PN-ABQ-154

GUIDELINES FOR THE PRIVATIZATION OF AGRO-INDUSTRIAL ENTERPRISES

DECEMBER 1992

PN-ABQ-154

AGRICULTURAL MARKETING IMPROVEMENT STRATEGIES PROJECT

Under contract to the Agency for International Development, Bureau for Science and Technology, Office of Rural Development
Project Office 4800 Montgomery Lane, Suite 600, Bethesda, MD 20814 • Telephone: (301) 913-0500 • Telex: 312636

GUIDELINES FOR THE PRIVATIZATION OF AGRO-INDUSTRIAL ENTERPRISES

Submitted to:

U.S. Agency for International Development

By:

The Agricultural Marketing Improvement Strategies Project (AMIS)

James G. Brown

December 1992

Prime Contractor: **Abt Associates Inc.**, 4800 Montgomery Lane, Suite 600, Bethesda, MD 20814 • (301) 913-0500

Subcontractor: **Postharvest Institute for Perishables,** University of Idaho. Moscow, Idaho 83843 • (208) 885-6791

Deloitte & Touche, 386 Woolwich Street, Guelph, Ontario N1H 3W7 Canada • (519) 822-2000

TABLE OF CONTENTS

PREFACE i

1.0 INTRODUCTION 1

2.0 THE PROCESS OF PRIVATIZATION 3
- 2.1 Purpose and Structure of This Paper 5
- 2.2 Phases of the Privatization Process 6
- 2.3 Organizing the Process of Privatization 8

3.0 ASSESSING THE CONDITION AND PROSPECTS OF THE ENTERPRISE . . 10
- 3.1 Physical Evaluation 10
- 3.2 Commercial Assessment 12
- 3.3 Legal Assessment 14
- 3.4 Organization, Management and Staffing 16
- 3.5 Financial Analysis 19

4.0 ASSESSING THE POLICIES AND REGULATIONS THAT AFFECT THE ENTERPRISE 28

5.0 DETERMINING THE TYPE AND EXTENT OF PRIVATIZATION 32
- 5.1 Transfer of Ownership 32
- 5.2 Transfer of Management 34
- 5.3 Lease of Assets 35
- 5.4 The Liquidation of Assets 36

6.0 ATTRACTING PRIVATE INTEREST 38

7.0 NEGOTIATING AND IMPLEMENTING THE CHANGE 49

APPENDIX A SUMMARY OF STEPS IN PRIVATIZATION PROCESS

PREFACE

The Agricultural Marketing Improvement Strategies project (AMIS), core-funded by the Agency for International Development's Bureau for Science and Technology, is a five-year project designed to assist USAID Missions and developing countries to:

- improve diagnosis of agricultural marketing system constraints, using rapid appraisal techniques,
- conduct in-depth analysis of specific marketing problems identified during rapid appraisal or by other studies,
- identify, design, and monitor appropriate marketing system innovations and improvements, and
- build local capacity in both the public and private sector to do marketing systems analysis.

AMIS is also assisting AID/W and USAID Missions in planning new marketing initiatives and projects.

The rationale for the AMIS Project, which began operations in October 1987, was the realization that benefits from increases in agricultural production, often the result of successful AID or other donor-sponsored projects, frequently do not reach farmers and others in the marketing chain because of constraints or bottlenecks in marketing systems. Likewise, inefficient distribution systems for fertilizer and other inputs may result in late deliveries and high cost to farmers. These constraints may be technical, institutional or infrastructural, but they are often the result of government policies with disincentive effects — policies that discourage private sector participation in marketing. Through analysis and active interventions, AMIS is promoting a better understanding and appreciation of the importance of marketing in the agricultural development process.

The prime contractor for the AMIS Project is Abt Associates, a Cambridge, Massachusetts-based policy research and economic analysis firm, operating through its Washington, D.C. area office. Abt is assisted by two subcontractors: The Post-Harvest Institute for Perishables at the University of Idaho, a research and information center dedicated to improving post-harvest handling and marketing of perishable crops, and Deloitte, Haskins & Sells, an accounting, management, and agricultural development consulting firm with special expertise in market liberalization studies.

1.0 INTRODUCTION

Privatization represents one of the most difficult structural adjustments an economy or an enterprise can undergo. The act of changing the ownership or control of assets is only the keystone of an intricate structure of institutional and regulatory liberalization. The privatization of an enterprise encompasses many of the issues and phenomena associated with these changes at the level of the economy.

Governments in developing countries became active participants in productive sectors of the economy because of perceived widespread failure of market forces to satisfy economic expectations. Social and political agendas added fuel to the drive for public sector domination of the economy. And there is little doubt that the private sector as it existed at the time of independence in many countries was characterized by deficiencies which, in the short-term, would have prevented it from playing the role it enjoys in industrialized countries. However, as owners and managers of productive enterprises, the public sector is faced with inherent disadvantages compared to private firms. These have led to successive financial issues in most cases, and a trend toward re-introduction of private ownership and management

This paper assumes that the decision has been taken to increase private sector participation in an agri-business enterprise or groups of enterprises. It is not intended to assist policy makers in reaching decisions concerning the merits of privatization. Nor is it intended to serve the strategy needs of those planning privatization across a sector. The purpose of the paper is to identify the factors which will influence the results of the decision to privatize a particular enterprise, and to provide guidelines to assist in addressing these issues and carrying out the many tasks that are required to complete the privatization process.

The discussion and sections of the paper follow approximately the chronology of events and activities as they should occur in the privatization process.

James Brown of Deloitte & Touche Management Consultants prepared this paper, under the auspices of the Agricultural Marketing Improvement Strategies (AMIS) Project of the United States Agency for International Development (USAID).

The report has been prepared by Mr. James Brown of Deloitte & Touche Management Consultants as part of the Agricultural Marketing Improvement Strategies (AMIS) Project of USAID.

2.0 THE PROCESS OF PRIVATIZATION

Privatization — transferring the ownership or control of state-owned assets to private hands — is the keystone of an intricate structure of institutional and regulatory measures aimed at liberalizing economic activity. It is this structure, and the sensitivity and thoroughness with which it is installed, that can alter the productivity of an economy's assets.

This paper assumes that the decision has been taken to increase private sector participation in an agri-business enterprise or group of enterprises. It is not intended to assist policy makers in reaching decisions concerning the merits of privatization. Nor is it intended to serve the strategic needs of those planning privatization across a sector. The purpose of the paper is to identify the factors which will influence the results of the decision to privatize a particular enterprise, and to provide guidelines to assist in addressing these issues and carrying out the many tasks that are required to complete the privatization process.

Governments in developing countries became active participants in productive sectors of the economy for a variety of reasons.

- There was the perception of a widespread failure of market forces to satisfy economic expectations.

- New governments in some cases felt they were at the mercy of the industrial interests of former colonial powers.

- In some countries there was only a nascent private sector business community at the time of independence, without the resources or acumen to assume a dominant role in economic activity;

- In other cases the entrepreneurial talent and resources were in the hands of ethnic minorities.

- Financial markets were not well developed, adding to the scarcity of investible capital in private hands.

- There was the general belief that government was a more objective distributor and user of economic resources than the private sector, and social and political agendas added fuel to the drive for public sector domination of the economy.

Development agencies supported many of these views and assisted governments to expand their intervention in economic activity.

Many governments entered the agricultural sector to secure their own position by ensuring the supply of staples to strategic groups of the population. This created vested interests

that can be expected to resist vigorously the loss of their privileged access to employment and products that would accompany privatization, and these groups are often in a position to destabilize a government if their demands are not met. In other cases, governments entered the sector to protect jobs as colonial corporations withdrew or other international interests declined because of market conditions. Government's presence in this capacity has protected employment, albeit often at the cost of growing inefficiency, but it has also preempted the development of new employers. Consequently, the withdrawal of the government today poses the same risk of loss of employment that induced the public presence in the first place.

Marketing and processing enterprises have an even farther-reaching impact in that they also provide "employment" for the farm families that supply their raw material; in some cases a marketing board or factory has become the mainstay of a region because of the dominance of a basic commodity in the economy. These difficulties of privatizing an agro-industrial venture are compounded by the political sensitivity of agriculture and by the persistent weakness of international markets for most agricultural products from developing countries.

As owners and managers of productive enterprises, the public sector is faced with a number of disadvantages compared to private companies:

i) Competing and conflicting objectives representing a cross-section of the constituents of the state. For example, assisting rural households through support prices not related to market conditions, or providing employment rather than viewing labor as a factor of production to be used in efficient combination with capital and other assets to maximize long term net benefit to the firm. On the marketing side, the objective of low urban consumer prices has often conflicted with the need to generate resources for marketing services and to provide a remunerative producer price.

ii) Cumbersome decision-making processes. While these evolved from the need to ensure that all constituents participate in the allocation of resources and benefits, they result in delays for publicly-managed companies in relation to their more authoritarian privately-managed competition.

iii) Financial policies and procedures based on the overall allocation and control needs of the state. The result is often inappropriate allocations of investment and working capital to the enterprise, untimely releases and inadequate control over the funds that have been received or generated.

iv) Detachment of the interests of personnel from the interests of the enterprise. Career development, benefits, and job security tend to be associated with criteria other than the performance of the firm, and standards and conditions of employment are tied to those of central agencies. The result has been to impose costs on the firm that are unrelated to its capacity to pay, and to divide employee loyalties between the firm and its supervising ministries.

v) Progressive isolation of the enterprise from its markets. Operating decisions tend to be associated with budgetary, bureaucratic or political considerations rather than consumer preferences. This has led state-owned firms to be unresponsive to customer needs, and to fail to innovate either in terms of process or product.

To sustain enterprises in the face of these difficulties, governments were required to impose progressively wider regulatory control over the distribution of resources in the economy and over the activities of potentially competing enterprises in the private sector. Each of these measures had a direct cost, but the distortion in resource allocation and the suppression of private initiative were even more detrimental in terms of their impact on economic performance. Eventually the social and economic cost of these distortions could no longer be sustained by the sluggish or declining base of economic activity.

Financial crises gradually eroded the capacity of public agencies to sustain their control over productive assets. Resistance to increased private control has given way, and a widespread shift of policy has seen many publicly-owned enterprises moved into private ownership, private management, or liquidation. Unfortunately, ideology still clouds some of the strategic thinking among advocates of privatization, with the result that the transition is not adequately thought through and the benefits do not materialize to their full potential.

2.1 Purpose and Structure of This Paper

This paper is written primarily for the public official charged with carrying out the decision to privatize an enterprise or group of enterprises, and for development agency staff who may develop programs of technical and financial assistance for this process. It assumes that the reader has a basic knowledge of the financial and legal aspects of corporate ownership, and of the operation of the selected agro-industrial enterprises.

The title of the paper refers to agro-industrial enterprises, those that add value to materials of plant or animal origin through processing, storage and/or marketing. However, most of the issues and steps addressed in this paper are applicable not only to agro-processing enterprises, but to other forms of agri-business and to enterprises in other sectors. For this reason, the reader should not be concerned with the occasional reference to agri-business, a term which is generally taken to include commercial agricultural production and the supply of farm inputs. If a comment or recommendation is activity-specific, it will be so stated.

