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COUNTRY PRIVATIZATION STRATEGY

July 1987

CENTER FOR PRIVATIZATION
1750 New York Avenue, N.W. - Washington, D.C. 20006

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MEMORANDUM FOR USAID MISSIONS

July 30, 1987

SUBJECT: COUNTRY PRIVATIZATION STRATEGY

Privatization became part of the world's vocabulary only a few years ago, but already it has become recognized as a powerful agent for economic growth in both industrialized and developing countries.

Within the U.S. Agency for International Development, privatization has become an increasingly important element in USAID country programs throughout the world. The broad scope of papers presented at the Administrator's International Conference on Privatization in February 1986 provided insights into the complexity of the process. The policy determination paper Implementing A.I.D. Privatization Objectives, which followed in June, delineates A.I.D.'s policy with respect to privatization and policy conditions important for privatization.

Over the past eighteen months, consultants from the Center for Privatization have spent time in over twenty five countries on a wide range of assignments. From this experience some generalizations about privatization opportunities, techniques and pitfalls can begin to be drawn, to provide further useful guidelines in formulating a country privatization strategy. The Center for Privatization has assembled some of these thoughts, ideas, experiences and lessons learned, in outline form, to serve as a resource for ongoing work in privatization.

Most importantly, we have learned the paramount importance of carefully planning a privatization strategy appropriate to the particular requirements of a country, rather than proceeding on an ad hoc basis with opportunistic divestiture which could impair the success of further privatization.

Our objective is to provide a broadly applicable guide for thinking through all aspects of privatization by concerned A.I.D. Missions, government officials and others involved in privatization. It has been prepared in an outline format to show the overall flow of the

critical elements of the privatization process that must be considered prior to making strategy or program decisions with respect to privatization. It can be adapted to the varying stages of development in different countries and can be built upon and expanded as our experience grows.

Having considered the elements called for in this guide, planners may draw reasonable conclusions about the state of privatization in the host country and the potential for proactive initiatives. Planners then will have a good sense of what approaches are appropriate and what specific technical assistance can be called in to advance the privatization process.

Privatization should be recognized as primarily a political process. It has important financial, economic and social implications when done successfully. It is an ongoing, continuing process, not a single event or happening. It is a complex process of change, involving risks and pitfalls along the way which can be serious and must be taken into account.

We hope that USAID Missions will find this outline easily adaptable for their own use, and that they may expand and select from it to fit the needs of their individual country environment. The Center welcomes comments and suggestions as we continue to expand on the ideas presented here.

As a result of experience to date, the Center has a number of consultants available to advise and work with a mission in the development of a country specific strategy for privatization. Also, if there are particular areas any mission would like to explore in greater depth, we would be pleased to respond to mission inquiries or requests for assistance, either with suggested additional reading materials or specific technical assistance, whichever may be most appropriate.

Enclosure:

1) Illustrative Country Privatization Strategy Framework

GOFJ:asg/c-memformi 7/30/87

PREFACE

The attached privatization framework was designed for use by development professionals already familiar with basic privatization terminology. The objective here is to present a complex process in a quickly readable format so the reader can focus on flow, content and inter-relationships. We hope that our self-imposed ground rule, to present each thought in a single line, does indeed provide a useful resource document for the various purposes it is designed to serve.

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JULY 15, 1987

ILLUSTRATIVE COUNTRY PRIVATIZATION STRATEGY FRAMEWORK

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I. INTRODUCTION

A. Purpose of this paper

1. This paper provides a framework and guidelines
   a. For use by USAID Missions and LDC governments
      i. To shape and pursue a country privatization strategy
      ii. To identify and bring about needed policy changes
      iii. To increase public awareness and understanding
      iv. To privatize a specific govt enterprise/facility/activity
      v. To institutionalize the privatization process within an LDC

B. Current trends, worldwide

1. Severe LDC debt crises are creating imperatives for change
2. Growing recognition that market economies outperform state-managed
3. Many LDC's are now seeking to privatize government functions
   a. (Provide/attach list of examples)
4. Privatization is difficult and takes time
   a. Not all parties agree to its wisdom and efficacy
   b. Must increase the sense of urgency that action is needed

