2004 First Quarter
Final Progress Report

GBTI Task Order No. 845

January 1 – March 31, 2004

Privatization Implementation Project
With the Government of Egypt

Implemented by IBM Business Consulting Services
Funded by USAID

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FINAL QUARTERLY PROJECT REPORT - FIRST QUARTER 2004

SUMMARY OF ACTIVITIES AND RESULTS OF THE PRIVATIZATION IMPLEMENTATION PROJECT
(Task Orders 821 and 845, August 2000 – March 2004)

PRIVATIZATION IN EGYPT

Background and Institutional Structure

Egypt's privatization focus has been on a subset of government enterprises: Law 203 Affiliates

Egypt's policy to privatize some of its major manufacturing and service enterprises was formalized by the Public Business Enterprise Law 203 of 1991. At that time the total number of public sector companies had reached 500 which were responsible for almost 55% of industrial production and comprised almost 90% of the banking and insurance sectors. The 1991 law established twenty-seven holding companies (HCs) (100% owned by the Government) responsible for privatizing as well as operating some 314 wholly-owned subsidiaries (called Affiliates). Under the statute, HCs and Affiliates come under the purview of the Ministry of Public Enterprise (MPE). To expose these companies to free market conditions and facilitate their privatization, the government also abolished credit guarantees from the national budget and investment financing.

Government-owned banks were not among the enterprises subject to Law 203. (International Monetary Fund studies show that financial sector reform, including bank privatization, is among the most important reforms and "leads to a more rapid accumulation of physical and human capital, and faster technological progress by enabling the identification and funding of better investment…"[1])

Insurance companies, as well as economic authorities and other major enterprises such as Egypt Petroleum and Egypt Air were not among the government-owned business activities subject to Law 203, and thus have not been the main focus of privatization efforts.

Nor were over 500 incorporated enterprises (subject to Presidential Decree 341 of 1996 and Law 159) in which the state owned less than 100% of the shares (called JVCs). Only in early 2000, did the Ministry of Foreign Trade[2] receive the mandate to manage and coordinate divestiture in these JVCs in cooperation with the MPE.

Results During the Early Years of Privatization 1993-1999

[1] Banking on Development, Finance & Development March 2003, Volume 40, Number 1

[2] Formerly the Ministry of Economy and Foreign Trade

During the first three years of the privatization program (1993-1995), the pace of privatization was slow. After over $10 billion debt forgiveness to Egypt by the Paris Club in 1994 for policy reforms including privatization, the main vehicle or inducement for continued implementation of privatization became a $200 million a year USAID Sector Policy Reform (SPR) program that provided substantial cash for policy reforms. This SPR was later expanded to include the USAID Agricultural Policy Reform Project (APRP) that provides $50 million a year over a four year period from 1996 to 2000 for policy, regulatory and institutional reforms in agriculture, including privatization. From the beginning of the initial SPE program, privatization was included as one of its initial four major "sector" components, along with reforms in fiscal, foreign trade and monetary policy. These later reforms, together with other subsequent reforms in privatization, greatly improved the direct and indirect enabling environment for Egyptian privatization.

Early on, the rate was 30 transactions p.a. Through FY 2000 some 133 majority interests and 37 minority interests were privatized.

Egypt's privatization program accelerated during the boom years of the late 1990s, when the global economy experienced high investment and high growth. As a result of faster privatization in this favorable investment environment, during the period 1996 through 2000 Egypt privatized some 170 Law 203 Affiliates with 133 of those transactions comprising majority privatization. During the period 1996-1999 an average of thirty transactions were closed annually.[3] Through year 2000 the total proceeds from privatization reached LE15.5 billion.

For well over a decade, much of the privatizing emphasis in Egypt was on the Law 203 Affiliates. Egypt's privatization program provided much of the impetus for the growth of its stock market with sales proceeds of LE 5.6 billion by early 1999 well ahead of the LE 1.2 billion in proceeds from sales to so-called Anchor Investors.[4] Progress in privatization was consistent between 1996 and 2000, with the benefits of those privatizations clear. In addition to the more the privatization proceeds of some LE2.4-3.1 billion annually in proceeds, the economic burden imposed by many unprofitable companies had been eliminated; costs of eighteen closed holding companies had been eliminated; tax receipts from privatized companies increased; and an estimated US$1 billion of new investment was injected in to privatized companies.

Following 1999, and as the global boom receded, there was less success through the stock market, privatization in Egypt lost its momentum and portfolio investors lost interest. During this period, the pace fell off with the majority of privatizations coming about from sales to Anchor Investors. By early 2002, since the inception of the program sales to Anchor Investors had reached almost LE 7 billion.[5]

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[3] The Results and Impacts of Egypt's Privatization Program, Privatization Coordination Support Unit, Carana Corporation August 2002 (The Carana Study)

[4] Privatization in Egypt Quarterly Review April-June 2001 Carana Corporation, p. 32

[5] Investing in Egypt, Ministry of Foreign Trade, p.51

On the other hand, the public sector contribution to GDP remained at about 37%[6], for as stated in the Carana Study, Government investment between FY1993 through FY 2001 in Industry and Mining amounted to LE 7.7 billion, in Agriculture and Irrigation to LE 21.4 billion and in Construction and Infrastructure to LE 70.4 billion.

In late 1999, Dr. Etef Ebeid, formerly Minister of Public Enterprise and responsible for overseeing the period of accelerated privatization, became Prime Minister.[7]

PwC/IBM PRIVATIZATION IMPLEMENTATION PROJECT[8]

In environment described above and during the first months of 2000, Egypt's Ministry of Public Enterprise planned to accelerate its privatization program supported by technical assistance from USAID.

The rate of equity investment in emerging markets fell precipitously in 2001 and 2002.

However, during 2000, worldwide equity investments to emerging markets continued dropping and dropped to $147.5 billion in 2001 and $113.2 billion in 2002. Foreign Direct Investment also slowed from $139.8 billion in 2001 to an estimated 93.6 billion in 2003.[9]

The rate of privatizations in Egypt fell from thirty p.a. in earlier years to ten p.a. during 2000 – 2003.

During the forthcoming period of PIP's technical assistance, which commenced in August 2000, substantially more privatization transactions were anticipated to occur. But foreign direct investment in Egypt peaked in 2000 and then dropped off. And compared to the fiscal years 1996-2000 when privatizations totaled about thirty per year, the period during which PIP provided technical assistance (August 2000 through March 2004) yielded only about one-third of that number of privatization transactions (ten) per year. Nevertheless, in the difficult economic and political environment from early 2000 the pace of privatization could have been substantially faster, and many good opportunities were foregone.

Reasons for the slower pace of privatization and observed impediments to faster privatization will also be addressed later in this report. The purpose of this discussion is to describe the conditions under which PIP provided assistance and management's response to the unanticipated circumstances of a political and investment environment less conducive to privatization.

6 Privatization in Egypt, World Bank

7 The PwC/USAID Task Order 821 (July 1, 2000) p.3. stated, "Recent changes, including a new Prime Minister and a new cabinet appointed in October 1999, have reinvigorated the [privatization] program, and the Government is committed to aggressive and far-reaching targets.

8 As of October 1, 2002, IBM Business Consulting Services (IBM) acquired the consulting practice of PricewaterhouseCoopers, and thereby assumed management of the Privatization Implementation Project. The contract with USAID was novated to IBM. PIP management is referred to hereafter as IBM.

9 Capital Flows to Emerging Market Economies, Institute of International Finance, Inc. January 15, 2004

As a result of the disappointing performance of the privatization program, during the period of its operations from the latter part of 2000 through the first quarter of 2004, the Privatization Implementation Project (PIP or the Project) went through several transformations to accommodate to the unexpected slower pace and evolution of anticipated activities in privatization. PIP's technical assistance evolved based on actual experience with the pace of privatization in Egypt.

Phase 1 (August 2000 – July 2001) : Project Initiation

The Privatization Implementation Project managed by IBM began technical assistance in August 2000.

Conditions Necessary for Accelerated Privatization

Faster privatization would require greater standardization, political consensus and coordination among government ministries and enterprise owners.

From the outset, IBM perceived that two essential aspects of the privatization effort needed improving to support faster-paced privatization. They were

- ***Transparency and Standardization.*** Despite (or perhaps, in part, because of) years and millions spent on developing the privatization program, there had been relatively little standardization of the basic procedures required to privatize specific companies. The fundamental responsibility for privatizing Law 203 Affiliates remained with some ten Holding Companies, each with its own bureaucracy responsible for valuing and negotiating transactions. Furthermore, information on candidates chosen for privatization was difficult to come by, and/or difficult to interpret. Such lack of standardization and transparency in processes, procedures, pricing and negotiation, increased perceived risks for investors that transactions would close successfully. IBM's approach emphasized pipeline management and the dissemination of policies/procedures and guidelines that sought to strictly manage asset sales to maximize investor interest and restore momentum to the program. IBM also sought to focus on the development of auction or other electronic bidding type formats to both accelerate the pace and increase the degree of transparency in terms of valuation and price setting.

- ***Consensus and Coordination.*** The GOE's program had been plagued by a lack of shared objectives among the various stakeholders involved. IBM's approach for improving program coordination sought to address challenges on a number of fronts:
  (a) Improved coordination between the Ministry of Economy and Foreign Trade (MOEFT), Ministry of Public Enterprise (MPE) and other government entities responsible for defining policy changes and sector liberalization measures necessary to facilitate transactions;
  (b) Improved coordination between the MOEFT and MPE so that JVC divestitures in each of their portfolios would be effectively programmed, and

(c) Improved coordination within the JVCs and HCs to improve the timeliness and quality of information made available to the MPE/Public Enterprise Office (PEO) and MOEFT.

It was clear that IBM could not carry out the privatization agenda and improvements outlined above on its own. Creating an accelerated program required that PIP develop close working relationships with GOE counterparts and develop a *consensual* approach and government backing for creation of a pipeline management system, sales strategies and asset promotion techniques.

PIP noted in its first quarterly project report that the process of "case-by-case" privatization, the necessity for the PIP Team to deal with an average of one different public sector shareholder representative for every two JVs, the lack of standardized privatization procedures, and the assignment of nonviable companies to the PIP would not accomplish the GOE/MOEFT objectives of privatizing the majority of Joint Venture shareholdings over the ensuing three year period.

Valuations had recently been completed for government-owned insurance companies. Among a number of recommendations at that time, PIP recommended that one of the government-owned insurance companies with interests in JVC be privatized, thus accomplisheing two objectives in one transaction. PIP noted that implementation of that recommendation, and others, would require high-level, joint initiatives by the Privatization Implementation Project ("PIP") Team, USAID, the Ministry of Economy and Foreign Trade (MOEFT) and the Ministry of Public Enterprise/Public Enterprise Office (MPE/PEO), which as the Project progressed were not forthcoming to the required degree.

PIP's work plan focused on establishing broad support for large volume privatizations, to rapidly privatize the Government of Egypt's (GOE's) remaining inventory of 191 Law 203 affiliates (Affiliates) and 511 joint venture companies (JVCs), of which 167 represented majority interests.[10]

PIP's Goal and Product Delivery

Working with its government counterparts, the Public Enterprise Office of the Ministry of Public Enterprise and the Ministry of Economy and Foreign Trade during this initial period, the Project organized to systematically facilitate large volume privatization. PIP produced a significant amount of product and provided a broad array of assistance working with virtually the entire inventory of Affiliates and JVCs profitable (Tier 1) companies, as well as less attractive (Tier 2) companies and chronically distressed (Tier 3) companies, designed to accelerate privatization and, as appropriate, recommendations for liquidating certain assets.

[10] Privatization in Egypt – Quarterly Review January – March 2001, Carana Corporation p. 38

Goals – 90 companies were to be offered during 2000; 62 during 2001; and 44 during 2002
Results – 12 companies offered; 7 others prepared for privatization for 2000.

The goal for privatization was for ninety companies or assets (liquidations) to be offered for sale by the end of year 2000; sixty-two firms to be offered in 2001; and forty-four to be offered in 2002. In addition to providing general assistance, PIP was assigned sixty-one companies to work on directly, of which twelve were offered for sale, and seven others were prepared for sale. Work on the nineteen companies included market studies, preparation of company profiles, information memoranda, valuation analyses, promotion and the development of data rooms. While PIP provided investment banking-type assistance for the owners of these companies, the primary effort was directed toward project management normally associated with large volume privatization. For example, PIP sponsored and/or participated in a total of fifteen events and conferences - more than one a month (four offshore and eleven in Egypt) and distributed over 6,000 introductory brochures and company profiles. PIP also identified over 100 investors, and investors purchased approximately fifty information memoranda describing the businesses of nine companies.

Government's Response to PIP's Technical Assistance

For a variety of reasons efforts to develop a consensual working relationship with the MPE and MOEFT, as well as JVC owners and Law 203 Holding Companies and to develop standardized practices were not really effective.

During this period, PIP was perceived by the PEO primarily as a *production center* relied on to turn out a large number of diagnostic reports, sector studies, valuations, company profiles, and information memoranda. PIP also provided leadership in setting up (and underwriting) a variety of promotional conferences. Furthermore, during the early period, the MOEFT was not actively involved in generating JVC privatization opportunities and did not have effective control over owners (government-owned banks and insurance companies that had continuing portfolio management profit and other objectives in addition to divesting assets.) Each JVC owner had its own agenda and seldom worked cooperatively to privatize companies in which there were a group of separate government owners.

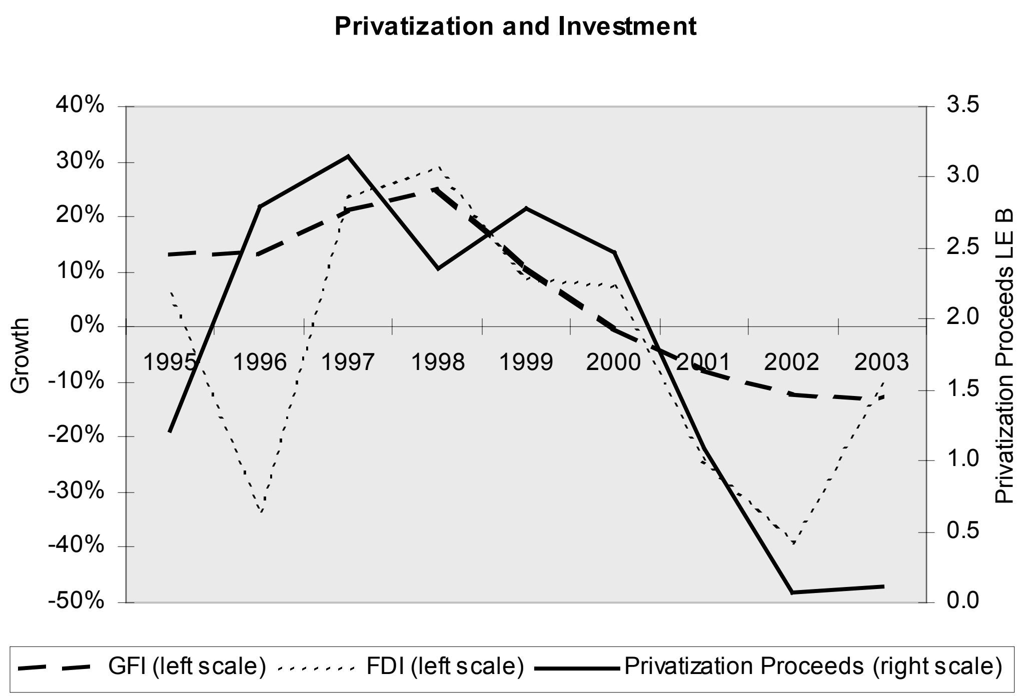
It is worth noting, that the GOE's inventory of Law 203 Affiliates and JVC represented only a portion of government-owned enterprises, and excluded wholly-owned banks, insurance companies, and economic authorities, as well as numerous enterprises administered by Ministries and corporatized enterprises, like Telecom Egypt. JVCs could have been privatized quickly and virtually automatically if the government-owned banks and insurance companies, which own a large number of the JVC shares.

Results during Phase 1 (August 2000 to July 2001)

The GOE's goal was a total of 152 privatizations for years 2000 and 2001, but only one transaction was accomplished.

During PIP's first year, despite the ambitious goals noted above that were publicly committed the pace of privatization of Law 203 Affiliates by the Egyptian Government virtually ground to a halt with only six companies privatized during the nineteen month period January 2000 through July 2001, the end of the first year of PIP's operations. In fact, there was only one privatization transaction (Egyptian Gypsum) during the Project's first operating year (actually recorded in August 2001). The most noteworthy failed privatization effort involves an attractive investment property, Misr Hotels, which owns the Nile Hilton in Cairo. Misr Hotels has been on open tender since March of 2001.

The following chart shows privatization proceeds, gross fixed investment (GFI), and foreign direct investment (FDI) in Egypt from 1995-2003.



When accelerated privatization occurred during the period 1996-99, foreign direct investment rose significantly, as did overall gross fixed investment. When privatization activity fell off, the growth of both FDI and GFI became substantially negative.[11] The cause and effect relationships aren't clear, of course.

[11] Source: The Costs of Not Privatizing: An Assessment for Egypt; data from Economist Intelligence Unit (2003)

Reasons for the overall lack of results in privatization are a matter of opinion based on observation and circumstances. Clearly, global events such as the East Asian crisis had a negative impact, but there were controllable circumstances that also contributed to the drop in privatizations for 2000 – 2003, which totaled only a little more than LE 1 billion in aggregate proceeds. Our opinions in this regard have evolved as our experience with privatization in Egypt developed over the three and a half years IBM has been providing technical assistance and will be discussed later in this report.

Phase 2 (August 2001 – November 2001): A Period of Reappraisal

IBM undertook a reassessment of the stated goals and the realities of accomplishing rapid privatization.

Based on the lack of results for the privatization program during PIP's first year, USAID undertook a review of the nature and extent of its technical assistance toward the end of the Project's first year. Also at this time (September 2001), the Project prepared and submitted a revised Six Month Work Plan (September 2001 through February 2002) to focus on creating near term success with a limited number of important transactions and to avoid work on activities involving distressed companies or companies which were determined to be inappropriate for privatization in the medium term.

The Project also undertook (1) to assess the progress of its efforts and those of the privatization program by the end of 2001, and (2) if privatization results would not improve to recommend to USAID that the project scope, staff and budget be reduced to a level consistent with the Government's expected privatization activities.

Major Issues

Valuation and Pricing

Few "meeting of the minds" between GOE and investors on pricing.

As a result of experience during its first year, PIP observed that the GOE's floor prices were normally significantly higher (from 6%-60%) than the prices investors were willing to bid. Furthermore, the GOE was extremely reluctant to accept bids that were significantly lower than the reserve price, despite a recent Executive Regulation, which would permit accepting such bids. For the fifteen months between August 2000 and November 2001, the GOE had privatized only four Law 203 Affiliates: Egyptian Gypsum, Arab Carpets, Helwan Cement and Abu Zabaal Fertilizers.

PIP's Role in Valuations

A related issue was PIP's role in preparing valuations. We initially considered that it was not a good use of PIP's resources to prepare labor-intensive valuations. In PIP's view, a properly conducted tender process should generate an appropriate market price. However, as the Project progressed, we changed our position about preparing valuations, because it became apparent that Affiliates and HCs did not have the capacity, and sometimes the interest to prepare a timely valuation as per the required standards. In an effort to avoid having valuation preparation become a stumbling block to privatization, PIP accepted the task of preparing valuations for sellers.

Results of Valuations

Unrealistic valuation methods and long approval processes were major impediments to privatization.

Between August 2000 and November 2001, PIP assisted in preparing twenty valuations, only one of which – Helwan Cement – eventually resulted in a privatization transaction. PIP also revised its valuation methodology to calculate the value of the enterprise (Shepheard Hotel) to the owner, rather than assess a theoretical market value, which was the technique preferred by the Government. With USAID's support, PIP proposed that valuations would only be prepared for companies that the GOE expected to tender within 3-6 months and where there was identified investor interest. The Central Audit Agency had been reluctant to engage in a dialogue with a private sector consulting firm and showed little willingness to alter its methodology, which employed unrealistic techniques (e.g. asset valuations for going concerns and unrealistically low discount rates in developing discounted cash flow valuations.) The Project set an objective to engage the Central Audit Agency in high-level discussion of perceived problems and issues surrounding the valuation of public enterprises.

Poor Market Conditions

9/11 tragedy and the Israeli-Palestinian conflict along with a poor global investment environment reduced investor interest.

Clearly, the slower pace was partly the result of uncontrollable circumstances – the weak world economy, the decline in Egyptian and world stock markets from 2000 to 2002, the somewhat lower quality of the remaining companies, and regional political uncertainties – that have reduced the flow of investment, both foreign and domestic. . In view of the prevailing regional economic and political situation (especially after the 9/11 tragedy in the US, Gulf investors continued to prefer more conservative investment options and international investors were concerned with the on-going Palestinian-Israeli conflict. Investors took a "wait and see" attitude, particularly in the face of the GOE's seeming more conservative approach to pricing.

In addition to the over-valuation issue, there have been other controllable or partially controllable impediments to privatization, and these include a rapid drop in exchange rate after 2000, problems of contract enforcement, arbitrary bureaucratic decision-making, investors' unsatisfactory past experiences, cumbersome and unsustained privatization selection processes, and excessively discretionary customs and taxation practices. To illustrate the effect, among the Law 203 Affiliates and JVCs tendered for sale to strategic investors,

- Out of eleven potential investors who purchased bid documents for Omar Effendi, only one investor showed serious interest after preliminary investigations.

- Out of 14 potential investors in Misr Hotels, not one had submitted a publich share purchase offer since the tender was announced four months earlier in April 2001.
- There was only one bidder for Abu Zabaal Fertilizers (a lease transaction that was later concluded).
- There was only one bidder for Red Sea Contracting, who quickly lost interest.
- There was only one serious party interested in NEEASAE, but only with important concessions, which were not forthcoming.
- There was only one potential bidder for Al Nasr Steel Pipes who quickly lost interest over unrealistic pricing expectations by the seller.
- There was only one bidder for Alexandria Cooling Co.
- There was very limited investor interest for Misr America International Bank, which had earlier been offered unsuccessfully in a manner that caused the market to question the intentions of the seller to complete a transaction

Packaging

Many privatization candidates required "repackaging" or financial restructuring for the market.

Packaging of the investment opportunities was also a reason for lack of progress. Many Affiliates employed redundant labor, were debt burdened, and obsolete inventories, uncollectible receivables and out-of-date poorly maintained equipment, and there seemed to be no serious interest by the owners to resolve these issues in the interests of succeeding in a sale. Owners were also unwilling to un-bundle assets, e.g. Omar Effendi, Misr Hotels, and Meridien Heliopolis, in order to make sales more attractive to the investor market. In one case, Misr Hotels, an intra-governmental dispute prevented privatization.

Furthermore, PIP noted that several of the companies assigned to it needed to either be liquidated, or financially restructured requiring major investment writeoffs by the GOE owners, and or could not be sold at the shareholder's minimum expected market price.

Role of the PEO in Developing Policy and Carrying Out Privatization Goals

Responsibility for privatization is de-centralized with 10 HCs and several JVC owners in each case.
PEO lacks adequate authority.

The authority and responsibility for implementing privatization goals rests with the owners of Affiliates and JVCs.

PIP's primary counterpart didn't have (and continues to lack) the political muscle to "knock heads" to make transactions happen. The PEO's self-described role in the privatization process is one of "facilitator and coordinator". PIP had numerous meetings with the Minister of Public Enterprise concerning accelerating specific transactions, particularly transactions on which PIP worked directly, such as Misr Hotels and Shepheard Hotel. Based on assurances by respective HCs as well as the Ministry and the PEO, it appeared to PIP that these transactions would move forward with the Ministry's support. However, the privatization processes involving valuations, data gathering, plans for tenders, and discussions with investors were drawn out, and failed to produce closed transactions. In some cases, investors were even unable to meet with HC and JVC owners. The Ministry also did not take the lead in implementing the political steps necessary to develop consensual working relationships among stakeholders, as well as to remove disincentives and develop new incentives to encourage the system respond to a policy of rapid privatization.

The PEO, which lacked authority and political clout, as best we can discern did not itself participate in developing and implementing policy, and thus could not include PIP to assist in the process of developing and implementing policy. *Confirming what was apparent, we were informed that in addition to policy, implementing decisions were often made in Cabinet meetings, and in most cases the few transactions that did move forward were delayed until the Cabinet confirmed pricing, even on very small transactions.* Each of the various government agencies involved in privatization continued to march to its own drummer. Meanwhile, as a result of the lack of activity and support for the privatization program, and with USAID's support, PIP reassessed its scope and function.

PIP's Recommendations for Scope Change

IBM recommended revised and narrowed scope of work.

The Project recommended a revised and narrowed scope, to focus efforts on closing eleven pending Law 203 transactions and progressing seven selected Affiliate privatization opportunities. PIP also proposed a greater focus on fourteen identified JVC opportunities, which were assessed to have a higher probability of success due to different and more expeditious processes for approving transactions.

In order to carry out this type of revised work plan, the Project's management team was changed to include personnel with greater investment banking and transaction experience. The Project reorganized its marketing and investor promotion efforts by phasing out general privatization promotion activities and empowering smaller transactions teams to market selected companies directly to targeted investors.

In line with the revised work scope, benchmark revisions were also proposed.

In the late summer of 2001, USAID also undertook a review and assessment of its funding for privatization technical assistance. Although PIP was not informed of the specific results, it was apparent that USAID also desired to narrow and redirect PIP's scope. As a result of USAID and PIP's revised work plan agreed to with the PEO and MIC, PIP entered a new, more limited, phase of operation.

It is worth pointing out that there were substantial uncertainties in the ME region as a result of the attacks on NYC's World Trade Center during this period. Additionally, during the period in late 2001 when there was substantial investment uncertainty, PIP management also took measures to reduce the level of effort of Egyptian professionals and expenses by mandating unpaid leaves.

Phase 3 (December 2001 through June 2002)
Change in Focus, Scope, Personnel Transformation and Budget Reduction

USAID negotiates revised scope of work for technical assistance focused on completing certain transactions.

Because of the less than satisfactory privatization results through November 2001, and based on the earlier recommendations to narrow the Project's scope, on December 3 USAID provided a letter to the Ministry of International Cooperation in which it proposed a substantially reduced PIP's scope and budget effective as of December 1, 2003 commensurate with a substantially revised and narrowed scope of work. The scope of work under the task order was narrowed to allow only work on a list of twenty-nine potential transactions, which PIP had identified with good potential for privatization. The associated benchmark was the privatization of at least thirteen of these potential twenty-nine transactions.

Based on the narrowed and more focused scope of work, PIP's monthly run rate was reduced to just over $200,000 from an approximate $500,000 average monthly budget. The full time expatriate staff was reduced from seven to three, almost 60%. Furthermore, the Chief of Party, Deputy Chief of Party, and Senior Investment Banking Advisor were all replaced.

PIP management achieved spending reductions primarily by (a) foregoing five long-term expatriate positions (a reduction from eight to three), (b) through less reliance on short term expatriate personnel who were utilized from time to time on an as-needed basis to respond to requests from the Public Enterprise Office for assistance relating to information memoranda, valuations and sector studies, and (c) terminating two local professionals.

Thus, PIP fundamentally changed the nature of its operations from a broad based project management function to a focused transaction assistance function, which required a transformation of skill sets and a reduction in staffing.

PIP's Activities

PIP focus on completion of at least 13 of 29 identified potential transactions.

The Project's activities were limited to technical assistance relating to the privatization of the twenty-nine enterprises, which PIP determined had reasonably good prospects for concluding transactions:

Specifically, the revised and narrowed scope of work provided that assistance would be focused at the firm level and include:

Task 1: General Advisory Services to the GOE

- advisory services to the necessary GOE authorities (including the MPE, PEO, MOEFT, HCs, and other owners of public enterprises) in order to achieve the successful privatization of the target firms listed below.

Task 2: Preparation of Sale

- Valuation support to the GOE, including conducting valuations (based on discounted cash flow analysis and comparable financials) and updating financial and other basic information for asset-based valuations, if required.

- Contract with, or advise the GOE on the contracting of, other firms or resources to conduct complete asset-based valuations, as deemed necessary by the IS contractor.
- Preparation of valuation reports and assistance in obtaining approvals from the required GOE authorities.
- Assistance to the GOE leading to the selection of a sales method
- Assistance to the GOE in selection of investment promoters
- Support to the GOE in conducting sellers due diligence
- Preparation of bid documents appropriate for each transaction
- Identify and target potential investors
- Assistance to the GOE as needed to prepare bid terms, advertisements, and data rooms

Task 3: Support for Transaction Closure

- Establish bid evaluation criteria
- Support to the GOE in bid evaluation, negotiation, and title transfer (as needed and subject to USAID approval *on a case-by-case basis*)."

Following is the list of the twenty-nine public enterprises for which PIP devoted its resources to assist in privatizing during the period 1 December 2001 to 30 June 2002.