The reader should note one important distinction between the process developed in this paper and more conventional approaches to capital restructuring. Agro-industries are not as likely as enterprises in other sectors to attract private investors solely on the basis of an appropriate share valuation. In the first instance, many countries dominated by this type of industrial activity do not have the capital markets in which bidders will set or validate a share price. Furthermore, there are many factors in addition to the price of shares that will determine the future success of the venture, and which prospective buyers will want to discuss with agents

of the seller. Consequently, the latter stages of the privatization process will often involve negotiation and confidentiality; measures to ensure the quality of the outcome and protect the integrity of those participating must be built into the process. Where the prospects of the enterprise are readily apparent, and where a formal capital market does exist to arbitrate between seller and multiple buyers, many of the measures discussed in the latter sections of this paper may be unnecessary, and the seller can take a more conventional approach to financial and ownership restructuring.

Except where clearly stated otherwise, the perspective of the paper is that of an individual or agency engaged to assist the seller to plan and implement the privatization of an enterprise or group of enterprises. However, prospective investors in the enterprise will conduct an evaluation for their own purposes which will be very similar to that developed here. In both cases the purpose is to establish a solid information base on which to assess constraints, potential and, thereby, a sense of the value of the enterprise. The criterion for successful completion of the process will not be the maximization of sales value, but the introduction of private participation, whether partial or complete, on terms which are satisfactory to both parties and which offer the prospect of financial success for the enterprise in the future.

While different types and degrees of privatization will be discussed in Section 4.0, the general approach of the paper will be to assume and refer to the sale of the enterprise. This will simplify the language of the paper and, because sale is the most complete form of privatization, it will encompass most concerns attached to other types.

2.2 Phases of the Privatization Process

The sections in this paper follow approximately the chronology of events and activities as they might occur in the privatization process.

Assessing the Condition and Prospects of the Enterprise. Section 3.0 addresses the various components of enterprise appraisal: physical, commercial, financial, legal, and organizational. This evaluation leads to an explanation of the current circumstances of the enterprise, an assessment of its needs and potential, the identification of impediments to effective privatization, and an assessment of value. In summary, this analysis will provide answers to the following questions:

- What is the condition of the enterprise in respect of each of the areas of inquiry (commercial, technical, financial, managerial, organizational)?

- What is its performance potential, in terms of its assets and markets, but also in terms of the economic and political conditions in which it operates?

- What is needed in terms of management, technology, financing, and market access?

- What is the firm's potential appeal to private interests?

- What changes in assets, operations or structure will increase its appeal to prospective owners or managers, and consequently its market value for the present owners?

Assessing the Policies and Regulations That Affect the Enterprise. Section 4.0 examines the complex framework of policy and regulation within which the enterprise functions. Some of the elements may have supported or hindered performance as a state-owned enterprise, and some would impinge on performance after privatization. Section 4.0 assists the analyst to address such questions as:

- What are the major elements of the policy and regulatory environment in which the enterprise functions?

- What are the financial and economic implications of this environment?

- What are the restrictive or distorting elements of the environment that should be changed?

- What are the reinforcing or supporting elements that may be removed as part of liberalization policy, and what would be the impact of the loss of this support?

- Are there issues of policy and regulation that extend beyond the enterprise which need to be addressed either to enhance the value of the enterprise or to adjust for the change in public/private sector roles with the sale of the subject enterprise.

Determining the Type and Degree of Privatization. Section 5.0 identifies various forms of privatization and discusses some of circumstances under which their respective features may be most desirable. Questions to be addressed include:

- Given the nature of interest groups and the condition and prospects of the enterprise in hand, what type and degree of privatization would be most effective?

- Might it be possible to enhance benefits and reduce resistance by phasing privatization over time and among types?

- How does the seller establish reasonable expectations regarding the negotiations?

- What issues are likely to arise in negotiations, and what arrangements are likely to satisfy buyer and seller?

- What are the most appropriate legal and financial instruments to be used under different circumstances?

Attracting Private Interest. Section 6.0 develops a detailed outline of the typical steps in the solicitation of private sector interest in the enterprise. It develops each step sufficiently that the user can adapt the guidelines to meet the circumstances of any particular enterprise or socio-economic setting. The key questions addressed in this process are:

- What strategy is to be used to elicit the interest of prospective buyers or managers?

- What are the conditions likely to be placed on an agreement?
- Are there particular groups of private interests to be solicited, perhaps because of their familiarity and compatibility with local conditions, or because they can bring a needed resource to the enterprise in addition to capital?

- What measures are essential to elicit any interest?

- Are there financing sources available to facilitate the agreement?

- How much of this preliminary work should be done independent of prospective partners, and at what point should they be brought into the picture?

Negotiating and Implementing the Change The successful negotiation and implementation of a privatization agreement depends on the realism of expectations on the part of both parties and on a common understanding of the issues to be resolved. Section 7.0 identifies measures to ensure the best outcome. In addition to the preparation implicit in earlier sections, issues need to be addressed such as:

- How does one establish reasonable expectations with respect to the value and the terms of an agreement?

- Are there financing sources available to facilitate the agreement?

- What remedies are to be included in the agreement?

- When should agreements take effect and over what period will transition be phased?

- What arrangements are to be made for the disposal of any assets and the assumption of any liabilities that may not have been included in the sales or management agreement?

- How should parties to the agreement monitor implementation and performance?

2.3 Organizing the Process of Privatization

As the various steps outlined in the following sections will illustrate, there are many tasks to be accomplished if privatization is to succeed, and many decisions to be made in a timely

fashion. These require the efficient participation of parties with different areas of competence and authority. Anticipating the process ahead of time will avoid delays and omissions in arranging their participation. On behalf of the seller, there will be three main groups of participants: representatives of the owners, from the supervising ministry and the Registrar of Companies or the Board of Investments to the core ministries of Finance and Planning; technical specialists from auditors to process engineers and attorneys; and representatives of the enterprise management, who will have to oversee special assignments over and above their management functions.

The first organizational task will be to prepare an outline of the steps to be followed in the privatization process, and to identify the parties who will be responsible either to conduct each step or to provide information required for it. It is also important to identify those parties who have a legal obligation to participate in decisions regarding the enterprise or sector concerned. These may be specified in an omnibus law or a privatization law pertaining to the particular sector or enterprise. Then determine how the participation of these various parties is to be managed and coordinated. This will usually involve creating a committee or task force at the level of the government agency charged with overseeing privatization and a working group at the level of the enterprise.

The specialized input required by these groups will usually be provided by a contracted firm working in close collaboration with designated counterparts. Ideally, counterparts will be chosen who will have continuing responsibilities related to the enterprise or the privatization process. This will enhance the build-up of experience and personal commitment to the outcome of the privatization process.

The work plan, schedule, and delegation of responsibilities should be discussed by all participants in an early forum, and adopted formally so it can serve as an authoritative reference during the privatization process.

3.0 ASSESSING THE CONDITION AND PROSPECTS OF THE ENTERPRISE

The prospective buyer or new managing entity will certainly want to conduct its own evaluation of the enterprise, but the government also needs to analyze the company for the following reasons:

- To understand the condition of the enterprise, and the reasons for that condition.
- To identify alternative solutions to the problems of the enterprise, as a basis for more informed negotiations with prospective participants.
- To identify the interested parties whose concerns will have to be taken into account in a comprehensive solution to the needs of the firm.
- To arrive at reasonable estimates of value and thereby to establish a negotiating position with new participants.

The evaluation of an enterprise that precedes its privatization should be similar in scope and thoroughness to that which investors or creditors would expect at the time of the creation of the enterprise or any other major change in its structure or operations. This evaluation should include physical, commercial, legal, organizational, and financial aspects of the firm. Notwithstanding the general chronology of the steps in the privatization process, these interdependent aspects of evaluation can proceed in parallel or in a different order to that presented in this chapter. There should be close coordination among those carrying out these assessments to avoid duplication of effort on issues such as asset valuation which involve more than one aspect of appraisal.

3.1 Physical Evaluation

1.	Identify the facilities, equipment and material of the enterprise and determine their condition and usefulness.

In its simplest form, this appraisal consists of determining what tangible assets make up the enterprise. It is not unusual for firms to have lost track of old or unused assets, to have taken for granted certain facilities or pieces of equipment which in fact are not titled to them, or to have built up inventories which no longer have use in operations. The principal sources of information will be the asset register of the company, inventory records, physical inspection of the facilities of the company, and interviews with employees who have been with the firm for many years. Once the list has been established, the physical condition of assets should be determined, and their relationship to present operations established.

This is primarily a technical evaluation, in which the assets are examined in the context of the processes of the enterprise. It should precede the financial evaluation discussed in Section 3.5 because, in the case of a potentially-viable enterprise, the value of assets will normally be greater if they can be used in operations of the firm rather than being liquidated.

2.	Examine the technology and processes of the enterprise.

These aspects of the enterprise should be examined in relation to those of competitors, and the state of relevant technology. In addition, however, the analysts need to consider the suitability of the operation for local conditions - the resource mix, labor and management skills, supporting services and infrastructure. The review should include the following aspects of technical performance:

i)	Conversion efficiency	- Input/output ratios and the nature of byproducts and waste material
ii)	Energy efficiency	- The type and quantity of energy used per unit of output
iii)	Capacity	- Rated or "real" capacity; for comparison with local supply prospects and market opportunities in order to estimate potential capacity utilization.
iv)	Operating efficiency	- Capacity utilization; time in operation as share of available time, and reasons for down time, such as mechanical failure or lack of raw material; also the efficiency of material flows and work patterns in the plant
v)	Quality control	- Technical and managerial capacity to control quality in relation to the standards of the market to be served.
vi)	Product specifications	- The nature of the product in relation to current market expectations other than quality.
vii)	Flexibility	- Scope for product variation in response to changes in market conditions or the supply of raw material.

A material and energy balance can be an important evaluation tool in the case of complex processes such as sugar production, where a single material passes through a series of processes,

or where branching occurs into a number of different processes. Such a balance gives a useful picture of overall conversion efficiency but, more importantly, it can help the analyst pin down the location and cause of an inefficiency. Again, comparisons with industry norms and immediate competitors add to the value of the exercise.

3. Identify combinations of assets which represent production or operating units.

An important part of the physical evaluation of assets is to identify those assets which, together, form integral units; together, they have the greatest productive potential. In the event that a buyer is not found for the firm as a whole, these groups of assets have the greatest value when disposed of as a set. For example, a grain marketing company may have many assets in different locations, but those at a particular site which, together, constitute a rice mill ought to be treated as a unit for purposes of sale as a going concern, negotiation of management contracts, or in liquidation, at least in the first round. By process of elimination, the analyst will also arrive at a list of assets which could be disposed of independently either because their value is not dependent on other assets of the firm or because their value is too low to materially alter either the price of the enterprise or the negotiating position of the seller.

4. Consider alternative uses for the assets of the enterprise.

Whether in liquidation or through refitting and modification, many of the firm's assets would be useful in activities other than that of the enterprise. For example, vehicles can be sold "as is" for service elsewhere; buildings and equipment can be modified for alternative uses. If this can be done readily for major assets of the firm, prospective buyers will have the flexibility to exploit the assets they acquire and amortize their investment. This flexibility will add to the value of the firm as a going concern, but alternative uses are also a good indicator of salvage value in the event of liquidation.

3.2 Commercial Assessment

This aspect of evaluation addresses the purchasing and sales relationships of the enterprise — its suppliers of raw material and other inputs, and its customers. While the analyst will be primarily concerned with the historic pattern of these relationships in the first instance, it is important to bear in mind that changes in the policy and regulatory environment of the firm may force, or create an opportunity for, changes in these relationships. This will certainly be the case if the subject privatization is occurring in the context of the liberalization of activity in the economy.

