures. A broad application of this rule, howevever, can adversely affect the privatization. Foreign companies, by and large, are unlikely to have a significant interest in portfolio investment. Their preference would normally be for majority ownership.

Additionally, in order to minimize political visibility, foreign investors prefer to enter the local markets through arrangements falling under general investment rules rather than on a case by case basis or through loopholes. In those cases where the national interest is at stake, the Government may wish to consider the use of a "Golden Share," that is, a share retained by the Government which has voting rights only in certain well defined circumstances affecting the national interest, but which is controlling when used. For example, in the privatization of British Telecom, the British Government retained a Golden share, thereby retaining the right to determine all cases concerning mergers, takeovers and sale of key assets.

E. Structure

1. Treating Going Concerns Differently from Assets. The Governmei owns both Companies and physical assets through its agencies or i banks. However, in order to focus the privatization effort in direction which is going to be economically and political successful, the effort should be centralized on the going concern or Companies rather than on assets such as machinery or land. Ma of the Companies that are privatization candidates are what tl Government calls non-performing assets (NPAs) and belong to tl Development Bank of the Philippines (DBP), the Philippine Nation Bank (PNB) and the National Development Corporation (NDC). Some (the DBP and PNB Companies that the Government would want t privatize, and is currently considering to do so, are in minin hotel, and transportation industries. Manila Gas Corporation is example of an NDC Company which may not be technically an NPA b may be considered a good privatization candidate.

   We recommend that assets, such as land, machinery and oth non-going concerns, which have come into the ownership of DBP a PNB, should continue to be managed and disposed of by DBP and PNB.

2. A Clearing System. Although we do not recommend the creation of holding company, or a fund, a mechanism to deal effectively wit legal and administrative matters is important. For example, system should be developed to facilitate the liquidation of tl losses or surpluses associated with the privatization.

3. Privatization Unit and the Board. It is very important that tl privatization unit has no responsibility for the operation management of the Companies. Furthermore, the director and tl staff should be engaged on fixed term contracts of 2 to 3 yea depending on the scope of the privatization. It should be ma clear at the outset that no extension of contracts is expected. Th following categories should be included.

   i) Staff. It is composed of 3 basic groups.

      Negotiators. Four to six professionals whose prima responsibility is to market and subsequently negotiate the sal of the Companies and have primary contact with the potentia buyers. Negotiators are likely to be between 35 and 40 yea in age with relevant financial qualifications, e.g. experienced MBAs. Wherever possible, they should have no majo connection with the Companies though some may be recruited fro DBP, PNB or NDC.

      Evaluators. Four to six professionals whose prima responsibility is to help the negotiators by providing sal brochures, carrying out valuations of the Companies coordinating all matters related to auditing and othe technical information. Each evaluator should be matched wit one negotiator to form a two man team. Evaluators are likel to be between 30 and 35 in age.

Lawyer. An inhouse lawyer with experience in constitutional and corporate law and a good understanding of the Ministries should provide legal assistance. This lawyer may work for both NDC Companies and DBP and PNB Companies. His role is extremely important when completing complicated or creative structurings such as an Employee Stock Option Plan (ESOP).

ii) Executive Director. The unit would be headed by an executive director who would report to the board of which he would be chairman. The director would be a man of reputation and standing in the community with no previous connection with the Companies. He would have considerable discretion and authority over the privatization process.

iii) Board. The board members would be representatives of various Government Ministries and Agencies, and local businessmen of high reputation and independence. Its main purpose is to serve as a buffer so that the privatization can take place without political impediments.

The board would meet at regular intervals to consider recommendations from the privatization unit on the terms of the sale and the buyer for each Company. The board would have the power to accept a recommendation or reject it. It would not have the power to amend any recommendation. It is expected that members would make their decision on the basis of a dossier on each Company provided at least 24 hours in advance of the meeting, coupled with a presentation on the recommendation from the director.

The Government may also wish to consider whether any recommendations for the sale of Companies exceeding a certain peso value, having been approved by the board of trustees, should be submitted to the Cabinet for final approval. The purpose of this procedure would be to demonstrate that a particular recommendation has the full support of the Government.

