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CASE STUDIES ON PRIVATIZATION IN THE PHILIPPINES: PHILIPPINE AIRLINES, INC. (PAL)

Final

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EXHIBITS

Note: Exhibit 1 precedes the case study text. Exhibits 2-22 follow the case study and precede the Epilogue.

Exhibit 1: Definition of Terms

The following are definitions of commonly used terms in the airline industry:

Available Seat Kilometers (ASK): The unit of measure of the available passenger capacity of an airline. It is computed by geographic sectors, with the sector distance multiplied by the number of seats available on that particular sector.

Available Ton Kilometers (ATK): The unit of measure of the total available passenger, cargo, excess baggage, and mail weight capacity of an airline. ATK is measured in tons and, like ASK, is computed by geographic sectors. ATK is computed by multiplying the airline's available capacity by the sector distance.

Entitlements: Traffic rights granted by a foreign government to an airline for the transport of passengers and cargo to its country for a particular duration. Entitlements are expressed as the number of aircraft allowed to travel to a country per week.

Fiscal Year: PAL's fiscal year begins on April 1 and ends on March 31; e.g. fiscal year 1991 began on April 1, 1990 and ended on March 31, 1991.

Freight Ton Kilometers (FTK): The unit of measure of the freight traffic volume of an airline for a particular sector. FTK is computed by multiplying the freight load tonnage of a particular sector by the sector distance.

Freight Yield: The average revenue per passenger kilometer of an airline. Freight yield is calculated by dividing the freight traffic revenue by the total freight ton kilometers.

Gross Yield: The unit of measure of the average revenue obtained per revenue ton kilometers (RTK). Gross yield is calculated by dividing the total traffic revenue of an airline by its total revenue ton kilometers (RTK).

Net Yield: The net average revenue obtained per revenue ton kilometers (RTK).

Overall Load Factor: The rate of utilization of the available capacity of an airline. The figure is arrived at by dividing the revenue ton kilometers (RTK) by the available ton kilometers (ATK).

Passenger Load Factor: The rate of utilization of the total passenger capacity of an airline. The figure is calculated by dividing the revenue passenger kilometers (RPK) by the available seat kilometers (ASK).

Passenger Yield: The average revenue obtained per passenger kilometer. Passenger yield is calculated by dividing the passenger traffic revenue by the total revenue passenger kilometers (RPK).

Revenue Passenger Kilometers (RPK): The unit of measure of the passenger traffic volume of an airline for a particular sector. RPK is computed by multiplying the total number of passengers carried on a particular sector by the sector distance.

Revenue Ton Kilometers (RTK): The unit of measure of the total traffic volume of an airline. RFK is calculated by multiplying the total cargo, passenger, excess baggage, and mail tonnage of a sector by the sector's distance.

Traffic Revenue: Revenue derived from the carriage of freight, excess baggage, mail, and passengers.

Trunkline Airports: Secondary airports catering to small aircraft that service rural or provincial areas.

Turbo-props: Aircraft with turbo-propeller engines, which combine turbine (jet) propulsion with standard propeller engines.

CASE STUDY

In early November 1991, Jesus P. Estanislao, Secretary of Finance of the Republic of the Philippines under President Corazon C. Aquino, scanned the newspapers enroute to a very important meeting with the Committee on Privatization (COP). The headlines and the accompanying articles in the three major papers--which he made a habit of reading in the car as his driver maneuvered through Manila's traffic gridlock--did nothing to ease the Secretary's mind:

"IMF UNLIKELY TO CONCEDE HIGHER 1992 BUDGET DEFICIT TARGETS"
"INFLATION RATE RISES TO 19%"
"POLITICIANS ALIGNING FORCES FOR MAY NATIONAL ELECTIONS"

As Secretary of Finance, Estanislao was responsible for spearheading the government's major economic reform initiatives and for balancing the national budget. The Philippine economy was lagging behind its ASEAN neighbors many times over. Estanislao had already been accused of being overly influenced by the IMF as a result of having accepted harsh fiscal and monetary constraints in exchange for additional loans. The Aquino administration was nearing the end of its tenure, and the season for political grandstanding was just beginning. There was certain to be more criticism ahead.

To add to these concerns, Estanislao now had to resolve a problem that had been nagging the Aquino administration for the last three years: when and how to privatize Philippine Airlines? He mentally reviewed the situation and the various options at hand.

Philippine Airlines (PAL), the flag carrier of the Philippines and Asia's first airline, had undergone a drastic financial restructuring two months earlier, through a US$521 million debt assumption in exchange for an 80% ownership of the company. This was necessary to improve PAL's balance sheet and to prepare the company for privatization.

As a result of the restructuring, Philippine Airlines now presented itself as an attractive candidate for privatization, with a positive net worth, a modest refleeting program, a streamlined organizational structure, and an international network based in a potential Asian hub. However, the airline had suffered losses of nearly P2.2 billion (approximately US$82.4 million) during the previous fiscal year, primarily due to sharp increases in operating expenses and reduced air travel during the Gulf War.[1] Potential investors reviewing the company's financial performance would not be impressed by the track record.

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[1]The peso-dollar exchange rate at the time was P26.70 to $1.00.

This case was written by the Intrados/International Management Group. It is designed to serve as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

The recommendation submitted to the Committee on Privatization (COP), which Estanislao chaired in his capacity as Secretary of Finance, entailed privatizing the airline by offering 67 percent of the airline's equity to a consortium of private investors. A second option was to raise equity through a public offering on the Philippine stock exchange. Estanislao also considered the possibility of postponing the privatization for a year or two, in anticipation that improved economic conditions would result in a higher sale price.

Secretary Estanislao was well aware that there were numerous factors to be considered when making his decision: the company's erratic financial performance in recent years, the capability of the local capital market to absorb a large equity issue, the level of public interest in this transaction, and the uncertainty of finding potential investors. In addition to these considerations, politicians were ready to pounce on him for any perceived error of judgment.

As the secretary saw it, there were benefits and uncertainties associated with each of the options. The success of the privatization and the long-term viability of the airline under private ownership were important considerations of public interest that had to be carefully weighed. The short- and long-term consequences of Estanislao's decision would greatly affect the lives of many Filipinos.

I. The Philippine Privatization Program

Under the Marcos administration, the Philippine economy had plunged into crisis. GNP declined dramatically, accompanied by a steady increase in Philippine foreign debt. Capital flight continued unabated, due to widespread discontent and social unrest over graft and corruption within the government. A large deficit became a regular feature of the government's financial performance during the years prior to 1986 (Exhibit 2).

Immediately following the popular revolution which toppled the Marcos administration in 1986, the Aquino administration undertook the task of reviving the country's failing economy. The strategic objectives of the administration's economic reform program were aimed at accelerated growth and increased economic efficiency, alleviation of poverty, promotion of social justice, and the reduction of government involvement and interference in the economy. To finance these reforms, the government earmarked revenues generated by privatization.

The Philippine Privatization Program was initiated by the Philippine Government on December 8, 1986 with the issuance of Proclamation No. 50 by President Corazon Aquino. The program was intended to dispose of the government's share in state-owned enterprises over a five-year period, through December 1991.

The privatization program was a major vehicle for attaining the strategic objectives of Aquino's development plan. In addition to addressing its social justice component by financing agrarian reform, the program sought to reduce government involvement in enterprises more appropriately managed by the private sector and to focus government attention and resources on more pressing concerns, while enhancing the economic benefits which were expected to accrue from the privatization of state-owned entities.

The immediate target of the government's privatization program were Government-Owned and Controlled Corporations (GOCCs) and Transferred Assets (TAs), which were non-performing assets originally under private ownership but foreclosed by government-owned financial institutions. Under these broad categories were shares of stock held by the government, obligations or receivables due to government financial institutions, and real and personal property owned by the government or by various government institutions.

Each of the GOCCs was assessed to determine whether it should be retained by the government, privatized, liquidated, consolidated with another entity, or commercialized. Out of 301 GOCCs in the government corporate sector when Aquino assumed office, 122 GOCCs were targeted for privatization.

The Committee on Privatization

Proclamation No. 50 provided for the creation of the Committee on Privatization (COP) to oversee the government's privatization program. The COP was comprised of five cabinet-level officials: the Secretary of Finance as chairman, Secretary of Budget and Management, Secretary of Justice, Secretary of Trade and Industry, and the Director of the National Economic and Development Authority. A Technical Committee provided support to COP.

The Committee on Privatization was charged with formulating policies and general guidelines for the privatization program; approving the sale and disposition of GOCCs, TAs, and other assets; and monitoring the progress of privatization activities. It also designated and supervised the disposition entities (DEs) responsible for the actual marketing of specific government assets identified for disposition.

A total of 14 DEs were under the supervision of the COP. These included the Asset Privatization Trust (APT), the Development Bank of the Philippines (DBP), the National Development Company (NDC), the Social Security System, the Philippine National Bank (PNB), the Government Service Insurance System (GSIS), and several other government departments and agencies (Exhibit 3). Each DE was responsible for drawing up privatization plans for the GOCCs assigned to it for disposition. The privatization plan indicated the extent of privatization of the company, the mode and method of disposition, and timetable for implementation. If the plan was approved by the COP, it was then implemented by the DE. The DEs dealt directly with potential bidders and drew up bidding guidelines and other documents relevant to the sale of the company.

Once the bidding or negotiated sale was conducted, the DE went back to the COP for final clearance regarding the price and buyer.

Of the 122 firms earmarked for privatization at the outset of the program, 80 were the responsibility of the NDC, APT, PNB and GSIS. These represented approximately 87 percent of the total asset value of firms initially slated for privatization. Of the disposition entities, the GSIS held in its portfolio a number of companies which were considered to be among the most attractive assets for privatization, including the Commercial Bank of Manila (Combank), the Manila Hotel, the Philippine Plaza, and Philippine Airlines.

The Asset Privatization Trust

Proclamation No. 50 also created the Asset Privatization Trust. The APT was established to serve as the primary disposition entity for the privatization of nearly 400 TAs assumed from the Development Bank of the Philippines and the Philippine National Bank. It was also tasked with the disposition of 26 GOCCs. Like the COP, the APT was initially created for a five-year period, to end December 1991.

II. Philippine Airlines[2]

In late 1991, Philippine Airlines (PAL) was the flag carrier of the Philippines, an archipelago in Southeast Asia composed of over 7,100 islands. PAL has the distinction of being Asia's first airline. Its domestic network serviced 43 points within the Philippine archipelago, while its international network covered 32 cities in 23 countries worldwide. The airline's base operations were located in Manila.

PAL employed over 11,500 individuals, including administrative and management personnel, cockpit and cabin crew, ground engineers and technicians, and rank and file employees. This workforce managed the airline's flight operations and other related services such as cargo handling, ground handling, catering, in-flight sales, refueling, and aircraft maintenance services. PAL's fleet was composed of 54 aircraft, ranging from large 747-200s to smaller SD 360 aircraft. Other physical facilities included a technical center and maintenance base complex, an in-flight center with a training center for crew members and a large in-flight kitchen, a data center housing two IBM 4381 and two IBM 3090 mainframe computers, an international cargo terminal, and an elaborate marketing network composed of over 110 ticket offices in the Philippines, plus 37 ticket offices and 44 general sales agents around the world. PAL's head offices were located in Makati, Metro Manila.

[2]A list of terms commonly used in the airline industry is provided as Exhibit 1.

History

Andres Soriano, a leading Filipino industrialist, founded PAL on February 26, 1941, as a joint venture with a number of other businessmen. The company's only asset at the time it began operations on March 15 of that year was a small twin-engine Beech Model 18 transport, which flew one flight daily between Manila and Baguio. The company acquired a second Model 18 in April, and soon PAL was servicing six points in the country. With the outbreak of World War II, however, the company's planes were commandeered by the military. They were eventually destroyed during the course of the war.

On February 14, 1946, PAL resumed its operations, with Andres Soriano remaining as president. It had a fleet of five twin-engine Douglas DC-3s acquired from the military, servicing eight points in the country. In July of that year, PAL became the first Asian carrier to cross the Pacific, flying American servicemen back to the United States using chartered four-engine DC-4s. On December 3, PAL began scheduled (as opposed to chartered) service between Manila and San Francisco. The following year, PAL acquired its own DC-4s and began scheduled service to Europe.

In 1948, Philippine Airlines bought out two of its competitors and the government acquired majority control of the corporation. Through the acquisition of its competitors' assets, PAL had sufficient aircraft to operate scheduled domestic flights, thereby becoming the country's only scheduled airline as well as its flag carrier. Over the next six years, Philippine Airlines purchased additional aircraft to meet the growing demand for flights to and from the Philippines. By 1952, the company operated flights to 16 cities abroad. In 1953, twin-engine aircraft were added to PAL's fleet to service the Hong Kong, Taipei, and Bangkok routes. The development of secondary, trunkline airports in rural and provincial areas allowed the same aircraft to be utilized for domestic service as well.

In March 1954, the government suspended all of PAL's international services for financial reasons and subsequently sold all of the aircraft which had serviced those routes. At the same time, however, PAL expanded its domestic operations. With the acquisition of a single-engine aircraft, PAL was able to offer domestic service to 17 points in the Visayas and Mindanao regions, which could not previously be serviced by twin-engine planes. In 1957, PAL purchased a larger four-engine turbo-prop aircraft for flights to the larger cities in its domestic network.

In the 1960s, with the improvement and opening of airports within the country, PAL expanded its domestic service to 72 points and upgraded its domestic fleet. As air traffic increased, turbo-prop aircraft were gradually phased in on trunkline routes. In May 1966, domestic jet service was introduced for Davao, Cebu, and Bacolod. By the late 1960s, all of PAL's turbo-prop aircraft had been sold or replaced by jets.

PAL also underwent several rapid changes of leadership during the 1960s. In March 1961, Eduardo E. Romualdez replaced the airline's founder, Andres Soriano, as president. Less than a year later, Renato L. Baretto was elected president of the company. Baretto resumed PAL's international services in June 1962 with the acquisition of a Douglas DC-8 jetliner.

Baretto left PAL in August 1963, and Rafael G. Igoa assumed the presidency. Like Romualdez and Baretto, Igoa's tenure in office was brief. In January 1965, PAL came under the control of private investors when the government auctioned off half of its shares. Benigno P. Toda emerged as the majority shareholder, with 74% ownership, and was elected president and chairman of the board. The National Development Corporation held a 25% stake, with the remaining shares divided among several other investors.

On January 1, 1974, the Marcos government decreed that PAL was the only domestic carrier permitted to operate scheduled flights. Other domestic carriers would be allowed to offer charter flights only. Despite this protected status, the company experienced heavy losses. As a result, PAL's major shareholder and president, Benigno Toda, relinquished control of the airline to the government in 1977. His shares were acquired by the Government Service Insurance System (GSIS).

GSIS president and chairman, Roman A. Cruz, took over as president of PAL, a position he held for nine years. Under Cruz, more jets were added to the airline's international fleet, replacing aircraft purchased in the 1960s. Construction of the PAL in-flight center, technical center, and data center was also initiated during this period.

The end of the Marcos era in 1986 brought sweeping changes to PAL. Between 1986 and 1989, the company's new president, Dante G. Santos, embarked on a massive program to modernize its domestic fleet, acquiring three new aircraft. In March 1991, Feliciano Belmonte, Jr., then president of the GSIS, succeeded Santos as PAL president. The Aquino government had by this time decided to accelerate the divestiture of Philippine Airlines under the five-year privatization program.

