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RESTRUCTURING AND PRIVATIZATION OF PSEs

A STRUCTURAL FRAMEWORK FOR PRIVATIZATION

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The following is a brief discussion of certain transactional and practical considerations which need to be weighed carefully in developing a program for privatizing state-owned enterprises (SOEs) and industries. These considerations may be of particular importance to legal practitioners who are involved in the legal, policy or implementation aspects of privatization efforts in their individual countries. These factors are not meant to be exhaustive in nature but merely provide a discussion of some of the complexities involved in planning a strategy for privatizing particular sectors or enterprises. Moreover, the views expressed herein are my own and do not reflect the policy of the U.S. Agency for International Development or the U.S. Government.

I. INTRODUCTION

This paper has a threefold objective. First, my aim is to provide the participants of the Tokyo Conference of the Asian-African Legal Consultative Committee with a perspective on the macro-economic and macro-legal framework for privatization. The social underpinnings within this context are often critical to the success of any privatization program. Therefore, the constraints and supports for privatization within a particular sector or industry need to be carefully examined at the outset in order to design an appropriate privatization strategy, *before* such a program is actually launched.

Since the process of privatization is essentially an activity undertaken by the Government in question, my second objective is to identify and examine the Government's objectives in initiating a program for privatization. This is particularly important since privatization, by its nature, involves the elimination of Government ownership and control of state-run enterprises. The government's objectives may, for example, include: (1) an overall reform of the economy including a change in macroeconomic conditions through the elimination of price controls or subsidies, perhaps in coordination with guidance issued by the International Monetary Fund; (2) developing a cross-sectoral plan for restructuring specific industries; (3) relieving itself of the debt burden of keeping unprofitable SOEs afloat; or (4) encouraging the development of the private sector and private ownership. The Government's objectives of privatization must be clearly defined within the context of privatization, and are critical to designing a successful program for privatization.

Lastly, my objective is to provide the participants with a cross-section of privatization techniques available to lawyers and other decision-makers involved in the privatization process. Again, this is not an exhaustive discussion but simply a menu of options which will hopefully increase the participants' understanding of and familiarity with various approaches to privatization. These techniques, in coordination with each other, may be sequenced in a manner which fits the overall privatization objectives of the relevant Government which is exiting a particular sector and transferring ownership to private entrepreneurs.

Case studies which discuss actual privatization studies in somewhat more detail are set forth in annexes to this paper along with a sample transactional document. In the end, I hope that the participants will have better understanding on how to develop a strategic plan for privatization, and some idea on how to negotiate documents which set forth some of the fundamental agreements and understandings necessary to effect a transfer of ownership of a certain industry or enterprise.

II. GENERAL DISCUSSION

A. What is Privatization?

The process of privatization involves the transfer of property rights (i.e. public ownership and/or control of assets, shares or activities of an enterprise) from a public body (e.g., State, government, ministry, public agency, local government body or enterprise owned and/or controlled by a public body) to a private entity. The desirability and sustainability of a program for privatization should be carefully examined before the process is initiated.[1] This paper assumes that a decision to privatize an

[1] Generally, privatization is attempted because an SOE has become unprofitable or unsustainable. The principal reasons why SOEs fail may include, for example, any number of the following:

(1) unprofitability and the lack of a profit motive (there may be no incentive to produce goods or services cheaply or efficiently since the Government may support SOEs through state-financed subsidies, tax revenues, cheap loans and loan guarantees, reduced taxes, tax and duty exemptions, and fail to levy penalties on SOEs for unpaid utility bills, supplier credits and overhead expenses);

(2) the lack of competition (the creation of state monopolies may discriminate against more efficient and competitive enterprises by: (a) introducing a biased tax system; (b) creating preferential systems of incentives and distribution; (c) enforcing tariffs and market entry barriers which exclude private and foreign enterprises; and (d) creating artificial price levels adding to inflation and other macroeconomic imbalances);

(3) the mismanagement of tax revenues (SOEs often rely heavily on publicly financed support for the industrial base, distribution and marketing of goods and services they produce which may result in the misuse or misallocation of tax revenues for economic production rather than for social programs);

(4) the indebtedness of SOEs (the debt burden of SOEs may add to the overall debt burden of the State creating an inflationary impact on the economy and ultimately affecting the creditworthiness and borrowing power of the State);

(5) redundant employment (SOEs are often overstaffed and overly bureaucratized

industry, sector or enterprise has already been made by the relevant Government and therefore, will not examine the political processes implicit in reaching a decision to privatize.[2]

B. Context of Privatization:

(a) **Macro-Economic Framework:** The adoption of a sound macroeconomic framework is essential to designing and implementing a successful program of privatization. Strong and reliable fiscal, monetary and exchange rate policies are needed to attract the large-scale financing needed for privatization as well as to support the general economic restructuring which generally accompanies a program for privatization. The absence of exchange rate and price stability will undermine investor confidence, fail to attract new (and foreign) investment, and impede long-term planning to transform SOEs into profitable enterprises.

Additionally, large scale fiscal deficits caused by carrying the debt load of SOEs, poor fiscal discipline generally, and a marginally operative banking system also impede the availability of credit resources with which to purchase assets and shares of failing

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Footnote 1 continued. . . .

which may encourage a tendency towards graft, corruption and employment protection measures which further add to the unprofitability and inefficiency of the enterprise; or

(6) the inefficient regulation of the SOE by the State (the State may fail to adequately regulate or supervise SOEs because of inoperative or nonexistent regulations, environmental controls and industry standards which usually adds to the general inefficiency and lack of profitability of SOEs.)

[2] If privatization is being contemplated without a specific political agenda (e.g., privatizing state-owned utilities in the U.K., France or the U.S.A.), then no "political capital" *per se* is needed. However, if privatization is sought as a political restructuring of the Government's priorities, then it may involve a political shift as well. (This may be particularly true of developing countries mainly in Africa and Latin America using a state-led approach to economic growth; and socialist countries such as those in Eastern Europe and the former Soviet Union which featured centrally planned economies.) The role of government may need to be redefined from that of supporting the productive sectors of the economy to one of fostering economic development by addressing governance, regulation and social safety net issues. The political process of privatization is the first step in the analysis of whether to privatize in the first place. After all, privatization is fundamentally a political process which is initiated, controlled, and implemented by the State.

SOEs. Moreover, the attempts of the Central Bank to limit credit ceilings in an effort to control inflation (or even hyperinflation) in an environment that has been created, in part, by the failure of SOEs to meet their debt obligations will ultimately affect the viability of proposals to privatize SOEs. Liquidity in the system needs to be encouraged to permit recapitalization and the development of capital markets. However, liquidity in terms of capital resources and credit needs to be carefully controlled and monitored in order to avoid inflationary pressures on the economy. This delicate balance needs to be gauged in a politically sensitive manner.

Apart from sound banking policies and practices, economic management and planning may need to be shifted away from the continuation of direct and indirect subsidies and other pricing mechanisms which shelter SOEs from competitive market forces. Many SOEs (including banking and credit industries) have been allowed to continue even though they are no longer viable operations. The systems of subsidies, price controls, unchecked expenditures with little return on investments, and captive markets and distribution networks may need to be reevaluated and changed in order to facilitate a true program for privatization.

(b) **Macro-Legal Framework:** A successful program for privatization depends heavily on the establishment of a "market-friendly" legal framework for the divestiture of state-owned assets and enterprises. A critical assessment of existing laws, pending legislation and the current (or proposed) regulatory framework may be necessary to determine whether such a macro-legal regime supports privatization. Since these issues of particular interest to lawyers, the following factors should be considered in making this determination.

(i) **Rule of Law:** The law should be equitably and fairly applied to all domestic (and foreign) investors, creditors, debtors and all other public entities and private parties wishing to participate in the privatization process. This means that the law, and its application, should be transparent and easily accessible to the public. Translated into practical terms, a Government contemplating a large-scale privatization program may find that it is necessary to completely overhaul its legal and judiciary systems (e.g., promulgate and publish laws and regulations, post or publish such laws and ordinances in public places or widely circulated journals and establish new tribunals or administrative law courts). In other words, clarity and predictability in both the law (and its administration) are critical to creating and maintaining a stable macro-legal framework for privatization.

