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Some Practical Issues of Divestment and Privatization Facing LDC Governments

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The arguments, theoretical and practical, regarding the political and economic consequences and rewards of the decision to embark on a program of divestment and privatization of state owned enterprises (SOEs) have been treated in earlier memoranda. This paper deals with the broad strategy of the approach to divestment which an LDC government must develop once the decision to privatize all or parts of the public sector has been made. It is also concerned with the steps that must be taken to implement a divestment program and the order in which they should be taken. Any government will have to consider these and other questions before serious moves are made.

Three major strategic issues must be addressed at the outset:

1. Does the government seek complete sale of entities to be divested or to maintain an equity interest in the divested firms (i.e. partial divestment)? Can the government's interest be protected by the exercise of its sovereign powers without retention of partial equity?

2. What techniques and instruments are to be used to sell the companies to be privatized?

3. To whom will shares of the divested firms be sold?

The major options are:

1. Sale to a single buyer.

2. Partial divestment with government retaining a major or minor equity interest.

3. Sale to a joint venture partner, domestic or foreign.

4. Sale to the public by stock offering.

   If this option is chosen, what restrictions will be placed on stock acquisition (e.g. sale limited only to nationals of the country or only to limited groups of nationals, with or without foreign participation)?

Are shares to be reserved for acquisition by employees of the divested firms or other preferred shareholders (e.g. the British Telecoms model)? These techniques are discussed in greater detail below.

A well planned overall strategy for privatization is desirable as a preliminary step, but this may not always be possible if the announcement of the program is made in the heat of a political campaign. If it must be announced at that time, it should be couched in the most general terms and references to it kept purposely vague, since inevitably it will not go as easily as expected and may be quite different in execution from its original conception.

Officials in charge of a divestment program should realize that the decisions they will have to make will be highly complex, since a variety of individual and group interests will inevitably be involved and that disposal will take a much longer time than anticipated, particularly if the kinds of enterprises to be sold vary widely.

Setting Objectives

A major problem encountered in any initial consideration of a program is that the government frequently has no clear objectives in mind in privatizing. Establishment of objectives and policies to reach them is a key issue at the outset. The political leadership may see the immediate goal as reduction of subsidy costs. But this is often confused with other unrelated objectives (for example, to satisfy international lending agency requirements or to encourage private sector activity). Government should set explicit and well understood priorities while realizing that these may change as privatization gets under way, since the initial choices of candidates for divestment or the techniques selected may have unforeseen outcomes.

Choices Among Objectives

Objectives once decided upon cannot easily be changed once the privatization process has begun. If, for example, the government decides, for political reasons, on sale of the shares to the general public, officials must be aware that it may produce lower return than if the sale were to a single buyer, because of brokerage and other marketing costs. This need not always be the case, however, depending on the state of the local capital market or the profitability of the firm being sold. The government must decide initially, then, whether its objective is wide distribution of ownership or maximum revenue from the sale or some combination of the two. The trade-offs are distribution to the public as a whole, to specific ethnic groups, or to employees of the divested companies versus maximizing proceeds from the sale; none is without political or economic cost.

The complex issues of privatization cannot all be resolved before the selling process begins. But, where larger issues such as the break up of a government-owned monopoly come into play, it is preferable that they be settled before the divestment process begins. It is desirable to start the disposal with entities in which there are fewer difficult policy issues to be resolved; a few successful sales initially will increase the chances that the whole program will be successful.

Estimating Value and Setting the Price for Firms Being Divested

A critical issue for the government in any prospective sale is the price to be set for the SOE. Unfortunately, there is political risk involved no matter what price is set. If the government insists on demanding an inflated book value for the firm, the chances of finding a buyer are reduced or may even be eliminated. But if the sale is made at a more realistic market figure, the political leadership exposes itself to the charge of giving away the national goods to entrepreneurs who will exploit them for private gain--a charge which will be even more damaging if the sale is to a foreign investor. Moreover, the government will fail to realize the anticipated reduction of the national deficit that may have been previously touted as a benefit from the divestment.

To forestall criticism, the public should be prepared beforehand for the possibility of sale at a loss and the long term benefits should be strongly emphasized. An open audit of the SOE's books (showing assets, liabilities, net worth and good will value) made public before or at sale time will serve to silence some critics. There may, of course, be no real loss, since the government may have written off the assets of the company before deciding on privatization. Nevertheless, there may be public objection prompted by political opponents that the private sector is reaping the harvest of years of public investment. In any case, it is unlikely that the government will ever recover its original investment in the firm.

