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REPUBLIC OF KYRGYZSTAN

**PRIVATIZATION PROGRAM
REVIEW AND RECOMMENDATIONS**

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INTRODUCTION

The United States Agency for International Development (USAID) was requested by the State Property Fund (SPF) of Kyrgyzstan to assist it with its program for the privatization of state enterprises. In response USAID fielded a team to review SPF's program, suggest immediate measures that could be taken to strengthen the program and recommend additional assistance which might be appropriate.

The USAID team, comprising two privatization specialists from Price Waterhouse-International Privatization Group and a team coordinator from the office of USAID (Washington), visited Bishkek from September 8-22. During its visit, the team met with several SPF managers, Kyrgyz government officials and private business persons. The team also visited several state enterprises scheduled for privatization. A list of persons met is in Annex 10.

Upon arrival in Bishkek the USAID team coordinated its proposed work plan with the Chairman of SPF, Mr. Abdyjapar Tagaev. Mr. Tagaev made the following requests of the team:

- (i) to provide practical advice regarding methods of privatization;
- (ii) to examine mechanisms for financing privatization;
- (iii) to provide guidance for the valuation of enterprises;
- (iv) to make recommendations regarding their system of vouchers (special payment means for privatization);
- (v) to suggest ways to accelerate the privatization process;
- (vi) to assist them in privatizing a few enterprises, and
- (vii) to help develop the concept and design of holding companies for public participation in the privatization process.

The USAID team agreed to respond to the above requests within the time and resource limitations of their visit. Below is a report covering the team's findings and recommendations.

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I. EXECUTIVE SUMMARY

This report analyzes the Government of Kyrgyzstan's program to privatize state owned assets. Principal responsibility for developing and implementing the privatization program rests with the State Property Fund, which was established by and is accountable to the Parliament. The chairman of the State Property Fund reports to the President on operational matters.

The USAID team has found the Government of Kyrgyzstan to be strongly committed to privatization, but the potential for investment (foreign, domestic, or from the Former Soviet Union) in the enterprises to be privatized appears to be limited. As with the rest of the Former Soviet Union (FSU), the enterprise structure in Kyrgyzstan is not based on market forces. Kyrgyzstan has little installed capacity to process its own raw materials. Most of its agricultural and industrial enterprises were established to process inputs from other former Soviet republics and re-export them to these markets. Equipment is obsolete. Most enterprises have excess labor.

There are some prospects to generate investment in Kyrgyzstan. For the most part, however, foreign investors will prefer starting new projects, closer to their inputs and markets, rather than privatizing outdated enterprises with management and employment rigidities. Potentially attractive investment areas, particularly mining, are not included in the present privatization program. Domestic capital is limited.

The recommendations in this report focus on four objectives: accelerating domestic investment in small enterprises; restructuring policies to increase attractiveness to potential foreign investors; facilitating orderly liquidation of non-viable enterprises; and moving property out of state control as quickly and effectively as possible. A summary of the recommendations is provided in Annex 1.

Work plans for additional technical assistance on the privatization program and specific transactions are provided in Annexes 2 and 3. This report also includes sample forms for a catalogue of enterprises and for investment profiles, a list of enterprises to be considered for more detailed viability analyses, and descriptions of a holding company concept and a bidding process to accelerate the sale of state shares in privatized enterprises.

The report is based on visits to selected enterprises that have been or will be privatized; review of limited data regarding enterprise sales, employment and fixed capital; and meetings with government officials (particularly in the State Property Fund), private business persons, some banks, three World Bank teams, the IMF resident representative, an IFC team, and U.S. Embassy staff.

II. THE PRIVATIZATION PROGRAM

The value of total state assets for privatization is estimated at 23 billion rubles (in 1985 terms). To date, approximately five percent of this value has been privatized. The target agreed upon with the IMF is to transfer 35 percent of state assets to private ownership by the end of calendar year 1993.

Kyrgyzstan's privatization program emanates from a privatization law issued by Parliament in January 1992 and in a subsequent Presidential decree on privatization. The program has three principal components: housing, small enterprises, and medium and large enterprises. While the concepts of small, medium and large are used to structure the privatization program, they are not defined in either the privatization law or decree. The two key factors in defining the size of enterprises should be the number of employees and their fixed capital. Based on the review of employment and capital statistics for a number of enterprises, suggested definitions for small, medium and large are:

Small: less than 200 employees and a fixed capital of less than 5 million rubles;

Medium: Between 200 and 1,500 employees or a fixed capital between 5 and 15 million rubles;

Large: Over 1,500 employees or a fixed capital greater than 15 million rubles.

All privatization activities in Kyrgyzstan, except housing, are under the domain of the State Property Fund. The Fund was created by Parliament. Its chairman is accountable to the Parliament and reports directly to the President on operational issues. The Fund has a national office and regional branches. Medium and large enterprises, and nationally based small enterprises, are privatized through the national office. Locally based small enterprises are privatized through the Fund's regional offices. The Fund also initiates the privatization of housing by issuing vouchers (discussed below) to all Kyrgyz adults. Implementation of the housing privatization program is decentralized to local housing bureaus or to individual enterprises which control housing either in a specific area or, in the latter case, for the enterprise's employees.

Five mechanisms exist to purchase state assets:

1. Public auctions: used solely for small enterprises. The highest bidder is awarded the enterprise.

2. Competitive bids: used for enterprises of "special significance", principally for small enterprises. Sale is based on the terms of the bid considered to be the most favorable, which includes consideration of price, provisions for retaining current employees and a commitment to continue the enterprise's current activities for at least a year.
3. Lease/purchase: used for small enterprises with lease periods extending 3 to 5 years. Also used for medium and large enterprises which have been under existing lease for at least three years.
4. Joint stock companies: used for medium and large enterprises. 25 percent of all shares must be reserved for purchase by the public through a voucher program (discussed below). Workers have preemptive rights to up to an additional 20 percent of the shares at a discount from the sales price of up to 30 percent.
5. Purchase at fixed price: used exclusively for housing sales based on 1984 book value.