(ii) **Property Law:** Property law is the cornerstone of any market-based economy. If no right to private property exists, it may require a constitutional amendment or other enabling legislation. The transferability of free and clear property titles in a transparent and easily accessible manner is mandatory. For example, titling, registration, implementing a national cadastre to measure and record land parcels of private owners, enforcing legal rights to own property as well as mortgaging, credit and foreclosure procedures and property-related concerns must be adequately addressed.

If historically, the State has expropriated or nationalized private property, then this may also become a contentious issue in the privatization process. Generally, "nationalized" property of private citizens may be addressed by one of two avenues: (1) restitution to the private party if adequate records in the not-too-distant past exist to prove current ownership and legitimate claims or, alternatively; (2) compensating the private party for justified claims which may require that separate administrative or judicial procedures and tribunals be established. However, it is important that the privatization process is not held hostage to the settlement of past claims on ownership. (Settlement of such property claims may be carried to an extreme where, for example, the German Parliament had to enact a "Law for the Removal of Obstacles to the Privatization of Businesses and for the Promotion of Investments.")

(iii) **Business Law:**

(a) **Contract Law** -- like property law, contract law is critical to the sustainability of any privatization process. Private citizens should be able to enforce private contracts and agreements through speedy and just means through established avenues of legal recourse. Often the expense of doing so acts as an impediment or a deterrent to entering such legal understandings in the first place. But in order to ensure the full and fair accessibility of privatization to the private citizens interested in participating in the process, both the letter of contract law and the means of enforcing it should be clear and transparent. And, to the extent possible, the process of enforcing contract law principles should be as affordable and as efficient as possible.

(b) **Company Law** -- a body of corporate law adequate to support the privatization process should include the necessary laws, regulations, and procedures for the establishment, incorporation, operation, management, and liquidation of companies as juridical persons. This may also require promulgating laws which permit the establishment of certain basic types of privately-owned companies. The implementation of such company law should also provide for well-defined rules of corporate governance; shareholder and officer liability for company debts; transfer of share ownership; functions and liabilities of corporate officers and directors; and the creation, management and sales of subsidiaries, affiliates and branches of such enterprises. Further, the daily operations of such companies should also be supported by adequate legal guidance concerning accounting and auditing, tax reporting and public disclosure requirements. (In fact, in many instances, a Government may need to promulgate the necessary laws and regulations which permit the legal conversion of SOEs into private joint-stock companies before the privatization process is initiated.)

(c) **Bankruptcy Law** -- the Government (or municipality) should also adequately address the termination, wind-up, insolvency and sales provisions of bankrupt enterprises. Under liquidation provisions which are governed by company law in most cases, ownership of the enterprise's assets and liabilities is transferred or sold to the new owner who assumes the liabilities of such enterprise. This may assume that the SOE cannot be reorganized or transformed into a going concern leaving termination as the only option. This usually means selling the physical assets of the SOE, paying its debts to the extent possible, and transferring any remaining facilities or assets (and liabilities) to the new owner.

In contrast, under bankruptcy laws, the SOE is assumed to be insolvent and the bankruptcy process is supervised by the courts with the assistance of court-appointed trustees and administrators. Again, bankruptcy laws may have different provisions for SOEs that can be salvaged and for those who cannot. The judicial system for bankruptcy and trusteeship procedures may not be well-established in particular countries, particularly those functioning under a civil law system. This may mean that more legal reform is necessary before the liquidation of the SOE, or a part thereof, may take place.

(d) **Tax and Customs Law:** The taxation of newly established private companies may be somewhat problematic for a Government. This may mean, for example, that a new system of tax schedules, laws, regulations as well as implementing and regulatory authorities may need to be put in place. The taxation of corporate assets of newly privatized SOEs or closely-held private corporations owned by one or two private owners may mean that the Government needs to pass an interim tax code or regulations. The collection of such taxes and the reporting and withholding requirements of such privatized SOEs, and their employees, may also require that the State set up the mechanics of doing so. Secondly, for private companies which import and export goods, the Government may need to adjust the customs duties fee structure and establish an enhanced means for enforcing such duties (or exemptions). Clearly, this undertaking is a difficult and time-consuming process.

(e) **Competition and Trade Law:** Once the privatization program is launched, the Government should not treat the public and private sectors differently. In fact, it may have been the disparate and favored treatment of public enterprises in comparison to private sector enterprises that leads to macroeconomic imbalances in the first place. Thus, in order to create a "level playing field," the State may need to: (1) remove subsidies (including State guarantees on borrowings by SOEs); (2) liberalize controls on prices by removing price ceilings; (3) harmonize tax laws for public and private sector enterprises; (4) remove market entry barriers that keep private competitors out; (5) change procurement regulations to permit more liberalized bidding; (6) break up monopolistic positions through legislation or by the fragmentation of SOEs during the privatization process; and (7) prevent the establishment of private cartels, trusts, monopolies and other restrictive business and trade practices. (Antitrust provisions, if not legislated, may need to be set forth in divestiture documents during the privatization process so that public monopolies are not replaced with private ones.)

(f) **Regulatory Framework:** This may involve a spectrum of laws and regulations that may cover areas as diverse as environmental controls, regulation of the sector or industry being privatized, intellectual property protection, foreign exchange controls, taxation, labor laws, and international dispute settlement. Additionally, administrative and judicial practices for dispute resolution pertaining to the implementation and enforcement of such laws and regulations may also need to be created.

(g) **Other Supporting Laws:** Additionally, banking laws, securities and commodities laws and regulations, foreign investment laws, Central Bank policies on interest rates, exchange rates, convertibility of currency and debt equity exchanges, and other industry or sector-specific laws and regulatory regime may need to be developed.

C. The Government's Objectives in Privatization:

It is very important to identify the State's objectives and priorities before designing a plan of action or strategy for privatization. These objectives may include one or more of the following, but please keep in mind that this is not an exhaustive list:

1. macroeconomic concerns in fostering more productive and competitive enterprises to support greater overall economic development;

2. budgetary relief from the financial burden of keeping unprofitable SOEs afloat;

3. increasing tax and other revenues from newly privatized SOEs to support a social safety net or other Government programs;

4. increasing the efficiency of SOEs in terms of production, distribution and marketing as well as addressing consumer concerns with sector performance;

5. exiting from productive sectors and shifting resources and priorities to governance and regulatory functions as well as dealing with social safety net issues; and,

6. increasing public participation in the ownership of private enterprises and supporting private sector growth.

Clearly, privatization is a dynamic process that may involve the coordination of more than one political agenda. If, for example, a break-up of monopolies is sought, then the State should act to remove market entry barriers and dissolve vertically integrated industries by instituting a new regulatory framework for that industry. If, on the other hand, large-scale private ownership of certain industries or sectors is sought, then perhaps the State may want to develop a pilot program of vouchers or coupons or public auctions of assets and/or shares of SOEs. Alternatively, if capital markets are well developed in the subject country, then perhaps a public floatation of shares may be introduced to increase liquidity and change ownership. Or, if changes in management and technology transfers are sought, then perhaps joint ventures with foreign firms is a possible solution. In sum, the method of privatization should be targeted to meet the specific objective of the Government.

Once privatization is chosen as a political mandate of the Government and the objectives behind privatization are adequately identified, then a strategy for actual privatization may then be developed. However careful planning must take place before privatization begins, otherwise the Government risks losing the benefits of such a privatization strategy. In fact, the penalty may be quite high since the social and economic displacement which may be caused by a privatization plan that is not well developed may result in the loss of political power for the Government. The stakes in certain situations, as evidenced by the recent developments in Eastern Europe and the former Soviet Union, may be quite high.

Benefits

If however, a successful program for privatization is launched, the benefits may also be quite dramatic. For example, privatization may result in improved efficiency since it may involve the better use of natural, technical and human resources. The elimination of captive markets, pre-established distribution networks, and a preferential tax system means greater responsiveness to competitive market forces resulting in improved efficiency and profitability. Further, the removal of entry barriers and state-supported SOEs may encourage new and increased competition by increasing the number of firms and foreign investment. (However, care should be exercised at the strategic planning stages so that public monopolies are not replaced by private ones.) Moreover, attracting foreign investment may lead to technology transfers, job creation, export development and the creation of new domestic and foreign markets.

Additionally, privatization may result in greater fiscal stability. Government expenditures in supporting SOEs through subsidies and covering their debt burden will be reduced or eliminated once SOEs are privatized. Moreover, better management, improved efficiency and greater responsiveness to competitive pressures often results in increased returns on sales, equity, and assets. As a consequence, the overall capitalization of the privatized enterprise tends to improve. This leaves more funds available for technological improvements, training for staff and developing new markets.