International Passenger and Freight Service

In late 1991, Philippine Airlines provided international service to 32 cities in 23 countries worldwide, including destinations in North America, Australia, Asia, Europe, and the Middle East. Agreements entered into by PAL over the years permitted the company to operate close to 200 flights a week to its international destinations (Exhibits 4 and 5). PAL's international network carried over 11.5 billion ASK (Available Seat Kilometers) in fiscal year 1991 alone. The North American sector represented 42% of the total, Asia accounted for 28%, Europe 20%, and the Middle East 10% (Exhibit 6). The profitability of each sector had fluctuated over the years, as measured by pesos per RPK (Exhibit 7). Major airline manufacturers predicted significant air traffic growth worldwide through the year 2000, with a major increase expected in routes to Asia from Europe and North America, and on routes within Asia; PAL's operating assumptions through 1996 reflected these projections (Exhibits 6, 7 and 8).

The North American route had four destinations: Honolulu, Los Angeles, San Francisco, and New York. PAL operated 13 flights weekly on this route. Destinations in Europe included Paris, Frankfurt, and London. PAL flew to Paris and London three times a week and to Frankfurt five times weekly. Most of PAL's international flights were within Asia, with over 15 destinations in this region. PAL provided daily service from Manila to most of its Asian destinations, and three flights weekly from Cebu to Tokyo. Ho Chi Minh City and Hong Kong had sufficient passenger traffic to sustain two and three flights a day, respectively.

PAL's other international routes were to Australia, Pakistan, and the Middle East. Australia was served five times a week from Manila, plus weekly flights from Cebu to Sydney and Melbourne. Flights to Dubai and Saudi Arabia served their destinations six times weekly, en route to Europe. PAL also flew to Karachi, Pakistan six times a week.

PAL's passenger load factor on its international route network, which averaged 74.3% between fiscal years 1987 and 1991, was high in comparison to other Asian airlines (Exhibit 9). This was particularly significant in light of numerous events during those years--including the 1986 coup d'état, the Gulf War, and natural calamities--which had a negative impact on the market for air travel.

PAL's international freight network was identical to its passenger route network. With no dedicated cargo planes, its freight carriage capacity was derived from the cargo compartment capacity of its international flights. Between 1987 and 1990, PAL's international freight service grew steadily, from 207.6 million Freight Ton Kilometers (FTK) in 1987 to 309 million FTK in 1990 (Exhibit 10). Although this figure dropped to 256.6 FTK in fiscal year 1991, international freight still accounted for 11.3% of the airline's net income from international services that year. This was remarkable considering the negative impact of the Gulf War on PAL's international operations during that period.

The strategic location of the Philippines at the center of the Asian-Pacific region made its international network all the more attractive, given the growth potential of this sector and Manila's potential as an Asian hub. PAL's protected status as the country's flag carrier further enhanced its value in the region. The company's inventory of traffic rights, including unutilized entitlements, was a key to PAL's strategy for growth and profitability. In 1991, the company--together with the Philippine government--aimed to increase its inventory of traffic rights, particularly in Asia. It sought to gain additional traffic rights to Japan, Vietnam, and Italy because of perceived market opportunities. As of the last quarter of 1991, negotiations were underway to allow PAL to service Canada, Oman, and Qatar, and new rights had been granted by Dubai. Moreover, an agreement between PAL and Aeroflot regarding traffic rights to the USSR had been reached and was pending ratification by the two governments involved. Existing agreements with the USA, Germany, and France had built-in mechanisms which increased PAL's traffic rights and frequency entitlements following a pre-determined timetable.

These activities to expand PAL's traffic rights worldwide took place despite the fact that in 1991, PAL had utilized only 66% of its total route entitlements as compared to its competitors, which, on average, utilized 71% of their entitlements. PAL's unused and newly acquired entitlements represented opportunities to increase revenues and to develop related markets. The value of its unused entitlements, particularly in Asia, represented a vast area for the company's growth.

Domestic Passenger and Freight Service

From its base in Manila, PAL provided domestic service to 43 points throughout the country, including 17 destinations in Luzon, 13 in Visayas, and 13 in Mindanao (Exhibit 11). From fiscal year 1987 to 1991, PAL's passenger service posted an average of 2,344.6 million ASK on its domestic network, representing an average load factor of 77.6%.

PAL's domestic freight service grew steadily from 1987, when it posted 32.4 million FTK, through 1991, when it posted over 40.8 million FTK. The 1991 figures represented an increase of 1.3 million FTK from the previous year (Exhibit 12).

Fleet

In 1991, Philippine Airlines had a modern fleet, as indicated in Table 1. Only five Airbus 300-B4s and ten BAC 1-11s were owned by PAL; the balance of the aircraft were leased (Exhibit 13).

Table 1: PAL Fleet and Network

Aircraft	No. of Aircraft	Service Network
Boeing 747-200	9	International
Boeing 737-300	9	Domestic
Airbus 300-B4	7	International
DC-10	2	International
BAC 1-11	10	Domestic (see Note)
Fokker 50	10	Domestic
SD-360	7	Domestic
Total	**54**	

Note: As of 1991, eight of the BAC 1-11s were not operational and were earmarked for disposal.

PAL's fleet size and performance were regularly evaluated, and adjustments made as necessary. In 1991, the average age of PAL's entire fleet was 6.2 years. The average age of its international fleet at the time was 10.7 years, which was comparable to most Asian airlines (Exhibit 14). In anticipation of significant increases in air traffic projected for the 1990s, and to maximize its potential share of this growing market, the company had plans to add 18 aircraft to its fleet by 1996 (four B-747s, six B-737s, three Airbus 300s, and five Fokker 50s). As of 1991, however, only four B-737s had been ordered.

Financial Performance

The financial performance of Philippine Airlines over the past two decades was never spectacular. As previously discussed, heavy financial losses prompted the major shareholder of PAL to relinquish control of the airline to the Philippine government in 1977. This development only served to further exacerbate PAL's financial condition. Under the Marcos administration, PAL became one of a number of nationalized corporations controlled by individuals close to the Marcos dictatorship. As a direct result, management policies and decisions were greatly influenced by political considerations, without due regard for the financial well being of the company. Moreover, corruption among airline officials contributed to the already troubled financial situation of the carrier. Between 1980 and 1986, PAL accumulated over US$275 million (P5.6 billion) in losses.

In 1987, following the change of government and improved political environment in the Philippines, PAL reported its first earnings in six years, with a net income of P318.1 million. Unfortunately, however, the airline's financial performance declined again the following year, with the company registering losses of P70.1 million in fiscal year 1988. While PAL's financial performance in fiscal years 1989 and 1990 seemed to indicate a turnaround, with net income of P304.6 million and P583.6 million respectively, this trend was undermined by the negative effects of the Gulf War in 1991, when the airline posted a staggering loss (Table 2).

Table 2: PAL Net Income (1987-1991)

Year	Net Income
1987	318.1
1988	-70.1
1989	304.6
1990	583.6
1991	-2,183.8

Note: Figures are in millions of pesos.

The heavy losses registered during fiscal year 1991 were due largely to increases in oil prices and insurance rates linked to the Gulf Crisis. During 1991, PAL's fuel and oil expenses for its international operations rose 56.9% (from P2.3 billion in FY 1990 to P3.6 billion in FY 1991) and the airline's insurance expenses rose 86.7% (from P63.7 million to P 118.9 million). At the same time, passenger traffic on PAL's Middle East routes declined by 36.1% (from 1,762.1 million ASK in 1989 to 1,126.3 million ASK in 1991) as a result of decreased travel on the part of Filipino overseas contract workers in the region.

The adverse impact of these negative factors on the airline's operations, combined with heavy interest payments for debts that the company had accumulated in the previous five years and a devaluation of the peso in 1991, resulted in a net loss of P2.2 billion (US$79 million) for FY 1991 (Exhibits 15 and 16).

III. Philippine Airlines Privatization

By 1988, the Aquino administration had assured the public of its commitment to privatize Philippine Airlines. There was a consensus among Philippine government officials that the airline was a liability to the government, wasting precious public funds and diverting resources and attention from more important undertakings. The government was convinced that the airline could contribute more to the economic development of the Philippines as a private company.

However, in order to attract private investors, the government had to improve the attractiveness of the airline as an investment, since PAL's nagging financial problems made it difficult to implement the privatization plan. To accomplish this objective, the government made several strategic moves which significantly addressed both the political and the financial issues relating to the privatization of the airline.

PAL Privatization Committee

Bureaucratic resistance presented a major stumbling block to the privatization of PAL. In the earliest stage of the process, the GSIS--which owned 74 percent of PAL's shares and had controlled the airline's operations since 1977--was tasked to develop and execute the privatization strategy for the company. However, the GSIS was reluctant to give up control of the airline and was not committed to the privatization. It openly expressed its reservations and used political leverage to stall if not completely derail the privatization plan. A resolution to this conflict of interest was therefore necessary if the PAL privatization was to take place.

To overcome this obstacle, the government created the Philippine Airlines Privatization Committee to assume the task of disposing of the airline. This committee was extremely visible, with the Secretary of Finance, the Governor of the Central Bank, and the President of the GSIS as its members. The Committee had the authority to rescind the appointment of the GSIS as a disposition entity, which it accomplished through the mechanism of a debt for equity transaction.

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The Department of Finance and the Central Bank held huge claims against Philippine Airlines. The government, through the Committee, offered to assume US$521 million (approximately P14.5 billion) of the airline's debts effective September 30, 1991, in exchange for equity and subsequent control of the company.[3] Given the airline's negative net worth, the GSIS was in no position to decline the offer made by its creditors, as represented by the PAL Privatization Committee. The government's proposal was thus accepted by the GSIS, and control of the airline passed to the Committee, which took over as disposition entity. As majority owners, the Committee could privatize PAL without resistance from the GSIS, a scenario which under different circumstances would have required considerable political intervention.

The creation of the PAL Privatization Committee and the debt assumption by the government were significant steps toward the privatization of PAL. Aside from easing bureaucratic resistance to the divestiture, these moves by the government also improved the attractiveness of PAL as a privatization candidate. In particular, the assumption by the government of a significant portion of the airline's debt assured potential investors that they would acquire an airline with a workable financial condition free from heavy debt obligations. More importantly, by converting debt into equity, PAL could be privatized through the sale of shares.

Debt Assumption

The US$521 million debt assumed by the national government included Central Bank short-term trade obligations, commercial bank obligations, and Paris Club obligations (Exhibit 17). In effect, the airline's long-term debt was reduced by US$101 million, its short term debt was reduced by US$334 million, and accrued interest on these debts was reduced by US$86 million.

In addition, 800 million new shares of stock, with a par value of ten pesos per share and representing 80 percent ownership in the airline, were issued to the Philippine government. This move increased PAL's capital stock by P8.0 billion (US$287 million). Additional paid-in accounts also increased, by P6.5 billion (US$234 million). After the debt assumption, the company's balance sheet showed a positive net worth (Exhibit 18).

With the airline's major debt obligations resolved, PAL management could readily draw up projections for the next five years based on improvements in the balance sheet. The projected results were very promising. Net revenue for 1992 was projected at P26 billion (US$934 million), with an expected average increase of 21.6% a year, to reach P57 billion (US$2 billion) in 1996. Over this five-year period, the airline's operating income was projected to increase at

[3]The peso-dollar exchange rate at the time was P27.83 to $1.00.

an average of 31% a year, from P2.3 billion (US$83 million) to P6.1 billion (US$219 million) (Exhibit 19).

Preparations for Privatization

In addition to the debt assumption, other measures were undertaken to address financial and business issues, which ultimately facilitated the PAL privatization. In early 1990, PAL's board of directors engaged the International Finance Corporation (IFC), which had recommended the debt assumption and its mechanics, to implement a plan of action for the privatization of the company. The IFC's recommendations focused on a number of issues; the results of their analytical studies eventually served as the basis for the PAL Privatization Plan and its representations to interested investors.

One of the key issues to be addressed was the valuation of the airline. A technical appraisal was undertaken to assess the current market value of PAL's tangible assets, including physical plants, aircraft, technical and engineering facilities, ground handling and support equipment, and training facilities. A particularly challenging aspect of the process was the valuation of PAL's intangible assets, such as its international and domestic route networks, international flight entitlements, and the government franchise itself. After the process had been completed, a working range for the airline's fair market value was formulated.

Another preparatory study recommended by the IFC entailed a comprehensive review of the airline's operational and financial projections. Statistical data on PAL's available-seat-kilometers, available-ton kilometers, revenue-passenger-kilometers, occupancy and load factors, revenue-ton-kilometers, operational expenses, and other data were compiled and analyzed in relation to market trends and macroeconomic assumptions. The operational projections and financial figures arrived at were ultimately used in presentations to potential investors.

The IFC's final study focused on the company's organizational structure. In response to the IFC's recommendations, PAL's organizational structure was significantly revamped through a corporate streamlining. To improve management efficiency, overlapping positions and functions were eliminated and reporting and responsibility lines were clearly defined (Exhibit 20).

Privatization Options

By November 1991, Secretary Estanislao was satisfied with the developments in the preparatory stage of the PAL Privatization Plan. The financial problems of the airline had been resolved, resulting in a positive net worth and promising projections for the years to come. Major improvements had been made in the organizational structure, which enhanced the efficiency of the airline's management. A fleet modernization program was also underway. PAL had indeed made substantial progress toward privatization, and the company was now an attractive privatization candidate.

However, time was running out for both the Committee on Privatization and the PAL Privatization Committee, both of which Estanislao chaired. The five-year statutory term for the COP was coming to an end, and the Aquino administration faced an uncertain future in light of the upcoming 1992 presidential elections. Secretary Estanislao realized that the time had come to choose the most profitable and appropriate mode of privatization for the airline.

Faced with this task, the Secretary carefully reviewed his options, which had been narrowed by the Department of Finance to three: to offer shares of the airline's stock through public auction; to offer shares through the equities market; or to put the privatization of the airline on hold.

The choice was not easy, given the many factors and variables to consider in privatizing an entity such as Philippine Airlines, in which an important public interest was at stake. The circumstances of the situation--the uncertainty of attracting suitable, capable, and willing buyers for an auction, combined with the proliferation of new equity issues in the stock market--made it even more difficult.

The first option called for the bidding-out of 670 million shares of the airline to a consortium of private investors, with the government retaining 130 million shares. Bidders would be required to have significant experience in airline operations.

The second option was to launch an initial public offering (IPO) of 670 million shares of PAL on the local stock market. As with the first option, the remaining 130 million shares would be retained by the government. The feasibility of this option, however, would depend upon the capacity of the equities market to absorb large equity issues.

Public share offering had been utilized as the privatization modality for the Philippine National Bank (PNB) in 1989. A total of 10.8 million shares, representing 30% of the government's total outstanding shares, were offered for sale, generating gross revenues of P1.8 billion (US$83 million). Approximately 25,000 investors participated in the public offering, thereby giving the bank the widest ownership base of any Philippine financial institution. The share offering also contributed significantly to the development of the country's equities market. According to a report issued by the PNB, the June 1989 listing in the country's two stock exchanges added approximately P4.7 billion (US$216 million) to total market capitalization in just two months. It also brought a large number of new participants into the market and pioneered the way for public stock offering to be considered as a privatization modality for other government corporations.

During the following year, however, the Philippine equities market had demonstrated a limited capacity to absorb large equity issues over a short period of time. Only two of the eight IPOs launched in 1990 were oversubscribed. One of these was the largest IPO of the year (P1 billion, or US$36 million), indicating that local investors were still attracted to large companies. During the first half of 1991, the equity market continued to demonstrate a limited absorptive capacity.

