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A PLAN FOR PRIVATIZATION

(HOTEL QUITO — INDUSTRIAS GUAPAN)

ECUADOR

REPORT BY

Robert E. Laport

CENTER FOR PRIVATIZATION

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

Project No. 39

April 8, 1987

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

CENTER FOR PRIVATIZATION

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Robert E. Laport has nearly 30 years of experience in the United States and Latin America dealing with all types of merchant banking and consulting assignments. From 1983 to 1986 he headed The Latin American Banking Group of American Express, Ltd. He is now working as an independent consultant on privatization matters.

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Without the collaboration of Dr. James Finucane and the assistance of his staff in Private Sector, USAID Mission, Quito, this work could not have been accomplished in a timely fashion.

EXECUTIVE SUMMARY

The Center was asked to assist USAID Mission, Quito, Ecuador in response to two problems raised by Instituto Ecuatoriano de Seguridad Social (IESS) involving their Hotel Quito property and S.A. Industrias Guapan, a cement company. The Center was also asked to survey the divestiture plans of Corporacion Financiera Nacional (CFN), and to make appropriate recommendations. The three week assignment was accomplished in February/March 1987.

IESS
The Hotel Quito involves a 2.8 hectare hilltop property and a 220 room hotel completed in the late fifties. Initial operations were managed by Hotel Corporation of America, and in 1967 a twenty year management contract was signed between IESS and Intercontinental Hotels (ICH) which expires December 31, 1987. The contract was poorly drawn and has led to acrimonious relations between the parties, an insuffient return on investment for IESS, serious deterioration of the hotel property, and a difficult labor situation. Both sides have tried to renegotiate aspects of the contract negative to their interests without success.

As owner of the property, IESS must decide whether to fund a major renovation project and negotiate a new management contract, or make an effort to sell the property as is to a local or international group who could undertake the renovation and possible expansion of the physical facilities. We have recommended the latter course of action given the excellent location and emphasis on tourism development following the completion of an internal appraisal of the property now underway, and the completion of a feasibility study to determine the cost and efficacy of a major renovation and possible expansion which we have also recommended that IESS undertake.

S.A. Industrias Guapan was formed by IESS, who own over 99% of its stock, in 1954. An expansion plan to expand its 240 MT/day capacity by 1100 MT/day was begun in 1979. The $35 million project was halted for three years as a result of the Latin financial crisis, and work didn't recommence until late 1985. The project is now about 85% complete and is expected to take one more year.

IESS recently requested that a team from La Cemento Nacional, a sister company in which IESS owns a small interest and which supplies 70% of the national market, review the expansion to date and recommend changes or adjustments which should be made while the remainder of the project is being completed. We were present at the briefing of Guapan management by the LCN team, and have studied a copy of their report. We share IESS's concerns that present Guapan management does not have the depth nor the skills necessary to see the project through to successful completion, and given the fact that the expanded facility will be over four times present capacity, may not have the ability to manage the company efficiently.

As an interim step, we have strongly supported the LCN recommendation that IESS cause Guapan to retain outside technical assistance until the completion of the expansion project, or as long as necessary. As a longer term solution, we have urged that IESS immediately begin seeking an international cement producer interested in acquiring at least a majority shareholder position in Industrias Guapan. We have recommended that IESS utilize the assistance of a well known investment or merchant bank to identify this party and assist in structuring a financial package to accomodate the acquisition. The presence of a strong know-how partner at the earliest possible date will go a long way toward insuring the successful completion of the project and the efficient and profitable operation of the company thereafter.

CFN

CFN is a Government of Ecuador entity and is the largest development finance company in the country with capital funds in excess of Sucres 9 billion. It both lends to and makes seed capital equity investments in sectors which the Government wishes to see developed, primarily industry, agro-industry, tourism, and regional financial institutions. At present, CFN has equity positions in 50 companies, 35 of which are mature and, to a greater or lesser degree, salable. Over S/6 billion, or an amount equal to two-thirds of CFN's capital funds are tied up in this latter group of thirty-five. The implication contained in CFN's by-laws is that the equity portfolio turn over and be re-invested in new enterprises. No significant sales of CFN equity positions have ever taken place, however.

A new General Manager has been named and has made a personal commitment to the President of the Republic tht the divestiture program which the President wishes to see enacted will take place in the remaining 14 months of his tenure in office. The General Manager's request for Mission assistance was one of his first acts in office. Our survey found that the valuation efforts by CFN staff were well under way, but that past activity had been sporadic at best. The real commitment of the group involved, the Gerencia de Empresas, to the divestiture process is questionable, as this group is responsible for managing the investments and derives its influence from the size and number of investments managed. However, they are also responsible for re-investing the proceeds of a sale.

We have recommended that the General Manager establish a new "Gerencia" to work in parallel with the Gerencia de Empresas and be solely responsible for the mechanics of selling CFN shares according to the priorities which have already been established. This will circumvent the apparent vested interest of the Gerencia de Empresas to retain investments well beyond the company's need for a constructive CFN presence. It will permit the Gerencia to concentrate on its primary duties of new investment and portfolio management, and the new "Gerencia" will have the time and staff with the skills necessary to accomplish the complex packaging which will be essential to the successful divestiture of a number of companies involved. We understand that this recommendation will be adopted.

The Mission has offered the services of the Center to CFN on a continuing basis to advise the General Manager on the overall divestiture program and assist its progress, to provide special expertise which may be required from time to time in the more complex divestiture situations, and to help CFN in fulfilling its role in the creation of new investment by assisting in the development of investment strategies and techniques. This offer, which is in the process of being formalized in the Mission budget for 1987, was very well received. The General Manager fully understands, however, that the offer is contingent upon approval of the program within the USAID structure.

FINAL REPORT

HOTEL QUITO

I. Present situation.

The Hotel Quito was built in 1958 by IESS to accommodate the Pan American Congress which took place in Quito that year. During the first 10 years, it was operated under contract by the American Hotel Corporation. In 1967 a new 20-year contract was signed with Inter Continental Hotels, a subsidiary of Pan American Airways. This contract is still in force and expires at midnight on December 31, 1987.