	HC / GOE Rep	**Company Name**
1	Bank of Alexandria	Misr Aswan Company for Fishing and Fish Production
2	Banque du Caire	Cairo Far East Bank
3	Banque du Caire	Misr America International Bank
4	Banque Misr	Ismailia Misr Cooling and Storage Company
5	Banque Misr	National Housing for Professional Syndicates (Meridian Heliopolis)
6	EGOTH	Arab Co. for Tourism & Hotel Invest (Semiramis)
7	EGOTH	Nat'l Co. for Hotels & Tourism (100% Cairo Sheraton, 10% Conrad)
8	El Shark Insurance	Rowad Tourism
9	Ministry of Housing	Misr Brick Company
10	Misr Insurance	Misr Real Estate Investment and Tourism
11	National Bank of Egypt	Egyptian Glass Company
12	National Insurance	October Development and Real Estate Company

	HC / GOE Rep	Company Name
13	National Investment Bank	Kuwaiti Egyptian Investment Company
14	Chemicals	Abou Zabaal Fertilizers
15	Chemicals	Nasr Fertilizers
16	Chemicals	Delta Fertilizers
17	Engineering	Al Nasr Electrical Apparatus (NEEASAE)
18	Maritime	General Warehouses
19	Food	Gharbeya Rice Mills
20	Food	Misr Dairy Products
21	Tourism	Misr Hotels
22	Tourism	The Shepheard's Hotel
23	Metallurgy	Al Nasr Glass & Crystal
24	Metallurgy	Helwan Portland Cement
25	Cotton & Textile Industries	Delta Spinning and Weaving
26	Cotton & Textile Industries	Misr Iran Spinning & Weaving ("Miratex")
27	Trade	Alex Cooling
28	Trade	Misr Import Export
29	Trade	Omar Effendi

Valuations

PIP minimized work on preparation of valuations until methodology and approval processes would improve.

During this period, PIP undertook to work only on valuations where there was a clear commitment by the GOE to offer the enterprise for privatization within six months.

The Central Audit Agency (CAA) and owners systematically employed lower than market discount rates. Thus the Government had a built in bias toward overvaluation, which prevented buyers and sellers from reaching market-clearing prices. In an effort to improve the suitability of valuations and thereby enhance the chances of reaching agreement on pricing, PIP contracted with Standard &

Poor's Corporate Value Consulting (S&P) to calculate appropriate discount rates for commercial banks and hotel properties in Egypt to be employed in discounted cash flow valuations. S&P's discount rates were significantly higher than those employed by the CAA and provided a professionally determined, market-based, benchmark for PIP's valuations. The report was submitted and used in subsequent valuations prepared by PIP.

USAID also encouraged the convening of a high level panel of experts to advise on developing more appropriate valuations for the purpose of setting minimum prices. If these two objectives were not achieved by June 30, 2002, USAID indicated to the Ministry of International Cooperation that it would be difficult to continue its privatization technical assistance. USAID said that it would reassess the program on or about June 30, 2002 based on results.

With the encouragement of USAID and PIP, a panel of valuation experts comprising the Quadripartite Committee met on March 4, 2002, to discuss a range of issues related to the valuation of public enterprises. The panel included representatives from the Public Enterprise Office, Central Audit Agency, National Bank of Egypt, Cairo Alexandria Stock Exchange, Capital Market Authority, Chemical Industries Holding Company, CIIC, Banque Misr, Shawki & Co./Deloitte and Touche. The panel recommended, among other things, that there be no ceiling for discount rates employed in discounted cash flow valuations. PIP was not privy to valuations and reserve prices set by the Government, so it was difficult for PIP to assess the degree to which the recommendations of the committee were implemented, except through evidence provided by a series of successful transactions.

Government Personnel Changes

Private Sector professional appointed to head Public Enterprise Office

During the first quarter of 2002, the Ministry of Public Enterprise appointed a new Executive Director of the Public Enterprise Office (PEO), Eng. Hamdy Rashad, who formerly headed GTE Egypt. For the first time, the Executive Directorship was filled by a person with considerable private sector and investment experience. The Executive Director was also named Chairman of the Joint Venture Privatization Committee, a progressive step to provide more centralized decision-making authority for privatization. Expectations were for an enhanced relationship with the PEO and a renewed and more realistic effort toward privatization.

Marketing and Promotion Activities

PIP's Gulf marketing effort results in major privatization: Egyptian Sheet Glass

During this period and despite increasing political conflict in the ME, PIP continued marketing efforts relating to the companies identified for privatization by holding conferences and meetings in Abu Dhabi, Dubai, Bahrain and Kuwait City. The most significant result of this trip was that PIP convinced National Industries to combine with Khoraffi Group and Guardian Industries to bid for Egyptian Sheet Glass Company, which was being tendered. This consortium (other than Guardian which dropped out due to pricing concerns) succeeded in its bid and acquired the company in June 2002 for

LE 206 million. (Guardian later bought shares in the company.) PIP played a major part in this important privatization not only by sourcing the investor, but also by assisting National Bank of Egypt, which represented the owners, to negotiate a workable confidentiality agreement relating to the company's technical licensor, Pilkington (UK) to facilitate buyer due diligence.

Results during Phase 3

Nine privatizations accomplished in seven months through June 2002; major results include joint ventures, not Law 203 Affiliates.

During the period December 2001 through June 2002, PIP assisted the GOE to accomplish a significant part of the goal of thirteen privatizations established by PIP's approved work plan.

The following table summarizes progress by June 30 for the 32 target companies in the benchmark measures: investor interest, companies officially offered or tendered by the GOE, investors who conducted due diligence, offers received for each company, successful divestitures to Employee Share Associations, and completed transactions. (Note that the number of target firms in the task order increased from 29 to 32, which represents replenishments for early privatizations.)

	Company Name	HC / GOE Rep	Investor interest	Officially tendered	Investor due diligence	Offers received	ESA	Completed privatizations
1	United Textiles Trading Company**	Trade	Y	Y	Y	Y	Y	Y
2	Arab Textiles Trading Company**	Trade	Y	Y	Y	Y	Y	Y
3	Misr Ameraya Spinning & Weaving	Banque Misr	Y	Y	Y	Y		Y
4	Al Nasr Glass & Crystal	Metallurgy	Y	Y	Y	Y		Y
5	Gharbeya Rice Mills	Food	Y	Y	Y	Y	Y	Y
6	Abou Zabaal Fertilizers	Chemicals	Y	Y	Y	Y		Y
7	Helwan Portland Cement	Metallurgy	Y	Y	Y	Y		Y
8	Misr Import Export	Trade	Y	Y	Y	Y	Y	Y
9	SABI (Precision Industries)**	Engineering	Y	Y	Y	Y		
10	Cairo Metallurgical Products Company**	Engineering	Y	Y	Y	Y		
11	Egyptian Glass Company	National Bank of Egypt	Y	Y	Y	Y		Y
12	Alex Cooling	Trade	Y	Y	Y	Y		
13	Misr Clay Brick Company	Ministry of Housing	Y		Y			
14	El Fayoum for National Food Security**	Banque du Caire	Y	Y	Y			
15	Misr Aswan Company for Fishing and Fish Production	Bank of Alexandria	Y			Y		
16	Sinai Manganese**	Chemicals	Y					
17	Delta Fertilizers	Chemicals	Y	Y	Y	Y		
18	Misr Hotels	Tourism	Y	Y	Y	Y		
19	Ismailia Misr Cooling and Storage Company	Banque Misr	Y	Y	Y	Y		
20	Helnan Shepheard Hotel	Tourism	Y	Y	Y	Y		
21	Arab Co. for Tourism & Hotel Invest (Semiramis)	EGOTH	Y		Y	Y		
22	Cairo Far East Bank	Banque du Caire	Y		Y			

	Company Name	HC / GOE Rep	Investor interest	Officially tendered	Investor due diligence	Offers received	ESA	Completed privatizations
23	Misr America International Bank	Banque du Caire	Y					
24	Delta Spinning and Weaving	Textile Industries						
25	Misr Iran Spinning & Weaving ("Miratex")	Textile Industries	Y					
26	Misr Dairy Products	Food						
27	Al Nasr Electrical Apparatus (NEEASAE)	Engineering	Y					
28	National Housing for Professional Syndicates (Meridian Heliopolis)	Banque Misr	Y					
29	National Co. - Hotels & Tourism (100% Cairo Sheraton, 10% Conrad)	EGOTH	Y	Y	Y	Y		
30	Kuwaiti Egyptian Investment Company	National Investment Bank	Y					
31	Misr Real Estate Investment and Tourism	Misr Insurance						
32	Omar Effendi	Trade	Y	Y	Y	Y		
	Totals		**29**	**19**	**22**	**20**	**4**	**9**
**Added to the original list as replenishment for early privatizations								

As noted in the table above, nine enterprises were "privatised" between December 1, 2001 and June 30, 2002, two of which were major transactions involving JVCs. In addition, it was PIP's opinion that the GOE was capable of closing eleven other transactions before year-end. As it turned out, only one of these companies (Alex Cooling) was privatised.

As of June 30, 2002, PIP had provided the following deliverables under Task Order 821.

Type of Deliverable	Number
Information Memoranda	15
Company Profiles	50
Diagnostic Reports	65
Valuation Reports	25
Training and Capacity Building (documents and events)	27
Marketing and Investor Outreach (documents and events)	57
Policy Memoranda	35
Sector Studies	4

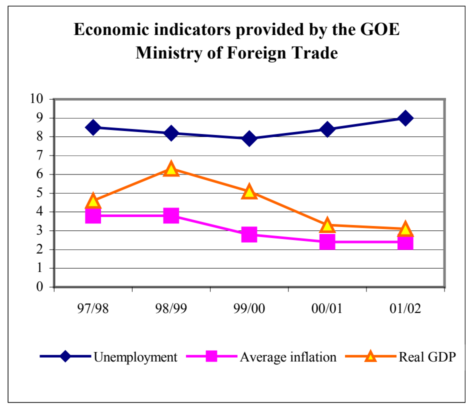
Phase 4: 1 July 2002 through 30 September 2002

During the summer of 2002, PIP operated under extensions of Task Order 821, although this produced a significant amount of uncertainty about its role in completing transactions it had begun. Nevertheless, PIP continued to carry out its work plan through September at which time Task Order 821 was terminated and replaced with another Task Order, 845.

The Government of Egypt's privatization program experienced a number of macro-economic challenges amid several helpful policy changes during this period. Uncertainty associated with political relationships among Middle Eastern nations as well as the UN's more demanding stance toward Iraq made it more difficult to attract potential investors. Furthermore, the Egyptian economy showed signs of slowing.

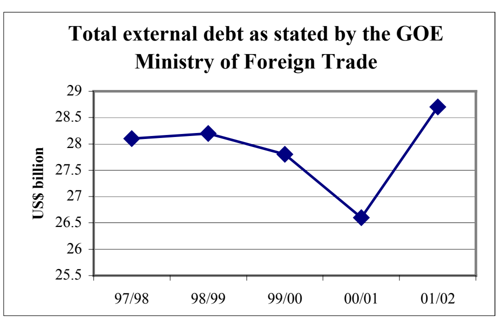
On the other hand, the Government initiated policy changes to improve the management and effectiveness of the privatization program. The MPE announced a change to facilitate the procedure for divesting joint venture companies, and the PEO took significant, positive steps to divest under-performing Law 203 affiliates, which held promise for improving the sale process and pricing for all Law 203 affiliates. The following is a summary of these external and internal factors and their effects on the privatization program.

Major Macro-economic Events Affecting Privatization



Regional and global economic conditions continued an unfavorable effect on the pace of privatization in Egypt during the summer of 2002. The situation associated with the Israeli-Palestinian conflict and the uncertainty emanating from Iraq's response to UN Resolutions had a negative effect on investment in Egypt. Evidencing this, according to the Central Bank of Egypt, foreign direct investment declined from $1.6 billion in fiscal year 2000 to only $428 million during fiscal year 2002 - during which each ensuing quarter was down from the previous quarter. Even more than in earlier recent quarters, the global investment community perceived the Middle East as a less than competitive investment environment.

A currency under pressure (unofficially trading well above official levels), a slower pace of economic activity and concerns about increasing unemployment also negatively affected the pace of the privatization program. Since the 2001 third-quarter reporting period, the GOE had devalued its currency by 22% and the difference in the official and unofficial rates was probably in the range of 12-14% according to many estimates. This contrasted with a relatively stable Egyptian pound during the mid/late nineties. The official unemployment rate, which many observers believe is consistently low compared to the actual rate, increased to 9% from a low of 7.9% during a two-year period. And total external debt rose from its four-year low in 2001 to US$ 28.7 billion at the end of fiscal 2002. As of fiscal year-end 2002, total domestic debt rose to 85.1% and government domestic debt to 57.1% of GDP; both were at recent record highs according to the Ministry of Foreign Trade. These economic indicators illustrated the importance of re-invigorating the privatization program in the interests of progressing economic reform.



In addition to valuation and currency issues, there have been other controllable or partially controllable impediments to privatization, and these include problems of contract enforcement, excessively discretionary customs and taxation practices, arbitrary bureaucratic decision-making, investors' unsatisfactory past experiences, and cumbersome and unsustained privatization selection and marketing processes. Some of these factors also discouraged private investment generally.

New Privatization Policies and Initiatives

Structural Improvements During the third quarter of 2002, the GOE enacted two beneficial decrees, one of which shifted the responsibility from the Ministry of Foreign Trade to the Ministry of Public Enterprise for managing the divesture of the GOE's interests in joint ventures (JVCs) in which Law 203 HC had ownership interests. The other decree appointed the Public Enterprise Office Director as Chairman of the Divestiture Committee, which is responsible for divesting (including pricing) public sector shares in JVCs. This change in the management of divestiture of JVCs, along with the initiatives (described below) relating to loss-making and marginally profitable companies, as well as changed policies toward valuations were designed by government authorities to facilitate the divesture of public sector shares in JVs and Law 203 companies. These were the first significant positive changes relating to privatization since PIP's operations began almost two years before. These changes seemed to indicate progress toward centralizing responsibility for privatization and badly-needed improvement in pricing that would attract investors.

**Two process improvements:
(1) HCs to manage privatization of certain JVCs
(2) PEO to Chair JVC Privatization Committee.**

Privatization Focus on Under-performing Companies

The MPE also made a strategic decision to focus on privatizing eight under-performing Affiliates. While PIP was not invited to participate in generating this decision, PIP participated in discussions with the PEO relating to implementing the initiative, particularly relating to including private investment promoters and developing realistic pricing. At the same time, PIP also encouraged and advised the PEO to continue to pursue at the privatization of more attractive enterprises and to work to resolve issues that were preventing the privatization of more distressed Affiliates, especially those in the textile industry with heavy debt burdens and excess labor. For example, PIP provided the PEO with a draft discussion outline of a plan to resolve the debt overhang problem of many Affiliates to government-owned banks. However, the draft was never acted upon or discussed.

MPE decision to focus on privatization of eight under-performing companies.

The perceived opportunity for re-capitalizating under-performing companies apparently emanated from Bolivia's privatization program. It was explained to PIP that these companies' new shares would be priced based on a book value concept approved by the Highest Ministerial Privatization Committee, which for reasons left unexplained, was politically acceptable in terms of perceived appropriate pricing. PIP advised that it would be merely coincidental if book value were to equate to a market price. PIP also advised that a discounted cash flow calculation based on the seller's prospects for generating value would be more appropriate than a valuation based on book. On the other hand, *PIP pointed out that so long as the book-based value produced a reserve price* ***below*** *market, there could be a meeting of the minds between buyer and seller that would produce successful transactions in a competitive bid environment beneficial to the GOE.* The PEO informed PIP that indeed the book value-based sellers' share prices were anticipated to generate reserve prices less than market prices - and thus the program should succeed.

Investment Promoters

Cabinet approved LE 2 million spending for retaining Investment Promoters.

From the inception of the Project, IBM had recommended "privatizing" the privatization process by retaining professional investment promoters. A major potential improvement in the Privatization Program backed by the PEO was Cabinet approval for the PEO to spend LE 2 million to pay retainer fees to investment promoters to represent and promote the selected under-performing companies. Properly employing these funds with investment promoters was intended to contribute to enhancing support for the privatization program among the investment community, as well as advancing the sale of the selected eight companies. This approval seemed to give a measure of badly-needed control to the PEO; however, because promoter agreements were with the HCs, who were not responsible for current retainers, only for success fees, this event may actually have been counterproductive.

Termination of Task Order

As of September 30, 2002, Task Order #821 was terminated. USAID determined to issue a new Task Order #845 covering a seven-month period including a one-month closeout to April 30, 2003 with an option to extend for one year until April 30, 2004. Apparently, USAID continued its privatization technical assistance on the basis that (1) ten companies were privatized during the period prior to September 30, 2002, (2) there had been advances in methods of valuation, (3) the structural improvements noted above, (4) and perhaps most important, the recent appointment of an Executive Director of the PEO with private sector experience.

Summary of Activities and Achievements under Task Order 821

Transaction support – historical	
Value of Privatizations*	LE 2,118.7
Completed Privatizations	… 19
Investor Interest	… 29
Officially Tendered	… 19
Investor Due Diligence	… 22
Offers Received	… 20
ESA	… 4
* *Millions*	

Since commencing the Privatization Implementation Project in August 2000, IBM achieved considerable progress maintaining the momentum of the program is terms of advising the GOE on privatization best practices. Project success can be measured not only by the number of completed transactions, but also by the generation of investor interest, number of companies tendered, investor due diligence arranged and offers received. There are also other indicators of support by the Project provided to the GOE including the number of information memoranda, company profiles, diagnostic reports, valuation reports, training and capacity building, marketing and investor outreach, policy memoranda, and sector studies. While these indicators may have long term impact on the privatization program, the only reliable measure is the number and value of transactions completed, and their impact on economic performance. In purely commercial terms (which is perhaps the most available and accurate measure) the cost of the assistance provided under Task Order 821 was reasonable compared with the sales value of privatization transactions closed.

Sales Value for Companies Privatized
(From August 2000 to September 2002)

Type	Company Name	PIP Direct Involvement	Method	Date	Value (LE million)
Law 203	Alexandria Cooling*	Yes	Liquidation	Aug-02	33.0
Law 203	Shobra Armenian Factory – Cairo Metallurgical Products	Yes	PA	Jul-02	8.5
JV	Egyptian Glass Co. - EGC	Yes	AI	Jun-02	206.4
JV	Misr Amereya Spinning and Weaving**	Yes	Lease	Apr-02	800.0
Law 203	United Textiles Trading Co.	Yes	ESA	Feb-02	4.9
Law 203	Arab Co. for Textiles	Yes	ESA	Feb-02	5.8
Law 203	Telephone Equipment	No	AI (10%)	Feb-02	11.4
Law 203	Abou Zaabal Fertilizers	Yes	Lease with a deferred sale	Nov-01	182.8
Law 203	Helwan Portland Cement	Yes	IPO - AI	Sep-01	661.2
Law 203	Misr Export & Import	Yes	ESA	Jul-01	17.9
Law 203	Gharbeya Rice Mills	Yes	ESA	Jul-01	51.2
JV	Fast Tourism Projects & Ambulances	No	10	Feb-01	1.4
JV	Arab Financial for Exchange	No	AI (25%)	Feb-01	1.1
Law 203	Sadat Gypsum Factory	No	LT Lease	Feb-01	8.0

Law 203	Home Appliances Factory – NEEASAE	No	PA	Dec-00	19.3
JV	National Food Industries (SONAT)	No	AI (10%)	Dec-00	3.6
JV	Developing Upper Egypt Industrial Co.	No	AI (14%)	Oct-00	0.2
JV	Egyptian British Bank	No	AI (6%)	Sep-00	63.0
JV	Egyptian American Insurance Co.	No	AI (98%)	Aug-00	39.0
	TOTAL * **				**2,118.7**

*Alex Cooling was reported as an anchor investor transaction during 2001 for LE 33 million but later changed to a liquidation transaction during 2002.
**Misr Amereya was classified as being privatized (via lease). We have not been informed that this transaction finally closed.
*** Out of this figure, LE 1971.7 million is with the direct assistance of PIP.

The following is a summary of the delivery achievements for the period August 1, 2000 to September 30, 2002 by transaction support and deliverable type. Refer to figure 1 for details on transaction support, and to figure 3 for details on the number of deliverables produced during the current and previous reporting periods.

There was substantial progress made during the period December 2001 to June 2002. For example, during the twelve-month period preceding the project's scope of work (and budget) reduction, the GOE completed only one transaction. Immediately following the SOW change which included USAID's benchmark for transactions, eleven transactions (directly associated with PIP's support) were completed from December 2001 to June 2002. This positive momentum provided a basis for the GOE to continue its efforts; consequently USAID and the GOE agreed to realign the SOW as a result of this progress.

Deliverables

	August 2000 Through September 2002
Information Memoranda	17
Company Profiles	51
Diagnostic Reports	71
Valuation Reports	27
Training and Capacity Building	27
Marketing and Investor Outreach	58
Policy Memoranda	35
Sector Studies	4

Phase 5: 1 October 2002 – 31 March 2004 Task Order # 845

USAID commenced a new Task Order (#845) on 1 October 2002 for six months of technical assistance plus one month closeout to 30 April 2003 with a one-year option. (The one-year option was eventually exercised by USAID and the work scope remained for the entire eighteen month period.)

The new Task Order included a new, revised and expanded Scope of Work. The Scope of Work for the earlier Task Order (821) confined PIP's activities to transaction assistance for a selected group of thirty-two companies. Summarizing, the new Task Order called also for general transaction support, general policy and advice, public awareness and public relations building, and monitoring and reporting.

- **Task One: Specific and General Transaction Support**

- as requested by the Public Enterprise Office and approved by the USAID CTO the PIP would support specific potential privatizations. Such support would be limited to no more than thirty companies, although only twenty-three companies were requested and approved during the Task Order. The intent was for such candidates in most cases to have a reasonably high probably of being privatized as measured against certain criteria; and
- to (1) assist in the selection of companies which might be assigned to investment promoters, and to recommend specific transaction approaches; (2) monitor the importance and sectoral impact of transactions and the impact on the increasing role of private enterprises in that sector; (3) track and report all Law 203 and JV privatization activity; (4) provide advice, guidance and limited training in the transaction process; (5) provide assistance to help procure the services of investment promoters; (6) provide general promotional support.

- **Task Two: General Policy and Advisory Assistance** including (1) examine the feasibility of re-capitalization; (2) examine the feasibility of separating privatization decision-making from operating management; (3) propose and advocate strategies to compensate investment promoters; (4) propose and advocate strategies to increase incentives for owners to advocate and support privatization; more strongly; (5) determine the significance of international agreements on operations of specific public enterprises; (6) at request of PEO, advise on liquidation of selected companies; (7) work with the Central Audit Agency to achieve more flexibility in pricing, and gain a greater acceptance of attracting investment capital.

- **Task Three: Design a Public Awareness and Public Relations Plan** to increase political and public support for privatization. The plan would focus on the overall benefits of privatization compared to the cost of not privatizing.

- **Task Four: Provide Limited Monitoring and Reporting Services** including a regular translation of press articles and a quarterly privatization review.

We will discuss below activities and results related to each of these areas of work.

Specific and General Transaction Support

During the first year of the new Task Order, and as a result of the lack of success in the privatization program during the prior two years, there was a significant amount of skepticism in the investment community among both offshore and local investors as to the seriousness of the GOE’s privatization effort. To overcome market skepticism and allow the program to progress more rapidly, in private meetings supplemented by letter PIP encouraged the PEO and MPE to progress the program with a broad marketing effort including attractive privatization offerings to investors, as well as the need for improvement in currency stability and the general environment for private investment.

The Privatization-by-Capitalization Initiative

> **Privatization focus was on a Privatization-by-Capitalization Initiative for eight "distressed" or underperforming companies.**

The privatization-by-capitalization initiative (the P-by-C Initiative or P-by-C), described earlier, really commenced at the outset of the new Task Order 845. The Initiative was the PEO's major focus and comprised the major part of PIP's work on transactions during the period of Task Order 845; thus, for this Final Report we will describe the development of the Initiative, PIP's role and the results of the Initiative in some detail. While there were several policy advances made in connection with this Initiative, the Initiative failed and illustrates many of the impediments to privatization in Egypt.

Policy Advances

Offering Price for New Shares Simplified Candidate companies' new shares would be priced based on a book value concept approved by the Highest Ministerial Privatization Committee. This formula pricing concept cut down the time required for setting the Government's reserve price, clearly an improvement.

On the other hand, PIP pointed out that to be functionally useful the book-based value must produce a reserve price *below* market, or there would be no meeting of the minds between buyer and seller that would produce successful transactions in a competitive bid environment beneficial to the GOE. It would be purely coincidental if book value were to equate to a market price. Thus, either the GOE's formula price would always be above - or below - market. PIP also advised that a discounted cash flow calculation based on the seller's prospects for generating value would be more appropriate than a seller's valuation based on book value. PIP had for some time recommended that owners rely more on a competitive bid process than on reserve pricing to assure successful pricing outcomes.

The PEO informed PIP that indeed the book value-based sellers' share prices were anticipated to generate a reserve price *less* than market prices - and thus the program should succeed. Without going further in to the formula pricing calculation approved by the Cabinet, PIP also advised the PEO that there was substantial room for owners to negotiate pricing based on the Cabinet-approved formula which made no distinction between interest bearing liabilities that would affect the investor's cash flow and other non-interest bearing operating liabilities. *PIP advised the PEO that all-in pricing flexibility by the GOE would probably be required in many cases in order to achieve successful transactions.* Thus, while the circumstances weren't perfect for succeeding with the Initiative, if the program were conducted with flexibility it could succeed.

As discussions progressed, it became the GOE's publicly announced position that indeed it intended to negotiate with flexibility regarding the all-in pricing of transactions. (All-in pricing would include the amount of labor obligations and debt that the re-capitalized company would retain after investment, as well as the possibility for write-down of questionable assets, such as receivables and inventories.

As noted, having a prior-approved formula price considerably improved the process of offering candidates for privatization, since the previous procedures for establishing a reserve price were cumbersome, often biased in favor of reserve prices above market, and almost always obsolete by the time an enterprise was tendered. (On the other hand, and as noted earlier, PIP recommended that generating a competitive market and relying on a bidding process to set price would have been far more conducive to speeding up privatization.)

Proceeds of Transactions to be Invested in Enterprises The major advantage of the approved Initiative was that it would allow virtually all the proceeds of purchase to be invested to improve the businesses, thereby maximizing the manpower requirements and maximizing the microeconomic expansionary impact. Although the Ministry of Finance would not benefit directly by receiving proceeds of transactions, more profitable enterprises would provide new corporate tax revenues, new investments would be made, and the economy would benefit from more productive employment.

The Initiative, *if properly implemented*, could be expected to produce positive results for the privatization program.

Retainer Fees Approved Further enhancing the expectations for success was that the Initiative was approved by the Cabinet along with approval for spending up to LE 2 million for investment promoter retainer fees. For the first time during the privatization program the MPE was supporting and paying for the retention of private investment promoters – *privatizing the privatization program*, which PIP had recommended. This gave the GOE a financial incentive for a successful outcome – so long as retainer fees were paid.

Market-based Pricing for JVCs The Cabinet also approved at the MPE's initiation simplified pricing for JVCs with listed and traded shares. The approved pricing methodology would employ a historic five year average trading range for thirty-three companies with listed and traded shares. Unfortunately, as with any predetermined pricing scheme based on history the resulting price calculation will be either above or below *then prevailing* market. If the calculated price is above current market, i.e. the market is below its previous five year average, investors will not buy government-owned shares. If the calculated price is below current market, it is questionable whether the government will sell – based on decision-making related to the P-by-C Initiative described below. While simplifying pricing calculations is a worthwhile objective, it is not surprising that none of the thirty-three companies shares have been sold using this technique in markets - until recently - depressed.

Privatization by Capitalization Implementation

Offering Price for Existing Shares Not Included It is important to note at this point in the discussion of the privatization-by-capitalization initiative that there was no attention given to pricing approval by the Cabinet for purchase of existing shares. Thus, if it were more beneficial for an investor to buy an enterprise outright, there was no approved reserve price in place, which could be used to conclude a full buy-out if investors found that option more attractive than buying newly issued shares.

> **Selection Process for P-by-C Candidates did not produce optimal candidates; for those that were optimal the GOE did not follow through to achieve success.**

Candidates Not Chosen Based on Probability of Success Initially, the PEO provided PIP with a preliminary list of nine candidates under the Cabinet-approved P-by-C Initiative. PIP assessed the candidates and recommended three to be the first candidates put forward. PIP recommended that the initial candidates should be chosen to maximize the probabilities of succeeding with the Initiative, because the perception in the market was that the privatization program was dead in the water. However, only one of the three, SEMAF (a rail carriage manufacturer), was among the eight companies thereafter selected by the MPE for development under the Initiative.

Disadvantages of the Offering and Pricing Technique Even in SEMAF's case, PIP recommended offering existing shares rather than new shares, since the company's value, as determined by the Cabinet-approved book-value pricing method, appeared too high to provide viable investment opportunities to employ the significant amount of new shares that would have to be issued to give the investor a controlling interest in the total shares outstanding after investment.