II. THE BASIC PROBLEM

A. Typical characteristics of state-owned enterprises (SOE's)

1. Bureaucratic management; emphasis on process rather than results
2. Frequent changes in top management
3. Overstaffing, nepotism, political patronage, excessive overtime
4. Required employment of civil service/military in top posts
5. Confusion over conflicting social/political/economic objectives
6. Political interference in decision making and daily operations
7. Lack of accountability at all levels
8. Inability to delegate--decisions go to the top
9. Inability to negotiate, make politically difficult decisions
10. Easy acceptance of financial losses for social reasons
11. Economic subsidies - direct and indirect
    a. Tariff protection and import restrictions
    b. Sole source supplier to other govt agencies
    c. Tax exemptions
    d. Low interest borrowing with government guaranties
    e. Legal restrictions to limit market entry by competitors
12. Operate outside the government budgetary process
13. Lack of accurate/up-to-date financial records
14. Assets underutilized--inadequate planning/feasibility studies
15. Assets overvalued--unwillingness to recognize market value
16. Poor maintenance of capital equipment
17. Antiquated/outmoded production facilities/procedures/technology
18. Lack of know-how or budget funds for marketing
19. Insensitivity to consumer needs and desires
20. Inability to reward good performance/penalize unsatisfactory

B. Problems created by government ownership/control

1. Scarce resources divert to political purposes or personal gain
2. Cabinet and Ministers have less time for policy matters
3. Lack of private sector opportunities stimulates capital outflow
4. Foreign borrowing adds to country's foreign exchange problems
5. Operating losses increase government budget deficit and debt
6. Required new investments are postponed; facilities deteriorate
7. Informal sector (black market) expands, loses tax revenues
8. Failure to face problems now, increases cost of correction later
9. Centralized economy makes political democracy more fragile

III. DEFINITION AND GUIDING PRINCIPLES

A. Definition of privatization

1. Transfer of govt entities/functions/activities to private sector
2. An ongoing process, not a single event or happening
3. It can include any of the following:
   a. Deregulation/liberalization/commercialization
      i. Remove legal/other barriers to private competition
      ii. Eliminate special privileges (low interest, tax exempt.)
      iii. Establish user fees
   b. Leasing, contracting out or franchising facilities/services
      i. Production of product or service
      ii. Distribution of product or service
      iii. Both of the above
   c. Partial privatization
      i. Joint ventures
      ii. Partial stock offering
      iii. Load-shedding: Spin off functions/activities, or withdraw
   d. Complete disengagement
      i. Divestiture/sale/disinvestment of the enterprise
      ii. Liquidation/sale of assets
   e. NOTE: Steps (a) and (b) can be designed to lead to (c) or (d)

B. Privatization is a political process

1. It only happens to have economic/financial implications
2. Key decision makers are usually politically accountable
3. Rule #1 in politics is survival

C. Privatization requires genuine commitment from the top

1. Both the power and the will to implement

2. Clearly enunciated policy, objectives and selection criteria
3. Willingness to disclose SOE financial performance and true value
4. Open decisions, openly arrived at

D. Need a clear plan

1. Ad-hocracy only helps the bureaucracy

E. Need an independent staff/task force assigned to privatization

1. Direct access to the highest possible level in the government
2. Authority to resolve disputes, make things happen

F. Early visible success is essential

1. Must demonstrate that good things happen when you privatize

IV. POLICY DIALOGUE AND POLICY CHANGE

A. Analyze the policy environment

1. Host government:
   - a. Top-level commitment to privatization? (Enunciated policy?)
   - b. Accessibility for dialogue?
   - c. Government's power to implement new/existing policies?
   - d. Rule-making mechanisms--parliamentary/executive/administrative?
   - e. Private sector influence on government policy decisions?
   - f. Willingness to disclose accurate SOE operating costs?
   - g. Civil servant compensation/reward system - official/unofficial?
2. Political/economic environment:
   - a. Legal barriers to privatization?
   - b. Economic stability?
   - c. Political stability?
   - d. Ethnic minorities?
   - e. SOE share of the economy? (Reasons for SOE's?)
3. Business climate:
   - a. Regulatory constraints on private industry/services/agriculture?
   - b. Tax climate - theory vs. practice?
   - c. Extent of the informal economy?
   - d. Management entrepreneur pool? (Accounting/audit skills?)
   - e. SOE preferences - obstacles to competitors?
   - f. Other donor presence/support?
4. Financial markets:
   - a. Long-term financing - types/activity level?
   - b. Financial markets - types/activity level?
   - c. Significance of non-bank financial institutions?

d. Availability of entrepreneurial capital?

e. Foreign investor interest/restrictions?

f. Capital flows in/out of the country - trends?