Plus, there is less of an inflationary impact on the economy due to the privatization of SOEs since the State is relieved of its debt burden of supporting non-performing, nonprofitable SOEs. A revised, more equitable tax base may also help generate tax revenues from former SOEs which may then be used for social safety net programs, health, education or capital infrastructure support. These new Government investments may increase the overall productivity in the economy.

Finally, privatization often means a change in management which gives the new owners and managers the opportunity to replace and eliminate excessive bureaucracy. This is often critical in improving a sector's overall efficiency and performance. Since jobs are no longer guaranteed by the State, workers are more apt to respond in more efficient ways. And if successful, privatization should result in substantially improved social benefits to consumers, primarily in the form of more efficiently produced products and services which are made available to consumers at lower costs. Moreover, privatization may ultimately result in greater (not fewer) job opportunities, and the creation of new capital markets and investment opportunities.

III. TECHNIQUES OF PRIVATIZATION

Once privatization is chosen as an option for the Government, then the following techniques or methods of privatization should be considered in order to develop a strategic plan for conversion of an SOE or an entire public sector.

A. Denationalization:

(1) **Public Offering of Shares (Full or Partial)**: Under this procedure, the State sells all or large portions of its stock held in a wholly or partially owned SOE to the general public. (Generally speaking, such an SOE is a going concern which has been organized as, or converted to, a public limited company.) If only part of the State's shares are being sold, this results in joint State and private ownership. The resulting company is often known as a "joint-stock company," and may be the first deliberate step towards full privatization.

Usually a prospectus is prepared for the public offering using the services of an investment banker. A syndicate to underwrite (i.e. guarantee the purchase of unsold shares) the public offering of the new shares may also be considered. Further, the public offering may be on a fixed price or tender basis with options for convertible debentures or stock warrants.[3] Alternatively, the shares of a publicly traded company can be offered on local and/or international stock exchanges to domestic and foreign investors.

A public offering is, however, predicated on at least a few of the following factors: (1) that the SOE is a sizeable going concern with a reasonable earning potential (i.e. the rate of return on an investment in the privatized SOE is expected to be reasonable); (2) that full and truthful disclosure of the SOE's financial health is publicly available and easily accessible; (3) that the valuation of the SOE's assets, and perhaps more

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[3] Under convertible debentures, no new investment is made but a debt instrument of the privatized SOE is issued to the debenture holder. Under stock warrants, new shares will be issued when the warrants are exercised which will result in new equity investments for the SOE.

importantly, its liabilities, is fairly reliable; (4) that there is sufficient liquidity in secondary capital markets; and finally, (5) that the State encourages widespread ownership in such companies by the general public.

(2) **Private Sale of Shares (Full or Partial)**: Under this option, the State sells all or part of its shareholding to a single, pre-identified group or groups of private purchasers. The actual offering of equity shares is done by: (1) full competition for shares by bids (either with or without the prequalification of bidders in accordance with prescribed criteria); or (2) direct negotiation of a share purchase contract with a buyer.

The buyers usually bring managerial, technical or marketing expertise to the enterprise and, as future shareholders, are generally interested in operating or reorganizing the SOE (or former SOE) after purchasing the shares. This approach may be the State's sole option where equity markets are not well developed or where the particular SOE is weak and not performing. However, caution should be exercised by the State in keeping the negotiation and sale process transparent and fair in order to avoid the perception of underhanded dealings between certain privileged private parties and the State.

(3) **New Private Investment in SOEs**: The SOE may also be recapitalized by introducing new private equity investment in an enterprise without the State relinquishing any of its shareholdings in the SOE. Recapitalization results in the dilution of the State's interest in the SOE, and may be the first step in privatization resulting in joint ownership of the SOE by the State and private parties. Generally speaking, however, new private investment in SOE does not normally result in sales proceeds for the State. The new issuance of shares may be handled through a public offer of stock subscriptions, or the private placement of shares to selected parties. This option is generally favored for undercapitalized SOEs, particularly where foreign joint ventures are sought for their managerial and/or technical expertise.

B. **Mass Privatization**:

(1) **Vouchers/Coupons**: In some case, particularly in Eastern Europe and the former Soviet Union, the political mandate for privatization is so strong that immediate divestiture of the State's ownership interest in enterprises becomes imperative. Widespread public access to the privatization process, especially in being able to purchase or acquire small and microenterprises, was formally instituted in Eastern Europe and the former Soviet Union though the innovative and systematic use of vouchers and auctions.

(a) **Case Study: Czech Republic**

The Czech Republic's mass privatization program was instituted in 1991, and permitted each Czech citizen over 18 to receive vouchers worth 1000 investment points by paying 1000 koruny (25% of the average monthly wage of a worker), plus 35 koruny for the voucher booklet itself. Approximately 1491 companies were chosen for the first wave of privatization which was to be completed in five rounds. Share prices were set by the Ministry of Privatization on a dynamic basis so that for shares in high demand, the price was raised accordingly for the next round of bidding. (One share of each firm represents 1000 koruny of book value, and it is anticipated that investment points will subsequently be exchanged for actual shares in privatized companies. However, to date, there has been no trading of investment points for shares pending passage of a securities law.)

Most citizens invested in Investment Privatization Funds (IPFs) which deal in investment points and are established as joint stock companies organized pursuant to the Law on Large Privatization and on the Guidelines for Establishing Intermediaries. IPFs register with the Czech Ministry of Privatization and must hold at least 5% of their equity in a bank account or in State bonds. The IPFs are "closed" which means that, unlike mutual funds, no further funds may be invested once a certain level of capitalization is reached. There is an absence of a fully operational stock market to convert the IPF shares into securities; but a stock market is expected to be readied for full operation by 1994.[4]

(b) **Case Study: Romania**

The first step in privatization in Romania was the promulgation of a law converting SOEs into commercial companies or autonomous state monopolies in strategic spheres such as mining, energy, arms and the postal service. One year later, the Law on the Privatization of Commercial Companies was passed completing the legislative framework for privatization. It is estimated that at least 30% of the stocks in eligible enterprises will be transferred or entrusted to five Private Ownership Funds (POFs) who will issue a property certificate to each eligible citizen. These certificates shall be in bearer form and may be transferred to other Romanians (but not foreigners), and exchanged for shares in individual joint-stock companies. The certificates also entitles the bearer to: (1) dividends from profits made by POFs; (2) discounts of up to 10% on shares; and (3) brokerage services offered by the POFs. (Finally, it is anticipated that after five years, the POFs will be converted into joint-stock companies.)

The remaining 70% of the shares of joint-stock companies in Romania shall be transferred to the State Ownership Fund (SOF) which will divest its interest in joint stock companies at a minimum rate of 10% per year for up to 10 years. If the shares are sold by public auction or sales, the public may purchase such shares at a 10% discount.

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[4] Cf. In the Russia Republic, vouchers with a face value of 10,000 rubles began to be distributed on October 1, 1992 with employees having the option to purchase shares at a 10% discount; however, little progress has been made to date using vouchers.

If the shares of joint-stock companies are sold through direct negotiations by the State with a private party, the public may exercise the right of first refusal. The Law on the Privatization of Commercial Companies also authorizes the sale of SOE assets, and permits bidding by foreigners on a subsequent round of bidding if satisfactory prices were not obtained in the initial rounds.

(2) **Public Auctions/Public Tenders:** Another method of mass privatization are public auctions where transparency and accessibility are guaranteed. Additionally, public tenders through the use of sealed bids may be used (where the highest bid wins) to purchase the assets and/or shares of a company being privatized. This method has been used successfully in the Russian Republic and Eastern European countries. The new owner of the shares (or assets) would assume the liabilities of the SOE, unless the State otherwise agrees to retain the SOE's liabilities. This approach may be adopted out of necessity by the State in order to facilitate the sales of small or non-performing state-owned enterprises.

For example, the city of Nizhny Novgorod was chosen as the first site of Russia's privatization effort. Small-scale municipal enterprises such as retail businesses, shops and restaurants were sold to private owners through auctions based on two fundamental principles. First, since such small businesses generally share their retail space with other businesses, city officials decided to lease, rather than sell, such retail space to the new private owners. Secondly, the enterprises were first liquidated whereby all their assets were sold, their bank accounts frozen, and their operations were closed. The city then assumed all financial and other liabilities of the old businesses which were subsequently financed through auction proceeds. The new private owner was then freed of past financial claims and liabilities, and could then start a new business afresh.