F. <u>Marketing the Companies</u>.

In order to maximize the return to the Government, we recommend that the privatization unit, under the leadership of the executive director, and in certain cases with the approval of the board, undertake the following areas of preparation carefully.

1. Audit. The first requirement is a full audit, as of the latest practicable date, performed by one of the "Big Eight" firms or one of its local affiliates. A copy of the signed audit report would normally be a part of the sales brochure. An audit which corrects any previous over valuation of net assets, should greatly help the Government to minimize the possible criticisms that the national patrimony was being sold cheaply.

2. Data Room. For most major Companies there is likely to be a large volume of detailed information, books of account, inventory list, etc., which a serious purchaser will want to examine. For this purpose, a data room should be arranged. An adviser with offices in the major international cities for example, Tokyo and London, may also set up data rooms in these cities for Companies for which significant foreign interest exists.

3. Financial Restructuring. Some Companies have a debt burden too great to be serviced by their cash flow. In these instances the unit should recommend the amount of debt the Government or its agencies should absorb and how much should be left on the balance sheet of the Company. The bidder would himself have views on whether he wishes to pay a relatively low price and accept a high debt burden or to pay a higher price and take over less debt. In considering what course of action to take, the Government should bear in mind the public reaction to the sales price which is likely to be reported. That is, the higher the reported apparent sale price, the better.

   In preparation for potential debt assumption and restructuring, the Government should establish guidelines as to which categories of liabilities will be assumed and which in general would not. For example, the Government may not wish to assume social security payments, though it may forgive tax liabilities.

4. Corporate Restructuring. Additionally, we recommend that in some situations the Government should look into the possibility of privatizing certain operations or a branch of a Company through a spin-off. The advantage of this alternative is that where the core of the Company could not or may not be privatized, the Company may nevertheless have subsidiaries, or operations, that can be privatized without harming the Company's core business. Even if the whole Company can be sold, it sometimes makes more sense to divide the Company into parts and sell them separately either to create competition or to achieve a higher return to the Government.

G. Role of an External Adviser

The privatization unit would be advised by an external financial adviser who can guide and assist unit members on the following:

1. Recruiting and Training the Privatization Unit Staff. The recruiting process normally takes about a month. During the first month of work, negotiator/evaluator teams would be assigned to Companies and with the director, would make a list of Companies to be sold in order of priority. Each team would become familiar with the important issues of the Companies in their list. Subsequently, each team would be trained on the typical pitfalls in marketing the Companies and trained on how to use software designed to help evaluate Companies and to draft sales brochures.

2. Information and Data Management. Information and data management can be a major bottleneck to a privatization process involving many entities. An adviser should recommend the appropriate hardware and software, which in some degree may already exist. While the adviser would be involved only in the sale of going concerns, information and data management can also be helpful for the sale of assets by DBP and PNB.

3. Valuation of Going Concerns. This would entail the examination and evaluation of Companies in distress with a view to determining the potential value in the future to a buyer. This is not a conventional evaluation derived, for example, from an asset based accounting treatment. The primary consideration in the valuation of a going concern is the potential cashflow, therefore, hidden assets, good will, and the industry outlook are some of the important issues to study.

4. Preparation of Sales Memorandum. The adviser would ensure that no significant information relevant to a purchaser is omitted and that the facts are presented accurately but attractively.

5. Preparation of a Potential Buyer List. In this aspect the probable worldwide connections of the adviser are likely to be of continuing assistance.

6. Information Distribution. The manner in which information is distributed to potential buyers is of crucial importance. For example, only a short summary should be sent prior to the signing of a confidentiality agreement by a potential purchaser. Additionally, only the brokers who have written evidence that they act for a specified client should be given information on the Companies.

7. Bid Development and Negotiation. In general, a negotiated bid is likely to produce the best return to the Government. Interested bidders would be required to submit written bids by a specified date. The form of the bid should be flexible but reflect the priorities of the Government and include positions on such issues as employment. Following the receipt of all bids, the units would negotiate the offers with each bidder.