B. Evaluate potential for employee ownership/participation

1. Identify any experience in the private sector already
2. Identify pension or other funds which could be tapped
3. Identify potential supporters/champions
4. Evaluate political value of active ESOP ingredient
5. Identify legal or tax regs which would help or hinder

C. Develop a priority list of legal/policy changes needed

1. To legalize privatization
2. To simplify the private sector regulatory environment
3. To remove competitive advantages from state enterprises
4. To remove subsidies/protection/foreign exchange controls
5. To improve availability of credit
6. To facilitate employee participation opportunities

V. PUBLIC AWARENESS AND UNDERSTANDING--SUPPORT CONSTITUENCIES

A. Identify critical issues and proposals to deal with them

1. Beliefs that economy will grow enough without privatization
2. Excess staffing--loss of jobs, income, fees
3. Excessive debt burdens
4. Bureaucratic resistance--loss of power/prestige/influence
5. Too many "cronies" and under-the-table "kickbacks
6. Shortage of local managers/entrepreneurs
7. Overvaluations--public perceptions vs. market realities
8. Poor image of the private sector (rich getting richer)
9. "Unacceptable buyers" for political reasons
10. Reluctance to shift from public monopoly to private monopoly
11. Desire to protect the people's patrimony--national security
12. Potential for buyer malfeasance

B. Analyze perceptions, motives, reward systems of affected parties

1. Senior government ministers
2. Government civil service
3. Military
4. Managers/employees of state-owned enterprises
5. Labor unions
6. Political parties/legislators
7. Financial institutions/lenders/investors
8. Private sector business leaders
9. General public--consumers/taxpayers/voters
10. Media
11. Academia - intellectuals - students
12. Other national and international aid donors

C. Develop privatization support groups/coalitions

1. Business leaders, chambers of commerce, trade associations
2. Academic research papers on SOE's

D. Develop a public policy paper to support privatization

1. Benefits of transfer to the private sector
2. Future costs if govt doesn't privatize--savings if it does
3. Potential revenues to the government from privatized firms
4. Potential for economic growth thru private sector vs. govt
5. Reassurances to workers whose jobs are threatened

E. Use a variety of tools for ongoing dialogue

1. Survey public perceptions/attitudes at regular intervals
2. Consult with union leaders
3. Identify and work with local privatization champions
4. Hold one-on-one discussions with key decision makers
5. Train leaders for discussion groups within SOE's
6. Sponsor dialogue between government and private sector
7. Provide background briefings for the press
8. Write speeches and magazine articles
9. Participate in radio talk shows
10. Develop and promote employee stock ownership plans

VI. PREPARATION OF A COUNTRY PRIVATIZATION PLAN/STRATEGY

A. Establish legislative and organizational framework

1. Establish organizational responsibility and authority
   a. Establish a high level privatization task force
   b. Designate authority to approve initial "valuation"
   c. Designate authority to approve buyer & final terms of sale
   d. Establish responsibility for expanding equity ownership
   e. Consider special training for privatization staff
2. Require full disclosure of SOE financial viability/results

B. Establish relative importance of privatization objectives

1. Reduce financial drain on govt--generate new revenue sources
2. Unlock capital frozen in unproductive government investments
3. Reduce the role of the state in commerce/industry/agriculture
4. Generate domestic/international business confidence
5. Attract back domestic capital from overseas
6. Attract foreign capital investment
7. Expand domestic equity ownership--create new shareholders
8. Stimulate growth of local capital markets--create capital
9. Convert foreign debt into investment--thru debt-equity swaps
10. Remove govt interference in operating decisions
11. Free govt officials to focus on policy instead of operations
12. Create growth-oriented jobs instead of "make-work" jobs
13. Improve customer service/satisfaction
14. Improve decisions on allocations of human/capital resources

