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**PRIVATIZATION OF
INDUSTRIA NACIONAL DEL CEMENTO (INC)
AND OTHER GOVERNMENT-OWNED ENTERPRISES
IN THE REPUBLIC OF PARAGUAY**

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INTRODUCTION

This paper has been prepared at the request of the Bureau for Private Enterprise of the U. S. Agency for International Development (USAID) and the USAID Mission in Paraguay, to advise the Government of Paraguay (GOP) in connection with its plans to privatize La Industria Nacional del Cemento (INC), to review alternative means of divestiture and assist with further planning of certain details of the program. Since the GOP has expressed an interest in privatizing several other state owned enterprises (SOE's), there is also included a review of the major elements of any privatization program for Paraguay, together with some suggestions (which will require longer range study) of possible steps that might be taken to use privatization transactions to assist in the development of the capital market in Paraguay.

My assignment did not include making, nor did I have time to make, a personal study of the INC situation; however, Appendix F to this report summarizes my understanding of the background for the GOP decision to divest this expensive, overbuilt and historically graft-ridden parastatal monopoly for which almost a fifth of Paraguay's international debt was incurred.

PURPOSES OF PRIVATIZATION

In planning for privatization, whether for INC or for any other state-owned entity under consideration, it is important that government officials define what it is they hope will be accomplished through privatization. In the countries where privatization has been undertaken, many of the following have been considered to be important purposes:

- (1) Reduce losses/deficit in the government budget
- (2) Reduce the international debt burden, through using the proceeds of sale to repay debt, or through swaps or other piecemeal arrangements

- (3) Shrink size of government and enable officials to concentrate on important policy questions instead of overseeing management of businesses
- (4) Provide for more efficient and profit-oriented management of enterprises important to the national economy
- (5) Eliminate opportunities for corruption
- (6) Broaden the ownership of capital assets in the country, among investors generally, management and employees
- (7) Strengthen the private sector as an engine for economic development in a democratic society
- (8) Develop the internal capital market for credit and equities
- (9) Expand opportunities for profitable investment in the legal sectors of the economy
- (10) Encourage return of flight capital
- (11) Attract foreign investment
- (12) Gain technical and management knowhow
- (13) Gain access to foreign markets
- (14) Facilitate other privatizations

It would appear that most, if not all, of the foregoing (and perhaps others as well) are desirable goals for Paraguay and have undoubtedly been in the minds of those officials who have become advocates of a privatization program. To the extent they can be agreed upon, such aims should be kept in mind in making decisions with respect to details of the divestiture program, overcoming resistance, defining potential buyers, and designing a marketing plan.

PROBABLE RESISTANCE TO PRIVATIZATION

As is already evident with respect to the INC privatization, and will be with others, either because of circumstances relating to the particular enterprise or as a matter of principle, there are bound to be areas of resistance at the outset, including:

- Political (ideological or tactical)
- Bureaucracy (fear of change or loss of power)

Labor (fear of loss of jobs or union influence)
Public (concern for product price rises or wrongful sale of national patrimony, or lack of understanding)
Press (ideological, political or lack of understanding)
Academia (philosophical, suspicious, may fail to understand the private sector)

A program for divestiture should to the extent possible be planned with such potential resistance in mind, so that appropriate steps can be considered to overcome or counter anticipated objections where possible. It will be found useful, for example, to focus the political dialogue on the purposes of undertaking the proposed program and demonstrate that the benefits of attaining defined goals are much greater than the costs of the status quo.

CURRENT PLANNING CHOICES TO BE MADE FOR THE PROPOSED INC DIVESTITURE

The current policy questions with regard to the INC privatization plans should be addressed with the foregoing purposes and possible objections clearly in mind. Review of the necessary elements of a privatization program, set forth in Appendix A, may also be found useful in dealing with decisions relating to INC. Some of the decisions which appear to be required at the present time are discussed below, together with my recommendations, where appropriate, based on privatization experience elsewhere:

Should the President and Cabinet support privatization strongly, deal with the growing opposition and do whatever is necessary to get the job done?

Unless they are clearly committed to it, the INC divestiture program should be abandoned quickly. Experience has shown that in the absence of firm and publicly expressed support for privatization by the Chief Executive of the country, most privatization projects never get completed.