5. Conduct an assessment of the marketing strategy and performance of the firm.

Many state-owned enterprises have enjoyed access to protected markets for which they did not have to compete because entry was restricted, or in which they had a distinct advantage based on taxation, regulation, or quantitative restrictions imposed on competitors. In such cases marketing strategy is not a meaningful concept, but it is important to assess how the firm went about satisfying the market it was given. Where competition did exist to some degree, the analysis should include a review of the principle elements of marketing strategy:

i) Target Market Have the buyers been well defined? Is this market appropriate in terms of the inherent characteristics of the enterprise and its product alternatives? To what extent has the market been dictated to satisfy a non-commercial objective of the enterprise? What shift would occur if the market place of the firm were liberalized?

ii) Product Does the product of the firm respond to the needs of the selected market? Is the product well defined in terms of quality, package, and so forth? Does that product make good use of the raw material or other competitive advantage of the enterprise?

iii) Distribution System Is the distribution system effective in terms of cost and customer satisfaction? What alternatives might be considered by independent management, and why?

iv) Price What is the basis of price determination — competitive position, cost-plus, what the market will bear, or some form of subsidized price? How are price changes determined and how has this affected the firm's competitive position? By comparison with historic market prices, estimate the foregone revenue from pursuit of any price policy other than market-determined. If the firm is a large supplier in the market, estimate the impact of price on volume of sales.

v) Promotion Practices Has there been a promotion strategy? What were its principal elements — such as discounts, mass media advertizing, direct advertizing and so forth — and how does this compare with the practice of potential competitors in a liberalized market?

6. Examine the raw material supply relationships of the enterprise.

Were these based on any form of compulsory supply? Did the firm have any contracting relationship with its raw material suppliers? Is there competition from other buyers of raw material, and if so, how has the firm fared in securing its requirements? How have prices to

suppliers been determined, and has this had a bearing on the quantities the firm has been able to secure or on its competitive position in the sale of finished products? If the firm had to compete openly for its supplies of raw material, what would be its prospects and what would be a good purchasing strategy?

7. Examine other supply relationships.

Has the firm enjoyed privileged access to other input requirements, and if so what has been the physical and financial impact of these privileges on the firm's operations? Will these privileges continue and, if not, what will be the impact of alternative arrangements on the firm? Are suppliers satisfied with the terms of sale and the actual payment performance of the firm? Have prices and terms been advantageous for the firm or have alternative sources and changes in market conditions been neglected in favor of convenient or non-arms-length relationships?

3.3 Legal Assessment

8. Determine the legal status of the enterprise.

The legal status of the enterprise is important in determining the scope for sale of equity or the assignment of management rights. It may limit the range of activities in which the firm can participate, without a change of status, and it determines the scope for independent operating decisions by those who manage the enterprise. These constraints will influence the interest of private parties in assuming an ownership or management role, and they will influence whether or not privatization can have a material affect on the performance of the firm.

The greatest scope for privatization occurs in the case of an incorporated enterprise which has equity divided into share capital. It is not unusual, however, for an enterprise to have existed and provided goods and services for many years without having a separate legal identity of any kind. It may be a branch or agency of a larger government unit which has simply been treated as a cost or profit center, with more or less management autonomy. It may be a budgetary unit which receives and dispenses funds on one hand and generates revenues which accrue to a consolidated revenue account on the other.

In each of these cases, the venture will not have equity in any saleable form; its assets can be sold or leased by the parent ministry or the authorized agent of government, but the entity cannot be sold as a going concern. If sale as a going concern is the objective, the process must begin with the creation of a separate legal identity for the enterprise. The assets and liabilities related to the activities that are the subject of the going concern are then transferred to the new company and shares are issued in name of the government. A portion of liabilities

may be withheld by government as a means of increasing the net value and the market appeal of the new enterprise. The newly- issued shares then become the object of the sale.

If the enterprise does have separate legal identity under corporate law, it is necessary to determine the range of activities authorized by its articles and by the laws under which incorporation took place. For example, can the enterprise expand or alter the nature of its equity? Can it independently incur debt, alienate assets and otherwise determine its own operating policies? Was special legislation passed to support the creation of the entity, and if so were there provisions which differed from prevailing corporate law? If the statutes or articles of incorporation are conventional in respect of operating autonomy, are impediments contained in by-laws or other forms of internal regulation? What procedure and authority are established for the amendment of these regulations?

It is also useful to examine the nature of capital authorized by the articles of incorporation and the equity issued and outstanding. Some forms of equity may enjoy pre-emptive rights such as the first claim on distributed income enjoyed by preferred shares; there may be retirement options attached to some issues; and there may be conversion rights or warrants outstanding which could alter the value of the current voting shares.

If the enterprise in question enjoys separate legal status, but that identity was established by legislative act, a different problem will normally arise, akin to that of a venture without identity. These statutory bodies are by definition public, and cannot be transferred in their present form to private owners. A new corporate identity will have to be established under corporate law, to which the assets and liabilities of the enterprise will be transferred in exchange for shares issued to the government. The sale of those shares then becomes the focus of the privatization effort.

9.	Identify the legal rights of shareholders, creditors, employees, suppliers, and other interested parties.

Finally, the analyst, with appropriate legal advice, needs to establish the legal rights of interested parties with respect to the ownership and operation of the enterprise. Who are these parties? What are their rights? Who are their authorized representatives and how do they exercise their rights? In particular, the analyst should look for rights assigned to:

i) Previous owners of assets now under the control of the enterprise;

If assets were nationalized, were the conditions of sale satisfied and is that fact documented? Was a prior right of acquisition offered to previous owners in the event of resale by the state? Are these prior rights tied exclusively to the expropriated assets, or can other assets of similar value be substituted to preserve the integrity of the assets of the enterprise? Have mortgages and other forms of lien been duly discharged and

removed from official records? Are there any non-specific claims such as a mechanic's lien which would prevent the sale of assets?

ii) Personnel who may have received rights as simple as share options or as complex as job tenure, which must be honored, either in the manner specified or through compensation;

iii) Creditors who may have liens, explicit or by virtue of applicable law, on assets of the firm;

Some may be in the form of a mortgage or lien on specific assets, others may be debentures or promissory notes and some may be unsecured. Even unsecured creditors may be granted court protection which would force a halt to privatization. In all cases, claims will have to be adjudicated and settled.

iv) Customers who may have outstanding contracts for the delivery of goods or services.

These claims may enhance the value of the enterprise or detract from it, but they must be settled as a condition of privatization, or confirmed as an obligation of the new owners.

3.4 Organization, Management and Staffing

The basis for an assessment of these aspects of the enterprise should be a clear understanding of the objectives of the enterprise. The evaluation then focuses on the effectiveness (the degree of achievement) and efficiency (the cost of achievement) with which those objectives have been pursued. However, as has been previously discussed, one of the problems that characterize a state-owned enterprise is a conflict or ambiguity among its objectives. The purpose of this assessment is to determine the extent to which sub-optimal performance of the enterprise may reflect on how its assets and privileges were used, rather than on the nature and conditions of its assets. This would be an important factor in price negotiations for the eventual sale of the enterprise.

10.	Identify the objectives of the enterprise, whether explicitly stated or implicit in the behavior of the firm.

Once these objectives have been identified, rank them in terms of the apparent priority they received, and identify any competition or conflict that exists among them that was evident in terms of operating efficiency, the use of resources, and the strategy with respect to revenue generation. For example, a rice milling and marketing firm may have stated profit objectives,

while it has in practice been selling its products below market prices to stabilize urban consumer costs.

11.	Assess the organizational structure of the enterprise in the context of its objectives and the setting in which it operates.

Physical conditions such as the distance among operating units, communication and transport facilities, distance to markets, as well as the types of material and processes of the firm will all influence the best choice of organization. The availability of capital, and a financial sector which provides ready transfers and good control permits one approach to organization; inadequate financial services dictates another. And the nature of raw material supplies and markets is also an important consideration. In assessing the effectiveness and efficiency of the organization under these circumstances, consider the following:

i) Accountability of successive levels of management, and the adequacy of the means to discharge their responsibilities.

ii) Efficient use of special expertise such as engineers or computing specialists and provision of common services such as electrical and mechanical repair facilities.

iii) Settlement of disputes clearly and effectively at an appropriate level.

iv) Degree of centralization or decentralization

12.	Examine the quality of management systems and decisions.

The two basic aspects of management to be reviewed are the management systems and management decisions. Organization, which has been considered above, is one of the management systems; other systems to be evaluated are: planning; information and decision-making; measurement and control; personnel selection and development; and compensation.

In assessing the quality of management decisions, look at:

- Timeliness;
- The effective use of available information;
- Consistency with stated objectives;
- Consistency with distribution of authority and responsibility; and

- Consistency with targets and with performance standards applied elsewhere in the industry.

In the case of state-owned enterprises, one will often find that the management systems are common among a number of enterprises with different operations and circumstances. They may in fact be simply copied from the departmental structure of the government. The review will then identify ways in which those systems did not effectively or efficiently serve the objectives of the firm, and these will become focuses of discussion with any new ownership or management participants.

The unconditional sale of the enterprise would obviate this review and discussion, as the new owners would install their preferred organization, processes, and management personnel. However, the situation more typical of sales in the agro-industrial sector involves negotiation and compromise between new investors, the state which retain a portion of ownership, and the employees who may also become owners but who must in any event be effectively involved in transition discussions if the privatization is to succeed.

13.	Examine the staffing pattern of the enterprise.

The staffing pattern of a state-owned enterprise will usually be one of the most difficult aspects to address in a restructuring program. The enterprise may have been used as a means to pursue state employment policies independent of the actual labor needs of the venture, and the terms of employment often reflect civil service conditions rather than those typical of a commercially oriented enterprise. Under these circumstances, the size of the work force and the qualifications and work habits of the employees will have become inappropriate for the needs of the firm.

At this stage of the evaluation, it is important to determine the actual number of employees, the mix of skill and experience, and the distribution of employees among organizational units. Form a judgement of the appropriateness of this work force for the operations of the enterprise, using competitor comparisons, industry norms, and quality of work. Also examine factors such as tardiness, absenteeism, turnover, and formal grievances to assess the morale and stability of the work force. This will have a direct bearing on the ease of adjustment to private ownership and management and, conversely, on the cost of adjustment. Finally, note any skill gaps that new owners will have to fill through hiring or training to ensure the efficient operation of the enterprise.

14.	Establish the rights of workers in each category of employment, and the procedures which must be adhered to in adjusting their terms of employment or in separation.

Failure to anticipate the legal and financial implications of reducing the number of employees has brought many privatization efforts to a standstill. The task of establishing the status of employees is itself a costly exercise in sorting through documents and claims that should be started early to avoid delays at critical stages of negotiations with the new owners or managers. At some point, the cost of separation will need to be incorporated into the financial projections of any scenario that involves staff reductions.

This review may uncover the fact that the status of many employees is unclear; employment documents may have been misplaced; seasonal workers may have acquired the rights of permanent employees by virtue of not having been formally terminated at the end of the season; part-time workers could have become full-time. In most cases, the rights of workers will not be contained in specific employment contracts but in the labor laws or public service laws of the country, in their pursuant regulations, and in judicial precedent.

15.	Identify sources of employment, retraining and financial assistance which could reduce the impact of restructur-ing on personnel who may be separated from the firm.