C. Select from the criteria below to establish a ranking system

1. Estimated investor interest, based on:

   a. Enterprise profitability and future prospects

   b. Existing management capability

   c. Government willingness to accept market valuation

   d. Confidence in accuracy/completeness of financial records

   e. Potential investors identified or identifiable

2. Extent of serious impediments, such as:

   a. Legal obstacles

   b. Problems with other stockholders

   c. Political/special interest opposition

   d. Excessive debt overhang

   e. Number of excess employees

3. Degree of political acceptability/visibility:

   a. Presence of actual/potential private sector suppliers

   b. Opportunity to improve customer service/satisfaction

   c. Potential for employee ownership

   d. Potential for broad local stock distribution

   e. Absence of national security/"national pride" repercussions

4. Potential to impact favorably on government/economy, through:

   a. Reduction in loan guaranties/budget deficit

   b. Reduction in operating problems at the Cabinet level

   c. Opportunity to demonstrate genuine commitment to privatization

   d. Opportunity to speed growth in priority sectors of economy

   e. Opportunity to attract international attention/foreign capital

D. Prepare an inventory of State-Owned Enterprises (SOE's)

1. Summarize basic data and financial highlights for each SOE
   a. (See illustrative one-page formats attached)
2. Analyze the reasons SOE's were created
   a. Define "strategic" and non-strategic
   b. List SOE's where original purpose no longer exists
3. Evaluate actual/potential domestic private sector suppliers
   a. List enterprises/activities with private sector alternatives
4. Evaluate potential buyers/investors

E. Select enterprises to privatize--near term and medium term

1. Use objectives and criteria above to create a selection ranking
2. Identify near-term and medium-term groupings
3. Emphasize early success in the eyes of the public
4. Priority where fair competition will exist after privatization

VII. DEVELOP IMPLEMENTATION PLANS FOR SPECIFIC ENTERPRISES

A. Establish a "reference price" valuation for near term SOE's

1. First establish an "As-is, Where-is" all-cash price
   a. Going-business vs. liquidation price
   b. Need public acceptance when market value less than book
2. Quantify special terms of sale which could increase price
3. Quantify special requirements/restrictions which reduce price
4. (See Consultant Memo #5)

B. Identify and deal with political issues for the enterprise

1. Policy dialogue within the enterprise
2. Provide for worker severance/security/retraining
3. Demonstrate benefits for those who stay
4. Develop support groups/coalitions
5. Convert losers to winners/create win-win situations
6. Reduce impact of government regulations on the enterprise

C. Initiate any essential restructuring prior to sale

1. Remove legal impediments (prior owner claims, other lawsuits)
2. Engage independent auditors to prepare financial statements
3. Commercialize as much as possible--establish legal structure
4. Remove excessive debt
5. Employee relocations or terminations if necessary
6. Remove non-contributing officials from board

D. Select privatization mechanism most appropriate for each SOE

1. Complete divestiture of the business entity
2. Partial divestiture (over 50%) - joint venture
3. Sell assets; retain liabilities
4. Sell off or withdraw from segments of an enterprise

5. Liquidation sale
6. Lease
7. Contract out/franchise services performed by SOE
8. Encourage private competitors
9. Remove all support--let it "wither away"
10. NOTE: Govt "golden share" can retain key policy controls

E. Look for ways to maximize employee participation opportunities

1. Loans to assist stock purchases--with changes in work rules
2. Equity distribution in exchange for reduced cash severance
3. ESOP version of debt-equity swaps--sell debt to worker trust
4. Provide for borrowing against future earnings

F. Develop a marketing plan for the enterprise

1. Analyze potential buyers/sources of capital/media to access
   a. SOE managements
   b. Employees
   c. Current shareholders
   d. Local capital markets
   e. Local investor groups
   f. Bank and non-bank financial institutions
   g. Investors/entrepreneurs in nearby countries
   h. Other foreign investors/entrepreneurs
   i. Multinational corporations
   j. International donor organizations
2. Prepare summary data sheets and detailed prospectuses
3. Mail to industry trade groups/media/prospective buyers
4. Look for other "multipliers" who would know buyers
5. "Show-and-tell" exhibits/open house for investors

6. Video presentations for use by overseas embassies/consulates

G. Develop a negotiating strategy

1. Involvement of employees/unions/customers/creditors
2. Develop creative financing (retain meaningful buyer commitment)
3. Public stock offering
4. Public auction; solicit sealed bids
5. Direct negotiation with interested prospects

H. Provide for after-sale monitoring/assistance

1. Break external bureaucratic log jams/barriers to success
2. Safeguard public interest
3. Offer management training, investment promotion
4. Monitor performance
5. Modify national privatization policies as appropriate

GOFJ: 7/27/87

VIII. ATTACHMENTS

A. "Privatization Completed or Underway" (Ref: Section I.B3)

B. "Data Summaries for SOE's" (Ref: Section VI.D1)

C. "Valuation/Pricing of an Enterprise to Be Privatized" (VII.A4)

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MEMORANDUM FOR CONSULTANTS #9

August 11, 1987

Subject: PRIVATIZATION COMPLETED OR UNDERWAY

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1. One of the most frequently asked questions in planning for privatization in developing countries is, "who else is doing it?