Should the decision to privatize INC be subject to obtaining a "good" price?

In practice, the decision to move forward should be based on an anticipated "fair market value" (see "Valuation" in Appendix A). Highly qualified independent experts will shortly deliver their opinion on INC's market value. It may disappoint some who have exaggerated ideas of what INC may be "worth". However, I have reviewed with them the method used for this study and believe it should produce a realistic valuation on which the GOP ought to be able to rely.

Once committed to the privatization process, the GOP's acceptance of the final price must be based on satisfactory assurance that it results from above-board arm's length negotiations. So assured, acceptance should be the natural result of the GOP's initial determination that divestiture of INC is in the national interest of Paraguay and that the long range economic benefits of sale will significantly outweigh the costs of continued operation as a parastatal.

Should the GOP retain a minority ownership interest (perhaps about 15% to 20%) in INC after the sale?

A prompt decision should be made on this question. It is recognized there may be some political implications in relation to the GOP posture toward the French debt incurred to finance INC, but they probably should not be over-emphasized since the basic decision to sell has been made for other reasons.

One reason for retaining a small interest (which I recommend if acceptable to the buyer) would be to assure a seat on the Board of Directors with the ability to monitor and influence decisions which may affect the national interest. Due to basic government prerogatives specific authority is seldom necessary, but I recommend that a so-called "Golden Share" be retained in any event, entitling the GOP to prevent or require specified actions*. Relying on this, the GOP might allocate its shares to a management/employee trust, or alternatively retain the option to later sell to Paraguayan investors all or some portion of whatever ownership interest it initially keeps.

Retention of an interest can also be a protection against criticism that a prospectively very profitable asset (which some may see as part of the "national patrimony") is being disposed of without regard for the public interest. The right of the GOP to share in future profits, if any (in addition to the taxes to be received), can be a strong argument with critics. It can also help to silence criticism of sale of a company with a monopoly position in its industry.

In fact, some potential buyers (particularly foreign) may prefer that the GOP retain an ownership interest, so long as the buyer has the controlling share necessary to independently manage the business on a profit-making basis with the GOP as a passive investor and perhaps protector.

*To enforce the "Golden Share" rights, a subordinated note payable could be established, to become due and payable immediately if the new owner attempts to carry out specified undesirable actions.

In the absence of a retained interest or a "Golden Share", it would probably be necessary to establish some sort of GOP regulatory authority because of the monopoly. I do not recommend this; it can readily lead to abuses and bureaucratic mishandling on its own, whereas it is preferable to interfere as little as possible with the operation of the free market.

Should the sale of INC consist only of an important majority interest to one (or more) foreign buyer(s) or should there be an attempt to market minority shares to Paraguayan investors (and perhaps management of INC)?

While it might take longer, I believe it would be highly desirable to include Paraguayan investors and management (and possibly other employees) through a public stock sale. The sale could take the form set forth in Appendix B entitled "An illustrative Marketing Plan". In summary, as a sociedadad anonima, the shares of stock might be distributed (at roughly the same price per share as the foreign buyer pays) approximately as follows:

Foreign Buyer(s)	65%
Paraguayan investors (public)	15%
Paraguayan management/employees*	5%
Government of Paraguay	15%
Total	100%

*Arrangements could be made for bank/GOP financing of employee purchases.

The relative percentages are subject to various things: how much the GOP wishes to keep; how little a foreign buyer is willing to accept; management identity and purchasing power, and further investigation of the possible potential market among investors.

While I recognize the limitations of the capital market in Paraguay and the lack of precedent (see "Privatization and the capital market" below), I believe INC is one (perhaps not the best) of about four Paraguayan SOE's* that could very possibly have considerable appeal to the public for personal investment. In INC's case, this is because of:

(1) the national importance of INC and the role cement should play in future development of the country,

*The most likely to have broad investor appeal would be ANTELCO, ANDE, APAL, and INC; the first two of which are not presently regarded as candidates for divestiture.

(2) INC's potential (as I am advised) for profitable operation when better managed and freed of the present huge debt burden (and available for purchase at the same price acceptable to a sophisticated foreign buyer),

(3) the prospect of having (a) the GOP as a "partner" and (b) a foreign purchaser (presumably an experienced industrialist) in control, and

(4) the openness with which the GOP appears prepared to treat the INC financial situation, assuming that it would continue to have this done. This would be important to overcome what appears to be Paraguayans' instinctive distrust of anyone except close associates.