Any information and assistance that can be provided in these respects will reduce resistance to change on the part of employees, and facilitate the restructuring. To the extent that statutory agencies or special programs exist that provide financial assistance to displaced workers, the cost of restructuring to the firm will also be reduced, as the labor laws of many developing countries make retraining a charge on the terminating employer under normal circumstances.

3.5 Financial Analysis

Whether by law or by sound business practice, the privatization process will normally include an independent professional audit of the enterprise. That audit will determine the adequacy of the accounting system to accurately reflect the financial transactions and condition of the enterprise. It will identify weaknesses in that respect, and present as accurate a picture as possible of the condition of the enterprise at a recent point in time. However, in and of itself, an audit will not include the financial analysis on which factors such as the estimated value of assets, the efficiency of operations, or the projections of future condition can be based. Consequently, the financial aspects of the privatization process must include two dimensions: (1) the audit; and (2) the financial analysis to address specific concerns of present and future owners and managers.

16.	Determine if the accounts of the enterprise are sufficiently current and complete to permit a meaningful audit.

If the accounts are current and complete, initiate the audit. If not, establish a task force, including external accountants as required, and a timetable to bring the accounts up-to-date.

The condition of the enterprise and the professional conventions governing audit will determine the extent to which the audit and the financial analysis can proceed simultaneously, and make use of the same specialist expertise. In this discussion, it is assumed that the audit is commissioned to proceed independently and to provide, upon its completion, information which is given to the seller and buyer, and serves the analytical needs of both.

17.	Conduct a preliminary financial assessment on the basis of financial statements prepared from existing accounts and records.

Of primary interest at this stage is the adequacy of the accounting system to support detailed analysis, and the overall condition of the enterprise as indicated by a number of ratios. While final judgements should await the availability of audited figures, use the preliminary analysis to identify critical problems and areas to be investigated.

The relative importance of individual ratios will depend on the condition and circumstances of the enterprise, but generally the analyst will be concerned with:

- Credit worthiness, as indicated by the relationship of debt, equity, and income;
- Liquidity as indicated by the current ratio and its derivatives; and
- Profitability, reflected in measures of net income in relation to turnover, assets, and equity.

In cases where the decision to privatize an enterprise comes after many years of financial difficulty, the picture emerging from this assessment may be very poor. The debt to equity ratio will be much higher than industry norms, implying a heavy debt service burden and higher risk of default. Repeated operating losses may have eroded equity to the extent that it is negative, with the total of liabilities exceeding the book value of assets. Liquidity will also be inadequate for reasons which should subsequently be determined, but at this stage it suffices to establish the relationship between current assets and current liabilities and the nature of the assets included in these categories. Be particularly conservative in assessing the liquidity of inventories and accounts receivable.

18. Evaluate the assets of the enterprise

The valuation of assets is an important step toward establishing a range of values for the enterprise, which will be undertaken in Step 23. It is also one of the most controversial aspects of the privatization process. The price to be attached to assets is the subject of genuine differences of opinion. For example, within a short time after the date of purchase, the value of an asset is no longer simply a function of cost, despite arguments that it is in "brand new" condition. In fact some costs, such as transportation or hook-up, which are included in the new installed cost, may actually reduce the resale value of an asset if it is to be salvaged and returned to the general market. The critical factor at this stage in preparing for privatization is to ensure that the basis for asset valuation is clearly set out, and that price comparisons, where available, are objective and documented.

The tangible assets of the firm will have been identified in Step 1. To these must be added financial assets such as deposits in banks and with government financial agencies, deposits with suppliers, prepaid expenses, accounts receivable, loans receivable, securities and other investments, and warranties. Each type of asset has peculiar considerations when it comes to valuation, but in general, physical assets will be measured in terms of either value in use or value in sale, while financial assets will be valued in terms of their risk and return in relation to face value. In the event of a financial crisis, liquidity may be another important factor, that is, the speed with which the asset can be converted to cash. In most cases it is not realistic to estimate value in use for individual assets; this can be best done for groups of assets, such as a factory, in the context of overall enterprise valuation which is discussed as Step 23.

i) Real Estate. First establish that clean title exists and is duly registered (refer to Legal Assessment, Step 9). The title may be clean, but it may be registered in the name of a supervising ministry or some other agency of the state, in which case determine the authority and process required to dispose of the asset as part of the proposed privatization. Then, if any contingent agreement of sale has been issued such as the resale to original owners, determine if there was a valuation provision in the agreement. If not, normal real estate appraisal methods should be applied, which include determining land values and the value of improvements by comparison with similar assets that have been sold or leased in the recent past.

ii) Other Fixed Assets. Stationary machinery and equipment may be included together with real estate as an integral part of a productive group of assets, or treated as separate chattels. The determination will usually be made on the basis of comparing the salvage value of the asset, or its value in alternative use, with its value as part of the production unit. Versatility and the cost of relocation are two important factors influencing the relative value in use or salvage. For example, a boiler installed to service a factory will usually have more value as part of that factory than in salvage, whereas weaving looms may have greater value if sold to another firm which is operating efficiently. When considering an asset's value in use, bear in mind its remaining productive life in

comparison to new equipment, any unusual maintenance costs because of age or condition, or, alternatively, the investment cost to restore the asset to its full productive capacity.

iii) Chattels. By their nature, these materials and equipment are readily moved and will therefore be expected to realize, in the event of liquidation, a greater share of their cost, than would fixed assets. Nevertheless, assets which are in reasonable condition and are not obsolete in relation to the activities of the firm will normally have more value in use than in liquidation. This assumes of course that the basic operations of the enterprise can be viable. This "going concern" value will be considered below. At this stage, determine quantities and conditions and, in the case of equipment, determine remaining useful life and any unusual repair or rehabilitation costs expected during that period as a result of age or condition. Determine replacement costs and book value for large items and major categories of materials.

iv) Financial Assets. Financial assets can readily be valued in relation to maturity by using either the bearing rate of the instrument or another yield which is generally accepted at the time of the evaluation. However, adjusting for risk is more subjective since there will not be a secondary market for many the assets of the firm which can be used to set prices. Some generally considerations follow for the major types of financial assets.

a) **Bank deposits and tradeable securities.** Use face value or current market price, adjusted for any accrued interest or charges.

b) **Loans and non-tradable securities.** If the account has been consistently current, determine present value based on the terms of the asset and make a subjective judgement as to future collections. In other cases, solicit first-hand and third party information on the credit worthiness and solvency for the borrower. Determine the ranking of the asset in the obligations of the borrower, whether the legal ranking or the priority implicit in the behavior and needs of the borrower. Determine the cost and prospects of legal remedies, and finally arrive at a revised value based on probabilities and outcomes. Some of the most difficult accounts for a state-owned enterprise to recover are loans to employees and loans to other government entities.

c) **Accounts receivable.** In the first instance, accounts receivable should be aged, and confirmed with the buyer. Any accounts in dispute should be promptly submitted to arbitration or litigation according to the circumstances. Note that if it is the value of the account that is contested rather than its existence, a negotiated settlement will normally be best in terms of net gain, in view of the time and cost of prosecution. Based on age of accounts, condition of the buyer and the value of any security such as unused portions of goods sold, classify accounts as to their collection potential. Place values on these accounts by discounting their face value on the basis of a realistic estimate of collection

prospects. For accounts that have the best collection prospect, or those which offer a large pay-off, implement a short-term collection program, combining focused personal efforts, payment discounts and clear threat of litigation.

d) **Prepaid Expenses and Deposits with Suppliers.** In the event that the respective good or service will be used by the company, or if a refund is possible without discount or penalty, these assets can be valued at their face value. Otherwise, the analyst must choose a value based on the terms of refund of the advance payment, the salvage value of the assets to be purchased, or, if the cost of completing the purchase exceeds the salvage value, the analyst may choose to abandon the claim and write-off the deposit of prepayment.

e) **Contingent Assets.** Guarantees and warranties may have value to be considered in privatization depending on the circumstances. For example, a government guarantee for a bank loan or a security issues may be invoked to liquidate the liability. Repurchase provisions may still be in effect for certain types of stocks and inventory. Identify these and note their conditions for consideration in the development of alternative scenarios.

19. Identify the liabilities of the enterprise, and determine their status.

Liabilities will normally be more precisely determined than assets, since the creditors themselves insist on remaining visible. The exception may be purchases and loans from other government agencies. The task at this stage in preparing to privatize the enterprise consists of identifying all liabilities, confirming their status with the creditors, identifying any assets that may be specifically encumbered by a liability, and ensuring that documentation is complete with respect to each liability and lien (see also Step 9). Lien holders may agree to the transfer of a liability to new owners, but consultation and accurate records are essential.

Any formal record of liabilities should present them at book-value with accrued charges, but in the case of liabilities that are long overdue, informal inquiries may be initiated to determine the prospect of a negotiated settlement at less than face value. Care must be exercised in this respect so as not to provoke a general creditor reaction that would have an adverse effect on the operations of the enterprise or the opinion of prospective private partners.

In anticipation that the ultimate decision may be to liquidate some or all of the assets of the enterprise, liabilities should be classified as to seniority and any assets pledged as security should be clearly identified with the associated liability.

20.	Examine the capital accounts to determine the exact ownership of equity, and the disposition of retained earnings and surplus accounts.

Identify the agency of the state that is the named owner of the shares in the enterprise, and the agency, whether the same or different, that is authorized to represent the interests of the state in the operation of the enterprise. Also, in many state- owned enterprises there are minority private sector shareholders whose interests may or may not be actively represented in the management of the enterprise. Their shares may have been held in limbo during state-controlled operations, but potential new private partners will want to know of these owners, and ensure that their interests do not re-emerge to complicate operations after the sale or transfer of control. Equitable treatment of these minority claims is also important in terms of the signal effect it will have on the confidence prospective partners will place in agreements with the state.

Concerning retained earnings and surplus accounts, determine whether they have positive balances and, if so, whether they are offset even in part by loans or transfers to other agencies of government rather than by assets within the firm. Also examine recent records concerning dividend payments or other distribution of earnings. These may be subject to recall through litigation by creditors in the event of any form of privatization that did not satisfy the full value of outstanding liabilities.

21.	Repeat the overall financial assessment of the firm, using audited accounts and supplemental information from the preceding analysis.

The analysis conducted in Step 17 should be repeated at this stage using statements based on audited accounts. These statements will be the basis for any projections in Step 22 which derive from current and historical performance. In addition to the normal ratio analysis, some sensitivity analysis should be done using different assumptions about loans and accounts receivable and any contingent liabilities.

22.	Develop financial projections on the basis of historical trends and with several conservative estimates of change in key variables that have emerged from the analysis to this stage.

The first projection should be a simple extension of historic performance with only those adjustments which are known at the time of analysis. In the jargon of marginal analysis, this will become the "Without Project" case. Then identify several significantly different scenarios based on changes in key variables that were identified during the preceding evaluation. It is important to avoid generalization at this stage such as "sale of company to private interests". Such a change has no direct impact on performance; indirectly it will certainly lead to changes

such as "a more focused marketing strategy leading to an increase in 10% in annual sales", or "a better procurement procedure leading to a reduction of 10% in cost of goods". In this case the scenario will be based on increased sales or reduced operating costs, not on the sale of shares.