Vouchers will be provided to all Kyrgyz adults to participate in the privatization program; to date, about 40 percent have received their vouchers. Each voucher has a specified ruble value based upon the individual's contributions to the economy, particularly length of service and average wage. The State Property Fund estimates that average value ranges between 5,000 - 10,000 rubles. To put this in perspective, the State Property Fund indicates that a 3 room flat has an estimated book value of 7,000 rubles; individuals have suggested that such a flat may have a possible market value of up to 1 million rubles. Vouchers can be used by individuals to purchase housing, buy shares in an enterprise, and/or as a contribution to an offer price in an auction or bid. The vouchers cannot be sold or traded. Public interest in using vouchers appears to be limited. Some might use their vouchers to buy flats, but with rents at less than a ruble a month and with no prospect for where to live if one sells one's flat, incentives are limited.

Standard financing terms offered by the State Property Fund are 25 percent down payment with up to 3 years to pay the 75 percent balance. More extended payment arrangements are available through banks and are provided solely to worker collectives purchasing an enterprise enterprises, not to individual buyers. There is no prohibition to buyers (collectives and other enterprises) borrowing their 25 percent down payment from the commercial banking system (if they can obtain credit), but individuals cannot do so. If the management and employees of a state enterprise wish to participate in the purchase of an enterprise, they can use their vouchers to contribute to the

purchase cost of their shares.

III. ANALYSIS OF THE PRIVATIZATION PROGRAM

This section analyzes potential issues which have arisen or may develop as a result of the current structure of the privatization program.

A. *Legal Framework*

During the same period over which this report was completed, a World Bank team undertook an in-depth review of laws and regulations in Kyrgyzstan related to privatization (e.g., the laws on privatization, enterprises, lease/purchase, property). Readers should refer to the World Bank report for specific comments on the legal framework. Two points merit particular emphasis:

1. It is our understanding that the World Bank concludes that the basic laws affecting privatization must be completely restructured. Although the Government of Kyrgyzstan has made significant progress in passing and amending laws to promote a market economy, the legal framework remains imbued with the concept of collective ownership. It is also our understanding that specific recommendations have been made to the Government to create a legal basis for privatization based on private ownership of property and competitive markets.
2. The Government of Kyrgyzstan continues to retain many laws and regulations which encumber private enterprise and make it difficult for new businesses to be established. In particular, prospective entrepreneurs must seek approval from various levels of government including, in some cases, select committees from Parliament which must review business proposals. While such approvals do not directly relate to the privatization process, they discourage new investment in the economy at a time when all reasonable measures to encourage investment and job creation should be taken.

B. *Small Enterprises*

The small enterprise privatization program should move more quickly, but it achieves the basic objective of transferring small businesses to private hands. The three main concerns are:

1. The State Property Fund goes through a cumbersome valuation process for each enterprise which is not necessary since it then proceeds to sell the enterprises through bids or auctions. Given the difficulty of estimating the current value of capital in Kyrgyzstan, market prices derived through auctions or bids are the most practical and efficient way to value an enterprise.
2. The evaluation of competitive bids is time consuming and not fully transparent. A committee must be established to review bids. Since awards are based on subjective criteria, the process of evaluation takes time and could result in questions over the outcomes and their consistency.
3. The lease/purchase arrangements unnecessarily delay the process of actual state divestitures for several years even though other sales options are available. Extended payment terms could be made available to purchasers to ease financing constraints. The lease/purchase method does, however, move management of the assets to the private sector.

C. *Medium and Large Enterprises*

The key issues in Kyrgyzstan's privatization program relate to medium and large enterprises which employ a significant share of the population (we still have not obtained comprehensive employment estimates). Economic and financial issues that will face potential investors include:

1. The current enterprise structure is not based on market forces but is based on the directives of a command economy formerly controlled out of Moscow.
2. One result of central directives has been that Kyrgyzstan has not developed the capacity to process its raw materials. Most raw materials were shipped for processing to other republics. Other raw materials, particularly in the mining sector, were not developed because central planners identified other republics as exclusive suppliers to the rest of the FSU.

3. A second impact is that both inputs and markets for Kyrgyz enterprises are far away. Even a textile manufacturer imports cotton and wool from other parts of the FSU because local production is of poor quality. The common pattern is to import raw materials and then to re-export finished or intermediary goods. Of all exports, 98 percent are to FSU countries.
4. Adjustments to market prices will continue to cause massive production cost increases in Kyrgyz enterprises. For example, the price of steel for one enterprise visited has increased in 1992 from 70 rubles per kg, to 280 rubles in June, and to 700 rubles in a recent price increase. The most severe shock may come as Russia raises petroleum prices to international levels. A doubling in petroleum prices is scheduled for October, with import parity scheduled to be phased in through 1994.
5. As Kyrgyz enterprises increase their prices to reflect higher input costs, they will begin to lose price competitiveness in foreign and FSU markets. In a sample of a few industries, Kyrgyz enterprises are charging about a fifth of international prices for their products. While this is presently a wide margin, it will quickly be lost as both direct and indirect subsidies are ended. (Note: all direct budget subsidies from the former Soviet Union have ended, and large implicit price subsidies are being phased out. Kyrgyzstan's budget deficit is running about 5 times greater than the 1992 projection as price adjustments have decreased enterprise viability and, hence, tax revenues and increased government expenditures.)
6. Equipment is obsolete. Plants are oversized. A few enterprises have relatively modern equipment, but this is the exception rather than the rule. Needed investments in order to meet international quality standards will further reduce price competitiveness. Virtually all enterprises employ far more labor than required.
7. A majority of current medium and large enterprises are not likely to be viable in a market economy, and the state is unlikely to have the resources to keep such enterprises going through subsidies. New economic opportunities are bound to evolve, but it is likely that there will be a transitional period of significant unemployment.