A brief operating "resumen" for the last three years is shown below:

	1984	1985	1986
Total income	5.272.8 m	3.374 m	5.465.1 m
Gross operating income	2.6 m	16.5 m	77.3 m
No. habitaciones	244	244	244

	1984	1985	1986
No. habitaciones disp.	82,532	81,760	81,760
No. habit/ocupadas/días	41,866	45,387	45,656
% ocupación	50.7%	55.1%	55.8%
Precio promedio por habitación en sucres	3,008	3,879	4,915

II. Stated objectives of IESS

In interviews with Econ. Rubén Ortiz, Head of the Investment Division of IESS, and Ing. Carlos Salvador, Director General, we were told that:

A) IESS will not renew a contract in its present form with Inter Continental Hotels. It might consider a new form of contract with Inter Continental Hotels or another hotel operator, but it would prefer not to have to make the necessary investment for remodelating, re-equipment, and renovation.

B) IESS would consider integrating its present holdings into a Sociedad Anónima to be formed as a stockholder along with national or international investors and a professional hotel operator. This scheme would probably result in IESS becoming a minority shareholder as complete renovation and possibly an expansion of the room capacity is contemplated.

C) IESS would consider an outright sale of its present hotel properties if the price were right.

III. Options

A. Renegotiate lease with Inter Continental or other.

1. Approx. Sucres 300 million (US$ 2 million) needed for renovation. IESS to contribute.

2. Status quo on ownership structure.

B. Constitute new Sociedad Anónima Hotel Company.

1. Contract preparation of feasibility study (Horwath & Horwath) to:

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2. Status quo on ownership structure.

B. Constitute new Sociedad Anónima Hotel Company.

1. Contract preparation of feasibility study (Horwath & Horwath) to:

a) value present property;

b) recommend on modernization of present facilities, renovation, remodeling, telephone and other infrastructure;

c) expansion of room capacity, etc. in light of expanded tourism;

d) expansion of banquet and convention facilities;

e) other improvements that might be recommended;

f) estimate approximate costs of accomplishing the above.

2. Based upon the study of Horwath & Horwath and the formation of the new Sociedad Anónima, select an internationally known merchant bank to:

a) locate appropriate equity partner willing to invest approximately US$10 million or equivalent in equity (60% o/a);

b) locate a hotel manager acceptable to IESS and the new investors willing to invest about US$833,000 in equity, or approximately 5%;

c) arrange financing for the remainder necessary to construct the new facilities recommended and the necessary renovations.

New equity would be paid into the Sociedad Anónima resulting in an ownership structure as follows:

- Investor group	60%
- IESS	35%
- Hotel manager	5%

totalling approximately US$ 18 million. The Sociedad Anónima would undertake loans of approximately US$19 million to accomplish an expansion of 250 rooms and the required renovation if recommended.

C. Outright sale of the property.

IESS could offer through public bid the sale of the land and buildings constituting the Hotel Quito property.

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1. In August 1985, IESS officials prepared an appraisal giving a value of S/ 893.7 million of which S/ 424.8 million was land, S/ 420.6 million construction, S/ 40.3 million furniture and fixtures, and S/ 8 million in special installations.

2. Knowledgeable buyers would realize that an amount of between S/ 300 million and S/ 1 billion would be required in additional expenditure. The lower figure would accomplish a complete renovation and the higher would include an extensive architectural overhaul including plumbing, wiring, and expansion of some of the facilities.

3. There have been indications from both Ecuadorean and foreign investors of interest in purchasing the Hotel Quito and there appear to be reasonable prospects for selling the Hotel as is for between US$ 6 and 7 million.

IV. Discussion

Whichever option IESS were to choose, the valuation of the

Hotel Quito as a going concern and, more importantly, the potential value of a renovated and possibly expanded Hotel Quito should be ascertained professionally. The 1967 contract between IESS and Inter Continental Hotels has provoked enmity and distrust between the parties, primarily because the compensation clause did not properly contemplate the rapid decline in the value of the Sucre which was S/18 = US$1 at the time it was drawn. Subsequently, there have been impasses on a number of important areas of the operation including labor's participation in profits and set asides for the cost of renovation.

The operation is profitable, the site is excellent, and the prospects for a renewed and expanded Hotel Quito should be excellent, especially given the expansion in tourism to Ecuador that will take place given the assistance of USAID and the BID.

We are informed that IESS is presently preparing an updated valuation to that prepared in August 1985.

A study by experts, such as Horwath & Horwath, would also assist in indicating the best route for IESS which if outright sale is not chosen will include the opportunity to participate in the growth of tourism to take place over the near and medium term. An outright sale of the property may be preferable, however.

There are apparently poor labor relations existing between Inter Continental Hotels and their local union. Moreover, the 1984 contract has expired and a new two-year contract has been signed and is before the Minister of Labor for approval. An accumulated sum of approximately S/ 35 million in accrued profit sharing has not been paid and is owed to the workers. The labor situation interferred with a potential sale of the Hotel by IESS about two years ago. The situation has apparently not improved and a settlement with the Union in some form or other, must be a part of any of the options open to the IESS. In the extreme, a settlement could require indemnification of the present employees which would permit a fresh start by the new owners. It is essential that IESS lawyers and possibly outside counsel prepare a full study of the IESS-Intercontinental contract and the current labor contract so that the responsibilities and consequent exposure of the parties by clearly defined now, well before the expiry of the contract, so that IESS may take whatever steps may be appropriate to protect itself.

V. Recommendations

Your consultant recommends that the following steps be taken by IESS in resolving the Hotel Quito situation:

1. IESS immediately have its Procurador General review the IESS - Intercontinental Hotel contract and the Intercontinental Hotel - Hotel Quito Union contract to ascertain IESS exposure in certain areas and determine ways to limit that exposure. Study should also be given to ways to recover the approximately S/ 35 million owed to IESS by Intercontinental which has been in dispute.

2. IESS should complete its internal evaluation of the Hotel Quito property at the earliest possible time.

3. Independent of the above valuation, IESS should contract a recognized firm such as Horwath and Horwath to perform a feasibility study on the Hotel Quito within the context of the Ecuadorean Tourist industry and to comment upon the extent to which remodeling, re-equipment, and possible expansion is necessary or desirable. This report will constitute a part of the eventual bid package.