Prepare only a couple of scenarios based on different assumptions about the nature of future operations. Be sure to consider cases of reduced scale or scope of operations, or conversely, any scenario which includes additional investment or scope of activities where a deficiency is readily apparent in the present operations. Finally, one scenario should be closure of the enterprise, including liquidation of its assets and the settlement of its liabilities. Bankruptcy will not be a realistic option for a state-owned enterprise.

Be sure to note the assumptions that underlie each scenario, and be able to explain why the stated changes might be expected to occur now when they didn't occur prior to the decision to privatize. It is not realistic to project simply that employees will work harder, managers will be more decisive or customers will buy more. On the other hand, liberalization of agricultural markets, the abolition of export duties, or a change in the objectives of the owners will stimulate a change in behavior.

The projections should be prepared in the form of pro forma financial statements, usually a profit and loss statement and a balance sheet. At the point when capital requirements are discussed, for the operation of the firm, a pro forma cash flow statement will also be needed.

23. Prepare estimates of the value of the enterprise.

In the final analysis, an enterprise or a simple asset is only worth what someone will pay for it. Owners may set a minimum price based on their investment cost, or on some estimate of value to them, but the only proof of value is sale. Nevertheless, present owners need to have an indication of value in order to set reasonable expectations and to estimate the net proceeds or residual debt that will accrue to them depending on the outcome of the sale.

The range within which a value for assets will normally be agreed between buyer and seller lies among prices determined by four methods: replacement cost; going concern value; book value, and salvage value.

1. Replacement Cost The cost of buying/constructing a similar facility at current prices.

2. Going Concern Value The value of the net benefit stream that could be generated by using the subject assets. That benefit stream should be discounted to a present value. The market analysis conducted earlier will be critical to good projections in this exercise (Steps 5 - 7).

3. Book Value The purchase value of assets, less accumulated depreciation.

4. Salvage Value The estimated proceeds from the sale to buyers who intend to dismantle the assets for alternative use.

If the enterprise is to be sold as a going concern, its value will be the present value of the net benefit stream, adjusted for any liabilities or economic or political risk that were not fully reflected in the cash flow projections.

Among agro-industrial enterprises which have been in operation for many years, it is common to find that book value is much lower than the value that can be realized from the sale or operation of the enterprise. This assumes that the enterprise is, or can be, commercially sound, and that the assets have not been revalued to take into account changing conditions since their purchase. If revaluation has taken place, the analyst should be satisfied that the basis and rates used were reasonable. Salvage or scrap value will also normally be lower than the going concern value because of the cost associated with dismantling and relocation, and because of the percentage of capital cost (plumbing, electrical and mechanical works, and ancillary equipment) that is associated with the particular configuration and location of the plant.

On the other hand, replacement cost will tend to be higher than the value that could be expected from sale or operation, not simply because of wear and tear, which can be readily estimated, but because of changes in technology, economic conditions, and the cost of capital equipment since the facilities were originally constructed.

Unless the investment was very poorly conceived in the first place, or economic or political conditions have materially changed, the greatest value of a set of assets is almost always to be realized through some form of continued operation.

Over and above these general considerations, there are other factors which will enter into the assessment of value: If the performance of the facilities has been at or near its rated levels, then a good estimate of value can be made by discounting a projection of historical financial data. However, it often happens that the physical and financial potential of a package of assets is not realized because of factors such as inadequate raw material supply, poor management, political intervention, labor problems or market constraints. Furthermore, minor changes in the package of assets through small additional investment may also change performance. When any of these factors are present, valuation should be based on some assumption about their continued constraint on performance, or about beneficial changes that are to be incorporated in the projections.

After the evaluation of assets and liabilities as discussed in the preceding sections, it will often become apparent that, while the books of the enterprise may show a positive net worth, in fact the value of liabilities exceeds the realizable value of assets. In this case, preliminary discussions need to be held with the government concerning which liabilities it is willing to

waive or assume outside the sale in order that some interest will be shown in the assets and some value recovered against the total cost of the investment.

24.	Prepare an assessment of alternative future scenarios, including a narrative of the physical, legal, commercial and organizational assumptions that underlie each.

This represents the conclusion of the pre-sale analysis. It sets out the results of the enterprise evaluation, the preferred courses of action for the owners, and the prerequisites and cost and benefits that will occur in respect of each option.

4.0 ASSESSING THE POLICIES AND REGULATIONS THAT AFFECT THE ENTERPRISE

The appraisal described in Section 3.0 will have identified a number of policies and regulations that affect the operation of the enterprise. As a state-owned enterprise, the company may have enjoyed forms of protection; as an employer it may have been subject to personnel costs imposed under government employment policies. However, of much greater significance in most cases will be the impact of policies and regulations on the firm after it becomes privately owned or managed, for most government intervention in business is intended to control or influence private enterprise. The purpose of examining policies and regulations at this stage is two-fold:

i) Assess the actual and opportunity cost to the firm of having to comply with government regulation.

ii) Identify those policies and regulations which may prevent the successful outcome of the restructuring, either because private interests will not participate with those interventions in place or because the enterprise cannot be viable while complying with them.

25.	Identify policies and regulations that affect the operations of the enterprise and assess their impact.

Most of the regulations and policies to be focused on here will have become apparent in the appraisal of operations. However, with the anticipated change in ownership and perhaps scope of activities, others may well come into play. Consequently, a review of at least the following areas should be undertaken: licensing, price controls, labor laws, incentive and protection regime, financial controls, trade restrictions and taxation.

i) Business Licensing . It is normal to have licensing requirements to document business activity and provide a means of monitoring compliance with other laws such as taxation by the business community. However, in countries that have not encouraged private sector business initiative, licensing has tended to become unnecessarily cumbersome and costly; it served as a barrier to entry into activities reserved for the public sector or other select groups; and it became a means of recurrent intervention in the activities of the firm through frequent renewal and information requirements; this in turn in some cases led to a system of informal taxation and intimidation.

Compare the licensing requirements of the country and activity in question with those of countries in which the private sector has operated successfully, or against other standards which may be relevant for the sector strategy of the government.

ii) Price Controls. Ideally, price controls would be phased out in the context of the same liberalization strategy which has brought about the decision to privatize the enterprise. However, particularly in the agricultural sector, price controls are politically sensitive, and may take time to remove.

Identify those price controls that have a direct and indirect impact on the performance of the firm, and look for evidence of reduction, or the lack of change, that can be used to make reasonable assumptions about the situation in the near future. Make a judgment as to the importance of these controls to the well-being of the firm, and the political prospect of effecting their removal.

iii) Labor Laws. In many developing countries, labor laws have pushed private enterprises to remain small or to use an inordinate share of capital equipment in their operations to keep labor costs and exposure to labor problems to a minimum. And where laws foster that sort of choice by private firms, public enterprises have, by contrast, often been forced to be very diligent in conforming to every requirement and interpretation of law. Restoring some balance in the size, skill mix, and cost of the labor force in the firm is the first test of the prevailing laws and, perhaps more critically, a test of the judicial interpretation of these laws. The other factor that private parties consider in labor law before making an investment decision will be the extent to which the laws permit adequate management flexibility in the recruitment, advancement, and termination of employees.

Identify the laws applicable to the company and its personnel at present, during the process of restructuring, and as they are foreseen after the changes have been put in place. Estimate the direct cost of actions such as separation, and assess the impact of these laws on management flexibility in the future. Identify those elements of the law that appear prohibitive for the pursuit of the adopted strategy for the enterprise. Also review the record of the courts in labor cases; although the laws themselves may be conventional, the jurisprudence could contain a strong bias in favor of employees or employers that alters the real impact of the law.

iv) Incentives and Protection. Most countries have adopted an investment code which clearly sets out incentive and protection measures and their administration. This approach is replacing the ad hoc concessions that characterized investment administration in many countries in the 1960's and 70's. That system led to biases in favor of individual enterprises which were based on the relationships and relative negotiating strength of the investor and the authorities. The extent to which investment assistance has been put in coherent, publicized form and consistently applied with the minimum of administration complexity is an important measure of the practical progress a country has made in the liberalization of its investment policies.

Identify the incentive and protection measures to which the restructured firm will have access and evaluate them in terms of their impact on financial performance and

competitiveness. Include an assessment of the actual and opportunity cost of complying with the procedures and the restrictions on operations required to receive these benefits. Examine projected performance with the progressive loss of incentives as well as protection, in anticipation that the government may adopt further liberalization measures in future.

v) Financial Controls . This is a diverse area of intervention, from securities instruments to foreign exchange, from banking to payment mechanisms. The purchase and sale of equity, access to foreign exchange and the repatriation of capital and earnings will be among the most immediate concerns of prospective foreign private investors.

Identify the controls to which any of the firm's transactions will be subjected. Assess these in relation to the practices in economies dominated by private enterprise, and in terms of the costs they will impose on the firm or its investors. Determine whether there are any desirable activities which would be effectively prevented by these controls.

vi) Trade Restrictions . As a state-owned enterprise, the subject firm may have benefitted from trade restrictions imposed on its competitors. These may not continue in effect to the benefit of new private owners. In addition, the reform of trade regimes is a priority area of change in liberalization programs, and it is likely that recent or pending change will have the protection environment in a state of flux at the time of the privatization review. The elimination of quantitative restrictions, the lowering of tariff levels and reduction in the range of tariff rates are common features of this reform. It will be important to assess the impact of these changes on the competitive position of the firm.

Identify any trade restrictions which are likely to affect the operations of the enterprise. Estimate the direct cost of complying with these, and identify any business opportunities which they effectively preclude. Be sure to take into account pending changes in these restrictions, including a conservative judgement about the time that will be required and the effectiveness with which desired change can be achieved.

vii) Taxation. This is an important area of concession in the incentive and protection package. However, with liberalization, reform is being encouraged in tax systems as well, with the ultimate view of making special concessions redundant. Again, this is an area that is likely to be in a state of flux at the time of this appraisal, with the prospect of reduced periods of special concession and proposed reductions in regular taxation.

Examine the existing tax regulations to which the firm would be subject without investment code benefits. Determine how these have changed or will change in the near future. Use this information in assessing the benefits of qualifying for code

benefits, but also to determine whether particular types of tax may be prohibitive for the ownership structure or trade pattern envisaged for the firm. For example, examine the impact of taxes on securities or a retention tax on repatriated earnings or investment capital.

26.	Identify those policies and regulations which jeopardize the restructuring program and recommend changes.

In the case of an enterprise that operates in an activity which also has private competitors, it is unlikely that there are elements of policy and regulation that would be materially adverse or prohibitive to the restructuring. The problem arises in the case of activities which have been the exclusive purview of state-owned enterprises — perhaps a monopoly of the enterprise in question. This will certainly be a topic for posturing during negotiations, so the government ought to identify real issues ahead of time and have a strategy to alleviate the constraint which it can offer to prospective buyers.

5.0 DETERMINING THE TYPE AND EXTENT OF PRIVATIZATION

Privatization refers to any significant increase in the management or ownership role of private interests in enterprises which had previously been predominantly owned or managed in the public sector.

The best known and most conventional type of privatization is the sale of corporate shares to private interests. This option is often prescribed out of exasperation with public sector enterprise management, without considering alternatives that may be more appropriate to the economic and political circumstances of the firm. In the final analysis, the form of privatization will be a matter of negotiation because for any outcome desired by the state, there must be a willing private party. Nevertheless, it is essential that the state, as the seller or lessor, have a strategy in mind, with an ideal outcome and clearly identified limits to the range of acceptable alternatives.

27.	Examine alternative types of privatization and identify those that best suit the objectives of the state and the conditions of the enterprise.