Selling INC in part to a broad group of buyers could have various advantages:

It avoids the risk that price could be criticised (if it is on the low side, at least anyone can take advantage of it) or that favoritism could be alleged.

It very possibly could eliminate much of labor and bureaucratic resistance, as well as some of political objections.

This transaction could, although not without risk of failure, turn out to be an important first step in the long term development of an equity capital market in Paraguay.

The public attention to such a transaction could help to make future privatizations easier, provided the anticipated future profits actually result.

Should enabling legislation be presented to Congress quickly, before getting into negotiations with specific buyers or developing specific price views?

I think going to Congress as soon as possible is important, and I understand legislation is currently being drafted with this aim in mind. I understand it is to cover not just INC but future privatizations as well, which has the advantage of helping to focus discussion on the purposes of privatization and get the political debate out of the way before price, identity of buyer and other specific details can increase the controversy. The result will be broad authorization to proceed on the basis of a law already enacted. In Appendix C I have listed some thoughts regarding the content of the proposed law, and I have offered to review the draft now being prepared.

It should be noted that this legislation could be drawn so as to apply only to INC if for some reason this is found politically or legally necessary, but I feel it is much preferable to have it cover, as proposed, other entities (named or not named) under consideration for possible privatization.

Should a public relations effort be organized?

I recommend this as an important precaution, in the light of the remarks above under "Probable resistance to privatization". When likely centers of resistance and support have been identified, it would be useful to work with a public relations expert to plan and carry out an appropriate ("soft sell") public awareness/official contact program, i.e. meetings, speeches, presentations, seminars, press releases, advertisements, etc. It is important, however, to have in mind the hazards of having to focus on specific enterprises because there are so few obvious candidates for successful sale. Remember, too, that the debate in Congress will be the first step in public awareness also.

Should privatization of INC be tied in any way to negotiations over the French debt? That is, should success with debt renegotiation take the place of privatization of INC?

It is understandable that renegotiation and possible reduction of the French debt, incurred in connection with the construction of the cement facilities, should be under consideration along with arrangements for rescheduling of other debt. It is logical also that it should arise as sale of INC is being studied. However, it is important to remember that such debt, in the last analysis, is guaranteed by the Central Bank and will remain on the books of the GOP (as renegotiated) even if INC is privatized. I would urge that the GOP not think of either the rescheduling or the privatization as related to or contingent on the success or failure of the other.

Is the GOP organized to carry out privatization effectively?

A check list of the major matters that need to be taken care of in each privatization is attached as Appendix A. It will be evident that there are frequent major decisions to be made and many details to be worked out carefully, often with the assistance of professional advisors.

I suggest particular attention be given to the section entitled "Government Supervision" in Appendix C, which covers how the GOP might organize the personnel who will be required to carry out privatization. That section discusses a proposed structure along the lines of that shown below:

Proposed Government Organization
to Supervise the Privatization Process

Cabinet Committee - not more than three or four senior ministers with full authority to take all actions required or permitted by the Privatization Law. This Committee could consist, for example, of the Ministers of Finance, Industry & Commerce and Planning, plus the President of the Central Bank. In a privatization of an entity within another ministry, that minister could be added to this group.

Ministry Responsible - One minister (probably Industry & Commerce) should have ultimate political responsibility, representing the Cabinet Committee, for all privatizations.

Privatization Coordinator - A senior officer at the under secretary level of the responsible ministry should have direct day-to-day supervision of the privatization process, and reporting to him should be an

Assistant Coordinator - A full-time highly qualified individual with legal/financial credentials recruited for the purpose, with

Staff.

The purpose of recommending that one ministry be responsible for all privatizations, with a high level Coordinator and Assistant, is (1) to assure adequate concentration on, and direction for, the process and (2) to provide the continuity to develop professional experience with the privatization process so that subsequent divestitures can be done more efficiently. There is a great risk in privatization of continually "reinventing the wheel". Opportunities should be sought for these two individuals to attend conferences, seminars, etc., such as those available through the Center for Privatization, sponsored by USAID or the United States Information Service in Washington, Latin America or even locally, where ideas, techniques and privatization experience can be shared.

