PN ABW-284

Deloitte Touche Tohmatsu

Bosnia Privatization Training Seminar

Course Materials (English)

Delivery Order No. 39

Contract No. EUR-0014-I-00-1056-00
Eastern Europe Enterprise Restructuring and Privatization Project

USAID

U.S. Agency for International Development
EUR/ENI

April 28, 1995

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May 12, 1995

Mr. Mark Abramovitz
USAID - ENI/PER/ER
1800 North Kent Street
Room 3203, SA-15
Rosslyn, VA 20523

Re: Contract No. EUR-0014-I-00-1056-00, Delivery Order No. 39, Bosnia Privatization Training Seminar - Course Materials (English)

Dear Mark:

In accordance with Article IV of the above-referenced delivery order, we are pleased to submit the English-language version of the Course Materials prepared for the Bosnia Privatization Training Seminar (PTS) held in Prague in March 1995. The Serbo-Croat (Bosnian) language version is being submitted under separate cover. While developed specifically for presentation to the delegation from the Republic and Federation of Bosnia-Herzegovina, these materials provide a solid foundation for discussing the principal elements of privatization.

These deliverables were prepared for USAID by Deloitte & Touche. If you have any questions concerning these deliverables, please call me at (202) 879-5650.

Sincerely,

Adrienne Brombaugh

Deloitte Touche
Tohmatsu
International

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* No slide materials were used in conjunction with presentations on Day 7.

Privatization Seminar

Day 1: Privatisation and Economic Transformation

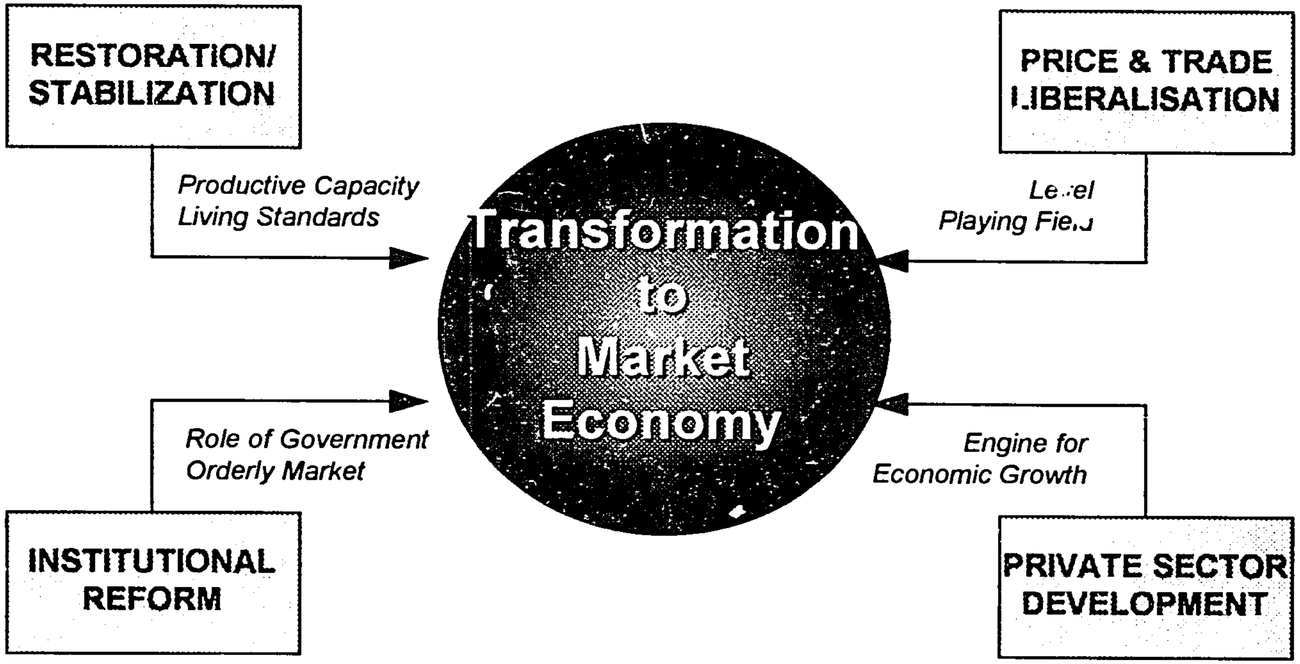
Contents:

- **Privatisation and Economic Transformation**
- **Review of the Basic Background Document for Enterprise Privatisation**
- **Analysis of the Basic Background Document**

Privatisation and Economic Transformation

Privatisation - A Part of the Transformation to Market Economy

Major Aspects of the Transformation to Market Economy:



Development of private-sector-dominated economy includes

Private sector initiatives - domestic and foreign

Privatisation of social capital in small enterprises

Privatisation of social capital in large enterprises

Restitution

Economic Transformation - A Question of Timing

TIME

War Time — **Post-War** — **Complete Transformation**

RESTORATION AND STABILIZATION

Normalise Viable Production **Restore Standards of living**
Prioritise Uses of Foreign Aids **Control Inflation** **Rebuild Infrastructure**

PRICE AND TRADE LIBERALISATION

Food Stuffs **Industrial Products** **Utilities**
Consumer Products **Luxury Goods**

INSTITUTIONAL REFORM

Legal framework for market economy **Banking Reform** **Currency Convertibility**
New Laws introduction **Investment Incentives**

PRIVATE SECTOR DEVELOPMENT

Private Investments **Restitution**
Small-Scale privatisation **Large-Scale Privatisation**

The timing and order of implementing the various aspects of economic transformation are as important as the soundness of the programs.

Lessons Learned from the Other Eastern European Countries

"Those countries that pressed ahead more radically on all four aspects have been rewarded not only with relatively rapid movements towards a market economy, but also, in most cases, by more modest falls or earlier recovery in output."
EBRD Transition Report 10/94

Underlying reasons:

- Early and and visible changes were needed to make the shift to market economy credible.
- Early liberalisation forced state enterprises to be more efficient.
- Early liberalisation also created the environment needed for the growth of efficient private business.

Lessons Learned from the Other Eastern European Countries

"Emergence of a new and dynamic private sector is more important than privatisation of the old state enterprises, so long as the latter are forced to adapt by tough fiscal discipline and price liberalisation." *Financial Times 7.3.95*

Underlying reasons:

- Liberalisation allowed private start-ups to emerge as competitors to the state enterprises and to compete under the rules of the market.
- Lack of competition from the private sector and continuation of subsidies to state-enterprises provided no incentives to restructure for survival in a market economy.
- Continuation of subsidies to state-enterprises pushed up inflation and played a major role in currency devaluation.

Lessons Learned from The Taiwan Experience

Key Policies

Land Reform -1949 to 1959:

- Implemented land reform to give incentives to farmers to produce more food in a more efficient manner.

Foreign Currency Reform -1958:

- Adopted a unitary FX rate and depreciated currency to a realistic level

Investment Encouragement -1960:

- Allowed a five-year tax holiday for selected industries and increased availability of industrial land.

Export Processing Zone (EPZ) -1966:

- Established the first EPZ in the world to reduce governmental red tapes on export related manufacturing.

Science and Technology Development -1970's:

- Established research institutes and science-based technology park.

Results

- Resulted in an ample supply of food and increased farm income but also a surplus for investment in both agriculture and industry.
- Encouraged domestic businesses to be more export-oriented.
- Increased private investments in selected industry clusters thus increasing the international competitiveness of such sectors.
- Attracted 128 firms, included numerous foreign firms, within 2 years. 2 more EPZ's were opened in 1971. Today, the 3 zones employ more than 65,000 people and export more than US$5 billion a year.
- Help develop technologies, especially for small to medium-sized companies and attracted high-tech investment. Thus allowed Taiwan to diversify from labor-intensive industries to knowledge-intensive industries.

The Philosophy of Policy-Making - *Kwoh-Ting Li, Former Economic Minister of Taiwan*

Respect for the Free-Market System. - "The emphasis on private initiative and free-market principles are of vital importance to all developing countries in the world today. Many less-developed countries failed in their development efforts because their governments assumed too many obligations for too long. Also their economic development policies were more often guided by administrative controls than by market forces."

Pragmatism - "The essence of pragmatism is resolving problems quickly and efficiently as they arise, without the constraints of dogma or ideology."

Timing - "Right policy decisions must be made at the right time, and, as internal and external conditions change, so should government policies,"

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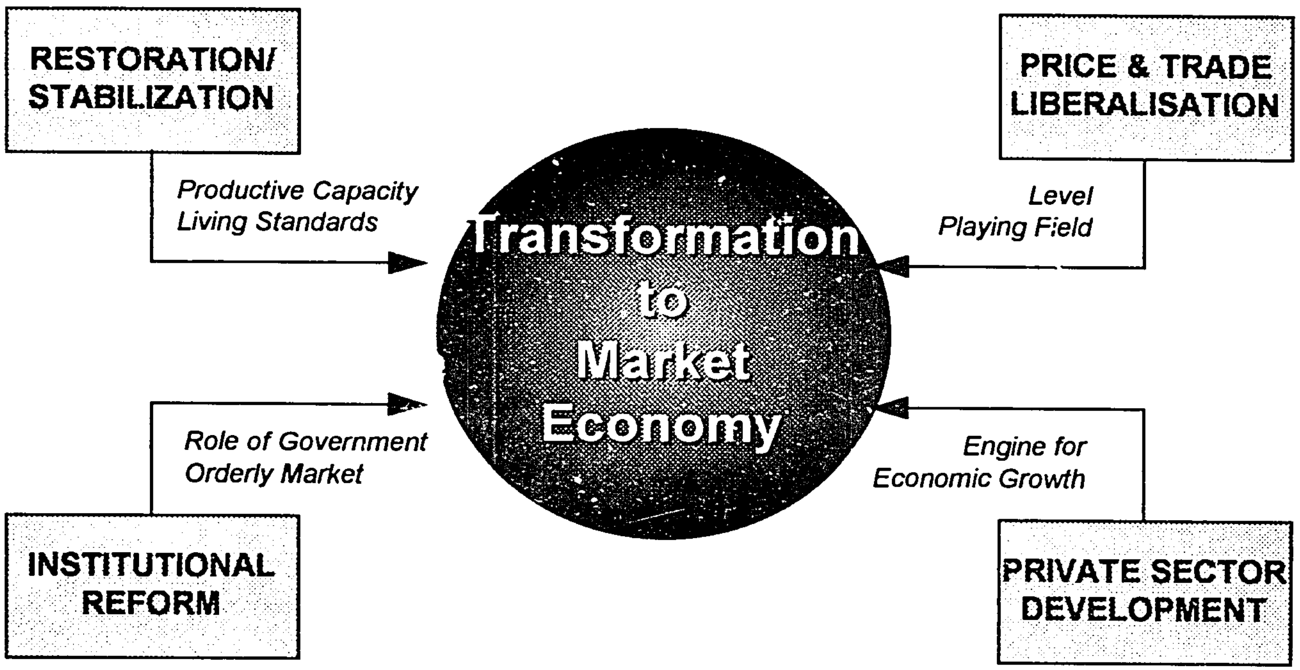
Major Question: Is there a consensus on how to prioritise the various aspects of the economic transformation?



A more fundamental question may be:

Is there a shared commitment to transform to a market economy?

Is the commitment strong enough to survive any "transition pains"?

Building Consensus on the Priority of Transformation Activities

For Each Aspect of the Transformation Process:

- Identify a list of activities to undertake or issues to be addressed through brainstorming exercise.
- Select those activities/issues which are considered significant by more than half of the group.
- Rank the selected items in terms of their urgency, i.e. requiring immediate attention, by using "Weighted Voting Technique".

Comparison of the Top Two or three Issues in Each Aspect with the other Top Issues:

- Establish the group's overall preferences among the top issues in the transformation process by using the "Paired Comparison" technique.

Group Discussion of the Above Outcomes

Weighted Voting Analysis -

- ☐ Restoration
- ☐ Instit. Reform
- ☐ Liberalisation
- ☐ Private Sector Growth

Participant	Issue 1	Issue 2	Issue 3	Issue 4	Issue 5	Issue 6
Total Votes						

Number of votes per participant = 1 1/2 Times the number of Issues.
1 vote must be casted per Each Issue.