Moreover, the auction process was supported by carefully drafted privatization laws (on both the state and city levels), a regulatory framework, and the necessary administrative machinery to keep the whole process moving smoothly. These laws also provided clear definitions of the respective rights and responsibilities of the parties involved in privatization. The results are quite impressive.

C. **Restructuring:**

(1) **Fragmentation (Reorganization of SOE Into Component Parts):** This option involves breaking up the SOE into its component parts. The SOE's shares or assets of its component parts are then transferred to a holding company with several subsidiaries. These subsidiaries then assume the assets and liabilities of the individual components of the SOE being privatized. (The holding company may be State-owned.) This option may also involve the State retaining ownership and control of certain non-productive components of an SOE while productive components (or entire enterprises in a particular sector) are sold to private parties.

Breaking up a vertically integrated industry or, for example, a port authority into its component services (e.g., stevedoring, general port services, transit, towing) may be part of the State's plan for economic transformation. The break-up of a monopoly and the subsequent sales of SOEs to private concerns may also foster competition and make the particular industry or enterprise more responsive to market forces.

(2) **Liquidation (Sale of SOE Assets):** This option involves selling the assets rather than the shares (i.e. equity) of an SOE. The SOE's assets are generally sold through auctions, direct bids or negotiated contracts with known parties. Dissolving or liquidating an SOE, or a part of its operations, may help make a final private sale or help transform the part of an SOE that is a going concern into a more profitable entity. Liquidation usually means one or more of the following: (1) selling the physical assets of an SOE; (2) the State writing off uncovered (i.e. unsecured or non-guaranteed) liabilities; (3) spinning off certain activities or rights; or (4) selling market shares to a private purchaser for a market or negotiated price. Further, dissolution and winding-up an SOE (or a part thereof) may involve bankruptcy proceedings, compensation of personnel being terminated, dissolving the corporate structure of the SOE, and paying the SOE's creditors (by the State or the new private owner) to the extent feasible.

D. **Change in Ownership/Management:**

(1) **Management/Employee Buy-Out:** A Management Buy-Out (MBO) refers to the acquisition of a controlling share in an SOE by a group of managers and/or employees. If the MBO is leveraged, this means that credit was used to finance the acquisition of the shares of the SOE, and that the assets of the company was used as collateral or security. In most MBOs, a holding company is created through a special equity issue which is exclusively subscribed to by the management and/or employees and which results in new capitalization for the SOE. The holding company then acquires the SOE to be privatized by using equity funds and, in the case of leveraged MBOs, borrowed funds (e.g., direct loan financing provided to an employee-owned consortia, or other guarantees issued by financial institutions).

For example, in Chile, a large computer firm known as ECOM was acquired by its own workers who formed a separate corporation. The workers then developed a financing package of $1.5 million by using: (1) advances of their own retirement funds; and (2) a loan with a maturity of 10 years at 5% interest from CORFO, a state holding company. The selling price for ECOM was set at its liquidation value. The guarantees for the loan financed under this scheme were the shares of the newly formed employee-owned corporation and the assets of ECOM. After acquiring ownership of ECOM, the workers initiated a complete managerial change including wage adjustments, sales of disposable assets, and moving ECOM's offices to a less expensive building while leasing the original space for a profit. The results are reportedly impressive.

Further, a U.S. model for transferring ownership of an enterprise are Employee Stock Ownership Plans (ESOPs) which are a regulated trust device similar to a pension fund. Under an ESOP plan, employees buy large blocks of shares in an SOE without paying cash. (The shares may be in the form of newly issued or existing shares depending on whether the SOE needs new capitalization.) The purchase price is usually deducted from the salaries of the participating employees. The ESOP fund, once established, then borrows funds from a bank to acquire the shares which may then be bought by interested employees. The lender bank, however, has no recourse against the employees for its loan. The SOE then services the bank loan given to the ESOP fund by paying the principal and interest of the bank loan, and receives tax advantages for doing so. Further, the lending bank (or other financial institution) also receives tax incentives for income tax payable on the reflows or profits generated by the ESOP loan which is serviced by the SOE. Although current U.S. tax incentives for ESOPs may not exist in other countries, it may nevertheless prove to be a fruitful starting point for discussions involving privatizations.

(2) **Worker Cooperatives:** In certain instances, it may be advantageous for industrial or agricultural state-owned worker cooperatives with a high degree of participation in management decisions to organize a private cooperative. A private cooperative may issue (either publicly or privately traded) shares in a cooperative or collective to its employees on a preferential, discounted basis. (Democratic Worker Ownership Trusts organized by 85 industrial cooperatives in Spain provides a useful model, and Zimbabwe is reportedly developing legislation to permit privatization through workers' cooperatives.) Alternatively, the employees may organize into non-incorporated membership associations. As a result, the employees become the owners and managers of the enterprise and may benefit directly from any management or other changes they institute.

(3) **Leases:** In this case, there is no transfer of ownership and no divestiture of State-owned assets. Instead, certain operations of an SOE are effectively "leased" to a private company to increase profitability perhaps as a first or intermediate step in an overall program of privatization. The private lessee or contractor may take an equity participation in the SOE or be given the option to purchase shares as a first step in transferring ownership to the lessee or as an added incentive to increase profitability.

Leases with private sector management mean that a private operator leases the assets or facilities owned by the State for a specified period of time and for specific compensation paid to the State, usually regardless of actual profitability. The lessee hires its own staff (or may integrate existing staff into its operations), and exercises complete control over the premises and operations of the SOE, subject to repair and maintenance covenants.

(4) **Management Contracts:** Under this option, the management company assumes responsibility to manage the enterprise for a fee. Whereas the lessee pays the

State for using the SOE's facilities, the management contractor is paid by the State for its management services. The management contractor takes no financial exposure, and is paid the fee regardless of the profitability of the SOE. Further, the management contract does not relieve the State of any financial burdens (e.g., overhead expenses, utilities, debt, salaries of employees) of the SOE. The State continues to bear full commercial risk in operating the SOE.

A management contract may be the first step in readying the SOE for actual privatization by making it more efficient and profitable. The distinction between a management contract and lease may be blurred by requiring a management contractor to take an equity position in the SOE, or by giving the lessee the right to negotiate a reduction in the rental fee if profitability falls below a certain level. Additionally, the lessee/contractor may be a joint partner with the State under a joint venture agreement.

(5) **Concession/Leasehold ("Affermage")**: This type of arrangement was originally developed in France over 100 years ago and is usually applied in the power and water sectors. Under a concession arrangement, the private party finances (and fully owns) the planning, construction and implementation of a facility. The concession is usually for a period of 20-30 years to permit the private party to recoup its investment, at the conclusion of which ownership is transferred to the State or municipality.[5]

An affermage (or leasehold) arrangement is one whereby the private operator rather than the owner is legally responsible for the provision of the utility services, collecting fees for the service from consumers, and taking all commercial risks including charging consumers for taxes and levies for the operation of the facility, and complying with all applicable regulations and environmental controls.

An affermage may also involved mixed ownership. For example, the operation of the water supply in Cote d'Ivoire was placed under an affermage in 1973 where the Societe de Distribution d'Eau de la Cote d'Ivoire (a corporation owned by the Ivoirien Government) owned 4%; SAUR (France) owned 46%; private Ivoirien shareholders owned 48%; and private French shareholders owned 2%.

Additionally, if the utility or facility is broken up into component parts, certain operational components may be under a concession (e.g., to expand and finance the

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[5] This is very similar to Build-Own-Operate (BOO) or Build-Own-Transfer (BOT) arrangements also common in construction and capital infrastructure projects whereby a private contractor/financier agrees to design, build, operate, and transfer ownership back to the public sector once its original investment is redeemed through the profits generated from a fully operational facility. (Under specially negotiated terms, the private contractor may agree to retain ownership or sell its ownership interest to another private party.)

expansion of a facility), and certain components may be under an affermage (e.g., operation and maintenance). The joint-stock character of a public utility may prepare it for total privatization in the future.