2. The attached summary highlights some of the significant privatization activities being planned or underway in developing countries, in many cases with the support and assistance of USAID Missions and the Center for Privatization.

Encl.

Privatizations Completed or Underway in Developing Countries

I. AFRICA

Congo	Under a World Bank/IMF sponsored economic reform program, the Congo government will privatize several large state-owned farms, an animal feed factory, a poultry plant, and cement, record, and textiles enterprises.
Gambia	In qualifying for US aid in 1985, the government agreed to privatize the rice trade and lift controls on rice prices. This along with other policy measures has allowed the rice market to flourish and has created an environment for further privatization efforts. The government is planning to sell a state-owned sawmill, and is also examining the possibilities of privatizing the Produce Marketing Board, the largest state-owned enterprise in the country.
Guinea/Conakry	The government plans to liquidate a fruit processing enterprise at the urging of the USAID mission. The World Bank reports that as a part of the overall structural readjustment, a total of 90 commercial, industrial and banking enterprises have already been liquidated or privatized, and approximately 80 additional commercial/ industrial enterprises will be privatized or liquidated.
Malawi	The government has decided to divest the assets and holdings of the Agricultural Development and Marketing Corporation, one of 3 major state-owned enterprises in the country.
Nigeria	In April 1985 the Federal Military Government announced that it would liquidate all the major export market boards in the country. As a result of their liquidation, prices and production increased and private entrepreneurs were encouraged to enter the market. In addition, a government-owned agribusiness conglomerate was partially liquidated and sold to the private sector. Several other agribusiness enterprises were

either liquidated and or sold by many of the 19 states. Plans are underway to sell a series of state owned hotels to the private sector and several private investment banks are now preparing prospectuses.

Senegal — The government has liquidated two agricultural enterprises with assistance from USAID; while the World Bank reported the sale of six agribusiness and manufacturing enterprises (textiles, water wells, farm implements, petrochemical distribution, and tuna/tomato canning) to the private sector, as well as the liquidation of two additional state-owned agribusiness enterprises.

Togo — The government launched its privatization program with the highly publicized lease of a shut-down steel mill on terms that were very profitable for the lessee. This has attracted considerable attention from foreign investors in other Togo investments. Since the initial leasing, Togo has privatized ten more companies and liquidated eight.

II. ASIA & NEAR EAST

Bangladesh — The government undertook an ambitious privatization program, selling off numerous industrial enterprises (jute, steel, chemical, etc.). The USAID mission supported a comprehensive post-privatization study to identify "lessons" from Bangladesh's experience.

Jordan — The government has commissioned a study to determine the feasibility of privatizing the bus system. Also under study is the sale of the Royal Jordian Airlines.

Philippines — An Assets Privatization Trust has been established under President Aquino. The privatization of sections of the National Food Authority is underway.

Malaysia	The government's first privatized property, the Klang Container Terminal, will be floated on the public market in 1989. The government also plans to privatize four additional port services (the conventional cargo, dry bulk terminals, stevedoring and marine services). A bill to provide for privatizing of the Malaysian Railway has been passed and a feasibility study for privatization of the postal service is being conducted.
Sri Lanka	The Parliament has enacted legislation that paves the way for privatization. Initial plans to privatize a food extraction plant are underway. There is significant interest in studying the possibility of privatizing telecommunications in the country.
Thailand	The number of state enterprises has been reduced from 105 to 65 since 1962. Recent divestitures include a marble plant, a jute mill, a hotel and a paper mill. Current National Plan calls for more privatization.
Turkey	The Turkish government with assistance from the World Bank and the IMF has developed a Privatization Master Plan. In 1984, the government offered "revenue sharing certificates" for the Bosphorous Bridge and the Kaban Dam, selling-out in under three hours to over 15,000 investors. The government has established a full time privatization staff and has undertaken a series of measures to improve the overall climate for private investment. The government's primary emphasis is on share offerings in expanding capital markets.