If IESS is decisive in acting on the above recommendations, this first phase should be complete before the end of April 1987. With this information in hand, IESS will be better armed to undertake the second, active phase.

4. Prepare a bid document to encompass both Option B), formation of a joint-venture Sociedad Anónima by the buyer with IESS participation, and Option C), outright sale of the Hotel Quito property by IESS to the buyer for an amount greater than the base price which is mentioned in the bid document.

It is anticipated that a properly structured bid document encompassing Option B) and Option C) will elicit a wide range of responses, both directly from potential investors, and indirectly through efforts from financial intermediaries working primarily with the international hotel sector.

5. Hotel Intercontinental Group should be informed through local management of the nature of the bid document as they may be interested in putting together an investor group themselves. This action will serve to disabuse themselves of the possibility of a further

contract renewal that they are still hopeful of negotiating.

6. Before publication of the bid document, it is recommended that IESS itself, or an appropriate party, prepare the Quito Hotel Union for eventual changes that will take place. Direct contact should be maintained throughout the process.

7. Likewise, the public should be prepared through the press, appraised of the general background of the situation and informed of the range of improvements that will take place.

8. The bid document should be released at the appropriate time after these initial contacts have been made. At the same time, the major banks and investment firms should be contacted as the Hotel Quito represents an opportunity to assist on a success fee basis payable by the buyer to assemble a hotel management and investor group to bid, along with the accompanying financing opportunities.

IESS is confronted, in the Hotel Quito case, with a serious time constraint and a series of unattractive alternatives if a satisfactory sale or joint-venture arrangement is not arrived at by the end of October so the deal can be finalized, with financing in place, before the end of the year. If decisions are taken promptly, the first steps begun now, and a bid released in early May calling for proposals to be received by mid July, IESS will have three months to negotiate the various proposals, make a choice, and meet an end October deadline.

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FINAL REPORT

INDUSTRIAS GUAPAN S.A.

I. Present Situation

A. S.A. Industrias Guapán, located in the town of Azogues near Cuenca, was founded in July 1955 as a cement plant to produce 220 tons per day of Portland Grade 1 cement utilizing the wet method with a capital of 25 million sucres. Initially the shareholders were the Counties and the Municipality, but since they were not able to pay the suscription of shares, the IESS acquired all the rights to suscribe the shares consolidating its position as main shareholder. The present shareholders are the Instituto Ecuatoriano de Seguridad Social with 99.67% and the Banco Nacional de Fomento with 0.33%. Capital stock was Sucres 479 million at year end 1978. Subsequently, in March 1986 there was a capital increase in the amount of 1.219 millon sucres, with which the actual capital stock is 1.698.5 millon sucres, which was covered with the capitalization of two loans granted by IESS to Guapán (1.196.4 millons including interests) and the capitalization of profits of 1984 (22.8 millon sucres).

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B. In 1976 a feasibility study prepared by CIC Cía. Ltda. recommended the construction of an 1100 MT/day cement plant and subsequently Decreto Supremo 1137 (15/2/77) authorized the IESS to invest the funds necessary for the expansion. Contracts with the Fuller Company for design, engineering, and the supply of equipment, and with A. Granda Centeno for civil works, were signed on 13/9/78. Work on the project progressed normally until the financial crisis of 1982/83. Work stopped in June 1982 and litigation between contractor and suppliers took place, awards were made, and eventually the contracts were renegotiated in November 1985. Considering the size of the project, IESS and Guapán did very well to limit the increase in contract prices to Sucres 462 million in the case of Fuller, and Sucres 605 million in the case of A. Granda Centeno. Work recommenced in late 1985 and is ongoing.

C. Thus far the project has been financed as follows. Of an estimated cost to completion of US$35 million, IESS has:

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Increased capital	S/ 300 million
First credit (utilized)	S/ 400 million
Interest capitalized	S/ 286 million
Second credit (utilized)	S/ 510 million
Expansion fund 31/12/84	S/ 67 million
Aporte to operating plant 6/85	S/ 29 million
Capitalized 1984 profits	S/ 23 million
Third credit 1985/86	S/ 940 million
Sub-total	S/2,555 million
Financed with internal resources	S/ 62 million
Total to date	S/2,617 million

We are informed that the above loans and capitalizations, given the various exchange rates over the years, total approximately US$28 million of a total estimated cost of US$35 million. Based upon funds expendend one could say that the project is 80% complete.

D. In actuality, the plant is about 85% complete. Installation of equipment, machinery and controls principally, continues, and numerous details remain to be accomplished. The major processing blocks are in place. Three adjunct projects, the responsibility of Guapán, remain to be started:

1. A water treatment facility to supply the plant's closed circuit system at a cost of approximately Sucres 40 million. This is essential to the operation of the plant.

2. An electric power substation. Lines are in but two heavy step down transformers must be ordered. Bids are being opened at the present time. Lead times for delivery are approximately 10 months to one year. Estimated cost is S/110 million.

3. Additional heavy trucks to transport limestone from the quarry must be ordered. These are also long lead-time orders. Estimated cost is S/ 60 million.

Additional working capital for start up of Sucres 120 million is required.

E. Given the above, Dr. Cristóbal Cordero Vega, Gerente General of Industrias Guapán, feels secure in predicting a February 1988 start up for the project. Thereafter, Fuller Company has six months to oversee the adjustments to be made in order that the plant will meet the production schedules and electrical energy utilization targets which it has guaranteed pursuant to its contract with Industrias Guapán.

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F. On 23/2/87 full discussion of a report on the current status of the plant which had been prepared by a team from La Cemento Nacional C.A. lead by Ing. Fernando Romero took place at Guapán. The report had been requested by IESS. It should be noted that La Cemento Nacional produces approximately 70% of Ecuador's cement production and is considered to be one of the best managed and most efficient and modern operations of its kind in the hemisphere.

The conclusion of the report, which makes recommendations on numerous changes, adjustments and work which remains to be accomplished, is that every cement plant is unique, different from every other even of the same design and capacity. In that the final stages of a project of this type are the most crucial in terms of the fine-tuning of the operations, training of personnel, and preparing the myriad details required to bring a new plant over four times the existing capacity on-stream, the report recommends bringing a full time consulting team of five or six specialists to the site. Their first task would be to prepare a PERT chart and schedule of the tasks remaining and to oversee their completion.