8. Fairness Statement. Finally, the adviser would supply a letter of opinion giving his view on the reasonableness of the offer and whether the transaction was professionally handled.

9. Brokerage Service. If any particular Company proposed for sale is sufficiently large, complex, or likely to generate significant international interest, the adviser should, if requested and cleared through the board, conduct the total sale procedure itself using its own staff worldwide.

H. Conclusion - Requirements for Success

Based on our meetings in Manila and diversified privatization experience, we strongly believe that the efficient privatization of the Companies require the following basic characteristics.

1. Centralization. The privatization effort must be centralized around one designated body that has all the responsibilities with respect to the privatization. Furthermore, the privatization process should be carried out without political impediment once the decision to privatize is made.

2. Clear Line of Responsibility. The reporting lines to the Government of those in charge of the privatization effort must be clear and unequivocal.

3. Simplicity. Structures which are complicated beyond the necessary minimum have a tendency, over time, to lead to attitudes among staff in which preservation of interests and jobs becomes more important than the efficient disposal of Companies.

4. Flexibility. The organization must have the flexibility to respond quickly to the requirements of each Company. It must not run according to rules which ensure that each Company, regardless of its needs, is dealt with in an identical manner.

5. Action Orientation. Well developed structures are necessary but the best sign of commitment to the privatization is an early sale of a significant Company. For this reason it is extremely important that there is a successful sale of a relatively large and visible Company within 6-9 months from the start of the program.

6. Speed. If the privatization takes too long, the problems of the Companies, which are currently perceived as those inherited from the previous administration, will no longer be interpreted as such and will be attributed to the current Government.

7. Willingness to Acknowledge Losses. The Government's commitment to privatization and to the long-term success of the effort is often measured by its willingness to take losses in order to carryout the best possible transaction.

8. Choosing the Best Buyer. The best buyer is not necessarily the one that makes the best bid. The Government should make sure that the buyer has the financial and the managerial capabilities to be the new owner.

What makes privatization successful is Government commitment. A simple structure, with an emphasis on speed and flexibility with minimum political impediments is vital. We also believe that experience an adviser brings to the Government can help avoid "reinventing of the wheel" that can happen in every facet of the project.

Appendix

A PRIVATIZATION PROGRAM FOR THE GOVERNMENT OF THE REPUBLIC OF THE PHILIPPINES

List of meetings
Manila, June 19th - 27th, 1986

JUNE 19TH

Jaime Estanislao	Chairman Development Bank of the Philippines
Carlos Valdez Carmelita L. deLeon	Carlos Valdez & Company

JUNE 20TH

Victor Lim Aurelia Penquet Raul Concepcion Felix Maranba and others	Philippine Chamber of Commerce and Industry
Corazon de la Paz Alejandro Corospe G. B. Schwartzkopf Alberto R. Tejanoi	Price Waterhouse
Florentino P. Feliciano Andres B. Sta. Maria	Sycip, Salazar, Feliciano & Hernandez

JUNE 23RD

Ralph R. Moore and others	Economic Counselor Embassy of the United States of America
The Honorable Jaime Ongpin and others	Minister Ministry of Finance
Vijay K. Chaudhry	Chief of Mission International Finance Corporation
Robert Bakley	Director Country Desk Asian Development Bank

JUNE 24TH

Sonny Dominguez	Deputy Minister Ministry of Agriculture and Food
Eduardo C. Lim and others	President Makati Stock Exchange Inc

JUNE 25TH

Rafael G. Suarez	Assistant General Manager National Development Corporation
The Honorable Jose Concepcion, Jr. and others	Minister Ministry of Trade and Industry
The Honorable Luis Villafuerte	Commission on Government Reorganization
Ernest Leung	Deputy Minister Ministry of Finance

JUNE 26TH

Frantz Whiting	Representative Philippine American Chamber of Commerce
Edward David	Manager The Philippine American Life Insurance Company
Victor Macalincag	Deputy Minister Ministry of Finance
Evelyn M. Escudero	Assistant to the Governor Central Bank of the Philippines