E. **Other Methods:**

(1) **Debt Equity Swaps:** In some cases, the commercial (and occasionally, the official debt) of an SOE may be exchanged for equity positions in the newly privatized SOE. In other words, if the terms of the loan agreement permit, a private investor may be given the opportunity to purchase the SOE's bank debt and convert the debt into equity (i.e. shares) in the SOE. The debt of the SOE is actually sold on the secondary market at a heavily discounted rate The buyer essentially purchases the debt obligation from the creditor bank, and then exchanges the loan instrument for equity in the SOE under the terms of the conversion agreement. Alternatively, the creditor bank may agree to take the debt which the SOE owes to it, and exchange it for equity in the newly privatized entity. However, in either case, the equity must generally be held locally in the form of shares and not repatriated as hard currency out of the country in a process known as "round-tripping."

For example, in Argentina, the local telecommunications company wanted an experienced partner to take a significant equity position in the industry and invest $5 billion in capital improvements over the next 10 years. The Argentine telecommunications company was sold in November 1990 for $214 million with a $2 billion reduction in the face value of the debt through swaps made on the secondary market through an auction.

(2) **Joint Ventures:** A Government may also decided to enter into joint venture agreements with private foreign firms in order to facilitate a technology transfer, the introduction of new management practices, and the development of new markets and distribution networks. The Government may wish the joint venture partner to take and equity stake in the former SOE as a sign of its commitment to the success of the enterprise. This may involve converting the SOE into a joint-stock company to permit the foreign firm to acquire shares in the SOE. A joint venture may be an intermediate step to full privatization once the operations of the former SOE become profitable and competitive.

IV. IMPLEMENTATION OF THE PRIVATIZATION PROCESS

In a nutshell, there are three basic steps involved in planning a privatization program. First, develop a scheme for an overall, sequential program of privatization; secondly, prepare the SOEs for privatization; and finally, establish an agency or committee to oversee and manage the process of privatization. Briefly, this process may include the following.

A. Preparing the SOE for Privatization:

(1) **Diagnostic Work**: At the outset, it is important to analyze the SOE's finances and operations; establish preliminary values of assets and/or shares of the SOE to be privatized; and determine which method(s) of privatization will be implemented. This may need to be done for an individual SOE or for an entire sector.

(2) **Corporate Financial Analysis**: Secondly, the Government should arrange for the appropriate financial review of the SOEs to be privatized. This examination should include a careful and exhaustive analysis of the capital structure, debt exposure, and past financial performance of the SOE. Auditors should examine financial statements of the SOEs to be privatized in accordance with internationally accepted accounting principles. (The lack of financial discipline of some SOEs may account, in part, for their poor financial status and performance.)

(3) **Financial Restructuring**: Further, it is often necessary to revise and update the SOE's balance sheets which may include writing down the value of the SOE's assets; writing off its debt or other liabilities; or recapitalizing, restructuring, spinning off or liquidating the SOE's capital assets and/or subsidiaries. Further, anti-monopoly concerns should be taken into account when breaking up or restructuring existing SOEs. Additionally, physical rehabilitation of the premises, installing new capital equipment or replacing old technology as well as changing employee salary structures and benefits may also be necessary before privatization may be attempted.

(4) **Debt Restructuring**: Moreover, if substantial debt is involved, the threshold question is whether to sell the SOE at a depressed value or whether the Government should repay the SOE's debt and incur the resulting financial loss. Options to consider are: (1) debt rescheduling; (2) debt repayment (along with the sale of assets to pay outstanding debt obligations); (3) the direct buy-back of the SOE's debt by the Government; (4) converting debt into equity; (5) the assignment or transfer of the debt liabilities to a government (or private sector) holding trust who will assume the outstanding debts of SOEs scheduled for privatization; or (6) bankruptcy or liquidation proceedings for all or part of the SOE with its assets to be assumed by a newly organized private corporation. Naturally, variations of these options should be carefully considered and tailored, as appropriate, to the circumstances of the individual SOE being privatized.

Additionally, any loan or loan guarantee agreements entered into by the State with development and/or commercial banks may have restrictive clauses preventing sales or transfers of the Government's ownership interest in the SOE unless the prior consent of all syndicated lenders is obtained. This may substantially affect the ability of the Government to reschedule, transfer or write off the debt of the SOE. Therefore, negotiations with the appropriate parties for resolving the SOE's outstanding debt balance may be necessary before the SOE may be sold or transferred to private ownership.

If the Government has on-lent funds borrowed from multilateral or bilateral lending institutions (such as the World Bank or USAID) to the SOE or, alternatively, guaranteed repayment of commercial loans to the SOE and become a subrogated creditor, then the Government may, for example: (1) cancel the debt under a direct loan or guaranteed debt obligation; or (2) convert the debt into equity positions in non-voting, preferred stock with fixed dividend rights in the newly privatized SOE. Additionally, if the second option is chosen, the right of the Government to redeem its non-voting, preferred stock for common, voting stock may be agreed to and exercised at a prospective date set forth in the underlying documentation.

The need to privatize an SOE at an acceptable debt-equity ratio also needs to be balanced against the Government's ability to maintain the liabilities (directly or through loan guarantees) of newly privatized SOEs. The Government may, for example, be able to support the repayment of the SOE's debt by assuming the foreign exchange risk in repaying hard currency denominated loans, waiving import duties or taxes, or by other means to keep the newly privatized SOE afloat with additional capital.

(5) **Recapitalization**: New capital investment in an SOE scheduled to be privatized may be engineered by floating new shares. This new capital increase may add new equity to the SOE, thereby diluting the Government's share. Sourcing foreign capital investment may be an attractive option since this normally supports foreign exchange reserves in the developing country. Additionally, the Government's shares may also be sold to private investors permitting full divestiture to take place.

Further, the present and future rights of existing shareholders (including preemptive rights and consent required for certain types of transactions) must also be considered in assessing the legal liabilities of the SOE. And, if the public issuance of shares is contemplated, the company must conform with public disclosure and due diligence requirements.

B. Conversion of the Legal Form of SOEs:

The existing legal form of most SOEs may also need to be converted to another legal form before privatization may occur. Legal "retooling" may involve simple amendments to the articles of association (or incorporation); the formation of a limited liability company or joint-stock company; or the dissolution of an SOE with a subsequent transfer of assets and liabilities to a new corporate entity. Of course, this assumes that a macro-legal framework sufficient to support the privatization process already exists. If it does not, then special legislation may need to be enacted at the national, state or even municipal levels.

If the SOE has been created by an Act of Parliament, the Government may need to convert it to an ordinary private corporation and, if relevant, remove the SOE's monopoly powers by legislation. Moreover, the Government may need to enact special regulations to govern the newly privatized entity. For example, the Government may need to enact legislation to establish a licensing system or create an environmental protection regime.

C. Valuation and Pricing of Assets/Shares:

This is a difficult and sensitive process, and is often determined by a formula based on past or future potential earning capacity, the adjusted value of existing assets, or the liquidation value of the SOE. The value of intellectual property, technological processes, special markets and other criteria may also enter the process of valuation of assets and determining the sale prices of assets and/or shares.

For example, in a public offering of the shares of an SOE to be privatized, the Government may: (1) offer shares at a fixed price which is set before the release of shares for sale to the public (and whereby each subsequent round of public offerings can be adjusted based on the market demand for shares); or (2) invite sealed tenders to be submitted and set a "striking price" which is especially well-suited for "niche" enterprises; or (3) set the share price by public auction. For a private placement of shares, the Government may use negotiated contracts or sealed bids.

The market price of shares may be affected by the public perception of the overall profitability of the SOE, and the expected rate of returns on the investment. Additionally, the availability of financing, including the use of employee or other discounts, and the accessibility of credit to purchase shares will affect the marketability of the assets and shares of an SOE targeted for privatization. Further, the manner in which shares are offered to the public will also affect pricing. For example, assets sold at auctions will be traded differently than those assets which are sold under the terms of a privately negotiated contract.)