Preparation of SOEs for Sale

1. Finance and Accounting

The great majority of SOEs cannot simply be placed on the market without substantial previous preparation. Their accounting procedures may be so faulty that it is virtually impossible to draw up an accurate profit and loss sheet even though it may be clear that the firm has not been profitable over a long period. But a "best effort" should be made; otherwise prospective buyers may feel that the real condition of the firm is being kept from them. A full-scale business analysis should be undertaken, often by a foreign accounting firm if local talent is not available. Even if it is, the government or the prospective buyers may place more confidence in the neutrality of an outside group(possibly in combination with local auditors). Such an analysis would normally include a market survey, domestic and overseas, present and future, for the company's product and a sound and professionally prepared business plan. Once this has been completed, it may become clear that the firm will have to undergo financial reorganization before being put on the market. Depending on its prior condition, this reorganization might entail establishing proper accounting and management information systems, budget priorities, debt restructuring and recapitalization for modernization of equipment.

2. Management

The question of whether the management of the firm should be replaced prior to divestment requires careful consideration. The present management may, in fact, be reasonably competent but may have been prevented from making the enterprise profitable through no fault of its own because of macro-economic policy decisions over which it has no control. A case can still be made for installing a new management team whose explicit mandate is to prepare the firm for privatization. This may serve to make the changes required more acceptable to the labor force and to impress potential outside buyers with the government's seriousness of purpose.

In cases where alternative indigenous management is not available, a contract with a foreign management firm may be the best solution, since time will be required by the new managers to establish a track record attractive to potential buyers. The government, meanwhile, will have to reconcile itself to the fact that, while the preparation process may take time and money, it will pay off ultimately in the increased value of the firm when it is sold.

3. Managing the Sale

Successful privatizing depends heavily not only on government's willingness to sell its assets but on the organization established within government to carry out the procedure. If the group entrusted with ultimate sale decisions is too small, the government opens itself to the charge that it is secretly trying to sell public property. If it is too large, or representative of too many interests, it may become bogged down in administrative detail and may present too many opportunities for vested interests in the bureaucracy and outside government to sabotage the privatization plan. Whether individual Ministries should be entrusted with negotiating sales, as opposed to a high level committee of the Cabinet, depends on the degree of autonomy with which the Ministries operated in their control over SOEs under their jurisdiction.

Whatever structure is used, the best available talent among the Ministers and the senior bureaucracy should be utilized. Outside divestment counsel, such as investment bankers and brokerage specialists, will be needed since the decisions on prospective buyers require a variety of skills. Civil servants in most countries, and particularly in the LDCs, have neither experience nor training in selling industrial firms nor in franchising state owned services. It may be that the negotiating process should be left to a commercial firm with specialized knowledge and experience in marketing manufacturing firms. Assistance is often needed to raise funds for preparation costs as negotiations proceed; here the help of an internationally known investment banking firm will add credibility to the entire transaction. Final decision on the buyer must rest in the hands of top government leadership. This is essentially a political question that cannot be dealt with at any other level.

4. The Role of Government after the Sale

It must be made clear both to politicians and bureaucrats that, once having fully or partially divested itself of a firm, the government can no longer exert control although it may retain some equity and certain regulatory functions over services supplied. New or interim management will wish to make substantial changes, both in operation and financial structure, which will eliminate the firm's former social overhead objectives. The goal of the firm will now be profitability which will alter substantially the government's relationship to it. Any effort by government to interfere after divestment to the private sector will sharply reduce the chances of successful sale of other units in the planned privatization program.

Techniques of Divestment

These may take a number of forms:

(1) Direct sale to a single buyer.

This will depend in part on the size of the firm being sold, the availability of local capital or, in the case of purchase by foreign investors, on the degree of control by outsiders the government is prepared to accept. Sale to a single buyer should produce a higher return, since the cost of marketing shares is avoided. A single buyer may, however, be in a stronger negotiating position and therefore be able to force the price down in return for a quick disposal of the SOE. The disadvantages of single buyer sale can be political as well as economic. It may provoke strong public reaction if it is made to a well-known powerful domestic group or individual and even stronger reaction if to a large multi-national. Moreover, a single buyer could simply liquidate the firm at a later point after draining it of cash and salable assets, thereby defeating the government's purpose or demand special favors for continuing operation.

(2) Partial divestment with government retaining majority or minority control.

The government may decide on a mixed ownership arrangement for the firm, leaving some opportunity to exert official interference in management decisions. It is possible to divest a majority control if government retains " a golden share"--that is, minority shares bearing specified rights of voting control. Such an arrangement, however, usually reduces the attractiveness of the firm to prospective buyers.