III. LATIN AMERICA & THE CARIBBEAN

Belize	USAID assisted the government in divesting the banana marketing board, involving the sale of state plantations to private growers and a management reorganization of the banana marketing board. The government, also with the assistance of USAID, has partially divested a state meat-processing facility and contracted out its management.
Chile	The Pinochet government's "popular capitalism" privatization was set back by economic collapse in the early 80's. It became active again in 1985 with privatizations, both full and partial, in a broad range of state-owned enterprises, including electric utilities, telecommunications, steel, nitrates and banking. Workers now own 100% of two firms and shares in seven others.
Costa Rica	The government sold its aluminum plant and other holdings of CODESSA to a USAID mission trust which is offering the operations to the private sector.
Grenada	The government, with the assistance of AID, has proposed the privatization of two state-owned banks, and is studying the possibility of privatizing the electric company.
Honduras	Legislation was passed (12/85) allowing the privatization of the government development bank's portfolio of sixty companies and other state-owned enterprises. USAID is assisting a top level Privatization Commission in privatizing a paper mill, a foundry, a food processing plant, a dairy products company, sawmills, hotels, sugar mills and others. One sawmill was leased in 1986.
Jamaica	USAID assisted in the lease of hotels in 1985. The government then sold much of its stake in the National Commercial Bank in 1986 shifting the majority of stock-holdings to private sector. It plans to sell its remaining shares in the coming years. It is scheduled to sell the hotels and a state-owned cement plan in the summer of 1987.

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MEMORANDUM FOR CONSULTANTS #8

August 10, 1987

Subject: Data Summaries for S.O.E.'s

1. It is desirable whenever possible to use a standard CFP format to summarize available data on State-Owned Enterprises with which we are involved.

2. Attached are two illustrative tables for use by CFP consultants:

a) Enterprise Data Summary

b) Financial Highlights

3. These two data sheets are intended for use as early as possible in a project, and, with appropriate modifications, may also serve as useful summary sheets for circulation to potential investors.

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ENTERPRISE DATA SUMMARY

Organization Name:

Type of Business

Location:

Year Founded:	Annual Sales: $
Ownership:	Operating Profit: $
Operating Status:	Net Worth: $
Number of Employees:	Estimated Market Value: $
Potential for Employee Ownership:	Accumulated Debt:

1. PRODUCTS/SERVICES:

2. FACILITIES:

3. HUMAN RESOURCES:

4. MARKET TRENDS:

5. COMPETITORS/MARKET SHARE:

6. LEGAL STATUS:

7. OTHER DATA:

SUBJECT OF SALE:

ESTIMATED SELLING PRICE:

FINANCIAL HIGHLIGHT

ORGANIZATION _____

	Current Year: (U.S.Dollar)*	Current Year: (Local Currency)*	Last Year: (Local Currency)*	Comments:
A. INCOME STATEMENT				
SALES/REVENUES				
COSTS				
DIRECT/VARIABLE				
INDIRECT OVERHEAD				
SUBTOTAL				
OPERATING PROFIT				
OTHER COSTS/INCOME				
FINANCE COSTS				
OTHER EXPENSES				
(OTHER INCOME)				
TAXES				
SUBTOTAL				
NET INCOME				
B. BALANCE SHEET				
CURRENT ASSETS				
RECEIVABLES				
INVENTORY				
TOTAL CURRENT ASSETS				
TOTAL CURRENT LIABILITIES				
NET WORKING CAPITAL				
FIXED ASSETS				
OTHER ASSETS				
LONG TERM LIABILITIES				
GOVERNMENT				
COMMERCIAL				
SUBTOTAL				
NET WORTH (BOOK VALUE)				

*all figures in thousands

AUDITED BY: _____ DATE OF LAST AUDIT: _____

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MEMORANDUM FOR CONSULTANTS #5

February 19, 1987

Subject: VALUATION AND PRICING OF AN ENTERPRISE TO BE PRIVATIZED

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1. INTRODUCTION

A. One of the recurring themes in any privatization assignment is the question of how to value an enterprise to be privatized. Valuation is a complex process by which we try to establish a price which a willing buyer would pay for an enterprise. It is a value which should be exclusive of any special concessions or warranties which the seller may be willing to make or require to sweeten the deal for the buyer or to protect against undesirable actions by the buyer after the sale is made.

B. Privatization is the process of putting politically acceptable buyers together with willing sellers. Governments must understand that you can't have sellers without willing buyers, and that there is often a large initial gap between the value perceived by the seller, mostly based on sunk historical costs, and the value perceived by the buyer, who has alternative opportunities to invest his time and money. Much can be done to generate and mobilize buyers, thus reducing this gap somewhat, but it must be dealt with early in the privatization process. The process of bringing the government and general public into the world of realistic market values is one of the real challenges in privatization in developing countries.