D. Restructuring SOE Ownership:

The nature and importance of the sector or individual SOE to be privatized also needs to be evaluated before a scheme for full or partial privatization may be developed. The strategic importance of certain enterprises may mean that the Government may wish to retain special rights, or maintain veto power over strategic decisions for a definite period of time. In other words, the Government may feel that it should retain control over strategic decisions in order to protect the national interest or preserve Government ownership of key capital infrastructure facilities such as telecommunications. Thus, the Government's retention of certain voting shares, governance through two-thirds or majority vote for critical decisions, or other means of control need to be fully vetted before actual restructurings are implemented.[6]

Government control (or veto power) over these strategic issues may be accomplished by issuing symbolic "golden shares" to the Government. A golden share is generally issued to the Government at the time of legally reorganizing or amending the charter of the privatized company. The issuance of a golden share basically entitles the Government to exercise special rights or veto power over particular decisions of strategic importance (e.g., dissolution, liquidation, permitting foreign control of the privatized SOE, nationality requirements of the CEO or Board directors, the issuance of certain classes of shares such as convertible debentures or preferred shares with special dividend and voting rights, or borrowing on the basis of State-backed loan guarantees). Moreover, the issuance of a golden share may entitle to the Government to appoint a non-voting member to the Board of Directors or compel the newly privatized SOE to obtain special Government approval for certain actions.[7]

The nature and extent of the Government's continuing participation in an SOE that is being privatized is important. For example, the Government may wish to place certain restrictions on individual shareholders in order to prevent a conglomeration of either domestic or foreign economic power. Several approaches may be taken by the Government. One approach may include setting a limit on the percentage of total shares which an individual or investor group may purchase, with mandatory divestiture procedures if the limit is exceeded, in order to prevent monopolistic or oligopolistic

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[6] For example, in Brazil, the convertible debentures and a new equity issue by Electrobras was conducted in a way so that the Government's share was set at the minimum percentage necessary to retain absolute voting control. Also, in Chile, the sugar mill IANSA was targeted for a 49% divestiture by the Government which still gave the Government a simple majority.

[7] For example, the U.K. Government retained a special share in British Sealink requiring the company's ships to remain under the British flag and be requisitioned by the Government in cases of national emergencies. As another example, Senegal's Law on Privatization requires that SOEs covered by or on-lent with government loan guarantees must amend their charters through an "action speciale" to ensure repayment of the loan guarantees to the State. This law also prevents private shareholders from acquiring controlling interests in Senegalese SOEs. Another illustration is the French Government's reduction from a two-thirds share in an initial offering of shares for Societe Nationale ELF Aquaintaine to a simple majority along with the issuance of a special share giving the French Government veto power over any one shareholder acquiring over 10% of all outstanding shares.

practices.

Alternatively, the Government may ensure that restricted non-voting shares are issued. Or, the Government may, under certain conditions, buy-back the shares of the privatized corporation to retain control over the corporation. Further, the Government may wish to limit foreign investment in a newly privatized SOE. For example, up to 30% foreign investment in a private enterprise is permissible in Malaysia under the New Economic Policy with exceptions permitted for export-related industries; 20% total foreign investment in an enterprise is permitted in France; and up to 7.5% private foreign investment in the National Commercial Bank of Jamaica is permissible. It is important, however, that these restrictions are clarified at the outset of privatization.

E. Employee/Management Concerns:

Employees are generally perceived as being opposed to privatization since it may involve the total or partial dissolution of the SOE or its components, loss of jobs and security as well as new management and unfamiliar practices. However, privatization may also create additional jobs by opening up new markets, updating technology and creating new avenues of marketing.

It may be possible to alleviate some of the difficulties associated with privatization by encouraging employee participation in privatization. Several strategies may be developed such as reserving shares for current employees; discounting blocks of shares for employee purchases; permitting the use of borrowing from employee retirement funds as credit to buy shares; installing a new profit-sharing plan for employees; and exploring ESOPs or other share-purchasing mechanisms. Although discounted or leveraged (i.e. bought on credit) shares do not add to the capital base or fiscal stability of an SOE, it may make the process of privatization palatable for the existing employees. This may broaden the base of ownership -- and this may, in fact, be an overall objective of the Government in undertaking a program of privatization.

Additionally, some of the adverse consequences on current employees of SOEs may be mitigated by adopting one or several of the following measures: (1) making severance pay or cash incentives available to employees who voluntarily resign; (2) instituting a program of attrition, early retirement and other workforce reduction schemes; (3) absorbing redundant employees by the Government or by providing alternative employment; (4) providing training, counseling, outplacement and other support for job placement; (5) adjusting pension, safety net and welfare support or other benefits; (6) addressing health and other benefits through cash support or eligibility in state-financed health care; or (7) obtaining a commitment from a private purchaser of an SOE to retain redundant employees during the deployment time. Although these measures may ease the pain of transition to privately owned industry, it may nevertheless lead to a deflation of the purchase price and net proceeds to the State following privatization.

V. MANAGING THE PRIVATIZATION PROCESS

Again, to summarize the basic steps involved in managing the privatization process, first, define the specific political goals of the Government in instituting a program for privatization. Secondly, identify and diagnose the industries/sectors to be privatized and in what manner. And finally, set up implementation, management and oversight units to manage the entire privatization process.

A. Organizational Units for Implementing a Program for Privatization:

Establishing the organizational, administrative and reporting structure of a privatization program is critical to the political viability of the process. Implementation units may include the following: (1) a specialized Government Ministry (e.g., the Macedonian Privatization Agency which collapses the already existing Development Fund and the Agency for Restructuring; or the Ministry of State Enterprises in Togo); (2) a permanent privatization committee or task force as found in Brazil, the Philippines, Senegal and Canada or such as the Gambia National Investment Board or Senegal's Commission Speciale de Suivi du Desengagement de l'Etat comprised of various Ministers; (3) a sectoral ministry to organize privatizations within a sector such as telecommunications, railways, airports or seaports; (4) privatization by the parent (State) holding company which will then systematically divest itself of its subsidiaries such as IRI in Italy, SOGITEX in Tunisia, or CORFO in Chile; or (5) a special government agency or trust such as the Asset Privatization Trust in the Philippines which privatizes and sells assets of companies under its jurisdiction as approved by the Cabinet-level Committee for Privatization.

B. Costs of Privatization:

The following examples of costs should also be considered and carefully planned for in developing an overall scheme for privatization.

(1) **Transaction Costs:**

(i) financial restructuring costs (e.g., settlement or assumption of debt, loan or loan guarantee obligations, other financial liabilities, tax arrears, recapitalization, and physical rehabilitation);

(ii) administrative costs (e.g., advisory, legal, investment banking, underwriting, insurance, loan guarantees, brokerage fees and commissions, discounts on shares as well as leveraged or credit transactions for purchasing shares);

(iii) employment claims (e.g., severance pay, pension plans, unemployment insurance, retraining, health and insurance claims).

(2) **Residual Costs:** Also important to consider are residual liabilities from the assumption of debt by the State or by the new private owner/investor; net capital losses; and initial planning, feasibility studies, evaluation costs and pre-privatization planning.

C. Financing Privatization: Resource Mobilization

(1) **Private Capital Markets:** It is difficult to gauge actual liquidity in an undeveloped or non-existent capital market (i.e. "money under the mattress" type of investment). However, despite this apparent lack of liquidity, capital markets and public voucher schemes are often very responsive to public offerings of shares.[8]

(2) **Credit:** The availability of credit will often determine the method and success of privatization. It may also influence the final decision in choosing the specific option or options for privatization (e.g., whether to use a public offering, private sale, leveraged management/employee buy-out). Although the private sector tends to rely heavily on banks to provide credit, in certain circumstances, individual investors may wish to pool their funds in trusts or investment clubs. If there is insufficient liquidity in the economy, special credit mechanisms may need to be established by the Government in order to support a successful privatization program.

(3) **Debt Equity Swaps:** Debt equity swaps are usually formulated for purposes of debt relief, but may also facilitate privatization when eligible debt instruments may be purchased and/or exchanged for equity positions in SOEs. For example, debt equity swaps were used in Mexico to privatize a ceramic tile company and a fish processing company. Further, Mexican debt being traded at a discount on the secondary market was purchased by a conglomerate of foreign investors and swapped for equity in the copper mining industry.

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[8] For example, the Jamaican public offering of shares of the National Commercial Bank (NCB) was preceded by an extensive education campaign on the nature of capital markets and shares which ultimately resulted in NCB shares being oversubscribed by 2.7 times. Further, the privatization of Barclay's Bank in Kenya was oversubscribed by 7 times, including by a number of first time rural subscribers. In the end, Barclay's shares were issued by lottery. Also, in Togo, the Societe Togolaise de Siderurgie successfully floated an increase in shares to finance a new line of steel machinery equivalent to $1.3 million. Additionally, the privatization of the 33 pension plans in Chile resulted in better management and increased liquidity in the market by the creation of very strong institutional investors.