Paired Comparison -

	Issue 1	Issue 2	Issue 3	Issue 4	Issue 5	Issue 6
Issue 1						
Issue 2						
Issue 3						
Issue 4						
Issue 5						
Issue 6						
Vertical (Spaces)						
Horizontal (X's)						
Total						
Ranking						

Instructions:

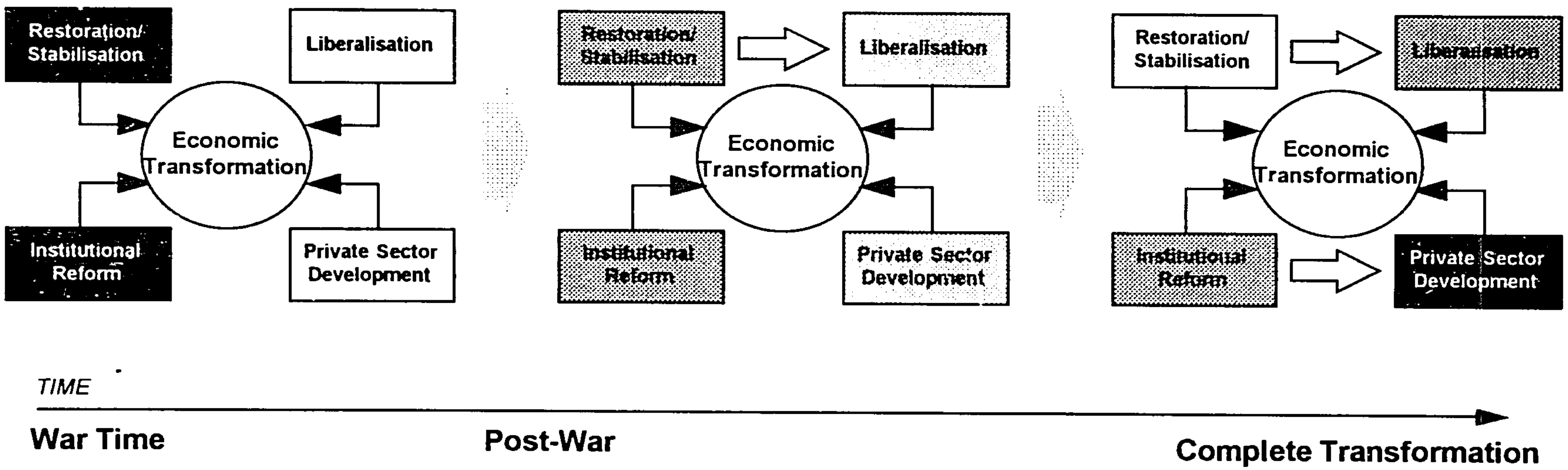
1. Evaluate 1. against 2. If more important, place "X" in box under #2; if less important, leave blank. Repeat with each remaining number. (Work only within the triangle of white boxes.) Continue to next line; repeat.
2. Add up the "X's" across for each number; enter in Horizontal box at bottom. Add up the blank "spaces" down for each number; enter in Vertical box at bottom. Add both Horizontal and Vertical for Total.
3. Largest number under Total will be #1 in Ranking; next largest will be #2. If two or more issues have the same Total, Ranking is determined by comparing each subjectively against the others. (Normally, this will not happen unless there is an inconsistency in your analysis.)

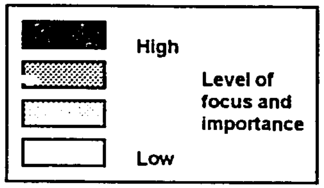
Consensus Building - Discussion of Results

- **Does the priority within each aspect of economic transformation appear to be reasonable?**
  - — Restoration and Stabilisation
  - — Price and Trade Liberalization
  - — Institutional Reform
  - — Private Sector Development
- **Does the overall ranking of issues across all aspects of economic transformation appear to be reasonable?**
- **Is there any disagreement?**
- **Are you prepare to support the above results?**
- **Have you given up the right to sit back and say, "I told you so."**

Translating Consensus into Actions - Changing Focus at the Right Time

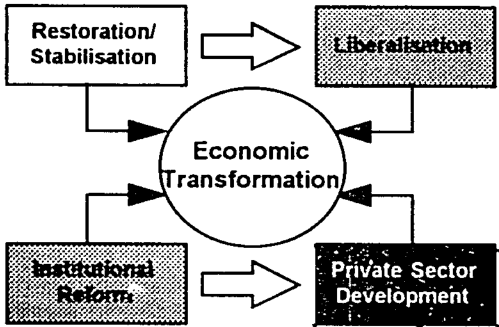
A Potential Scenario





Once the core team reaches a consensus on the priority of economic transformation activities, it is time to plan for detailed action steps.

Next Step: Focus on Privatisation



Review of the

Basic Background Document

for Enterprise Privatisation

and

Identification of Open Issues

Review of the Basic Background Document for Enterprise Privatisation

Purpose of this Review.......

- Agree what the current Proposal is.....
- Express the Proposal in a form that we can easily analyse
- **So we can clarify and expand the open issues and design a program for addressing them**

Privatisation Process Overview

Phase 1: Preliminary Work

Phase 2: Realisation

Privatisation Process Overview
Phase 1: Preliminary Work

Steps

1. **All enterprises prepare an Initial Balance Sheet**
2. **Enterprises with state/social capital transform their legal status**

Issues

Privatisation Process Overview
Phase 2: Realisation

Steps

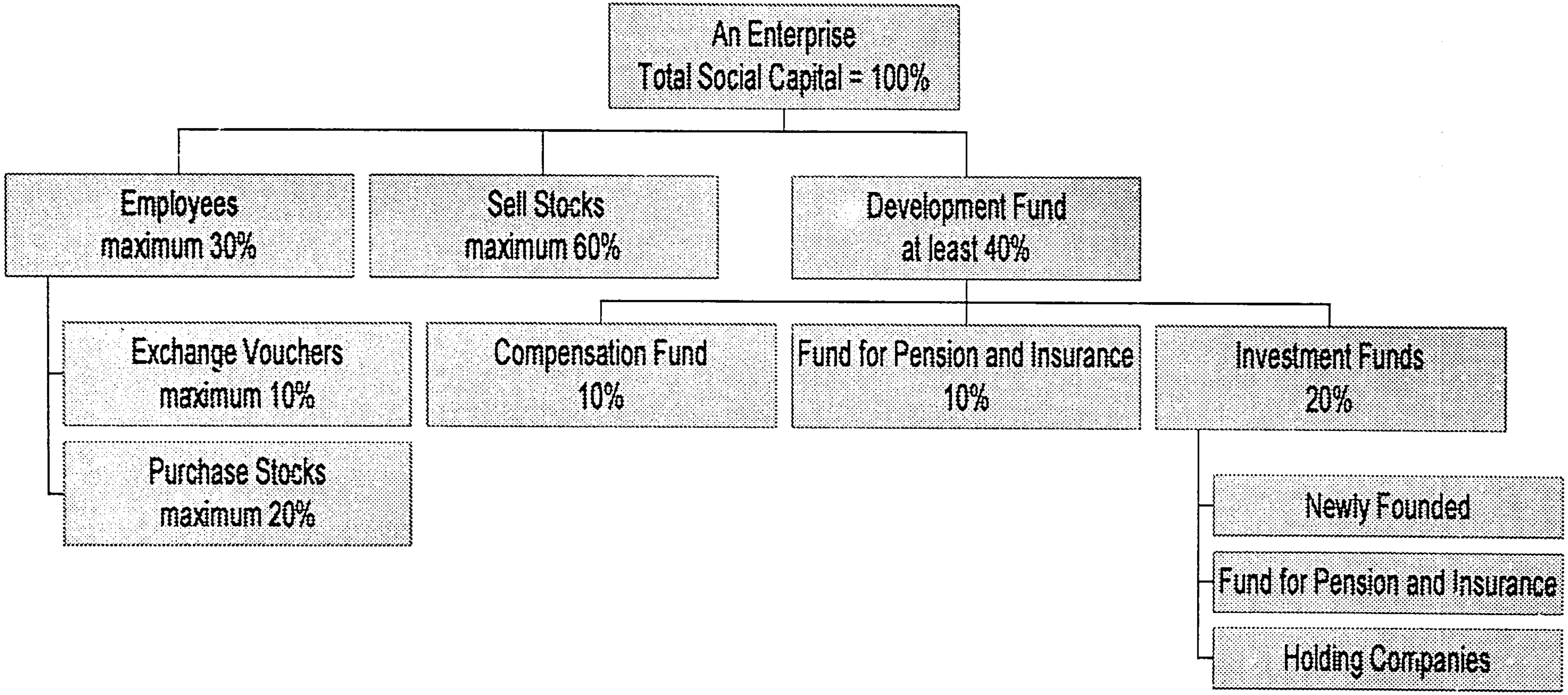
1. **Enterprise Prepares Privatisation Plan**
2. **Submits to Privatisation Agency for approval**
3. **Agency approval**
4. **Privatisation**
   - Large scale
   - Small Scale
   - Liquidation
   - Can include Restructuring
5. **Finalised at Court**

Issues

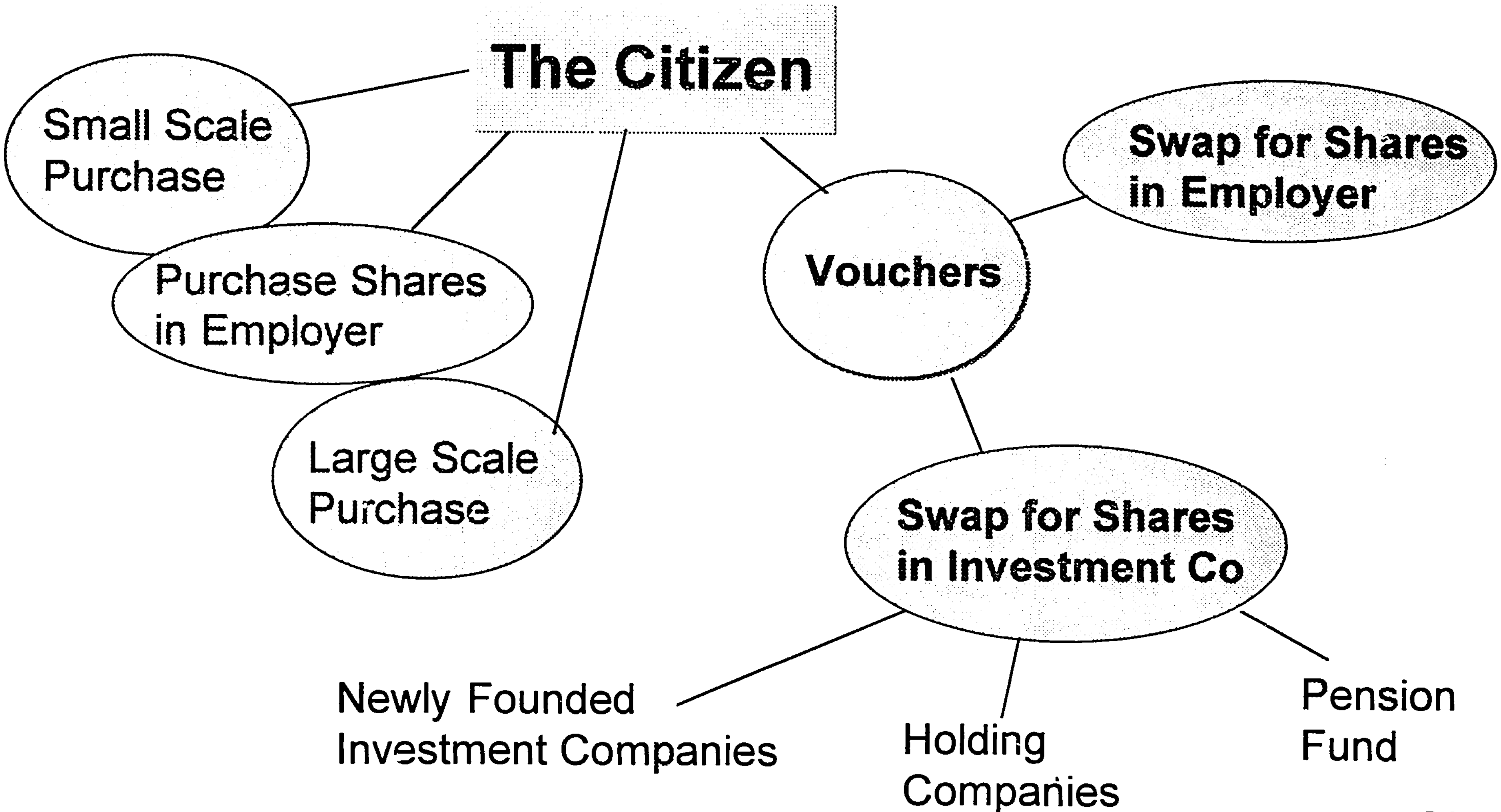
Privatisation Process: Small Scale Privatisation

Steps	Issues
1 Prepare Initial Balance Sheet 2 Enterprise suggests method of sale (auction or bidding) 3 Agency selects method of sale 4 Agency conducts sale 5 Open to foreign and domestic purchasers 6 Development Fund distributes part of proceeds to Compensation Fund and Pension and Insurance Fund	

Possible share purchasers via large scale privatisation



Privatisation from the citizen's perspective



Analysis of the Basic Background Document

Privatisation=Creating Private Ownership in Socially-owned Enterprises It changes the characteristics of an enterprise:

From	To
Free capital	Risk capital
Capital Availability based on political strengths	Capital Availability based on enterprise's performance
Worker self-management	Directed by owners of risk capital
Income allocation primarily based on input	Income allocation based on risks assumed by different stakeholders
Job security and social benefits are considered entitlement of the workers	Job security, wages and social benefits must be earned by the workers

Privatisation in the Republic/Federation of Bosnia and Herzegovina (RBH) Strategic Objective - Primary

"Achieve stronger economic efficiency in tandem with efficient changes in the managing structure of the enterprises"
Basic Background Document

Other Strategic Objectives:

Generate funds for the Government

Increase capital mobility

Attract foreign capital and know-how

Introduce modern technology

Reduce political influence on business enterprises

Compensate citizens for past services

Provide funding to social benefits funds

Privatisation in the Republic/Federation of Bosnia and Herzegovina (RBH) Process Criteria :

Pluralism	*Multiple alternatives*
Transparency	*Understandable alternatives by the public*
Tested	*Process based on certain practical experience*
Acceptability	*Socially acceptable solutions*
Phased Approach	*Continuous and gradual process*

"The privatisation process should balance speed with the level of proceeds, guaranteed improvements in efficiency and social justice" Basic Background Document

Privatisation in the Republic/Federation of Bosnia and Herzegovina (RBH) Perceived Obstacles:

Underdeveloped market economy

Lack of management knowledge

Incomplete legal system

Lack of capital

Current condition of socially-owned enterprises

Would the management efficiency be improved under the proposed ownership structure?