Technical Assistance and Investment Banking Services

Due to the accumulated experience of consultants who have specialized in work on privatization, considerable professional assistance should be useful and is presumably available to Paraguay through USAID and/or other donors. Details concerning this possibility and its estimated cost are set forth in Appendix D.

My opinion having been requested, Appendix E presents in some detail my personal views on the usefulness of an investment banking firm, primarily in connection with the actual sale negotiations or other marketing arrangements. As to the choice of a firm for assistance in privatization, in my view it is somewhat subject to the marketing plan being considered. For example, I regard Citibank as one of the leading international organizations experienced in privatization work and fully qualified to represent the GOP in negotiations with a single buyer. Others would be The First Boston Corporation (New York) or Morgan Grenfell & Co. (London). However, if sale to the Paraguayan public (and perhaps employees) is being considered, an investment banking firm with similar privatization qualifications but also experienced in promoting "retail" distribution of securities might be a better choice. Examples would be Shearson Lehman Hutton (affiliated with American Express) or Schroder Wagg & Co. (London). Undoubtedly there are other firms similarly qualified for either or both of these tasks.

Privatization and the Capital Market

I have not had the opportunity to examine carefully the Paraguayan capital market. However, my observations are that the use of available credit in the domestic market is dominated by government needs, to the detriment of the ability of the private sector to obtain investment or working capital. Borrowing from banks is difficult, expensive and very short term (maximum about three years). Savings of individuals, whether wealthy or not, appear to generally get invested in (first) U.S. dollars and (second) agricultural land. Any excess may go into a very small (except for the wealthy) private business. Those savings that are in the hands of banks, insurance companies and private pension funds are mostly on deposit or loan to the Central Bank. Private pension funds are held in the banks, or on loan to the future beneficiaries.

There is no trading in equity securities. Most business enterprises are owned by a single individual or family, perhaps with a few close associates. Savings held by banks or insurance companies that might in another country be available for equity investment, are unable to

find equity purchase opportunities, not least because of the lack of trust in the financial figures (frequently inventive) provided by Paraguayan businesses and entrepreneurs.

I am told that, for excellent reasons, GOP officials place a high priority on development of the capital market as a means of energizing economic development. There is much to be done to bring this about. It will be important to overcome the traditional distrust for Paraguayan financial statements, which will probably require a complete overhaul of the tax system and the customs system (both of which I understand are under study). This should be followed by more honest and open financial reporting, which perhaps should be then enforceable by a new securities law, which is also under study. Beyond those measures, successive privatizations, starting with INC, could be important to this development.

It is my view that the essential element in developing a capital market in a country such as Paraguay is not to build a "stock exchange tower", but to find ways to spread the ownership of stock among enough people so that there will be reason to trade. Where an equity market does not exist, because private sector companies are closely held and no shares of companies are available for trading, privatization of major government owned companies through public sale of shares is probably the most effective way to begin capital market development. When there are some shares widely held, trading will start. Well known enterprises whose earnings and prospects are sufficient to attract buyers represent the best opportunity to bring this about.

For Paraguay I believe that, even under present capital market circumstances, shares of an attractive, profitable nationally recognized company, with the prospect of a favorable dividend yield, can be successfully offered to the public, and that this action will lead to the gradual development of the capital market. As I have suggested, I believe there is sufficient hope that INC could fill this description so that it would be worthwhile to obtain some technical assistance, from an international investment banking firm, to examine the possibilities of public sale.

I recommend that every national enterprise should be examined by the GOP to see whether it holds prospects for at least partial divestiture by public sale. For example, in many developing countries (as well as in the United Kingdom) the national telecommunications enterprise is regarded as an excellent opportunity for broad public sale, because of the

industry's recognized profitability worldwide, its continual need for investment capital to keep pace with technological development, and its importance to the development of the economy. There may be important reasons for not making this obvious choice for Paraguay, but there is no doubt that it could be successful and would contribute to the success of other relatively less attractive divestitures (among which I would have to include INC).