CONCLUSION

Privatization is a complex, time-consuming and difficult process that could result in a better managed and more productive economy as well as greater political stability. The risks and the possibility of failure as well as the upheaval caused by privatization must be balanced against the political and economic gains in the end. If, however, a strategic plan for privatization is well-designed and smoothly implemented, the overall political success and social benefits may be well worth the effort.

Annexes: Case Studies
Sample Transactional Document

ANNEXES

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ANNEX A: CASE STUDIES*

MALAYSIA

SRI LANKA

TOGO

* These case studies are summaries of larger reports issued by the World Bank.

CASE STUDY: MALAYSIA

Malaysia has used a variety of privatization techniques, including the sale of shares to the public, leasing, and entering into management contracts with foreign firms. The Malaysian privatization effort has been fairly well-structured and systematic with special attention being given the need to maintain ethnic balance. The Malaysian Government encouraged public sector-led growth in the 1970s, and adopted the New Economic Policy; however, the results were disappointing. The Government then decided to divest itself of some of its large holdings in state-owned enterprises, and began a campaign for privatization in 1983, culminating in the issuance of "Guidelines on Privatization," Economic Planning Unit, Prime Minister's Department, Kuala Lampur, January 1985.[1]

The principles of privatization as set forth in the Guidelines were intended, *inter alia*, to relieve the Government of the financial burden of keeping non-profitable SOEs afloat; to promote efficiency, competition and productivity of these SOEs thereby improving the condition of the overall economy; and to encourage private investment and reduce the size of the public sector. Moreover, the Government was committed to preserving and protecting the private ownership and entrepreneurial interests of the Bumiputera (the indigenous, ethnic Malay population) so that each privatization will result in not less than 30% Bumiputera ownership. And, apart from formulating these guidelines for privatization, the Government also set up an institutional framework in which to implement its program for privatization.[2]

Malaysian Airlines System

The Malaysian Airlines System (MAS) Berhad is the national airline of Malaysia. The federal government of Malaysia owned 90% of its shares along with the states of Sabah and Sarawak owning 5% each. (MAS has two subsidiaries involved in trucking and coach transportation for MAS travelers.) Although the operations of MAS were generally profitable, increasing losses spurred the Government's decision to offer its shares in a public offering in September 1985. In preparation for privatization, MAS underwent significant capital restructuring and management changes to increase productivity resulting in returns on shareholder investment going from 7% in 1982 to nearly 36% in 1985.

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[1] See footnote 3 to World Bank Technical Paper No. 89, Vol. II, H. Nankani, "Techniques of Privatization of State-Owned Enterprises," at 64, hereinafter referred to as "Vol. II."

[2] The Government established an inter-departmental committee called the Privatization (Main) Committee under the direction of the Director General for the Economic Planning Unit. Additionally, a separate Privatization Secretariat was established under the leadership of the Director of the Privatization Task Force. (*See* Vol. II at 65.)

A new share subscription of 70 million new shares was offered to the public. The Government's 35 million shares in MAS were also offered for sale to Government-approved Bumiputera institutions. Of the 70 million new shares, 17.5 million shares was reserved for MAS employees; 49.5 million was offered to Malaysian individuals and institution; and 3 million was reserved for Bumiputera institutions.[3] MAS was the first wholly-owned Government limited liability corporation to offer its shares to the public, who responded by oversubscribing the shares 6.6 times.

As a result of this public offering, MAS received M$126 million from the sale of 70 million shares, and the Government received M$63 million from the sale of 35 million shares. Moreover, the Government's equity ownership of MAS was reduced from 90% to 63%, and the shares of Sabah and Sarawak went down from 5% to 4% each. The public acquired 30% of MAS's share capital. This public offering was followed by a private placement of 52.5 million shares in October 1986 and 20 million shares in December 1986.[4] The Government still controls MAS with a 42% equity interest in it as of June 1987, and has the right to appoint the managing director as well as six other company directors. Despite this however, the example of MAS demonstrates that divestiture of Government ownership, if not actual control, can still support a privatization agenda. Privatization may even support the creation of robust capital markets.

Malaysian International Shipping Corporation

The Malaysian International Shipping Corporation (MISC) was formed in November 1968 as a joint venture between the Government and a group of private entrepreneurs. The ownership of MISC was later expanded to include the states of Sabah, Sarawak, Selongor, Penang, Jehor and Pahang. The federal Government's shareholding in MISC amounted to 36.8%. and the other five states held 4% each for a total aggregate of public ownership of approximately 61%.[5]

Reducing the Government's equity in MISC was seriously contemplated since Government loans and Government-backed loan guarantees for MISC's borrowing in support of its shipping operations was putting tremendous financial pressure on the Government. MISC's debt-to-equity ratio of about 10:1 was extremely high since only 10% of its net worth was being financed with shareholder funds. The Malaysian Government hoped that the dilution of its ownership in MISC, a reduction in MISC's debt-to-equity ratio, and terminating the practice of issuing Government loan guarantees would improve the financial picture of MISC and relieve the Government of some of its financial burden.

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[3] *See* Vol. II at 72.

[4] Ibid. at 74.

[5] Ibid. at 76.

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Nearly 85 million shares were offered to the public by 11 major shareholders of MISC. As a result of this public offering, Government equity in MISC (both federal and state) was reduced from 60.8% to 48.6%.[6] Moreover, the Government was given a special or "golden" share which enables it to ensure that MISC's operations and functions are consistent with Government policy. However, this "golden share" does not give the Government the right to appoint directors to the Board of MISC. Further, the debt-to-equity ratio improved from 10:1 to 3:1 since the pre-privatization recapitalization resulted in a fresh capital infusion. (The value of the shares was deliberately kept low, and consequently oversubscribed, in order to guarantee widespread public ownership.) But as a result, MISC was better able subsequently to raise its own funds without having to rely on Government loans or loan guarantees.

In conclusion, the Malaysian examples demonstrate that "denationalization" or the dilution of the Government's ownership interest in public companies can help relieve the Government of its debt burden in keeping such enterprises afloat, and may ultimately make such companies more financially sound.

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[6] Ibid. at 82, 83.

CASE STUDY: SRI LANKA

Sri Lanka has experimented with a variety of techniques of privatization including full divestiture of the Government's ownership of a particular enterprise: reorganizing SOEs and selling portions of it as going concerns; liquidating SOEs; fragmenting SOEs into newly created subsidiaries which are then sold to the private sector; and entering into management contracts and joint ventures with foreign firms.

Sri Lanka has a large and complex public sector plagued with a number of severe problems.[7] Fueled by the need to increase efficiency and answer consumer demands, the Government embarked on a program for privatization with a high degree of political commitment. Serious efforts at reorganizing the public sector began in 1977 when the Government then in power began to reduce subsidies, abolish exchange controls, change exchange rate policy generally and began to institute a more market-based economy.[8]

Further, beginning in the 1980's, certain public companies were converted into limited liability companies with the Government retaining a controlling interest in such enterprises. The Government founded the Committee on Public Enterprises (the "Committee") in 1980 which was designed to facilitate and centralize planning for privatization of SOEs on a transactional basis. Moreover, the Treasury drafted legislation in 1982 with the assistance of the Committee that provided for the legal conversion of public corporations and Government-owned business undertakings ("GOBUs") into joint-stock companies. This legislation was enacted on May 15, 1987, and was designed to facilitate the conversion of SOEs into private companies.

State Rubber Manufacturing Corporation

The State Rubber Manufacturing Corporation (SRMC) has eight factories primarily located in rubber-producing areas of Sri Lanka. Despite its profit-making margin, the Government decided to liquidate SRMC and create a new joint-stock company in its place. Accordingly, SRMC was dissolved on December 31, 1984 and a new joint-stock company that was 60% Government-owned was formed. The remaining 40% of the shares were to be offered for sale to former SRMC employees and the public. The total shares of this new

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[7] Sri Lanka has a variety of public sector enterprises. For example, there are public corporations governed by the State Industrial Corporations Act of 1957 or, alternatively, the Finance Act of 1971; Government enterprises such as capital infrastructure undertakings such as railways and telecommunications;Government-Owned Business Undertakings conscripted into the public sector under the nationalization program under the authority of the Business Undertakings (Acquisition) Act of 1971; wholly Government-owned companies where the Government owns 100% of the SOE's shares; and public companies governed by the Companies Act. *See* Vol. II at 114.