1. The present Guapán management team does not have experience in operating a plant utilizing the dry process.

2. The level of management staffing is thin considering their reponsibility for continuing operations as well as the expansion program. As completion nears, the time required to test and adjust various component parts of the plant intensifies.

3. At this stage of the contract, Fuller, who has received most of its money, will be required to make the adjustments necessary to meet its guarantees. These ongoing negotiations will be delicate, and it is felt that a competent intermediary will be helpful in achieving positive results.

The report recommends, and Guapán management agrees, that an outside consultant be retained for the duration of the project, to interface between Guapán management and Fuller. This will alleviate the shortage of experience and time extent, and provide the additional leverage with Fuller which is felt would be very helpful.

II. Discussion

A. It is a foregone conclusion that IESS must make available the additional monies necessary to complete the plant expansion as quickly as possible. The fact that Guapán expansion will be completed at a cost of US$35 million is highly commendable given a three and one half year delay during the construction process. We were told that a 1,100 MT/day plant planned today at present prices would cost in the vicinity of US$110 million. Furthermore, with the price control mechanism on cement in force in the Country, a plant of this size would not be built today as there would be no economic return.

B. If Guapán comes on stream in early 1988 and is producing at full capacity by the end of the year, the incremental capacity of 880 MT/day (1100-220 as the old plant will be shut down) will theoretically offset projected national import requirements for a time. Other expansion plans by La Cemento Nacional and

Cementos Selva Alegre have been shelved because of the price controled environment, so one could predict that imports will again be a factor until a rationalization of the cement pricing system takes place. However, regardless of the eventual outcome, the increased Guapán production will be readily absorbed by the market.

C. Industrias Guapán (and its major shareholder IESS) face two immediate challenges:

1. the timely completion of the project, and
2. the efficient operation of the expanded plant over the long run.

Management acknowledges the need for additional help in the final phases of the project, complementing the recommendation of the La Cemento Nacional team. Whether or not management recognizes a need for assistance on a continuing basis after the plant is completed is not known. However, there was extensive discussion of the invaluable role played by Holderbank (46% shareholder) in making La Cemento Nacional the highly efficient operation which it is, and the ability of LCN to operate on private sector lines along with highly skilled management was given as the sole reason for its success by the members of the LCN team.

D. This is undoubtedly part of the reason why IESS and the members of the Guapán Board of Directors are considering the privatization of Industrias Guapán. We concur with this direction in thinking, because it was made clear that sound operations require highly technical skills and constant care along with close attention to detail. The incentives to build and maintain a high level of efficiency are best provided in the private sector. Similarly, however, one would also expect that IESS would want to retain a shareholding, probably an important minority, in order to benefit over the long run from the capital and human effort that it has expended to date.

III. Recommendations

A. Completion of the Project.

1. That IESS authorizes through the Board of Directors of Industrias Guapán that Guapán retains the services of a full time consulting group

expert in the dry process to carry out the recommendations of La Cemento Nacional study group until the completion of the project, and possibly through the testing phase.

2. Renegotiate terms of IESS credit for S/ 940 million for 14 months maturity from 5/86 as the plant will not be on stream for at least another year.

3. Similarly, it is recommended that work begins immediately on the design and construction of the water treatment facility, and that steps be taken to place orders for the additional trucks necessary to transport limestone.

B. The Privatization Process.

1. In that the number of well known international cement companies is limited, IESS should make contact with the industry to obtain an indication of interest in the sale of a majority of its shares. Those interested would be invited to bid. The timing for an actual closing of the sale could be set either for the completion of the

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works, in which case the new controlling shareholders would be responsible for the final interaction with Fuller during the testing stage, or later at the time the project is proven out and Fuller is released. These would be topics for discussion with potential buyers during the investigation process.

2. The Arthur Andersen audit of 2/4/85, apparently the last done, is highly qualified. At an appropriate time a new audit to value the plant should be contracted which would recognize the sunk cost of the new plant at historical exchange rates, or perhaps in dollar terms, as the primary use of the document would be to assist in the sales process and to set a base price. In fact, quotations for IESS shares could probably be requested in dollars in the eventual request for bids.

3. In preparing for the sale of a majority of its shares, IESS has the choice of capitalizing Guapán's debt (Sucres 794 million on 31/8/86 plus amounts still to be funded), or retaining the final amount as debt to be repaid in Sucres at 23%

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per annum interest from the net profits of the expanded operation. Potential buyers would probably prefer to repay a Sucre debt from the operating earnings of the Company. IESS would be better off with a dollar debt repayable by the parent company of the buyer after having capitalized the Guapán debt.

In our opinion, given the current shortfall in the supply of cement to satisfy national demand, the Guapán expansion should turn out to be a good and timely investment if it is operated properly. We foresee the ability of IESS to recuperate its investment with a reasonable return on its invested capital over time if knowledgeable management is installed via the privatization process with the accompanying incentives to operate the plant as efficiently as possible. Lastly, we observe that the recommendations of La Cemento Nacional and these other recommendations be acted upon now as the timing is most propitious.

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PERSONAL AND CONFIDENTIAL FOR THE GENERAL MANAGER

March 12, 1987

CORPORACION FINANCIERA NACIONAL

Survey of the Gerencia de Empresas y Rehabilitación.

Officials interviewed: Econ. Alfonso Cordovez, Gerente del Departamento, Econ. Fernando León, Sub-gerente de Area, Econ. Rodrigo Sáenz, Asesor de Empresas, Econ. Ramiro Acosta, Asesor de Empresas, y Contador Celio Vega, Consejero, Price Waterhouse.

I. Objective of the survey:

To assist the General Manager by: 1) reviewing the plans and accomplishments to date relative to the divestiture of shareholdings by the Gerencia de Empresas y Rehabilitación, and to suggest changes or improvements therein; and 2) to suggest an action plan for the sale of several shareholdings which could be reasonably accomplished within the next three months.