	Employees	Individuals	Investment Co.	Funds
Level of ownership				
Own capital at risk				
Ability to influence managers				
Management know-how				
Corporate Governance know-how				
Conflict of interest				
Sufficient time to govern				

Can the other privatisation objectives be achieved under the current plan?

Objective	Yes/No	If yes, provide the conditions that must exists. If no, suggest how and when it can be achieved.
Cash for Gov't		
Capital Mobility		
Foreign Capital		
Foreign Know-How		
Modern Technology		
Less Political Influence		
Reward for Service		
Funding Social Causes		

Can the obstacles be overcome under the current plan?

Objective	Yes/No	If yes, provide the conditions that must exists. If no, suggest how and when it can be achieved.
Under-developed market economy		
Lack of management know-how		
Lack of capital		
Incomplete legal system		
Current Condition of state enterprises		

Privatization Seminar

Day 2: General privatization concepts

Privatization Seminar

General Privatization Concepts

Module 1: Background

March 16, 1995

Components Of Effective Economic Transformation

Important for Immediate Impact on the Transformation Process:

- Regulatory and accounting reform
- Legal reform (bankruptcy law, commercial law, corporate law)
- Real property ownership reform
- Creation of taxation environment which stimulates investment
- Rapid restitution/compensation of property to original owners

Important for Continual, Long-Term Impact on the Transformation Process:

- Promotion of small business development
- Promotion of foreign investment
- Creation of capital market institutions
- Creation of rational trade policies
- ***Privatization of state-owned enterprises***

Why Privatize ?

- To create a layer of private ownership in the economy
- To decrease the government's burden for providing services to the community
- To provide enhanced access to capital, technology, managerial expertise, know-how
- To provide a source of government revenue
- To put the responsibility of management into the hands of the best managers
- To create profit incentive

Why Isn't Government A Good Business Manager?

Because it has trouble providing:

- Expert management of a company
- Access to capital
- Access to technology
- Protection of assets
- Supervision
- Motivation

Privatization: An International Trend

- Current privatization efforts around the world

  A. France
  B. England
  C. The United States
  D. Other (Germany, Italy)

- Anticipation of significant privatization growth in the coming years within "developed" nations

  A. Public utilities and services (postal service, ambulance service, trash collection, water, electricity, etc.)
  B. Public highways and road systems
  C. National airlines, air traffic controllers
  D. Other

Privatization: A Regional Focus-*Slide 1*

◊ **Mass Privatization with Intermediaries (Poland)**

Emphasis is on decentralizing the privatization process

ADVANTAGES

- process is completed by professional fund managers,
- process, once started, is separated from government interference
- better corporate governance is more likely

DISADVANTAGES

- preparation is longer, start date is typically delayed
- fresh capital and technology injections are less likely
- new management is less likely

Note: Poland also conducted extensive sectoral studies on sensitive industries to prepare an "industrial policy". This resulted in the delay of privatization of these companies.

***Privatization: A Regional Focus**-Slide 2*

◊ **Centralized Privatization (Germany, Hungary)**

Emphasis is on the sale transaction

ADVANTAGES

- fresh capital, technology, and management is more likely
- maintains greatest control over process and timing
- preparation is typically very quick
- the concept of value is more widely understood

DISADVANTAGES

- process, once started, is typically slower
- potential for government interference in the valuation process
- financial support from government of non-viable companies, pending privatization, is typical
- identification of ultimate owners is delayed

***Privatization: A Regional Focus**-Slide 3*

◊ **Distribution or Voucher Privatization (Czech Republic, Russia)**

Emphasis on inclusion and fairness

ADVANTAGES

- spontaneous, widespread private ownership
- includes citizens in the privatization process
- excludes the government from management of the companies
- imposes responsibility for individual company privatization strategy on the stakeholders of that company

DISADVANTAGES

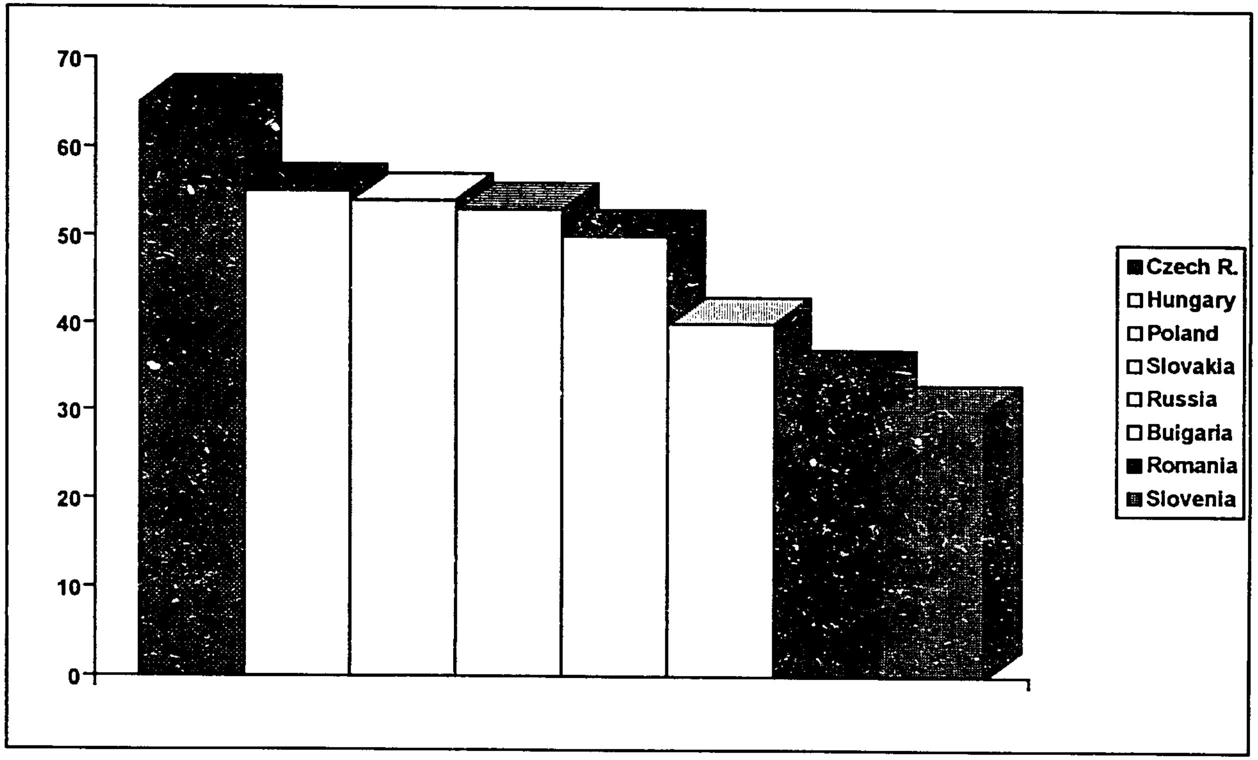
- inexperienced owners
- proceeds to the State are low in short-term
- weak corporate governance
- fresh capital and technology injections are less likely

***Privatization: A Regional Focus**-Slide 4*

Conclusions?

Which approach produces the best result is up for debate. Perhaps the best approach is a combination of the above..........

A Comparison of Regional GDP Figures: What Per Centage of GDP is Generated by Private Entities?



Competing Issues of Privatization

Needs of the Company

- Desire to maintain control over destiny
- Reduce employment levels
- Improve and streamline operations
- Sell off excess assets/reduce debt
- Remain competitive
- Attract outside capital, skills, markets

Versus...

Needs of the State

- Need for increased revenue
- Need for cash
- Protect strategic industries
- Favor domestic buyers
- Avoid selling out cheap to foreigners
- Demonstrate fairness
- Need for political approval
- Protect jobs and employees

Privatization Seminar

General Privatization Concepts

Module 2: The Privatization Process

March 16, 1995

THE STEPS OF PRIVATIZATION-*Slide 1*

1. **Establish main privatization approach** (mass privatization with intermediaries, centralized privatization, voucher privatization, etc.).

   Note*: This decision must be based on, among other factors, the "philosophical" objectives of the country (e.g. inclusion, no giveaways, etc.).*

2. **Determine which companies will come under the privatization program and to which specific privatization program they belong** (construction of holding company portfolio).
   - "Quick" Privatization: quick sale of small/medium-sized entities
   - "Small" Privatization: quick sale of locally-controlled retail entities
   - "Deferred" Privatization: applicable for sectoral studies and companies subject to pre-privatization restructuring
   - "Main" Privatization: mass, centralized, or voucher privatization.

THE STEPS OF PRIVATIZATION*-Slide 2*

3. Establish appropriate privatization institutional framework (investment funds, holding companies/agencies, stock exchanges, ministry of privatization, etc.).

4. Proceed with corporatization (transform socialized enterprises into corporations with greater self-control, albeit under majority state ownership pending privatization).

Note*: This step is necessary to classify each entity in such a way that potential buyers understand what it is that they may, in fact, buy.*

5. Proceed with initial individual company privatization efforts (see flow diagram).

THE STEPS OF PRIVATIZATION-*Slide 3*

6. **Complete business valuation and share pricing** (Day 4).

7. **Prepare tender invitation** (Module 4).

8. **Proceed with offer evaluation** (Module 4).

9. **Negotiation of final terms**(Module 4).

10. **Award the sale and write contract** (Module 4).

11. **Payment, closing, and monitoring** (Module 4).