However, as noted above the Cabinet approved the valuation formula to apply only to a new share issue, but not to the sale of existing shares. Since valuations were (and unfortunately still are) a time-consuming, lengthy process in Egypt; this effectively precluded offering the investor the option of buying existing shares, which in the case of SEMAF would be the most attractive option.

Selecting and Retaining Investment Promoters PIP worked with the PEO to solicit indications of interest from investment promoters selected from a list of forty-two promoters, which had been pre-qualified prior to the onset of the Project. This process started during the first month of the new Task Order. PIP also worked with the PEO to develop template agreements for retaining the promoters as well as the tender announcement. Once tenders were received by each HC, PIP participated as a member of a committee advising the HC, and provided its assessment of each promoter's offer. PIP conducted due diligence of each promoter's qualifications and provided its assessment of each promoter. PIP also participated as an advisor in the relevant HC's selection process.

It was PIP's opinion (expressed to the PEO) that the HCs did not arrange the retainers and success fees associated with the promoter agreements at a high enough monetary level to attract the most qualified investment promoters and to properly incentivize the promoters, and privately advised the PEO accordingly.

Seven qualified investment promoters were retained for the eight candidate companies approved by the Cabinet. However, the process of selection was time consuming. The process took approximately six months from the time of solicitation to retaining the seventh investment promoter. All involved agreed the process was too cumbersome and took too long to implement. An extraordinary amount of time was involved in the selection process and in generating a retainer and success fee agreement.

Assessing Viability of Candidates Subsequent to the selection of the eight candidates, PIP undertook an analysis of each to determine the feasibility of the book-value based pricing technique – specifically to determine the threshold future performance by the company that would justify investment at the Government's book-value based price (which as noted is not the most appropriate way to price a going concern.) Thus, it could be determined whether it would be worthwhile to pursue the Initiative with each of the eight companies. This process was time consuming, and not unlike conducting a valuation. PIP visited with and gathered information from each of the HC owners as a basis for its assessments. All eight candidates were assessed and reviewed with the PEO over a period of several months.

On the basis of these diagnostics, it was clear that one of the candidates, Dyestuffs, was clearly not a feasible candidate for the Initiative without very substantial flexibility in the negotiating process. Others were questionable and presented significant challenges: NEEASAE, Kom Hamada, Mahmoudeya and Naroubin. Thus, five out of eight candidates turned out to be very difficult challenges based on the approved pricing mechanism.

Subsequent to the retention of investment promoters for all companies, GOE determined that the pricing formula would produce a price too far below perceived market for three of the candidates (SEMAF, Edfina and Engineering Automotive), although the basis for the perception wasn't explained to PIP.

As a result, the GOE decided that the three companies' shares would in some manner be *revalued* for purposes of pricing the new shares. It may be recalled that the viability of the Initiative was based on the notion that the formula price at which shares would be sold would be below market – although there would be room, if necessary, for the HC to increase the price by negotiation of balance sheet items and labor retention. *These were the only companies that represented reasonably good candidates for privatization based on their business circumstances, and the GOE chose to remove the previously approved pricing formula for these candidates – without replacing them with another pricing formula conducive to sale.*

Meanwhile, the other five candidates had significant issues that impeded their privatizations.

In one case (Engineering Automotive), at the behest of the investment promoter the decision was reversed. In the remaining two cases, it was never clear how the share prices would be determined.

After substantial efforts over the course of well-over a year undertaken by seven investment promoters on behalf of eight companies, the P-by-C failed to produce a privatization. In fact, one candidate, SEMAF, the only candidate with good prospects for being sold, may be sold to a quasi-government entity, the Arab Organization for Industrialization.

Unfortunately, the lack of results for the P-by-C Initiative will undoubtedly cause investors to lose interest in pursuing future opportunities, and should there be other initiatives to use the services of investment promoters, it will be more difficult to convince them that there will be successful transactions at the end of the tunnel.

After well over a year of intensive effort, the P-by-C Initiative and the new pricing scheme for certain JVCs failed to produce a privatization.

Impediments to Privatization-by-Capitalization

In addition to the general impediments noted above involving the pricing formula, the selection of candidates and the selection of investment promoters, the following issues also impeded the process:

HCs did not generally support the P-by-C initiative; most appeared concerned about potentially being accused of selling too cheap.

- First and foremost, the GOE has not relied on a competitive tender to determine price of the new shares; rather it set reserve prices according to an irrelevant book-value concept.
- Although in the interests of the overall privatization program, it was necessary to demonstrate success, five of the eight candidates would be difficult to privatize under the best of circumstances; one of these was simply not a feasible candidate from the outset.
- The pricing formula produced a below market price in the three cases which were good candidates for privatization, but each price was withdrawn without a substitute pricing formula.
- The approved pricing formula did not produce a published per share price at the outset and on which a competitive tender could ensue as a basis for negotiation.
- HCs did not aggressively pursue sales by tendering at a fixed price, but rather waited for investors to indicate interests in principle on the basis of which the HCs chose to negotiate terms. This passive approach did not attract investors.
- Even when approached by investors, HCs were slow to respond to investor indications of interest. In some cases, the HCs discouraged investor communications.
- Negotiations that did take place were long and drawn out. HC's were not decisive in their responses. In many cases, investors lost interest and questioned the owner's serious intent.
- If there were intent for the GOE to employ flexibility in negotiations, as it publicly announced it would, PIP observed no significant flexibility on the part of the GOE.
- In the case of excess labor issues, some HCs did not have a pre-approved mechanism to resolve the issue prior to discussions with potential investors.
- HC management was seriously concerned about politically-motivated accusations of improperly handling transactions, and particularly of being accused of selling at a too-low price (e.g. corruption). This, perhaps more than any other single factor, impeded success and may have been the cause for the passivity and lack of decisiveness on the part of HCs.
- The HCs did not have a financial stake in the outcome, which otherwise would have incentivized them to complete transactions.

Dyestuffs

Dyestuffs, whose business prospects had earlier been assessed by a consultant funded by the EU, was clearly the most difficult of the candidates to sell. Turnaround would essentially involve developing a Greenfield investment. It was questionable whether there was any value left in the company's assets and business at the time the candidate was selected. Shortly after the investment promoter was retained, PIP met with the promoter and provided its assessment of the viability of the offering and advised the promoter that a deal could be done only with significant enhancement in the offering. Without substantial concessions by the GOE, this privatization was extremely questionable from the start.

It is unclear why this company was selected for P-by-C by the Cabinet. Liquidation, as implied by the EU study, would have been more appropriate.

Edfina

The investment promoter received little support from the Food Holding Company to facilitate a transaction. In fact, a potentially fatal land issue, which had been known within the HC, was not disclosed to the PEO and the investment promoter until well into the development of the deal. Furthermore, as noted previously the pricing formula used to establish a reserve price was dropped but not replaced with another. The investment promoter introduced a prospective British investor, but after several months of attempting to resolve the issue of whether Edfina owns the land on which it operates, the investor lost interest. The investment promoter has billed under the retainer agreement, but at the time of this writing had not been paid.

Considering the apparently irresolvable land issue, it is unclear why the HC supported adding this company to the list of candidates for re-capitalization. Furthermore, it is unclear why the pricing formula for re-capitalization was withdrawn for application to Edfina, because although it may produce a reserve price lower than market, it is clear that there is investor appetite for Edfina and a competitive bid process would probably have produced a market clearing price above the reserve price.

SEMAF

This candidate choice has a possibility of leading to a transaction; however, foreign railway companies interested in acquiring this company were turned away in favor of a quasi-government entity, whose sole financial interest is held by the GOE, we are told. If SEMAF is sold, one could argue that the transaction would not qualify as a "privatization" as currently being pursued. *One might contend that politics impeded the full privatization of this company.*

Kom Hamada

Negotiation over pricing has been the major impediment for this potential transaction. Particularly difficult has been the inclusion of discrete land value by the HC as required by the Cabinet-approved pricing formula, which is not appropriate for a going-concern. *It is also evident that the Textile HC is concerned about political ramifications of selling the company at a price below perceived market value. A more detailed analysis of the impediments to this transaction is included as an Attachment to this report.*

Mahmoudeya

The same types of issues encountered with Kom Hamada were also encountered with this company, since both are subsidiaries of the Textile HC.

Engineering Automotive

There are interested investors for this candidate, but according to the investment promoter, *the HC is not being helpful in moving the discussions and tender forward.*

NEEASAE

We were informed by the PEO that there was an investor for this company and that a transaction was expected to occur early in 2004, but PIP has seen no evidence of a transaction happening.

Naroubin

While several investors indicated interest in this company, there has been no substantial progress in re-capitalization.

PIP's Direct Assistance for Privatization Candidates

Under Task Order 845, PIP was requested and approved to provide direct support for the privatization of some twenty-three companies, three of which were JVCs and twenty were Affiliates. Three of these candidates actually preceeded Task Order 845, so PIP continued to provide assistance into the new Task Order. PIP provided marketing assistance for fifteen of these companies, promotion for eight, valuations for six, data rooms for three, profiles for eleven, and information memoranda preparation assistance for thirteen.

PIP provided direct support for 23 candidates, 2 of which were privatized.
GOE's selection process was less than optimal – many candidates were later dropped as active candidates.

Figure 1: Status of companies approved for specific transaction assistance

Ref	Company Name	Activity from	Activity to	Months with activity	Status
1	Cairo Far East Bank	Oct-00	Mar-04	41	Banque du Caire has ceased pursuing sale of this bank because of new higher capital requirements which make it impractical to operate this bank at its current size. **This bank won't be further privatized, but perhaps merged with its major parent, Banque du Caire.**
2	Alexandria Refractories	Jul-02	Mar-04	21	HC for Metallurgical Industries requested a valuation and information memo for the company. Following the completion of a preliminary valuation a technical problem relating to furnaces was disclosed and would reduce the valuation. *Not unlike Edfina, the company was aware of this impediment to privatization prior to selecting the company as a candidate*. PIP requested an assessment of the cost impact in order to adjust the valuation accordingly, but it was never forthcoming. **Privatization is thus problematic.**
3	Misr Iran Spinning & Weaving ("Miratex")	Jan-02	Mar-04	30	PIP prepared a fact sheet, diagnostic report, company profile, info memo, valuation report, and part of the data room. Both the Egyptian and Iranian shareholders had been willing to sell their shares. The Chairman, an important industry figure, supported privatization. The untimely and unfortunate passing of the Chairman of the company impeded privatization. There are indications that political relations between Iran and Egypt may be improving, so there may be some greater opportunity for privatization, if relations in fact improve. **Privatization won't happen in the near term.**
4	NEEASAE	Jan-03	Mar-04	18	Investment promoter retained and info memo completed. One Egyptian and one Chinese investor were interested. We understand from PEO that the Minister indicated that a deal would be struck during first quarter of 2004, but it didn't happen. **The available market for this company's privatization is very limited.**
5	NAROUBIN	Jan-03	Mar-04	18	Investment promoter retained. Info memo prepared and submitted to HC for approval. No further developments. **Did not result in privatization during first quarter 2004.**
6	Car Engineering	Jan-03	Dec-03	15	Investment promoter retained, info memo completed, several investors were interested including ones from India, Korea and Japan. No further development. Investment promoter has never been paid retainer by HC. **Did not result in privatization during first quarter 2004.**
7	Kom Hamada	Jan-03	Dec-03	15	Profile completed, investment promoter retained One investor has negotiated with HC, but the parties haven't been able to agree on a ballpark price**. Unlikely to result in privatization under present conditions.**
8	El Mahmodeya	Jan-03	Dec-03	15	Investment promoter retained. Info memo prepared and submitted to the HC for approval Four investors interested , but no progress in tender decision. **Unlikely to result in privatization under present conditions.**
9	EDFINA	Jan-03	Dec-03	15	Investment promoter retained and info memo prepared. HC not pursuing rapid privatization. *In fact, only late in the process did the HC disclose a potentially fatal land issue.* **Unlkely to result in privatization in the foreseeable future under these conditions.**
10	SEMAF	Jan-03	Dec-03	15	Investment promoter retained and info memo prepared. Four offshore strategic investors interested. We have been informed that other government considerations make it *unlikely that the effort will result in privatization by parties unrelated to government.* **This company has a reasonable likelihood of being sold – but to a quasi government entity.**
11	Dyestuffs	Jan-03	Mar-04	15	Profile complete and investment promoter retained. No info memo prepared; **this effort is very doubtful**.

Ref	Company Name	Activity from	Activity to	Months with activity	Status
12	Egyptian Starch & Glucose	Aug-03	Jan-04	5	Tendered during the third quarter. Information memo completed by PIP. PIP has contacted fifty foreign and Egyptian companies by fax and email to promote this sale. Company bought by an Americana consortium at LE 27.50 per share. **42.99% government ownership sold for LE 54.4 million.** Primary seller: Food HC.
13	Ferro Alloys	Aug-03	Dec-03	4	Information Memorandum nearly completed, but PEO **removed this company as privatization candidate** for reasons unexplained.
14	RAKTA	Aug-03	Dec-03	4	**Taken off list of candidates** due to an un-resolvable environmental issue identified by PIP.
15	Paints & Chemicals Ind PACHIN	Aug-03	Dec-03	7	Fact Sheet, profile completed; marketed by PIP in Gulf. **Excellent candidate/publicly traded. Delayed privatization for reasons that were unexplained**.
16	Transport & Engineering (TRENKO)	Aug-03	Mar 04	4	Assisted in valuation update; preparing info memo, but large losses incurred for 2003. Increasing losses indicate TRENKO **will not be privatized during first half of 2004.**
17	UNIRAB (POLVARA)	Aug-03	Dec-03	8	Company profile and information memorandum completed and sent to HC for review. Status unknown.
18	Suez Steel	Aug-03	Mar-03	6	Valuation was completed and reviewed by the CAA. The private sector shareholder expressed interest in buying the government shares, but there was substantial resistance to sale by the senior executives of the company. Substantial debt and substantial losses apparently need explanation. **Finally, we are told, BduC repurchased the minority shares, reversing the earlier privatiziation**.
19	ARACEMCO	Sep-03	Jan-04	6	Information memorandum completed. **Lecico Egypt purchased 43.52% of shares at LE 10.50 per share for a total purchase of LE 34.2 million.** (Sellers: Metallurgical HC and General Co. for Porcelain)
20	National Paper	Aug-03	Dec-03	5	**Postponed due to a technical problem (obsolete equipment) identified by PIP**
21	El Nasr Casting	Sep-03	Dec-03	4	Assisted with valuation. Met with potential investors. **Heavy bank debt must be resolved before privatization can occur.**
22	Mitghamr	Feb-04	Mar-04	2	PIP assisted in preparing an information memorandum. Too early to judge results, but prospects are not good for privatization.
23	El Ahlia	Feb-04	Mar-04	2	PIP assisted in preparing an information memorandum. Too early to judge results, but prospects are not good for privatization.

Summary of results for List of 23, Above

Of the twenty-one companies that PIP worked with directly to assist with privatization

- Six were removed as privatization candidates, two because of potentially fatal issues.
    - Cairo Far East Bank
    - Dyestuffs
    - Ferroalloys
    - TRENKO
    - National Paper
    - RAKTA
- Two were delayed because HCs did not disclose critical problem issues until late in the process indicating less than full support for privatization by the owners.
    - Alexandria Refractories

    - Edfina
- Five are difficult to privatize and owners didn't aggressively seek privatization and/or didn't demonstrate flexibility in the negotiating process.
    - Kom Hamada
    - El Mahmoudeya
    - Naroubin
    - Car Engineering
    - NEEASAE
- One excellent candidate was not pursued aggressively by the government shareholder without explanation.
    - PACHIN

Two were privatized for a total of LE 88.6 million paid to government entities. Both minority, but controlling, interests.
    - ARACEMCO and
    - Egyptian Starch & Glucose
- One was a reverse privatization and one is probably going to result in a virtual reverse privatization:
    - Suez Steel
    - SEMAF

Three still have possibilities for privatization but not in the near term
- Miratex
- UNIRAB (POLVARA)
- El Nasr Casting

Thirteen – almost two-thirds - of the twenty-one companies that have been in preparation for more than two months either weren't properly vetted by the government as suitable for privatization or owners weren't prepared to give their full support to privatization. The most recent two candidates (Mitgamr and El Aleya) are unlikely to succeed without substantial financial restructuring. An additional two will end up as reverse privatizations!

Clearly, the current system for selecting and promoting companies for privatization is dysfunctional. Too often companies are selected and then removed as candidates or privatization is deferred for one reason or another. In the interests of effectively promoting the program with investors and maximizing results, a consensus and appropriate incentives need to be developed by all stakeholders, which commits them to supporting each candidate until it is privatized. Additionally, a professional marketing program for the full program needs to be developed and sustained in major available investor markets. The investor markets, both inside and outside Egypt, perceive that the GOE is not serious about implementing its privatization program and are thus not attracted to pursue the opportunities that do exist.

Candidate Selection for Marketing to Gulf States Further evidence of this phenomenon is the manner in which the promotional effort to the Gulf in the fourth quarter of 2003 was carried out.

Holding Companies did not provide support for marketing efforts.

Early in the preparation of a marketing effort to the Gulf States of Abu Dhabi, Dubai and Bahrain, PIP proposed and the MPE supported the identification of the following companies as candidates for aggressive promotion activities in the Gulf:

- Nile Oil & Detergents
- General Company for Paper Industry
- Tanta Oil & Soap
- Egyptian Salt & Soda
- Paints and Chemicals PACHIN
- Egyptian Starch and Glucose
- Engineering Company for Automotives
- Edfina Company for Preserved Foods
- Amoun Island Hotel

The plan was to develop a portfolio of candidates that would appeal to Gulf investors, e.g. larger viable going-concerns, particularly in the food-related sectors and which would have attractive markets. PIP prepared marketing information for the foregoing companies, in addition to another twenty-seven companies that were less suitable, but nevertheless worthwhile, to promote. PIP also invited owners to attend the meetings and conferences arranged with investors and investor representatives to promote the foregoing listed candidates.

The marketing effort was carried out without participation of the Food HC, owner of five of the nine companies being promoted. Although one HC Chairman tentatively agreed to participate, he cancelled late in the process. The only HC represented by its privatization advisor was the hotel holding company, which promoted primarily land development schemes rather than going-concern properties, such as Amoun Island Hotel, Misr Hotels and Shepheard Hotel. Unfortunately, investor one-on-one meetings were not attended by Chairmen of HCs (legal representatives of owners - although they were all invited), rather only by the Executive Director of the PEO and PIP personnel. Lack of participation by owners sent a negative signal to investors, many of whom were high net worth Gulf investors (not their representatives.)

Marketing Coordination with other Government Investment Initiatives

PIP was instrumental in establishing a relationship between the General Authority for Investment and Free Zones (GAFI) and the Public Enterprise Office (PEO). PIP and the PEO were represented at GAFI conference in Ireland and the UK, and GAFI supported PIP's marketing efforts in the Arab Gulf and elsewhere. This relationship, we are confident, will prove fruitful if the barriers to privatization cited earlier are removed. It is particularly encouraging that GAFI is being given increasing authority as a one-stop shop for foreign investors. We hope that this trend will continue, so as to overcome the bureaucratic impediments to foreign investment in Egypt that remain.

Law 203 Affiliate Debt Burden

Despite MPE efforts, the Law 203 debt overhang to government-owned banks remains un - resolved.

Early in the 845 Task Order, it was clear that a major impediment to privatization of many Law 203 Affiliates was the significant amount of unserviceable debt owed to government-owned commercial banks. PIP provided a draft proposal for resolution of the issue, which received no significant interest by the PEO.

Later PIP was informed that the MPE had coordinated a proposed resolution to the debt problem, which was agreed in principle among the HCs and banks involved, and that the proposal, along with the in principle agreements, had been forwarded to the Ministry of Finance for its approval and implementation. The implementation was to have taken place, PIP was told, by the end of July 2003. Resolution to the bank debt problem would remove a major impediment to privatizing Law 203 Affiliates. Since July, eight months have passed without a sorely needed resolution to this issue.

Special Assistance Provided for Promoting the Privatization of Abu Tartur Phosphate Project

Abu Tartur privatization did not proceed in part because of lack of cooperation and coordination among involved ministries.

At the request of the PEO and as approved by USAID, PIP provided limited assistance to the Ministry of Industry and Technology to prepare to promote the lease of its Abu Tartur Phosphate Mining Project. An information memorandum was prepared by the Ministry with assistance from the Project. Additionally, the Project identified a large number of potential investors, which it provided to the Ministry and attended a conference at which Abu Tartur was promoted for lease by the Ministry. USAID eventually requested PIP to cease work relating to Abu Tartur as a result of concerns by a US supplier of mining equipment that assistance would be detrimental to settlement of a claim for non-payment of equipment supplied to the project.

The major impediment to privatizing Abu Tartur was the there was no coordination and cooperation among the Ministry of Trade and Industry (which operated the project), the Ministry of Electricity (which provided power to the project), and the Ministry of Transportation (which owned and operated the only link to the sea port) each of which would need to be incentivized to make such a complicated project transaction succeed.

Policy Advice

Objective of Policy Advice

The ultimate objective of the PIP's policy advice was to accelerate the pace of privatization, and identify and induce the removal of the inefficiencies and other barriers to achieving privatization results. As pointed out elsewhere in this Report, too much time has been expended on privatization transactions that were never consummated.

There are a number of impediments to privatization in Egypt. While some of these as previously mentioned are outside Egypt's control, influenced by changes in external economic and political conditions, our focus is necessarily on those impediments that are controllable. We summarize below the key issues and the solutions that PIP has advocated.

Valuation and Pricing Issues

Problems observed

Reserve prices set by government are too often too high.

The failure of transaction pricing to meet valuation expectations is a common reason – or excuse in some cases – for a privatization transaction failing to be consummated. PIP observed that this is often the result of confusion of value and price and misunderstanding of the concept of value itself. Valuations, sometimes long and time-consuming, are performed as if there were only one value for a firm, with that "value" equaling either a "fair price" or the minimum price. There is a misplaced effort to set prices administratively, rather than to rely on competition to determine prices. The result is that the minimum ("reserve') prices expected by the sellers are too often too high.

When proposals from investors more often than not don't meet valuation expectations, there is strong evidence that the valuations themselves are flawed.

Principles promoted by PIP

Value to the seller must be distinguished from value to the various potential buyers. Clearly, if the seller is to agree on a price with a given buyer, the buyer must value the enterprise more highly than the buyer. And each buyer will value the enterprise differently from every other buyer. There are many reasons for this – differing financial resources, differing strategies, differing costs of capital, differing existing businesses, differing access to markets, etc.

Value to government, rather than perceived "market" value, should represent the reserve price.

Consequently, valuations must clearly state *for whom* value is estimated. A seller should always estimate the value to itself of a firm that is offered for sale. This should be an honest financial assessment, not wishful thinking. Reflecting past performance, it should realistically project the future based on the constraints (especially constraints of finance and marketing) facing the seller. Often it is reasonable to project a continuation of sales and profitability trends in the recent past. The seller's value (which can be negative) represents the *minimum price* that the seller could accept while leaving it in a better position than the alternative of retaining ownership and management.[12]

However, it is also useful for the seller to estimate value to a hypothetical buyer, which constitutes an estimation of the *maximum price* that the buyer would pay. Nevertheless, it is prudent to be modest in these estimations because every buyer is different, each will pursue a somewhat different strategy and each will have differing resources available to it.

PIP also observed that valuations, for whatever purpose, tend to be too detailed and take too much time. Because valuations inherently deal with the future and the uncertainties can never be fully resolved, the law of diminishing returns sets in quickly. The uncertainties are best handled by sensitivity analyses on the key variables and assumptions, rather than with an over-detailed and spuriously accurate valuation.

Book value is inappropriate as pricing basis for going concerns.

Privatization-by-Capitalization, which was undertaken by the MPE in late 2002, makes a lot of sense if interpreted broadly. The concept explicitly recognizes that some enterprises, particularly weak ones that require new capital investment to achieve profitability, must be sold primarily on the basis of the *amount* of new capital committed by the investor rather than on the basis of the price (often minimal) that the investor offers to pay for existing shares. Nevertheless, as implemented, Privatization-by-Capitalization has been seriously flawed because the price of shares is based on book value, adjusted for the present market value of land and fixed assets. This adjusted book value approach involves two fundamental errors:

1) *It assumes that book value is always an attractive basis for pricing shares -- that is, the price is advantageous to the buyer.* This is usually true for healthy, profitable companies, as evidenced by market capitalizations of such listed companies usually being well above book value. Such companies are normally more than simply the sum of their parts because they are well managed and respond to growing markets. But for money losing companies requiring new investment – for many of the companies for which the Privatization-by-Capitalization technique was designed -- this is not true. In fact, many Public Enterprises are worth to both buyers and the seller less than book value or adjusted book value, or even less than the original paid-in capital. Many firms in fact have

[12] Some economist call this the "seller's reserve price," but we prefer to avoid this terminology so as to avoid confusion with an announced tender reserve price, which might, for tactical reasons in some circumstances, be set above the seller's value.

negative values to the GOE, since they represent continuing cash drains with no prospect of turnaround under GOE ownership.

Accounting approaches such as book value are simply inadequate for valuation purposes, with accounting data constituting nothing more than a starting point (albeit a useful one) for valuation. For example, the need for a future investor to make a major cash outlay for new capital equipment to restore a company to profitability, appears on no accounting balance sheet. The book value also doesn't take in to account the obligation (perhaps informal, but real) of public enterprises to redundant labor and for under-priced loans, as often occurs with loans from HCs and government-owned banks. The failure to look realistically at value is not entirely attributable to misunderstanding – there is also a reluctance to recognize formally the obvious: that boards and managements of many government-owned enterprises have *destroyed value,* and therefore the enterprises are worth well below book value to the seller and usually to potential buyers as well. *HCs and the MPE are understandably reluctant to admit having diminished value.*

2) It confuses liquidation valuation with going-concern valuation. In a liquidation situation, the market value of land and fixed assets is an essential element in the calculation of liquidation value. In the case of a going-concern enterprise – and all capitalization transactions are predicated on the condition that the enterprises continue as going concerns – land and fixed assets do not have values independent of the future cash flow that is expected to be generated by the enterprise. The assets in this case have no intrinsic value for purposes of pricing, their values being inextricably linked to the future cash flow performance of the enterprise. Therefore it makes no sense to attempt to superimpose liquidation values on a going concern valuation. Yet this is precisely what has happened in the Privatization-by-Capitalization initiative approved by the Cabinet and undertaken by the MPE.

Valuation training provided for HCs and Central Audit Agency.

Valuation training became an important part of PIP's mission as a result of the foregoing-observed problems. Week-long training programs were offered to all the Law 203 HCs and accepted by most. The last valuation training session was specifically addressed to the Central Audit Agency, which sent approximately twelve senior persons to attend. The training was well received by all groups that participated.

Reference documents

Valuation principles were laid out by PIP in a January 2003 memorandum, "Valuation and Pricing Policy Issues Relating to the Roles of Sellers and Investment Promoters."[*] While developed in the context of the Privatization-by-Capitalization cases under active review at the time, the paper addressed valuation issues relevant to any enterprise privatization.

[*] Document is appended to this Report.

In addition to many case-by-case valuation recommendations, PIP conveyed in a February 2003 memorandum a critique of Privatization-by-Capitalization pricing.[*]

Tendering Issues

Problems observed

The fundamental problems are that:

- tenders take far too long to launch; they are often launched only after detailed pre-tender negotiations with at least one investor;
- tenders often result in no sale despite investor bids having been submitted;
- reserve prices are not announced in tenders;
- and post-tender negotiations often involve re-negotiation of terms that were already addressed in a tender.

Current tendering processes too often discourage bidders, and thereby reduce competition.

Investors will be attracted by a transparent and rapid process in which they feel they are competing on an equal basis with others. However, the result of these fundamental problems is that investors are distrustful of the Public Enterprise tendering process, and, consequently, their participation in tenders is discouraged:

- Detailed pre-tender negotiation with one bidder suggests that the tender is only a formality to designate the favored bidder. This is confirmed when the deadline for submitting bids is unusually short, such as several weeks as is sometimes the case.
- The history of failed tenders suggests that sellers often have no serious interest in selling and that the tenders are concocted to create a false impression of a serious privatization effort.
- Not announcing reserve prices gives potential investors no idea as to whether the seller is serious or is realistic in its expectations; and it suggests that the seller will adjust his hidden "reserve price" according to the level of bids that are submitted, using it as a negotiating tactic to claim that a high bid must be increased to meet the supposed reserve price.
- Common post-tender negotiation of price and other fundamental terms suggests that the seller views the tender as only one step in a negotiating process rather than the determinant of terms of sale.

On the technical side, tenders should be better designed to reflect multiple criteria (e.g. both the price for existing shares and new capital commitments); and that, in Privatization-by-Capitalization situations, tenders should allow for the possibility that some bidders will prefer a partial or full acquisition of existing shares, in addition to making new capital investment.