Market projections for the first half of 1992, the target period for launching the PAL IPO, gave indications of improved absorptive capacity. However, several other large capital issues were anticipated during that period, including an IPO of the Manila Electric Company, valued at P2.6 billion (US$93 million), and a public offering of an additional 13% of the PNB's outstanding shares, valued at approximately P2.8 billion (US$100 million). PAL's issue of 670 shares, valued at approximately P8.5 billion (US$319 million), far exceeded the size of those offerings and would usurp the PNB's 1989 record as the largest public offering in the history of the Philippine stock market.

The third option represented Secretary Estanislao's last alternative should variables in both the political and the economic environment seem too inconclusive to justify a major decision in the privatization process. This alternative would allow market forces to take their natural course and for the Philippine economy to stabilize. The world's economies were on the rebound following the Gulf War, and resulting economic trends were yet to take shape. Postponing the privatization process at this point would allow the airline to operate for a period of time with the benefit of the improved financial condition resulting from the government's debt assumption and the major operational improvements undertaken. However, this alternative would expose the privatization process to the uncertainties of the presidential election. PAL would also continue to be a financial burden for the government.

The Choice

By the last quarter of 1991, the Gulf War had just concluded. As a result of the war, fiscal year 1991 saw jet fuel prices and insurance rates soar, while passenger travel declined, particularly in the Middle East sector, all of which had a negative impact on the financial performance of the airline. Moreover, the value of the peso vis-à-vis the U.S. dollar had depreciated sharply, from P22.7/$1.00 in the previous year to P27.8/$1.00 in 1991. Whatever mode the Secretary chose, interested investors would be shown an airline with poor financial performance in its most recent year of operations.

Despite the financial setbacks during fiscal year 1991, Secretary Estanislao felt strongly that the airline's healthy financial condition, combined with the projections drawn up by PAL management after the debt assumption which had taken effect in September, 1991, would impress potential investors (Exhibits 21 and 22). Moreover, the projections for market growth in the 1990s were very promising for the industry, particularly in the Asian region. PAL was in a strong position to increase its market share, thereby further strengthening its prospects for profitability.

The current privatization program actually represented PAL's second encounter with privatization. As previously mentioned, the government had divested half of its shares to the private sector in 1965, only to resume control in 1977 due to heavy losses incurred under private ownership. This time around, however, the domestic political and economic environment under the Aquino administration was relatively more stable. The economy was starting to move, and the upcoming presidential elections in 1992 promised to be the most peaceful transition of power in years.

Secretary Estanislao carefully studied the pros and cons of the three options open to him. The PAL divestiture was one of the most highly publicized transactions of the government's privatization program, and there was much at stake. The ownership structure of PAL as a private enterprise, to be determined at this junction, could greatly affect the stability of the airline and its long-term success. A move towards privatization would necessarily entail determining an acceptable price range for 67 percent ownership of the company, taking into consideration the many complex issues involved, including--but not limited to--the valuation of PAL as an on-going concern, its future prospects, and the political dimensions of any decisions made.

The PAL privatization story had so far been one for the text books, with the remarkable transformation of the company from a large asset value, debt-ridden, and politically sensitive enterprise into an attractive privatization entity. The next stage could result in a crowning achievement for the government's privatization program, or a major disappointment. It was now up to Secretary Estanislao to decide which direction the COP should take.

Exhibit 2: Philippine Economic Indicators (1980-1987)

	1980	1981	1982	1983	1984	1985	1986	1987
National Government Financial Performance:								
Revenues*	34.7	35.9	38.2	45.6	56.9	69.0	79.2	103.2
Expenses*	38.1	48.1	52.6	53.1	66.9	80.1	109.8	119.9
Overall Surplus/Deficit	**- 3.4**	**- 12.1**	**- 14.4**	**- 7.3**	**- 10.1**	**- 11.1**	**- 30.6**	**- 16.7**
Nominal GNP*	264.5	303.6	335.4	378.7	527.3	597.7	614.7	703.4
Nominal GNP growth rate (%)	---	14.8	10.5	12.9	39.2	13.4	2.8	14.4
External Debt Service Burden (as % of Nominal GNP)	4.18	4.57	5.73	5.61	6.04	5.23	6.85	6.04
Consumer Price Index	138.9	157.1	173.2	190.5	286.4	352.6	355.3	368.7
Average Inflation Rate (%)	18.2	13.1	10.2	10.0	50.3	23.1	0.8	3.8
Average Peso/US Dollar exchange rate	7.51	7.90	8.54	11.11	16.70	18.61	20.39	20.57

* (billions of pesos)

Source: Central Bank of the Philippines

Exhibit 3: Organizational Structure for PAL Privatization

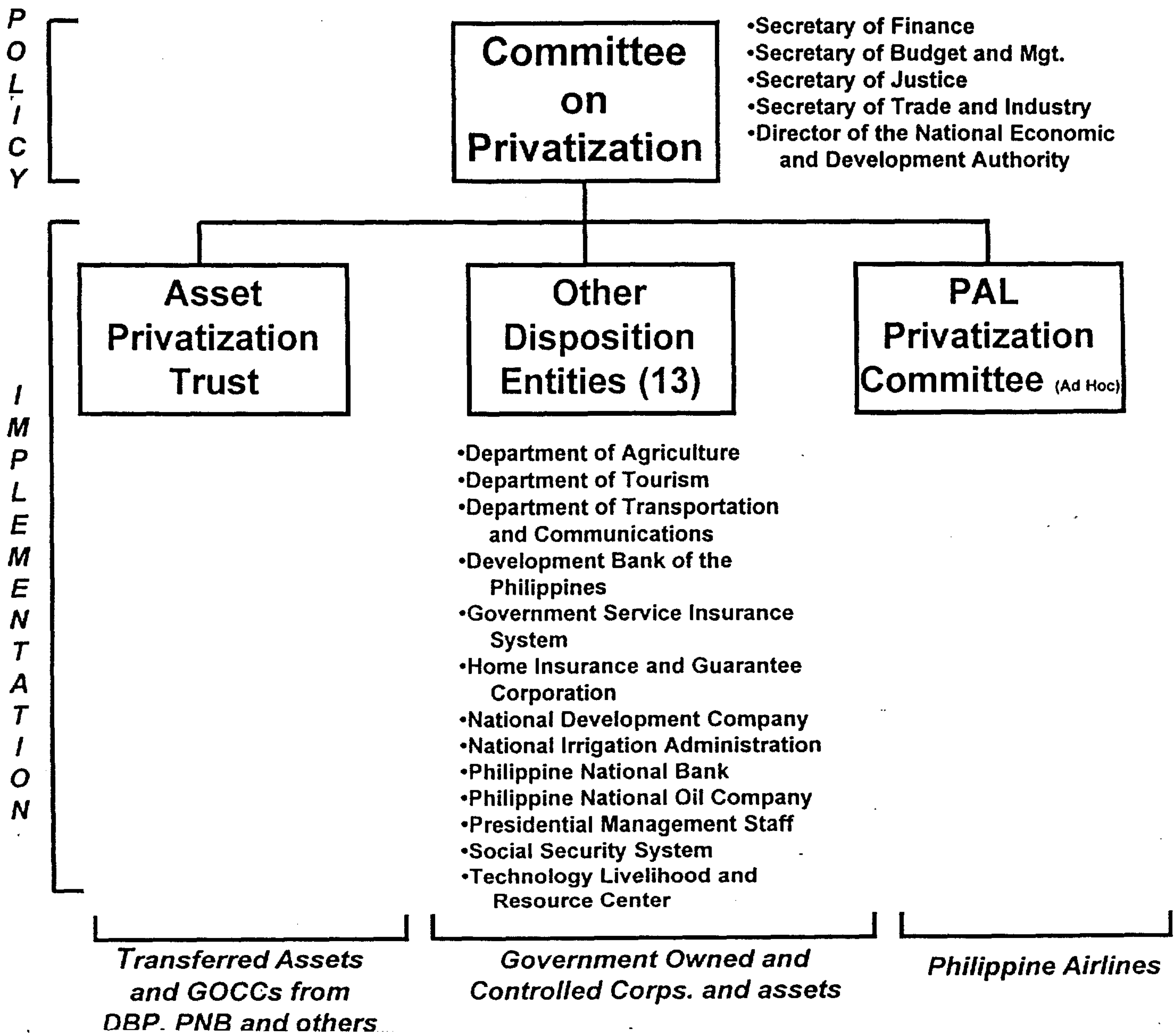


Exhibit 4: Philippine Airlines International Network (1991)

ASIA

Bandar Seri Begawan	Ho Chi Minh City	Seoul
Bangkok	Hong Kong	Singapore
Beijing	Kota Kinabalu	Taipei
Canton	Kuala Lumpur	Tokyo
Guam	Port Moresby	Xiamen

(Points served: 15)

AUSTRALIA

Brisbane
Melbourne
Sydney
(Points served: 3)

MIDDLE EAST

Cairo	Karachi
Dhahran	Jeddah
Dubai	Riyadh

(Points served: 6)

EUROPE

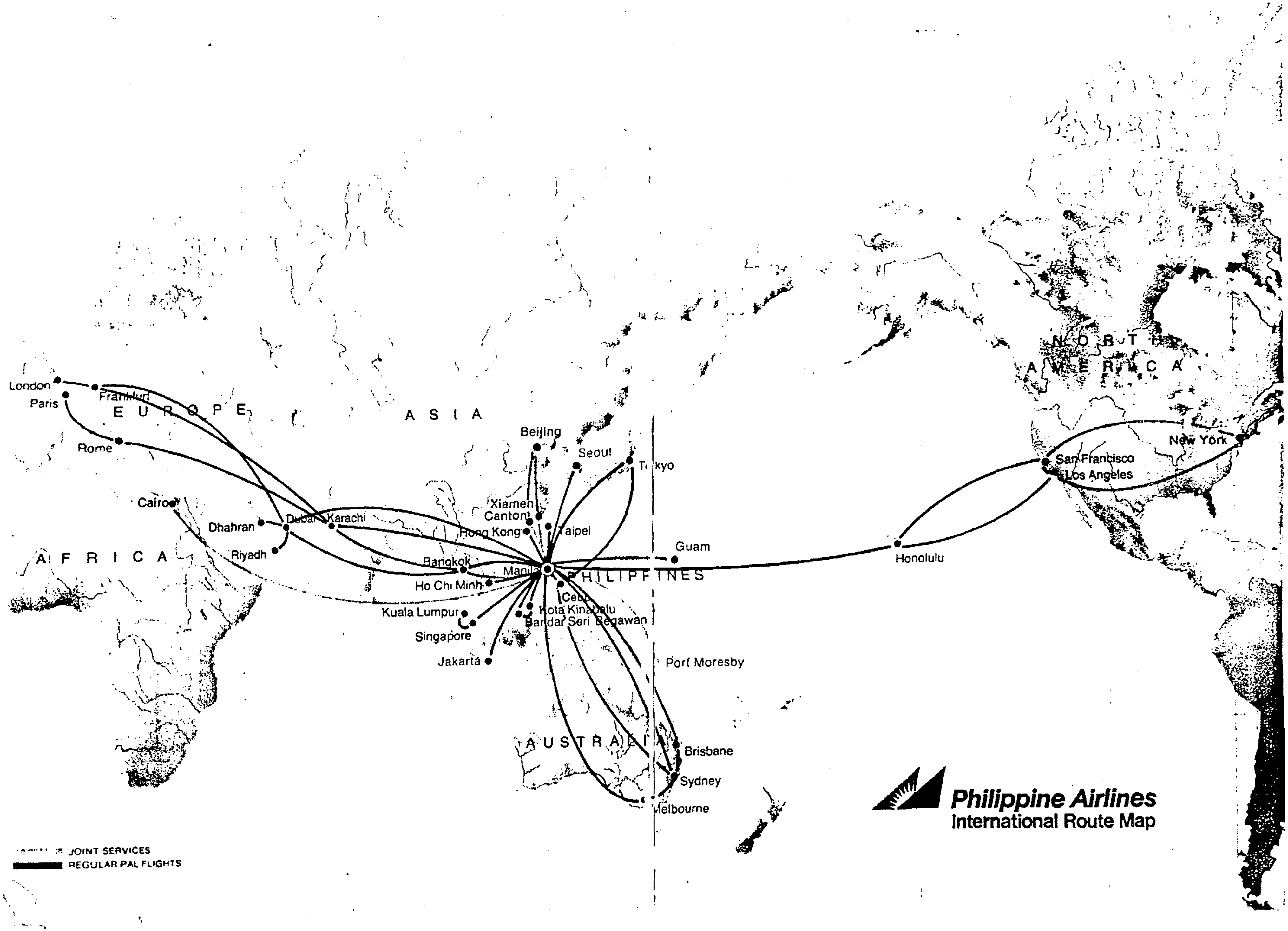
Frankfurt
London
Paris
Rome
(Points served: 4)

NORTH AMERICA

Honolulu
Los Angeles
New York
San Francisco
(Points served: 4)

Total Points Served: 32

Source: Philippine Airlines



London
Frankfurt
Paris
EUROPE
ASIA
Rome
Beijing
Seoul
Cairo
Xiamen
Canton
Dhahran
Dubai
Karachi
Hong Kong
Taipei
Riyadh
AFRICA
Bangkok
Manila
Ho Chi Minh
Guam
Honolulu
Kota Kinabalu
Bandar Seri Begawan
Kuala Lumpur
Singapore
Jakarta
Port Moresby
Brisbane
Sydney
NORTH AMERICA
San Francisco
Los Angeles
New York
Philippine Airlines
International Route Map
JOINT SERVICES
REGULAR PAL FLIGHTS

Exhibit 5: Philippine Airlines Flight Entitlements and Weekly Utilization (1991)

Destination	Entitlements per Week		Entitlements Utilized/Week	
Australia	5	DC-10 or 4 B747	5	DC-10
Bahrain	3	B767	0	
Belgium	2	DC-10	0	
Brunei	5	B737	3	B737
China	5	B767 or A300	2.5	B737
Dubai	14	B747	3	B747 or DC-10
Egypt	2	B747	1	B747
France	4	B747	3	B747
Germany	5	B747	5	B747
Hong Kong	24	A300	21	A300
Indonesia	2	B737	2	B737
Italy	1	B747	1	747
Japan	9	B747	6	B747 or 4 A300
Kuwait	3	B747	1	B747
Korea, South	3	A300, B727,or DC-10	2	A300
Malaysia	9	BAC 1-11 or B737	5	B737
Netherlands	2	B747	0	None
Pakistan	3	B747, 2 DC-10	5	B747
Papua New Guinea	1	B707	0.5	A310
Saudi Arabia	7	B747	3	B747 or DC-10
Singapore	10	A300	7	A300
Switzerland	2	B747	0	
Taiwan	10	A-300	7	A300
Thailand	12	DC-10	7.5	DC-10
United Kingdom	3	B747	3	B747
United States (incl. Guam)	23	B747	13	B747
Vietnam	2	A300	2	A300

Source: Philippine Airlines

NOTE: Entitlements are made by government agreement between the two countries involved. The rules governing the utilization of entitlements are determined by the specific terms of each agreement. In many cases, aircraft equivalent to or smaller than the ones stipulated by the agreement may be utilized, but not larger aircraft. For example, in Japan, PAL utilized a combination of B747s and A300s, which are equivalent in size. In other countries, it may be permitted to substitute two B737s where it is entitled to one B767.