Breakout Slide 1: Management Develops Privatization Strategy

1. To whom should we sell?
- Strategic investor
  - Customer
  - Supplier
- Financial investor
- Domestic investor
- Foreign investor

2. What is our business?
- Ultimately requires preparation of a business plan

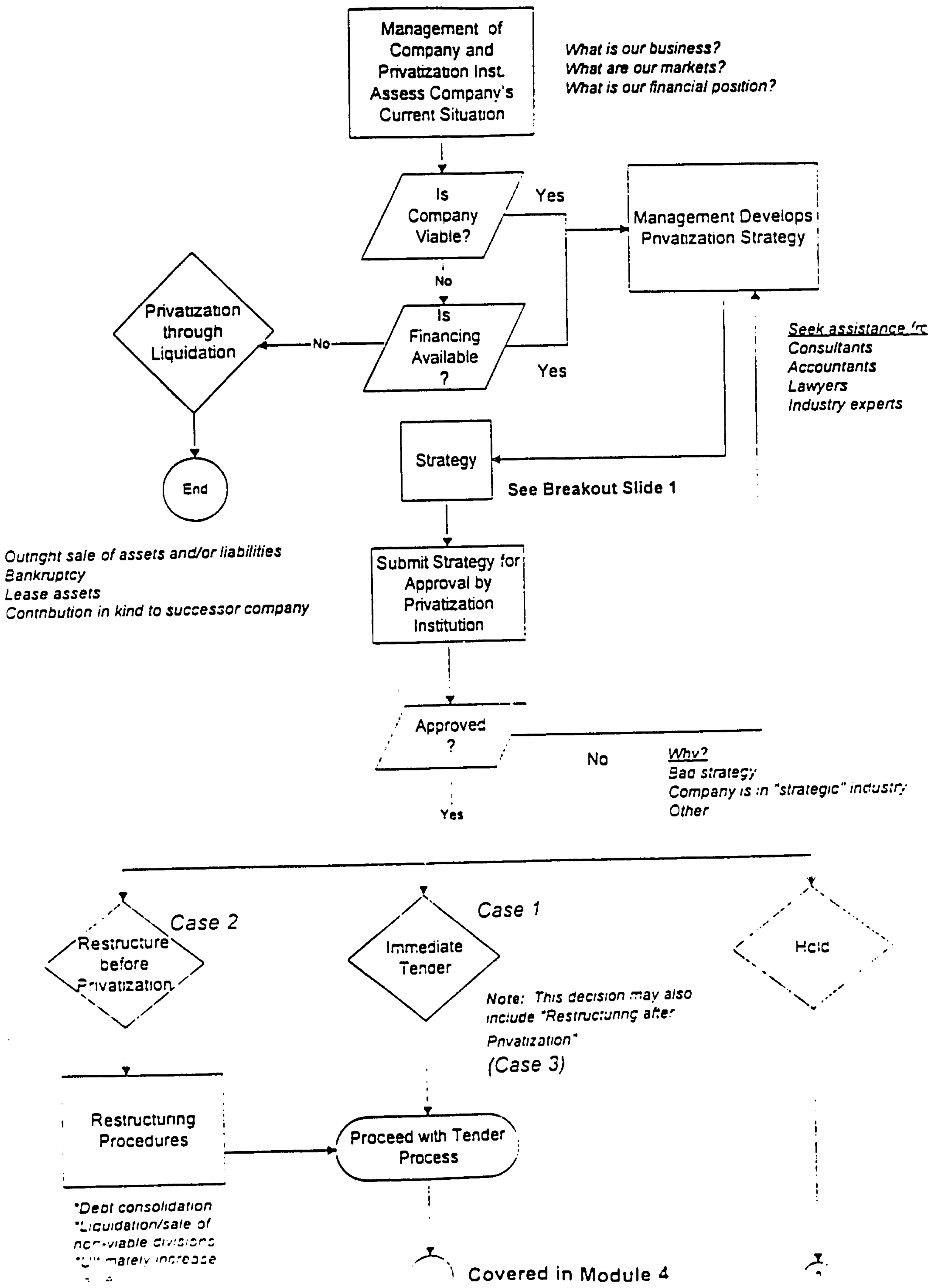
3. What is our business valuation?

4. What are the social consequences?

5. What are our capital, technology, and markets requirements?

6. What are our sale conditions?
- Capital injections
- Management assistance
- Maintenance of employment levels
- Access to specific new markets
- ESOP/MBO
- Asset management/Lease

Detailed Steps of Individual Company Privatization



Privatization Seminar

General Privatization Concepts

Module 3: Case 1
PRIVATISATION OF PROFITABLE COMPANY

March 16, 1995

CASE STUDY COMPANY 1

MAJOR HEAVY INDUSTRIAL MANUFACTURER

PRIVATISATION OF PROFITABLE COMPANY

INTRODUCTION

A STRATEGIC MANUFACTURER OF HEAVY INDUSTRIAL COMPONENTS TO THE ELECTRICITY AND COMMUNICATIONS MARKETS

<u>THE COMPANY</u>

SALES:	$110 MILLION
EMPLOYEES:	2,600 PEOPLE
EXPORTS:	26% OF SALES
LOCATIONS:	FIVE FACTORIES IN FOUR CITIES
CUSTOMERS	ELECTRICITY, TELEPHONE AND RAILWAY COMPANIES

FINANCIAL SUMMARY

OPERATING DATA

(USD MILLION)

	1989	1990	1991	1992	1993
SALES	109.2	99.8	109.1	105.7	98.5
GROSS PROFIT	4.5	1.6	3.3	6.1	4.4
GROSS PROFIT MARGIN	4.1%	1.6%	2.7%	5.7%	4.5%
EMPLOYEES	3,078	3,003	2,646	2,404	2,231

- REAL SALES DECLINING
- VARIABLE MARGINS

CHARACTERISTICS OF THE COMPANY

- LONG OPERATING HISTORY WITH STRATEGIC MARKET POSITION WITHIN ITS INDUSTRY
- CAPITAL-INTENSIVE BUSINESS, REQUIRING SIGNIFICANT CAPITAL INJECTION FOR MODERNISATION AND NEW TECHNOLOGY
- CAPABLE MANAGEMENT WARY OF THE BENEFITS TO BE GAINED FROM PRIVATISATION
- MULTIPLE LOCATIONS, SOME IN ECONOMICALLY DISADVANTAGED CITIES
- GLOBAL INTEREST IN INDUSTRY - TIMING WAS CORRECT

Pgj5

PRIVATISATION STEPS

1993 JUNE	COMPANY TRANSFORMED FROM STATE ENTERPRISE INTO SHAREHOLDING COMPANY
1993 SEPT	ONE-ROUND OPEN TENDER ISSUED WITH 45 DAY PERIOD
	COMPANY EVALUATED BY FOREIGN BIDDERS DURING TENDER PERIOD
1993 OCT	WINNER ANNOUNCED
1993 DEC	PURCHASE CONTRACT SIGNED

ISSUES - SELLER'S OBJECTIVES

WARRANTIES	NO WARRANTIES - OPERATING, TAX, ENVIRONMENT
EMPLOYMENT	EMPLOYMENT GUARANTEES WITH PENALTIES FOR NON-COMPLIANCE
FOLLOW-THROUGH	IMPLEMENTATION OF BUSINESS-PLAN, INCLUDING CAPITAL AND TECHNOLOGY INJECTIONS
OPERATIONS	CONTINUED OPERATION OF EXISTING PLANTS TO MINIMISE IMPACT ON DEPRESSED LOCAL ECONOMIES
TIMING	NEED TO CLOSE BEFORE YEAR-END IN ORDER TO USE TAX BENEFIT LEVERAGE

ISSUES - BUYERS' PERSPECTIVE

	POSITIVE	NEGATIVE
GENERAL	• DOMINANT MARKET POSITION • STRATEGIC INDUSTRY • AVAILABILITY OF TAX BENEFITS • ABLE TO OBTAIN MAJORITY CONTROL	• NEEDED CAPITAL INFUSION TO UPDATE EQUIPMENT • SHORT TENDER PERIOD REDUCED EVALUATION • CLOSING REQUIRED IN SHORT PERIOD TO OBTAIN TAX BENEFITS
TECHNICAL	• BROAD PRODUCT RANGE WITH HIGH QUALITY AND GOOD REPUTATION	• NO IAS AUDITED FINANCIALS • PROPERTY REGISTRATION ISSUES DUE TO RECENT TRANSFORMATION

THE NEGOTIATION PROCESS

PRIVATIZATION AGENCY ADVANTAGES:

- ATTRACTIVE BUSINESS
- ABILITY TO OFFER THE FOREIGN BUYER A 100% TAX HOLIDAY IF CLOSING OCCURED BY YEAR-END

PRIVATIZATION AGENCY DISADVANTAGES:

- FACED A SKILLED NEGOTIATING TEAM INCLUDING FORMER GOVERNMENT EMPLOYEES, ADVISORS AND LAWYERS

FOREIGN BUYER HAD INSIDER INFORMATION ABOUT THE COMPANY GAINED THROUGH PAST RELATIONSHIPS

CHARACTERISTICS OF WINNING BID

INITIAL PURCHASE OF SHARES	$40 MILLION
CAPITAL INJECTION	$20 MILLION CASH $20 MILLION IN KIND (EQUIPMENT AT MARKET VALUE)
OPTION SHARES	UP TO $20 MILLION
TOTAL INVESTMENT	$ 100 MILLION

BALANCE SHEET

(USD MILLION)

	12/31/1992	%
FIXED ASSETS	34.2	45%
INTANGIBLE ASSETS	1.1	1%
LAND AND BUILDINGS	10.6	14%
PLANT AND MACHINERY	13.5	18%
FINANCIAL INVESTMENTS	9.0	12%
CURRENT ASSETS	40.9	54%
INVENTORY	16.5	22%
ACCOUNTS RECEIVABLE	21.6	28%
SECURITIES	0.1	0.1%
CASH	2.8	4%
ACCRUED ASSETS	0.7	1%
TOTA ASSETS	**75.9**	**100%**

(USD MILLION)

	12/31/1992	%
EQUITY	38.4	51%
ISSUED CAPITAL	35.5	47%
ACCUMULATED PROFIT RESERVE	2.9	4%
BALANCE SHEET PROFIT	0.05	0.07%
PROVISIONS	0.8	1%
LONG-TERM LIABILITIES	2.4	3%
SHORT-TERM LIABILITIES	33.9	44%
ACCRUED EXPENSES	0.4	1%
TOTAL EQUITY AND LIABILITIES	**75.9**	**100%**

PROFIT AND LOSS ACCOUNT

(USD MILLION)

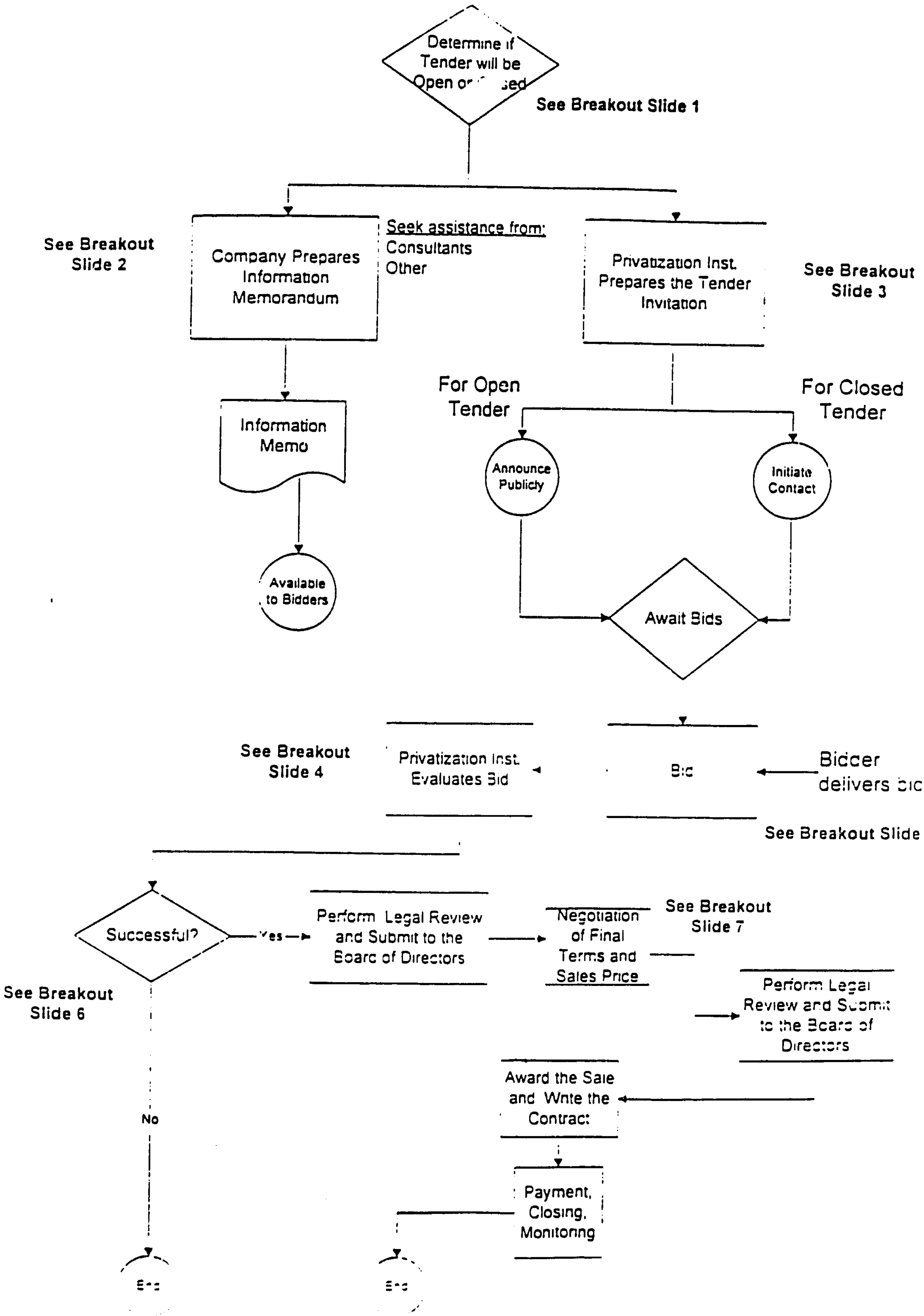
	12/31/1991	12/31/1992
SALES	105.7	98.5
DIRECT COSTS	72.9	67.6
INDIRECT COSTS	29.5	24.8
TRADING PROFIT	3.3	6.1
FINANCIAL PROFIT	-1.7	-6.4
EXTRAORDINARY PROFIT	0.2	0.5
PRE-TAX PROFIT	1.8	0.2

Privatization Seminar

General Privatization Concepts

Module 4: The Tender, Evaluation, and Offer

March 16, 1995



Determine if Tender will be Open or Closed
See Breakout Slide 1
See Breakout Slide 2
Company Prepares Information Memorandum
Seek assistance from:
Consultants
Other
Privatization Inst. Prepares the Tender Invitation
See Breakout Slide 3
Information Memo
Available to Bidders
For Open Tender
For Closed Tender
Announce Publicly
Initiate Contact
Await Bids
See Breakout Slide 4
Privatization Inst. Evaluates Bid
Bid
Bidder delivers bid
See Breakout Slide
Successful?
Yes
Perform Legal Review and Submit to the Board of Directors
Negotiation of Final Terms and Sales Price
See Breakout Slide 7
See Breakout Slide 6
Perform Legal Review and Submit to the Board of Directors
Award the Sale and Write the Contract
No
Payment, Closing, Monitoring
End
End

Breakout Slide 1: The Type of Tender

- *Privatization through tender is simply a publicized sale offer. The tender is for minority/majority of shares.*

Open	Closed
Seller does not specify investors who can participate	Only certain investors are allowed to submit bids
Appropriate when: • market for seller's industry is already diversified • assets offered for sale are not of strategic importance	Appropriate when: • trying to avoid selling to buyers who may gain monopoly position • trying to avoid hostile takeovers • assets offered for sale have strategic significance

Breakout Slide 2: The Information Memorandum

What is it?