C. The process starts by determining a realistic initial market valuation for the enterprise to be privatized. In doing so it is important to recognize that the market valuation of an asset is in many ways dependent on the method of privatization used and the degree of political support built up during the process. Special concessions or required warranties can then be brought in either before determining an offering price, or during the negotiating process with prospective buyers to influence the price up or down from the initial valuation.

D. This memorandum offers a suggested process or checklist to go through in valuing an enterprise for privatization. It is based on a dialogue among active privatization practitioners in Washington, D.C. on December 10, 1986. A special Center Booklet contains four papers dealing with various aspects of valuation and illustrative techniques and formulas.

2. BE SURE THE GOVERNMENT'S OBJECTIVES ARE CLEARLY UNDERSTOOD

A. Are the Government's objectives in divestiture:

1. Cut losses -- stop a budget drain -- get rid of "white elephants"?

2. Raise capital -- convert assets into cash?

3. Broaden equity ownership?

4. Attract new capital?

5. Enlarge capital markets?

6. Improve the efficiency of the operation and thus create economic growth?

7. Reduce management distraction/workload or government staff?

B. Establish the relative importance of these objectives where there are more than one.

3. FOCUS FIRST ON THE VALUE OF THE ENTERPISE AS IS AND WHERE IS

A. Establish the liquidation value for the assets: Land, facilities, trade names, etc.

B. Look for any prio buy/sell transactions involving related or comparable businesses.

C. Establish its value as a going business -- i.e. market value, based on value of future earnings. (See additional steps below.)

D. Prepare an accurate balance sheet showing all assets, liabilities and contingent liabilities.

E. Prepare a profit and loss statement and a cash flow analysis for the past 2 - 5 years.

F. Review market trends and competition.

G. Prepare a 3-year sales/expense/income/cash flow forecast. (Be sure to define the various assumptions on which the forecast is based.)

H. Define special political/external risks which could impact the business but are outside the control of owners/investors/management.

I. Establish acceptable pay-back time frames for different investors - e.g. acceptable rates of return necessary to attract investment. (Need to define future inflation and interest rate assumptions).

J. Are there any special protective policies of the Government which are essential to support this "as-is, where-is" valuation? (e.g. price controls, foreign exchange regulations/allocations, import duties or quotas etc.)

K. What would be the value of the business if it sells assets only, instead of existing or contingent liabilities?

L. Will potential sources of required future credit concur in our valuation?

M. How large is the gap between book value and market value? What kind of an "education" program is required for Government officials, media or the general public to accept the realistic market value?

4. IDENTIFY VARIABLES WHICH COULD INCREASE THE SELLING PRICE

A. Make a list of government policies, restrictions, exceptions or other special treatment which have helped protect the enterprise from outside competition.

1. Should the Government commit to maintain any of these? How long?

2. What are the commitments worth to the buyer?

B. How would the price change if the Government offers extended financing terms with below-market interest rates? For what purposes? (We should not encourage Government lending for operating expenses to carry the enterprise under private ownership -- the new owners must become genuine stockholders in the future success of the enterprise.)

C. Should the Government restructure, reorganize, or split the enterprise into separate entities to increase the selling price?

D. How much should the price change if the Government cancels debt where it is the holder of debt? Or offers contingent repayment terms?

E. How much would the price change if the Government agrees to terminate all employees and allows the new owners to pick and choose? How much if the Government agrees to absorb all employee termination payments incurred during the first year or first six months?

F. Would an allowance for the purchase of political risk insurance against renationalization increase the selling price more than the cost of the premium?

G. Can the Government reduce the political risk of privatization, and thus increase the market value, by adopting a policy of wide ownership of the privatized enterprise?

5. IDENTIFY BUYER RESTRICTIONS/OBLIGATIONS WHICH WOULD REQUIRE REDUCTIONS IN SELLING PRICE?

A. Any requirements to keep the business going? e.g. restrictions against selling and moving the facilities elsewhere?

B. Any requirements to retain certain management or employees?

C. Any requirements to continue certain unprofitable lines? e.g. bus routes, telephone services, or other "public good" objectives?

D. Are there any restrictions on eligible buyers-- e.g. foreign nationals, indigenous ethnic groups?

E. Are there any restrictions on ability to repatriate capital or pay dividends?

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