In pursuit of such a program, I have included in Appendix G a brief description of what might be a worthwhile project sometime in the future: the creation of a publicly marketed investment trust or mutual fund, which would hold small portions (not more than 10% or so) of all or most of the GOP's more profitable national enterprises. It would introduce the concept of stock investment to small investors, who need diversification and should ultimately contribute to the development of a stock market. It would also subject government enterprises and their managers to the rigors of public financial scrutiny focusing on full disclosure and profitability.

* * *

APPENDIX LIST

Appendix	Title
A	Elements of a privatization program
B	An illustrative marketing plan
C	Some thoughts on a Privatization Law for Paraguay
D	Requirements for technical assistance for privatization in Paraguay
E	Role of an investment banking firm in the privatization process
F	The INC situation
G	Creation of an investment trust or mutual fund

* * *

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Elements of a Privatization Program
(A summary check list)

In planning the program for privatization of any parastatal, the decisions and actions to be taken include the following (in the case of INC much of this has been done or is in process):

Legal: Determine the appropriate legal form of the sale or transfer, i.e. sale of assets subject to certain liabilities or sale of shares of a corporation (which may have to be formed before sale). Determine whether legislative action is required (I think it is very desirable anyway) to make the sale and, if so, have a proposed law drafted and organize political effort to assure enactment. Have a legal survey made for other potential legal problems and institute necessary actions.

Financial and Accounting: Arrange for any necessary audit or revision of accounting necessary for a public prospectus or direct sale. Assure that unit to be sold is financially and functionally separate in all necessary respects from general financial arrangements of the ministry or bureau. Draft the prospectus or other sales document (for INC an offering memorandum should be drafted with the assistance of the investment banker chosen to negotiate the sale).

Operations. Restructure the management, staff, and functions of the entity so that it can operate independently of the ministry of which it is a part, to facilitate contemplated transfer; if a public offering is planned, seek to recruit and put in place new top management if appropriate to planned ownership. Determine extent of employee redundancy, if any, and consider any action to be taken with respect thereto, including separation payments and possibly retraining.

Valuation: Arrange for a valuation study to be made by a well known international firm of experts, to determine a fair market value or range of likely market values. The most appropriate methodology for determining a realistic valuation is to construct a discounted cash flow model and incorporate expected investment return ratios for domestic or foreign investors. The historical costs of investments almost invariably are not relevant in establishing current fair market value. In the case of INC an independent valuation study has just been completed and a report is expected before July 1, 1989.

Policy Matters affecting the Privatized Entity:
Identify policy matters to be considered, i.e. subsidy changes, monopoly rights, etc., and estimate effects. Determine how, if at all, they affect valuation and purchaser interest. Develop policy recommendations for decision.

Time Schedule: Adopt a realistic time schedule with a target date for completion, based on requirements of various elements of the program which would be proceeding simultaneously.

Marketing Plan: Determine mode of sale, i.e. single buyer, public offering, employee stock purchase, investment trust, etc. Obtain specialized legal advice where appropriate. Identify and retain an investment banking firm with necessary qualifications (see Appendix E, "Role of an Investment Banking firm in the privatization process"). Agree on necessary steps in marketing program.

Public Relations: Identify likely centers of resistance and support and plan appropriate public awareness/official contact program, i.e. meetings, speeches, presentations, seminars, press releases, advertisements, etc.

Government Supervision: Assign a committee of Cabinet ministers (ideally not more than three or four)* with the necessary power to make policy determinations (such matters as timing and mode of sale, final price approval, conflicts of interest, etc.), provide executive oversight, resolve bureaucratic tangles and generally "energize" the process to keep it moving. Under their direction an appropriate ministry (Industry and Commerce or Finance) should be assigned overall supervision of the process (for all privatizations to take advantage of acquired experience) and a well qualified under-secretary-level official placed in direct charge with ready access to the ministerial committee. It will be useful if this individual, and

*In some cases where designation of such a committee required legislation, it was been found necessary to at least consider putting a member of the political opposition on the committee. In at least one instance where this has been done, experience has shown that it was important to calculate the numbers so that necessary action will not be inhibited (but political understanding and responsibility will be enhanced). In Costa Rica work on the CODESA divestitures came almost to a halt until such a committee was disbanded in 1986.

perhaps others, can have an opportunity to attend one or more of the international training seminars on privatization conducted by the Center for Privatization and others.