[*] Document is appended to this Report.

Principles promoted by PIP

Competitive tender should be the principle mechanism for determining price.

A competitive tender, rather than a valuation, should be the principal mechanism for determining a price. Consequently, it is important to design tenders to maximize, rather than discourage, investor participation. The greater the number of competitors in the tender, the more will price and other terms reflect buyer valuations. By contrast, if there are only one or two bidders, it is likely that the terms will primarily reflect the seller's value. PIP has proposed means to increase the level of bids under these circumstances.

PIP has recommended that

- there be no long and detailed pre-tender price negotiations; that tenders be widely advertised, often through direct contact with potential investors;
- reserve prices (and any other minimum conditions) reflect value to the seller and be stated in the tender; and
- assuming at least one bidder meets the minimum conditions of the tender, there be no further negotiation of principal bid terms.

Tendering process must be efficient to achieve goal of 35 privatizations p.a.

The tendering process must be fast and efficient if the Ministry of Public Enterprise is to have any hope of meeting its recently announced target of selling 35 companies a year over the next three years. Of course, there are other important impediments to attaining or exceeding that goal, such as unnecessarily cumbersome valuation procedures (see above) and a convoluted decision-making process.

Reference documents

PIP's March 2004 paper, "The 'Second-Price Method' of Increasing Prices Offered in a Competitive Sealed Tender"* suggests a tendering tactic to increase the level of price bids to the respective valuations of the buyers.

To address the fundamental problems and the technical problems of multiple selection criteria, specifically in the context of privatization-by-capitalization, PIP delivered to the PEO in August 2003 a detailed memorandum entitled "Tender Evaluation Criteria/ Privatization-by-Capitalization."* Proposed tendering criteria were included for two sample privatization-by-capitalization candidates.

* Document is appended to this Report.

Investment Promotion and Marketing Issues

Problems observed

PIP had long recommended the engagement of investment promoters to speed the privatization process. An investment promoter program was approved in 2002, and the selection of promoters for eight privatization-by-capitalization candidates was launched at the end of that year.

More cooperation and support from many HCs and Affiliates are required.

Nevertheless, nearly eighteen months later, not one of the eight companies has been privatized.

The story in the intervening time is one of lack of cooperation by some holding companies and a consistent inability (or unwillingness) to make decisions.

Profiting from experience with the first cases in 2003, investment promoter selection and contracting should be streamlined in future cases. Selection and contracting periods were too long.

Various incentives to buyers have been offered by the GOE to potential investors, and some of these are effective and others not. The incentive regarding the valuation of assets should be substantially changed (if not eliminated entirely) because their effect is to impede rather than advance privatization. Again, this is a problem of confusing liquidation and going concern sales.

As for attracting foreign investment (normally a major source of investment for privatizations), there are many barriers that apply to privatization as well as to other investments. Some of these are within Egypt's control, while others are not. In the former category, uncertain and arbitrary effective taxation rates, currency instability, complex and arbitrary customs duties, and a state-dominated banking system are particularly worthy of mention.

Many impediments are controllable by government. Series of unsuccessful privatization efforts discourage investor participation in future tenders.

Principles promoted by PIP

PIP has consistently emphasized the importance of marketing and increasing the competitiveness of tenders. But neither hiring investment promoters nor increased marketing efforts will help to sell companies if the fundamental problems of valuation, pricing, tendering, and indecision are not resolved. On the contrary, under current circumstances, hiring promoters and marketing to investors has, in retrospect, only served to highlight to the promoters and investors the impediments to successful privatization,

GOE should assure implementation will be efficient and effective before going to market. Many recent efforts have been counterproductive.

which will make it more difficult to regain their attention after those problems are overcome.

Marketing efforts among investors in the Gulf revealed the poor perception that investors have of Egypt. Many told stories of long and costly delays caused by Government, whether or not related to privatization situations. Fortunately, most expressed eagerness to reconsider Egypt if they could be convinced that an investment in negotiation would end with a deal. But no level of marketing, however aggressive, will result in the sale of companies if the seller shows itself to be unwilling to sell, inflexible and/or incapable of making decisions.

Reference documents

PIP's "Critique of Incentives to Privatization," conveyed as a letter to the PEO February 2004, explains our concerns with asset valuation provisions, as well as commenting on other incentives.[*]

A March 2004 letter to the PEO, "Kom Hamada Privatization as an Example of Decision Impediments to Privatization," presents a case example.[*]

Various memoranda conveyed to the PEO late 2002 and early 2003 address issues of investment promoter selection, the tender for promoters, and a proposed model "Investment Promotion Agreement."

Textile Sector Issues

Problems observed

Among the Public Enterprises, the spinning and weaving sector represents the greatest economic burden, yet little privatization has been achieved. Public ownership has, over the decades, effectively undermined this sector by using the firms to employ large numbers of unneeded labor. In the short term, this no doubt brought some political benefits, but in the long term it has been disastrous for the sector and detrimental to the competitiveness of Egypt's textile industry.

Absence of privatization in textile sector has resulted in lost market share and future employment.

Countries like China, India, and Pakistan have taken over market share that could have been Egypt's. Because cash was persistently drained from these companies to pay for unneeded labor, the companies had few resources to make the capital investments that were required to replace worn out equipment, acquire modern and efficient equipment, and to develop new

[*] Document is appended to this Report.

markets. The decline of the sector's 29 companies is evidenced by LE 8.9 billion of losses, not including interest, in the year ended June 30, 2002, with LE 8.6 billion of debt on annual sales of only LE 2.3 billion.[13]

Over-employment in Public Enterprises has undermined employment in the sector and in the broader economy as well.

Aggressive and rapid privatization is the only solution to the textile challenge.

Moreover, textile quotas worldwide are due to be eliminated as of January 1, 2005. This is simultaneously a threat and an opportunity for Egypt. To take advantage of the opportunity, major new capital investment is essential to modernize the capital stock of the sector. Aggressive privatization is the only solution, yet investor negotiations for relatively small transactions like Kom Hamada (see references above and PIP's meeting report with the MPE (April 2003) and March 2004 letter cited earlier) drag on interminably, while most of the sector receives little or no privatization attention. The lack of aggressiveness in privatization threatens further the viability of this sector – meanwhile, competing countries increase their textile market shares at Egypt's expense. Increasingly, January 2005 is looming as a threat rather than an opportunity.

Principles promoted by PIP

Attractive structuring options for privatizing textile companies are available, e.g. *fonds de commerce*.

It is encouraging that investor interest has been identified for such chronic loss-making firms as Kom Hamada. Nevertheless, there are some investors who will prefer to invest in new ("greenfield") plants rather than take over an existing firm and the problems which that entails. At the same time, some potential greenfield investors are deterred from investing in the spinning and weaving sector because of competition from "subsidized"[14] Public Enterprises that control 80% of the sector's capacity and have other priorities than generating profitability.

Consequently, PIP identified and developed an approach that can expand the market for existing firms in the sector to include potential greenfield investors. Briefly, this approach entails the acquisition of the *fonds de commerce*[15] of the Public Enterprise by a greenfield investor. This means that the investor acquires movable assets, brand names, and customers, but does not acquire liabilities, the legal entity, or land and buildings. In addition, employees would be acquired, less those that are retained (and presumably indemnified) by the Public Enterprise pursuant to closure. In short, the investor acquires what is of value to him, while the seller preserves jobs (although not all) and is free to dispose of land and buildings. PIP envisions, as part of the negotiated package, that the

[13] Privatization Implementation Project, *The Cost of Not Privatizing: An Assessment for Egypt*, page 57.

[14] Public Enterprises under Law 203 of 1992 cannot be subsidized. Nevertheless, the companies often effectively "subsidized" through loans from the public sector banks.

[15] A concept in Egyptian as well as French law. The *fonds de commerce* can either be sold as such, or the same result can be achieved through an appropriately constructed asset sale.

greenfield investor would agree to acquire nearly all its workers through transfer of labor contracts from the Public Enterprise. The legal aspects, including labor issues, have been reviewed at PIP's initiation by legal counsel (Baker MacKenzie's Cairo affiliate, Hamsa and Helmy).

PIP has promoted this concept to GAFI, EU officials in Egypt, Japanese businessmen in Egypt, the Swiss foreign investment promotion agency (SOFI), and selected investors. The concept was also outlined to GAFI investment seminars in Dublin and London. If transactions are to be concluded, investors must be convinced of the seriousness of the seller. This can best be accomplished through a tender that includes acquisition via *fonds de commerce* as an option.

Reference documents

An analysis of the spinning & weaving and cotton ginning sectors is found in PIP's "Costs of Not Privatizing – 1) Spinning, Weaving, Dyeing sector 2) Cotton ginning sector."[*] An abbreviated version is included as an appendix to *The Cost of Not Privatizing: An Assessment for Egypt*, March 2004.

The sale of *fonds de commerce* to greenfield investors is detailed in PIP's "Selling Distressed Public Enterprises to Greenfield Investors,"[*] September 2003. The legal opinion on labor law implications is found in the letter form Hamsa and Helmy of August 13, 2003.

Competition Policy Issues

Problems observed

Competition law needs to be carefully considered; if drafted for wrong reasons, it could become an impediment to investment, including privatization.

There remains in Egypt, both in press and in government, a noticeable residue of socialist thinking in terms of price and its determination. According to this thinking, if a price rises significantly, it is likely the consequence of "monopoly," and if a price falls significantly, it must be the result of "predatory pricing." The socialist mind appears incapable of ridding itself of the notion that there is one "correct" price and that only the "correct" calculation is capable of determining it. Of course, no one can agree, including the socialists themselves, on what the "correct" calculation should be.

There have been many articles in the Egyptian press in recent months attributing widely observed price increases to "monopolists." That a budget deficit approaching 10% of GDP and an attendant inflation of the money supply might have something substantial to

[*] Document is appended to this Report.

do with the increase in prices seems to be ignored. *The hope is usually expressed that the anticipated, new anti-monopoly law will be a vehicle for bringing prices down.* (Other articles complain that foreign imports or "predatory pricing" force some prices "too low," to the detriment of Egyptian producers, which implies that too much competition is not so good either. It appears that there is a "correct" level of cartelization, as well as a "correct" level of price, and that we must rely upon the journalist in question to tell us what it is.)

The cement industry is a case in point. Late in 2003 a press article – citing at least one unhappy cement producer -- claimed that privatized, foreign-owned companies (collectively representing only 30% of the market) were engaging in predatory pricing, that cement prices were consequently "too low," and that the cement pricing cartel of state ownership days should be re-instituted.

At the request of the PEO, PIP addressed the predatory charge in detail in a January 2003 paper. A year later, press articles are still complaining of cement prices that are "too high," attributing the phenomenon to monopolistic practices supposedly characteristic of market economies. The latter charge may have some merit – because the government may have encouraged re-cartelization among producers in response to the complaints of the previous year – but this is hardly a consequence of the operation of the free market.

Principles promoted by PIP

A new competition law has for some time been under consideration by Parliament. This law would, appropriately, provide for the oversight of mergers and for the control of cartels. It is unclear, though, whether it would apply to government-sanctioned cartels, usually the cartels of most substantial and enduring consequence.

While most of the draft law appears to represent an important step in the right direction, the section on "abuse of a dominant market position" raises concern in the business community and elsewhere. In view of the problems and observations outlined above, PIP's reservations on this section of the draft law fall into three areas:

1. Treating "pricing below cost" as an anti-competitive practice will produce far more problems than benefits.

Predatory pricing, as discussed in detail in PIP's assessment of the allegations in the Egyptian cement industry, is quite rare in practice. It simply is not a rational strategy for a producer to pursue on the hope that eventually prices will increase enough to offset certain foregone income now. A competitor may go out of business (for whatever reason), but productive capacity would not be destroyed and the market would remain contestable to new entrants, whether foreign or domestic.

2. Inclusion of a percentage threshold (35% in the current draft law) to define a "dominant" market position.

PIP's concern is that this provision will lead to interminable debates on the definition of a particular "market;" that it will subject firms to surveillance or to reporting requirements when they are judged to have a dominant position; and that a firm's holding a 35% market share (or any other percentage) gives virtually no information on whether or not a competitive abuse has occurred or is likely to occur. The costs of defining a threshold may well outweigh the benefits.

3. There is not, we understand, any mention of market contestability in the draft law.

This is related to the preceding point, in that contestability – or lack thereof -- offers much more information on the potential for abuse than market share. Even a 100% market share need not be a concern if, for example, a major international competitor is free to enter the market. On the other hand, a trade association of small firms might reduce contestability by colluding to form a cartel or to block the entry of competitors through trade or other restrictions. (The latter case would presumably be effectively addressed under the anti-cartel section of the competition law.)

Our overriding concern is that both foreign and domestic investment, *including for privatization,* will be deterred if this section of the competition law leads inadvertently to a bureaucratic morass or if efficient competitors can be threatened with lengthy and expensive legal actions on spurious grounds. We see this as a likely outcome of the draft law given the inclination in some parts of the press and government to favor action to "correct" prices that the market, in their view, gets wrong. The risk is that the competition law will have the unintended consequence of becoming a tool for price fixers rather than a guarantor of competitive market pricing.

Reference documents

The cement industry case cited above is addressed in PIP's "Privatization, Predatory Pricing, and Monopoly in Egypt: Examination of Alleged Abuse in the Cement Industry,"* January 2003. The concerns with the "abuse of dominant position" portion of the proposed law have been addressed in correspondence to those involved in drafting it.

Prospects for Accelerating Privatization

Elements of Progress – and disappointment

The principles outlined above have been conveyed to the Public Enterprise Office and, to the extent feasible, to the respective holding companies. The acceptance of the concept of "Privatization-by-Capitalization" and the hiring of investment promoters are certainly positive, although the potential has not been realized because of the significant problems of implementation that have been observed. Worse, the experience of some of the investment promoters is so unfavorable that it will be much more difficult to attract

* Document is appended to this Report.

promoters in the future. When a promoter is not paid for value provided or when a promoter attracts investor interest but is then confronted with an uncooperative holding company that has no serious interest in selling, then word gets around in the market - and the market falls away.

Valuation principles have been accepted by the audiences that we have been able to address, and the quality of discussions of value and price have clearly changed for the better. Nevertheless, when new people become involved, the old misunderstandings resurface. *One of the fundamental problems is that so many people are involved in the convoluted decision-making process, so many people have* de-facto *veto power at any of the approximately eighteen steps in that process, that it is virtually impossible to convey to all correct approaches to value and price.*

The same applies to tendering issues. Two of the PEO officials with a thorough understanding of PIP's recommendations have left the organization. Because no capitalization-by-privatization tender has been launched, it has not been possible to implement and make routine the recommended procedures. Again, inaction has its price: an opportunity to reinforce and establish the new tender criteria may have been lost.

In fact, most of the problems identified are inter-related: If valuations are unrealistic, investors will show little interest; if Egypt builds a reputation of indecision in privatization, investors are discouraged and marketing efforts are to no avail; and if little investor interest is expressed, then tenders are not launched. This is a major argument for centralizing implementation of the privatization process.

The Fundamental Problem: Decision Paralysis

The fundamental problem is the inability – and often unwillingness -- to make decisions. Decision paralysis often leads to ineffective and counterproductive policies and implementation. Regional political uncertainties and the worldwide economic downturn after 2000 – both outside Egypt's control -- have certainly posed challenges to privatization, but these challenges should only have been a motivation for a more effective and dynamic approach.

Decision paralysis is a consequence of several factors:

1. Decision-making authority is diffuse

The power of decision is dispersed among nine holding companies. While the holding companies report to the Ministry of Public Enterprise, the HCs tend to seek approvals from the High Ministerial Committee for Privatization to protect themselves from accusations of inappropriate behavior. Moreover, the Central Audit Agency, which serves in an "advisory" capacity on valuation and pricing issues, sometimes delays or discourages transactions with lengthy valuation reviews often involving misapplied valuation concepts. As stated earlier, PIP has identified eighteen steps in the decision-making process.

2. A bias toward inaction

The costs of action are highly visible, such as lost jobs in some cases or politically motivated accusations of having sold "below value" in others. Such "costs" are easily associated with any privatization transaction. By contrast, the costs of doing nothing (the costs of *not* privatizing), while quite substantial, tend to be diffused throughout the economy and therefore less readily associated with inaction.

3. Decision-makers face economic disincentives to privatize

Company executives risk being replaced by the eventual new shareholders, consequently losing both employment and attractive fringe benefits. Holding company chairmen, and usually some other holding company executives, may lose attractive fees for sitting on the board of directors of a holding company or a joint-venture affiliate. Subject to a decision of the General Assembly, all holding company board members have a right to share up to 5% of profits of the holding company after reserves and other distributions. Assemblies typically approve 5%, which is clearly a *disincentive* to sell profitable companies.

By contrast, positive economic incentives to privatize are minimal.

4. Decision makers fear accusations of conflicts of interest

Egypt's ongoing anti-corruption campaign is commendable. The problem is that accusations of conflicts of interest can flow too freely and without substantiation, so that the bias toward inaction in decision-making is reinforced. An accused official can be relieved of his responsibilities, his reputation can be destroyed, and he must bear the costs of his own defense if formal accusations are brought against him. An accusation itself becomes a condemnation involving a high penalty for the accused, whether guilty or not.

5. The Public Enterprise Office (PEO), which is the focus of privatization activity in Egypt, can act only in an advisory capacity.

The PEO has only limited authority to identify, direct, and conclude privatization transactions, despite its being the center of privatization expertise in Egypt. It *advises* the holding companies on privatization matters, and it *recommends* privatization actions to the Minister, who in turn normally recommends to the High Ministerial Committee on Privatization. While the PEO *promotes* the privatization process, it cannot *command* the process. In fact, there is no commander, no one organization or individual that is given both authority and responsibility exclusively for execution of the privatization program.

6. The Ministry of Public Enterprise, to which the PEO and the holding companies report, is responsible for both the performance of the public sector portfolio and for privatization.

These responsibilities conflict. For example, there is a reluctance to recognize past failures, such recognition being implicit when companies can only be sold at below book value or below the amount of paid-in capital. The PEO finds itself competing for ministerial favor with holding company executives who, in some cases, have more political influence and are resistant to privatization.

Reference documents

In addition to *The Cost of Not Privatizing: An Assessment for Egypt*, an assessment of the organization problems impeding the privatization process are included in the 2003 document "Organizational Impediments to Privatization: Assessment and Recommendations."

Summary of Key Policy Positions

1. The organization impediment to privatization decisions needs to be corrected, whether through changes in law, regulation, implementation, or a combination.

2. Competitive tenders should be the mechanism for determining price and other terms of sale. They should be designed to maximize investor participation.

3. Valuation should be a facilitator of privatization rather than an unnecessary barrier. Its purpose is *not* to determine the "correct" price." Most important, a *realistic* value to the seller must be estimated. This should be unbiased by wishful thinking or the refusal to recognize past failures. It is also useful to estimate values to potential buyers, as a guide to a tendering strategy.

4. Sustained investment promotion and marketing of the privatization program are important elements for developing investor participation in tenders. Incentives, if they are to succeed, must reflect investor perspectives.

5. The need for privatization of the textile Public Enterprises is urgent, whether through outright sales, sales of *fonds de commerce* to greenfield or other investors, or asset sales.

6. A competition law is important, but it should be designed to avoid unintended consequences. That is, it should encourage rather than discourage investment in Egypt, both foreign and domestic.

Information Management Systems and Database Management Assistance

The PEO expressed interested in modernizing its IT System and developing a more flexible and adaptive system, such as employing MS Access and other SQL applications. PIP collaborated with the PEO to improve its current practice of data collection and management by assisting in the development of an application system. PIP also negotiated with a local company to provide training for PEO staff on data entry as well as application building and maintenance – the audience and course names to be delivered through April 2004 are as follows:

Basic Database	**Start Date**	**Status**	**Duration in hours**	**Attendees**
Mastering Access	14/Jun/03	Completed	48	9
Access Core	14/Jun/03	Completed	20	4
Access Advanced	1/Jul/03	Completed	20	2
SQL-Core	1/Jul/03	Canceled	24	11
Technical	**Start Date**	**Status**	**Duration in hours**	**Attendees**
Windows 2000 NET & OS	21/Jun/03	Completed	24	5
Windows 2000 Adv. Server	14/Jul/03	Completed	40	5
Windows 2000 Net Infra.	21/Aug/03	Completed	40	5
Windows 2000 Directory Ser.	14/Sep/03	Completed	40	5
Exchange Server	14/Oct/03	Completed	40	5
ISA Server	7/Feb/04	Cancelled	16	6
IIS	17/Jan/04	In Progress	24	5
SQL Query	21/Feb/04	Postponed until June 04	16	5
SQL Prog.	27/Mar/04	Postponed until June 04	40	6
SQL Admin.	10/Apr/04	Postponed until June 04	40	6
Web Design	**Start Date**	**Status**	**Duration in hours**	**Attendees**
Web Designing & Development	1/Feb/04	Completed	150	5

The courses improved organizational performance for the PEO IT staff by teaching techniques utilizing technology to leverage business development and operations. The MS Access course assisted the PEO staff to transfer the database of company profiles, fact sheets and financial statements for Law 203 Affiliates and JVCs from Microsoft Excel format to Microsoft Access. This database had collected five years of information for over 670 companies. The Microsoft Access file format made file sharing on the intranet as well as transferring all fact sheets and other promotional material to the ministry' website much more convenient and time saving, and with much better quality. IT members from the PEO also became Microsoft certified in some topics as M.S. System Engineers, and they are working on enhancing the PEO network structure and managing PEO servers as well.

During the first quarter 2004, technical IT personnel implemented learned web site architecture and design. Visual improvements were made, making the site more appealing to users. Design improvements are planned to better link the MPE's site with other related sites.

Privatization Transaction Results

GOE achieved 17 privatizations for an aggregate value of LE 936 million.

Despite the embedded impediments to privatization, many of which are noted above, almost one privatization occurred each month during the period of the Task Order. Seventeen interests were privatized over the eighteen month period for an aggregate value of nearly LE 1 billion, which exceeded the value benchmark set by USAID for this period. Seventeen transactions were recorded, slightly under the twenty transactions set as the goal.

During Task Order 845, there has there been rewarding activity in implementing private ownership of JVCs in which the government owns only a partial interest. Many of the successful transactions, for the first time, involved JVCs owned by banks and insurance companies, which began to experience capital stress due primarily to a deterioration in their loan and investment portfolios, which provided an incentive to sell their equity investments. *More than two-thirds of the value from privatization during the period resulted from sales of JVC minority interests.* The results for Law 203 Affiliates continue to lag.

Sales Value for Companies Privatized
(From 1 October 2002 to 31 March 2004)

Type	Company	Method	Date	Value (LE million)
JV	Cairo Barclays Bank	AI (40%)	Mar-04	345.0
JV	Arab Chini – Aracemco	AI (34.8%)	Mar-04	27.7
JV	Egyptian Starch & Glucose	AI (42.5%)	Feb-04	54.4
Law 203	1st group: Cinemas Indoor & Outdoor)	LT Lease	Jan-04	76.3
Law 203	2nd group: Cinemas Indoor)	LT Lease	Jan-04	81.3

JV	May Press	AI (17.5%)	Dec-03	2.6
Law 203	Ampoules & Mostorod Factory – El Nasr Glass and Crystal Co.	PA	Nov-03	63.0
Law 203	Cast Iron Pipes Factory – Cairo Metallurgical Products	PA	Sep-03	8.5
JV	Egyptian American Co. for Sanitary Ware – Ideal Standard	AI (20%)	Sep-03	26.2
Law 203	Yassin Factory – El Nasr Glass and Crystal Co.	PA	Sep-03	31.0
Law 203	Isis Floating Hotel - EGOTH	PA	Mar-03	8.9
Law 203	Osiris Floating Hotel - EGOTH	PA	Mar-03	7.6
Law 203	El Nasr Tanning	PA	2003	2.2
Law 203	Liquid Batteries factory – National Plastic Co.	PA	Nov-02	1.2
Law 203	Bags factory – National Plastic Co.	Lease ending with purchase	Nov-02	2.0
Law 203	Egyptian Ship Building & Repair Co.	AI	Nov-02	17.5
JV	Gezira Hotel and Tourism Company – Gezira Sheraton*	AI (23.1%)	Oct-02	181.0
	TOTAL			**936.4**

* Represents the selling value multiplied by US$/LE exchange rate (US$ 13.867 million x 4.62). Previously reported as the total of two privatization transactions with approximately 241,000 shares (or 65%) at $162 per share or LE 181 million. Recent year public sector share privatized was US$ 13,867 million or 23% of total selling value.

<u>Public Awareness, Political Advocacy, and Constituency Support Building</u>

With the possibility of another option year for task order 845, along with a new PEO Director, PIP undertook to develop a wide reaching public awareness campaign to promote support for privatization. A step-by-step process commenced during December 2002. PIP's comprehensive approach took issues specific to the Egyptian population and utilized a methodology based on a successful IBM-developed public awareness campaign for Croatia.

Initial Preparation

In December 2002, PIP presented a public awareness campaign plan to the PEO, which included television episodes through the American Chamber of Commerce in Egypt (AmCham), privatization public service announcements on radio and television, HC and Affiliate newsletters, privatization newspapers, parliamentary briefings, journalist seminars, a journalist study trip, and roundtable discussions.

With approval of the PEO, research was conducted for topics in the AmCham episodes, guest lists for the television episodes were collected and focus groups were held to assess the Egypt's specific needs. PIP solicited four proposals from various media companies to produce radio and television spots as well as print announcements for a full campaign.

AmCham TV interviews on Privatization arranged for Minister of Public Enterprise and plan agreed with PEO

While the first AmCham episodes were being filmed with the Minister of Public Enterprise, M-Graphics International (an Egyptian firm) was selected as the advertising agency for public announcements; lists of journalists were gathered for upcoming seminars; and a study tour was explored. The campaign progressed rapidly with the active support and participation of the PEO. Focus groups confirmed key issues that should be addressed in the public awareness campaign.

Plan Finalized and Proposed

A timeline and budget for the program was finalized. As a result of multiple meetings with the PEO, the following list of activities was approved:

- Six themes identified in the focus groups would be covered in public service messages for radio, television and print;
- Seminars and/or a study trip would be planned for journalists to better understand the benefits of privatization;
- Holding companies with affiliates in the process of privatizing would publish special in-company newspapers to communicate important issues to employees;
- Parliamentary briefings would inform leaders of the progress made in the privatization program and the political support needed to achieve results.

USAID exercised its option for an extension of the PIP for an additional year, which included implementing the campaign to develop enhanced public support for privatization.

Implementing the Campaign

During the second quarter of 2002, PIP made significant strides in getting the first two messages ready for production. PIP staff wrote scripts, M-Graphics drafted storyboards, and the PEO contributed with revisions to the various scripts. PIP's role was to write the messages and facilitate production, but PEO/MPE support was critical to access time on television and radio stations. Distribution and communication of these messages were dependent on the Ministry to secure airtime.

Ensuing comments and recommendations from the PEO staff for revisions to the scripts substantially lessened the impact of the messages recommended by PIP. In continuing discussions, the impact of the announcements was diminished by the PEO staff to the point that PIP recommended that the PEO reevaluate whether the campaign would be worthwhile. Meanwhile, further attempts to develop to a journalist study trip and seminars ceased at the request of the PEO.

PIP recommended that only a fully developed campaign with high impact would justify the budgeted expense, and sought the MPE's support for a high intensity campaign, which included securing airtime and enhancing media support for privatization. PIP met with the MPE and described its recommended campaign following which the PEO informed PIP that the MPE would defer the campaign because of then currently heightened political issues relating to the perceived impact of faster privatization on employment.

Fully developed PR campaign presented to MPE, which deferred broad and aggressive implementation due to concerns around labor issues.

Campaign to Generate Support through HCs and Affiliates, as well as the NDP

With the PEO's support, two important aspects of the Support Building Campaign, an effort to enhance support among labor affiliated with Law 203 Affiliates and NDP policy support, was completed successfully. On the basis of their demonstrated support for the privatization program, the Metallurgy and the Chemicals HCs were selected by the PEO for the production and publishing of specialized newspapers addressing important aspects of the privatization program with similar high impact messages that were developed for the more general public campaign. The management of these holding companies welcomed the support available for communicating with their employees about the importance and benefits of privatization, and worked directly with PIP to prepare in-company newsletters, which were published and distributed in early 2004.

Two HCs and policy arm of NDP's Business Secretariat supported campaign.

Cost of Not Privatizing Assessment

As a result of the reluctance to confront labor issues relating to privatization, it was apparent that there was in government a focus on the costs involved in privatizing with out also taking in to account the costs of inaction, particularly the costs to Egypt of delayed privatization, not only in terms of budgetary impact, but also in terms of foregone economic growth and employment.

"Cost of Not Privatizing" provides a new cost perspective supporting faster privatization which was well received by many observers.