(3) <u>Sale by Public Share Offering</u>.

This type of divestment is preferable from a government point of view, in that it creates a wide distribution of ownership, encourages the public to participate in the capital market and creates the impression that the government has the best interests of the citizens at heart in disposing of assets owned by the state. Share offering depends, of course, on the capabilities of the local capital market and on the existence of a viable stock market or other suitable marketing mechanism. It has the additional advantage that it can be arranged to benefit selected target groups in the participating population -- favored ethnic groups (and conversely, to exclude other groups), company employees and other preferred customers or foreign investors (as in the case of British Telecoms). For prospective lower income shareholders it is possible to spread the cost of share purchase over time.

The difficulty with share offering, however, is that it puts a premium on the ability of government to set a per share price, which will simultaneously be low enough to attract popular response while also not undervaluing the company. Setting the initial offering price is perhaps the most difficult part of the entire privatization process. It is at this point that the government will most need the expert advice of outside capital market experts; only in the rarest cases should government officials act alone or independently on this decision. An artificially high price reduces the attractiveness of the offering and prevents wide distribution of the stock. Too low a price, on the other hand, will rob the state of revenue and risk concentration of the stock in the hands of a few individuals who may be able to afford to buy out the small shareholders at a later point. It is, of course, possible to envisage a combination of sale of a minority of shares by public offering combined with sale of the remainder to a control group, while requiring the group to make public offering of part of the majority shares at a later date. In this way government can have the best of all possible worlds.

It is important to note that the technique of deliberately setting a below market price for initial share offerings may have financial disadvantages but has substantial political pay-off, as the case of British Telecoms amply illustrates. The shares acquired by initial buyers almost doubled in price within a short period, much to the satisfaction of the new shareholders who became strong supporters of privatization and will provide a ready market for future privatization offerings. Moreover, they are likely to oppose any attempts at renationalization at any future point.

4. <u>Giving Away Shares to the Public</u>

This somewhat novel option has received a good deal of discussion and is favored by some proponents of privatization. It has great political attraction in that it offers something to a large group of citizens (each new born baby could automatically receive a specified number of shares, for example, or they could be given to low income or elderly groups). This avoids the thorny problem of setting a price on the stock at the time of divestment. The difficulty with this approach is that, if the shares were given to the new-borns, the firm would have to be managed for the shareholders by a government selected board of trustees which would effectively defeat the whole purpose of privatization.

Such a magnanimous gesture, however valuable politically, would be expensive in that the government would receive no additional revenue from divestment of the firm and the administrative costs of distributing the shares would be very high. Moreover, the firm would not be exposed to market forces if it were controlled by trustees and management would be freed from the constraints of the market. It has also been suggested that the shares be given to the bureaucracy as an incentive not to oppose or sabotage privatization efforts since government workers would then have an interest in the continued profitable operation of the firm by the private sector buyers.

Whatever method of privatization the government elects to follow (and there are numerous variations not mentioned here) the technique to be adopted should be decided upon before privatization is announced and should be adhered to subsequently except in the most unusual circumstances. Should post-sale regulatory restriction be contemplated, this should be made clear to prospective buyers early in the negotiations to avoid charges of bad faith being levelled after the sale has been consummated.

Government's Relations to the Privatized Firm

1. Regulation

At least in theory, the relation of government to a firm which has been successfully privatized should be no different from that to any other firm in the private sector. However, in practice, the situation of the newly divested entity is much more complex. Normally, the government would have the power to insist that, as a condition of ale, some of the former SOE's social overhead obligations be continued. For example, an electricity generating and distributing system might be required to continue uneconomic distribution to customers in remote rural areas, or transportation services maintained on money-losing routes in the public interest. Whether government continues to be a shareholder in the divested firm is perhaps irrelevant in such cases, since it continues to retain regulatory powers to enforce requirements for services to meet public demand.

2. National Security

An important consideration in privatization plans is national security. Strong objections to divestment can be made by the military who may, ostensibly for security reasons (but often out of self-interest), wish to have a particular firm remain under government control. Security of supply in case of hostilities is the usual argument; if the company is in private hands, it may not be able to respond to urgent military requirements. The military may also want to make sure that the firm does not go out of business so that a production facility for critical military hardware does not disappear.

While there may in special situations be some validity to the national security arguments against divestment, they are frequently somewhat disingenuous. The government always retains the power to assume control of a critical production facility in time of national emergency; meanwhile the private sector can frequently produce the product better and more cheaply than can a state owned factory. If it appears that the government is going to place certain restrictions for security reasons on the ability of the privatized firm to produce, these will lower the value of the firm to a private sector buyer.