Role of President of Paraguay: Due to the potential for resistance (particularly political and bureaucratic) to transfers to the private sector of what may be widely regarded as "national patrimony", experience elsewhere has shown that a privatization project has little chance of actually being completed unless the chief executive of the country is personally and by public pronouncement firmly committed to it. At the appropriate time (evident if legislation is to be introduced) this should not be overlooked.

Follow-up after Sale: If foreign technical expertise is not being obtained through the sale and the entity will be on its own, it is desirable in the interest of future privatization efforts that management monitoring of the newly-private company, and assistance if necessary, be provided at the outset. This can frequently be obtained from the International Executive Service Corps (U.S.) or possibly from USAID or other donor agency.

An Illustrative Marketing Plan

While the focus in planning the sale of INC has so far been on potential foreign investors already involved in the cement business, various considerations already mentioned suggest that the possible sale of a portion of INC broadly to local investors should be evaluated. Outlined on the next page is an illustrative marketing plan to include Paraguayans. It could be appropriate for INC or could be used for some later divestiture under not dissimilar circumstances.

In considering this plan it must be recognized that there is probably no precedent for it in Paraguay. Before the GOP commits to attempting a public sale, a careful survey should be made by experts, probably an international investment banking firm experienced in the "retail" distribution of securities, to form a judgment on the likelihood and size of a favorable reception. In the event such a firm concludes that the suggested public offering could be successfully made, they should be retained to assist in carrying it out (see Appendix E on "Role of an Investment Banking firm").

Although it would take more time to organize than a direct sale to a single foreign buyer, this plan could provide a number of advantages, as follows:

1. GOP continues to be informed about INC and is able to exert influence if a national policy issue becomes involved.
2. GOP keeps some shares to benefit from increases in profits (in addition to taxes it will henceforth receive on profits).
3. Having a number of buyers assures that price cannot be criticized nor can favoritism be alleged.
4. Public sale including employees is very likely to eliminate much of labor and bureaucratic resistance, as well as some of the potential political objections.
5. This could be an important first step in the development of an equity capital market in Paraguay.
6. The public attention could help to make future privatizations easier (provided the offering price is seen as having the potential for future profit).

The plan would require that the entity be converted to a stock corporation (sociedad anomina), and would include the elements shown on the next page. Percentages are

approximate, for illustrative purposes, and it is emphasized that in an actual case the preference of the buyer would influence the proportionate shares and, as indicated below, the amounts assigned to private sector investors would depend on the views of an investment banking firm after they had made a detailed analysis of the present "market" potential.

AN ILLUSTRATIVE MARKETING PLAN
(Subject to further analysis of purchase ability of private sector investors)

Marketing Element	Percent of Total Stock of Corporation
Sell a partial interest to a single foreign buyer at a price negotiated with the assistance of an independent investment banking firm	60%
Sell a portion to investors in Paraguay, including banks, insurance companies, pension funds and individuals, in a publicly advertised offering, at the same price per share	15%
Offer shares to management and employees of the entity (and possibly other members of the bureaucracy involved with it, at the same price but with arrangements for delayed payment out of earnings and possibly a bank borrowing to provide the GOP with immediate funds	5%
GOP retains a minority interest, possibly together with a "golden share" to give it a controlling vote under narrowly stipulated circumstances	20%
Total	100%

SOME THOUGHTS ON A
PRIVATIZATION LAW FOR PARAGUAY

Such a law might recite ("considerando") some of the reasons why privatization is in furtherance of the national interest (see "Purposes of Privatization") to achieve, for example:

Reduction of GOP deficit

Reduction of international indebtedness

Strengthen the national economy through better and more efficient management of an important national enterprise

Attract foreign investment, etc.,

and then decree:

(1) broad authorization defining what is to be privatized (i.e. assets, subject to specified liabilities as appropriate, etc.). Provision should also be made for conversion of autonomous entities into newly created stock corporations (Sociedad Anonima) where appropriate

(2) blanket authority to designated members of the Cabinet (I recommend a small Committee, perhaps already constituted, of not more than four senior cabinet ministers) to take all acts necessary to sale (conversion to stock corporation, restructuring, selection of experts, definition and acceptance of terms of payment, etc.,

(3) the Minister to be directly in charge of carrying out the process,

(4) by what criterion the entity to be sold would be valued (reasonable market value), and whose opinion would be relied on (internationally recognized independent professional organization),

(5) provision for a minority interest to be retained by the GOP or for (a) a "Golden Share" or (b) limited regulatory arrangements (perhaps in a separate law) to limit abuse of monopoly power,

(6) to what purpose(s) proceeds of sale are to be applied, and

(7) other authority deemed necessary.