II. Present status:

A. Portfolio.

Corporación Financiera Nacional at present has shareholdings amounting to S/ 6.396 million in 50 companies of which 35 are in operation and whose shares represent a value of approximately S/ 6.237 million. The values heretofor mentioned represent the original cost of the shares plus retained earnings and shares issued for stock dividends and for the revaluation of fixed assets. On 31/12/86 the "patrimonio" of the 35 operating companies represented 98% of CFN's total investment; among the 35 operating companies, 7 companies account for S/ 5.440 million, or 87% of the operative "patrimonio". The single largest investment is La Cemento Nacional with S/ 2.192 million in capital value followed by Azucarera Tropical Americana with S/ 1.160 million. The remaining 5 companies in this top group have a CFN patrimonio declining from S/ 886 million (Corporación Andina de Fomento) down to Arte Práctico in which CFN has a patrimonio of S/ 162 million. CFN's share in each of the the remaining 28 companies is under S/ 100 million. During 1985, the last year for which full figures are available, 6 of the companies operated at a substantial and very respectable profit i.e. with rates of return in excess of 25% per annum which is CFN's nominal opportunity cost, 11 of the companies operated at a loss, and the remaining half of the companies operated at a marginal profit, i.e. below or well below the desired 25% return. In terms of economic sector, CFN's largest investment is in cement (3 investments) followed by agroindustry, and then finance, forest products and furniture, metal products, chemicals, and hotels. Overall, the portfolio showed a small loss in 1983, a return of 10.1% in 1984, and 10.41% in 1985.

B. The disinvestment plan:

The Gerencia de Empresas policy paper dated 12/12/86 describes both an investment plan and a plan for disinvestment. It characterizes CFN as the agent for the Ecuadorean Government in assisting in new projects in cooperation with private enterprise and stresses a social responsibility, both economically and in terms of the creation of employement by describing these projects as being in the national interest. The paper, however, goes on to state that the CFN investment in a project is "temporary" in nature.

The "disinvestment policy" is portrayed as the general policy of CFN, i.e., that the policy of selling off matured investments where CFN's presence is no longer necessary to the entity has been permanently in place. There is no indication that disinvestment is a response to a new program being sponsored and vocalized as a new initiative of the President of the Republic. The December 1986, policy paper is a virtual copy of a similar paper prepared a year earlier. One would think that the divestiture process would be ongoing, yet the evidence shows that preparatory efforts have been sporadic and few if any sales of shares have actually been accomplished.

In the Gerencia de Empresas plan, the 35 companies have been divided into three groups for disinvestment chronologically. In actuality, there are 33 companies in three groups of 11 companies each. The first group gets sold off first, then the second, and third, in order. However, no dates have been set and the initial process of valuing the corporate shares is far from complete. Rather careful analyses have been prepared by the "asesores de empresas" in the Department on 9 of the companies on the lists, however several are in the second and third category. The analyses, which by and large are based upon asset valuations or adjusted book values rather than on income and cash flow analysis, are quite thorough. This method works amazingly well when valuing a healthy company in the absence of a securities market to set the value. However, it tends to over-value the share price when the company is marginal or when it is losing money. The Department is aware of this fact and has employed Price Waterhouse to develop a composite process in the form of a computer model which is in the process of being completed. All of the analyses done to date will be redone. It is estimated that the model will be completed and ready for use in about two weeks. Thereafter the analysts will begin to gather information from each of the companies, a process which will take several days in each case due to the extensive detail required.

In summary, the valuation process is to start anew. The Gerencia will value 26 of the operating companies utilizing the Price Waterhouse method, while the remaining 9 companies, the larger and more complicated ones, will be valued by outside consultants such as Price Waterhouse. This process should be starting by the end of March.

The Corporación has received blanket authority from the Superintendencia de Compañías to sell shares which it owns by virtue of a Resolution of the Superintendencia de Compañías dated March 4, 1986. The Resolution places the decision for sale and the conditions of the sale in the hands of the Board of Directors of CFN. However, the Resolution requires that the sale of shares be made through the stock exchanges which operate in the country.

In reply to numerous questions on this point, under the realization that the breadth and depth of the Ecuadorean stock markets is not sufficient to undertake and distribute CFN shares in most of the companies in the portfolio, I was told that the stock markets are being used more as an outward manifestacion of fairness than as an actual means of broad share distribution. In the majority of the cases which we discussed, primarily those 9 companies on which analyses were available, the transaction would take place across the stock exchange, following the pre-identification of the interested buyer and the negotation of the sales price and conditions. However, difficulties could and probably will arise in a number of the more complicated cases if CFN is obliged to make the trade through the stock market. The rules of the Superintendencia de Compañías require a 30-day period for publicity following which the shares will be inscribed at the stock market. According to what I am told, CFN's agent on the stock exchange has 3 days with which to negotiate the sale of the shares. If the shares are not sold within 3 days they are returned to CFN. This mechanism does not lend itself to the sale, for instance, of Cemento Selva Alegre shares, where a knowledgeable technical manager along with very substantial amounts of money are required. In such a case, CFN should be free to employ the bidding process to identify a short list of 2 or 3 possible candidates after which the winner can be selected through a process of negotiation. In short, the process of using the Bolsa lends itself to the smaller or less complicated situation where management responsibility is not in question and where the buyers are Ecuadorean. In those cases where the situation begs for a new managing shareholder, possibly of foreign origin, as well as fairly substantial amounts of money, the necessity to use the Bolsa de Valores will not suffice in my opinion. CFN requires greater flexibility in the methods of divestiture which it may employ.

III. Comments:

At the initiation of the study, I had concerns about the level of commitment in the Gerencia de Empresas toward carrying the divestiture process forward. The sporadic work which the group had done, which from outward appearances was very much on a start and stop basis gave rise to these concerns, and to a large degree, the power of a vested interest is always very strong and, at times, difficult to overcome, particularly when a program is suggested and enforced from above.

For some reason or other, the previous General Manager, Dr. Teodoro Arízaga, was unable to realize any concrete accomplishment in this area. It may have been because of a relationship with Econ. Cordovez, it may have been because the group within the Gerencia de Empresas was not prepared to carry the program forward, or there may have been other reasons why no material progress has been made to date. There now appears to be a relatively significant degree of progress in the preparation for the eventual sale of some of CFN's shares. As mentioned previously, the Price Waterhouse model is within about two weeks of being completed and tested out. Once this is done, there will be little excuse for a lack of tangible results. Most importantly, the new General Manger is determined to see that the program succeeds.