Exhibit 6: Historical and Projected Available Seat Kilometers (ASK) on PAL's International Network (millions) (1991)

HISTORICAL

Sector	1987	1988	1989	1990	1991
Asia	1,723	1,893	2,423	2,501	2,486
Australia	593	605	634	594	600
Europe	1,958	2,123	2,456	2,430	2,353
Middle East	1,582	1,649	1,762	1,490	1,126
North America	4,045	3,957	4,366	4,340	4,828
Total	**10,084**	**10,374**	**11,769**	**11,497**	**11,603**

PROJECTED

Sector	1992	1993	1994	1995	1996
Asia	2,902	3,743	4,135	4,820	5,457
Australia	913	913	980	1100	1163
Europe	2,927	3,498	4,237	4,557	5,193
Middle East	1,511	1,526	1,556	1,602	1,666
North America	5,572	6,403	7,947	8,159	8,803
Total	**13,826**	**16,084**	**18,855**	**20,238**	**22,283**

Source: Philippine Airlines

Exhibit 7: Historical and Projected Net Passenger Yield (Pesos/RPK) on PAL's International and Domestic Networks (1991)

HISTORICAL

Sector	1987	1988	1989	1990	1991
Asia	1.364	1.455	1.490	1.679	n.a.
Australia	0.748	0.813	0.842	1.022	n.a.
Europe	0.749	0.831	0.936	1.023	n.a.
Middle East	0.925	0.883	0.886	0.912	n.a.
North America	0.593	0.571	0.643	0.774	n.a.
Domestic	0.913	1.104	1.252	1.483	1.913

PROJECTED

Sector	1992	1993	1994	1995	1996
Asia	2.48	2.75	3.06	3.25	3.55
Australia	1.63	1.81	1.93	2.10	2.22
Europe	1.55	1.71	1.98	1.99	2.31
Middle East	1.67	1.82	1.95	2.09	2.23
North America	2.48	2.75	3.06	3.25	3.55
Domestic	2.37	2.96	3.20	3.42	3.63

Source: Philippine Airlines

Exhibit 8: Air Traffic Projections for 1990-2000

Traffic Sector	Avg. Annual Increase Percentage
Asia-Europe	12.6
Inter-Asia	9.0
Asia-North America	8.5
Inter-Europe	5.7
Asia-Middle East	3.9
Inter-Middle East	3.4

Source: Philippine Airlines

Exhibit 9: Load Factor of Selected Asian Airlines (1987-1991; Average Percentage)

Airline	1987	1988	1989	1990	1991
All Nippon Airways	53.4	68.7	73.7	72.4	68.4
Cathay Pacific	73.6	77.1	77.6	75.9	N.A.
Japan Airlines	70.9	73.8	75.4	74.7	72.6
Philippine Airlines	74.5	74.2	76.5	74.6	71.8
Singapore Airlines	72.5	74.8	78.9	78.3	75.1

Source: Philippine Airlines

Exhibit 10: Total Freight Ton Kilometers (Millions) on PAL's International Network

Sector	1987	1988	1989	1990	1991
Asia	26.4	29.6	37.7	47.6	41.4
Australia	24.8	25.1	22.5	25.4	21.9
Europe	60.5	58.0	68.2	87.7	82.5
Middle East	30.8	29.7	28.7	27.0	22.7
North America	65.1	77.7	127.1	121.2	88.2
Total	**207.6**	**220.1**	**284.2**	**309.0**	**256.6**

Source: Philippine Airlines

Exhibit 11: Philippine Airlines Domestic Network (1991)

LUZON

Baguio	Laoag	Puerto Princesa
Basco	Legaspi	San Jose
Busuanga	Mamburao	Tablas
Cauayan	Mariduque	Tuguegarao
Catarman	Masbate	Virac
Daet	Naga	

(Points served: 17)

VISAYAS

Bacolod	Ormoc
Butuan	Roxas
Calbayog	Surigao
Cebu	Tacloban
Dumaguete	Tagbilaran
Iloilo	Tandag
Kalibo	

(Points served: 13)

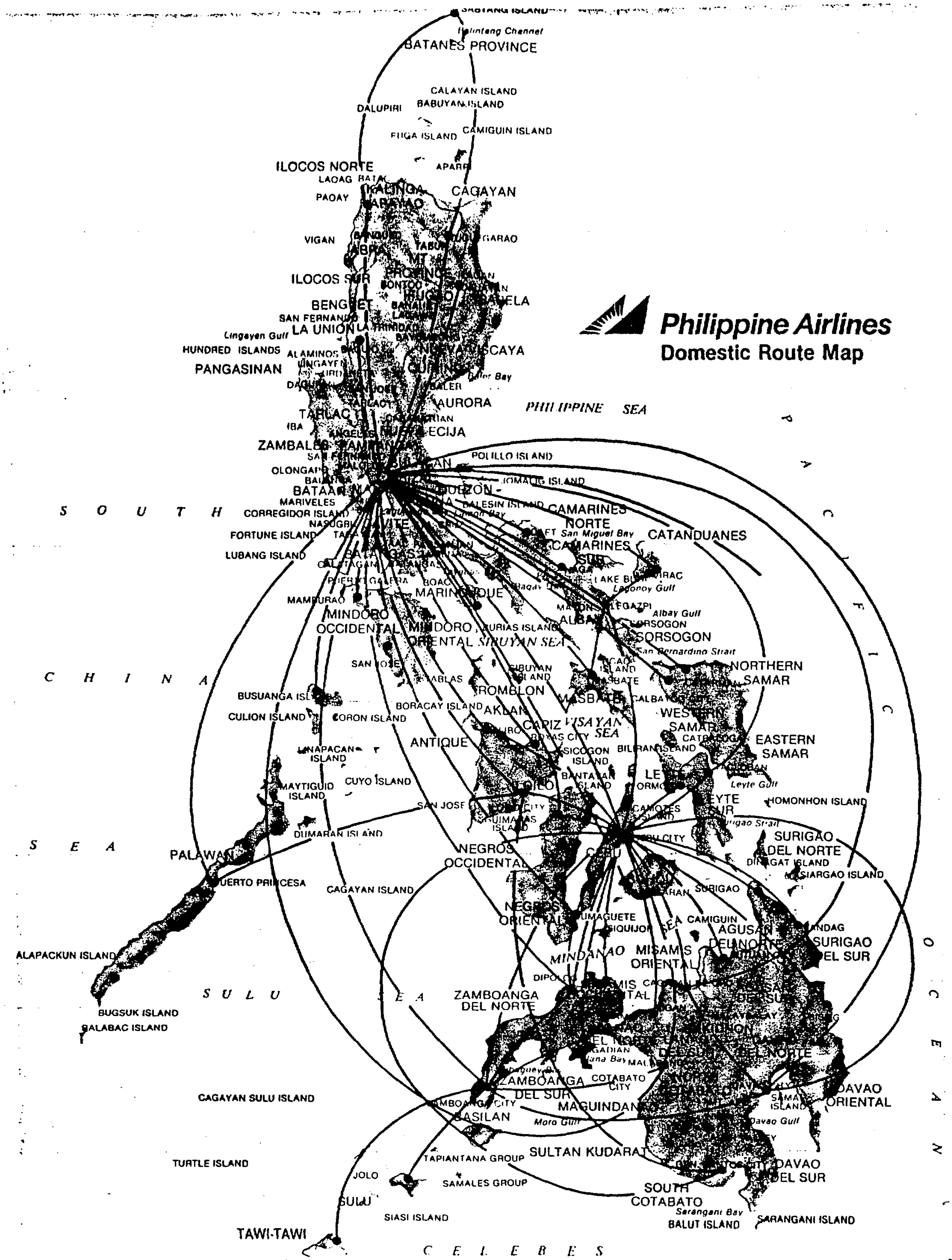
MINDANAO

Bislig	Iligan
Cagayan de Oro	Jolo
Camiguin	Ozamis
Cotabato	Pagadian
Davao	Tawi-Tawi
Dipolog	Zamboanga
General Santos	

(Points served: 13)

Total Points Served: 43

Source: Philippine Airlines



Philippine Airlines
Domestic Route Map
SABTANG ISLAND
Balintang Channel
BATANES PROVINCE
CALAYAN ISLAND
BABUYAN ISLAND
DALUPIRI
FUGA ISLAND
CAMIGUIN ISLAND
APARRI
ILOCOS NORTE
LAOAG
PAOAY
CAGAYAN
VIGAN
ILOCOS SUR
BENGUET
SAN FERNANDO
LA UNION
Lingayen Gulf
HUNDRED ISLANDS
ALAMINOS
PANGASINAN
AURORA
PHILIPPINE SEA
TARLAC
IBA
ZAMBALES
OLONGAPO
POLILLO ISLAND
JOMALIG ISLAND
BATAAN
MARIVELES
CORREGIDOR ISLAND
CAMARINES NORTE
San Miguel Bay
CATANDUANES
FORTUNE ISLAND
LUBANG ISLAND
CAMARINES SUR
Lagonoy Gulf
MAMBURAO
MARINDUQUE
LEGAZPI
Albay Gulf
MINDORO OCCIDENTAL
MINDORO ORIENTAL
SIBUYAN SEA
SORSOGON
San Bernardino Strait
NORTHERN SAMAR
SAN JOSE
ROMBLON
MASBATE
BUSUANGA ISL
CULION ISLAND
CORON ISLAND
BORACAY ISLAND
AKLAN
CAPIZ
VISAYAN SEA
WESTERN SAMAR
EASTERN SAMAR
ANTIQUE
ROXAS CITY
SICOGON ISLAND
BILIRAN ISLAND
Leyte Gulf
CUYO ISLAND
HOMONHON ISLAND
SAN JOSE
DUMARAN ISLAND
NEGROS OCCIDENTAL
CEBU
SURIGAO DEL NORTE
DINAGAT ISLAND
SIARGAO ISLAND
PALAWAN
PUERTO PRINCESA
CAGAYAN ISLAND
SURIGAO
NEGROS ORIENTAL
CAMIGUIN
AGUSAN DEL NORTE
SURIGAO DEL SUR
ALAPACKUN ISLAND
MINDANAO
MISAMIS ORIENTAL
SULU SEA
ZAMBOANGA DEL NORTE
BUGSUK ISLAND
BALABAC ISLAND
ZAMBOANGA DEL SUR
COTABATO CITY
DAVAO ORIENTAL
CAGAYAN SULU ISLAND
ZAMBOANGA CITY
BASILAN
MAGUINDANAO
Moro Gulf
Davao Gulf
TURTLE ISLAND
TAPIANTANA GROUP
SULTAN KUDARAT
DAVAO DEL SUR
JOLO
SAMALES GROUP
SOUTH COTABATO
SULU
SIASI ISLAND
Sarangani Bay
BALUT ISLAND
SARANGANI ISLAND
TAWI-TAWI
CELEBES
SOUTH CHINA SEA
PACIFIC OCEAN

Exhibit 12: Philippine Airlines Domestic Freight Ton Kilometers (FTK) (1987-1991)

Year	FTK in Millions
1987	32.4
1988	36.9
1989	35.4
1990	39.5
1991	40.8

Source: Philippine Airlines

Exhibit 13: Philippine Airlines Fleet Ownership Structure (1991)

Aircraft	No. of Aircraft	Lessor/Owner
INTERNATIONAL FLEET		
B747-200	3	GPA Group
	2	Nora Leasing
	2	Bank of New York
	1	Wilmington Trust
	1	Bankers Trust
DC-10	2	Polaris Aircraft
A300-B4	5	Philippine Airlines
	1	Air Business Center
	1	GPA Group
DOMESTIC FLEET:		
B737-300	9	GPA Group
BAC 1-11	10	Philippine Airlines
Fokker 50	10	Aircraft Financing and Trading
SD-360	5	Air Tara
	2	Fortis Philippines

Source: Philippine Airlines

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Exhibit 14: Average International Fleet Age of Asian Airlines (1991)

Airline	Average Age in Years
Philippine Airlines	10.7
All Nippon Airways	9.3
Cathay Pacific Airways	11.0
Garuda International Airways	10.4
Japan Airlines	9.8
Korean Airlines	10.2
Malaysian Air System	9.6
Singapore Airlines	5.6
Thai Airways International	7.0
Regional Average	**9.3**

Source: Philippine Airlines

Exhibit 15: Philippine Airlines Financial Performance

	1987	1988	1989	1990	1991
Net Revenues					
Passenger	7,673.0	8,544.0	10,625.6	11,868.0	14,126.4
Cargo	1,122.0	1,267.4	1,636.0	1,773.6	1,920.0
Others	1,245.6	1,295.7	1,559.0	1,702.0	2,471.9
Total Net Revenues	**10,040.6**	**11,107.1**	**13,820.7**	**15,343.6**	**18,518.3**
Operating Expenses					
Fuel and oil	1,981.8	2,268.9	1,662.8	2,993.9	4,824.4
Lease charges	727.7	1,076.8	1,849.8	2,460.4	3,367.7
Maintenance & repairs	1,265.1	1,508.5	1,674.6	1,887.6	2,178.0
Sales, administrative & general	1,082.3	1,244.3	1,395.6	1,417.2	1,886.9
Passenger services	941.4	1,107.2	1,268.7	1,326.1	1,534.1
Airport & handling fees	828.0	896.8	1,103.6	1,196.1	1,532.3
Depreciation	645.3	684.6	780.0	745.9	876.3
Ancillary business costs	356.6	369.7	412.4	475.0	576.9
Other operating expenses	699.7	842.4	974.8	1,026.6	1,253.5
Total Operating Expenses	8,527.9	9,999.2	12,122.3	13,528.8	18,030.1
Operating Income	**1,512.7**	**1,107.9**	**1,698.4**	**1,814.8**	**488.3**
Other Expenses					
Financing charges	1,068.9	1,034.1	1,081.0	1,450.4	1,623.1
Amortization of def. forex loss	129.7	116.8	109.5	90.6	159.9
Foreign exchange translation	10.3	43.4	83.6	223.9	1,107.6
Discount on debt	0.0	0.0	0.0	- 516.3	- 564.8
Other	- 14.3	- 16.3	119.6	- 17.4	346.2
Total Other Expenses	**1,194.6**	**1.178.1**	**1,393.7**	**1,231.2**	**2,672.1**
NET INCOME/LOSS	**318.1**	**- 70.1**	**304.6**	**583.6**	**- 2,183.8**

Note: Figures are in millions of pesos

Source: Philippine Airlines

Exhibit 16: Philippine Airlines Balance Sheet (FY 1987-1991)

	1987	1988	1989	1990	1991
ASSETS					
Cash	313.2	343.2	444.6	503.6	418.7
Accounts receivable	1,639.1	2,303.2	2,638.5	2,646.8	3,776.2
Expendable materials, parts, supplies	841.0	975.4	1,267.2	1,876.6	1,851.5
Others	254.4	400.9	633.3	672.4	1,144.2
Total current assets	**3,047.8**	**4,022.7**	**4,983.6**	**5,699.4**	**7,190.5**
Property and Equipment					
Flight equipment	7,807.6	8,404.6	8,678.1	9,333.9	9,718.8
Ground property and equipment	1,936.2	2,062.5	2,247.6	2,409.4	2,940.0
Accumulated depreciation (equipment)	- 2,215.5	- 2,839.4	- 3,445.7	- 3,801.9	- 4139.3
Land	11.8	18.8	18.8	237.0	237.0
Current construction projects	178.8	228.4	279.2	377.6	371.0
Net property and equipment	**7,718.8**	**7,874.8**	**7,778.1**	**8,556.0**	**9,127.6**
Taxes on domestic fuel (pre-paid)	347.4	873.9	1,367.4	1,959.3	2,351.0
Investments	0.0	0.0	0.0	48.6	229.3
Deferred charges and other assets	561.7	597.3	634.5	961.3	1,630.8
TOTAL ASSETS	**11,675.8**	**13,368.7**	**14,763.6**	**17,224.5**	**20,528.9**

Note: All figures are in millions of pesos.