**Requirements for Technical Assistance
for Privatization in Paraguay**

Technical assistance from professionals specializing in various areas can be important in handling some of the steps set forth in the foregoing report and in Appendix A. I have been asked to indicate what might be involved. Some may be available locally, others experienced in privatization matters can be obtained internationally through the Center for Privatization or elsewhere. While it is understood USAID resources available for Paraguay are limited, these are the kinds of expenses frequently supported by USAID missions. If the illustrative marketing plan described above, involving a public offering, is to be first tried (after further study), more expert assistance will be required. Following are estimates of person-weeks of technical assistance that may be required (the remaining work on INC is shown as an example of a single buyer divestiture):

	Single Buyer(INC)	Illustrative Plan Amount	Source*
Privatization specialist	4	8	Foreign
Legal Advice	3	7	Foreign
Financial and Accounting	2	6	Foreign
Restructure Operations	2	4	Local
Valuation (completed)		5	Foreign
Marketing Plan	-	2**	Foreign
Public Relations	<u>4</u>	<u>6</u>	Local?
 Total person weeks	 15	 38	

*May be part foreign and part local source, depending on specialties available in Paraguay.

**Represents advice by investment banking firm prior to retainer for actual marketing.

The foregoing estimates suggest that the cost of technical assistance (excluding services of an investment banking firm in actual marketing - see Appendix E, "Role of an investment banking firm in the privatization process") might be in the order of US\$ 70,000 to 95,000 for sale to a single buyer (assuming limited use of foreign experts except for the valuation and the "privatization specialist") and US\$ 175,000 to 225,000 for the plan involving sales to public and employees (and more extensive use of foreign advisors).

Role of an Investment Banking Firm

The discussion which follows is intended to apply to future privatization activities. The INC divestiture appears to be close to the point where an investment banking firm should be put on retainer with a negotiated success fee, and there is no reason to consider the delay suggested below for future divestitures.

The many skills perfected by investment bankers over years of work in buying and selling companies, financing them, restructuring them, analyzing their investment merits and marketing their debt and equity securities, and performing related or similar functions for sovereign governments, make them well qualified to advise and assist the Government in a privatization program. At the same time, the skills of a firm of international repute are likely to be most effectively utilized by a client government in carrying out the actual marketing plan. The energies and experience of senior officers will be directed toward this ultimate transaction, and the substantial fee for successful completion reflects this. This fee is negotiated in advance and is dependent largely on successful sale, so that it is in effect paid out of the cash proceeds. It would not be unusual for a firm to ask a fee in the area of 2% to 5% of the sale price, depending on whether the actual buyer had been identified by them. Such fees are not ordinarily paid by USAID.

If a major firm is also expected to be engaged in advising and assisting with much of the preliminary planning, its compensation for that work should probably be separated so that its recommendations will not be biased toward a potential (perhaps inappropriate) transaction. Fees for such advisory work can be relatively modest, because the firm is likely to use junior personnel on this more tedious work, and to change individuals over time for "career development" purposes. In view of this, and particularly if USAID or other donor agency is to provide financial support, the Government might be better served if it were to use instead an individual consultant with extensive privatization and investment banking-type experience who could come and go periodically and maintain communication and involvement throughout the planning process. The Center for Privatization has a number of highly qualified such individuals on its roster who may be available at the limited compensation USAID is permitted to pay, and no doubt this kind of person may also be obtained through other consulting organizations.

As a practical matter, a major firm should be identified as soon as it is clear what the general marketing plan is to be, and the firm's opinion should be sought informally from time to time as the planning work progresses. Their engagement can then commence when the marketing stage is reached.

The foregoing is the opinion of the writer based on his own experience and on observation of the work of investment banking firms in privatization. In conversations on the subject with officers of several investment banking firms I have found substantial agreement with this view. Others may in good faith disagree.