In general terms, privatization can be of four types: The total or partial transfer of ownership to private concerns; the transfer of management; the lease of assets; or the liquidation of assets. Within each of these types, there are several techniques:

5.1 Transfer of Ownership

i) **Complete Sale of Shares.** The sale of all existing shares conveys to the new owners the full power afforded an enterprise under the corporate and commercial laws of the country. They can independently buy, sell, operate, and encumber assets within the scope of the company's articles of incorporation. It is this autonomy which gives rise to the greatest optimism for the use of this technique, and the greatest suspicion. To succeed politically, economically, and commercially, there must be a clearly understood set of corporate objectives which are accepted by all interested parties. The finality of the transaction is such that there must be complete agreement on the value of all assets and the value and status of all liabilities of the company. There must be an unexploited potential for the firm which exceeds the social and political risk assumed by the new owners and, to that end, there must normally be positive labor relations on which any necessary changes in employment can be based. Technically, the equity of the firm must exist in the form of finite units (shares), and any associated rights, such as warrants, will also normally convey with the sale of the shares.

ii) **Partial Sale of Consolidated Shares.** This offers many of the advantages of complete sale: it normally introduces management, technology, or markets along with capital, and the willingness of private interests to invest in the firm indicates that a plausible commitment has been made by the state to pursuing efficiency and profit objectives. It usually has more political appeal than total sale in that it does not appear that the state is giving away future benefits or abandoning the workers and customers of the enterprise. For the new partners, it affords an opportunity to establish a permanent relationship with the enterprise without the capital cost or political risk of full ownership. This is often considered as a transitional step because of its appeal to both parties.

There should be agreement on the future sale of shares, including the preemptive rights of existing shareholders and the method of valuation. If management is to be assigned in any fashion other than by majority vote of the shareholders from time to time, a separate agreement should be negotiated to that effect at the time of sale, and the provisions for review and renewal entered into the bylaws of the company and into the management contract.

Much ado is made of the issue of majority or minority holdings by the private and public partners. In most cases this is primarily a symbolic issue; the state has such power to influence the well-being of the firm outside of the board room, through regulation and policy, that the performance of the firm will seldom hinge on a few votes one way or the other among shareholders. The critical issue for new partners will be the direction of liberalization policy and the administrative and political capacity to sustain that change.

iii) **Partial Sale of Equity Based on Productive Units of the Enterprise.** Public enterprises are even more likely than private firms to have evolved in different directions in response to their multiple objectives; some of these activities have more financial potential than others and may be more readily separated from the consolidated assets of the enterprise. In this case, partial privatization can take place along the lines of individual locations, activities, and groups of assets. For example, a cotton marketing board may sell individual ginneries to private interests, while retaining certain central functions such as the setting and inspection of grades and standards.

iv) **Sale of New Shares.** Partial sale may also occur in the form of the sale of new shares to private interests with the retention of existing shares by the public sector. Some variation of this form many be appropriate if new assets or services are to be provided to the firm, and they are provided by a private party that has a long term interest in the firm. The same technical and strategic issues arise here as in other forms of partial transfer of shares.

5.2 Transfer of Management

i) **Contract Plan.** This approach results in a contractual increase in the autonomy and market orientation of the management of an enterprise. The owners and the current management negotiate a multi-year agreement based on performance targets rather than the usual budgetary controls. How those targets are achieved is left to the management, within certain clearly defined parameters, including, for example, the latitude to be afforded in personnel changes and in the borrowing of capital. Management performance and compensation are tied to the achievement of the agreed targets. In this way, managers are compelled to anticipate and respond to market changes, and while their status as public servants may or may not be formally rescinded, their compensation is now geared to their capacity to meet market demands.

If this approach is to work, the present management must have the ability, or be in a position to rapidly acquire the ability, to make independent decisions and to collect and use information about suppliers and markets. Also, the factors for success must be within the control of the management; if the economic or regulatory circumstances are not appropriate, for example, autonomy of this sort will do little to improve performance. Contract plans should also define carefully how investment plans will be developed and funded.

ii) **Fixed Fee Management Contract.** In this case, the owners engage the services of managers who have technical competence or trade and finance relationships that meet an important need of the firm, and it is judged that the provision of this service is enough to alter the performance of the firm. There is no risk or reward in the compensation of the managers based on performance of the enterprise, and this form has not, therefore, been very successful for general management.

iii) **Performance-Based Management Contract.** This is generally a better approach to management contracts than using a fixed fee in terms of inducing market-oriented behavior. In this case, a portion of the total compensation to managers is based on the performance of the enterprise in relation to agreed targets. The targets can be based on the financial and commercial objectives of the firm, but they can also be related to efficiency factors such as capacity utilization or conversion rates. In any event, they must be achievable, they must require consistent effort to achieve, and they must be related to the objectives or strategy of the firm.

The typical compensation package in a performance-based contract will consist of three components: personnel costs; other reimbursable costs; and, performance payments. In this case the management contractor — usually a firm — will be reimbursed for direct costs associated with managing the enterprise but, in lieu of a margin on these costs, or in addition to it, the contractor receives a fee based on an agreed quantitative measure of performance.

Elements of the Management Contract

Whatever its particular features, the management contract should cover the following topics:

- Statement of Purpose and Scope of Contract.
- Activities to be Managed.
- Personnel and Other Inputs to be Provided by Managers.
- Financial Resources Available for Operations
- Authority and Reporting Relationships
- Performance Targets
- Monitoring and Reporting Arrangements.
- Compensation.

5.3 Lease of Assets

i) **As an Ongoing Operation.** In cases where productive assets exist in relative independence from the balance of the enterprise, for example, a sawmill as part of a forestry company, and where personnel are either not present or their number and skills are consistent with the complement for normal operation of such a facility, it may be practical to consider leasing the operating unit to private interests. In this example, local loggers may wish to operate the sawmill, whereas they would have neither the capacity nor the interest to assume the overall operations of the forestry company.

ii) **Alternative Activity** . If the enterprise has effectively ceased operation, or been reduced to the level that some of its assets are not in use, assets thus idled may have value to other activities. For example, in the case of a grain distribution company, warehouse space or trucks may be leased to other enterprises pending resolution of the future of the subject firm. Choices include whether to simply transfer use of the asset, or to offer a "wet lease" in which case personnel, maintenance, and all operating costs are included.

5.4 The Liquidation of Assets

The liquidation of assets is usually a last resort because it means that the enterprise will cease to exist; any value that may exist in trade relationships and product reputation will be lost; liabilities not settled from the proceeds of the sale will have to be absorbed by another agency of the state; and, the sale of the assets will normally generate only a small fraction of their replacement cost.

i) **Sale of Production Units for Continued Operation.** Groups of assets that make up production units will generate their greatest overall value if they can be sold together for continued use as a unit. Installation costs and associated civil works will not be lost, and the strengths and weaknesses of the unit can be demonstrated and evaluated. New owners may also re-establish some of the trade relationships and employ some of the personnel, with the result that economic displacement is minimized. A somewhat less attractive variant of this model is the sale of groups of assets as production units, but for disassembly and transfer to another location. In addition to the greater disruption to local economy, this case will usually lead to less net proceeds to the owners because the value will be discounted by at least the cost of relocation.

ii) **Sale of Individual Assets for Salvage.** This is, overall, the least attractive solution in most cases. It is a last resort because the net proceeds from this liquidation will inevitably be lower than in any other type of sale. The only exceptions will be real estate which, if properly deeded, may have increased significantly in value irrespective of its use by the enterprise, and general purpose assets such as trucks and electric generators which can be easily incorporated into another enterprise.

28.	Prepare a preliminary assessment of private sector interest in the enterprise.

Privatization will be achieved through negotiation. This may be as impersonal as a bidding process in a capital market, or as personal as face-to-face discussions with prospective investors. In either case, it is useful to begin to identify potential private interest as soon as possible in the process. This will give those planning the transfer an indication of the nature of issues that are likely to arise, and a preliminary sense of the alternative forms of privatization that will elicit the greatest interest. In this way further work can be focused on the most promising alternatives and on anticipating the negotiations.

29.	Determine if a succession of privatization measures would provide better long-term adjustment to private operation of the enterprise.

Ideally, the optimum type of privatization will be put in place in the first round of negotiation. In practice, however, this often is not the case. Parties need time to get to know each other; gradual improvement in operations can lead to a better financial situation and a clearer sense of the value of the enterprise to both buyer and seller; third party resistance, for example among employees, local officials, or central ministry authorities can dissipate during a period of intermediate arrangements. A phased agreement, with progressively greater private responsibility and exposure, is well-suited to these situations. For example, one might begin with a fixed fee contract to manage a specific aspect of the enterprise with agreement to expand responsibilities and shift to a performance-based contract at an agreed future date. Alternatively, there could be a management contract with an option to purchase at a future date, or partial sale now with options to acquire the balance of shares.

6.0 ATTRACTING PRIVATE INTEREST

30.	Prepare an evaluation report and list of options for the proposed privatization.

Prior to this stage, the analysts have conducted an evaluation of the enterprise, examined the policy and regulatory framework within which it functions, and tested private sector interest in relation to various forms of privatization that the state may find acceptable. The results of this work should be assembled in a form which can be used by those making strategic decisions in later stages of the process and, perhaps, by those considering participation in the firm. The report should conclude with a list of not more than two or three alternative strategies that emerge from the analysis. It would also be useful to decision makers if the report were to contain the skeleton of an action plan outlining how the process could be carried to completion.

31.	If the strategy consists of selling assets, identify the lots that are to be sold as production units, and set criteria with respect to the eventual breaking up of those lots if required.

The overall value of assets will normally be greatest if they can be sold in productive units as one or more operating businesses. Effort would be well spent in preparing such groups; identify the lots, such as a cannery with its ancillary structures and facilities, and assemble the company records that will accompany the sale. Titles to real estate can prove particularly difficult to clear for sale.

32.	Identify potential private sector participants who have something to offer the firm.

The analysis discussed in Section 3.0 will have identified the markets, production capacity, supplies, capital, management, and technology that the enterprise needs. What type of enterprise or individuals are available to meet these needs? Can specific parties be identified in the form of a list of prospects?

i) **Markets.** The participation of individuals or corporate entities that represent either a large share of the target market or a principal intermediary serving that market could secure that outlet for the enterprise. The competitive position of the enterprise could perhaps be strengthened by attracting a competitor into the firm.

ii) **Suppliers.** Involving critical suppliers in the enterprise could reduce uncertainty as to supplies and prices.

iii) **Productive Assets.** Land, buildings, machinery, and other assets will be essential to the enterprise, and specific assets such as an ideal factory site or a low-cost reconditioned plant offered by a prospective shareholder may represent a considerable advantage to business prospects.

iv) **Capital.** Consider the capital requirements of the firm in the context of limits such as borrowing capacity, the weighted average cost of capital, debt-equity limits imposed by prospective lenders, and prudent interpretation of financial projections with respect to debt service. Identify potential participants who can provide capital in a form that satisfies these conditions.

v) **Technology.** Can the cost of technology be fixed or reduced by the formal participation of its supplier in the enterprise? Can participation be used to improve support services, continuity of information, training, and access to future developments?

vi) **Management.** If management skills and systems are in themselves a serious need of the firm, they may be sought in a specialized partner. Normally these skills are associated with expertise and relationships that can simultaneously satisfy other needs such as market connections, but that should not be permitted to cloud a careful scrutiny of management competence per se if that is a critical need. Evidence of the ability to deliver management services in an environment similar to that of the firm should be a requirement.