Exhibit 16
Page 2 of 2

	1987	1988	1989	1990	1991
LIABILITIES					
Accounts payable & accrued expenses	3,341.0	3.585.8	3,393.8	4,089.8	6,685.4
Unearned transportation revenue	764.6	974.8	1,265.6	1,711.3	1,426.8
Notes payable	2,193.8	2,819.5	3,241.6	3,511.8	4,577.4
Current portion of long-term debt	268.6	587.5	149.6	316.3	833.7
Total current liabilities	**6,568.0**	**7,967.6**	**8,050.5**	**9,629.2**	**13,523.2**
Long-term debt	8,057.5	8,180.0	8,937.9	8,835.6	9,579.7
Reserves and deferred credit	576.1	817.0	1,066.4	1,250.0	—
					2,100.1
Total liabilities	**15,201.60**	**16,964.6**	**18,054.8**	**19,714.8**	**25,203.0**
Stockholders' equity					
Capital stock	2,000	2,000	2,000	2,000	2,000
Additional paid-in capital	5.3	5.3	5.3	5.3	5.3
Revaluation increment in land[4]	6.3	6.3	6.3	223.8	223.8
Deficit	- 5,537.4	- 5,607.5	- 5,302.9	- 4,719.3	- 6,903.1
Total stockholders' equity	**- 3,525.8**	**- 3,596.0**	**- 3,291.3**	**- 2,490.3**	**- 4,674.1**
TOTAL LIABILITIES AND EQUITY	**11,675.8**	**13,368.7**	**14,763.6**	**17,224.5**	**20,528.9**

Note: All figures are in millions of pesos.

Source: Philippine Airlines

[4] "Revaluation increment" is the difference between the original appraised value of the land and its current book value.

Exhibit 17: PAL Loans Assumed by the Philippine Government

Creditors	**Amount (in US$ million)**
Paris Club Loans	205.9
Commercial Loans (restructured)	118.0
Central Bank	
Principal	99.5
Penalties and Interest	68.5
National Development Company	
(Philippine Government)	28.9
Total Debt Assumption	**520.8**

Source: Philippine Airlines

Exhibit 18: PAL Balance Sheet Pre- and Post-Debt Assumption (October 1991)

	Pre-Debt Assumption	Post-Debt Assumption
ASSETS		
Cash	672.6	672.6
Accounts receivable	3,872.8	3,872.8
Expendable material, parts	1,849.9	1,849.9
Other assets	1,155.4	1,155.4
Total Current Assets	**7,550.6**	**7,550.6**
Property and equipment	8,758.2	8,758.2
Taxes on domestic fuel	2,359.2	0.0
Deferred charges and other assets	1,718.4	659.4
TOTAL ASSETS	**20,386.4**	**16,968.2**
LIABILITIES		
Accounts payable and expenses	6,983.6	4,760.4
Notes payable	4,826.6	2,060.5
Unearned transportation revenue	1,120.1	1,120.1
Total Current Liabilities	**12,930.3**	**7,941.0**
Long-term debt	9,854.6	538.1
Reserves and deferred credits	2,060.4	1,784.4
Stockholder's equity		
Capital stock	2,000.0	10,000.0
Additional paid-in capital	5.3	6,482.1
Revaluation increment in land	223.8	223.8
Deficit	- 6,687.9	- 10,001.1
Total stockholders' equity	**- 4,458.7**	**6,704.8**
TOTAL LIABILITIES & EQUITY	**20,386.4**	**16,968.2**

Note: All figures are in millions of pesos
Source: Philippine Airlines

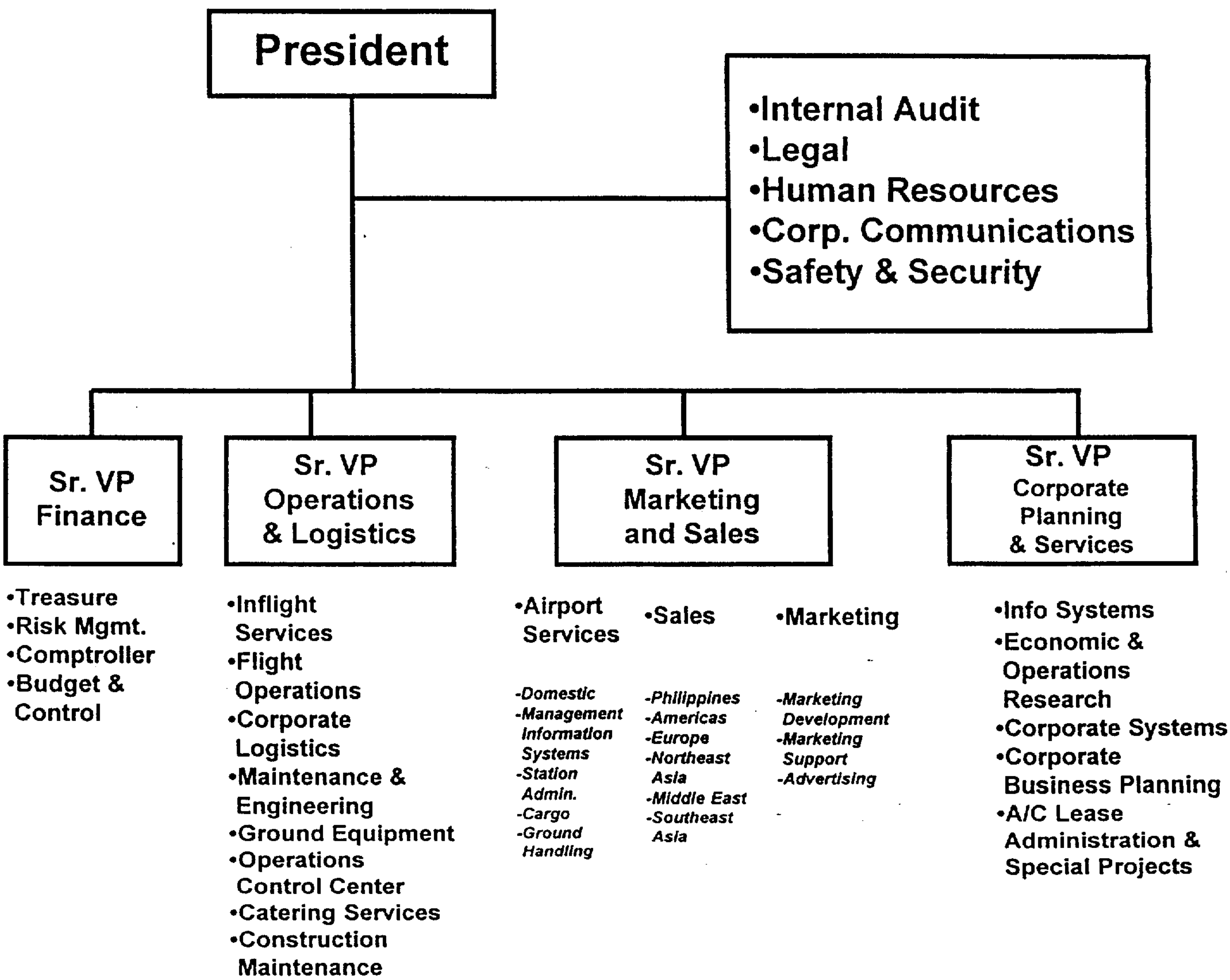
Exhibit 19: PAL Post-Debt Assumption Profit and Loss Projections (FY 1992-1996)

	1992	1993	1994	1995	1996
Net Revenues	25,982	32,921	41,101	47,277	56,646
Operating Expenses					
Passenger services	1,923	2,412	2,819	3,404	4,070
Airport & handling fees	2,533	3,625	4,530	5,589	6,722
Fuel and oil	5,439	6,908	8,840	10,603	12,948
Sales, administrative & general	2,436	2,679	3,074	3,532	4,086
Lease charges	4,373	5,211	6,218	7,209	8,693
Maintenance & repairs	3,134	3,411	4,284	5,138	6,307
Crew costs	1,422	1,995	2,523	2,986	3,547
Depreciation	1,030	1,250	1,451	1,631	1,830
Ancillary business costs	812	868	1,041	1,249	1,499
Fuel tax	305	297	316	340	362
Other operating expenses	274	326	385	447	493
Total Operating Expenses	**23,681**	**28,982**	**35,481**	**42,128**	**50,557**
OPERATING INCOME/LOSS	**2,301**	**3,939**	**5,620**	**5,149**	**6,089**

Note: Figures are in millions of pesos

Source: Philippine Airlines

Exhibit 20: Philippine Airlines Organizational Chart (Post-Restructuring)



Source: Philippine Airlines

Exhibit 21: Economic Assumptions and Business Projections (1992-1996)

	1992	1993	1994	1995	1996
MACROECONOMIC ASSUMPTIONS:					
Avg. peso-dollar exchange rate (P/$)	30.0	33.0	35.3	37.8	40.4
Peso depreciation rate	16.9%	10.0%	7.0%	7.1%	6.9%
U.S. inflation rate	5.3%	4.7%	4.4%	4.2%	4.2%
Philippine inflation rate	16.5%	13.0%	11.5%	10.5%	10.0%
Domestic lending rate	25.0%	25.0%	25.0%	25.0%	25.0%
LIBOR	8.0%	8.0%	8.0%	8.0%	8.0%
PROJECTIONS:					
Available Seat Kilometers (in millions)					
International	13,826	16,084	18,855	20,238	22,283
Domestic	2,659	2,923	3,110	3,401	3,630
Revenue Passenger Kilometers (in millions)					
International	10,130	11,320	13,370	14,386	15,687
Domestic	1,965	2,095	2,246	2,427	2,615
Freight Ton Kilometers (in millions)					
International	331.4	379.1	437.7	461.5	505.4
Domestic	47.2	48.3	53.0	59.1	65.9
Passenger Yield, Net (Peso/RPK)					
International	1.6	1.9	2.1	2.3	2.5
Domestic	2.4	2.9	3.2	3.4	3.6
Freight Yield, net (Peso/FTK)					
International	6.9	7.7	8.6	9.2	10.4
Domestic	14.2	17.6	18.9	20.3	21.5
Profit from other services (millions of pesos)					
Ground handling operations	153.8	193.2	231.9	278.2	333.9
Inflight sales	128.4	167.2	200.6	240.7	288.9
Catering services	80.0	109.7	131.6	157.9	189.5
Air cargo services	59.9	68.8	82.6	99.1	118.9
Maintenance services	94.5	115.1	138.1	165.8	198.9
Other services	4.2	5.6	6.7	8.1	9.7

Source: Philippine Airlines

Exhibit 22: PAL Historical and Projected Profit/Loss (1987-1996)

Note: figures are in millions
percentage= % of previous year

	[illegible]									PROJECTIONS										
	1987	1988	%	1989	%	1990	%	1991	%	1992	%	1993	%	1994	%	1995	%	1996	%
Net Revenues																				
Passenger	7,673	8,544	111	10,626	124	11,868	112	14,126	119	n.a.		n.a.		n.a.		n.a.		n.a.	
Cargo	1,122	1,267	113	1,636	129	1,774	108	1,920	108	n.a.		n.a.		n.a.		n.a.		n.a.	
Others	1,246	1,296	104	1,559	120	1,702	109	2,472	146	n.a.		n.a.		n.a.		n.a.		n.a	
Total	10,041	11,107	111	13,821	124	15,344	111	18,518	121	25,982	140	32,921	127	41,101	125	47,277	115	56,646	120
Operating Expenses																			
Fuel and Oil	1,982	2,269	114	2,663	117	2,994	112	4,824	161	5,439	113	6,908	127	8,840	128	10,603	120	12,948	122
Lease Charges	728	1,077	148	1,850	172	2,460	133	3,368	137	4,373	130	5,211	119	6,218	119	7,209	116	8,693	121
Maintenance and Repairs	1,265	1,509	119	1,675	111	1,888	113	2,178	115	3,134	144	3,411	109	4,284	126	5,138	120	6,307	123
Sales, administrative & general	1,082	1,244	115	1,396	112	1,417	102	1,887	133	2,436	129	2,679	110	3,074	115	3,532	115	4,086	116
Passenger Services	941	1,107	118	1,269	115	1,326	104	1,534	116	1,923	125	2,412	125	2,819	117	3,404	121	4,070	120
Airport and Handling fees	828	897	108	1,104	123	1,196	108	1,532	128	2,533	165	3,625	143	4,530	125	5,589	123	6,722	120
Depreciation	645	685	106	780	114	746	96	876	117	1,030	118	1,250	121	1,451	116	1,631	112	1,830	112
Ancillary business costs	357	370	104	412	111	475	115	577	121	812	141	868	107	1,041	120	1,249	120	1,499	120
Other operating expenses	700	842	120	975	116	1,027	105	1,254	122	2,001	160	2,618	131	3,224	123	3,773	117	4,402	117
Total Operating Expenses	8,528	9,999	117	12,122	121	13,529	112	18,030	133	23,681	131	28,982	122	35,481	122	42,128	119	50,557	120
Operating Income	1,512	1,108	73	1,698	153	1,815	107	488	27	2,301	472	3,939	171	5,620	143	5,149	92	6,089	182
Other Expenses																			
Financing Charges	1,069	1,034	97	1,081	105	1,450	134	1,623	112	n.a.		n.a.		n.a.		n.a.		n.a.	
Amortization of def.Forex loss	128	117	91	110	94	91	83	160	176	n.a.		n.a.		n.a.		n.a.		n.a.	
Foreign exchange translation	10	43	430	84	195	224	267	1,108	495	n.a.		n.a.		n.a.		n.a.		n.a.	
Discount on debt	0	0	0	0	0	-516	0	-565	109	n.a.		n.a.		n.a.		n.a.		n.a.	
Other	-14	-16	114	120	-8	-17	-14	346	-204	n.a.		n.a.		n.a.		n.a.		n.a.	
Total	1,195	1,178	99	1,394	118	1,231	88	2,672	217	n.a.		n.a.		n.a.		n.a.		n.a.	
NET INCOME/LOSS	318	-70	-22	305	-436	584	191	-2,184	374	n.a.		n.a.		n.a.		n.a.		n.a.	

EPILOGUE

On December 10, 1991, the Philippine Airlines Privatization Committee, headed by Jesus P. Estanislao, Secretary of Finance of the Republic of the Philippines, announced the holding of a public auction for a block of 670 million shares of Philippine Airlines, Inc.

The block of shares represented 67 percent interest and majority control of the airline. Interested bidders were required to be part of a consortium of investors with expertise in the management of airline operations. With the approval of the COP, the PAL Privatization Committee set the hurdle price at US$319 million (P8.5 billion).[5]

Criteria for Bidding

Given the size and importance of this transaction, the PAL Privatization Committee wanted to ensure that all potential bidders would be capable of managing the airline. Once a list of pre-qualified bidders was prepared, the only factor to be considered in evaluating the actual bids would be the offering price.