[8] Ibid. at 115.

limited liability corporation amounted to 7.8 million valued at Rs. 78 million.[9] Of these shares, the former workers of SRMC bought less than 1%. The balance of the shares were acquired by the Treasury. Since the legal conversion of the company, profits have steadily improved and a joint venture with a Japanese firm is being contemplated although it has not yet been consummated. It is not clear why the Government-owned shares have not been offered to the public at this stage.[10]

Cooperative Wholesale Establishment

Sri Lanka has also used the method of creating subsidiaries or joint ventures as a means of privatizing and eliminating Government ownership and control. Public corporations are often reorganized into subsidiaries operating in the form of limited liability companies. One such example is the Cooperative Wholesale Establishment (CWE) which was established in 1950 by an act of Parliament as a conglomerate or state holding company. Three of its subsidiary operations were targeted for conversion into joint-stock companies. Two of the three targeted subsidiaries, namely Sathosa Computer Services and Sathosa Printers, Ltd., were both set up as joint ventures with CWE and other private corporations as shareholders.[11]

The third subsidiary, Lanka Milk Foods, Ltd., was listed on the Sri Lanka Stock Exchange with its shares trading at Rs. 10 per share. During the first year of its operations as a publicly traded company, the public subscribed to 10,000 shares; the remaining balance of the 2.6 million shares offered to the public was acquired by CWE.[12] Although a profitable operation, CWE once again had to subscribe to the outstanding shares of Lanka Milk in 1986. It is not clear why the public are such reluctant investors in this company.[13]

However, in assessing the advantages of establishing subsidiaries and spinning them off to the private sector, the Sri Lankan Government should have ensured that the liabilities and responsibilities of the parent company in relation to its subsidiary (which may now be privately owned) be clearly set forth in the law. Otherwise, the financial and managerial

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[9] Ibid. at 122.

[10] Ibid. at 123.

[11] Ibid. at 124, 125.

[12] Ibid. at 125.

[13] Other examples of the formation of subsidiaries as a method of privatization may be illustrated by the Cement Corporation which created Lanka Cement as its subsidiary which it jointly owns with Petroleum Corporation and the Bank of Ceylon. The Ceramics Corporation also formed three subsidiaries as joint venture with foreign firms.

confusion which may result may destroy the purpose of privatization in the first place.

National Textiles Corporation

As an intermediate step readying the SOE for privatization, the Sri Lanka Government has entered into management contracts with foreign companies to update outmoded equipment and technologies, change the management structure, and improve productivity to increase profitability and prepare the SOEs for private ownership. Although these contracts have been criticized, they have helped ease the transition to a more competitive and market-oriented operation.

For example, four state-owned textile mills operated more or less as a monopoly because of a nearly complete State ban on foreign, imported textiles.[14] Yet due to outmoded technology, losses of these mills ran up to Rs. 400 million in 1979.[15] The Government then decided to enter into management contracts with U.K. and Indian firms, possibly with a view to transforming these arrangements into joint ventures. Thulhiriya Textile Mills is being rum by a consortium of three companies and is no longer being subsidized by the Government. Moreover, former loans are being paid off, and dividend earnings on shares are being issued. Pugoda Textile Mills was being managed by Lakshmi Textiles of India from 1981. It began to show profits in 1985 by significantly increasing its sales as well as showing enormous gains in employee remittances. Veyangoda Textile Mills is now being managed with a U.K. firm, Tootals Ltd., under what is believed to be a joint venture agreement where Tootals has responsibility for management and daily operations of the mill. The mill began to show profits in 1986 and has already had an increase of over 100% in employee earnings per month. All of these contracts are up for renewal, but it is not known whether they have been renewed.[16]

Despite the successes of these management contract arrangements, there is no apparent change in the structure or the nature of Government control and ownership of these SOEs. However, it may be the first important step in preparing these companies for privatization in the near future. Sri Lanka has demonstrated its political willingness to privatize and has taken a creative approach by developing different methods of privatizing.

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[14] Ibid. at 128.

[15] Id.

[16] Ibid. at 129.

CASE STUDY: TOGO

The Government of Togo has also taken a creative and widely diversified approach to privatization by liquidating non-performing parts of an SOE's portfolio and selling any remaining assets; entering into leasing arrangements with the private sector; and diluting its ownership of SOEs by offering the Government's shares to the public. The Government's initiative were essentially fueled by the unprofitability of these SOEs, the debt burden on the State for financing the continuing operational losses, and the cash drain caused by servicing the foreign and domestic commercial bank obligations of these SOEs.

The Government established the Ministry of State Enterprises in 1984 which classified approximately 72 SOEs into the following categories: 40 SOEs were to remain in the public sector; 8 SOEs were to be liquidated, and 24 SOEs were to be privatized. In its effort to privatize, the Government decided to (1)liquidate certain SOEs and sell their assets; (2) sell SOE shares to the private sector through joint venture arrangements; and (3) lease other SOEs to the private sector.

ITT/TOGOTEX (Textile Companies)

Both ITT and TOGOTEX were joint stock companies which were put into receivership. Their assets were sold to foreign companies, and the Government of Togo assumed their financial and contractual liabilities. The Government, with the assistance of the International Finance Corporation, decided to sell both mills to a consortium of U.S. and Korean investors known as the Pen Africa Company. The Pen Africa Company negotiated bids for the mills with the Government. The bidders agreed to purchase the mills for U.S.$9.3 million, and agreed to make an additional capital investment of U.S.$20.4 million. Approximately 35% of the project financing was to be equity-financed, and about 65% was to be debt-financed through loans made available by IFC, Banque Ouest Africaine de Developpement and the Togolese Government. Additionally, the Government signed a convention d'etablissement as part of this privatization deal ensuring that it will provide a stable and favorable policy regime in support of, *inter alia*, the free transferability of capital and earnings and agreed to make financial and other guarantees.

Industries Togolaises des Plastiques

This company entered into a restructuring plan between the shareholders (the Government of Togo, the Danish Development Fund, Daoplast and Pormotic) whereby the debt and tax claims of the Government and the Danish Development Fund were converted into equity. Further, fresh capital shares were issued by the company allowing for a nearly complete changeover in the investors. Government equity in the company has been reduced from 90% to 42%, and residual Government-owned shares may also be sold in the near future.

Societe Nationale Siderugie

This steel-making company was 100% Government-owned and was incurring tremendous losses since its production far exceeded the sales of its commodities. The plant was closed in 1983 by the Government upon the recommendation of the Word Bank. The Government then negotiated a leasing arrangement with John Moore, a U.S. entrepreneur, giving him the right to use the land, building, equipment and other facilities for ten years for a fee of U.S.$175,000 per year.[17] Other terms of the lease ensure that the company may import certain necessary raw materials duty-free, and benefit from a Government-imposed tariff protecting the company against foreign imports. When the plant reopened under new management, the employee force was reduced from 300 to 140 workers.

After the first year of operations under new management, preferred shares with a minimum dividend of 10% were issued through local banks since Togo does not have a stock exchange. As a result, 14% of the company's equity is now owned by Togolese investors, and 20% by other African interests.[18] The Government's share is now approximately 66%, and may be further diluted in the future.

The Togolese example demonstrates that a pragmatic and transactional approach to privatization is both necessary and workable. However, the Government failed to take the necessary steps to institute a legal and regulatory framework in order to support privatization. Without these fundamental structural changes, as opposed to just individual deals, there still may not be any lasting or permanent economic change despite the Government's program for privatization.

[17] Ibid. at 141-142.

[18] Ibid. at 142.

ANNEX B: SAMPLE TRANSACTIONAL DOCUMENTS

TERM SHEET FOR PRIVATIZATION

GENERAL INFORMATION:

Name of Owner:

If Federal Government, State, Municipality or Other Public Body, name of Relevant Department or Office:

Name of Responsible Official:

Address of Owner:

Type of Business or Property:

Location/Address:

Title to Property (Real or Personal):

Incorporation/Registration Documents:

INFORMATION ON ASSETS BEING PRIVATIZED:

Manner of Sale (e.g., sale at auction, sealed bids, negotiated contract):

Balance Sheet Value (Appraised Value) of Property:

Stock of Material Goods (Inventory):

Other Assets (e.g., Patent, Trademarks, stocks, bonds)

Liabilities:

Outstanding Rent
Outstanding Utilities
Suppliers
Creditors
Employee Salaries
Employee Benefits
Taxes (Arrears)
Customs Duties
Fines
Bank Loans (Principal and Interest)
Outstanding Dividends or Other Liabilities