An information memorandum contains a brief executive strategy outlining the company's business and strategy for sale. It also provides a detailed description of the company's operations, history, financial position, and markets.

Who prepares it?

Usually the company's management with the assistance of the privatization institution and consultants.

Who reads it?

The information memorandum is the subject of the <u>tender</u>, therefore its anticipated audience is any potential <u>bidder.</u>

Breakout Slide 3: Components of the Tender Invitation

- Invitation to potential bidders describing assets offered for sale (or asset management)
- Description of technical requirements of the bid
- Specification of time duration for which a bid must remain valid (bidder cannot withdraw the offer)
- Request for a deposit to confirm intention to bid (usually 1-5% of purchase price, deducted from sale price or refunded if bid is unsuccessful)
- Description of place and deadline for submission of bids
- Description of terms of selection (single round, competitive auction, multiple round)

- Invitation to potential bidders to request the available information memorandum

Breakout Slide 4: The Offer Evaluation

***Note**: The evaluation of bids is usually carried out by the privatization institution within a specified time-frame on behalf of, or in conjunction with, the company for sale.*

1. Determine whether bids are acceptable within the formal terms outlined in the tender invitation.

2. Determine whether offer is in the interest of the company.

    ◊ Effect on
    - long-term market situation of the company
    - employment structure
    - domestic and foreign competition
    - domestic suppliers and customers
    - future value of the company

◊ Necessity of expansion or reduction of current business activities

Breakout Slide 4a: The Offer Evaluation

3. Request an independent valuation of the company.

4. Determine whether purchase price **(most important)** and form of payment offered are acceptable.

   - Cash
   - Credit/Installment
   - Compensation vouchers
   - Government loans

5. Evaluate reputation, capital strength, development/business plan, and market relations of the bidder (see next slide).

6. Announcement of the winning bidder.

The Qualifications of the Buyer

- Strength of existing corporate governance (see next slide)
- History of ethical behavior
- Experience in the related industry
- Propriety and behavior of negotiations
- Quality of responses to the components of the bid
  - Bid price, method of payment, payment guarantees, increase of capital, employment guarantees,

Corporate Governance

What is corporate governance?

A relationship structure between a company's owners, board of directors, and managers which ideally ensures honesty and wise-decision-making; and which favorably impacts the employees, the customers, and the surrounding community.

Who previously had responsibility for a company's decisions?

The State

What are some of the common issues within the concept of corporate governance?

- Executive pay
- Litigation
- Business strategy
- Retirement plans
- Health benefits
- Perquisites
- Pollution
- Bonuses
- Financial planning
- Capital expenditures
- Stockholder relations
- Community services

Breakout Slide 5: Components of a Bid

- Business plan (see separate slides)
- Projected capital investment
- Intended workforce
- Treatment of environmental liabilities
- Purchase price
- Other

The Business Plan-*Slide 1*

Why is it important?

The business plan prepared and submitted by the bidder provides the privatization institution with evidence that the bidder, if awarded the sale, has a strategic plan for the company's future.

Components

I. Brief summary of investment proposal

II. Description of the bidding company

- History
- Business activity
- Marketing efforts
- Suppliers
- Distribution infrastructure
- Industry position
- Price position
- Labor relations

***The Business Plan**-Slide 2*

III. Description of management of bidding firm

- Training and qualifications
- Organizational chart
- Compensation system

IV. Ownership structure (current and proposed)

V. Market information (who are the competitors and what are the company's niches?)

VI. Proposed terms of financing or investment

VII. Apparent business risks (sporadic markets, government legislation, etc.)

The Business Plan-*Slide 3*

VIII. Financial forecasts of new company

- Description of rationale
- Projected income statement, balance sheet, and cash flows statement

IX. Current financial statements of bidding company

X. Legal documents of bidding company (articles of association, registration, other)

Breakout Slide 6: The Selection Process

Single Round	Competitive Bid	Multiple Round
Seller selects successful bidder after bids are submitted and evaluated after only one round.	Seller may request new bids from all or some of the bidders after initial bid is submitted.	Seller selects a group of bidders after the first round who are eligible to participate in the second (or additional) rounds. Modification of bids is necessary.

Breakout Slide 7: What Factors Affect Ultimate Sale Price ?

- Regardless of profitability, quality of assets, etc., international demand for the company's product is a critical factor determining sale price
- Negotiation skills of seller
- Sophistication of buyer
- External influences (political, social)
- Timing of sale

Privatization Seminar

General Privatization Concepts

Module 5: Case 2
CANNOT PRIVATISE WITHOUT RESTRUCTURING

March 16, 1995

CASE STUDY COMPANY 2

MAJOR CONSUMER GOODS MANUFACTURER

CANNOT PRIVATISE WITHOUT RESTRUCTURING

COMPANY CHARACTERISTICS

SECTOR: MAJOR SHOE MANUFACTURER

	1990	1993
SALES	7 MILLION SHOES	2.9 MILLION SHOES
SALES REVENUE	$ 63 MILLION	$ 27 MILLION
PROFIT (LOSS)	$ 2.5 MILLION	$ (0.9) MILLION
EMPLOYEES	5,000	2,800

NATIONAL SHOE INDUSTRY OUTPUT DROPPED DRAMATICALLY OVER THE PAST 10 YEARS:

	1985	1989	1992
SHOE PRODUCTION (MILLION PAIRS)	45	30	14

THIS WAS DUE IN PART TO:

- COLLAPSE OF COMECON
- EXPENSIVE IMPORTS FROM WESTERN EUROPE AND CHEAP IMPORTS FROM THE FAR EAST
- RECESSION AND HIGH TRADE TARIFFS IN WESTERN EUROPE
- DOMESTIC RECESSION

1992: LOSSES FOR THE FIRST TIME

THE COMPANY MADE A LOSS OF $5.4 MILLION

ON THE VERGE OF BANKRUPTCY

THE COMPANY WAS FORCED TO TAKE ADDITIONAL LOANS AND INCREASE SUPPLIER PAYMENT PERIODS TO FEND OFF LIQUIDITY PROBLEMS

MAY 1993: THE COMPANY INTRODUCED A CRISIS MANAGEMENT PROGRAM. THIS INVOLVED

- AGGRESSIVE MARKETING STRATEGY
- INCREASING PRODUCTIVITY BY 15-20%
- ESTABLISHING JOINT VENTURE WITH WESTERN FIRM
- INTRODUCING NEW QUALITY CONTROL METHODS
- REDUCING NUMBER OF EMPLOYEES

BUT:

- SEPTEMBER 1993: MAJOR CREDITOR DECIDES TO WITHDRAW FINANCING
- NOVEMBER 1993: LARGEST CREDITOR REFUSES TO RENEW OVERDUE LOANS

THIS LEAD TO A **LIQUIDITY CRISIS**

STATE NEGOTIATES WITH BANKS TO SAVE COMPANY

THE MAJOR CREDITOR DEMANDED A $1.5 MILLION LOAN GUARANTEE FROM MAJOR SHAREHOLDER (THE STATE). WITHOUT IT, THE BANK REFUSED TO CONTINUE FINANCING THE COMPANYS $6 MILLION DEBT

CUT OFF OF FINANCING WOULD HAVE DRIVEN THE COMPANY INTO LIQUIDATION

THE STATE WANTED TO AVOID LIQUIDATION, WHICH WOULD HAVE MAJOR CONSEQUENCES FOR THE REGION IN WHICH THE COMPANY IS SITUATED

STATE GRANTS $1.5 MILLION CASH INJECTION TO BANK

BALANCE SHEET

(USD MILLION)

	12/31/1992	12/31/1993	12/31/1994	%
FIXED ASSETS	18.5	17.8	17.4	72%
INTANGIBLE ASSETS	0	0.2	0.2	1%
LAND AND BUILDINGS	13.1	12.4	12.3	51%
PLANT AND MACHINERY	4.6	4.1	3.7	15%
FINANCIAL INVESTMENTS	0.7	10.9	1.2	5%
CURRENT ASSETS	9.9	9.1	6.8	28%
INVENTORY	4.4	4.4	3.9	16%
ACCOUNTS RECEIVABLE	4.8	2.4	2.4	10%
SECURITIES	0	0.1	0.2	1%
CASH	0.8	2.2	0.3	1%
ACCRUED ASSETS	0	0	0	0%
TOTA ASSETS	**28.5**	**26.9**	**24.2**	**100%**

(USD MILLION)

	12/31/1992	12/31/1993	12/31/1994	%
EQUITY	15.6	14.6	14.2	58%
ISSUED CAPITAL	20.3	20.3	20.3	84%
ACCUMULATED PROFIT RESERVE	0.7	-4.8	-5.8	(24)%
BALANCE SHEET PROFIT	-5.4	-1.0	-0.3	(2)%
PROVISIONS	0	0	0	0%
LONG-TERM LIABILITIES	1.3	0.9	6.1	26%
SHORT-TERM LIABILITIES	1.1	10.8	3.6	15%
ACCRUED EXPENSES	0.4	0.6	0.3	1%
TOTAL LIABILITIES	**28.5**	**26.9**	**24.2**	**100%**

PROFIT AND LOSS ACCOUNT

(USD MILLION)

	12/31/1991	12/31/1992	12/31/1993	12/31/1994
SALES	35.3	29.9	27.0	24.6
DIRECT COSTS	22.6	22.4	18.7	17.6
INDIRECT COSTS	10.6	8.5	7.7	6.9
TRADING PROFIT	2.1	-0.9	0.7	0.1
FINANCIAL PROFIT	-2.3	-2.3	-2.5	-1.8
EXTRAORDINARY PROFIT	1.7	-2.1	0.9	1.5
PRE-TAX PROFIT	1.6	-5.4	-0.9	-0.3

PRIVATISATION CHRONOLOGY

1991 JAN	TRANSFORMATION FROM STATE ENTERPRISE TO SHAREHOLDING COMPANY
1992 JULY	OPEN TENDER TO SELL SHARES IN COMPANY
	NO INTEREST WAS SHOWN BY INVESTORS
1993 NOV	DELOITTE & TOUCHE AWARDED CONTRACT TO DEVELOP ALTERNATIVE STRATEGIES FOR COMPANY PURPOSE: SURVIVAL OF COMPANY SALE TO INVESTOR

1994 FEB	INFORMATION MEMORANDA PREPARED, IN ORDER TO PROSPECT FOR POTENTIAL INVESTORS IN BUSINESS UNITS **SEVERAL BIDDERS FOUND, BUT NO DEALS MADE** THIS WAS BECAUSE THE PRICES OFFERED WERE SIGNIFICANTLY LOWER THAN PERCEIVED MARKET VALUE
1994 DEC.	DEBT CONSOLIDATION AGREEMENT CONCLUDED. COMPANY EQUITY REDUCED FROM $2 BILLION TO $1 BILLION AT BANK'S INSISTENCE.
1995 MAR	DELOITTE & TOUCHE BEGINS COMPANY RESTRUCTURING TO REVITALIZE PRODUCTION, MERCHANDISING AND DISTRIBUTION, IN ORDER TO ACHIEVE LONG-TERM PROFITS AND TO ULTIMATELY PRIVATISE THE COMPANY

INITIAL PRIVATISATION ATTEMPT OF 1992 UNSUCCESSFUL

A FOREIGN CONSULTANT WAS ENGAGED TO SELL THE COMPANY "AS WAS", WITHOUT RESTRUCTURING.