The criteria established by the Committee, as set forth in the PAL Auction Guidelines, were the following:

- the overall financial strength of the consortium;
- the consortium's airline industry expertise (defined as demonstrated ability to manage airline operations on an on-going basis);
- the ability of the consortium to consummate the acquisition expeditiously, with the least disruption to PAL, its employees, and customers, and within the existing Philippine legal and regulatory framework;
- the absence of a material conflict of interest; and
- such factors as the Committee may deem relevant.

The Committee determined that an acceptable bid for the purchase of PAL was to include two component. The first was a cash component of P4.0 billion (US$150 million), to be paid in two installments: an initial installment of 50 percent of the cash component was to be tendered on the closing date, March 31, 1992, and a second installment due three months after closing. All bidders were required to submit a bid bond of P125 million with their final and binding bid. The bid bond of the winning consortium was to be applied to the purchase price of the shares.

The second component of an acceptable bid was "eligible debt." Bidders were given the option

[5] The peso-dollar exchange rate at the time was P26.70 to $1.00.

to deliver to the government for cancellation the following categories of external debt:

- 1985 advances outstanding under the US$925 million Credit Agreement with the Central Bank of the Philippines;
- Credits outstanding under Restructuring Agreements signed in January or April of 1986, as amended by the Philippine National Bank, the Development Bank of the Philippines, the National Development Corporation, and Philippine Airlines, Inc., in respect of which the Republic of the Philippines would act at the time of closing as assuming obligor; or
- Credits outstanding under the Restructuring Agreement signed by the Central Bank of the Philippines in January 1986.

By January 29, 1992, the deadline for the submission of bids, three consortia had come forward with offers. These were: AB Capital and Investment Corporation and the Bank of Commerce, under PR Holdings, Inc.; Philippine Commercial and International Bank (PCIB); and Union Bank of the Philippines. PR Holdings submitted the highest bid, at P9.78 billion (US$368 million) (Exhibit 1). This figure was 15% higher than the hurdle price set by the PAL Privatization Committee.

As a result of the sale, PAL was returned to private ownership, with PR Holdings owning 67% of the airline, the Government Service Insurance System 15%, the National Government 13%, and the National Development Company 5%. The divestiture represented the largest financial transaction in Philippine history.

The Transaction

Secretary Estanislao was ecstatic at the outcome of the privatization, which had far exceeded his expectations. Reporters and other members of the media were quick to praise the government for its success. Financially, the transaction appeared very beneficial for the government. The national government had initially acquired its 80 percent ownership of the airline in exchange for the assumption of debts amounting to US$521 million. With the market value of PAL's debt paper at 52 percent of face value, this exchange actually cost the government only US$271 million. Thus, the actual cost to the government of the 67 percent interest stake was only US$227 million. With the sale of PAL fetching the cash equivalent of US$368 million, paper profit on the transaction was US$141 million--a windfall for the national government coffers.

Furthermore, with PR Holdings having paid US$368 million for 670 million shares, the 130 million shares retained by the government had an accrued value of US$71 million. Since the cost to the government of the 130 million shares had been US$44 million at the time of the debt assumption, the government recorded an additional paper profit of US$27 million. In the end, the Philippine government realized a total profit of US$168 million and finally closed one of the largest and most controversial chapters of the Philippine Privatization Program.

PR Holdings, Inc.

PR Holdings, Inc. was a consortium formed by two major corporate groups, AB Capital and Investment Corporation (ABCIC) and the Bank of Commerce (BC), for the purpose of submitting a bid and, if successful, for assuming control of Philippine Airlines, Inc.

The consortium was put together by Antonio O. Cojuangco, chairman and president of the Philippine Long Distance Telephone Company. It was composed of the following individuals and corporate entities:

Aeropartners, Inc. and affiliates (54.5 %)

- Antonio O. Cojuangco
- Bank of Commerce
- George Go
- Equitable Bank
- Landmark Group
- Hideco Sugar Group

Cumulus Holdings, Inc. (16.0%)

- Bank of the Philippine Islands
- Lead Smelter Group
- Carlos Araneta
- Benito Araneta
- Proleo Group
- Hambrecht and Quist Phil. Ventures, Inc.
- Walden Investments
- NIF Management Singapore
- BPI Trust Accounts

Andres Soriano Group (9.5%)

- Andres Soriano Corporation (ANSCOR)
- International Container Terminal Svcs, Inc.
- Philippine Long Term Equity Fund Ltd.

Philippine National Bank (7.5%)

Development Bank of the Philippines (7.5%)

Armed Forces of the Philippines Retirement Separation and Benefits System (5.0%)

Among the major private investors in PR Holdings were the Ayala Corporation, which had a controlling interest in the Bank of the Philippine Islands and was a key player in Cumulus Holdings, Inc., and the Andres Soriano Corporation (ANSCOR), which controlled San Miguel Brewery.

Lucio Tan

Another major figure behind PR Holdings but not evident in the roster above was Lucio Tan, a tobacco magnate who owned Asia Brewery and Allied Banking. Known in the business world as a ghost financier behind many holding companies, Lucio Tan quietly financed Cojuangco for his share in PR Holdings.

Lucio Tan initially invested approximately P4.1 billion in PR Holdings. An additional P1 billion was later on-lent to Cojuangco, for a total of P5.1 billion of the P9.6 billion put up by PR Holdings. Despite his large interest in the consortium, it was not until January 1992 that Lucio Tan surfaced as a major investor. A number of political and strategic reasons may have accounted for his reluctance to come forward. As an alleged crony of the former dictator and the owner of a number of companies being investigated for tax evasion, Tan's presence on the board of PR Holdings would have limited the consortium's chances of obtaining the government's consent for the purchase of PAL. Moreover, Tan's holdings in Asia Brewery and Allied Banking made him a competitor to the Ayala and Soriano groups in the banking and beer industries. Had his interest in the consortium been disclosed, these key investors would most likely have been dissuaded from participating.

The apparent deception perpetrated by Cojuangco was deeply resented by the Ayala and Soriano groups. Tan's participation in the consortium was not expected, and his emergence as a controlling figure meant that industrial competitors were sitting across from each other in PAL's boardroom.

Although there were no political ramifications for the government when Tan's participation became public knowledge, the battle for control of PAL which ensued significantly undermined the operations of the airline immediately following the takeover. Squabbles over policies and decisions paralyzed the board of directors and impeded the company's rehabilitation. Among the programs immediately affected was PAL's refleeting plan, which had to be temporarily put on hold until the board could resolve its internal conflicts. Over the next three years, PAL would continue to register losses.

Privatization Progress

In December 1991, the Philippine legislature passed Republic Act 7181 which extended the statutory term of the Commission on Privatization and the Asset Privatization Trust from December 8, 1991 to August 31, 1992. This gave the COP and the disposition entities additional time to dispose of the remaining GOCCs and TAs under government control. Estanislao continued to serve as Secretary of Finance and Chairman of the COP until the expiration of Corazon Aquino's term as President of the Philippines in 1992, following which he became president of a charitable foundation established by Mrs. Aquino.

The May 1992 national elections resulted in victory by plurality for Fidel V. Ramos, the candidate of Corazon Aquino. Ramos continued the privatization program initiated by his predecessor, and in December 1993 the Philippine Legislature further extended the terms of the COP and APT to June 30, 1995.

From its inception in 1987 through August 1994, a total of 130 GOCCs and 419 TAs had been earmarked for privatization. Of these, over 400 were divested by that date, generating gross revenues of P111 billion (US$4.2 billion)--nearly three times the government's original target figure of P41.12 billion for the privatization program.[6]

[6] The average peso-dollar exchange rate in 1994 was P26.42 to U.S.$1.00.

EPILOGUE

Exhibit 1: Philippine Airlines Bidding Results

Consortium	Cash Component	Eligible Debt $ Value	Eligible Debt Discounted Peso Value	Total Bid
HURDLE PRICE	P 4,000	319	P 4,400	P 8,400
PR Holdings	P 4,000	419	P 5,780	P 9,780
PCI Bank	P 4,000	370	P 5,107	P 9,170
UB Philippines	P 4,000	217	P 2,993	P 6,993

Note:All figures are in millions.
Source: PAL Privatization Committee

Peso-Dollar Exchange rate at the time of the transaction was P26.53 to $1.00

TECHNICAL NOTE: PHILIPPINE PRIVATIZATION

Public and Private Enterprises in the Philippines

The privatization program launched by President Corazon C. Aquino in December 1986 could be most accurately described as a re-privatization of business enterprises in the Philippines. Historically speaking, the Philippines had a fairly consistent policy of private-sector dominance of the economy. This was the case from the beginning of American colonial rule in 1898, through the Commonwealth administration of its first president, Manuel Quezon, through the administration of Ferdinand Marcos. For most of those years, the country had a mixed economy characterized by free enterprise, with very little participation by the public sector. Government activities during most of those years were primarily limited to those associated with its constitutional and administrative functions such as defense, public utilities, and other activities consistent with what was deemed to be of national interest.

Despite a clear policy favoring the private sector throughout Philippine contemporary history, the public sector grew to rival the private sector during the Marcos era, from the early 1960s to 1986. In 1935, there were only 14 public enterprises in the Philippines. This number increased slowly over the next 25 years, to a total of 40 in 1960. Between 1960 and 1965, however, 22 new public enterprises were formed, bringing the total to 62. By the time the Marcos administration fell in 1986, there were 327 public enterprises in the Philippines.

One factor contributing to the phenomenal increase of public enterprises under the Marcos dictatorship was an extensive campaign of development projects undertaken by the Marcos administration. These projects--which included massive infrastructure, public works, and highways--were mainly carried out by public enterprises.

In addition, as the Marcos policies of martial law and heavy national borrowing took their toll on the Philippine economy, many private sector entities had been unable to meet their financial obligations. The government had taken an increasingly active role in business under Marcos through loans, subsidies and direct investment (Exhibit 1). Consequently, government indebtedness grew 27% annually from 1980-84, and reached $26 billion in 1985 (Exhibit 2). Many of the enterprises receiving government loans failed and ultimately came under government control, further draining the national coffers of their already meager resources.

It is also possible that the corruption alleged to have been prevalent during the Marcos era contributed to the dramatic increase in the number of public enterprises. During that period, many administration officials were suspected of utilizing public enterprises to launder illegally obtained government funds.

Managing non-performing assets worth over $7 billion was a huge drain on the economy. An article in the *ASEAN Economic Bulletin* stated that government owned or controlled corporations (GOCCs) had consumed up to a quarter of the national budget in recent years. There was little pressure on GOCCs to return dividends to the government, and their debt rose by 23% annually from 1980 to 1985, representing 70% of public external debt by 1985, as many firms developed an over reliance on easily available credit. GOCC performance had been poor, with average rates of return on equity (ROE) and return on assets (ROA) of 2.9 and 3.7 percent respectively.[7]

Economic chaos following the assassination of opposition leader Benigno Aquino in 1983 and charges of widespread corruption within the Marcos regime led to rising discontent among the Philippine people. The declining GNP, mounting balance of payments deficit, large government deficits, and rising foreign debt--which reached $26 billion in 1985--took their toll on the economic outlook (Exhibit 3).

Under pressure, Marcos declared a snap election on February 7, 1986; he was defeated by Corazon Aquino in the popular vote. Marcos' dispute of the election results incited non-violent boycotts of businesses and institutions allegedly controlled by Marcos and his cronies. A series of bank runs occurred, and the value of the peso and stock prices plummeted. Interest rates rose from 9% to over 20% (Exhibit 4). Some prominent businessmen, frustrated with excessive election spending and steep increases in interest rates, resigned from government advisory positions in protest.

The Impetus for Privatization

Preliminary steps to regulate and re-privatize public enterprises in the Philippines were taken before Corazon Aquino assumed power. In 1985, the Presidential Commission on Reorganization (PCR) began work to formulate a new policy framework for public enterprises. It was a tedious undertaking which entailed consulting with public regulatory entities such as the Commission on Audit, the Civil Service Commission, the National Economic and Development Authority, the Ministry of Finance, the Central Bank, and others. This work resulted in Presidential Decrees 2029 and 2030, which called for the "orderly disposition of certain assets of government institutions." These were enacted on February 4, 1986, less than a month before the military mutiny and popular revolution that toppled the Marcos Administration and propelled Aquino to power.

Aquino assumed the presidency in 1986 with the strong support of the Philippine people and the international community. Her immediate priority was to reverse the severe economic decline of the past few years, through which Philippine growth had lagged behind other East Asian nations

[7]Zinnia F. Godinex, "Privatization and Deregulation in the Philippines," ASEAN Economic Bulletin, March 1989, pp. 259-289.

(Exhibit 5). The Administration's principal economic objectives were:

- greater attention to poverty alleviation and social justice;
- acceleration of growth and increased economic efficiency; and
- expansion of economic activity through increased private sector involvement.

One of Aquino's first initiatives was program of economic reform that included a comprehensive plan to rationalize the government corporate sector. Each GOCC was assessed to determine whether it would be retained by the government, privatized, liquidated, consolidated, or commercialized. Out of 301 GOCCs in the government corporate sector when Aquino assumed office, 122 GOCCs were identified for privatization, including Philippine Airlines, as well as 419 transferred, non-performing assets (TAs). Eight more GOCCs were later added to the list, bringing the total number of GOCCs targeted for privatization to 130. The list included a broad range of assets, including industrial firms, banks, hotels, and the national airline.

The Administration's privatization objectives were to:

- focus government resources to provision of basic public goods and services;
- create a favorable investment climate;
- broaden ownership and develop capital markets; and
- generate revenues for priority government expenditures (ie., land reform, public infrastructure, and others).

As a corollary to these objectives, the government sought to reduce budgetary deficits by eliminating expenditures for non-performing public assets and government-owned or controlled corporations. Privatized entities were expected to contribute substantially to tax revenues. In addition, employment opportunities were expected to increase as a result of the reactivation of idle assets.

When the privatization program was first announced, some officials complained that pressure from the international financial community was the real impetus behind the policy. An IMF stabilization program that introduced fundamental economic reforms to the Philippines had focused on GOCCs, since these enterprises accounted for approximately 80% of the country's foreign debt accumulated during the Marcos era. Changes that the World Bank and IMF had demanded privatization as a condition for future assistance caused some resentment. In spite of these complaints, however, there was broad domestic political support for privatization. The right supported the advantages of broader public ownership of the nation's industries and market oriented policies, while those on the left supported reform to increase accountability and reduce corruption.

Aquino's Privatization Program

The "Freedom" Constitution which Aquino adopted upon assuming the presidency expressly mandated government reorganization. Her commitment to privatization was announced early in her presidency, and it remained a priority of her Administration. Proclamation 50, issued in December 1986, officially launched "a program for the expeditious disposition and privatization of certain government corporations and/or the assets thereof." This ruling established the policy and procedural framework for privatization and created the Committee on Privatization (COP) and the Asset Privatization Trust (APT) (Exhibit 6).

The COP was a cabinet-level committee responsible for overseeing the Philippine privatization program. It was an executive office reporting directly to the Office of the President of the Philippines. Pursuant to its mandate under Proclamation No. 50, the COP approved the sale of Government assets or corporations as to price and buyer. It also designated and supervised the disposition entities responsible for the actual marketing of GOCCs identified for disposition.