These factors suggest that prospects are limited for investment in privatization. Foreign investors will prefer new projects free of the baggage and obsolete equipment of failed state enterprises -- preferably closer to their raw materials and markets.* The Kyrgyzstan parliament has withheld mining, possibly the most attractive sector for foreign investment, from the privatization plan for at least five years. FSU investors are likely to focus on extensive investment opportunities within their own economies. Potential investors in Kyrgyzstan have limited capital. Business persons interviewed indicated that, due to high inflation, they would seek investments with quick returns rather than invest in long-term projects.

The *potential scenario* for medium and large privatized enterprises -- which indeed seems to be evolving based on selected enterprise visits -- is bleak:

1. Investors in privatized enterprises are likely to be limited to workers and management. The State Property Fund continues to retain a large percentage of shares in privatized enterprises, at times over 50 percent. The stated intent is to sell these shares to voucher holders and to foreign investors.
2. Enterprises controlled by current management and workers with no capital injection or external expertise have limited potential to restructure their work force, improve management systems, and extend their marketing capability outside the FSU.
3. The state, as a major shareholder, has the potential to interfere in enterprise management or reverse progress toward privatization. Foreign investors face the prospects of having to negotiate two deals to invest: with the state, and with shareholders comprising management and the workers.

* Government officials often point to a factory in Tokmak which produced televisions as an example of the potential for joint ventures. Information obtained from an interview with the factory manager revealed that the "joint venture" consisted of a one-time contract of one year under which a Korean firm supplied parts to the Kyrgyz firm for assembly. No technical know-how, capital or marketing assistance was provided by the Koreans.

4. With limited capital injection, many privatized enterprises are likely to fail. If that proves the case, the privatization of such enterprises could prove counterproductive, in the end leaving workers disillusioned and causing significant social problems as unemployment increases. This is not an argument against privatization, but an argument for managed liquidation of non-viable enterprises.

D. Sector Issues

It was not within the scope of this report to fully analyze sector-specific issues related to the privatization program. The following comments are limited to three sectors with considerable prospects for privatization which merit further consideration.

1. **Transport:** the transport sector is a good target for privatization since state assets, particularly trucks, can be divided into relatively small units which can be privatized through means similar to small businesses. The transport sector also affects the viability of other sectors of the economy through the movement of raw materials, inputs, food and other processed products. At present, the privatization target for transportation is very low (it is stated as "no less than ten percent") and could be accelerated. Moreover, creative means of privatizing the transport sector should be explored, particularly to encourage numerous owners of trucks who can compete against each other.
2. **Agriculture:** agriculture is also an attractive target for privatization since state assets can be divided into relatively small units that expand the number of private entrepreneurs in the economy. The government has already begun to privatize some state farms. However, greater attention must be given to dismantling the State Order System if privatization in agriculture is to prove effective. The state continues to purchase a major share of the principal food crops at fixed prices and to allocate distribution. As long as the state determines prices and distribution, privatization in agriculture will not have the desired impacts on increased productivity and food availability. A World Bank team has been in Kyrgyzstan to review the agricultural sector, and their forthcoming report will treat this subject in greater detail.

3. Mining: the mining sector may be the most attractive to potential foreign investors, but it is presently excluded from privatization for at least five years. Nonetheless, government officials reported that the government is discussing mining ventures with several foreign firms. While discussions with potential foreign investors are to be encouraged, they should be pursued in the most open and competitive way possible. It appears that discussions are initiated by foreign firms without the benefit of international competition. For the government, potential disadvantages of the current approach could be that they do not achieve the best possible terms for Kyrgyzstan, and that they do not attract the highest quality international mining firms.

IV. OBJECTIVES OF PRIVATIZATION RECOMMENDATIONS

In light of the limited prospects for domestic and foreign investment in privatized enterprises, and the critical need to attract capital to restructure Kyrgyzstan's economy, the following recommendations seek to address four objectives:

1. Accelerate domestic investment in small-scale privatization which has the potential to increase capital among a wide base of people in the economy. Small-scale privatization offers the best short-term prospect for mobilizing domestic capital and promoting investments that contribute to economic restructuring and generate employment. Employment creation is particularly important in order to mitigate the impacts of the inevitable liquidation of many medium and large enterprises.
2. Develop policies that may attract foreign investors in limited areas of potential interest. While the prospects for foreign investment in privatized enterprises are not high, specific measures can be taken to attract investors in selected enterprises and sectors.
3. Facilitate the orderly liquidation of non-viable enterprises. Such enterprises have no future as either private or state-owned firms and their drain on the economy should be terminated.
4. Accelerate the process of moving property out of state hands and into the private sector.

V. SPECIFIC RECOMMENDATIONS

This section of the report outlines thirteen specific recommendations to improve the management and investment impact of the privatization program in Kyrgyzstan. These recommendations are summarized in Annex 1 of this report.