During the course of this inquiry, thought should be given to coincident characteristics of partners that would help focus the solicitation effort. For example, is there reason to prefer foreign or domestic participants, in terms of how they can satisfy the stated needs of the firm? Is the level of skill and commitment among existing employees such that an employee buy-out is a realistic alternative? If so, it certainly offers good social and political advantages.

33.	Determine the best approach to soliciting the interest of preferred participants.

The best strategy for soliciting interest will depend on the type of party being sought, and the mechanisms that are available for interested parties to participate in the firm. For example, if one is looking only for capital and there is a reasonable well developed capital market, a public offering of shares may be appropriate. But if the intent is to acquire a proprietary technology, direct negotiations with the patent holder or licensee to acquire a franchise or license would be the only option.

Most agri-businesses will need new participants to bring something in addition to capital to the firm, be it markets, sources of supply, management or technology. Participants who are able to provide a particular combination of inputs for a given commodity and activity will be limited, and they will be reasonably well known in the business community, even on a world-wide basis. Consequently, a somewhat more focused search is often desirable in terms of both efficiency and image. One approach is a written solicitation of expressions of interest sent to a number of pre-screened prospects. This could be accompanied by a prospectus or business plan, and an invitation to more detailed discussion. Another approach is to contact other enterprises in the same activity, or elsewhere in the same product chain, as the enterprise to be privatized. If there is to be an attempt to privatize the enterprise as a going concern, sellers need to avoid creating the impression that the enterprise is desperate, willing to take any comers; unless the sale is part of an overall change in government policy, it is easier to accomplish this with selected mailings or personal contacts than with wholesale public solicitation.

The solicitation process should include several stages, with a means of identifying serious prospects from among the parties who respond out of curiosity. This may be done by requiring that important information, such as the report of the evaluation and projections described in earlier sections, be purchased by interested parties at a fee sufficiently high to discourage the idly curious. Alternatively, the sellers may offer to arrange inspection visits and detailed discussions with interested parties, at the facilities of the enterprise. Responsible agents or representatives of the buyer would be expected to participate at the expense of the buyer.

As a group, private sector businesses perform best under open competition, but individual firms will go to great lengths to avoid competition. They tend to place value on information not known to others, and to discount generally-held information. There is a suspicion of the value of something that is widely known, as if acting on it while others do not is foolish. This becomes increasingly the case as a prospective bidder advances to later stages in the decision process. All parties expect that general information about the pending sale of the enterprise will be common knowledge, for example, and even some facts about the preliminary offer, but by the time negotiations begin, a bidder expects to be given exclusive attention. The only exception to this pattern may be an auction process, a strategy that may be used to advantage if there are a number of prospective bidders and the assets or rights being sold have a generally recognized value.

This desire on the part of prospective partners to enter exclusive negotiations as quickly as possible may fall into conflict with the public sector's concern for neutrality and transparency in transactions. The latter is based on the sound desire to avoid any appearance of favoritism and bias, but if it is carried too far it will drive away good prospective partners who simply are not prepared to do business "on camera".

In order to realize the greatest value from the sale of the assets or enterprise, this preference for confidentiality on the part of the buyer will have to be respected. The risk of either the appearance of collusion with the seller's agent, or the conclusion of an agreement that is not in the seller's interest, can be minimized with the following measures:

i) The preparatory analysis described in preceding sections should be thoroughly done so that, before negotiations begin, the government can establish a range of acceptable values and conditions (Step 23);

ii) The process of identification and initial canvassing of prospective parties should be known to all interested parties; and,

iii) The initial information provided to all identified parties should be the same.

34. Establish acceptable terms for each of the most probable forms of privatization.

On the basis of the evaluation described in previous steps, the owners should establish the range of terms which they find acceptable for each of the forms of privatization for which proposals are most likely to be received. For example, establish an acceptable range for the price of shares if the enterprise is to be sold as a going concern, the value of assets if they are to be sold separately, and the minimum performance criteria if a management contract is to be sought. Setting value ranges and conditions ahead of time gives all interested parties an opportunity to discuss their expectations and to recognize factors other than cost or replacement value which need to be taken into account. It also forms the basis for all parties to accept the results of negotiations that will probably take place in confidence between the new participant and agents of the seller.

However, having set expectations, the seller or lessor must recognize that these are only estimates of what the market could reasonably be expected to yield. There is no guarantee that a reasonable participant will make an offer within the expected range. Market conditions may have deteriorated, or the results of the seller's analysis may have been too optimistic; in either case a potentially very good owner or manager may make an offer that is below expectations, and the established review procedures must not preclude further consideration without assessing the merits of the offer.

In normal sales transactions, the terms to be settled include the price, the value to be paid on date of contract, the interest and period to apply on payment of the balance of the purchase price, security offered by the buyer in respect of the deferred portion of the purchase price, responsibility for incidental expenses relating to the sale, and the timing and conditions for transfer of title to the concerned assets.

Price — Set negotiating targets and lower price limits for all major assets and lots. Remember to recognize market conditions at the time of sale, and the political and labor uncertainties of the region in setting this expectation. Is there to be a performance bond or earnest money paid at the time of the sales agreement?

Down Payment — If most of the liabilities to be paid out of the proceeds of the sale are sunk costs, cash on date of sale is not as critical as it would be if the liabilities were made up of debts that still had a regular service schedule. Therefore, the down payment may be primarily a sign of capacity and good faith on the part of the bidder, or it may be critical to the continued survival of the enterprise pending completion of the transfer to new owners. The state should also bear in mind that liquidity is often a limiting factor in investment decisions, even by competent operators, and that down payment expectations should therefore be modest. This position would also avoid the risk that a good buyer might subsequently experience a working capital shortage.

Finance Terms — These terms, particularly the rate of interest, should not differ from those prevailing elsewhere in the financial sector. Setting special credit terms complicates the management of the financial sector, creates privileged classes of borrowers and transactions, and generally leads to inefficient resource allocation. If the state wishes to create an incentive for the sale of these assets, it should do so in setting either the price or the down payment.

Collateral — Chattel or real estate mortgages on the assets in question should be the minimum security required for term financing. If a third party such as a merchant or commercial bank finances the purchase, it may also require a lien on other assets of the buyer, depending on the nature of his business and the value of the loan in relation to the estimated value of the assets being purchased.

Incidentals — Such costs as title search, deed registration, vehicle registration, land surveys, final inspection of facilities prior to transfer of possession, and legal services may be required in each sales transaction. The authorities responsible for the sale should have identified these, and determined how they wish to have them met. This may become a

matter of negotiation, but their cost should be explicitly recognized by both parties.

Titles

When, and under what conditions will title to assets be transferred to the buyer? This will depend of course on the nature of the assets and the terms of sale, but it must be clearly set out at the time of sale.

35. Establish criteria and procedures for the evaluation of offers.

The criteria for the evaluation of offers for the enterprise or for operating packages of assets should be selected from the following: [1]

- Price;
- Suitability of the grouping of assets being bid;
- Conditions proposed with respect to purchase;
- Proposed transition, with attention on minimizing the disruption of operations;
- Proposed terms of payment (In most cases it would be appropriate to have a weighting factor in favor of cash payment);
- Credit worthiness of the bidder;
- Experience of the bidder in the activities of the enterprise;
- Bidder's knowledge of the geographic area of the enterprise;
- Impact of the bid on employment and other economic factors in the region of operations;
- Impact of the bid on the distribution of ownership of assets in the region by locals, nationals, and others; and,
- Impact of the bid on the well-being of competent personnel of the enterprise.

[1] Criteria for smaller lots of independent assets such as vehicles or scrap steel should be much simpler, focusing on price and the credit-worthiness of the bidder.

The procedure for evaluation will depend to some extent on the method of soliciting buyer interest (See Step 33). If competing bids are invited, then a means of comparison will be required. If individual offers and direct negotiation are to be accepted, then the evaluation of bids must be against set standards with respect to each of the above factors.

In either case, those responsible for the sale must decide ahead of time the relative importance of each of the factors, and the minimum value or conditions they require for each factor. If contentious issues are expected to arise, or if offers are likely to differ widely in some of these factors, it may be appropriate to formalize the process. Develop an evaluation sheet in which the factors are listed, and their relative importance is expressed as a percentage of the total possible points that could be awarded to a bid. Those charged with evaluation can then assign values to a bid on the basis of how well it responds to the expectations for each factor. The bid with the highest combined value would become the Highest Evaluated Bid, and that bidder would normally be invited to negotiate a contract.

Whether or not this evaluation sheet is actually used to compare competing bids, it will serve to guide the evaluation of any given purchase proposal. It will also help identify the factors on which counter offers should be based if original offers are not entirely acceptable.

36.	Identify those responsible for facilitating the privatization process.

Organization for the privatization process was discussed in Section 2.0 and will, in practice, be agreed in general terms very early in the planning stage. However, as the process enters the solicitation and negotiation stages, care should be taken to ensure that supporting functions are identified, and assigned to competent parties. Such functions include:

i) Special tasks at the level of the enterprise to improve its saleability, for example the repair and clean-up of assets, the assembly of a complete asset register, and the reduction of accounts receivable;

ii) The preparation and distribution of factual and promotional material, and initial contact with prospective partners;

iii) Facilitating negotiation with services such as logistics, legal documentation, and secretariat; and,

iv) The analysis and evaluation of bids, and preparation of recommendations to the committee of the State concerning acceptance, rejection, or counter-offer. It is important to ensure that these officials include those with competence in the business of the enterprise and familiarity with the assets in question.

If arrangements for each of these supporting functions can be made ahead of time, they will not become distractions for those engaged in negotiating the best terms for the future management or ownership of the company. A professionally competent marketing process is also a demonstration of the ability of the state to host private business, and will thereby have its own positive impact on the negotiations.

37.	Identify those responsible to make decisions concerning the privatization, and the procedures whereby those decisions will be made.

These issues will also have been addressed in general terms during the early planning stages. However, once the full scope of the process has been determined through the steps discussed to this point, a careful review should be made to ensure that designated parties and procedures not only comply with legal requirements, but that they are most suitable in terms of the commercial, financial, and political well-being of the firm after the sale. While decision authority may be clearly determined by law, much can be gained through the prudent inclusion of other interested parties in a consultative role during the solicitation and evaluation stages.

The agencies whose roles are most readily determined are those that have legal obligations with respect to the enterprise. There will also be agencies that are charged with specific services for the entire public sector, for example the Attorney General's office and the Treasury or Ministry of Finance. In addition, there are closely associated interests which may ask to participate, or they may be inserted in the process by central authorities to represent concerned constituents; examples include the Ministry of Labor for affected workers and the Ministry of Industry or Commerce for competitor and supplier interests. Finally, there may be other agencies that have the right to be informed because they are members of statutory bodies such as a Board of Investments or a Cabinet Secretariat which has jurisdiction in the matter.

If the privatization in question is an isolated transaction, the planners may have to find ways to accommodate the interests and rights of all of these agencies. Normally, however, a standing committee or some specially-constituted structure will have been established to represent the common interests of the state. In this case, the task for those planning a particular transaction is to identify the agencies which have interests in the enterprise in question, for example the Ministry of Agriculture, or the zoning office of the jurisdiction in which a major part of the firms assets are located.