Econ. Alfonso Cordovez and the group of young professionals working with him is, in my opinion, very capable and should be able to carry out the divestiture program in most cases without a great amount of outside assistance. There are a few of the more complicated companies such as Cemento Selva Alegre and AZTRA where outside help will be required, either from the consulting community or from the investment banking community, or both. However, I sense a slight degree of temerity within the group. I am not certain from whence this arises, but most probably from the realization of the great responsibility and political exposure one takes when one places a value on a publicly held asset. I do not feel, given the high quality of these people, that this feeling of temerity is damaging in any way. On the contrary, it is probably a healthy sign c this time and will probably disappear as the group gets a few successes under its belt. They should be encouraged to move forward in an intelligent fashion so that the progress of the project is not impeded and confidence is gained.

Since the General Manager agrees with the companies listed by the Gerencia de Empresas in phases 1, 2 and 3 of their plan, I have little to comment on that score. The priorities, and the criteria upon which those priorities are based, make emminent good sense in the writer's opinion.

The suggesting of the Gerencia de Empresas which has been approved, i.e., the establishment of a Fund for Reinvestment, is also a very good idea and is entirely appropriate within the by-laws of CFN to further the fulfillment of its responsibilites in the promotion of new industry in the industrial, agro-industrial, and tourism sectors. The establishment of the Fund and its uses should, in my opinion, receive an important amount of press coverage at the time of the first announcements offering shares of CFN companies for sale. If the public is made aware of the eventual use of the proceeds of these sales to create new industry and hence new employment, it will serve

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possible implementation. On the other hand, failure to confront these problems and explore possible alternatives will not ease the present burden but only exacerbate it.

IV. Recommendations:

1. That a firm schedule for the divestiture of the 11 companies in phase I be established to begin during May 1987 and to be completed, in most cases, by the end of September 1987. My recommendation is that the Gerencia begin with ECUFINSA, FIDASA, GANESA, and POLIECSA. FIMASA could be added to this first list if, as represented, a legitimate buyer is ready to purchase CFN's shares at nominal value. The sale of the shares in these four or five companies should be accomplished by the end of May. The valuation and prospectuses of the remaining six companies in the group could then be prepared and, with diligent follow-up, five of the six could be in the market by the middle of August or early September. The one long-term effort that I see among the phase I companies is Cemento Selva Alegre which, because of its size and complication, will probably take many months to complete. However, the planning to sell

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to counter adverse comments regarding the sale of CFN property which may occur. Indeed, the sale of CFN shares in mature companies and the reinvestment of the proceeds in new companies is a fulfillment of one of CFN's primary objectives.

My last comment concerns the activities which I believe that CFN should be initiating with respect to the small number of disaster cases which CFN holds in portfolio. AZTRA is foremost among these, and constitutes a substantial annual drain on both the resources of CFN and of the Nation. Obviously, AZTRA and several others are not candidates for sale or divestiture in the normal sense. However, solutions to these problems may be found which, with a large amount of creativity, may result in a diminishing drain of resources and, hopefully, a turn around situation becoming a productive and eventually profitable operation. I would urge that CFN and the Gerencia de Empresas confront these problem areas with an open mind, employ outside assistance as required, and work with those entities involved to find a solution which, may require a complete reorientation from their present activities. There is no harm in studying as many alternatives as possible before selecting a plan for

Cemento Selva Alegre should begin now as the eventual buyer will most likely be an international company.

2. The steps to be taken in connection with the sale of the first five companies in phase I and later with the second five companies in phase I are:

- a) the valuations which will be prepared in accordance with the Price Waterhouse model;

- b) the valuation will then be followed by the preparation of the prospectuses which will include the background information which has already been prepared in connection with the previous valuations of the first five names;

- c) following the preparation of the prospectuses, the Gerencia should search out potential buyers of its shares from amongst existing shareholders of the companies or other interested parties of which it is aware;

- d) after contact has been made with potential interested buyers, the notices of the sale must be published in Quito and Guayaquil as set forth in the rules laid down by the Superintendencia de Compañías;

- e) at the same time, appropriate publicity should be given to the divestiture effort and to the creation of the Fund for Reinvestment in the national press; and,

- f) the General Manager and the Gerencia de Empresas should ensure that this process is continuing through Phases II and III until the present program has been completed.

3. We present for your consideration a final recommendation which, in our opinion, would lend weight, prestige, and improve your ability to control the disinvestment process. We recommend that a new and separate Gerencia be formed to implement the sales process. Given the nature of the task, the Gerencia de Desinversiones, which during its lifetime should be on an equal status with the Gerencia de Empresas, would by its nature be temporary and would be disolved following the sale of CFN's shares in the 33 companies included in the program.

3 or 4 professionals, should include individuals with a background in finance and financial markets, international banking, and the law. We believe that this division of responsibilities and the creation of such a group within your organization would enhance the probability of success of the program immeasurably.

(5083L)

PID

I. C. Key elements in the Privatization Process.

1. Determination of the level of will and extent of the program:

   a. Must be educated and sold on idea, or

   b. privatization or divestiture process is being pushed from above by policy, or

   c. idea of privatization or divestiture is self generated.

   d. Is divestiture process to be selective or general?

2. Selection of entities to be privatized; considerations:

   a. Level of Government ownership; majority, minority.

   b. Objective of the sale; recapture and liquify investment, improve management and productivity, solve problem of a resource drain, solve a social problem.

   c. Level of strategic or political value; i.e., is the privatization or divestiture process highly controversial in a given case. If so, special preparation is required.

   d. Demonstration of the hypothetical value added which privatization will achieve on a case by case and on a cumulative basis.

   e. A thorough legal review should be made of all companies selected for sale to determine the extent of contractual obligations including labor, real estate leases, contracts with suppliers, lawsuits, etc., and other contingent liabilities which may or may not appear on the books.

3. Valuation of the selected assets to be sold:

   a. One of a number of methods, or a composite, can be utilized to arrive at a share valuation.

   b. These are basically asset value, value of the earnings stream, or liquidation value (the value of the component parts of the business).

   c. It is important that the valuation result in a share price that is politically defensable yet attractive for a prospective buyer. Otherwise, no sale will take place.