1. Create an information base for privatization activities. Such an information base would include a complete list of all privatized and state-owned enterprises. The State Property Fund has a list of enterprises planned for privatization by the end of 1993, but such list does not include the full universe of state enterprises that should be considered for privatization. More extensive information profiles should be completed for medium and large enterprises. A sample of such a profile will be left with the State Property Fund.
2. Disseminate information to potential investors. Within government, this will require coordination among the State Property Fund, the State Committee on Foreign Economic Relations, the Ministry of Finance and Economics, and Kyrgyzstan's embassies, all of which have some dealings with potential foreign investors. Standard international mechanisms to disseminate information through private channels should be exploited. The same information should also be made available to potential domestic investors.
3. Simplify the small business privatization process. Suggested measures include:
 - Eliminate the initial valuation of enterprises and let the value be set by auction.
 - Make auctions the standard means of privatization for small enterprises.
 - Utilize lease purchase arrangements only when auctions fail, thereby accelerating the state's divestiture of small enterprises. Financing concerns can be addressed through flexibility in payment terms.
 - Eliminate competitive bids since their evaluation is time-consuming, is not fully transparent, and the same objectives can be achieved more quickly through auctions.

4. Accelerate small business privatization targets. The national State Property Fund should set a deadline for all small businesses to be privatized by the end of 1993 and require transfer or liquidation by such date. Regional branches of the State Property Fund, which are responsible for the privatization of local small enterprises, should submit to the national State Property Fund, by December 1992, phased plans to meet this target.
5. Accelerate privatization of medium and large enterprises. The State Property Fund should set a deadline for all state enterprises to submit a privatization plan, in a specified form, by a near-term date. Review of these privatization plans should include an assessment of enterprise viability and be used to accelerate privatization of the more attractive enterprises not currently scheduled for privatization.
6. Do not privatize non-viable enterprises. These enterprises will require further study for possible restructuring before privatization. If there is no viable alternative, plans should be developed for their orderly liquidation. The State Property Fund should not be involved in developing social safety net programs. Its focus should remain on promoting viable private enterprise activity. However, it should coordinate closely with other parts of the government responsible for safety net programs to give them the opportunity to develop appropriate measures to address transitional unemployment.
7. Mobilize the use of vouchers within Kyrgyzstan. Specific measures include:
 - Allow for the purchase and sale of vouchers once vouchers have been fully distributed to Kyrgyz adults. Individuals who might not otherwise use vouchers might get some benefit from their sale, and will use the money from such sales in the economy. The trading of vouchers will also maximize their impact on domestic investment in the privatization process.
 - Encourage the establishment of private companies to manage the investment of vouchers on behalf of individuals. Such companies would act essentially as mutual funds. Individuals would invest their vouchers in the companies, which would use them to buy shares in medium and large enterprises and, possibly, to buy small enterprises through the auction system.

- Create holding companies which will combine, for a number of enterprises, the 25 percent shares retained by the State Property Fund for the voucher program. The State Property Fund would then distribute 100 percent of the shares in these holding companies through the voucher program, in turn divesting itself of the shares of a number of enterprises through one mechanism. The holding companies would also allow voucher holders to diversify participation in a range of enterprises. A description of this holding company concept is provided in Annex 4.
8. Create a bid process to accelerate the distribution of shares in state enterprises and holding companies. In such a bid process, the price of a share in a holding company or individual enterprise would be announced. Individuals and mutual funds that hold vouchers would offer to purchase these shares and would be given a specified time frame to tender offers. If all the shares are sold, then the enterprise or holding company would be divested. If shares are not fully sold, the price would be lowered and the process repeated. Management of the holding companies would also be transferred from the State Property Fund to the private sector. A more complete description of a possible bid process is included in Annex 5.
 9. Allow financial flexibility. The State Property Fund should provide more flexible terms to privatize viable enterprises with good management. As with small enterprises, payment periods could be extended or the price of enterprises could be discounted.
 10. Provide more flexible terms to attract foreign investment. Given the obsolete nature of most enterprises, the State Property Fund should be more concerned with capital injections than with proceeds to the state. Many foreign investors will not consider investments with significant worker or voucher ownership, and flexibility should be provided on a case-by-case basis to allow up to 100 percent of an enterprise to go to a foreign investor.
 11. Open additional sectors for privatization. The state has withheld from the privatization program key sectors that might generate significant foreign exchange, such as mining and minerals. Energy and public transit are other potential areas.

12. Target for promotion a limited number of enterprises with potential for foreign investment. Kyrgyzstan needs some high visibility ventures to attract foreign investor interest. Such ventures would likely occur in sectors that are not currently in the privatization plan.
13. Minimize state involvement in privatized entities. When the State Property Fund holds shares in privatized entities, it should do so in trust in order to sell such shares through the voucher program, and it should not participate in the board of directors. The State Property Fund should also minimize the percentage of shares it holds in an enterprise and seek to maximize private sector participation.

VI. PROPOSED TECHNICAL ASSISTANCE PROGRAM

The State Property Fund would benefit from technical assistance on management and policy issues related to privatization and on executing specific transactions under the privatization program. In order to maximize impact and continuity, a two-phase technical assistance program is proposed. Both of the phases are linked to implementing the above recommendations.

Phase 1 would consist of a short-term team of technical experts to begin the process of identifying firms of particular importance, assessing their viability and determining privatization alternatives. As indicated above in the recommendations, such viability assessments are critical for an effective and responsible process of privatization, especially given the limited prospects for many enterprises. The short-term team would also consult with the State Property Fund on the implementation of other recommendations outlined in this report. A work plan for phase 1 is provided in Annex 1.

Phase 2 would consist of a two-year program that includes both long and short-term advisors. To promote consistent advice on privatization policy, two long-term financial advisors are proposed to work with the State Property Fund. Their principal responsibilities would focus on the design and implementation of privatization policies and measures that accelerate the effective transfer of state assets to the private sector. Such assistance would include creation of a data base, design and implementation of holding companies, developing a bid process to sell shares for medium and large enterprises through the voucher program, and advising on the process for small enterprise auctions.