3. Passive Governmental Involvement

The obverse of the coin of continued governmental interference in a privatized former SOE is that, in attempting to demonstrably divorce itself from management, the government may lose its rights as a major shareholder. In an effort to prove that management is autonomous in its decision making, the government representatives on the board of the firm may in reality become disenfranchised by never disagreeing with management. The ironic result is that, while shareholders may be nervous about the role government might play in the firm, the government is in fact surrendering virtually full control to the firm's managers. Partial government ownership need not be an unworkable form of divestment, however, provided the potential private sector shareholders are confident that government, as a minority shareholder, will assume a business-like attitude to the firm (as has been the case, for example, of the British Government and British Petroleum).

Discouragement and Restriction of Ownership of Privatized Firms.

In addition to providing incentives for specific groups to participate in a public offering of a firm to be divested (or to exclude others) for domestic political reasons, the government may also wish for other reasons, to discourage other groups. Among these may be:

1. To prevent the replacement of a government monopoly with a private monopoly.

Creation of a private sector monopoly by divestment does not further the interests either of the public or the government because it fails to accomplish the prime reason for divestment, the encouragement of competitive market forces in the economy. Sale to a single buyer, if that buyer is in a position to prevent competition from developing, is usually disadvantageous, unless a clause is written into the sales agreement specifying that the single buyer must dispose of a percentage of the shares at a later date.

2. To prevent corporate concentration by ensuring the continuation of broad ownership of divested firms.

It may be advisable in pre-privatization planning to consider restricting the percentage of shares that may be acquired by individuals and/or groups at the time of the public offering. However, considerable care must be taken in establishing the level of such restrictions. Too low a level may result in distributing ownership so widely that control over the company effectively devolves into the hands of management since no individual or bloc of shareholders is in a position to influence or counter management decisions. On the other hand, in this situation, management may not be able to count on the help of a single large shareholder or group when support is needed. The challenge is to strike an effective balance between the two.

3. <u>To forestall possible take over attempts before the new management of the privatized firm has had time to establish a track record</u>.

While this may not be a serious problem in most LDCs at the moment, it could happen if foreign investment restrictions were relaxed to the point where a takeover bid by an outside individual could be successful. As the competitive position of the domestic economy is strengthened, these restrictions could be gradually removed.

4. <u>To prevent control over the privatized corporation from falling into the hands of foreign investors</u>.

Direct foreign investment or joint venture may be desirable and welcome, but not to the point where the objective of creating an aggressive and experienced domestic private sector would be defeated. Some foreign investment may be helpful, particularly if it is accompanied by technology transfer. It may serve to widen the domestic market for the shares, if it appears that foreign investors have faith in the company's future. If the company expects to develop an export market, foreign investors with marketing skills may be especially valuable.

These are only a few of many reasons that have been advanced for restricting the ownership of divested companies; their specific applicability can only be decided upon by analysis of individual firms and particular country circumstances.

<u>Conclusion</u>

If a privatization program is to be successful, it will require:

1. A coherent approach by the government requiring careful policy decisions concerning the objectives of the program, the expected results, and the reasons for which it is being undertaken.

2. Careful choice of the method of sale whether for individual entities or for the program as a whole. Technical advice may be necessary from outside accounting or investment banking firms and assistance in financing the program may have to be sought from international or bilateral donors. The government must be prepared to make difficult policy decisions and to stick with the program once it is announced if the confidence of the private sector is to be maintained.

4 Successful divestment will usually require a strong private sector. No divestment program will be successful if the indigenous private sector does not have available to it the necessary credit and financing facilities to enable the purchase SOEs put on the market. Development of capital markets, private development banks and extended commercial banking facilities should go hand in hand with long range privatization planning. More widespread popular knowledge of the advantages of share investment and in the operation of a stock market will make privatization quicker and easier.

5. There is an unavoidable degree of risk in privatization which the leadership must be aware of before embarking on privatization. A political risk analysis should be part of the entire divestment planning process. If, for example, the major political party is dependent on labor union support, the unions should be consulted from the outset. The risk can, however, be minimized if the political objections are carefully considered and methods adopted to counter them before privatization is announced.

6. The Multinational Development Banks can play an important role in privatization if their lending policies are directed toward providing resources directly to the private sector without government intermediation. Regional lending institutions are familiar with the specific needs of their areas and can more readily adapt their lending to the needs of the private sector in their member countries than can the larger international capital sources.

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