INSUFFICIENT INTEREST WAS GENERATED, BECAUSE:

- ASSETS WERE GROSSLY OVERVALUED COMPARED TO THE COMPANY'S BUSINESS VALUE

- LACK OF INTEREST BY STRATEGIC INVESTORS IN INVESTING IN THE COMPANY "AS WAS", DUE TO ITS SIZE AND STRUCTURE

- COMPANY'S OPERATING RESULTS AND FINANCIAL POSITION WERE CONTINUING TO DETERIORATE

1993: NEW CONSULTANT APPOINTED

DELOITTE & TOUCHE WON A COMPETITIVE TENDER TO ANALYSE THE COMPANY AND RECOMMEND ACTION STEPS.

RESULTS OF ANALYSIS WERE:

- RESTRUCTURING THE COMPANY'S DIVISIONS INTO SEPARATE BUSINESS UNITS, SO AS TO PROVIDE JOBS FOR EMPLOYEES AND AVOID SELLING OFF ASSETS ONLY
- WRITING AN INFORMATION MEMORANDUM ABOUT EACH DIVISION OF THE COMPANY, INCLUDING A REVIEW OF ASSET ITEMS AND THE DEFINITION OF AN ACTION PROGRAM
- PROSPECTING FOR UP TO 200 POTENTIAL STRATEGIC BUYERS OF THE BUSINESS UNITS

SECOND PRIVATISATION ATTEMPT UNSUCCESSFUL

SEVERAL BIDDERS CAME FORWARD, **BUT THERE WAS NO CLOSE.**

THIS WAS BECAUSE:

COMPANY MANAGEMENT, THE STATE, THE COMPANY'S MAJOR LENDER AND DELOITTE & TOUCHE (ADVISERS TO THE STATE) FELT THAT THE PRICES OFFERED FOR THE BUSINESS UNITS WERE SIGNIFICANTLY LOWER THAN THE VALUE PERCEIVED BY THE COMPANY, THE STATE AND THE BANK.

SIMULTANEOUSLY, THE "ACCELERATED" DEBT RESTRUCTURING PROGRAM WAS IN PROCESS

WHAT IS THE "ACCERATED" DEBT RESTRUCTURING PROGRAM?

A SCHEME INVOLVING STATE-OWNED COMPANIES WITH SIGNIFICANT DEBT BURDEN :

THE PURPOSE WAS TO SIMULTANEOUSLY REDUCE THE DEBT BURDEN TO THE COMPANIES, AND TO REDUCE THE AMOUNT OF BAD / NON-PERFORMING DEBT ON THE BOOKS OF THE BANKS.

TECHNIQUES USED INCLUDED:

• DEBT-FOR-EQUITY SWAP:	CONVERTING DEBT INTO EQUITY
• DEBT RESTRUCTURING	CONVERTING SHORT-TERM DEBT INTO LONG-TERM DEBT
• DEBT RESCHEDULING	POSTPONING DEBT REPAYMENTS
• DEBT FORGIVENESS	CANCELLING THE DEBT

NEGOTIATIONS OVER THE DEBT RESTRUCTURING PROGRAM LASTED FROM FEBRUARY 1994 TO DECEMBER 1994. DURING THAT TIME, THE COMPANY CONTINUED TO LOSE MONEY.

IN 1993, THE COMPANY MADE A PRE-TAX LOSS OF $0.9 MILLION
IN 1994, THE COMPANY MADE A PRE-TAX LOSS OF $0.3 MILLION

THROUGHOUT 1994, LIQUIDATION THREAT CONTINUED

ON MANY OCCASIONS, THE BANK THREATENED TO LIQUIDATE THE COMPANY IN ORDER TO RETRIEVE ITS MONEY. THE BANK WAS NOT ENTHUSIASTIC ABOUT A DEBT FOR EQUITY SWAP, BECAUSE IT WAS OWED $6 MILLION, EQUIVALENT TO ONLY 15% OF THE COMPANY'S EQUITY. IT WANTED A MORE SIGNIFICANT STAKE IN THE COMPANY IN RETURN FOR GIVING UP ITS SECURED CLAIM ON THE COMPANY'S ASSETS.

LIQUIDATION PLANS RESISTED

THE STATE, THE MANAGEMENT AND THE LABOR UNIONS WERE KEEN TO KEEP THE COMPANY AS A GOING CONCERN BECAUSE, IF THE COMPANY WERE LIQUIDATED, ONLY THE BANK WOULD BENEFIT (BY RECEIVING ENOUGH CASH FROM SALE OF THE ASSETS TO PAY OFF THE LOANS)

DEBT FOR EQUITY SWAP AGREED

IT WAS FINALLY AGREED TO REDUCE THE COMPANY'S EQUITY FROM $2 BILLION TO $1 BILLION, AT THE INSISTENCE OF THE BANK. SUCH A CONVERSION WOULD RAISE THE BANK'S HOLDING FROM 15% TO 30% OF COMPANY EQUITY.

IN THE EVENT, THE BANK ELECTED TO CONVERT PART OF THE OUTSTANDING DEBT INTO A LONG-TERM BOND WITH THE OPTION TO CONVERT TO EQUITY AT A LATER DATE.

WHAT WAS ACHIEVED BY DEBT RESTRUCTURING?

- SUBSTANTIAL REDUCTION IN FINANCIAL BURDEN / OPERATIONAL COSTS ($2.5 MILLION IN INTEREST CHARGES SAVED)
- BANKRUPTCY AND LIQUIDATION AVOIDED
- 2,500 JOBS RETAINED
- GOVERNMENT SAVED $2.5-3.0 MILLION IN UNEMPLOYMENT EXPENDITURES
- COMPANY TEMPORARILY SALVAGED, PROVIDING OPPORTUNITY FOR LONG-TERM RESTRUCTURING AND ULTIMATE SALE, GENERATING PRIVATISATION REVENUES TO THE STATE.

COMPANY REMAINS LOSS-MAKING

DEBT RESTRUCTURING DID NOT SOLVE ALL THE COMPANY'S PROBLEMS, BECAUSE:

- ONLY PART OF THE DEBT WAS SWAPPED FOR CONVERTIBLE DEBT.
- THE COMPANY STILL HAS $1 MILLION IN SHORT-TERM DEBT.
- THE COMPANY CONTINUES TO BE LOSS-MAKING

NEW STRATEGY NEEDED

IT WAS REALISED THAT THE COMPANY HAD TO BE MADE PROFITABLE IN ORDER TO ATTRACT INVESTORS

THE DELOITTE & TOUCHE TEAM CONDUCTED A MAJOR ANALYSIS IN 1994 OF THE COMPANY'S PROFIT-MAKING POTENTIAL.

THE ANALYSIS CONSISTED OF SWOT* ANALYSIS, MARKET STUDIES, THE USE OF FOOTWEAR INDUSTRY SPECIALISTS.

IT CONCLUDED THAT THE COMPANY COULD BECOME PROFITABLE IN THE LONG-TERM IF RESTRUCTURED AND NEW STRATEGIES ARE ADOPTED.

***SWOT:** STRENGTHS, WEAKNESSES, OPPORTUNITIES, THREATS

RESTRUCTURING FOR PROFIT

A COMMITMENT WAS SECURED TO FUND A 12 MONTH RESTRUCTURING OF THE COMPANY.

<u>GOAL:</u>

TO REVITALIZE PRODUCTION, MERCHANDISING AND DISTRIBUTION, IN ORDER TO ACHIEVE LONG-TERM PROFITABILITY

<u>STRATEGY:</u>

- ENHANCE RANGE AND QUALITY OF PRODUCT LINES
- UPGRADE RETAIL DISTRIBUTION
- SIGNIFICANTLY IMPROVE SUPPLY CHAIN
- IMPROVE UTILIZATION OF COMPANY'S SPECIFIC MANUFACTURING COMPETENCE
- COST REDUCTION INITIATIVES

- EMPHASIS ON QUALITY AND JOB FLEXIBILITY AS WELL AS PRODUCTIVITY

ON THE BASIS OF THESE CHANGES, IT WAS PLANNED THAT BREAKEVEN WOULD BE ACHIEVED IN 1995, WITH PROFITS TO FOLLOW IN SUBSEQUENT YEARS.

(USD MILLION)

	1993 ACTUAL	1994 ACTUAL	1995 PROJECTED	1996 PROJECTED	1997 PROJECTE
PROFIT	(0.9)	(0.3)	0.0	2.1	2.7
PROFIT MARGIN	(3.3)%	(1.2)%	0.0%	10.1%	11.1%

SUMMARY

<u>RESTRUCTURING BEFORE SALE WAS NECESSARY BECAUSE:</u>

1. COMPANY COULD NOT BE SOLD "AS WAS", AS ONE ENTITY
2. COMPANY COULD NOT BE SOLD "DIVISION BY DIVISION"
3. COMPANY BECAME INSOLVENT AND ON THE VERGE OF BANKRUPTCY

DEBT RESTRUCTURING AVERTED BANKRUPTCY AND REDUCED FINANCIAL COSTS

LONG-TERM BUSINESS RESTRUCTURING TO BEGIN, IN ORDER TO CREATE A PROFITABLE ENTITY OR ENTITIES THAT CAN BE ATTRACTIVE TO POTENTIAL STRATEGIC INVESTORS.

Privatization Seminar

General Privatization Concepts

Module 6: Guest Speaker- Mr. Vikas Thapas
International Finance Corporation, Prague

March 16, 1995

Privatization Seminar

General Privatization Concepts

Module 7: Case 3

PRESENTLY "NOT PROFITABLE"
SIGNIFICANT PROFIT POTENTIAL,
PRIVATISE AS IS

March 16, 1995

CASE STUDY COMPANY 3

REGIONAL FOOD RETAILER AND WHOLESALER

PRESENTLY "NOT PROFITABLE"
SIGNIFICANT PROFIT POTENTIAL,
PRIVATISE AS IS

INTRODUCTION

THE COMPANY WAS THE MONOPOLY FOOD WHOLESALER OF ITS REGION UNTIL 1988.

REALISING THAT IT COULD NOT RELY ON WHOLESALE ALONE, IT EXPANDED AGGRESSIVELY POST 1988 INTO RETAIL AND WHOLESALE CASH AND CARRY

THE COMPANY

- HAS TOTAL ANNUAL SALES OF $70 MILLION
- EMPLOYS 900 PEOPLE
- HAS 16 RETAIL OUTLETS
- HAS 6 WHOLESALE WAREHOUSES
- HAS 11 WHOLESALE CASH AND CARRY OUTLETS
- MADE A PRE-TAX PROFIT OF $1.3 MILLION IN 1994

CHARACTERISTICS OF THE COMPANY

- FOOD BUSINESS, RETAIL AND WHOLESALE
- REGIONAL OPERATOR, WITH SIGNIFICANT MARKET SHARE IN ITS REGION
- INCREASING COMPETITION FROM REGIONAL RETAILERS AND WHOLESALERS
- OWNS ALL OF ITS REAL-ESTATE (54% OF TOTAL ASSETS)
- RETAIL AND WHOLESALE OPERATIONS (16 SITES) ARE SUPPORTED BY 6 WAREHOUSES 60 KM APART
- NEWER RETAIL SEGMENT GROWING QUICKLY, HISTORICAL WHOLESALE SEGMENT SHRINKING EVERY YEAR
- OPERATING MARGINS VERY LOW DUE TO INFRASTRUCTURE AND STAFF COSTS

PRIVATISATION HISTORY

1992 JAN	COMPANY TRANSFORMED FROM STATE ENTERPRISE TO SHAREHOLDING COMPANY
1993 DEC	NEGOTIATIONS BETWEEN STATE AND POTENTIAL STRATEGIC INVESTORS
1994 JAN	OFFERING TO SMALL INVESTORS IN ANTICIPATION OF SUCCESSFUL INVESTMENT BY STRATEGIC INVESTOR
1994 APRIL	NEGOTIATIONS WITH INVESTORS ARE UNSUCCESSFUL
1994 JUNE	COMPANY FLOATED ON STOCK EXCHANGE
1994 SEPT	CASH AID BY DOMESTIC COMPETITOR REJECTED DUE TO FEAR OF EXCESSIVE MARKET SHARE
1994 DEC	SECOND OPEN TENDER ANNOUNCED, 90 DAY PERIOD

MODEST PROFITS, ADEQUATE CASH-FLOW

<u>THE COMPANY:</u>

- IS MAKING MODEST PROFITS,
- IS IN A STABLE OR GROWING INDUSTRY
- HAS NO SIGNIFICANT LIQUIDITY PROBLEMS
- IS EXPANDING RETAIL AND CASH-AND-CARRY OPERATIONS
- HAS A REASONABLY SIMPLE ORGANISATIONAL STRUCTURE

FOR THESE REASONS, RESTRUCTURING PRIOR TO PRIVATISATION WAS UNNECESSARY.