Phase 2 would also include a series of short-term technical consultancies focused on specific transactions and staff training. An in-country training program on enterprise valuation is strongly recommended. Short-term advisors would also assist with attracting and negotiating with foreign investors, enterprise-specific restructuring plans, enterprise liquidation plans, and other technical requirements which cannot be completed by the short-term advisors. Eight short-term technical assistance teams are proposed during phase 2, but the number of teams and their composition may vary within a designated number of person days, depending on actual technical needs.

A work plan for phase 2 is provided in Annex 3.

SUMMARY OF RECOMMENDATIONS**1 CREATE AN INFORMATION BASE**

database on regional and national basis

catalogue of large and medium enterprises

2 CREATE MEANS OF DISSEMINATING INFORMATION TO POTENTIAL INVESTORS

Coordination with State Committee on Foreign Economic Relations, Ministry of Finance and Economics and Embassies

Easy access for domestic investors

Distribute information to international private and public sector intermediaries

3 SIMPLIFY SMALL BUSINESS PRIVATIZATION PROCESS

Eliminate initial valuation, let value be set by auction

Use auctions as standard privatization mechanism

Utilize lease/purchase only when auctions fail

Eliminate competitive bids

4 ACCELERATE SMALL BUSINESS PRIVATIZATION TARGETS

National State Property Fund sets deadline for 100% small business divestiture by end of 1993

Regional State Property Funds submit phased plans by December 1992

5 ACCELERATE LARGE AND MEDIUM PRIVATIZATION PROCESS

Set deadlines for all enterprises to submit privatization plans in a specified format by a near term date.

Review of these plans should include an assessment of viability

Identify enterprises not currently scheduled for privatization for acceleration

6 DO NOT PRIVATIZE NON VIABLE ENTERPRISES

These enterprises will require further study for possible restructuring before privatization

If no alternative, develop plans for orderly liquidation

7 PROMOTE USE OF VOUCHERS

After all vouchers have been distributed allow purchase and sale

Encourage establishment of private companies to manage the investment of vouchers on behalf of individuals

Create holding companies which will hold a number of 25% interests. Distribute 100% of the shares of these holding companies

8 ACCELERATE THE DISTRIBUTION THROUGH VOUCHERS

Create bid process for distribution of shares reserved for voucher program

9 ALLOW FINANCIAL FLEXIBILITY

Provide more flexible terms to privatize viable enterprises with good management

10 PROVIDE MORE FLEXIBLE TERMS TO ATTRACT FOREIGN INVESTMENT

Be more concerned with capital injections than with proceeds to the State Property Fund

Allow up to 100% of an enterprise to go to foreign investors

11 OPEN ADDITIONAL SECTORS FOR PRIVATIZATION

For example, mining, minerals, energy, public transit

12 TARGET FOR PROMOTION A LIMITED NUMBER OF ENTERPRISES WITH POTENTIAL FOR FOREIGN INVESTMENT

Prepare investment profiles

Actively solicit foreign investor interest

13 MINIMIZE STATE INVOLVEMENT IN PRIVATIZED ENTITIES

Seek to minimize State Property Fund retention and maximize private sector participation

When the Fund holds shares in privatized entities, it should do so in trust and not participate in Boards of Directors

**PROPOSED PRIVATIZATION ASSISTANCE TO THE STATE PROPERTY FUND OF THE
REPUBLIC OF KYRGYZSTAN**

PHASE 1

SHORT TERM TECHNICAL ASSISTANCE

- GOALS:**
- o Identify a limited number of privatization candidates throughout the Republic which are considered to be of the most importance and assess their privatization alternatives.
 - o Provide consultative advice on the implementation of the recommendations of the advance team

APPROACH: In conjunction with the State Property Fund and its regional subsidiaries identify 10 to 12 enterprises considered to be important based upon size and/or strategic importance to the republic or a specific region. The assessment of privatization alternatives would be handled by a team consisting of:

- o A Team Leader/Privatization Expert (Financial Background)
- o An Industrial Engineer
- o A Senior Financial Analyst
- o Two Russian-speaking assistants with a financial or economics background to gather information

WORK PLAN: The Team would conduct the following activities following a request for assistance by the State Property Fund and approval of that request by USAID:

- o Identify 10 to 12 enterprises as outlined above
- o Solicit enterprise management acceptance of the assistance

- o Visit each of the selected enterprises for three to five days each and:
 - Establish a rapport with management
 - Determine the legal status of the enterprise
 - Review business plans
 - Obtain an understanding of the existing privatization strategy, if any
 - Gain an understanding of the business operation, its products, its markets, sources of supply, special contracts, existing competitive situation, characteristics of the work force
 - Review financial and statistical data
 - Prepare a brief report outlining the findings of the team and its recommendations for privatization. It is anticipated that these recommendations will have four alternatives:
 - # Domestic Privatization
 - # Solicit foreign investor interest
 - # Further study for restructuring prior to privatization or orderly liquidation
 - # Orderly liquidation
 - Discuss with the State Property Fund and enterprise management

To the extent that time permits, the Team Leader will consult with the State Property Fund on the implementation of the recommendations previously outlined in the body of this report.

OUTPUTS:

- o Oral report outlining experiences and conclusions reached to USAID and the State Property Fund
- o Brief reports on each enterprise outlining findings of the team and their privatization recommendations

REPORTING RELATIONSHIP:

The consultants will report to USAID and to the Chairman of the State Property Fund or his designate.