The privatization plans recommended by disposition entities (DEs) were subject to COP clearance. The plans included the proposed timing, extent and mode of privatization for each asset. Once a plan was approved by the COP, the DE handled the actual marketing and implementation of the transaction. The COP reviewed the asset valuation and sale agreement between the DE and the proposed buyer, and endorsed the recommendation to the President to privatize. Vetoes by the COP were rare and occurred only when the proposed sale price was deemed too low. COP guidelines on valuation recommended the use of standard valuation methods such as appraised value, replication cost, and earnings and cash flow methods. The guidelines were intentionally broad, recognizing that the valuation method will depend upon the nature of the asset being sold.

The COP was composed of five cabinet-level officials: the Secretary of Finance as Chairman, Secretary of Budget and Management, Secretary of Justice, Secretary of Trade and Industry, and the Director of the National Economic and Development Authority. A Technical Committee provided support to the COP. Immediately upon its inception, the COP was instrumental in obtaining presidential approval to privatize 122 GOCCs and 419 TAs, and subsequently in adding an additional 8 GOCCs to the list.

The APT was established to serve as the primary disposition entity for the privatization of the TAs, which had previously been under the control of the Philippine National Bank and the Development Bank of the Philippines. These government-owned banks had acquired a substantial portfolio of private-sector assets through loan default, and the Aquino Administration sought to centralize the disposition of these assets in a public trust entity.

As previously mentioned, the COP designated the disposition entity for the privatization of each

GOCC. The Government Service Insurance System (GSIS) was the COP-designated disposition entity for Philippine Airlines.

Government Service Insurance System

GSIS was an independent operating body designated as the custodian of 1.5 million government employee pensions. Its primary function was the management of this pension fund and a lending program for teachers and government employees. With 1987 assets valued at P22.5 billion, GSIS rivaled the largest private sector banks in size and dominated the insurance sector. GSIS ranked 14th in revenues among over 5000 financial sector entities and earned P2.47 billion in 1987.

Officers of the GSIS were political appointees and held upper management and board positions within each of the companies in its portfolio. These powerful positions entitled the appointees to compensation through salary and other benefits, in addition to their GSIS salaries.

Companies in the GSIS portfolio, which included Combank, Philippine Airlines, the Manila Hotel and the Philippine Plaza, were among the most prized assets targeted for privatization. The GSIS portfolio also included several corporations acquired during the Marcos years that had previously been in private hands.

Government officials differed in opinion regarding the benefit of and justification for privatizing companies in the GSIS portfolio. Some openly stated that the government should not be in business. On the other hand, one GSIS official commented that there was no valid case against the management of some government firms--GSIS portfolio firms were all profitable and the board was steering them properly. This official believed that it was important to distinguish between the GSIS assets and other GOCCs, since GSIS companies had been established as competitive private enterprises, rather than by the government for development purposes.

Privatization Techniques

Throughout the privatization program, the Philippine government preferred to utilize two primary modes of divestment: sale of shares and outright sale of physical assets.

The sale of shares entailed the disposition of public enterprises or corporations as on-going concerns. Such transactions by definition involved corporations or enterprises which, without prejudice to their financial situation, had reasonable operational effectiveness. In some cases, only a portion of the government's interest in the corporations was sold. The extent of the government's interest which was divested depended on whether the government intended to continue managing the corporations or merely to maintain a sufficient number of shares to veto or influence decisions of the new management.

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The outright sale of physical assets entailed, by definition, the sale of entire public corporations or enterprises. The new owners assumed all of the entities' physical assets but none of their liabilities. This mode of privatization usually entails a mass layoff of employees; however, provisions were made in some cases regarding the re-hiring of former employees.

Most privatization transactions were accomplished through public bidding, although a few enterprises, such as the Commercial Bank of the Philippines, were privatized through negotiated sales.

Public offerings through the stock market were also utilized for the disposition of shares. The partial privatization of the Philippine National Bank (PNB) in 1989 represented the largest public offering in the history of the Philippine stock market and pioneered the way for this modality to be utilized for other government corporations. A total of 10.8 million shares, representing 30% of the government's total outstanding shares, were offered for sale, generating gross revenues of P1.8 billion (US$83 million). Approximately 25,000 investors participated in the public offering--many of them new participants in the market--thereby giving the bank the widest ownership base of any Philippine financial institution. The share offering also contributed significantly to the development of the equities market in the Philippines. According to a report issued by the PNB, the June 1989 listing in the country's two stock exchanges added approximately P4.7 billion (US$216 million) to total market capitalization in just two months.

In 1992, an additional 13% of the PNB's total outstanding shares were made available through a public offering. This was very well received by the market, resulting in gross revenues of P2.8 billion (US$100 million). It extended the private ownership of the bank to 43%, with cumulative gross revenues generated of P4.6 billion (US$165 million).

Accomplishments

From its inception in 1987 through August 1994, a total of 130 GOCCs and 419 TAs had been earmarked for privatization. Of these, over 400 were divested, generating gross revenues of P111 billion (US$4.2 billion)--nearly three times the government's original target figure of P41.12 billion for the privatization program.[8]

Out of 130 GOCCs slated for privatization, 83 were divested as of August 1994. Among the big ticket GOCCs privatized during this period were Petron Corporation, Philippine Airlines, Inc., and the Philippine National Bank. Sales of these three entities alone accounted for P29.3 billion (US$1.1 billion), or 26% of the cumulative gross revenues of the privatization program through August 1994.

[8] The average peso-dollar exchange rate in 1994 was P26.42 to U.S.$1.00.

Impact of the Privatization Program

Impact on Employees

The privatization of GOCCs significantly affected the job security of workers in a number of public corporations and ultimately the employment scenario in the Philippines. Section 27 of Proclamation No. 50 issued by President Aquino in 1986 to officially launch the privatization program provided for the "automatic termination of employer-employee relations upon the sale or disposition of government corporations." This provision ignited significant controversies within the labor sector during the initial stages of the privatization program. In 1986, unemployment in the Philippines was already at 6.7%. There was significant concern about the social and political implications of adding to this number the workers that would be laid-off as a result of privatization.

The labor sector was worried about the potential effect of this provision on the job security of workers in privatized companies, and they were also concerned that it could be used to circumvent the recognition of existing unions and collective agreements. Employers, on the other hand, viewed this provision as necessary for them to exercise management prerogatives upon assuming ownership of the entities. The problem was exacerbated by the absence of a law requiring a purchaser of the assets of an on-going concern to absorb the employees of the firm. Courts in the Philippines maintained that the purchaser was only required to give preference to qualified separated employees of the acquired entity. It was therefore left to the parties involved to work out ways to reduce the negative impact of the sale or transfer on employees.

The position of the Department of Labor and Employment (DOLE) on the matter was to let labor dispute pass through the normal procedures of dispute settlement. However, given the fact that the court system did not sufficiently protect workers, particular emphasis was placed by DOLE on the resolution of disputes. In some instances, DOLE took it upon itself to enter into a memorandum of understanding with GOCCs stating that, in the event that they were privatized, the security of employees' tenure and the status of unions and collective agreements would be respected. DOLE also tried to open lines of communication between parties through its National Conciliation Mediation Board.

The APT, for its part, made it a precondition to bidding, on a case-by-case basis, that the employment force of the TAs slated for privatization be absorbed by the purchasing party. In so doing, many potential labor problems were avoided during the privatization process.

While labor-related problems did arise in the privatization of some GOCCs, such problems did not have an adverse impact on the privatization process in general. The government avoided many labor problems through open and continued dialogue with the employees of the GOCCs earmarked for privatization. Collective bargaining agreements were respected throughout the process. In the absence of such agreements, statutory requirements concerning the welfare of employees were followed.

To minimize the impact on the labor sector, Philippine privatization law subsequently incorporated provisions stating that "in the disposition of assets in corporate form, there shall be no undue dislocation of labor unless all benefits as provided by existing laws or Collective Bargaining Agreements shall be complied with; and provided that the old qualified personnel shall be given preference in the hiring of new personnel by the new owners."

Impact On Government

The government could have increased the positive impact of the privatization program had it consistently maintained the momentum and enthusiasm which it had displayed at the start of the privatization program in 1986.

Despite the fact that the disposition entities were charged with privatizing 130 GOCCs and 419 TAs before the COP's statutory term ended on December 8, 1991, as of mid-1991, only 48 GOCCs and 146 TAs had been sold. A sizable portion of the P111 billion cumulative gross revenues generated by privatization activities through August 1994 came from dispositions accomplished after the COP's original term was extended, a number of which were big ticket transactions. The virtual stagnation of privatization efforts at the height of the Aquino administration had a negative effect on achieving the government's objectives for the program.

Due to the slow pace at which the privatization of public corporations and assets were carried out, many potential investors lost interest. In some cases, technical developments in industry rendered the public corporations obsolete. In other cases, high-maintenance machinery became too expensive to re-operationalize.

Such developments caused by the delay in the disposition of GOCCs and TAs had hidden costs for the government. The government lost opportunities to generate additional revenues as a result of the obsolescence and increased maintenance costs of unprivatized assets. It was estimated that the P12 billion worth of assets still remaining with the APT for privatization cost the government P4.4 billion for every year of delay.[9] Moreover, the maintenance and operation of these assets drained an estimated P14.3 billion from public coffers, while an additional P3.6 billion had to be borrowed elsewhere.

However, despite such opportunity costs, the privatization program had satisfactory results for

[9]This figure represents hidden costs to the government amounting to 37% of the P12 billion worth of assets remaining with the APT as of the last quarter of 1991. These costs are broken down as follows: 24% opportunity cost of money, 10% depreciation, and 9% custodial costs (such as insurance, taxes, and security).

the government. Despite the fact that in August 1994 nearly 150 of the entities slated for privatization had not yet been divested, the gross revenues from privatization as of that date were nearly three times the government's original target figure for the entire program. Moreover, by year-end 1993, the privatization program had already contributed P21.6 billion to the government's Comprehensive Agrarian Reform Program. The revenues generated by the privatization program also helped the government cover its capital outlays and decrease its huge budget deficits, and it enabled the government to trim interest rates and arrest inflation.

Lessons Learned

Managing the Implementation Process

The experience of the Philippines indicates that in a privatization campaign, the disposition of the targeted corporations and assets must be carried out expeditiously. During the earliest stages of the Philippine program, private investors focused their attention on the public assets earmarked for privatization by the government. However, these investors lost interest as the government displayed a diminished resolve to privatize the assets. It was only during the latter years of the Aquino administration, and after a certain amount of pressure from foreign creditors, that the pace of privatization began to accelerate. This delay cost the government in two ways. On the one hand, potential investors became discouraged, leaving the government with fewer options for the privatization of assets. On the other hand, the decreasing value of the assets themselves, combined with the hidden costs and opportunity costs of delaying the disposition of these assets, hindered the government from maximizing the profits and benefits to be reaped through privatization.

It can also be observed, however, that a calculated delay may occasionally result in higher profits. In some cases, including the PAL transaction, problematic corporations were made more attractive to investors through the use of various techniques such as the revaluation of assets, reorganization, and debt-for-equity swap arrangements. The subsequent sale of such entities resulted in higher profits for the government.

Another lesson to be learned from the Philippine experience is the importance of considering the interests of all stakeholders and maintaining open communications throughout the privatization process. This was particularly evident in the case of the labor sector. As previously mentioned, it was anticipated that mass layoffs of workers following clean sales of assets would be a major drawback of the program. The problem was minimized, however, as a result of the government's commitment to open communication with all parties involved. The Philippine Labor Code also provided appropriate safety nets in terms of monetary benefits for employees affected by the privatization of these entities.

Managing the Expectations (Politics)

The strongest resistance to the Philippine privatization program came from the managers and owners of the public corporations and assets. In some instances, assets had to be removed from the auction block because of political stonewalling and legal impediments to their sale. Moreover, some owners of corporations and assets earmarked for privatization were designated as the disposition entities of the same assets. Understandably, the resulting conflict of interest delayed the privatization of these assets. An indication of this problem was the fact that after four years, only seven of the eleven disposition entities designated by the Commission on Privatization had actually sold all of their assets.

The Philippine experience demonstrates that to ensure a speedy disposition of assets, it is imperative that the disposition entity have no interest or role in the management of the asset to be divested. In the case of PAL, the designated disposition entity (GSIS) also controlled the company's operations and appeared to be using political leverage to stall the transaction. The government resolved this conflict of interest by creating the PAL Privatization Committee to replace GSIS as the disposition entity and acquiring majority ownership of the airline through a debt-for-equity transaction.

In addition, legal disputes should be addressed properly from the outset. At a conference on privatization and labor relations in the Philippines held shortly after the privatization program was launched, it was suggested that a special court be designated for hearing privatization cases. Although this suggestion has not been implemented in the Philippines, it remains an innovative approach to the issue of resolving legal disputes as expeditiously as possible in order to avoid delays in implementing privatization transactions.

TECHNICAL NOTE

Exhibit 1: Budgetary Support To Government Corporations
(Millions of Pesos)

	1981	1982	1983	1984	1985	1986	1987
Equity	10,759	8,517	4,623	9,297	2,474	1,190	3,200
Subsidy	592	541	614	539	884	1,235	2,000
Net Lending	929	2,218	2,393	10,086	12,734	28,777	14,400
Total	**12,280**	**11,276**	**7,630**	**19,922**	**16,092**	**31,202**	**19,600**
Budgetary Support as Percent of Total Budget	**25.5**	**20.1**	**12.3**	**22.0**	**19.8**	**26.2**	**15.2**

Source: Benjamin E. Diokno, "Budgetary Implications of Privatization of Public Enterprises", Conference Papers, Philippine Economic Society Annual Meeting, 1986.