In the early stages of the Privatization-by-Capitalization Initiative (P-by-C), as noted earlier in this report, PIP had undertaken analyses of the value to the HCs of the Affiliates chosen for P-by-C. As noted earlier, the Cabinet had approved a book value methodology for pricing new shares, which was to be the basis for privatizing the selected enterprises. Many of these concerns, in part because of inherent labor obligations (which were not accounted for in book value calculations), were determined by PIP to have negative "value" for their owners, the HCs. From a purely financial perspective, it would be reasonable for HCs to pay acquirers to take these obligations off their hands while making commitments to provide desperately needed new investment to grow these enterprises.

It was clear that the owners were not looking at their Affiliates from this point of view, and apparently neither was the MPE, as it sought a book value-based methodology for pricing these concerns. Nor was the leadership considering the lost tax revenues that would derive from the government's continuing interest in growing private concerns, as well as the overall beneficial impact that private investment and greater momentum for the privatization process would have on economic growth and employment. In other words, it appeared that only one side of a two-sided coin had been considered.

PIP reviewed each of the P-by-C candidates and described to the PEO the beneficial impact that pricing these concerns *based on value to the owner* would have on privatizing these, as well as other, concerns. PIP also prepared and provided the PEO with an aggregate micro-economic model for all Law 203 enterprises and HCs that demonstrated the budgetary cost to the government of not privatizing these enterprises. The intent of this exercise was to provide leadership with more comprehensive information on which to base decision-making concerning the pace of privatization.

As an extension of this work PIP undertook an assessment of the cost of not privatizing in Egypt. The purpose was to quantify and make visible the costs of inaction, to demonstrate the burden that slow privatization imposes on the Egyptian economy. The Study first estimated the costs of not privatizing to the Government of Egypt in budgetary terms, but also sought to address the macroeconomic losses.

In order to provide a more comprehensive base to use in considering the budgetary impact of not privatizing rapidly, PIP also assessed the budgetary impact of not privatizing 100% government-owned commercial banks and insurance companies, as well as selected economic authorities.[16]

The budgetary cost of not privatizing for the sectors covered is on the order of LE 100 billion in present value terms. The Study then estimated the macroeconomic implications, showing how delayed privatization increases unemployment, reduces investment, reduces economic growth, and puts downward pressure on the exchange rate.
The results of this exhaustive study were available prior to year-end 2003 and were shared with the PEO and other policy makers. A study was also produced which explores the roots of private economic activity in Egypt during the period before the mid century socialist period. This study provided evidence that private economic activity is essentially Egyptian, rather than an imported concept.

PIP was invited to present the results of the study to the influential Business Secretariat of the National Democratic Party, thereafter, we are told, that the Secretariat adopted the study's conclusions. On April 19, the Secretariat, with eight co-sponsors including Club D'Affaire Franco Egyptian, the British Egyptian Business Assn., the Egyptian Businessmen's Assn, the Egyptian Capital Markets Assn., the German Chamber of Commerce, AmCham, the Egypt International Economic Forum, and the Egyptian Junior Business Assn. hosted a public conference entitled "The Cost of Not Privatizing." Nearly 200 people attended from the business community, government (including the Ministers of Public Enterprise and of Industry and Technology), television, and the press. Some of the most senior and influential

[16] The coverage of the Study was in itself conservative because it excluded joint venture companies, various businesses operated directly by ministries, and various government owned companies – most notably in telecommunications, power generation, and air transport -- that do not come under Law 203 of 1991.

members of the Egyptian business community supported the study's findings and are advocating more rapid privatization. The Secretariat is expected to draft specific recommendations to make the privatization program more effective, hopefully addressing the fundamental impediments PIP has identified frequently in this report.

Monitoring and Reporting on Public Enterprises and Privatization

Throughout Task Order 845, during the period October 2003 through March 2004, PIP managed several activities to monitor the privatization program and report the results. These activities included:

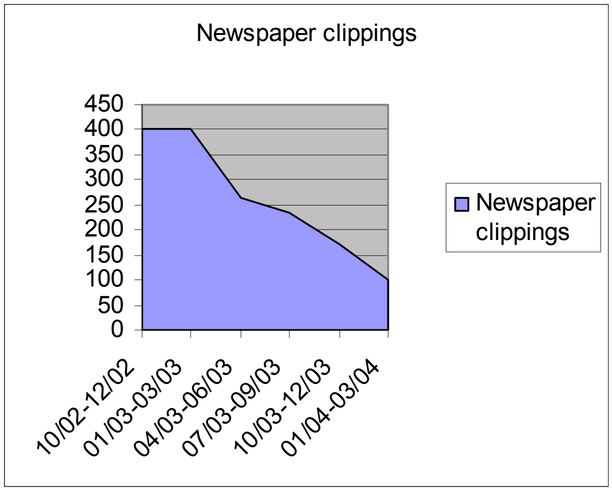
- Quarterly Privatization Report
- Selection, and summary translations of news articles
- Developing and maintaining a website and connecting with the MPE website.

Quarterly Privatization Report PIP consultants prepared a quarterly privatization report to inform the public of progress made in the Government of Egypt's Privatization Program. The report consisted of privatization transactions, tender announcements, any changes in law or the privatization program, company performances, and public announcements. PIP also tracked the developments in privatization by maintaining tables of transactions.

These reports were made available by email and through the PIP website.

Report Periods
October 2002 – December 2002
January 2003 – March 2003
April 2003 – June 2003
July 2003 – September 2003
October 2003 – December 2003
January 2004 – March 2004

News Briefs Newspaper articles related to Privatization, Economics, Investing, Financial Services, Law and Regulation were selected from local newspapers, summarized and translated into English. Each week, or twice monthly depending on volume, these translated summaries were posted to the PIP website and a notice distributed through email to the PIP mailing list. Over the course of the task order, the number of news articles was as follows:



Website Development and Maintenance PIP engineered, developed and launched a website with the purpose of promoting privatization and its events to include companies being offered through the PEO, activity reports of the program, summarized newsprint articles, company profiles, fact sheets and historical information regarding the privatization program.

The utility of this mode of communication is evidenced by the fact that the MPE, through the PEO, made significant improvements to its own website as a means to communicate more effectively with a wider audience. The PEO recognized that this modern method brings the appearance of transparency and standardization of information distribution. On average, the website received approximately 10,000 hits per month. During periods when a public enterprise was tendered, such as Egyptian Starch and Glucose in November 2003, there were significantly more hits.

Summary of Tasks and Results

Tasks	Results Task Order 845
Task One: Transaction Support	
1.1 Provide specific transaction assistance including: marketing/promotional assistance, advertising, international road shows, valuation assistance, data rooms, company profiles, information memoranda, prospectus, legal and bid documents – approved in advance on a case-by-case basis up to thirty transactions.	Provided specific support for twenty-three companies requested by PEO and approved by CTO: eight privatization by capitalization candidates and thirteen candidates for full buy-out.
1.2 Provide general transaction support: prepare quick diagnostics, financial analyses, and sector studies on the remaining public enterprises to identify strategic privatization opportunities - at varying levels of analysis, ranging from calculation of basic financial and operational ratios to more in-depth examination of the company.	Prepared diagnostics and financial analyses in the format of Kompass fact sheets for forty-six companies as general promotional materials.
1.3 Provide general transaction support: advise on, guidance, and limited training to the PEO, HCs, and JV shareholders on how to develop tenders, fact sheets, company profiles, information memoranda, data rooms, valuations, and bid documents.	Valuation seminars carried out for Housing, Tourism and Cinema HC, Food HC, Chemicals HC, Metallurgy HC, Maritime HC, Textiles HC, PEO, and Central Audit Agency, Banque du Caire, National Investment Bank. Information memo assistance for Textiles, Metallurgy, Food, Chemicals, HCs and Banque du Caire. Bid documents for Food HC.
1.4 Provide general transaction support: advisory assistance to the PEO, HCs, and JV shareholders to help them procure the services of investment promoters on a fee basis - develop guidelines before the end of 2002 for selecting and hiring investment promoters, review promotional plans, and monitor progress.	Prepared and submitted guidelines. Continued to monitor and participated in progress and assisted investment promoters in negotiating terms and conditions of offers for seven investment promoters in connection with eight candidates.
1.5 Provide non-transaction-specific promotional support (marketing campaigns and road shows) that advances the general goals of the privatization program or specific sectors, especially as they support the individual activities of investment promoters working on specific transactions - also, provide a list of possible international, regional, and local investors for all cases in which an investment promoter has been retained.	Assisted PEO in marketing campaign in Gulf states, Abu Dhabi, Dubai and Bahrain, London and Dublin, and in Egypt with Egyptian Businessmen's Association, Egyptian Federation of Industry, Amcham and EgyptInvest Conference. Provided list of investors to PEO for dissemination to investment promoters. Prepared 46 fact sheets in Kompass format for posting on Kompass website. Assisted MPE to improve its website and prioritize privatization candidates for promoting on MPE website. Connected PIP website to MPE website for dissemination of fact sheets prepared by PIP.
1.6 Provide general transaction support: monitor the strategic importance and sectoral impact of transactions, particularly the size and the role of a public enterprise to be privatized, and the impact of privatization on the sector.	Provided paper on a Sectoral approach to privatization in the textile sector. Completed analysis of "fonds de commerce" legal structure for textile industry and promoted structure with Swiss investors. Cost of not privatizing study yielded impact of

Tasks	Results Task Order 845
	privatization by sector, in particular textiles, banks and insurance companies. Specific analysis was developed in the Spinning and Weaving and Cotton Ginning sectors of the textile industry showing the importance of government activity in the sector as well as identifying risks of maintaining government dominance of the sector and cost to the government of not privatizing the sector. Conducted assessment of the cost of maintaining government ownership of commercial banks, insurance companies and certain economic authorities.
1.7 Provide general transaction support: track/report all Law 203 and JV privatization pipeline activity as measured by the number of tenders and offers, bidders purchasing bid documents and conducting due diligence, and bids received.	Provided in ordinary course of regular reports.
Task Two: General Policy and Advisory Assistance	
2.1 Examine the legal, financial, and economic feasibility of recapitalizing companies through capital increases offered to the private sector – alternative options that consider the total value of a proposed privatization transaction, such as explicitly valuing the investment plan of bidders in lieu of strictly cash bids, should also be considered.	Worked with PEO to implement flexibility inherent in pricing formula approved by Cabinet. Examined the financial feasibility of re-capitalizing eight candidates selected by the government. Demonstrated importance of entertaining proposals for existing shares, as well as new shares.. Direct discussion with Textile HC relating to developing rational pricing approach for Kom Hamada Provided tender evaluation methodology including debt/equity, labor and new capital investment tradeoffs for PEO consideration.
2.2 Investigate the feasibility of separating privatization decision-making authority from the operating management of the public enterprises and JVs.	Prepared a policy paper addressing fundamental legal and organizational problems that have seriously impeded progress on privatization. The paper recommends specific corrective measures, most of which will involve changes in law or regulation. The Cost of Not Privatizing Assessment completed and distributed by PIP provides additional support for the recommendations.
2.3 Propose and advocate strategies to compensate private sector investment promoters, paying particular attention to the different ways that retainer and success fees could be financed.	Provided PEO with advice and advocated methodology for paying investment promoters. Seven investment promoters were retained for eight companies using MPE funding with success fees to be paid by HCs.
2.4 Propose and advocate strategies to increase the incentives for owners of public enterprises to advocate and support privatization more strongly.	Paper completed and submitted recommending changes in incentives for HC managements and responsibility for executing privatization plans for Law 203 companies. Completed “fonds de commerce” research, which would enable buyers to more effectively address issues important to government sellers, e.g. labor and land.

Tasks	Results Task Order 845
2.5 Determine the significance of various international or multilateral commitments or agreements (such as WTO) on the operations of specific public enterprises and privatized companies, and use this information to assist the GOE in the development of appropriate privatization strategies.	PEO decided to pursue this study on its own.
2.6 Facilitate discussions, conduct a study, and advise the GOE on the liquidation of selected companies, while compensating fairly the employees and resolving debts in an economically and socially responsible manner, if requested.	Advised PEO relating to liquidation of Shepheard Hotel and Dyestuffs. Advised PEO relating to privatization by capitalization initiative and downsizing labor and debt burdens. Completed "fonds de commerce" research and educated owners, including PEO and Textile HC. This technique would allow an investor to buy the business including selected labor without buying certain assets, particularly land and buildings.
2.7 Work with the Central Audit Agency and other appropriate GOE authorities to achieve more flexible valuation and pricing policies, and more importantly, gaining greater acceptance of the importance of attracting investment capital and management expertise.	o MPE has initiated and implemented other methods of setting reserve prices, e.g. using p/e multiples. o Discussed with PEO and presented to HC personnel the concept of using value to seller as reserve valuation and relying on competitive bidding to set price. o Conducted training session in valuation techniques for personnel of five HCs and PEO. o Conducted training session in valuation techniques for personnel from the Central Audit Agency.
Task Three: PR	
3.1 Design a public awareness and public relations plan to increase the level of political and popular support for privatization.	o Completed 4th Quarter 2002 and presented to PEO. o Conducted public relations dialogue. o Presented to MPE during second quarter of 2003. MPE postponed implementation due to political concerns relating to potential labor issues. o Also completed newspapers based on the plan advocating privatization for the Metallurgy HC and the Chemicals HC. Both HCs published the newsletters.
3.2 Develop plan in consultation with the PEO and delivered to the GOE before the end of 2002.	Completed, delivered to PEO in 4th Quarter 2002.
3.3 Launch program in early 2003.	o Mass media campaign deferred by MPE due to concerns about labor issues. o Puibic dialogue undertaken with MPE in cooperation with Amcham. o Public focus groups conducted o Advocacy campaign with research and studies for assessing the cost of not privatizing o Cost of Not Privatizing Assessment completed, discussed with PEO, made available to MPE and public parties.

Tasks	Results Task Order 845
3.4 Obtain input and agreement on the basic approach of the plan from either the Minister of Public Enterprise, Ministerial Privatization Committee, or office of the Prime Minister.	o Basic approach for mass media radio and television deferred by Minister of Public Enterprise. o Obtained buy-in from Metallurgical HC and Chemicals HC and published newsletters o Obtained buy-in from private parties
3.5 Conduct seminars and focus groups, and dissemination of information to targeted audiences.	Completed focus groups February 2003.
3.6 Conduct meetings/focus groups with key constituencies (GOE, labor groups, HCs, industry & sector representatives)	Held seminar on Cost of Not Privatizing Assessment with the Business Secretariat of the NDP. Conference arranged in March '04 through Business Secretariat and major business groups such as Club D'Affaire Franco Egyptian, British Egyptian Business Assn., Egyptian Businessmens's Assn, Egyptian Capital Markets Assn., German Chamber of Commerce, AmCham.
Task Four: Monitoring and Reporting	
4.1 Provide limited monitoring and reporting for public enterprises and privatization activities, covering primarily activities of the MPE, PEO, HCs and affiliate companies, JVs, other public enterprises, and banks and insurance companies.	Reported on HC and JV privatization activities as well as other relevant activities to include laws, transactions, economic and financial overview in six quarterly reports, Privatization in Egypt.
4.2 Regular (at least weekly) translation and electronic dissemination of press articles.	Summarized and disseminated more than 94 newsprint articles
4.3 Quarterly privatization review disseminated via email and posted on a website.	Prepared and disseminated 2003 4th Quarter program report. Final Quarter program report 2004 1st Quarter to be disseminated by April 30, 2004.

Benchmarks

Benchmarks	To be achieved 1 Oct 2002 to 31 Mar 2004	Progress during period 1 Oct 2002 to 31 Mar 2004
Policy Benchmarks		
Increased separation of privatization decision-making authority from public enterprise management. Overall, improved decision-making authority for transactions.	Identification of specific steps to make the transaction management and decision-making process easier and more successful. Specific steps in the plan to be implemented.	o Responsibility of selling more than 79 JV companies in which Law 203 companies have an interest transferred to the MPE HCs. o Promoted concept of pricing problem assets at adjusted book value on a case-by-case basis so long as price is at or below market; concept implemented in P-by-C Initiative (however, not properly implemented.) o Promoted public announcement of reserve price, one case effected for Law 203; eight cases effected relating to P-by-C Initiative. o Promoted setting reserve price at value of the firm to the GOE rather than a more arbitrary perceived market value. o Recommended and promoted to PEO and policy-makers separation of authority for privatization performance from operating management.
Increased acceptance by the GOE to use private sector investment promoters, especially to pay retainer fees.	At least three cases of investment promoters being retained by the GOE.	o LE 2 million fund approved by Cabinet to support fees to retain IPs o Seven investment promoters selected and retained by HCs for eight companies.
Increase the incentives of the owners of the public enterprises to support privatization.	Conduct an economic impact study to determine the true costs of not privatizing	Study completed Q12004 and distributed.
Political Support Benchmarks		
Broad, high-level public relations plan, designed to increase public and political support for privatization, should be developed and delivered to the GOE.	Plan approved by the GOE and rolled out. Renewed, strong policy statement and mandate from top level of the GOE.	o Mass media campaign developed, but deferred by MPE after presentation in Q32003 o Two journalist meetings o Arranged with Amcham TV series with MPE addressing privatization. o New approach to developing PR support initiated with two newsletters published by two HCs. o Impact of Cost of Not Privatizing Assessment

		submitted to MPE and top policymakers.
Transaction Benchmarks		
Number and value of transactions, including the total value of cash, instalments, investment, debt resolution, and employee considerations included in the purchase agreement should increase.	Provide direct and indirect transaction support for an additional 20 companies, including distressed companies. At least 20 transactions with a total transaction value of at least LE 750 million	o 17 transactions closed at value of LE 936.4 million reported in Privatization in Egypt quarterly reports. o Direct and indirect support provided for 69 companies.
Strategic importance and sectoral impact of transactions, particularly the size and the role of the public enterprise in each particular sector, and the impact of privatization on the increasing role of private enterprises in that sector.	Role of Public sector in key sectors identified, calculated and analyzed. Role of public enterprises reduced certain sectors, exact number to be determined.	1. Role of public sector identified for Spinning and Weaving Sector: o Global competitive threats identified for Spinning and Weaving Sector. Deteriorating financial condition of sector studied and highlighted. Size of two transactions identified as very small, but very important as indication that issues can be resolved. PIP pushed for completion of transactions. 2. Role of public sector identified for confectionary sector: o Privatization reduced government involvement by 50% of market in confectionary food sector.

Preconditions for Rapid Privatization

At the commencement of this report, we listed two sets of pre-conditions for the GOE to achieve rapid privatization, which were set out by IBM prior to its initial work on privatization in Egypt. These pre-conditions were:

(1) transparency and standardization, and
(2) consensus and coordination.

As this report and results of the privatization program for the last several years demonstrate, these pre-conditions still need to be imposed in order for Egypt to avoid the budgetary costs of not privatizing and realize the benefits in terms of economic growth and competitiveness required to reach its employment goals.

Summary of Deliverables

	October 2002 Through March 2004
Information Memoranda	13
Company Profiles	21
Diagnostic Reports	11
Pre-Diagnostic Reports	5
Valuation Reports	11
Pre-valuation Reports	16
Public Awareness and Investor Outreach	17
Cost of Not Privatizing	11
Policy Memoranda	11
Factsheets	66
Minutes of Meetings	50
Letters	77
Tender Documents	3
Other	59
Presentations	1
Research	6
TOTAL	378

Privatization Policy Issues

Documents referenced in “Policy Advice” section, commencing on page 39

1. “Valuation and Pricing Policy Issues Relating to the Roles of Sellers and Investment Promoters”
2. “Privatization-by-capitalization: assessment of share valuation method employed”
3. “The ‘Second-Price Method’ of Increasing Prices Offered in a Competitive Sealed Tender”
4. “Tender Evaluation Criteria/ Privatization-by-Capitalization”
5. “Critique of Incentives to Privatization”
6. “Kom Hamada Privatization as an Example of Decision Impediments to Privatization”
7. “Costs of Not Privatizing – 1) Spinning, Weaving, Dyeing sector 2) Cotton ginning sector”
8. “Selling Distressed Public Enterprises to Greenfield Investors”
9. “Privatization, Predatory Pricing, and Monopoly in Egypt: Examination of Alleged Abuse in the Cement Industry”

Attachment 1

Valuation and Pricing Policy Issues Relating to the Roles of Sellers and Investment Promoters

We have identified the following valuation and pricing issue that should be resolved before investment promoters are engaged to manage privatizations. These issues are also relevant to selling situations in which no investment promoter is engaged. Throughout this report, our guiding objective is to accelerate the pace of privatization.

1. When should valuations be prepared and by whom?

2. What valuations should be prepared?

3. How should a "reserve price" be set?

4. Should the reserve price be announced to potential investors?

5. To which privatization candidates should "privatization by capitalization" be applied?

6. When should debt reduction negotiations take place?

<u>Value and price: an important distinction</u>

Before attempting to answer these six questions, it is useful to address a confusion of the concepts of "value" and "price" that leads to many errors. Because the holding companies will engage investment promoters only when they intend to sell companies as *going concerns*, the following remarks assume that we are dealing with going concern situations, rather than liquidations.

Reasonable estimates of value to the seller and to a prospective acquirer are essential in formulating the seller's tender and price negotiation strategies. Yet, what was written six years ago in *Supporting Development of Egypt's Financial Sector*[17] still applies. The report states that in Egypt many 'valuations' are actually misplaced efforts to predict selling prices. The assumption seems to be that an enterprise has 'a' value, that this value can be estimated objectively by the analysis of accounting data, and that price should equal value."

Currently, in certain cases related to distressed and marginally profitable businesses, "valuations" are contrived on the basis of an adjusted book value that is then used as a

[17] Bruce MacQueen, Chapter III, "Freeing the Term Credit and Equity Investment Markets," KPMG Peat Marwick Policy Economics Group, 1996, p. 64.

minimum price. While such a minimum price may serve the purpose of establishing a political consensus, it is not a useful measure of economic value in the market. If the minimum price calculated in this manner were to approximate a market price, it would be purely coincidental. Furthermore, as discussed above, there is no *a priori* assurance that such calculations will produce minimum prices below the economic value assessments of buyers, a prerequisite for successful sales.

Accounting book values, however adjusted, have very little to do with the *economic value* of a going concern to either a buyer or a seller. Balance sheets are based on the past, sometimes adjusted to reflect current market values of fixed assets and land, while the value of a going concern to a buyer or seller is based on expectations of *future* returns from the enterprise. Nor do investors view a going concern as merely a collection of fixed assets but rather as a stream of expected cash flows.

To quote further from *Supporting Development of Egypt's Financial Sector*[18]:

> Every potential buyer and seller will value an enterprise uniquely, depending upon the strategy he envisions, his attitude toward risk, his available alternatives, (financial resources, product line, access to markets), etc. A buyer's value assessment is the *upper limit* on the price that he will pay. A seller's value assessment is the *lower limit* on the price that he will accept. If a buyer's valuation is higher than the seller's valuation, a necessary precondition exists for a transaction to take place. The transaction *price* between those limits will depend upon the degree of competition that can be generated among potential buyers. Hence the marketing of the public enterprises, including the presentation and dissemination of information about the enterprises, is essential if the transaction price is to be pushed toward the upper end of the often wide range between the buyer's and seller's valuations.
>
> As misdirected efforts to predict price, the "valuations" that have been done tend to grossly exaggerate the value of the firms to the present government owner.

We can say that price is "objective," a matter of empirical observation at the conclusion of a transaction; while value is "subjective," a function of who is doing the valuing. When speaking of value, it is a good habit to specify value "to whom."

In conclusion, we should assess values by putting ourselves in the position of the seller or a hypothetical buyer. Valuation and strategy are closely linked: valuations must be based on assumptions of strategy, and such strategies must reflect the capabilities and financial resources of the seller or a prospective buyer. Valuation of a going concern business, which reflects an estimate of *future* returns to the investor, is never precise, and it is misleading and often detrimental to make decisions as if it were precise.

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[18] *Ibid.*

Keeping this important distinction between value and price in mind, we can return to the questions stated at the outset.

1. When should valuations be prepared and by whom?

Given their substantial success fee incentives, investment promoters have an incentive to sell companies under financial conditions (primarily price and committed new investment) that are realistic yet favorable to the seller. Therefore it is advisable that the promoters either have the primary responsibility for preparing valuations or that they have the right to challenge valuations that have been prepared by the PEO and its advisors. If unrealistic valuations are imposed on promoters, they will quickly lose their motivation to sell the companies.

If valuations are prepared by the PEO and its advisors, the work can begin before the promoter is selected. It nevertheless follows that valuations should be finalized after the promoter's appointment and concomitantly with preparation of the Information Memorandum. The assessment of the current state of the company, its strategic alternatives, and its future prospects, all of which are required to prepare the Memorandum, will form the basis of the cash flow projections that are in turn the foundation of the valuation process.

2. What valuations should be prepared?

This question has two parts:

a. Which valuation method should be used?

Any valuation prepared for a company to be sold as a going concern should be on a discounted cash flow basis, and we suggest for estimates of value to a buyer that an eight-year projection period normally be used. The fact that a company may be consistently losing money in no way invalidates discounted cash flow analyses. *This recommendation is made notwithstanding the preference of the Central Audit Agency to use a balance sheet approach to valuation in certain going concern (as well as liquidation) situations.* If an accounting rationale is needed to meet CAA requirements, it should be introduced later (see comments on "reserve price" below) and should not bias or distort an honest attempt at valuation. These valuations are for internal pricing strategy and decision-making purposes only; they should not be revealed to potential investors.

b. From whose perspective ("value *to whom*") should the valuation be prepared?

Value should be estimated from the seller's and buyer's perspectives.. Estimating the seller's value is normally relatively easy in privatization situations because the public seller usually, as in Egypt, has little or no capacity to invest new capital that would be necessary to implement an effective turnaround strategy. That is, the seller's strategic alternatives are limited, and a simple calculation capitalizing recent cash flow results is often sufficient.

Value to a buyer

For a seller or its advisors to estimate value from a buyer's perspective is usually more complicated. While it is always important to estimate feasible buyer strategies and their potential for adding value to an enterprise, sophisticated buyer-side valuations take time and money and therefore should be reserved for the most important cases. Such valuations require assessing feasible value-added strategies based on detailed advice from those knowledgeable of the industry, whether holding company or affiliate experts or, ideally, independent experts with an international perspective. Cash flows projections are then based on a chosen strategy. It is important to perform sensitivity analyses to test the effect on valuations of key strategic assumptions. *But even in cases where a sophisticated buyer-side valuation is not cost effective, it is important for the seller to estimate the prospects for a buyer to turn the company into a positive cash-flow generator and to project, at least roughly, the resources that the investor would have to bring to bear to achieve that objective.* It should also be emphasized that the value of a company to a buyer represents the *maximum price* that the buyer would pay for the existing shares of the company. No one would buy something at a price that exceeds his value assessment.

Value to a seller

Valuations from the seller's perspective will sometimes produce negative values. If a company is generating negative cash flows, and has no realistic prospect for producing an adequate return on investment under current ownership, the value of the enterprise as a going concern is indeed negative. This should not cause consternation, for several reasons:

a. As explained above, *the valuation should not be confused with a selling price.* It is not uncommon to find companies that have a negative value to a seller on a discounted cash flow basis, but which are likely to have a positive value to a buyer with the technical expertise, market access, and financial resources that will add value to the firm.

b. A low value, even a negative value, can be useful in defending a selling price from uninformed or malicious accusations that a selling price is "too low." Such accusations are inevitable in a political environment, and the seller needs all the ammunition it can get to defend itself.

c. Negative values do imply the possibility of agreeing to a "negative price," but this is not as strange as it may seem and does not need to imply a cash payment from seller to buyer. When debt is removed from the balance sheet of an affiliate prior to privatization by debt forgiveness or its assumption by a holding company, the seller realizes a negative present value. If the positive sale price is not sufficient to offset this amount, then the seller has effectively realized a net negative price.

Seller valuations are nevertheless very important because they give a realistic assessment of the minimum price at which the seller can dispose of a company and still be better off than if it retains the company. *If anything, discounted cash flow valuations over-estimate value to a government seller because they do not attempt to estimate the opportunity cost of tax revenues that will accrue to the government if a subsidized, loss-making, or minimally profitable enterprise can be revitalized into a substantial income producer.* Nor do such valuations include the returns that would accrue to Egypt from the more productive investment elsewhere of the subsidies, direct or indirect, that are squandered on value-destroying enterprises. Nor do such valuations consider the opportunities lost in terms of new investment that is deterred because of the existence of subsidized enterprises. *In short, the failure to dispose of value-destroying enterprises imposes a tremendous burden on Egypt's economy and people.*

This does not necessarily mean that a company *should* be offered in the market with the seller's valuation as a minimum price. This is a matter of selling tactics that will be discussed further under the next question on reserve prices.

3. How should a "reserve price" be set?

By "reserve price," we mean the minimum price that the seller will accept in a tender. The reserve price might well be the seller-side cash flow valuation, and in many cases that is the logical choice.

Nevertheless, there is a common circumstance where the seller may want to set the seller's reserve price in a tender above its discounted cash flow valuation. This is where a) the value to a potential buyer is estimated to be much higher than the value to the seller, and b) where there is doubt of the likelihood of attracting more than one bidder. The latter refers to the fact that the only reliable means of boosting the transaction price toward a buyer's valuation is to generate competition – or at least the presumption of competition – among buyers.