LEVEL OF EFFORT:

The level of effort required is estimated at 200 person days. Depending upon whether each enterprise requires 3,4 or 5 days the possible range of enterprise coverage will be 8 to 13.

**PROPOSED PRIVATIZATION ASSISTANCE TO THE STATE PROPERTY FUND OF THE
REPUBLIC OF KYRGYZSTAN**

PHASE 2

LONG TERM TECHNICAL ASSISTANCE

- GOALS:**
- o Ensure timely and effective implementation of the recommendations set out in the body of this report
 - o Ensure timely and competent follow up on situations identified in phase 1 requiring foreign investment, restructuring or orderly liquidation
 - o Transfer skills to locals through training programs, as appropriate, through use of local assistants and through the involvement of Fund employees in projects, wherever possible

APPROACH: Two long-term advisors will be situated in the offices of the State Property Fund to assist them on the implementation of the recommendations. This assistance could take two basic forms:

- o High level advice and monitoring of projects where the implementation skills exist
- o Day to day involvement and/or procurement and management of other consultants required to provide the necessary skills

The long-term team will consist of:

- o A Project Manager/Privatization Expert (Financial Background)
- o A Senior Financial Analyst
- o It is anticipated that the State Property Fund would provide a Russian-speaking assistant with a financial or economics background

To complement the long term assistance, provisions are made for a series of short term technical assistance which would focus on specific tasks. It is anticipated that short term teams would focus on:

- o Assistance with finding and negotiating with foreign investors
- o Restructuring studies
- o Orderly liquidation studies
- o Other enterprise specific projects

WORK PLAN: The long-term advisors would conduct the following activities:

- o In conjunction with the State Property Fund determine priorities for implementation of the recommendations
- o Assist in the establishment of task forces/working groups to implement the recommendations
- o As appropriate, participate and/or procure the necessary consultants to participate in the working groups
- o Provide advice to the working groups
- o Monitor the progress of the working groups
- o Determine what training programs may be appropriate
- o Arrange for and participate in the delivery of appropriate training programs
- o In conjunction with the State Property Fund determine priorities for follow up on recommendations from phase 1

- o Arrange for proper staffing of these follow on projects. Typically, these will be short term projects handled by a team consisting of:
 - A Team Leader with expertise in restructuring, liquidations or foreign investment, as appropriate
 - An Industry Expert
 - A Financial Analyst
 - A Russian-speaking assistant with a finance or economics background
 - Asset appraisers or other experts may be required from time to time
- o Participate in these specific short-term projects, as appropriate
- o Monitor the progress of the projects
- o In consultation with the project team and the State Property Fund, determine follow up required.
- o Monitor and participate in follow up, as required

OUTPUTS:

- o Periodic oral reports outlining experiences and conclusions reached to the State Property Fund and the financing donor
- o Quarterly written progress reports to the State Property Fund and the financing donor
- o Written reports at the end of each short-term project outlining experiences and conclusions reached and, as appropriate, recommended action plans
- o In the case of projects with potential for foreign investment, Investment Profiles

REPORTING RELATIONSHIPS:

The consultants will report to the Chairman of the State Property Fund or his designate and to the designate of the financing donor.

LEVEL OF EFFORT:

Assuming this is a two year program of technical assistance, the estimated level of effort for the two long term advisors is 528 person days. For the short term assistance it is assumed, for illustrative purposes, that each team will consist of 4 technical experts and that eight short term teams will be required over the two year period. The estimated total level of effort on the short term projects is 1056 person days. The composition and frequency of the teams may vary within this total ceiling based on specific technical requirements. The total level of effort for phase two, both short and long term, is 1584 person days.

CATALOGUE CONTENTS

We recommend that the State Property Fund should prepare a catalogue of all enterprises that are to be privatized. This should be published in book form and be available to all interested parties, domestic and foreign. This catalogue should contain a brief description of each enterprise. The following are the suggested subjects to be included:

1. Name of the Enterprise:
2. Legal Status:
3. Principal Business Activities:
4. Principal Products and Markets:
5. Location of Facilities:
6. Production Capacity in Units:
7. Value of Annual Sales:
8. Number of Employees:
9. Interests to be Sold:
10. Other Shareholders/Partners:

USE OF HOLDING COMPANIES FOR VOUCHER PROGRAM

We recommend that the State Property Fund consider the use of Holding Companies to promote greater interest in the voucher program.

Conceptually, the Fund could create a number of Joint Stock Companies, the purpose of which would be to combine the Fund's retained shareholding in a number of privatized Joint Stock Companies. The Holding Companies could be organized to each have a diversified portfolio of shares in other Joint Stock Companies in various industries.

The Fund would then undertake a two step process to transfer these companies to the private sector:

1. The Fund, as shareholder of each Holding Company, would cause the company to contract the management of the portfolio to a private investment company or bank.
2. The Fund would transfer its ownership of a Holding Company to individual voucher holders, through a bidding process.

After the shares of the Holding Company have been transferred to the voucher holders, the new shareholders would hold a first shareholders' meeting to elect a Board of Directors. The Board of Directors would be empowered to either retain the existing portfolio managers or to appoint new managers.

The advantages of this approach are twofold:

1. It allows a voucher holder to easily spread his/her voucher value over a number of enterprises and industries and thus lessen the risk that he/she will lose the entire value on a single company.
2. It allows the Fund to transfer its retained holdings to the private sector in an efficient manner.

This outline is conceptual and will require further study before implementation.

USE OF A BIDDING PROCESS TO DISTRIBUTE SHARES UNDER THE VOUCHER PROGRAM

The State Property Fund should establish a mechanism to ensure that all voucher holders have an equal opportunity to participate in the distribution of shares under the voucher program. One way to achieve this is by establishing a bidding process.