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THE INC SITUATION

I am advised that the background of the decision to privatize Industria Nacional del Cemento (INC) may be summarized as follows.

INC was established under Law No. 126/69 as an autonomous parastatal under the jurisdiction of the Ministry of Industry and Commerce to develop the cement industry and do all things necessary to promote expansion of national consumption and build a position in international markets. Attracted by the prospect of sales for the huge binational hydroelectric plants at Itaipu (joint project with Brazil now near completion) and Yacyreta (joint project with Argentina advancing slowly) on the Parana River, INC in 1984 entered into a major expansion of facilities which is only now reaching completion. Through major delays it missed the Itaipu construction and in the early Yacyreta planning Paraguay ceded to Argentina the right to provide all cement, reputedly for a large "commission". The increased capacity planned was nearly double the projected cement needs for both projects. As a result the now installed capacity is approximately three times the current Paraguayan demand (with projected annual increases of about 5%). Due to high costs there is no prospect of exports to Brazil or Argentina, both of which have lower costs (particularly Brazil, from which it appears significant illegal imports enter Paraguay) and excess capacity; Argentine law prohibits cement imports from Paraguay. Exports to other markets are unlikely due to freight costs.

The debt incurred to finance this expansion, mostly from French government and banking sources, exceeds US\$ 300 million, up to half of which is said to represent inflated invoicing and other forms of graft on a scale without precedent in Paraguay. Interest on this debt is currently not being paid. The new government plans to renegotiate this debt, expecting to obtain a significant reduction under the circumstances. Nearly all of the debt is guaranteed by the Central Bank of Paraguay. The GOP is determined to put this monster in private hands; officials recognize that the proposed divestiture of INC will have to be on a debt-free basis.

The GOP has been reducing in steps the subsidy that has been provided to INC to help keep the domestic cement price reasonably competitive. In 1988 an operating profit was shown for the first time, amounting to approximately US\$ 4 million before interest and taxes. I understand that studies by the valuation team provided by the Center for Privatization indicate that the production facilities are modern, well designed and of high quality, and they are able to project profitable operation based on various certain reasonable market and other assumptions (including no interest costs).

Creation of an Investment Trust or Mutual Fund

As the GOP proceeds with the consideration of privatization of other SOE's it will be important to focus on two goals which appear to be important to Paraguay, i.e. developing the capital market and broadening the ownership of capital assets among the professional and middle classes. In this connection consideration might be given to the creation of an investment trust or mutual fund (the "Fund"), holding an assortment of minority interest (not more than 20%) stockholdings in various profitable government controlled entities. This could be a first step in privatization within the limitations of the present capital market.

Shares of the Fund would be offered to insurance companies, banks and private pension funds (perhaps even IPS, the Social Welfare Institute?) and could be promoted and marketed to individuals through banks and insurance salesmen. While the amount initially taken by individuals might be small, with satisfactory performance it could grow. The stocks transferred to the Fund from the GOP would be valued on a favorable formula basis related to their earnings record and dividend potential. After distribution of shares of the Fund they would be revalued periodically according to a similar formula to provide a basis for repurchase and resale of shares through a designated bank. As the market expands, additional government owned stock could be transferred to the Fund.

This somewhat revolutionary Fund concept is currently being tried or considered in a number of countries. It should help to promote the concept of stock ownership, and provide a standby "market" until ownership of shares broadens sufficiently. It also subjects the management of government enterprises to public scrutiny using a profit criterion as a measure of performance.

Such a Fund can only be successful if the stocks provided to it are of attractive profitable companies such as telecommunications, electric power, etc. There should be enough different companies involved to assure reasonable diversification (ideally no one company should constitute much more than about 10% of the value of the Fund).

Establishment of this kind of Fund would require a basic GOP decision that there are advantages to sharing the ownership of such entities with private capital to improve their management and increase their economic potential.

As an illustration of what can happen when forced to face private sector profit-oriented scrutiny, British Telecom has aggressively branched out into many new profit-making activities since it was privatized several years ago, and is now immensely more profitable. At the time of the sale a significant number of redundant workers were identified. However, within a year total employment had increased well above the level at the time stock was sold.

If such a Fund should in the future become of interest to the GOP in its ongoing privatization planning, additional information should be available based on experience now being acquired.

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