If there is only one bidder, and the bidder is reasonably confident of this, then it will bid as close as possible to its estimate of the value to the seller. Despite confidentiality, it is not usually difficult for the buyer to estimate value to a seller. This is particularly true if the target company is consistently generating negative or minimal cash flow, in which case the buyer will know that the seller's value is near zero or negative.

So in these circumstances, "keeping the buyer honest" may well justify setting a tender reserve price that is above the seller's valuation. *There is a calculated risk in pursuing such a tactic that a bid above the seller's value but below the tender reserve price will be discouraged and that the seller will find itself stuck with a weak or loss-making affiliate.* This would be the worst outcome. The reserve price must therefore be set judiciously in an effort to balance the risk with the potential reward.

> Example 1: An indebted affiliate is generating negative cash flows, which are only expected to increase in the future because the seller lacks the financial

resources, the market position, or the technical expertise that would add value to the firm. Yet there are feasible strategies for a capable buyer that would add substantial value to the firm. In this case, it is not necessary for the seller to incur negative value by removing debt from the enterprise prior to offering it for sale. Rather, the seller should set a nominal reserve price (at least zero), while focusing the tender primarily on the commitment of new investment by the buyer, the buyer's employment plan, the buyer's capabilities and reputation. (We understand that this is the objective of "privatization by capitalization.")

Example 2: An affiliate has a positive discounted cash flow value to the seller, but appears to have a much higher value to one potential buyer. No other buyers are expected to present themselves. To protect itself, in the absence of competition, against a price bid well below the buyer's value, the seller sets a reserve price in the tender somewhere between its value and the estimated value to the buyer. The seller takes a calculated risk with this strategy, but depending on the magnitudes involved, it may well be a risk worth taking.

For reasons stated earlier, a book value or an adjusted book value has, in economic terms, virtually nothing to do with estimating the value to the seller or the buyer, or setting the tender reserve price. It is not uncommon for weak enterprises requiring substantial new capital investment to have values – to the buyer as well as to the seller – that are well below book value. In these cases, imposing a book value standard will prevent sale of the company and will perpetuate the destruction of value in the Egyptian economy. *Nevertheless, if official requirements are such that book value must be considered, then some form of adjusted book value might be used to "justify" the reserve price, while avoiding the risk that the adjusted book value would result in a reserve price that forces the price to a level that jeopardizes a sale.* In this case, it may be best to recognize honestly that the "adjusted book value" is merely a contrivance to reflect an economically-determined reserve price and to meet an unrealistic requirement based on a profound misunderstanding how a going concern enterprise is valued by potential investors.

It is worth emphasizing once more that a realistic assessment of the value of an affiliate to the seller, and an estimate (however crude or sophisticated) of value to a buyer, are essential for judging where a tender reserve price should be set. The reserve price cannot be set in a vacuum, based simply on a book value calculation. *It would be pure coincidence if an accounting book value were to approximate value to a seller, value to a buyer, or a reasonable reserve price for a going concern enterprise.* The worst application of accounting book value is to use it as a minimum price, as if it represented the value to a seller.

4. Should the reserve price be announced to potential investors?

Practice in the past, we understand, has been to set a reserve price that is held secret, not announced to investors. If no investor bids above the secret reserve price, the tender may be canceled. This practice has several important damaging effects:

a. It angers investors who spend, in many cases, a considerable amount of time and money in preparing bids.

b. It is conducive to accusations by investors, the press, business people, or political figures of dealing in bad faith, of changing the rules after the game has started.

c. The more widespread this practice is known, the more it will deter investors from bidding at all. This effect is often invisible because prospective investors have no incentive to announce why they are not bidding.

In defense of the practice, it is argued that given the reserve price, investors will tend to bid at the level of the reserve price. But this argument is not valid because:

a. Investors can do a reasonable job on their own of estimating the value of a firm to a seller, based upon recent financial results, knowledge of the industry, and the normally reasonable assumption that the state-owned shareholder is not in a position to invest the money that would be required for a turnaround. For example, in the cases of weak companies generating negative cash flow with little hope of turnaround in the absence of new investment, bidders will recognize that the company has negative value, and they will therefore assume that the reserve price is zero, or that they can demand debt forgiveness in addition to a nominal price. If there is only one bidder, it will normally bid close to what it estimates to be the seller's value.

b. When there is only one bidder and where it is deemed that the value to the buyer is much higher, the seller will almost certainly attract a higher bid by announcing a reserve price that is above the seller's value.

c. Whether the reserve price is stated or unstated, the only reliable way to boost the selling price significantly above the seller's value (or a stated reserve price) is to generate competition between one or more bidders.

It is also important to remember that, except in the case of relatively strong companies with consistently positive cash flows, the seller's decision criteria will include other factors than price, in particular employment plans, investment plans, and the credibility of the buyer and its business plan. An unworthy buyer may be disqualified because of a poor offer on these criteria, regardless of the price it bids.

We conclude that a reserve price should *always* be stated, whether this is a price equal to or higher than the estimated value of the firm to the seller. *If at least one buyer meets the technical qualifications and offers a price at or above the stated reserve price, a bid must be accepted. If no reserve price is stated, zero should be assumed to be the reserve price, and any price above zero should be accepted.*

We understand that new policies will indeed include the announcement of reserve prices, which will remove an important impediment to privatization.

5. What is "privatization by capitalization" and what valuation issues does it raise?

We have not seen the "privatization by capitalization" proposal that was approved by the High Ministerial Committee. It is nevertheless clear that it provides for the sale of new shares in certain weaker affiliates, primarily in consideration of new investment in the affiliate, such that the new shares issued will result, subject to negotiations, in the investor acquiring 51% or more of the shares. We also understand that in most cases the government (through the holding companies) intends to retain some shares, less than 50%, that it hopes will increase in value as a result of the new investment and other advantages that the investor will bring.

It is significant that the Ministerial Committee recognizes that in many cases attracting new investment to an affiliate is far more important than the price the holding company receives for its shares. This will be true for most low profitability or money-losing affiliate companies.

We are nevertheless concerned that the application of "privatization by capitalization", as revealed in recent weeks, relies upon adjusted balance sheet calculations to derive share prices that will be fixed in the tender. The adjustments – principally land revaluations, debt reductions, and current asset adjustments -- bring book values that are often negative for these distressed companies to at least the level of paid-in capital. This seems to be intended to avoid recognition that value has been destroyed by the enterprises. The assumption appears to be that the adjusted balance sheet net worth will normally be below the price that the affiliate will command in the market. This is often true for healthy, stable or growing companies, such as the majority of those listed on an established stock exchange. But the contrary is usually true of ailing companies that require new investment to survive or to achieve an adequate return on investment. *There is no reason to believe that the book value calculations we have seen will normally produce share prices that are acceptable to investors seeking cash flows yielding an adequate return on investment or will generate new capital that corresponds to the needs of the enterprise.* For example, investors are unlikely to consider proceeds from eventual land sales in their valuations of going concern enterprises, except that some investors may be attracted by *excess* land that they believe can be sold at a profit.

"Privatization by capitalization" can be viewed as a variation of the usual practice in tenders of weaker companies, by which an investor may offer a nominal price for some or all of a company's existing shares, with the commitment to invest a much more in the company after privatization. The distinctions between this and privatization by capitalization is essentially that in the latter case no existing shares are necessarily offered for sale at the time of tender and that the price per share is fixed in the tender. In either case, new investment in the affiliate is a far more important sales criterion than price.

While experimental calculations should certainly be encouraged on the bases of varied assumptions and techniques, we do strongly recommend that no book value share pricing formula be rigidly imposed on tenders. In the spirit of the privatization-by-capitalization program, we further recommend that tenders for weaker companies encourage and emphasize proposals for new capital investment required to ensure a company's survival. Tender pricing strategies can only be determined case by case, reflecting the economic circumstances and *future* prospects of each firm.

6. When should debt reduction negotiations take place?

In cases where it is determined that debt reduction is required, it must then be decided when in the privatization process negotiations with creditors should take place – *before investment promoters are recruited, after the winning bidder has been chosen, or before a tender is launched?*

Not all affiliates that have difficulty servicing their debts will require debt reduction prior to privatization. Again, what is important is the *future* – whether cash flows will be sufficient to service the debt. The amount of debt reduction that will be required must be judged in view of estimated future cash flows under a new owner willing and able to finance a value-added strategy. These estimates may be made in a detailed or cursory manner, depending on the significance of the amounts involved and the size of the privatization.

a. Debt reduction before investment promoters are recruited

Reducing excess debt before an investment promoter is selected reduces the promoter's uncertainty in submitting its proposal to the seller. Nevertheless, it is normally more important that the promoter, in view of its incentives and responsibilities, be given the opportunity in the course of its work to advise the holding company on the appropriate magnitude of debt reduction. Moreover, where the creditor is a third party such as a bank, debt reduction negotiations would unreasonably delay selection of the promoter, and the seller would not have the advantage in negotiations of the promoter's analysis of the debt situation.

We conclude that debt reduction negotiations should almost always take place *after* a promoter is engaged. In order to give the investment promoter confidence that excess debt can be reduced, the seller (holding company) and the PEO should make strong statements of their willingness and ability to a) reduce debt to the holding company where it is shown to be excessive and b) to support negotiations with other creditors where appropriate. Exceptions, perhaps significant in number, are cases where 1) it is obvious that substantial debt reduction will be necessary, and 2) the seller is the creditor. In these cases the seller may quite reasonably choose to reduce debt prior to engagement of a promoter, provided that this facilitates rather than delays engagement of a promoter.

b. Debt reduction after the winning bidder has been chosen

It may appear reasonable to simply make the amount of debt reduction one of the criteria of bids by potential investors, without any action to reduce debt prior to the tender. After the winning bid is chosen, debt reduction would be negotiated.

We do not normally see this as a good solution because *potential investors must be confident that debt reductions specified in their bids, in accordance with any limits specified in the tender, will be carried out.* Where the agreement of outside creditors is involved, such as banks, it is not possible to give investors this assurance, and *bids will be discouraged.*

If the creditor is the seller (holding company), and if the seller has full power to write off the affiliate's debt, debt reduction after award of the bid may appear more reasonable. It would of course be made clear to potential investors in the tender that the holding company is authorized (by its government shareholder and by any relevant law or regulation) that it has such power.

Debt reduction before a tender is launched.

Even when the seller of an over-indebted company is the creditor, it is preferable that at least some debt reduction take place *before* the tender to reduce uncertainty in investors' minds. The reduction of uncertainty and risk may cause some investors to bid that would not have otherwise bid. This is particularly true if the value of a company to the buyer is negative before debt reduction. Negotiations with the winning bidder may include a possible further debt reduction, but an appropriate pre-tender reduction should minimize the probability of this.

In conclusion, the best solution in most cases is that debt reduction takes place after an investment promoter has been selected and before a tender is launched. This ensures that the promoter is involved in this important decision and that the promoter's analysis is available to support recommendations to the seller and negotiations with third-party creditors. It removes an important element of uncertainty and risk that could deter investment interest in participating in a tender.

January 14, 2003 (revision and update of November 11, 2002, draft)

Attachment 2

Meeting, February 2, 2003

Privatization-by-capitalization: assessment of share valuation method employed

Observations

- Method uses an adjusted balance sheet with no assessment of the amount of new capital required or potential returns to an investor. Moreover, revaluations of land are of no consequence to an investor acquiring a firm as a going concern, except in the case of excess land that can be disposed.
-
- The value of the enterprise is assumed to be independent of a) the strategy that an investor will pursue, b) the amount of capital required to turn around the firm, and c) the returns that will accrue to investors. Yet the opposite is true: the value to a firm is inextricably linked to strategy, capital requirements, and future returns. For example, the value of the firm is different if it requires LE 20 million to effect a turnaround than if it requires LE 10 million.

- Acquiring more than 51% of the firm becomes increasingly (and prohibitively) expensive. Therefore higher levels of investment are discouraged even if the firm requires such higher levels for turnaround. This is a consequence of the assumption that the value of a firm is independent of its prospects, which in turn produces the result that the price of a share is constant for all levels of new capitalization.

- The book value calculations exaggerate the value of the firm in almost all eight of the current cases, even at the 51% shareholding level. Most of the firms are almost certainly not saleable on the terms proposed. That adjusted book value far exceeds shareholder value should not be surprising in the cases of weak companies requiring substantial new investment. (The contrary is commonly true of growing, healthy companies.)

- Fixing share prices imposes a severe constraint on the privatization process, encouraging investors to minimize new capital investment and effectively precluding interest by investors who would prefer to pursue more capital intensive strategies.

- In most cases, investors will not want government, whether or not through the intermediary of a holding company, as a significant partner with nearly 50% of the shareholding.

Conclusion and recommendations

Under any circumstances, it will be difficult to attract serious investor interest to most of the eight companies being offered. The method of privatization must therefore avoid imposing constraints that artificially narrow from the outset the range of viable investor strategies. On the contrary, it is in the interest of privatization to offer such companies with as few constraints as possible to maximize the probability that one or more investors will bid. There is no better way to improve the terms of sale than to have competing investors.

We therefore recommend the following:

- Privatization-by-capitalization should be interpreted broadly, to refer to those privatizations in which the amount of new capital invested in the firm is far more important decision criterion than the price the seller receives for the existing shares of the company.

- The price per share should not be fixed in tenders.

- The amount of debt to remain with the company should be a decision criterion in tenders of weak, over-indebted companies. Because every change in the debt level changes assessed value by an equal amount, debt and amount offered for existing shares can be added and treated as a single criterion.

- The results of adjusted book value calculations should not be shown to investors. It can only serve to reduce investor interest.

- The level of residual government ownership should not be a tender criterion in the sale of weak companies. Again, we should not impose constraints that will reduce investor interest.

- While the establishment and weighting of tender criteria will have to be carefully considered on a case-by-case basis, for weak companies the following criteria are recommended:

    - New capital to be invested in the enterprise (heaviest weight)
    - Debt to be left with the company, plus price for existing shares
    - Employment plan
    - Quality of investor and its business plan.

Attachment 3

The "Second-Price Method" of Increasing Prices Offered in a Competitive Sealed Tender

1. The problem

In our various presentations on value and price over the past eighteen months to the PEO, the holding companies, and, most recently, the Central Audit Agency, we have noted that the greater the number of bidders for a tendered enterprise, the closer we can expect the bids to be near the bidders' valuations. By contrast, if there are only a very few bidders – or perhaps just one – and if the bidders perceive (as is often the case) that there is little competition, then we can expect the bids to be close to the Seller's valuation. Value to the Seller is usually not difficult for a Buyer to estimate, given financial results in recent years and the knowledge that the Seller does not usually have the resources to effect a turnaround. We can illustrate the two situations this way:

Situation A: Many bidders

Seller's value   Buyers' values
/____________________/______________/_/__// //____/_/___/___//___/
valuations in monetary units
/______________________________________/
hypothetical range of prices bid

Situation B: Few bidders

Seller's value   Buyers' values
/__________________________________/______________________/
Bidder 1 value   Bidder 2 value
valuations in monetary units
/_____/
hypothetical range of prices bid

In the first case, strong competition will tend to force Buyers to bid near their respective valuations. In the second case, minimal competition will likely induce both Buyers to bid well below their valuations. The Seller will still be better off as long as the higher bid is marginally above the Seller's value. Nevertheless, the Seller would always prefer a bid closer to the highest valuation by a Buyer.[19]

[19] If the market were perfectly competitive, the price (highest bid) would equal the valuation of the highest valuing Buyer. But of course the market is never perfect, so this is not a realistic case. Far more significant is the fact that there are, in many privatization cases in Egypt, a wide range of possible prices that would make both Buyer and Seller better off. It is in

In presentations on valuation and pricing to the PEO, various holding companies, and the CAA, we have noted that some economists refer to the Seller's value as the "Seller's reserve price" and the Buyer's value as the "Buyer's reserve price." We avoid this terminology because it may be reasonable for the Seller in a case like "Situation B," above, to fix a reserve price that is above the Seller's value. That is, the Seller might well choose to take a calculated risk that the highest bid might fall between the Seller's value and the Seller's reserve price, in which case the Seller would lose an opportunity that would have left him marginally better off. The Seller and potential Buyers are engaged in a game (in the economic sense), with the stakes in the game being greater the more the market is uncompetitive and the wider the difference between Seller and Buyer values.

Because many of the Public Enterprises available for sale will attract few bidders, the potential of receiving bids only marginally above the Seller's value is a real one.

2. Solutions generally recommended by PIP

For nearly three years, PIP has consistently recommended that emphasis be put on developing the market rather than on futile attempts to predict prices with unnecessarily detailed and spuriously precise valuations. That is, the tendering process and its promotion should be designed to attract competitors. In many cases, where the company for sale is relatively attractive to multiple Buyers, this will be sufficient.

In cases where few interested Buyers are expected, despite the best marketing efforts and the best tender design, we have generally been recommending for tactical negotiating purposes that reserve prices be set somewhat above the Seller's value but below our estimate of likely Buyer valuations.

Contrary to current practice in Egypt and to ensure transparency and consequent Buyer confidence in the tendering process, we have also consistently recommended that reserve prices be publicly announced in the tenders. In cases where the Seller's reserve price is set above the Seller's value, there is an added advantage to announcing the reserve price: the probability of receiving offers above Seller's value but below the reserve price is minimized.

3. An alternative solution: the "second price method"

In a classic article in 1961 that eventually contributed to his award of the Nobel Prize, William Vickrey addressed the problem of sealed tender bids in imperfect markets: [20]

> It is easily shown that the required procedure is to ask for bids on the understanding that the award will be made to the highest bidder, but on the basis of the price set by the second highest bidder. If this procedure is carried

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fact quite reasonable and acceptable that the Seller seek a price *above* its value and that each potential Buyer seek a price *below* its value.

[20] Vickrey, William, "Counterspeculation, Auctions, and Competitive Sealed Tenders," *Journal of Finance,* 1961, page. 20.

> out," then the optimal strategy for each bidder…will obviously be to make his bid equal to the full value of the article or contract to himself, i.e. to the highest amount he could afford to pay without incurring a net loss or to that price at which he would be on the margin of indifference as to whether he obtains the article or not. Bidding less than this full value could then only diminish his chances of winning at what would have been a profitable, or at least not unprofitable, prices and could not, collusion aside, affect the price he would actually pay if he were the successful bidder.

That is, the tender is won by the highest bidder, but at the price bid by the *second* highest bidder. The Seller is better off because the incentive to the Buyers is to submit higher bids than they would in the traditional system of awarding the bid at the highest price. As Vickrey explains, it is in the interest of each Buyer to bid the value to himself – that is, the point at which he covers his cost of capital (including his minimal equity rate of return). If he is the winning bidder, he is assured of earning a return at least marginally above his cost of capital.

A collateral benefit of the second-price method is that more potential buyers may be induced to participate in the tender because the uncertainties of "gamesmanship" are eliminated. Instead of trying to outguess other bidders, attempting to estimate the value to other competitors, each Buyer need concern himself only with the estimating the value to himself of the firm to be acquired.[21]. Of course a Buyer has no incentive to bid *above* his value; while increasing his chance of winning, it would do so only at the risk of paying more than his value – obviously not in his interest.[22]

By contrast, the present system of tendering Public Enterprises in Egypt almost certainly *discourages* participation by potential bidders. This is because tenders are most often launched only after preliminary negotiations have been concluded with one bidder. This bidder is clearly perceived (and usually accurately) by other potential bidders as the favorite, the tender being viewed as a formality to justify awarding the tender to the favored bidder.

<u>Example</u>

The second-price method could be applied advantageously in both Situations A and B, above. (Only in a theoretically perfect market would Buyers otherwise be expected to bid at their valuations in a traditional tender.) In both cases, the Seller would expect to sell at a higher price than in a traditional tender, although the expected advantage is greater in Situation B.

[21] *Ibid., page 23.*

[22] *Ibid., page 21.*

Situation B: Relatively few buyers

Seller's value Buyers' values = Buyers' bids

/________________________________/____________________/

Bidder 1 value Bidder 2 value

valuations in monetary units

As pointed out earlier, in a traditional tender both bidders have an incentive to bid close to the Seller's value while trying to outguess the competitor, with the outcome likely near the Seller's value and below Bidder 1's value. Using the second-price method, it would be in the interest of both Bidders to bid at their values, as indicated above, with Bidder 2 being the winner at the price bid by Bidder 1. Clearly, the Seller is better off, having sold well above his value. Bidder 2 is also pleased because he expects to earn a return on his investment above his cost of capital. It is also possible that one of the bidders would not have participated in a traditional tender because of the uncertainties of outguessing his opponent and because the second-price system assures the winner of a return at least marginally above his cost of capital.

4. The possibility of collusion

Both Buyer and Seller may be tempted to collude to influence the result of the second-price method, but both risks can be managed by the Seller. After receiving the bids, an unscrupulous Seller might induce a friendly party (perhaps one of the bidders) to revise its bid to be second best and to be set very close to the highest bid. Buyers may be reluctant to participate in the tender if they see this as a possibility. However, it is easy to avoid such Seller collusion, simply by ensuring that the bids are opened by a trusted third party. Similarly, that third party would confirm the level of the second bid to the winning bidder, and the winning price should be published after the sale as a further control.[23]

An unscrupulous Buyer might also induce another, colluding party to submit a bid, in this case a bid that is set much lower than the Buyer's bid and close to the level of the Buyer's estimate of value to the Seller (or close to the reserve price, in cases where the reserve price is announced). Nevertheless, such collusion would be ineffective if there were more than one legitimate bidder. If the bogus bid were below the second best bid, it would have no effect on the price. If the bogus bid were above the otherwise second best bid, it would serve only to *raise the price*, to the Seller's advantage. That is the unscrupulous Buyer risks *raising* the price above the level it would have otherwise paid.

If there were only one Buyer colluding with a bogus low bidder, the Seller would probably be no worse off than under the first-price method. That is, in either case a single Buyer who knows or strongly suspects that it has no competition is in a strong position, and the Seller must expect that the transaction will be concluded near the Seller's reserve price. The Seller's best defense where there is a high risk of only one bidder is to tactically set the reserve price above Seller's value, recognizing of course that there is a risk of foregoing an

[23] *Ibid., page 22.*

opportunity to sell at a price between Seller's value and the reserve price that would have left the Seller better off.

5. Recommendations

We recommend that the second price system be tried for an upcoming tender. Clearly, this should be a tender where price is the principal criterion of selection.[24]

We recommend that such second-price tender be subject to the following supplemental conditions:

A. That the practice of engaging in negotiations with a Buyer before tender be discontinued, except in the special case where there is almost no probability of the transaction being of interest to any other potential Buyer. In other cases, such pre-negotiations, usually coupled with a tender with a short response time, only induces cynicism among investors and discourages participation in the tender with a result that will likely be less advantageous to the Seller than a *bona fide* tender in which all bidders participate on an equal basis.

B. That reserve prices be announced in tenders. Not doing so discourages investor participation in the tender, due to suspicion that the Seller either has no genuine interest in selling (as has been the case, for example, with certain hotel tenders) or will claim, as a negotiating tactic after the tender, that the best bid was below its unstated "reserve price." Reserve prices should be based upon the Seller's value (indifference point) and should not be futile attempts to guess what the price "should" be. There is no such thing as a "correct" price.

C. That price and other principal conditions of a tender not be negotiated after bids are submitted. Bids would be accepted as final. This would be good for the program in the long run, encouraging tender participation by giving confidence to potential Buyers that the Seller's intent to sell is serious and that the rules of selection and pricing are clear.

[24] There are other cases, such as "privatizations-by-capitalization," where the amount of new investment is a more important criterion of selection than price. These tend to be very weak enterprises can expect to command no more than a nominal price.

Attachment 4

<u>Tender Evaluation and Criteria/ Privatization-by-Capitalization</u>

August 2003

In proposing a tender evaluation framework, this paper assumes the following objectives:

- *The evaluation scheme must be flexible, to accommodate a range of potential offers*, particularly in cases where affiliates are offered under the privatization-by-capitalization method. This means that a buyer may propose to acquire a majority of the shares only by investing in newly-issued shares. But many buyers will also prefer to acquire some or all of the existing shares from the seller, in addition to committing new capital.

- *The evaluation criteria must avoid perverse results.* For example, an investor should not be able to "game" the evaluation criteria to achieve a superior score with an inferior offer.

- The criteria should reward offers that a) commit to a significant increase in capital in cases where new investment is important to the success or survival of the company; b) offer a higher price for existing shares than competing offers; c) retain more debt than competing offers; d) minimize employee layoffs; e) produce a realistic business plan; and f) propose a credible business plan and have the reputation, skills, and financial resources that give confidence that it will be carried out.

Five criteria are proposed, as illustrated in **Appendix A**: 1) an Adjusted Price calculation, combining the price offered for existing shares and debt retained; 2) Capitalization, reflecting new capital committed for investment in the business; 3) Employment Plan; 4) Business Plan; and 5) Qualifications of the Bidder.

Weighting of criteria

Two examples are attached as **Appendix C**, for Kom Hamada, a spinning and weaving firm, and **Appendix D**, for Auto Engineering, assembler and marketer vehicles. Kom Hamada has a substantial need for capital in order to survive, while Auto Engineering has a modest need for new capital relative to the size of the firm. This difference makes for a useful contrast between the two examples. Other cases may present even more of a contrast. For example, many healthy firms will not have a material need for new capitalization.

Because of these differences and others, *weighting cannot be uniform.* Some firms should be sold primarily or solely on the basis of the price offered for existing shares (as would be normal for private sector sales), while others (generally weaker firms) may be sold primarily on the basis of the amount of new capital to be invested in the firm. Weightings of other criteria can also be expected to vary from case to case, reflecting the respective objectives of the seller.

The weights in the example are suggestions based on estimations of their relative importance in each case. The subjective criteria (Employment, Business Plan, and Qualifications) have been given relatively less weight than the objective criteria. The subjective criteria might well be given more weight, although with a concomitant increase in the risk that the subjective evaluation will be challenged. These considerations are addressed in more detail below.

<u>One-round Bidding</u>

We favor a one round tender system, wherein the financial bids and the technical criteria are considered simultaneously. We oppose the "two-envelope" system for several reasons:

1. Those judging the bids are often not qualified to judge the technical merits of business plans and bidder qualifications or do not have the time.
2. A strong and credible financial commitment is by far the best indicator of the seriousness of a business plan and a bidder's qualifications. For example, if on closing an acceptable price is paid for existing shares and new capital is injected in consideration of newly issued shares, then the investor has every incentive to make the investment succeed.
3. A two-round system is more subjective and therefore more open to abuse. For example, the competitors of a favored investor might be eliminated inappropriately in the course of a subjective evaluation in the first round.
4. A clearly superior technical bidder may well have a less favorable financial offer than a minimally qualified technical bidder. In this case the tender would be awarded to the less qualified bidder in a two-envelope system, whereas the outcome is more likely to be different in a single round tender. *The "solution" to this dilemma – a side negotiation with the more qualified bidder to reduce its price -- is not desirable in that it a) defeats the fundamental purpose of the tender process -- to assess the bids of all investors on an equal and objective basis; b) opens the door to accusations of corruption; and c) leads to cynicism among investors that discourages participation and damages the reputation of the privatization program.*

<u>The criteria</u>

I. Adjusted Price

Because there is a direct and inverse relationship between the level of debt and the value of a firm, we have combined the price offered for existing shares into a single "Adjusted Price" formula. *Debt is incorporated into the formula because debt will normally be a subject of negotiation in the cases of weak and highly indebted companies, common in privatization-by-capitalization situations. In the case of a healthy company where the affiliate's debt level would clearly be acceptable to any reasonable bidder, there is no need to incorporate the* *level of debt in the formula.* We have experimented with a number of formulae, as illustrated by examples on the spreadsheet and commentary in **Appendix B** to this report.

We recommend that the following formula be used:

$P = x/s + d*s$, where

x = amount offered for existing shares
s = the percentage of shares owned by the Buyer after the purchase of new and existing shares; must be >50%
d = amount of debt on balance sheet at time of closing (in Egyptian pounds)

II. Capitalization

Capitalization will only be a criterion of evaluation in cases where the amount of new investment to be contributed by an investor is important for survival or adequate profitability, certainly including "privatization-by-capitalization" cases. Even in such cases, the weighting of the capitalization criterion must be varied according to the level of capitalization needs relative to the size and financial health of the firm.

We have introduced in the evaluation scheme a strong bias in favor of new capital that is injected at the time of closing. Commitments to invest subsequent to closing are less attractive because the commitment must often be controlled by external guarantees or by holding shares (i.e., any existing shares acquired) in escrow.

III. Employment Plan

We had considered treating the Employment Plan as partially a quantitative criterion by including any indemnities that must be paid by the seller as a deduction form price in the Adjusted Price formula. But we have rejected this idea for three reasons: 1) the level of indemnities is overshadowed by the objective of maintaining employment levels, with costs being a distinctly less important consideration; 2) there are subjective elements in the employment plan – for example, the length and credibility of employment commitments, or plans for future new hires -- that cannot be incorporated into a formula; and 3) we wanted to avoid creating the expectation that payment of indemnities by the seller is *a priori* acceptable.