The following are some suggestions on how a bidding process could work. It is not all encompassing and this subject will require further study before a definitive program could be designed and implemented.

STEP 1: The Fund establishes a minimum value for the shares to be distributed. These could be shares of an individual company or a Holding Company.

STEP 2: The Fund publishes a list of companies whose shares are to be distributed, together with the number and value of shares to be distributed and basic information regarding the company. A reasonable deadline for the submission of bids is also published.

STEP 3: There are three possible results:

- i) The number of shares bid for is equal to the total offered. In this case the process is complete;
- ii) The number of shares bid for is more than the total offered. In this case the shares should be issued pro rata to the individual bids and the remaining voucher value returned to the bidders to be used to bid for other companies;
- iii) The number of shares bid for is less than the total offered. In this case the shares bid for are issued. Then the offering price for the remaining shares is lowered and another round of bidding takes place.

STEP 4: In the case of iii) above, the number of rounds of bidding should be limited. If after the final round there are still unissued shares, the remaining shares should be returned to the Joint Stock Company for cancellation.

INVESTMENT PROFILE

Suggested Outline

We have suggested that the State Property Fund should prepare an investment profile for each enterprise in which foreign investment is to be solicited. The following are suggested categories of information to be provided:

Name of the enterprise:

Nature of Business: Including description and location of production facilities, raw material sources and other inputs, products, markets

Interests to be Sold: whether assets or shareholding and assumption of any liabilities; licenses and other rights

Other Equity Partners: If any, shareholding and roles in operations

History: When and how organized; recent significant projects; legal status

Summary Data: Including production capacity, historical production (in units and value), sales, costs of production and operating expenses

Assets: Description and estimated current values of major items of equipment, inventories, receivables, licenses and permits; equity interests in subsidiaries or affiliates

Management and employees: Organizational chart, description of key staff, number of employees, description of union/collective arrangements, benefits

Future Prospects: New business opportunities, projects

Investment Needs: Purpose, amounts and timing

Debts: Description and amounts of bank loans, suppliers credits, taxes due, employee benefits; repayment terms; interest rates; collateral

Other Relevant
Information:

If any, such as investment restrictions,
binding contracts, employee agreements,
marketing arrangements

List of Available
Documents:

Articles of incorporation, long-term
contracts and leases, loan agreements,
licenses, financial statements, asset
valuation reports, relevant laws and
regulations

PROFILE OF ENTERPRISES TO BE PRIVATIZED

UNIVERSE OF ENTERPRISES IDENTIFIED BY END OF 1993

	<u>Number</u>	<u>Value</u>	
		(MM Rs.)	(%)
1. By Sector			
Industry	26	7.54	32.9
Agriculture	21	4.05	17.7
Construction	20	1.11	4.9
Transport	5	0.89	3.9
Trade	370	0.66	2.9
Service	850	0.13	0.6
Muni.Services	-	2.85	12.4
Others	<u>17</u>	<u>5.66</u>	<u>24.7</u>
Total	1,309	22.89	100.0
2. By Region			
Chu	306	5.34	23.3
Bishkek	205	4.43	19.4
Osh	394	4.32	18.9
Jalal-Abad	145	3.76	16.4
Issyk-Kul	107	2.43	10.6
Talass	25	1.40	6.1
Naryn	<u>127</u>	<u>1.21</u>	<u>5.3</u>
Total	1,309	22.89	100.0

Note: This summary has been taken from a list of all enterprises to be privatized by the end of calendar year 1993 provided by the State Property Fund

Value is understood to be 1985 book value of assets.

PROFILE OF ENTERPRISES TO BE PRIVATIZED BY END OF 1993

MAJOR ENTERPRISES

Below is a list of enterprises with "Output" value greater than 100 million rubles or Number of Employees greater than 1,000, or "Capital Value" greater than 15 million rubles. The list of enterprises provides a base to select a smaller group of enterprises for the in-depth viability assessments proposed in the phase 1 work plan (annex 2)

Enterprises known to have been partially privatized are indicated by an *.

<u>Name of Enterprise & location</u>	<u>Output Value</u> (MM Rs.)	<u>No. Emp.</u>	<u>Cap. Value</u> (MM Rs)
<u>Heavy Industry</u>			
1. Lenin industrial mach. factory, Bishkek	280	16,560	264
2. Ala-Too Research & Prod. Assoc., Bish.*	-	9,559	126
3. Agricultural machinery plant, Bishkek	99	6,966	123
4. Electric bulb factory, Maili-Sai	117	7,684	112
5. Kirghiz Auto Machinery Assoc.	69	5,095	54
6. Kirghiz Kabel factory, Kainda	53	1,723	46
7. Radio equipment factory, Tokmak	41	1,269	36
8. Org Tekhnika Production Association	36	1,204	35
9. Electric equipment factory, Bishkek	27	1,759	28
10. Drill bit factory, Bishkek *	29	1,361	20
11. Electric equipment factory, Kadji-Sai	31	1,946	18
12. Tiazh Electro machine factory, Bishkek	19	1,330	17
13. Torg Mash factory, Sokul*	26	1,626	16
14. Auto assembly plant, Bishkek	100	1,076	13
15. Monitor. & measur. instr. factory, Bish.	15	1,196	11
16. Pump factory, Osh	15	1,086	11
17. Electric equipment factory, Bystrov	36	1,700	10
18. Kara-Kol electric equipment factory	8	1,700	5
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Subtotal	-	64,840	945