4. Securing the necessary approvals to make the sale:

   a. In some cases, blanket approvals may be given by the highest necessary political body delegating authority to the governing body of the entity involved.

   b. In other cases, particularly those involving a statutory entity such as national ariline, Cabinet and possibly Presidential approval will be required.

   c. Reverting to the concerns implied in Para. 1, the political will often waver as the moment of actual sale approaches.

5. Selection of the Methodology of Sale

   a. The sale can be handled directly by the entity involved, or utilize the services of a financial intermediary such as an investment bank.

   b. The sale might be made on a negotiated basis or utilize the capital market to the extent possible.

   c. In either event, prior to the sale the preparation of appropriate bid documentation will be required and a prospectus should be prepared in accordance with the law regardless of whether the sale is to the public or not.

   d. It also may be necessary that the entity, to facilitate a sale, must consider financing a portion of the purchase price itself or arrange third party financing. Offers of financing should be included in the bid documentation along with the criteria for qualification.

6. The Sale and Ancillary Considerations:

   a. The bid documentation and prospectus will set forth the details of time and share price at which a sale will take place.

   b. Complex situations may require previous agreements with labor unions or other interested groups.

   c. Publicity regarding the reasons for the sale and expected benefits may be desirable. The public relations factor could apply to an entire program as well as to an individual case.

(5088L)

PID

II.B. Project Description

2. Initial Divestiture Activities

A. Instituto Ecuatoriano de Seguridad Social (IESS)

1. Background. IESS is Ecuador's public sector social security system. It provides assistance to its _______ members in housing, finance, health services, pensions and __________. It controls an investment portfolio with shareholdings in 23 companies. In important instances it is the sole or major owner of a productive sector enterprise, a situation which in practice has not been conducive to efficient enterprises and which exposes the IESS to high risk as opposed to a lower risk, more diversified portfolio more appropriate for a social security system.

2. Preliminary privatization actions. IESS requested Mission assistance in February, 1987 with respect to two specific enterprises, the Hotel Quito, and S.A. Industrias Guapan. Both of these represented immediate problems to IESS. The Hotel Quito is operated under a 20-year contract between IESS and Intercontinental Hotels Corporation which expires

on 12/31/87. The hotel is in considerable disrepair, and urgent action needs to be taken by IESS to either repair the hotel and renegotiate a new management contract or divest itself of the hotel. Industrias Guapan is a cement company almost 100% owned by IESS which is in the latter stages of a US$ 35 million expansion program. The present management is, in our opinion and IESS opinion, not capable of completing the project without assistance or of efficiently managing the much larger entity which will result.

The Mission responded to the IESS request by contracting a consultant from the Center for Privatization to review both enterprises and prepare privatization options. Recommendations were presented to the Director General of IESS. These were accepted and additional Mission assistance was requested.

In the case of the Hotel Quito, the Mission has been requested to identify an outside consulting firm capable of making a physical inventory and recommendations for the renovation and rehabilitation of the hotel. The physical survey of the Hotel is the next step to be taken prior to a IESS decision to negotiate a new management contract with Inter-Continental at the end of the year or, alternatively, proceed immediately to seek a buyer for the hotel.

In the Guapan case, IESS has moved on the recommendation to contract an outside technical consultant for the duration of the expansion project which should take the best part of another year. They have asked the Mission to assist in locating American sources for the heavy transformer and a circuit-breaker for the power substation which must be completed before the expansion project can be placed on-stream. The Mission expects that IESS will request its assistance in locating an international cement company interested in purchasing all or a majority share in Industrias Guapán.

3. Proposed program. Beyond the hotel and Industrias Guapán, IESS has stock participation in an additional 21 companies. In a number of these IESS is involved in situations in which IESS is unable to exercise any control such as in the case of the hotel, or finds itself responsible for the management of a highly technical industry about which it has no knowledge as in the case of Guapán. Under the Project assistance will be provided to the IESS to:

a) complete the privatization of the Hotel Quito and Industrias Guapan;

b) to initiate and complete the privatizations of up to three additional companies;

c) work with the Director General to upgrade the level of professional expertise in the Investment Department which is deplorable at the present time;

d) to develop a portfolio management capacity and strategy which enables IESS to constantly divest itself of problem investments and improve its overall yield while reducing it's risk by reinvesting in appropriate ventures in an appropriate fashion.

B. Corporación Financiera Nacional (CFN)

1. Background. The Corporación Financiera Nacional which is the largest finance company in Ecuador, is an autonomous authority of the Ecuadorean Government. It provides short- and medium-term sucre and foreign currency loans to Ecuadorean industry for the purposes of development, and makes equity investments to assist the establishment or expansion of firms which are deemed to be in sectors of national interest.

The CFN equity portfolio consists of shareholdings in 50 companies of which 35 are mature, active, and privatizable. CFN's capital in the 35 companies represents approximately S/ 6.4 billion, or an amount equivalent to about 2/3 of the total capital of the CFN.

2. Preliminary privatization actions. During 1985 and 1986 CFN officials spoke often and considerable publicity was given to their intention to privatize, however no tangible results have occurred. In February, 1987 a new General Manager took office with a strong commitment to achieve results. Mission assistance was immediately requested to review CFN's current plan for divestiture, comment upon it and the reasons for the lack of action to date, and make suitable recommendations. The Mission responded by contracting the Center for Privatization consultant who was working on the IESS cases to carry out the tasks requested by the CFN.

Comments and recommendations were submitted to the General Manager who concurred, including agreeing to institute a fundamental change to divide the responsibility for divestiture from responsibility for portfolio management and reinvestment.

3. Proposed program for CFN.

a) Work with CFN on a continuing basis and assist as required in developing specific divestiture proposals for the 35 companies in their portfolio.

b) Play a major planning and coordinating role in a number of the very complex company situations in the CFN portfolio, including AZTRA (sugar plantation and mill), and Cemento Selva Alegre. These cases represent considerable resource drains and require a broad range of Mission assistance.

c) On a case by case basis, assist in identifying potential projects and joint venture partners along with sources of financing.

d) Work with CFN in the evaluation of, and make recommendations for the improvement of, its long range strategic plan. Provide training to technical level officials in the operation and control of a venture capital portfolio as a part of the plan.

(5093L)

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IV. H.