Again, the weighting of the Employment Plan will vary considerably according to the case. It will have a low, even zero, weighting in cases where employment levels are not an issue. But in those common cases where there is a significant number of excess employees, the employment plan should be weighted relatively heavily.

IV. Business Plan/Qualifications of Bidder

Because the Adjusted Price, the amount of Capitalization, and the Employment Plan are the best indications of the seriousness of the prospective investor, the Business Plan and Qualifications of Bidder criterion should have a relatively light weighting. Nevertheless, it is useful to include such a criterion to distinguish between two bidders that have proposals that are judged closely on the other criteria, thereby giving preference to the bidder with the stronger reputation, financial strength, and business plan.

<u>Kom Hamada and Auto Engineering examples</u>

The foregoing principles and conclusions are applied to Kom Hamada and Auto Engineering. The analysis of the former, badly in need of new capital to survive, gives a much higher weighting to Capitalization as compared to Adjusted Price. Auto Engineering, by contrast, is a healthier company with relatively smaller new capital needs compared to its size. Therefore, Adjusted Price has been given a higher weighting by comparison to Kom Hamada.

The weightings are by definition subjective, and we certainly could imagine other weightings. For example, in the case of Kom Hamada, which has a substantial number of excess workers, the Employment Plan should probably be given a higher weight.

Attachment 5

February 9, 2004

Essam Abdel Fattah
Executive Director
Public Enterprise Office
Ministry of Public Enterprise

Subject: "Memorandum on the Package of Incentives for Future Privatizations," Ministry of Public Enterprise

Dear Director Essam:

We thank you and Mohamed Hassouna for passing on the subject Memorandum. We offer the following comments based on our experience, and we hope you that you will find them helpful.

The incentives cited as a stimulus for the privatization program from 2004 to 2007 have been available for the past year, some much longer. While some of the incentives are helpful – although one is distinctly counterproductive – they have not led to faster privatization, particularly of Law 203 affiliates. Only one Law 203 affiliate was privatized during the past year, and that negotiation took well over one year. *The problem of very slow privatization is not caused by a lack of incentives to investors but rather by diffuse decision authorities, convoluted and excessively long decision processes, and financial and other disincentives to decision makers.*

Following are comments on the subject Memorandum according to the titles of its respective sections:

A. *Optimization of Investment*

The flexibility offered by this section is helpful. Presumably, buyers who may need excess land for a planned expansion of facilities will have the opportunity to acquire it.

B. Valuation of Assets

This provision is counterproductive and has served only to delay or block privatizations.

Asset valuations are appropriate for liquidation situations. They are not appropriate for sales of going concern businesses, and it is to these cases that asset valuation is being incorrectly applied.

The problem appears to arise from the liquidation value to the Seller of many loss-making companies being greater than the going concern value to a prospective Buyer, who will normally have to invest substantial amounts after privatization to effect a turnaround.

In these situations, which are not uncommon, the Seller needs to determine its objective, whether:

a) to pursue its own financial interest, in which case it should liquidate the business rather than try to sell it as a going concern, or
b) to preserve the firm as a going concern under new ownership and with new investment so that it may survive, maintain jobs, and add value to the economy. *In this case, the Seller cannot expect to be paid on the basis of asset valuations when the going concern value of the existing business to the Buyer is lower.*

Similarly, book value, paid-in capital, and accounting measures of "value" based on the past are largely irrelevant to buyers of going concern businesses. *For example, the necessity for the Buyer to make new, often substantial, post-privatization investment (usually capital investment, sometimes severance payments), to return the company to health is an obligation that does not appear on any accounting statements.*

The value of a going concern business to the Buyer is the net present value of future cash flows that the business is expected to generate. There is no "intrinsic value" of the going concern business that is independent of those cash flows, and it is counter-productive to pretend that there is. Asset valuations are only relevant to the Buyer to the extent that it will face the prospect of liquidation if the business fails.

There is a legitimate concern in cases where liquidation values, particularly of land, are greater than going concern values that the Buyer will disguise its motive to liquidate the company. In such cases, there are effective solutions, most of which have already been applied: the Buyer can be prohibited from selling the land for five years or longer; the ownership of the land can be retained by the Seller under a financial lease that will transfer ownership to the Buyer at the termination of the lease; the land can be offered to the Buyer under a long-term operating lease; or the holding company can be granted a right of first refusal to re-purchase the land at a pre-agreed price within a specified number of years.

Of course in situations where the Seller is convinced that any potential buyer could only have a liquidation motive, then the obvious solution is that the Seller effect the liquidation itself.

Much time and money are wasted by the Sellers on needless valuations of land, buildings, fixed assets, inventories, and receivables prior to the sale of a firm as a going concern or in the course of negotiations with a prospective Buyer. Resources would be far better spent promoting the privatization candidate among prospective investors, with more reliance on the competitive tendering process. Prices should be set by markets, not by accountants or asset assessors.

C. *Financial Mix*

The willingness to transfer excess debt and other unserviceable liabilities to the holding companies is essential for selling some of the weak and over-indebted companies. This is an important incentive that has been in place for some years.

Nevertheless, implementation does not require a long and cumbersome assessment of the amount of excess debt prior to a tender. Each Buyer will assess differently its debt servicing capabilities in view of its planned strategy. Rather, the amount of debt to be retained by the buyer should be one of the competitive criteria in the tendering process, and our memorandum of August 14, 2003, addressed to Dr. Hassanien Zamara of the PEO, shows how this and other criteria can be combined in a tender.

D. *Other Incentives*

Tax holidays will be helpful in some cases, although they are only available to privatization investors in circumstances where the investment meets the criteria of the Investment Incentives Law. So this is not a general incentive for all privatization investors. Tax holidays will have little value to acquirers of loss-making companies that have significant tax-loss carry forwards or that may require several years to achieve significant profitability.

Tax holidays would mainly be attractive to investors in profitable companies, and one must question the need for a tax incentive in the more attractive cases. If there is competition for the acquisition, it can be expected that the buyer would lose some or all of its expected tax benefit (in present value terms) by having to pay a higher price to the seller. On the other hand, if there is little expected interest among buyers, then the tax holiday may succeed in creating proposals that otherwise might not have materialized.

Tax holidays will be useful in some cases, but their importance should not be exaggerated.

Should you wish to discuss the Memorandum and this letter in more detail, we would be pleased to do so at your convenience.

Sincerely yours,

Richard Moss	Bruce MacQueen
Chief of Party	Policy Advisor

Cc: Remah Talaat, USAID
Tony Chan, USAID

Attachment 6

March 25, 2004

To: Essam Abdel Fattah
Executive Director
Public Enterprise Office
Ministry of Public Enterprise

From: Richard Moss, Chief of Party
Bruce MacQueen, Policy Advisor

Subject: Kom Hamada privatization as an example of decision impediments to privatization.

Dear Director Essam:

On February 8, we sent you a letter commenting on the Ministry's "Package of Incentives for Future Privatizations." We believe you will find it helpful to have the following case study as an illustration example of the points we raised in our earlier letter.

The situation:

The attempted privatization of Kom Hamada, a spinning and weaving company, exemplifies some of the key reasons that privatization in Egypt has slowed to a crawl. The purpose of this memorandum is to summarize these privatization impediments by reference to a real situation.

We will first put the Company into perspective:

- Kom Hamada is small, with sales of LE 40 million in the year ended June 30, 2003. Its sales represent less than 2% of the sales of the 29 Public Enterprises in the Spinning & Weaving Sector (as defined in the *Cost of Not Privatizing* study).

- The Company, like most of those in the Sector, is plagued by antiquated capital equipment. It is urgent that this equipment be upgraded if the Company is to take advantage of opportunities – and to avoid the concomitant threats -- offered by the WTO worldwide removal of textile quotas as of January 1, 2005.

- The Textile Holding Company has insufficient resources to make the necessary investments in capital equipment and marketing for this and other spinning and weaving companies under its control.

- Operating losses over the years have been financed by borrowings from the Textile Holding Company that can never be repaid from operating cash flow.

- Approximately two-thirds of the labor force is excess.

- For the foregoing reasons, Kom Hamada has substantial negative value to its current owner. Indirectly, this represents a budgetary burden to the GOE, whether in the form of foregone dividends from other public enterprises or from public sector banks that ultimately finance the negative cash flows of Kom Hamada and other value-destroying companies. The negative value should be the basis for setting the seller's reserve price in a tender. That is, the seller will be better off if it receives a net price for Kom Hamada (net of the cost of any concessions for labor indemnities or debt reduction) in excess of that value. In addition, Kom Hamada will pay income taxes to the GOE if it can be made profitable after privatization. . (See *The Costs of Not Privatizing: An Assessment for Egypt*, Appendix 3, "Textile Sectors Case Study.")

Decision impediments: Excessively long decision-making process and valuation procedures

Despite the urgency of the situation and the need to privatize many more companies in the sector (some much larger than Kom Hamada), the privatization efforts that began in January 2003, with the launch of requests for proposals from prospective investment promoters, are still not completed in March 2004, more than a year later.

The promoter was selected in the first quarter of 2003, and the contract between the Holding Company and the promoter was signed April 2003. Since that time the promoter has been exceptionally conscientious and diligent, having identified several interested investors in the textile business by the middle of 2003.

Delay and confusion was caused by pricing new shares at an adjusted book value that did not reflect the substantial investment that would have to be made by an investor after acquisition. No valuation was approved for the sale of the existing shares.

Most of the investors have since lost interest because discussions became mired in negotiations of the value of the Company's fixed assets, particularly the land on which the factory is situated. Because the Company is being sold as a going concern, not as a liquidation, the land value is largely irrelevant to the Buyer, except as an eventual means of recovering a portion of its investment should its turnaround of the Company fail. (If it is feared that the investor has a hidden liquidation motive, there are several methods, which have been well-documented by PIP in the past, for protecting against this risk.)

Instead of a superfluous negotiation of fixed asset prices, the Company could have been tendered early September in accordance with evaluation criteria recommended by PIP. These criteria can accommodate in a single tender "privatization-by-capitalization" (selling new shares only) as well as the acquisition of some, or all, existing shares. (The latter alternative is now preferred, quite defensibly, by the Seller.) Moreover, the level of debt to be assumed by the investor and the number of employees to be retained – also subjects of long investor discussions since the summer of 2003 – can be included as decision criteria in the tender, in accordance with the PIP recommendations. We believe that the PEO would have been willing to proceed with a tender, but, unfortunately, it does not have the authority to make that decision. Instead, the decision process is unnecessarily complex, involving too many entities, with a consequent bias is toward inaction.

Valuable time has been lost, time that could have been used by an investor to replace capital equipment, develop markets, and implement other desired management decisions. *The Company could have been active now in preparation for the opportunities and challenges posed by the impending elimination of textile quotas, and the Holding Company could be directing its attention to other urgent privatizations.*

Latest developments:

As of this writing, the Company still has not been tendered. The Holding Company, we understand, has agreed to retain the debt owed it by Kom Hamada. Disposition of excess labor is still under discussion. The land price appears to be resolved, although a minimum price of 150 per square meter has recently been imposed by the Seller as the price for buildings. *Again, this is all but irrelevant to a going concern buyer who is by definition concerned with the future cash flows from the operation of the business, not with asset valuations.* At the same time, one of the most significant near-term cash flows – the amount that the buyer must invest in capital equipment – does not appear on any accountant's balance sheet.

The Seller cannot expect to superimpose on a going –concern price negotiation the benefits it would have received from asset sales in liquidation, while avoiding some of the costs of liquidation (such as the extent that labor obligations are assumed by the Buyer) and while expecting the Buyer to make the investment necessary to revive the Company.

The year ended June 30, 2003, was a relatively good one for Kom Hamada, thanks to exceptional market conditions. In this "good year," the Company had a negative gross margin (but less negative than in previous years!), and it lost "only" LE 544,000 on sales that increased to LE 40 million from LE 27 million in the previous year. *Yet this result reflects zero interest expense on the nearly LE 45 million of debt that the Company owes to the Textile Holding Company.*

In conclusion, the failure to offer Kom Hamada for tender and the confounding of liquidation valuation with going concern valuation (as well as failure to set a minimum price for full buyout) have, until now delayed the privatization process and may, in the end, cause that process to fail entirely. Meanwhile, the Holding Company – and ultimately the GOE --

continues to finance the Kom Hamada burden through interest free loans. Despite that substantial subsidy and recent exceptional market conditions, the Company generates no positive cash flow that would allow it to finance the acquisition of new equipment. Revival of the Company as a going concern has been blocked, to the detriment of the company itself and to Egypt's competitiveness in textiles.

Attachment 7

Costs of Not Privatizing --- 1) Spinning, Weaving, Dyeing sector 2) Cotton ginning sector

We have estimated the "costs of not privatizing" the above two sectors as a guide to setting privatization priorities.

<u>The Approach</u>

The model:

1. We start with an assessment of the present value of the sector, assuming it is not privatized. Some sectors have a negative value in their current state.
2. We add the direct opportunity costs of not privatizing to the Government of Egypt (GOE). This primarily means adding foregone income taxes and foregone privatization proceeds, net of any concessions that may be necessary to sell the firms and net of the settlement of holding company debt obligations.

We estimate the costs of not privatizing in steps that show a) the value to the holding company sellers (whose interests are not identical with those of the Government) without privatization, b) the value to the GOE, and c) the opportunity costs of not privatizing.

The calculation is as follows:

\+ Present value of sector's future earnings before interest assuming no privatization
\- Debt on balance sheet (not including debt to holding company or affiliated companies)
\+ Cash on balance sheet

= Value of sector to sellers (the respective holding companies)

\- Present value of holding company costs and holding company debt attributable to the sector
\+ Present value of future estimated taxes without privatization

= Value of sector to Government of Egypt (GOE)

Following are the opportunity costs of not privatizing:
\+ Additional taxes that would be collected (tax opportunity cost) after privatization
\- Estimated debt and labor concessions, if any, needed to effect privatization
\+ Estimated privatization proceeds

= **Cost of Not Privatizing to GOE (present value)**

The model addresses the direct effects of privatization on the Government and Government-owned holding companies. It does not attempt to project benefits to the rest of the economy.

Key assumptions

The following base assumptions can be subjected to *sensitivity analyses*:

- Revenues are projected on the assumption that the arithmetic mean of real growth rates for the sector for 1997/98 – 2001/02 will continue in the future.
- Net income, in the absence of privatization, is projected on the basis of net income as a percentage of revenues for the sector during the past four years.
- Inflation rate, 1997/98 to 2001/02 (*Economist Intelligence Unit)* 3.2%
- Capitalization rate (weighted average cost of capital):
  Nominal capitalization rate 18%
- Less projected inflation rate (*Economist Intelligence Unit,* February 2003, 2004 - 2007 forecast average) 3.2%
  = Real capitalization rate 14.2%
- Average tax rate on future income 20%
- Privatization proceeds as percent of value to buyers of loss-making sector firms 30%
- Privatization proceeds as percent of added value of firms in sector (profitable sub-sectors). This assumes a higher level of competition among prospective investors. 60%
- Concessions (primarily debt and labor), if any, as percent of negative value of loss-making firms to consummate privatizations, based on cases studies. 50%
- For the purpose of estimating the opportunity cost of taxation with privatization, a real growth rate in revenue is assumed equal to the real projected real growth rate of the Egyptian economy for 2004 to 2007 (*Economist Intelligence Unit).* 4.2%
- Net income to revenue after privatization assumed according to recent experience of private companies in the sector (*Business Week* industry date, 2001 and 2002; estimates for Egypt). 3.7%
- Distinctly anomalous data are ignored as either erroneous or resulting from special conditions inconsistent with long term trends. For example, if past revenues dropped by 50% for two years and then recover to near the original level, the two low years are disregarded.

Results for Spinning, Weaving, and dyeing sector

29 companies are included in the sector, 27 from the Textile Holding Company and two – Tanta Flax and Dyestuffs – from the Chemicals Holding Company. 27 of the companies are habitually loss-making, two are normally profitable.

Value of sector to (GOE) without privatization	**-9.7 billion**
x (-1) = Cost of sector to GOE without privatization	9.7 billion
Privatization proceeds	0.5 billion
Less, debt and labor concessions to privatize	-4.8 billion
Income taxes after privatization	0.2 billion
= Cost on Not Privatizing	**5.6 billion**

Sensitivity analyses:

variable	test value	CNP[25]	% change % change, CNP
a. Capitalization rate	15%	5.8	+4.4%
b. Projected inflation rate	6%	5.8	+4.1%
c. Projected real growth	2%	5.5	-1.2%
d. Average tax rate, future income	30%	5.7	+2.2%
e. Privatization proceeds, losing firms	10%	5.3	-2.2%
f. Concessions, % value losing firms	75%	3.3	- 40.4%
g. Combining b and c, above		5.7	+2.0%

The results are relatively insensitive to changes in the key variables, with the notable exception of the assumption on concessions required for sale. This assumption is addressed in the next paragraph.

Comments:

It may seem curious that the Cost of Not Privatizing is greater than the Value to the GOE without privatization. This is because the vast majority of companies in the sector are loss making and a) are encumbered with excess debt that to banks that cannot be repaid and b) have excess employees. In this case, the model shows LE 4.5 billion of concessions as necessary to effect privatizations, which is substantially larger than the projected payments for existing shares. If we assume all concessions are in the form of debt reduction, this still leaves 3.1 billion of debt that would remain with the privatized companies. If the companies remain under state control, almost none of the LE 7.6 billion of total debt would be repaid, given that the sector is both unprofitable and rapidly shrinking. Privatization, therefore, offers the only hope for servicing some of the debt. Still, a substantial amount of debt will not be repaid under any circumstance. *Note: only external debt is included in this analysis, including bank debt at the holding company level. Debt to the holding company is in addition, and almost all in the loss-making companies is uncollectible. Intra-group debt is disregarded, as in an accounting consolidation.*

Were the sector in a steady state rather than shrinking, the negative value would be much higher --- losses would continue at current levels, implying a *negative value on the order of LE 15 billion*. Shrinking revenues are consistent not only with experience in recent years but also with the observations in the industry that, if not privatized, these companies will die slowly. Without privatization there is little potential to renew the outmoded fixed assets, a necessary condition for revival.

Moreover, the elimination of textile quotas worldwide from 2005 presents Egypt simultaneously with a threat and an opportunity. If the industry is revitalized with new capital investment, Egypt can profit from its natural advantages and grow its international market share. But if the industry is not revitalized, Egypt's potential will be relinquished to China and other countries.

Our analyses of some specific distressed companies in the sector supports the view that these companies can be turned around if sold to investors willing and able to invest the required

[25] Billions of LE

capital. Those analyses indicate a growth potential much higher after privatization than we have assumed in the current analysis.

It is appropriate to compare, for perspective, the present values in this analysis with short-term flows, such as the projected GOE budget deficit, projected at LE 42 billion for the current fiscal year.

Results for Cotton Ginning and Trading Sector

Ten companies are in the sector, all profitable and all in the Textile Holding Company.

Value of sector to (GOE) without privatization	**0.8 billion**
x (-1) = Cost of sector to GOE without privatization	-0.8 billion
Privatization proceeds	2.5 billion
Less, debt and labor concessions to privatize	-0.2 billion
Income taxes after privatization	0.9 billion
= Cost on Not Privatizing	**2.4 billion**

Sensitivity analyses:

variable	test value	CNP[26]	% change
a. Capitalization rate	15%	3.5	+72%
b. Projected inflation rate	6%	3.3	+65%
c. Projected real growth after privatization	2.8%	1.2	- 40%
d. Combining b and c, above		1.9	- 5%
e. Tax on incremental income	20%	1.6	- 20%
f. Privatization proceeds, % added value profit firms	80%	2.4	+18%

For this sector, the results are more sensitive to the key assume assumptions. Nevertheless, even with significant changes in the variables, the cost of not privatizing can still shows a range between LE1.2 billion and LE 3.5 billion.

[26] Billions of LE

Attachment 8

Selling Distressed Public Enterprises to Greenfield Investors

Focus on the Textile Sector

I. The Challenge

The cumulative losses of the public enterprises in the textile industry represent an important drag on the Egyptian economy. The companies have long been starved for capital investment, substantially because their cash is consumed by excess labor, which in turn further increases the cash drain as companies strive to survive with inefficient, outdated capital equipment.

Egypt faces in the near future greatly expanded market access for its textile products, thanks to new agreements with the EU; the expiry of textile quotas worldwide (most important, in the EU, USA, and Canada) from 2005; and the growing likelihood of a Free Trade Agreement with the USA. Yet trade liberalization is also a threat to Egypt to the extent that its competitors will also face expanded market opportunities, as will be the case in 2005 when quotas disappear.

If action is not taken urgently to ensure that massive new investment is made to revive insolvent public companies with antiquated capital equipment, instead of benefiting from the new market opportunities, Egypt will find that it has no choice but to liquidate most of the remaining public sector textile firms. Its textile industry will face further decline as the opportunities are taken up by countries such as Pakistan, India, and China.

To take advantage of the opportunities and simultaneously to counter the threat posed by the pending disappearance of quotas, Egypt must rapidly modernize its stock of capital equipment and invest in new marketing. Therefore the amount of new capital committed to these companies will normally be the principal criterion of investor selection pursuant to privatization tenders.

Yet, acquisition of textile public enterprises in Egypt is not attractive to most investors for a number of reasons:

- Most of the capital equipment must be replaced.
- Most of the companies are in poor locations that do not benefit from the tax advantages of the industrial zones.
- Most are plagued by substantial excess labor and excess debt.
- Quality is often poor.
- Customer loyalty is weak.
- Acquisition of a corporate entity entails the risk of hidden liabilities, and seller indemnifications are considered to alleviate but not eliminate that risk.

Instead, most potential new investors in the sector will prefer greenfield investments.
In a recent meeting, the Chairman of one of the most respected and successful private textile groups in Egypt cited such reasons for his lack of interest in acquiring public sector companies at any price. He added that what interest may be shown now is likely for spinning and weaving companies and reflects a short term shortage in the market. He agreed with the assessment that the Egyptian textile industry faces serious decline if it does meet the challenge, as well as the opportunity, posed by the end of quotas in 2005. He expects that the

public sector textile companies, assuming (as he considers likely) that buyers are not found quickly, these companies will be eventually forced into liquidation. He confirmed that new investors in the sector will normally prefer to establish greenfield plants.

Liquidation, however logical it may be in the cases of many public textile enterprises, is a last resort solution because of the amount of new unemployment that would be provoked. Moreover, some potential private greenfield investment in cotton textiles is deterred by the prospect of competing against heavily subsidized public enterprises, however inefficient they may be.

So Egypt must confront an important dilemma: the public sector textile companies represent a major drain on the economy, they discourage much needed new investment in the industry, they consume resources that could be more efficiently allocated elsewhere, yet the government cannot, politically, take the corrective actions that would have long ago been taken by private sector competitors facing hard economic constraints.

II. Toward a solution

How can Egypt extract itself from this trap? The ideal solution would preserve unemployment at current levels and ensure the major new capital investment necessary to restore profitability and competitiveness without subsidies. Given the substantial levels of excess employment (despite the widespread use of outdated, relatively labor-intensive capital equipment) the ideal is not attainable. Nevertheless, the number of jobs preserved is one of the criteria by which investor proposals should be judged, in addition to the principal criterion – the amount of new capital committed to the companies.

One possible solution anticipates the establishment of a greenfield textile plant, housed in a new legal entity. We envisage a "win-win" situation in which the public sector company would substantially reduce its production, or even close completely, in exchange for the greenfield investor agreeing to select nearly all its employees from the workers of the facilities to be closed. The investor would acquire experienced employees, while its competition would be reduced. The greenfield investor would also be in a strong position to sell to the former customers of the closed plant, which would constitute a significant advantage in some circumstances.

A few of textile firms might be privatized without any link to a greenfield investment. But this is not a general solution – many of the companies will not attract investor interest under any conditions, even if debt and all excess labor are entirely eliminated. Despite such concessions, investors will be faced with replacement of most capital equipment within a few years. Rather than buying into an existing enterprise with such massive restructuring requirements and attendant legal uncertainties, most investors will expect a greenfield investment to produce a higher rate of return. Given the seeming intractability of the problem, a sectoral approach addressing the Law 203 textile companies appears more promising than a case-by-case approach.

III. Recommended approach

A sectoral approach with the following characteristics appears worthy of implementation:

- Investors considering greenfield investments in the cotton textile sector are identified. (One such major investor, from Indonesia and with financing from the Islamic Development Bank, has already been identified.)
- Acquisition of existing firms, all of which would be announced as available for sale, will not be excluded as an alternative to greenfield investment. Multiple acquisitions by a single buyer would be encouraged.
- To make greenfield investment attractive -- and in addition to the usual investment incentives available in Egypt -- the government would engage to reduce existing production capacity at least as great as the amount of capacity represented by the greenfield plants. Large investments that would replace multiple existing firms would be encouraged.
- In return, greenfield investors would be required to recruit almost all their employees (e.g. 95% to allow flexibility to recruit skills that may not be represented) from the companies to be closed.
- The employee recruitment constraint will encourage investors to establish new plants within a reasonable proximity of the existing ones (thereby minimizing relocation expenses), although this would not be a requirement.

IV. Labor issues

We posed the following questions relating to Egyptian Labor Law to Hamza & Helmy, Cairo:

1. How can an employee be transferred from a Law 203 affiliate company ("company') to another entity (the greenfield investor) in each of the following circumstances?
    a) There is a contractual arrangement between the holding company (parent of the company) and the investor by which the company would be liquidated or cease production upon the investor's fulfilling stated obligations, in particular the obligation to draw most of its employees from the qualified employees of the existing company?
    b) The contractual arrangement between the investor and the holding company does not include liquidation of the company. Instead, the company would continue to operate, and only a portion of its production and sales would be terminated.

2. What is the contractual nature of the transfer of labor to the new entity – an assignment of the contract between the employee and the company, or some other arrangement?

3. Are there circumstances in which the employee's consent is not needed, other than the case in which the investor acquires the company? For example, consider that the greenfield investor:
    a) acquires only tangible and intangible assets (including trade names and clients) of the Law 203 company but excluding the legal entity, its real estate, or its debts and other liabilities (equivalent to acquiring the *fonds de commerce* in French law), or
    b) acquires neither the Law 203 company nor its *fonds de commerce* but only certain of the employees.

4. In each of the two circumstances in the preceding question, who is responsible for pension and other obligations to the employees that were incurred prior to the transfer of labor? In either case is the current employer (the company) obligated to pay indemnities to transferred employees?

5. Is there any other labor law impediment to the transfer of selected employees from the company to the new greenfield company?

We refer the reader to the response from Mohamed Talaat and Tamer El Hennawy of Hamza & Helmy, attached.

In addition, Richard Moss and Bruce MacQueen of PIP visited Mr. El Hennawy for additional clarification:

Question 1(a): We questioned whether in the case that there is no acquisition of the Law 203 firm whether the greenfield investor in the situation described would indeed be deemed to be a "Successor" under Egyptian law. The response was that the new investor would likely not be deemed to be a Successor and would need to offer terms acceptable to the employees it wants to attract.

Fonds de Commerce, Question 3: Mr. El Hennawy confirmed that *fonds de commerce*[27] is indeed a concept in Egyptian law that has been carried over from French law. He said that

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[27] From *Dictionnaire juridique et Contractuel des Affaires et Projets*, A-J Darton Avocats, Paris: *Ensemble constitué des biens mobiliers, corporels et incorporels, qu'un commerçant, qu'il soit personne physique ou personne morale, affecte à une activité commerciale. Il comprend notamment, au titre des éléments corporels, le mobilier commercial, le matériel, l'outillage servant à l'exploitation du fonds, les marchandises et, au titre des éléments incorporels, l'enseigne, le nom commercial, la clientèle et l'achalandage (ces deux termes recouvrant en pratique la même réalité), les droits de propriété industrielle, littéraire ou artistique attachés à l'activité.*

Le fonds de commerce ne comprend pas les immeubles (par nature ou par destination) ni les dettes, disponibilités, créances, contrats et documents comptables.

Le fonds de commerce peut être exploité par son propriétaire ou mis en location gérance. Il peut être cédé ou apporté en société.

the Firm has worked on at least one acquisition of *fonds de commerce* within the last two years. His first reaction is that this is a suitable means for implementing an arrangement with a greenfield investor.

Specifically, we see the following advantages to a sale of *fonds de commerce*:

- It is an established concept within Egyptian law.
- The greenfield investor acquires movable assets, tangible and intangible, such as capital equipment and trade names.
- The purchaser does not acquire land and buildings, which it would presumably not want in any case. (This also frees the land and buildings for sale by the Law 203 company.)
- The legal entity (in this case the Law 203 company) is not acquired, thereby avoiding the risk of hidden liabilities that can deter investors.
- Debts and other liabilities are not included, which in principle would increase the selling price of the *fonds de commerce* by an equal amount.
- The acquirer would almost certainly be considered a Successor under Egyptian labor law, meaning that the employees (i.e. those remaining at the time of the sale) would be automatically transferred to the greenfield company with all acquired rights. This is the same as the situation of an investor who would acquire the Law 203 company as the legal entity – any excess labor is a matter of negotiation between the seller and buyer. Any employees not selected for retention and eventual transfer would be paid indemnities by the seller prior to the sale.