In identifying concerned parties and arranging their representation as required, there are three objectives to be borne in mind:

i) Satisfy legal requirements;

ii) Facilitate prompt, decisive action during the process (in this respect, it is essential that named individuals and their alternates be appointed, and that their mandates be clearly established); and,

iii) Facilitate agreement and cooperation at later stages by providing a sense of participation in the privatization process.

38.	Identify sources of finance and other assistance that would facilitate private participation in the firm.

It is usually the responsibility of the bidder to locate financing and to present the best picture of credit worthiness. However, to facilitate the sale to a desirable owner or partner, it may be in the seller's interest to assist the bidder to locate financing. In fact, privatization programs in some countries are supported by special financial assistance from development agencies and the state. These will not be part of the routine relationships of a buyer, and the buyer will need assistance to approach the responsible agency and satisfy its requirements.

Assistance in locating financing will be less critical in the case of the sale of lots of assets such as vehicles and surplus equipment, but here the seller should know normal sources of financing in order to be able to confirm buyer declarations about his credit worthiness and source of funding. The seller should also facilitate the sale by promptly providing any documentation required by the buyer's creditor.

39.	Determine what information is to be provided to all prospective participants, and prepare it in attractive, readily usable form.

The first contact with prospective investors will be at the level of senior officials. Their interests will be strategic, and their immediate need for information will be limited to key indicators of condition, performance, and potential. Beyond facts and figures, they will be looking for indications of the seriousness of intent on the part of the state, of its appreciation of their own concerns and priorities, and the extent to which the presentation of the material and the proposed means of follow-up reflect an understanding of private business.

Initial written presentations can respond to these concerns in the following manner:

i) They should be brief and carefully structured to provide ready access to information.

ii) The offer by the seller should be clearly stated, together with the authority whereby the offer is made.

iii) Initial presentations should allude to additional information to be made available for more detailed investigation, and the means proposed for follow-up.

iv) Documentation should be well-written and presented in good quality, conservative print and materials.

There is no prescribed form for this type of communication, except in the case of a public offering of equity or debentures, where securities and exchange regulations must be adhered to in form and content when preparing the subject prospectus. However, an informal version of the prospectus is a good model to consider when preparing an initial solicitation.

Outline of an Informal Prospectus

- Summary of Offer
- Definitions and Acronyms
- The Company
  - Origins
  - Current Operations
  - Financial Performance
- Business Plan
  - Industry Setting
  - Economic Policy Setting
  - Marketing Strategy
  - Operating Strategy
  - Investment Program
  - Resource Mobilization
  - Resource Allocation
  - Performance Projections
- Offer
- Attachments

The exact structure and content should be decided on the basis of the type of enterprise and the selected recipients. Depending on the financial condition of the enterprise, and the urgency with which private participation is sought, some parts of the business plan will be difficult or impossible to prepare in a definitive manner. It may be entirely appropriate to indicate that certain aspects will be addressed jointly with prospective investors.

40. Solicit interest.

Implement the solicitation plan adopted in Step 33. It may be difficult for authorities charged with this process to recognize that they are in fact performing a marketing task. The temptation will be to think that they are defending the property of the state against exploitation, but this could be fatal to the sales effort. Newspaper and other public announcements for the sale of independent assets should provide enough information to assist prospective buyers in deciding whether or not to respond. Direct solicitation materials concerning production units should be sufficiently candid about operations and conditions to convey the serious intent of the state to enter into negotiations. Follow-up to responses should be informative, and authorities or their agents should be readily accessible to prospective buyers.

Announcements should contain dates by which responses are requested, and should identify additional information that is available and how it can be acquired. It will normally be appropriate to provide a period of 45 to 90 days in which prospective bidders can acquire additional information and prepare their proposals. The government and the management of the enterprise to be sold should make every effort to accommodate visits and requests for additional information by prospective investors.

7.0 NEGOTIATING AND IMPLEMENTING THE CHANGE

If the preparatory steps described in previous sections have been satisfactorily carried out, there will be sound reference points and procedures to guide negotiations and implementation. Owners can then focus on the particular opportunities or problems which arise because of the responses to the solicitation.

41. Evaluate responses to the solicitation of interest.

Implement the evaluation process adopted in Step 35. In practice, the solicitation will often not be a single presentation, but a series of progressively more detailed discussions and exchanges of information. Nevertheless, at some point, a prospective participant will be expected to make a formal offer and the evaluation process will be initiated.

42. Negotiate sale with selected bidder, including dates of effectiveness and terms of sale.

For production units, dates of effectiveness and transition arrangements must be agreed in detail to avoid delays in operations which, in agri-businesses, can be critical. It is not simply a matter of agreeing on a date when ownership and control change, and making sure that control is clearly understood throughout the period of change; there are other critical actions throughout the year that will need to be reviewed in the light of the changes in ownership or management. For example: applications for credit to buy raw material need to be submitted many months before the harvest and processing season, and the creditor may require proof of the negotiations in process, evidence of credit worthiness of the prospective owners, and some evidence of satisfactory contingency plans to operate the unit in the event that the transition is not complete.

Details of agreement in respect to these issues should be spelled out in a memorandum of sale.

43. Obtain formal approval for the proposed sale.

Implement the decision process adopted in Step 37. It is preferable to assemble responsible parties for face-to-face consultations at key junctures in the proceedings, rather than depend on written correspondence, particularly during final evaluation of proposals, in setting key issues for negotiations, and in final acceptance of an offer. This affords less room for ambiguity in agreed positions, and induces a greater sense of ownership in decisions.

44.	Establish transitional arrangements, particularly with respect to the use of assets and provisions for security.

Reference has been made in Step 42 to the importance of transitional arrangements for both the buyer and the seller. Avoiding losses in the conduct of a harvest campaign is one element to be considered in planning transition. Two other elements are also important: the need to stipulate responsibility for each of the many administrative and documentary steps, and for any costs resulting from delays in executing formalities once financial commitments have been made.

45.	Complete legal documentation, and the satisfaction of conditions precedent.

Conditions precedent to the final execution of sales or management contracts will have been agreed by both parties during negotiations. Those required of the seller or lessor will normally pertain to the clearing and delivery of title to assets such as real estate, the removal of liabilities from the books of the enterprise, or the completion of an operational measure such as the separation of some personnel or the start-up of new or repaired equipment. The buyer or laissee may have agreed to establish and maintain a security deposit or performance bond, to install key personnel, present shipping documents covering the delivery of equipment containing proprietary technology, or sign contracts with third parties such as product buyers which are essential to the well being of the enterprise.

46.	Complete the transfer or liquidation of assets not sold as part of the enterprise or production units.

In most cases, the assets included in production units will have accounted for the great majority of the realizable value of the enterprise. The assets that were not included are typically of two types: those that may have significant resale value as stand-alone items, such as vehicles; and miscellaneous equipment and materials that, because of small quantities, obsolescence or poor condition, have limited resale value. Voice or sealed bid auctions may be cost effective means of selling lots of miscellaneous items; stand-alone items may also be sold this way, or through written announcements to known users of similar equipment, particularly if there is an active market from which fair value can be estimated.

Those responsible to oversee the disposal of assets need to guard against spending too much time and effort completing the sale of remaining items because it is not unusual for these efforts to cost more than the value of the sale. In the case of vehicles, the sales value will be much greater if titles are available for inspection and the vehicles are in operating condition on the date of sale.

Unsold assets should be transferred to the balance sheet of another state-owned enterprise or agency, with the transfer price being book value or less, since there will be current evidence that there is no market for the asset in question.

APPENDIX A

SUMMARY OF STEPS IN PRIVATIZATION PROCESS

Preliminary:

Establish organization and responsibilities for the privatization process.

ASSESSING THE CONDITION AND PROSPECTS OF THE ENTERPRISE

1. Identify the facilities, equipment, and material of the enterprise and determine their condition and usefulness.

2. Examine the technology and processes of the enterprise.

3. Identify combinations of assets which represent production or operating units

4. Consider alternative uses for the assets of the enterprise.

5. Conduct an assessment of the marketing strategy and performance of the firm.

6. Examine the raw material supply relationships of the enterprise.

7. Examine other supply relationships.

8. Determine the legal status of the enterprise.

9. Identify the legal rights of shareholders, creditors, employees, suppliers, and other interested parties.

10. Identify the objectives of the enterprise, whether explicitly stated or implicit in the behavior of the firm.

11. Assess the organizational structure of the enterprise in the context of its objectives and the setting in which it operates.

12. Examine the quality of management systems and decisions.

13. Examine the staffing pattern of the enterprise.

14. Establish the rights of workers in each category of employment, and the procedures which must be adhered to in adjusting their terms of employment or in separation.

15. Identify sources of employment, retraining, and financial assistance which could reduce the impact of unemployment on personnel who may be separated from the firm.

16. Determine if the accounts of the enterprise are sufficiently current and complete to permit a meaningful audit. If not, establish a task force and timetable to bring them to that state. If so, initiate the audit.

17. Conduct a preliminary financial assessment on the basis of financial statements prepared from existing accounts and records.

18. Evaluate the assets of the enterprise.

19. Identify the liabilities of the enterprise and determine their status.

20. Examine the capital accounts to determine the exact ownership of equity, and the disposition of retained earnings and surplus accounts.

21. Repeat the overall financial assessment of the firm, using audited accounts and supplemental information from the preceding analysis.

22. Develop financial projections on the basis of historical trends and with several conservative estimates of change in key variables that have emerged from the analysis to this stage.

23. Prepare estimates of the value of the enterprise.

24. Prepare an assessment of alternative future scenarios, including a narrative of the physical, legal, commercial and organizational assumptions that underlie each.

ASSESSING THE POLICIES AND REGULATIONS THAT AFFECT THE ENTERPRISE

25. Identify policies and regulations that affect the operations of the enterprise and assess their impact.

26. Identify those policies and regulations which jeopardize the restructuring program and recommend changes.

DETERMINING THE TYPE AND EXTENT OF PRIVATIZATION

27. Examine alternative types of privatization and identify those that best suit the objectives of the state and the conditions of the enterprise.

28. Prepare a preliminary assessment of private sector interest in the enterprise.

29. Determine if a succession of privatization measures would provide better long-term adjustment to private operation of the enterprise.

ATTRACTING PRIVATE INTEREST

30. Prepare an evaluation report and list of options for the proposed privatization.

31. If the strategy consists of selling assets, identify the lots that are to be sold as production units, and set criteria with respect to the eventual breaking up of those lots if required.

32. Identify potential private sector participants who have something to offer the firm.

33. Determine the best approach to soliciting the interest of preferred participants.

34. Establish acceptable terms for each of the most probable types of privatization.

35. Establish criteria and procedures for the evaluation of offers.

36. Identify those responsible for facilitating the privatization process.

37. Identify those responsible to make decisions concerning the privatization, and the procedures whereby those decisions will be made.

38. Identify sources of finance and other assistance that would facilitate private participation in the firm.

39. Determine what information is to be provided to all prospective participants, and prepare it in attractive, readily usable form.

40. Solicit interest.

NEGOTIATING AND IMPLEMENTING THE CHANGE

41. Evaluate responses to the solicitation of interest.

42. Negotiate sale with selected bidder, including dates of effectiveness and terms of sale.

43. Obtain formal approval for the proposed sale.

44. Establish transitional arrangements, particularly with respect to the use of assets and provisions for security.

45. Complete legal documentation, and the satisfaction of conditions precedent.

46. Complete the transfer or liquidation of assets not sold as part of production units.