Agricultural Industry

1. Industrial bakery, Kant	29	462	23
2. Oktiabr winery, Suzak	17	1,100	22
3. Sugar factory, Novo-Troitsk	186	685	20
4. Bishkek dairy	77	864	19
5. Sugar factory, Kainda	169	672	18
6. Tokmak meat factory	201	745	18
7. Talas meat factory	12	385	15
8. Baking industrial production co., Bish.	56	1,577	14
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Subtotal	747	6,490	149

Textile Industry

1. Bishkek wool-weaving factory *	786	3,967	55
2. Kara Baltin carpet weaving factory *	215	2,778	46
3. Textile & weaving company, Bishkek *	194	5,386	38
4. Osh silk manuf. and trading company *	207	2,706	28
5. Posh factory, Tokmak	362	1,458	22
6. Tulpar textile company, Bishkek*	96	2,683	16
7. Komsomol sewing factory, Bishkek	81	1,073	11
8. 40th Revol. Anniv. sewing factory, Bish.	247	1,175	9
9. Osh sewing factory	31	1,742	6
10. May Day sewing factory, Bishkek	36	1,236	5
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Subtotal	2,255	24,204	236

Service Industry

1. Ai-Churek Central Dept. Store, Bish.*	1,339	2,758	4
2. Kirghiz Galantereya, Bishkek	136	185	3
3. Kirghiz Torg Odejda, Bishkek	352	273	2
4. Kirghiz Obuv Torg, Bishkek*	129	120	2
5. Kirghiz Bakaleya, Bishkek	281	224	2
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Subtotal	2,237	3,560	13

Construction Industry

1. Osh KPD Project Stroi	19	1,490	20
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Notes: "Output Value" understood to be value of 1991 production.
"Capital Value" understood to be January 1992 book value
of assets.

LIST OF PERSONS MET*State Property Fund*

Mr. Abdyjapar A. Tagaev, Chairman
Mr. Bolot Shaykov, Deputy Chairman
Mr. Vladimir Bukreyev, Deputy Chairman
Ms. Nina Kirichenko, Chief - Department of Analysis and Programs
Development
Ms. Larissa Karagulava, Director - Legal Office
Mr. Asana, Director - Department of Methods
Mr. Kazbek Saliev, Director - Industrial Department

The Kirghiz SSR Chamber of Commerce and Industry

Mr. U Karchin, Chairman

Invest Consulting

Mr. Abdynasyrov Uran, Chairman

Asia Invest

Mr. Alymbekov, Chairman
Mr. Mokenov, Deputy Chairman

Fund Invest

Ms. Nyrilya Barakanova, Assistant to the President

International Kyrghyz-Swiss Commercial Bank

Mr. Juruslan Toichubekov, President

State Committee for Foreign Economic Relations

Mr. Askar Sarygulov, Chairman

State Committee on Geology, Usage and Protection of Natural Resources

Mr. Vitaly Stavinsky, Chief Geologist

VLKSM Sewing Factory (Komsomol)

Ms. Karmyshova, Director

Drill Factory

Mr. Taranenko, Director

Agricultural Equipment Company

Mr. Posny, Director

Mr. Muratov, Chief Technologist

Mr. Kazantsev, Deputy Chief Technologist

Radioplant Tokmak

Mr. Tahtarakov, General Engineer

Mr. Nikitin, Chief Economist

International Monetary Fund

Harry Trines, Resident Representative

United States Embassy

Edmund Hurwitz, Ambassador

Alexander Martschenko, Second Secretary

KYRGYZSTAN FACT SHEET

Population: 4.5 million; about 1.5% of the FSU. Approximately 50% Kyrgyz, 20% Russian, 13% Uzbek, 2-3% Germans, 2-3% Ukrainian.

Geography: Landlocked, largely mountainous with 90% of the country at least 1,000m above sea level. 7% arable; 72% of the arable is irrigated. Slightly larger than Austria and Hungary combined.

Transport Network: International road links to Kazakhstan, Uzbekistan, China and Tajikistan. Internal north-south road links. Rail links to Kazakhstan and Uzbekistan with connections to most of the FSU. The principal international air connection is to Moscow.

Agricultural Economy:

• Approximately 33% of GDP. Fell to 28% of GDP in 1991 with the collapse of interrepublican trade and may fall further in 1992 due to input shortages. Approximately one third of employment.

- Most inputs are subsidized and state controlled. The state controls prices and marketing for principal food products. 6% of the land is privately farmed. Land is state owned and made available through leaseholds which can be inherited but not sold or mortgaged.
- Livestock historically accounts for about 67% of agricultural output. Arable land is devoted to: 48% irrigated fodder for livestock; 40% grain; 8% potatoes fruits and vegetables; 4% cotton and tobacco.

Industrial Economy:

- Traditionally 25% of GDP; increased to 33% as agriculture fell. Budget subsidies from FSU have stopped. Indirect price subsidies (e.g. for oil) continue but are being phased out. Kyrgyzstan provides some subsidies; the level is unclear due to off-budget expenditures.
- Major industries are agricultural and other machinery, food processing, electronics and textiles; hydroelectric potential is extensive. Mineral deposits include gold, mercury, antimony, tin, tungsten, coal and uranium; most are relatively undeveloped.

External Economy:

- Exports: 98% to FSU (non-ferrous metals, minerals, woolen goods, agricultural and food products, electric power, some electronics and machinery). 2% outside FSU (non-ferrous metals and ores, food and agriculture). Exports to FSU traditionally account for 34-37% of GDP.
- Imports: 73% from FSU (oil and gas, ferrous metals, chemicals, engineering products, pharmaceuticals, wood and paper, construction materials, foodstuffs). 17% from outside FSU (clothing, food, engineering and chemical products). Imports from FSU traditionally account for 43-44% of GDP.