ISSUES - SELLER'S PERSPECTIVE

THE STATE WAS LOOKING FOR:

- STRATEGIC BUYER WITH EXPERIENCE OF THE FOOD RETAIL INDUSTRY
- PURCHASE PRICE OF AT LEAST 115% OF NOMINAL VALUE
- A CAPITAL INJECTION OF AT LEAST $2 MILLION
- EMPLOYMENT GUARANTEES FOR THE WORKFORCE
- A PAYMENT PRIMARILY IN CASH

THE SELLER WAS WILLING TO CONTRIBUTE $3 MILLION OF THE PURCHASE PRICE BACK TO THE COMPANY AS A GIFT TO FUND FUTURE GROWTH AND DEVELOPEMENT

ISSUES - BUYER'S PERSPECTIVE

A SOPHISTICATED BUYER WOULD BE INTERESTED IN THE POTENTIAL TO SIGNIFICANTLY INCREASE PROFITS THROUGH THE FOLLOWING STEPS:

- **RATIONALISE DISTRIBUTION METHODS**
  THIS WOULD INVOLVE:
  - REDUCING NUMBER OF WAREHOUSES FROM 6 TO 1
  - IMPROVING INVENTORY MANAGEMENT SYSTEMS
  - IMPROVE MARKETING AT RETAIL OUTLETS

- **REDUCE INTEREST COSTS**
  THIS COULD BE DONE BY SALE AND LEASE BACK OF REAL ESTATE, USING PROCEEDS TO PAY BACK SHORT-TERM DEBT

- **MERGE THE COMPANY WITH A SIMILAR ENTITY OPERATING IN ANOTHER GEOGRAPHICAL PART OF THE COUNTRY**

THIS WOULD ENABLE SIGNIFICANT ECONOMIES OF SCALE AND INCREASE MARKET SHARE

BALANCE SHEET

(USD MILLION)

	12/31/1993	12/31/1994	%
FIXED ASSETS	17.4	17.9	59%
INTANGIBLE ASSETS	0	0	0%
LAND AND BUILDINGS	15.9	16.3	54%
PLANT AND MACHINERY	1.1	1.3	4%
FINANCIAL INVESTMENTS	3.4	3.4	1%
CURRENT ASSETS	12.2	12.4	41%
INVENTORY	8.5	7.1	23%
ACCOUNTS RECEIVABLE	3.2	4.4	15%
SECURITIES	0	0.3	1%
CASH	4.0	0.6	2%
ACCRUED ASSETS	2.9	0	0%
TOTAL ASSETS	**29.9**	**30.3**	**100%**

(USD MILLION)

	12/31/1993	12/31/1994	%
EQUITY	19.4	19.5	66%
ISSUED CAPITAL	13.3	13.3	44%
CAPITAL RESERVE	3.2	3.4	11%
ACCUMULATED PROFIT RESERVE	3.0	2.8	9%
BALANCE SHEET PROFIT	-0.2	0.6	2%
PROVISIONS	0	0	0%
LONG-TERM LIABILITIES	0		0%
SHORT-TERM LIABILITIES	9.5	9.3	31%
ACCRUED EXPENSES	0.9	0.9	3%
TOTAL LIABILITIES	**29.8**	**30.3**	**100%**

PROFIT AND LOSS ACCOUNT

(USD MILLION)

	12/31/1992	12/31/1993	12/31/1994
SALES	78.8	75.9	74.7
COST OF SALES	69.0	65.1	63.9
OPERATING COSTS	6.7	8.5	8.4
TRADING PROFIT	3.1	2.3	2.4
FINANCIAL PROFIT	-1.6	-1.2	-1.3
EXTRAORDINARY PROFIT	0.3	-0.9	0.3
PRE-TAX PROFIT	1.8	0.2	1.4

Privatization Seminar

General Privatization Concepts

Module 7: Case 3

PRESENTLY "NOT PROFITABLE"
SIGNIFICANT PROFIT POTENTIAL,
PRIVATISE AS IS

March 16, 1995

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CASE STUDY COMPANY 3

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- EMPLOYMENT GUARANTEES FOR THE WORKFORCE
- A PAYMENT PRIMARILY IN CASH

THE SELLER WAS WILLING TO CONTRIBUTE $3 MILLION OF THE PURCHASE PRICE BACK TO THE COMPANY AS A GIFT TO FUND FUTURE GROWTH AND DEVELOPEMENT

ISSUES - BUYER'S PERSPECTIVE

A SOPHISTICATED BUYER WOULD BE INTERESTED IN THE POTENTIAL TO SIGNIFICANTLY INCREASE PROFITS THROUGH THE FOLLOWING STEPS:

- **RATIONALISE DISTRIBUTION METHODS**

  THIS WOULD INVOLVE:
  - REDUCING NUMBER OF WAREHOUSES FROM 6 TO 1
  - IMPROVING INVENTORY MANAGEMENT SYSTEMS
  - IMPROVE MARKETING AT RETAIL OUTLETS

- **REDUCE INTEREST COSTS**

  THIS COULD BE DONE BY SALE AND LEASE BACK OF REAL ESTATE, USING PROCEEDS TO PAY BACK SHORT-TERM DEBT

- **MERGE THE COMPANY WITH A SIMILAR ENTITY OPERATING IN ANOTHER GEOGRAPHICAL PART OF THE COUNTRY**

THIS WOULD ENABLE SIGNIFICANT ECONOMIES OF SCALE AND INCREASE MARKET SHARE

BALANCE SHEET

(USD MILLION)

	12/31/1993	12/31/1994	%
FIXED ASSETS	17.4	17.9	59%
INTANGIBLE ASSETS	0	0	0%
LAND AND BUILDINGS	15.9	16.3	54%
PLANT AND MACHINERY	1.1	1.3	4%
FINANCIAL INVESTMENTS	3.4	3.4	1%
CURRENT ASSETS	12.2	12.4	41%
INVENTORY	8.5	7.1	23%
ACCOUNTS RECEIVABLE	3.2	4.4	15%
SECURITIES	0	0.3	1%
CASH	4.0	0.6	2%
ACCRUED ASSETS	2.9	0	0%
TOTAL ASSETS	**29.9**	**30.3**	**100%**

(USD MILLION)

	12/31/1993	12/31/1994	%
EQUITY	19.4	19.5	66%
ISSUED CAPITAL	13.3	13.3	44%
CAPITAL RESERVE	3.2	3.4	11%
ACCUMULATED PROFIT RESERVE	3.0	2.8	9%
BALANCE SHEET PROFIT	-0.2	0.6	2%
PROVISIONS	0	0	0%
LONG-TERM LIABILITIES	0		0%
SHORT-TERM LIABILITIES	9.5	9.3	31%
ACCRUED EXPENSES	0.9	0.9	3%
TOTAL LIABILITIES	**29.8**	**30.3**	**100%**

PROFIT AND LOSS ACCOUNT

(USD MILLION)

	12/31/1992	12/31/1993	12/31/1994
SALES	78.8	75.9	74.7
COST OF SALES	69.0	65.1	63.9
OPERATING COSTS	6.7	8.5	8.4
TRADING PROFIT	3.1	2.3	2.4
FINANCIAL PROFIT	-1.6	-1.2	-1.3
EXTRAORDINARY PROFIT	0.3	-0.9	0.3
PRE-TAX PROFIT	1.8	0.2	1.4

Privatization Seminar

General Privatization Concepts

Module 8: DANGERS, LIQUIDATION

March 16, 1995

What Are The Dangers In Privatization ?

- A foreign buyer closes down the company and exports into the country

SAFEGUARD: Production guarantees
Employment guarantees

- Management discourages potential buyers by, for example:

  - Concealing the most favorable aspects of the company
  - Refusing to provide financial or other information
  - Deliberately reducing company profits to push down price

REASONS: To retain their positions
To buy the company themselves

SAFEGUARD: Appoint transaction supervisor onto management board who works together with and oversees management with respect to privatization-related activity.

What Are The Dangers Of Slow Privatization ?

- Value of the company erodes
- Demotivation of employees
- Increase in thefts
- Diminishing position on the market

What Are The Dangers In Management/Employee Buy-Outs ?

- The new owners often cannot provide the capital, technology, know-how that the company needs

- The motive for management/employee buy-outs is often to preserve positions/jobs

This often results in:

Bankruptcy, due to inability to repay loans taken to finance buy-out, inability to pay creditors.

LIQUIDATION

COMPANY IS NOT VIABLE

PROBLEM	POSSIBLE STRATEGY
OPERATIONALLY UNVIABLE (REVENUES LESS THAN OPERATIONAL COSTS INCLUDING DEPRECIATION AND AMORTIZATION)	• RESTRUCTURE OPERATIONS IN PRESENT BUSINESS LINE TO MAKE PROFIT ON OPERATIONS • ENTER NEW BUSINESS LINE • LIQUIDATE COMPANY
OPERATIONALLY VIABLE, FINANCIALLY UNVIABLE (COST OF FUNDS GREATER THAN PROFIT ON OPERATIONS)	• INCREASE GROSS MARGINS • RESTRUCTURE FINANCING TO REDUCE COST OF FUNDS • LIQUIDATE COMPANY

ONE CAUSE OF UNVIABILITY: NO PLACE IN THE MARKET

TOO MANY COMPANIES IN THE SAME BUSINESS (eg. 35 MILK PRODUCERS IN A COUNTRY OF 20 MILLION PEOPLE)

COMPANY CANNOT DIFFERENCIATE ITSELF FROM COMPETITORS IN TERMS OF:

- PRICE
- QUALITY
- CUSTOMER SERVICE
- PROXIMITY TO CUSTOMERS
- NICHE PRODUCT(S)

OPERATIONAL , FINANCIAL UNVIABILITY

	(USD MILLION)	
BALANCE SHEET:		
BOOK VALUE OF ASSETS	1.0	0
LIABILITIES	2.0	0.8
NET BOOK VALUE OF COMPANY	(1.0)	0.2
PROFIT AND LOSS ACCOUNT:		
SALES	0.3	0.3
COST OF SALES	0.4	0.2
PROFIT ON OPERATIONS	(0.1)	0.1
COST OF FINANCE	0.2	0.2
PROFIT	(0.3)	(0.1)

1/17

LIQUIDATION

WHEN A COMPANY IS OPERATIONALLY AND/OR FINANCIALLY UNVIABLE, IT MUST RESTRUCTURE OR FACE BANKRUPCY AND POTENTIAL LIQUIDATION.

SOMETIMES LIQUIDATION IS THE BEST ECONOMIC PATH BECAUSE:

- VALUE OF ASSETS EXCEEDS VALUE OF THE COMPANY AS A GOING CONCERN
- INSUFFICIENT CAPITAL TO MAINTAIN LOSS-MAKING OPERATIONS
- RENOVATION / RESTRUCTURING NOT WORTH COSTS INVOLVED
- CREDITOR CAN SELL ASSETS AND RECOVER PART OF OUTSTANDING LOAN / RECEIVABLES
- LOSSES ARE TERMINATED
- BUYER CAN REDEPLOY ASSETS IN SUCCESSFUL BUSINESS VENTURE

HANDOUT

Capital Structure Overview and Recommendations

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APPENDICES

Privatization Seminar

Day 3: Special cases

BOSNIA & HERZEGOVINA

PRIVATIZATION OF STRATEGIC ASSETS

SPECIAL CASES

ORIENTATION ON **BOSNIA & HERZEGOVINA** (DEC 1994) INCLUDED INFRASTRUCTURE AND STRATEGIC INDUSTRY PRIVATIZATION:

<u>EXAMPLES:</u>

- RAILWAYS
- IRON AND STEEL
- CHEMICAL
- ENERGY

WHILE THE GENERAL PROCEDURES AND POLICIES OF PRIVATIZATION APPLY, THESE ENTERPRISES SHOULD BE TREATED DIFFERENTLY.

(Group make own list)

WHY ARE THESE SPECIAL?

- NATURAL MONOPOLY
- NEED FOR MASS RECONSTRUCTION
- INTERNATIONAL LENDING
- STATE ECONOMIC OR SECURITY NEEDS
- EFFICIENCY AND MARKET CONFLICTS
- POSSIBLE RESTRUCTURING AND "BREAK-UP"
- MAY NEED SPECIALIST OR EXPERT ASSISTANCE
    - WORLD MARKET
    - STATE OF THE ART TECHNOLOGY
    - BIG

(Group add to the list)

CONSIDER THE BIG PICTURE

- SECTORAL STUDIES
  - EXPERTS: TECHNOLOGY, ECONOMIC DEVELOPMENT
  - CONFLICTS: JOBS / SECURITY / POLITICS / ENVIRONMENT
  - BIG MONEY: FINANCING

- FUTURE OF ECONOMY, INDUSTRY, MARKETS
  - BEST USE OF RESOURCES
  - INTEGRATION OF OTHER ENTERPRISES, RESOURCES
  - TRADE IMPORTS / EXPORTS
  - RELATIONS WITH NEIGHBORS

- LEGISLATION AND REGULATION
  - RATE STRUCTURES
  - FRANCHISES
  - STATE FINANCING / TAXES / DUTIES

SECTORAL STUDIES (WHAT ARE OUR DECISION PARAMETERS ?)