Exhibit 2: Philippine Public Debt
(Millions of Pesos)

	1980	1981	1982	1983	1984	1985	1986	1987
Total	**41,182**	**49,365**	**57,563**	**62,790**	**86,077**	**116,287**	**144,352**	**161,100**
National Government	21,876	28,657	35,344	43,470	59,666	75,972	104,910	150,751
Local Governments	336	362	432	427	174	182	161	116
Government Corporations	4,979	6,656	9,856	12,157	13,206	14,004	14,881	9,313
Guaranteed	3,754	4,561	7,270	9,314	10,156	9,948	10,987	7,256
Non-Guaranteed	1,225	2,095	2,586	2,843	3,050	4,056	3,894	2,058
Monetary Institutions	13,992	13,690	11,932	6,736	13,031	26,128	24,399	920

Source: Central Bank Statistics

TECHNICAL NOTE

Exhibit 3: Selected Macroeconomic Indicators

	1980	1981	1982	1983	1984	1985	1986	1987
Selected Indicators as Percent of Nominal GNP:								
Overall Budget Surplus/Deficit	-1.28%	-4.00%	-4.29%	-1.70%	-1.58%	-1.97%	-5.60%	-2.37%
Current Account Surplus/Deficit	-5.41%	-5.36%	-8.15%	-8.07%	-3.53%	-0.32%	-3.16%	-1.30%
Overall BOP Surplus/Deficit	-1.00%	-1.42%	-4.25%	-6.21%	0.77%	7.16%	4.12%	0.77%
External Debt Service Burden	4.18%	4.57%	5.73%	5.61%	6.04%	5.23%	6.85%	6.04%
Nominal GNP (peso billions)	264.5	303.6	335.4	378.7	527.3	597.7	614.7	703.4
Nominal GNP growth rate		14.8%	10.5%	12.9%	39.2%	13.4%	2.8%	14.4%
Avg Peso/U.S. Dollar Rate	7.51	7.90	8.54	11.11	16.70	18.61	20.39	20.57
Nominal GNP (U.S. $ billions)	35.2	38.4	39.3	34.1	31.6	32.1	30.2	34.2
Population (millions)	48.3	49.5	50.8	52.1	53.4	54.7	56.0	57.4
GNP per capita (peso billions)	5475	6131	6605	7276	9884	10934	10976	12263
Annual GNP per capita growth		12.0%	7.7%	10.2%	35.8%	10.6%	0.4%	11.7%
Consumer Price Index	138.9	157.1	173.2	190.5	286.4	352.6	355.3	368.7
Average Inflation Rate	18.2%	13.1%	10.2%	10.0%	50.3%	23.1%	0.8%	3.8%
Constant GNP (peso billions)	92.5	95.7	97.5	98.6	91.6	87.9	89.5	94.7
Constant GNP (U.S. $ billions)	13.9	14.3	14.6	14.8	13.7	13.2	13.4	14.2
Constant GNP growth rate		3.4%	1.9%	1.1%	-7.1%	-4.1%	1.9%	5.8%
BALANCE OF PAYMENTS: (in billions of U.S. dollars)								
Merchandise Trade Balance	-1.9	-2.2	-2.6	-2.5	-0.7	-0.5	-0.2	-1.0
Current Account, Total	-1.9	-2.6	-3.2	-2.8	-1.1	-0.1	1.0	-0.4
Overall BOP Surplus/Deficit	-0.4	-0.5	-1.7	-2.1	0.2	2.3	1.2	0.3
NATIONAL GOVERNMENT CASH OPERATIONS: (in billions of pesos)								
Revenues	34.7	35.9	38.2	45.6	56.9	69.0	79.2	103.2
Expenditures	38.1	48.1	52.6	53.1	66.9	80.1	109.8	119.9
Overall Surplus/Deficit	-3.4	-12.1	-14.4	-7.3	-10.1	-11.1	-30.6	-16.7

Source: Central Bank Statistics

TECHNICAL NOTE

Exhibit 4: Selected Domestic Interest Rates

	1980	1981	1982	1983	1984	1985	1986
Interbank Call Loans (IBCL)							
Average			12.50	17.35	28.88	16.15	12.39
High			33.00	55.00	80.00	60.00	43.00
Low			4.00	1.00	12.00	4.00	4.50
Treasury Bill Rates							
91-Days	12.14	12.61	13.81	14.17	30.53	26.81	14.43
182-Days	12.50	13.06	14.48	14.75	42.10	30.77	15.44
364-Days	12.77	13.19	14.95	14.92	41.50	35.21	13.15
All Maturities	12.32	12.91	14.42	14.54	36.99	27.05	16.04
Weighted Average Interest Rates on Deposits:							
Deposit rates							
Savings Deposits	9.00	9.81	9.81	9.73	9.85	10.84	7.99
Time Deposits		16.74	15.81	15.30	24.16	21.83	14.77
Lending Rates on Secured Loans		17.12	18.22	19.33	26.74	28.23	17.35

Source: Central Bank Statistics

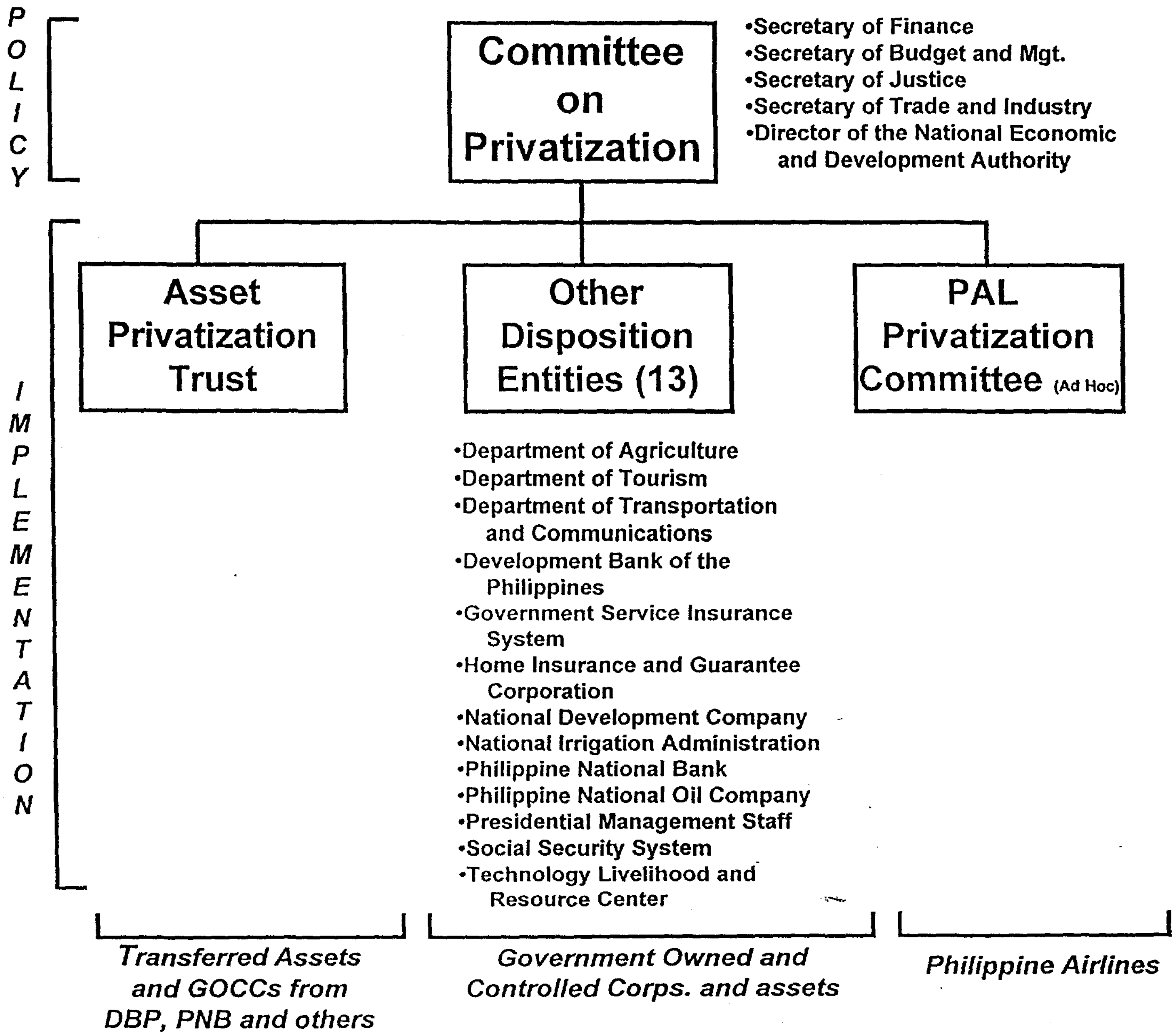
Exhibit 5: GDP Growth Rates in East Asia, 1980-1986

Southeast Asia:	1980-86	Northeast Asia:	1980-86
Philippines	0.3	China	7.8
Indonesia	4.8	Hong Kong	7.2
Malaysia	4.8	Japan	4.0
Singapore	6.1	South Korea	6.3
Thailand	5.2	Taiwan	6.7

Source: IMF, official country sources

TECHNICAL NOTE

Exhibit 6: Organizational Structure of the Philippine Privatization Program



TEACHING NOTE

Case Overview

COUNTRY:	Philippines
INDUSTRY:	Airline
DECISION-MAKER:	Chairman, PAL Privatization Committee
ISSUES:	Privatization process, use of debt-equity swap mechanism, choice of privatization mode, valuation of company

In November, 1991, Jesus P. Estanislao, Chairman of the PAL Privatization Committee and concurrently Secretary of Finance and Chairman of the Committee on Privatization, must decide when and how to privatize Philippine Airlines, Inc. (PAL). The flag carrier of the Philippines, PAL had suffered financial setbacks, and it was heavily indebted to the national government as creditor and guarantor of foreign-denominated loans.

On paper, the company is owned by the Government Service and Insurance System (GSIS) and the National Development Company (NDC), with ownership apportioned at 74 and 25 percent respectively; the remaining shares are held by several private investors. (The GSIS manages the retirement, housing, insurance, and other benefit funds of government employees, while the NDC is a government-owned investing/holding company.) In reality, however, PAL is owned by its creditors--principally the national government. The company has a negative net worth due to a high debt-equity ratio, mismanagement, and external factors beyond the control of the company. PAL is a burden to the national government financially but must be supported because it is the flag carrier.

Early in her term, Corazon C. Aquino, President of the Republic of the Philippines, issued Proclamation No. 50 creating the Committee on Privatization, a Cabinet-level group to oversee the privatization of the country's government-owned and controlled corporations and non-performing assets foreclosed by government financial institutions. The privatization program was a pillar of Aquino's financial and economic initiatives when she took office following the downfall of the Marcos government in 1986.

In spite of extensive political pressure to privatize PAL, the airline's management, through GSIS, has stalled the transaction for several years. To overcome this obstacle, the national government created an *ad hoc* PAL Privatization Committee, implemented a debt-equity conversion to acquire 80 percent ownership, and transferred responsibility for disposition of the airline from GSIS to the PAL Privatization Committee.

The PAL Privatization Committee oversees preparations for the government's divestment of PAL by cleaning up the airline's balance sheets, streamlining operations, and preparing long-term

These notes were written by the Intrados/International Management Group. They are designed to serve as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

projections of PAL's viability to present to prospective investors. The Chairman must decide whether PAL will be privatized through public bidding, or through a share offering on the equities market. He also contemplates postponing the privatization for a few years, in the hopes that the government could obtain a higher sale price as the Philippine economy improves.
The PAL Epilogue describes how the national government, through the PAL Privatization Committee, eventually privatized PAL. This section should only be distributed to students after discussion of the main case.

Learning Objectives

The PAL case concerns the privatization of an airline that is heavily indebted to the national government. It demonstrates a real-life scenario presenting various factors that influence a privatization program. The learning objectives are:

a) to expose students to the preliminary activities involved in preparing a technically bankrupt company for privatization;
b) to expose students to the use of debt-equity swap mechanisms as financial tools in preparing bankrupt and heavily indebted firms for privatization; and
c) to provide students with an understanding of other issues relating to privatization that transcend the purely financial considerations of the program but are nonetheless substantive in influencing the success or failure of privatization transactions.

Discussion Questions

1. What are the essential issues that must be addressed and resolved to prepare a company for privatization? What factors must be considered in determining the mode of privatization?
2. How can debt-equity swap mechanisms be used to facilitate a privatization program?
3. What intangible factors may affect the success or failure of a privatization program?

Teaching Plan and Case Analysis

Students are expected to have a basic working understanding of financial management, debt-equity swap mechanisms, and asset valuation techniques. This case may be used for mid- to senior-level government decision-makers and those responsible for implementing privatization programs.

1. What are the essential issues that must be addressed and resolved to prepare a company for privatization? What factors must be considered in determining the mode of privatization?

A key factor that dictates the speed with which a privatization program can be implemented is the organizational structure established to manage transactions. A second key factor is the preparation of the company itself for privatization. The following areas must be discussed:

Organizing for Privatization

As early as 1986, Philippine Airlines had been targeted for privatization. The major shareholder (GSIS) was initially mandated as the disposition entity. As such, the GSIS Board had the responsibility to privatize PAL. However, for various reasons, the privatization program never got off the ground until late 1991. Students may discuss the merits of assigning the responsibility for privatizing a company to disinterested parties vested with sufficient authority to override the management and directors of a company slated for privatization.

When the national government invoked its creditor-rights over PAL, which had a negative net worth, it was able to exchange its financial claims on PAL for a controlling 80 percent interest in the company. The members of the PAL Privatization Committee, who subsequently represented the controlling government interest, had no personal stake in the airline and, therefore, had no incentives to delay its privatization.

Preparing a Company for Privatization

- *Clean-up of the Balance Sheet*

  Prior to the government's move to convert its financial claims on PAL to 80 percent ownership, the company had a negative net worth of P4.7 billion against total assets of P20.5 billion.

  Students should be asked whether, in a negative net worth scenario, there are feasible ways to privatize the company and, if so, how should sales proceeds be allocated among the creditors. What should be the impact on the existing shareholders (GSIS and NDC), PAL's employees, and its unsecured creditors? What are the implications of privatizing a company with a negative net worth? What are the implications for the international community of privatizing a national flag carrier such as PAL?

- *Improving Operations*

  PAL's poor financial performance seriously impairs the attractiveness of the airline to potential buyers. Students can be asked to discuss how to improve the company's financial and operational performance, thereby enhancing the company's prospects for privatization.

  The causes of the company's failure can be analyzed and steps identified to improve financial performance. An analysis of costs and their rates of increases vis-à-vis revenues can be undertaken to identify disproportionate cost items.

- *Packaging the Company for Sale*

  Students may be asked to comment on the projected operating and financial scenario generated by PAL to show the Company's future viability. The discussion should also lead to an assessment of the credibility of the planning parameters and variables used in projected financial statements.

Choosing the Mode of Privatization

Secretary Estanislao is faced with choosing the mode of privatization for PAL. Alternatively, he may postpone the privatization while awaiting the recovery of the Philippine economy. His options are to bid out the government's shares to pre-qualified bidders or to offer the same shares through a public offering on the Philippine stock market. What are the advantages and disadvantages of each mode?

Are there other considerations that should be taken into account that would make one option better than the other? If so, the students may be asked to explain why. Clearly, Philippine Airlines, as a flag carrier, is an extension of the national government. Would it be prudent to offer its shares through an IPO to potentially unknown buyers, or would it be preferable to bid them out to initially pre-qualified bidders?

Establishing the Selling Price

Students may be asked to determine a quantitative basis for arriving at the government's minimum selling price. This will expose the students to various valuation techniques, tempered with such factors as PAL's inherent intangibles and goodwill as well as its future financial prospects.

2. *How can debt-equity swap mechanisms be used to facilitate a privatization program?*

The PAL scenario demonstrates the government's innovative use of the debt-equity swap mechanism to take effective control of PAL. Students may be asked why the government did not foreclose on PAL's assets but chose instead to allow the NDC and GSIS to retain 20 percent ownership of PAL.

The acquisition of 80 percent ownership of PAL also enabled the government to accelerate PAL's privatization. With controlling interest in the airline, the national government was finally able to implement the transaction because the Privatization Committee had clear authority over the company's fate.

Students may also be asked to comment on whether a similar debt-equity swap mechanism could be utilized as part of the privatization transaction itself. As illustrated in the Epilogue, the Philippine government enhanced the attractiveness of PAL to investors by including "eligible debt" as one component of the purchase price. This mechanism in fact allowed the bidders to purchase government debts at a discount in the secondary market and ostensibly lessened their costs per dollar offered.

3. What intangible factors may affect the success or failure of a privatization program?

This question may be used to summarize the broad range of non-quantitative factors that impact on the privatization of a company such as PAL. Successful privatization efforts require a top-level mandate, as demonstrated by the Aquino Government under its Proclamation No. 50. However, students must be made aware that a mandate from the top is not the only requirement. The political will to privatize must extend to the board and management of the company slated for privatization.

Students may also be asked to comment on how the national government organized itself to facilitate PAL's privatization by committing top administration officials' time to the effort. They may also be asked to discuss potential conflicts of interest that may arise when the board or management of a company is charged with the responsibility of privatizing the company.

Packaging for privatization is also important. Potential buyers need guidance as to how to assess the company's potential. This can only be undertaken if the company's management is properly motivated and imbued with a strong sense of commitment regarding the company's future value.