Implementing institutions

The degree of counterpart assistance and the quality thereof will differ greatly between IESS and CFN.

1. IESS. Experience thus far with the Investment Department at IESS is that the professional level of expertise and the level of motivation is dismal. Little constructive assistance from this department can be expected. A positive accomplishment of the Project (see II B-30) would be a reorganization and strengthening of the human resource base of the investment Department as a component part of the Project.

2. CFN. The professional skills, level of staffing, and the motivation of the professionals in the Gerencia de Empresas and, we expect, in the to be formed Gerencia de Desinversión, is high. CFN has operated on private sector lines for many years, and has a far higher level of compensation than many of the GOE state enterprises. CFN personnel can be expected to perform most of the required tasks with extensive outside assistance required

only in the most difficult cases. Otherwise, general Mission oversight to reinforce the political will to carry out the divestiture program is all that will be required.

(5101L)

INTERVIEWS

Ing. Carlos Salvador, Dir Gen.
IESS

Ec. Ruben Ortiz, Dept. Inv.
IESS

Ec. Guillermo Dahik, Gen Mgr.
Hotel Colon

Edgar Palma, Gen Mgr.
Hotel Quito

Roberto Ramia, Opr. Mgr.
Hotel Colon

Jose Luis Alvarez, Owner
Hotel Alameda

James Dean, Res. V.P.
Citibank

Ronald Miller, V.P. IBG
Citibank

Stephan Hotchkiss, Res. V.P.
Bank of America

Leonidas Sanchez, Jr. Partner
Peat Marwick

Cecil Teran, President
Ecuadorian Tours

Dr. Cristobal Cordero, Gen Mgr.
Industrias Guapan

Ing. Fernando Romero, Gerente
La Cemento Nacional

Dr. Leopoldo Baes, Gen Mgr.
CFN

Alfonso Cordovez, Manager
CFN

Ec. Rodrigo Saenz, Asesor
CFN

Ec. Ramiro Acosta, Asesor
CFN

Cont. Celio Vega
Price Waterhouse

Robert C. Fraser, Com. Attache
U.S. Embassy

Mary Forbes Singer
Bankers Trust Company

Ramiro Crespo, Member
Quito Stock Exchange

Edward M. Coe
Tourism Consultant

DATE: March 1st, 1987

FROM: Robert Laport, Center for Privatization

TO: James Finucane, Private Sector Officer

REF: Center for Privatization Task Assignment 86-ECU-06-AGI. Develop strategies for eventual privatization of the Hotel Quito and S.A. Industrias Guapán.

I am pleased to enclose the final reports on Hotel Quito and S.A. Industrias Guapán. As you are aware, draft copies of the reports have already been delivered to Econ. Rubén Ortiz, Jefe de la División de Inversiones, Instituto Ecuatoriano de Seguridad Social. I imagine that you will wish to send the final version to Ing. Carlos Salvador, Director General, under an appropriate cover letter.

The chronology of steps to be taken by IESS in each case is fairly well set forth in the reports, but for your convenience I will outline what I believe are the critical junctures below.

HOTEL QUITO

1. Rubén has told us that he expects to have an internal valuation of the property in hand in about three weeks. This will be an update on the last valuation which they had done in August '85. By that time they should also have available the Peet Marwick audit for '86. We should be given copies of both as a means of demonstrating our continuing interest and as a legitimate reason for maintaining contact with Ortiz.

2. I have made an urgent recommendation to Rubén that their Procurador General review the ICH and the labor contracts to determine the extent of IESS exposure in various cases. It would be helpful in having a copy of that document since at a later date it will be useful in structuring a proper bid document.

3. I will contact Horwath & Horwath in the States to see which office could supply a small team to do a physical survey of the Hotel (not an audit). Perhaps they could supply a team from Colombia or Mexico that would be less expensive than from the U.S. I would advise you, and you can pass the information on to Ortiz for action, if so desired.

4. I must say that I was disappointed not to have had a chance to spend some time with Carlos Salvador in Cuenca, as our

getting together had been his idea. He is undoubtedly an extremely busy man. On the other hand, my greater concern is that, given the tremendous political pressure that his Minister is under these days, he might be backing away from the privatization process. I hope that he can be made to see that in the case of Hotel Quito, inaction will only exacerbate the problem, and there is no reason why the sale of the property cannot be portrayed to the public as a positive action which will be to the benefit of all.

5. If IESS proceeds with the plan, I do not see the need for an outside consultant until the time comes to prepare the bid document (although this should be the primary task of local counsel) and taking the final version to several of the local and international financial intermediaries to help them get started on working on the problem. At the same time some assistance might be required in working with the Government's press representatives and those that will be working with the Union. The level of "Mission" involvement of course is a delicate consideration.

INDUSTRIAS GUAPAN

1. I was hoping to have heard that Rubén had received a telex request which he requested from Guapán managment that they bring in an outside consultant to assist during the final days of the expansion project. Guapán technical management is not impressive and my impression is that thus far, they have left things in the hands of the contractor. In this later stage they must, of necessity, take an advisorial point of view and insist that all the details be handled properly. I don't think they are up to it. I am attaching the report prepared by La Cemento Nacional team which will clearly point out the importance of this final phase as there is a lot of money at stake.

2. I would suggest that you gain Ing. Carlos Salvador's concurrence as the 99% plus shareholder of Industrias Guapán to meet individually with Citibank, Chase, and possibly Bankers Trust over the next month or two to elicit their ideas on marketing Guapán to the international cement industry and methods of financing the sale of a majority of the shares. Although this action on the part of Salvador would be without commitment at this time, it will serve to keep him moving in the right direction.

3. My own thinking, given the particulars of the attached La Cemento Nacional report, has changed. I now feel that a sale of the Guapán share prior to the completion of the

project is preferable to waiting until the project is complete and the plant tested out. The sooner that Guapán gets highly qualified management in place the better, and of course this also suits the political timetable better, as well. I see no reason why the effort to sell Guapán should not begin as soon as the Instituto makes the appropriate decision.

Thank you very much for your many courtesies during the past two weeks and for all the help which Susana has given to me. Let's hope that these reports and recommendations turn out to have some real value.

Respectfully submitted,

Robert Laport
Center for Privatization

RL/swdn