The application of the *fonds de commerce* concept has implications beyond the textile sector. It appears to be an attractive alternative means of selling weak companies or those perceived to entail significant legal risks or liabilities. The *fonds de commerce* rather than the legal entity would be tendered in these instances.

We recommend that a formal opinion on the sale of *fonds de commerce* be obtained from Hamza & Helmy.

BRM

Attachment 9

Privatization, Predatory Pricing, and Monopoly in Egypt

I. The issue

One of principal benefits of privatization is that formerly government-owned firms are freed to compete in the market while relieving the Egyptian people of the burden of costly subsidies. Privatization gives firms an incentive to become more market responsive and globally competitive. Nevertheless, it is sometimes contended that private firms in Egypt collude to restrict competition and to impose higher prices on consumers of their products, thereby reducing the benefits of privatization. There is also a concern that a single firm will become so dominant in an industry as to constitute a monopoly or near monopoly that will impose high, non-market prices on its customers. These possibilities suggest the need for a *competition policy* to control the risks that private firms will attempt to cartelize or monopolize the markets in which they operate.
In this paper, *competition policy* is defined broadly, to include all those policies that influence competition --- trade, private investment, privatization, and regulatory policies. Too often *regulation* is viewed as the sole or principal effective response to anti-competitive practices, but this is usually not the case. Taking this broader view, this paper a) assesses an example of an alleged abuse observed in Egypt, b) identifies the fundamental policy alternatives, and c) suggests policy directions that are appropriate for Egypt. The paper will be divided into two sections, addressing respectively concerns of *predatory pricing* and of *monopoly*.

Some privatized companies, particularly foreign-owned ones, have recently been criticized in the Egyptian press and elsewhere for having engaged in "predatory pricing," intended to drive out of business weaker, locally-owned firms. Presumably prices would then be raised as the industry is cartelized or even monopolized by a single competitor.

Such criticism, whether merited or unfounded, has consequences. The launches of at least two privatization efforts – both fertilizer companies – appear to have been delayed because of concerns of criticism based on competition issues.

While privatized firms hold – or potentially hold -- important positions in some industries in Egypt, issues of competition policy extend to all firms, whether privatized, private from establishment, or government-owned. Competition policy is addressed in the context of privatization policy because a) perceived or alleged anti-competitive practices among privatized firms are sometimes used as an argument against privatization itself or in favor of government maintaining a participation in the shareholding, and b) privatization policy can be a tool for creating more competitive markets.

II. Claims of competitive abuse in Egypt - Example

A specific accusation of predatory pricing appeared in *Al Ahram* on November 14, 2002.[28] The article states that cement prices in Egypt have dropped dramatically – an LE 70 fall -- since the beginning of the third quarter, from LE 190 to 120 per ton. Only one example is given to support this: sales by a privatized, foreign-owned cement company from Assiut selling in Sinai at LE 120 per ton. The claim is that, considering transport costs, this price represents a sale at LE 5 below "direct costs" and LE 40 less than "true" costs. The claim is that this is predatory pricing, that it is perpetrated by foreign-owned cement companies (although only one is named, in connection with the LE 120 per ton example), and that "The foreign companies will then raise the price of the cement to almost LE 400 per ton." The article also briefly cites two other industries where supposed "pricing chaos" is observed, iron and gravel.

A construction contracting executive (cement consumer) is quoted as saying that LE 130 per ton is a "fair" price, claiming that cement companies in past years had (in the translated words of the article) "exploited the growing reconstruction trend in Egypt, raised prices and realized huge profits in no time."

The article goes on to say that another cement executive claims that the cement prices should be "no less than LE 160," the "true" cost. It appears from the article that "true" cost is meant to be average *total* cost per ton, including bank interest and all costs other in addition to the out-of-pocket costs (probably what is meant by "direct costs" in the article) attributable to production activities. The marginal cost of production of a ton of cement, which would be lower than out-of-pocket costs per ton, appears not to be considered in the article.

III. "Predatory Pricing"

The "predatory pricing" claim is that a strong competitor in an industry (or multiple competitors working in cooperation) will sell at a price below average cost in order to drive one or more weaker competitors out of business, only to raise prices when competition is eliminated. Monopoly pricing is assumed to be long-term so that the investment in below-cost pricing can be recovered with an adequate return. If the monopoly cannot be sustained, there is little reason for the supposed predator to invest in its establishment -- and there is little reason for others to be concerned.

Claims of predatory pricing have been made in virtually all market economies for more than a century. The claims are almost always instigated by one or more market participants whose profitability is threatened by low prices of their competitors. It is in the interest of these threatened competitors to raise the accusations, whether directly or through allies in government, politics, or the press. Ironically, the objective of the accusers is often a price-

[28] El Barghouthy, Mohamed, "Collapse in the Cement Market," *Al Ahram,* Cairo, November 14, 2002, p. 3.

fixing arrangement that conforms to their own special interests and is to the detriment of the interests of consumers.

Clearly, industry competitors, particularly weaker ones, have a motive to complain about low prices and to blame the "unfair" pricing practices of other competitors. Consumers, by contrast, benefit from low prices and therefore do not usually instigate claims of "predatory pricing." This might indicate shortsightedness on the part of consumers (although these are often well-established businesses in their own right, sophisticated in their industry), or it may indicate that consumers see no substantial threat that they will be worse off in the long term, even if weak competitors are driven from the market.

But does predatory pricing make sense from the point of view of the alleged perpetrators? If a cut in price is indeed "predatory," then the perpetrator must "invest" in selling at below his average cost. There are so many risks in a predatory pricing strategy that one must seriously question its rationality. Among the things that may go wrong for the predator are:

- Competitors are not driven out of business.
- Driving competitors from business takes longer than anticipated, or requires lower product prices than anticipated.
- Competitors are driven from the market, but competition from increased imports prevents the predator from imposing the anticipated price increases.
- The capacity of the failed producer is acquired by a stronger competitor, or it may remain idle until such time as prices are raised by the predator to profitable levels. The existence of this capacity is a continuing threat to the predator's strategy. *Driving a competitor to bankruptcy does not destroy productive capacity.*
- The predatory strategy proves to be less profitable than many other alternative uses of the funds invested in the predation effort. In fact, the availability of investment alternatives, or the payment of dividends to shareholders, makes it unlikely that the highly risky predation effort would be undertaken in the first place.

There are legitimate business reasons – not involving the establishment of a monopoly or cartel -- for cutting prices or selling "below cost," however defined. For example:

- To respond to changes in supply and demand. Price movements can be particularly volatile in industries characterized by high fixed costs.
- To maintain business operations despite very difficult business and pricing conditions that are deemed to be temporary. For example, some state-owned textile companies in Egypt frequently sell below their costs.
- To build a business before economies of scale are attained. For example, when Ford Motor Company was started early in the 20th century, cars were sold below cost to build demand until production could be increased to economic levels.[29]

[29] DiLorenzo, Thomas, "The Myth of Predatory Pricing," Cato Institute, Washington, 1992, p. 7.

- To avoid laying off workers in a temporarily depressed market. In other words, labor costs are quite reasonably viewed as fixed in the short term. *Otherwise, employee layoffs would be the response to every change in supply and demand.*
- To build market share in a new geographic territory.

These are far more economically rational reasons for selling near or even below cost than the usually unrealistic hope that monopolistic prices might one day be established and maintained. This is why the concept of predatory pricing has little respect among economists. It is also why the U.S. Supreme Court has stated, "There is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful…Cutting prices in order to increase business often is the very essence of competition…economic realities tend to make predatory pricing conspiracies self-deterring." [30] In fact, there are no unambiguous examples in the United States of a monopoly having emerged through predatory pricing tactics.[31]

According to the U. S. Federal Trade Commission (FTC), if pricing below cost is prohibited, "…much legitimate conduct may be chilled because there are many good reasons for pricing below cost for a limited period." The FTC goes on to say, "If the seller cannot recoup its losses [from alleged predatory pricing], the below cost sales not only are unlikely to injure competition, but also probably did not arise as part of any intentional anti-competitive scheme." Referring to "very difficult and resource-intensive" below-cost pricing investigations, the FTC observes that "most ultimately conclude that there was no violation." [32]

Can competitors be hurt by pricing competition in a free market? Can some be driven to bankruptcy? Of course, but this is normal, and it is one of the mechanisms by which markets adjust to changing conditions of supply and demand or by which mistakes are corrected. The purpose of competition is not to ensure that weak competitors remain in business. As the FTC puts it, "Most modern competition law, including that of the United States, focus on protecting consumer welfare rather than individual competitors."[33] Modern economies are dynamic, ever-changing, and free markets ensure *adaptation* to that change. This is more important than ever in today's world, characterized by an accelerating rate of technology-driven change. Stagnation is the inevitable consequence of failure to adapt. Most state-owned firms in Egypt and elsewhere offer ample evidence.

Freeing firms to face the risks and rewards of the market, and removing business decisions from the political realm are among the principal advantages of privatization. Mistakes of state-owned firms are perpetuated with large and continuing subsidies because closing such firms is not consistent with the objectives, almost always short-term, of political decision

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[30] Matsushita Electric Industrial Co. v. Zenith Radio, 1986; cited in DiLorenzo.

[31] DiLorenzo, *loc. cit.*

[32] Federal Trade Commission, Washington, D.C,, letter commenting on Egypt's draft Anti-Trust and Anti-Monopoly Law, October 22, 2002, p. 14.

[33] *Ibid., p. 4.*

makers. Re-politicizing business by interfering with private pricing decisions is a major step backwards.

Not only does aggressive price competition usually serve an economic purpose in assuring market adjustments to ever-changing economic conditions, lower prices also benefit consumers. These consumers may be families and individuals, or they may be other businesses for which lower costs are conducive to survival. In times of economic recession, as much of the world faces today, lower prices in one sector are a stimulant to economic activity in another sector.

Furthermore, because the supposed object of "predatory pricing" is to monopolize a market to the detriment of consumers, competition *policies that further reduce or eliminate the possibility of sustaining a monopoly will be sufficient to ensure that competitors have no incentive to pursue pricing strategies designed to attain monopolistic pricing.* That is, regulating "predatory pricing" is superfluous, protecting against monopoly is sufficient. Anti-monopoly policies will be addressed below.

<u>A note on dumping</u>

These accusations of predatory pricing do not constitute, as sometimes alleged, instances of "dumping." "Dumping" is a term used in international trade that has traditionally meant selling in a foreign market at a price below that in the domestic market. More recently, as in US law, it has come to mean "selling a product abroad below cost." "Cost" is not defined in US law, and this has led (perhaps intentionally) to arbitrary application where differing cost standards may be claimed by disputants.

The usual economic rationale for anti-dumping duties is not that a monopoly will allegedly result. Rather, most economists favoring anti-dumping rules base their views on the desire to protect the domestic industry from peculiar, temporary conditions of over-supply affecting a foreign country. This is termed "sporadic dumping." That is, anti-dumping duties in these cases seek to protect domestic industry from cycles of contraction and expansion abroad.

John Gunn, an expert in international trade policies, and a former student of Jacob Viner, author of a landmark monograph on anti-dumping theory, states:

> My judgment is that anti-dumping duties have not been used primarily in cases of alleged predatory pricing, but more often against governmentally-subsidized exports that continued over years at a time, or against direct government production, where dumping was used in cases where global recession or foreign recession reduced demand for the product… Sporadic dumping, too, is more often associated with such attempts to smooth the market… than to predatory efforts, although the latter has occurred.[34]"

[34] Gunn, John, Professor Emeritus of Economics, Washington and Lee University, correspondence of December 2002.

That there is a rationale for anti-dumping policies in international trade does not mean that the application of the concept is always free from abuse. In various countries, including the United States, dumping litigation or the threat thereof can be a tool for harassment of one's competitors. Exaggerated accusations of dumping are backdoors to protectionism. Where costs are not precisely defined, as in the US law, the door is opened wider.

IV. Comment on the cement industry allegations

The *Al Ahram* article expresses the fear that because one company has sold at LE 120 per ton in Sinai, that a "foreign bloc" of cement companies will soon impose prices "five times" as high on the market. This is a strange claim given that several foreign-owned firms represent in total only about one-third of cement production capacity in Egypt. Government-owned firms control approximately the same percentage of capacity. Also, LE 120 per ton is only LE 10 less than the cited construction industry executive suggests is a "fair price," only slightly below current average prices, and slightly above average prices in some recent months.

Moreover, even were there only one producer of cement in Egypt, the price of cement could not increase by five times or to LE 400 per ton because imports (and considering the high cost of transport) would be substituted and demand would drop dramatically. Clearly under these circumstances, the expectation of raising prices so far above market in the future is not a motive for selling at 120 today.

While quoting a cement executive who condemns one of his competitors for lowering prices to LE 120, the article quotes a cement consumer who estimates that LE 130, less than 10% higher, is a "fair price" and condemns cement companies for charging much more in the past. But should one be surprised to hear cement executives blaming their competitors for charging prices that are "too low" and to hear a cement consumer blaming cement companies for charging prices that are "too high"? Each is simply arguing his own special interest, with no substantive economic justification on either side. Referring to these problems of defining predatory pricing, including the difficulty of determining what cost standard should be used, the FTC observes, "Regardless of the standard used, it is difficult for sellers to know their precise costs at the moment of a sale."[35]

As a solution to the alleged instance of "predatory pricing," the article concludes that the Supreme Council for Cement, a producers' price-fixing cartel, should be reinstituted. This will be in the special interest of cement producers, particularly weaker ones, who want to shift the costs and risks of their own business decisions to cement consumers. Yet, the whole purpose of competition policy is to *prevent* such price-fixing arrangements by cartels and monopolies. Ironically, the article proposes that a price-fixing cartel must be established to raise prices and to "protect" consumers from the eventual emergence of another, theoretical price-fixing cartel.

[35] Federal Trade Commission, *op. cit.*, p. 12.

Cement price trends

Certainly the supply and demand picture is less favorable today for producers in Egypt than it was a few years ago. Increases in production capacity have outpaced increases in local consumption. Below are the figures from 1995 and 2002.[36] It should be kept in mind that average prices among suppliers reflect differences in cement quality, supply and demand conditions in local markets, and timing of sales, as well as differences in pricing policies.

(000 MT)

	1995	1996	1997	1998	1999	2000	2001	2002
Total capacity	17200	17700	19200	21200	24600	27050	28600	31000[37]
Egypt consumption	18001	19480	21153	23727	27541	26334	26751	25840[38]
Exports	267	428	410	91	33	46	79	2801[39]

Consumption has declined slightly since 1999, yet capacity has increased significantly. Capacity will increase further in 2003 to more than 33,000 tons. Under these supply and demand conditions, it is normal that prices will decline. There is no reason to suspect a conspiracy by foreign-owned producers, who in any case represent only about one-third of capacity today.

The sharp rise in exports in 2002 reflects over-capacity in the industry. Because of transport costs, cement companies only export when they have no choice --- margins are necessarily low, and quite possibly negative on various cost bases. Yet because fixed costs are high, it makes sense for cement companies to sell product as long as variable costs are covered. In the short-term, labor should also be considered fixed, otherwise workers would be laid off whenever sales fall.

Clearly, the business decisions to increase capacity in recent years were made in anticipation of higher demand than has proved to be the case. There is nothing unusual in this. Businesses take risks, and sometimes the results do not meet expectations.

Following is the range of average product prices of three cement companies (Suez, Torah, Helwan) from 1996 to 2001:

1996	160.4 to 170.9
1997	174.3 to 177.4
1998	175.2 to 190.0
1999	180.9 to 208.0
2000	169.9 to 199.6
2001	162.2 to 180.0

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[36] Statistics are from industry and financial sources, except where otherwise noted.

[37] El Barghouthy, *loc. cit.* (New lines came on stream, particularly at Egyptian Cement.)

[38] Annual estimate based on sales through September of 19,385,000 MT (x 1.33).

[39] Annual estimate based on exports through September of 2,101,000 MT (x 1.33).

As an indication of more recent prices, Kawmeiah prices averaged 148 between July 1, 2001, and June 30, 2002. At Sinai Cement, the average monthly price from January to October, 2002, was LE 139, with a low of 112 in May and June, a high of 166 in July, and a level of 125 in October.

Current prices (December 2002) range as follows for six cement companies:

Helwan	140
Torah	139
Assiut	137
Beni Suef	135
Amereyah	130
Qena	130

There is nothing remarkable or "chaotic" in this price behavior given the fluctuations in supply and demand over the period. The article's claim of a precipitous drop, from LE 200 to LE 120 today, is simply not supported. Prices averaged well below LE 200 in 2001. Nor is lower, let alone "predatory," pricing by a "foreign bloc" supported. Certainly cement companies, Egyptian-owned and foreign-owned, would prefer higher prices but this is no justification whatever for regulatory intervention in pricing decisions. Prices appear to have recovered since the May – June period of seasonally low demand.

Another apparent objective of the article is more subtle: to suggest that producers in one locality be isolated from producers in other localities. This is why transport costs from Assiut to Sinai are cited to support the claim of predatory pricing. But markets do not operate on a cost-plus basis. Producers from other regions cannot be barred because they refuse to price their products uncompetitively on some specified cost-plus basis. Formulas that effectively reserve markets to local producers constitute a restraint of trade in most countries with competition policies. The FTC states, "…our experience has also shown that some types of joint conduct are never, or almost never, justified. These include agreements to fix prices, divide territories, or reduce output."[40]

<u>Conclusion</u>

Obviously consumers benefit from lower rather than higher prices, particularly in times like now when the economy is weak. Construction activity is stimulated when investors seek to take advantage of lower prices for building materials. If prices are kept artificially high by a cartel, then cement production will decline to a level less than it otherwise would have been. Cement workers will be laid off, and employment prospects elsewhere in the construction industry will decline. Cement industry investors will benefit, but the costs are transferred to others, including labor.

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[40] Federal Trade Commission, Washington, D.C., *op. cit.*, p. 13.

The purpose of competition is not to ensure that weak competitors remain in business, nor is the purpose of competition to ensure that businesses are protected from the consequences of their own errors, from changes in supply and demand, or from the bad outcomes that are always a possible consequence of the risks inherent in even the most reasonable business decisions. To protect competitors against such errors, changes, and risks only ensures economic stagnation. Public enterprises in Egypt offer a good example of the high costs to society that result from efforts to resist changing circumstances and efforts to insulate business from bad decisions and bad outcomes. Egypt should not attempt to duplicate the consequences of failed government ownership by imposing cartelization and excessive or superfluous regulation.

Prices fluctuate in a free market, and these fluctuations can be particularly significant in industries like cement with high fixed costs. The fact that some competitors sell at low prices is no indication whatever that there is a plot to monopolize the market. Even if there were such a plot, it would be almost certainly be doomed to failure. There is very little evidence anywhere of monopolies having been created through predatory pricing. Reducing prices is a rational response to changing supply and demand conditions. Lower cement prices today are the mechanism by which the relationship between capacity and consumption will be brought more nearly into balance. There is no justification for the establishment of a pricing cartel or other monopolistic practices to favor special interests in the cement industry.

IV. Anti-trust and monopoly law

As mentioned above, competition policy, broadly defined, should focus on preventing the establishment of sustained monopolies.

There are two excellent and recent papers, both prepared from a legal perspective, that address competition policy in Egypt, and there is no need for us to attempt to duplicate their work:

1. The letter, cited above, from the U.S. Federal Trade Commission to the U.S. Agency for International Development in Cairo, assesses Egypt's draft Anti-Trust and Anti-Monopoly Law. Those drafting the law should consider carefully the advice offered in this letter, which reflects long experience with the issues in the United States (including lessons from past errors), as well as sound economic reasoning. The letter consists of detailed comments on each article of the draft law.

2. A working paper published by the Egyptian Center for Economic Studies (ECES) entitled "On the Formulation and Enhancement of Competition Law in Emerging Economies: The Case of Egypt." The authors are Bahaa Ali El Dean and Mahmoud Mohieldin.

The FTC paper does not presume to address issues of enforcement in Egypt. The ECES paper does address enforcement issues, as well as offering assessments of comparative competition policy experiences in Poland, Hungary, and Mexico.

The following comments on these papers are limited to issues of economics and to incentives to invest in Egypt. Therefore the discussion covers the concept of perfect competition, which figures in the ECES paper; non-regulatory means of protecting against the establishment and maintenance of monopolies; and the enforcement context in Egypt.

Perfect competition

The ECS paper states, "…the concept of perfect competition is useful for two reasons: as a benchmark and as an institutional characterization of some markets, e.g. primary commodities." The paper continues, "Since there is widespread diversion from the ideal paradigm [perfect competition], there is a necessity for corrective intervention by government."[41]

This is a misuse of the theoretical construct of perfect competition, and it can lead to important policy errors. Far from being an "ideal paradigm," perfect competition, were it ever to exist, would characterize a stagnant market devoid of innovation. Markets work because they offer incentives, particularly high profit incentives, to invest and innovate. It is the attraction of profits above normal that energizes a dynamic modern economy. Perfect competition is a static concept, commonly used as a teaching tool in introductory courses in economics. The reality of markets today is one of rapid change, continual innovation, "creative destruction" in Schumpeter's words. "Perfect" connotes "desirable," and the semantic bias is unfortunate. The ideal, in Egypt as elsewhere, is dynamic markets that continually allocate and reallocate resources, not stagnant or "perfect" ones.

The concept of predatory pricing is an example of the misuse of the concept of perfect competition. As DiLorenzo states:

> The theory of predatory pricing fails to recognize that price cutting--even below average cost--is a normal activity in competitive markets. That is because the theory is derived from the so-called perfect competition model of economic theory. In an ideal, or "perfectly competitive," market, every firm charges an identical price, and in equilibrium that price is equal to average total cost.[42]

The FTC paper makes clear by implication that perfect markets are not the ideal by which market practices and regulatory policies should be judged. Attempting to apply a standard of "perfect competition" would undermine, not advance, the objectives of competition policy.

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[41] Ali El Dean, Bahaa and Mahmoud Mohieldin, "On the Formulation and Enhancement of Competition Law in Emerging Economies: The Case of Egypt," Egyptian Center for Economic Studies, Cairo, 2001, p. 4.
[42] DiLorenzo, *op. cit.,* p.

Non-regulatory protections against monopoly

An open economy is the best defense against cartels and monopolies. Egypt's economy has been plagued by restraints on competition, but these restraints, as so often is the case elsewhere, have mostly been sanctioned by government. The former cement pricing cartel is an example. Another example is government-subsidized pricing that discourages the entry of competitors to the market. History shows that monopolies and cartels are rarely persistent in the long-term unless enforced by government policy.

Cartels and monopolies, where they may be established, are threatened by a) members withdrawing in order to increase sales, b) imports, c) entry of new competitors, and d) new technologies. Therefore, restrictive trade practices -- high import duties and non-tariff barriers -- should be discouraged; the market should be open to foreign investors; regulatory approvals for establishing a business and for new project investments, whether foreign or domestic, should not be cumbersome; and the introduction of new or more efficient technologies should not be impeded by special interests or regulatory obstructions. Egypt's accession to the World Trade Organization is a quite positive development that will help to ensure that the country's markets are open.

Privatization policy can also help to ensure that markets are open. Where constraints on competition exist among public sector companies, the privatization process should help to ensure (as it appears to do in practice in Egypt) that such constraints do not persist after privatization. Where there are only one or two domestic competitors in an industry and cartelization is feared, a privatization might be designed to disperse ownership by breaking an existing enterprise into two or more competing privatized companies. Nevertheless, if a market is open to imports, even a single domestic competitor may not constitute a threat to consumers. The FTC offers, "For example, if there is only one company selling semiconductor chips in a country, that company would control 100% of the domestic market. But if Intel were poised to enter that nation's market, the domestic company's 100% market share would give it little market power, as a practical matter."[43]

Enforcement context in Egypt

There is a very good discussion of the Egyptian enforcement context in the ECES working paper. Because this is such an important determinant of the effectiveness of any regulatory policy, such as embodied in the draft Anti-Trust and Monopoly Law, some comments follow. As Ali El Dean and Mohieldin state, "Enforcement issues represent the main difficulty in introducing competition law…Establishing an efficient enforcement agency capable of implementing sophisticated competition legislation can only be seen as a long-term objective."[44] The ECES paper goes on to cite "…the problem of judges in emerging economies who often lack the necessary training to enforce sophisticated laws that require economic analysis."[45]

43 Federal Trade Commission, *op. cit.*, p. 6.

44 Ali El Dean and Mohieldin, *op. cit.*, p. 13.

45 *Ibid, p. 14.*

Indeed, one of the fundamental reforms required in Egypt, as noted by both foreign and Egyptian observers, is that of the court system. In addition to concerns of economic expertise expressed in the ESCS paper, the slow pace of litigation, with even relatively simple cases dragging on for years, raises further questions as to the enforceability of competition policy in Egypt.

A cumbersome litigation system, combined with regulators and judges ill-trained to handle the complexities of competition regulation, may undermine rather than promote the rule of law. For example, under such circumstances, special-interest plaintiffs may use the law as a means of harassment of more efficient competitors. The recent cement industry accusations in Egypt suggest that there will be no shortage of unhappy competitors willing to use the law for such purposes. *In short, an ill-equipped enforcement system may serve to turn competition laws and regulations into a tool for undermining competition.* Moreover, investment in the economy will be deterred rather than encouraged if there are fears that competition laws and regulations will be used by competitors to gain advantage rather than to protect consumers, or if legal procedures will be long and cumbersome.

As a solution Ali El Dean and Mohieldin suggest a *per se* regulatory system in which clearly defined rules, as opposed to the rule-of-reason in advanced economies, are applied. There is substantial merit to this suggestion, although there remains reason for caution: the *per se* rules embodied in law may themselves be anti-competitive. For example, a *per se* rule reflecting the conventional wisdom that "selling below cost" is by definition bad, would be destructive of competition. If the *per se* approach is taken, the rules should be few and well-targeted. For example, proof that an agreement among competitors exists to divide markets geographically or by customer would be an appropriate *per se* offense,[46] as would an agreement among competitors to price according to an agreed "cost-plus" or other formula.

V. Conclusions

Predatory pricing as a prelude to monopoly or cartelization is a theoretical construct with little relation to reality. In the USA, "there have been hundreds of federal antitrust cases based on claims of predatory pricing, economists and legal scholars to this day failed to provide an unambiguous example of a single monopoly created by predatory pricing."[47] Evidently, the concept of predatory pricing is flawed in theory as well as in practice.

Claims of "predatory pricing" usually prove to be fictions perpetrated by special interests seeking to raise prices at the expense of consumers. The probability of a predatory pricing scheme yielding an adequate return to the perpetrator by generating monopoly profits is rarely great enough to justify initiation of the effort, let alone produce success. Even if a competitor were driven to bankruptcy, industry capacity is not destroyed but becomes

[46] Federal Trade Commission, *op. cit.*, p. 14.

[47] DiLorenzo, *op. cit.*, p. 9.

available to new investors at a price based on market conditions for the products produced. The *Al Ahram* article cited above appears to reflect a classic case of special interests seeking favors from government: concentrating benefits among a privileged few (cement companies in this case), while broadly dispersing costs among consumers.

Privatized firms have not instigated predatory price declines. Rather the price declines in 2002 simply reflect a significant increase in capacity coupled with a more modest decline in demand. There is no reason to restrain privatization activity on the basis of experience in the cement industry. Nor does there appear to be any reason to suspect that privatization is conducive to anti-competitive practices. *By contrast, in the cement industry privatization has coincided with the abandonment of former anti-competitive price fixing practices.*

While an anti-monopoly law is in theory desirable for Egypt, it seems that reform of the judicial system is a greater priority if not a prerequisite. Egypt may, in the interim, be better off relying on non-regulatory competition policies, such as free trade and open entry to markets. While a second-best solution, this may be the best attainable under current circumstances. Also, the costs of not having an anti-monopoly law and regulation may not be as high as may first be feared. Today, Egypt faces a greater challenge in convincing investors that they can earn adequate returns on their investment than in combating monopolists that are earning profits that are too high. The prominent monopolies or price-fixing arrangements in Egypt are sanctioned by government, although private collusive arrangements no doubt exist as well. It appears at this stage in Egypt's development that government policies are more likely to be the cause of economically destructive competitive restraints than private collusion.

It does appear feasible, even under existing enforcement conditions in Egypt, to devise *per se* rules that would make a positive contribution to the competitive environment. But devising appropriate rules places a heavy burden on the legislature, and therefore it is urged that law makers be carefully advised on appropriate rules by experienced regulators in other countries. As pointed out earlier, inappropriate rules may hinder rather than promote competitive markets.

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January 15, 2003