- EXPERT VIEW OF SITUATION (NATIONAL AND INDEPENDENT)
  - INVESTMENT
  - TECHNOLOGY
  - COMPETITION

- ENVIRONMENTAL IMPACT

- STRATEGIC PLAN
  - DEMAND ANALYSIS
  - RESOURCES, EMPLOYMENT
  - FINANCIAL FORECASTS
  - REGULATION

- PRIVATIZATION PLAN (WHERE APPROPRIATE)

TWO SECTOR STUDY EXAMPLES

Capital Structure Overview and Recommendations

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PRIVATIZATION PLAN

- WHAT KIND OF OWNERSHIP ?
  - PRIVATE/PUBLIC
  - MANAGEMENT CONTRACTS
  - FRANCHISES

- WHO CAN SUPPLY OUR NEEDS ?
  - TECHNOLOGY
  - FINANCE
  - MARKETS
  - INDEPENDENCE AND SELF-SUFFICIENCY

- WHAT STRUCTURE WORKS (IS EFFICIENT) FOR US ?
  - COMPETITION
  - SEGMENTATION
  - INTERNATIONAL INTEGRATION

HOW TO PREPARE A PLAN

- USE PROFESSIONALS
  - TECHNICAL / FINANCIAL
  - WORLD MARKET
  - VALUATION
  - SELLING STRATEGY

- COMPETITIVE TENDERS FOR ASSISTANCE
  - SEE WHAT IS OFFERED
  - LOWEST FIXED COST / INCENTIVES
  - TRANSPARENT / INDEPENDENT

- MANAGE PRIVATIZATION AT A HIGH LEVEL
  - NATIONAL INTERESTS
  - ECONOMIC AND SOCIAL PRIORITIES
  - COORDINATE LEGISLATION / REGULATION
  - CASE BY CASE

CONTROL THE PRIVATIZATION PROCESS

- DEFINE RESPONSIBILITIES, AUTHORITIES
- HAVE A PLAN, SET GOALS, DEADLINES
- MONITOR PROGRESS, INSIST ON RESULTS

CASE STUDY:

ELECTRIC POWER INDUSTRY

THIS CASE STUDY IS FOR ILLUSTRATIVE PURPOSES ONLY. WHILE USING THE HUNGARIAN EXPERIENCE AS A STARTING POINT, MANY CHANGES HAVE BEEN MADE TO ILLUSTRATE THE ARGUMENTS PUT FORWARD EARLIER. IT DOES NOT CLAIM TO BE A DESCRIPTION OR ANALYSIS OF HUNGARIAN PRIVATIZATION POLICY.

ELECTRIC POWER INDUSTRY SECTOR PRIVATIZATION

PRIOR TO 1991: CENTRAL PLANNING OF GENERATION AND DISTRIBUTION (PRICING, DEVELOPMENT AND OPERATION CONTROLLED BY GOVERNMENT)

1991: OWNERSHIP (SHARES) TRANSFERRED TO PRIVATIZATION AUTHORITY

1992:

GOVERNMENT DECIDES WILL KEEP 50%+1 FOR SOME TIME

EXPERTS EMPLOYED TO ADVISE ON PRIVATIZATION:

- FUTURE STRUCTURE
- REGULATORY FRAMEWORK
- PRIVATIZATION PLAN

1993:

PREPARATION FOR PRIVATIZATION BEGAN (ASSISTED BY OUTSIDE EXPERTS)

- ATTEMPT TO SELL MINORITY SHARES FAILED, DUE TO LACK OF REGULATION

1994:

ELECTRICITY ACT PASSED

- REGULATION STARTED
- OPERATIONS MODEL DESIGNED

1995

START PRIVATIZATION STEPS

- PRICES (RATES) RAISED
- COMMENCE DUE DILIGENCE, AUDITS, VALUATIONS
- SELECT INVESTMENT BANKS TO MANAGE SALE
- INFORMATION MEMORANDUM, TENDER STRUCTURE, ETC.

STATE OBJECTIVES

- ENSURE A SECURE SUPPLY OF ELECTRICITY
- ENSURE LOW COST POWER
- DEVELOP A MODERN POWER SYSTEM
- ATTRACT FOREIGN CAPITAL TO FINANCE INVESTMENT REQUIREMENTS
- OPTIMIZE STATE PROCEEDS FROM PRIVATIZATION

WHAT ARE THE POSSIBLE CONFLICTS ?

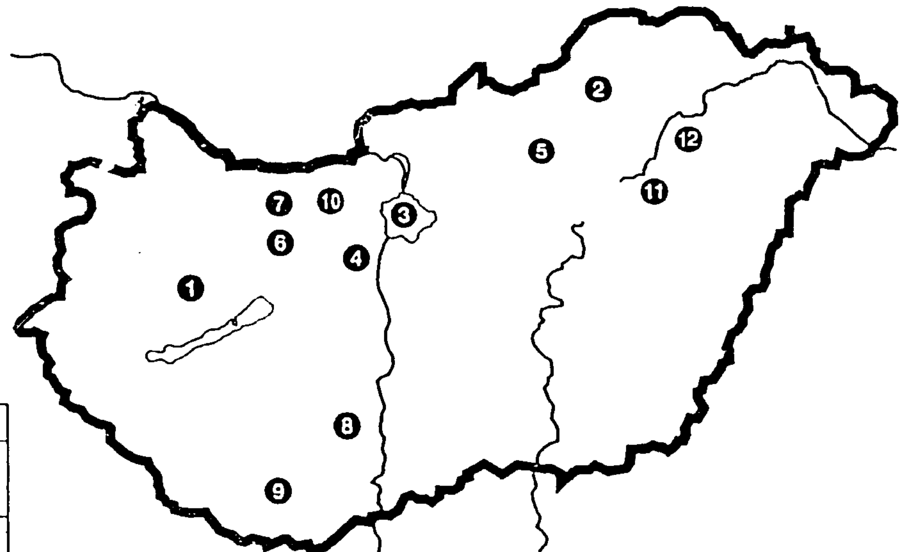
CHARACTERISTICS OF SECTOR

<u>THE SECTOR CONSISTS OF THREE TIERS:</u>

1. GENERATION	EIGHT COMPANIES
2. TRANSMISSION	THE HOLDING COMPANY
3. DISTRIBUTION	SIX COMPANIES

1.) ELECTRICITY / HEAT GENERATION

- EIGHT ENERGY GENERATION COMPANIES
- GENERATE 97% OF POWER AND ENERGY
- COAL OPERATIONS OLD AND INEFFICIENT
- SUPPLIES MAJOR HEAT REQUIREMENTS

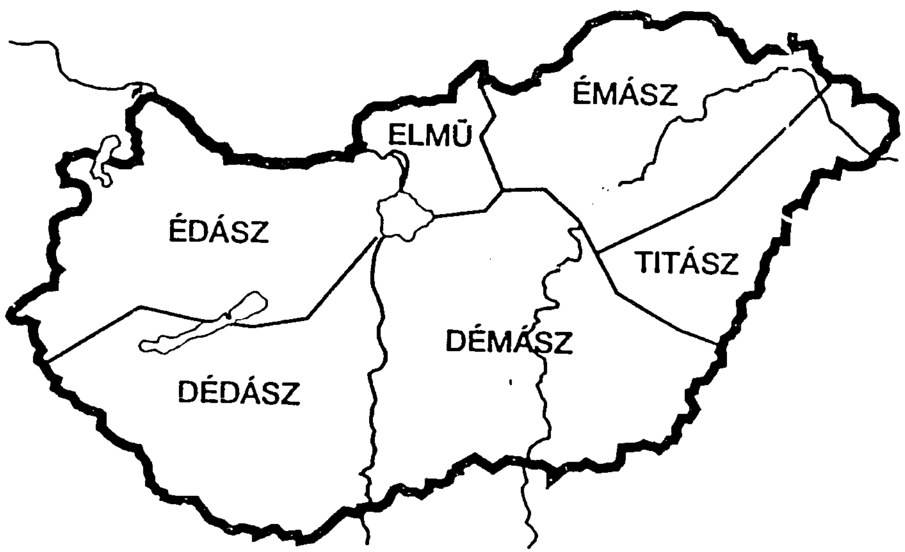


Power station	Fuel	Units			In 1992		
		No.	Capacity Per Unit MW	Total Electric Capacity MW	Nominal Heat Capacity MW	Electricity Generation GWh	Heat Supply TJ
1 Ajka	coal	6	3x30+12+10+19	132	395	476	3361
2 Borsod	coal	9	4x30+1+5+10+12+21	171	532	599	3168
3 Budapest	hydrocarbon	16	min 1.3-32 max	131 163	2504	640	16314
4 Dunamenti	hydrocarbon	13	6x215+3x150+50+40+2x20	1870	646	4275	7967
5 Matra	lignite	5	3x200+2x100	800	55	3798	151
6 Inota	coal	5	4x70+12	92	160	122	680
6 Inota GT	oil	2	2x85	170	-	0.2	-
7 Oroszlany	coal	4	1x55+3x60	235	50	1436	388
8 Paks	nuclear	8	8x230	1840	135	13964	629
9 Pecs	coal	6	2x60+2x35+2x30	250	521	955	3389
10 Banhida	coal	1	100	100	38	617	105
11 Tiszapalkonya	coal	7	1x50+13+15+7+3-55	250	315	932	2422
12 Tisza II	hydrocarbon	4	4x215	860	-	2616	-

2.) ELECTRICITY TRANSMISSION

- ONE COMPANY
- PRIOR TO 1991; RELIANCE ON SOVIET UNION (1/3 OF SUPPLY)
- SHARES BORDERS WITH SEVEN COUNTRIES
- THREE HIGH VOLTAGE TRANSMISSION LINES CONNECTING FORMER SOVIET UNION, MAJOR POWER STATIONS AND THE SIX SUPPLY COMPANIES
  PLAN POWER LINES AND INTERCONNECTIONS FOR LARGE REGIONAL GRID

TERRITORY OF SIX REGIONAL POWER SUPPLY COMPANIES



Regional Electricity Demand (GWh)

Regional Power Supply Company	1991	1992
ELMŰ-Budapest	7,892	7,738
ÉDÁSZ-North West	6,555	
ÉMÁSZ-North	5,446	
DÉDÁSZ-South West	3,713	
DÉMÁSZ-South	3,341	3,284
TITÁSZ-East	3,424	
TOTAL	30,271	

3.) ELECTRICITY DISTRIBUTION

- SIX REGIONAL ELECTRICITY DISTRIBUTION COMPANIES (FRANCHISE OR MONOPOLY)
- RECEIVE ELECTRICITY FROM HIGH-VOLTAGE GRID AND POWER STATION COMPANIES AND INDUSTRIAL POWER STATIONS WITHIN THEIR REGION

PRIVATIZATION PLAN

- DEVELOP ALTERNATIVE SCENARIOS
- DEVELOP LEGAL AND RATES STRUCTURE
- DEVELOP OPERATIONAL MODEL (HOW OWNERSHIP AND REGULATION WILL WORK)
- PUT POWER DISTRIBUTION COMPANIES UP FOR SALE FIRST
- OPERATE ALL POWER STATIONS, BEGIN WITH VIABLE COMPANIES
  - REINVEST PRIVATIZATION REVENUES
  - REVIEW SECTOR INTERESTS (L0CAL JOBS, SUPPLIERS)
- TRANSMISSION AND HOLDING COMPANY TO RETAIN 50% + 1 SHARE.
- SHARES TO BE SOLD:
  - FOR COMPENSATION NOTES
  - TO SMALL INVESTORS

RECOMMENDED INDUSTRY OWNERSHIP STRUCTURE

- THREE TIER (SEGMENTED) STRUCTURE
  - GENERATION
  - TRANSMISSION
  - SUPPLY (DISTRIBUTION)

PRIVATIZE

- SEVEN POWER GENERATION COMPANIES (NOT THE NUCLEAR PLANT)
- SIX SUPPLY (DISTRIBUTION) COMPANIES
- TRANSMISSION COMPANY (50% MINUS 1 SHARE)

INVESTORS

- STRATEGIC (TRADE) INVESTORS TO PURCHASE MAJORITY SHARES (OPEN TENDER)
- CAPITAL INCREASE AS REQUIRED
- MINORITY SHARES TO DOMESTIC AND INTERNATIONAL BUYERS (PUBLIC OFFERING)
- DOMESTIC BUYERS MAY USE COMPENSATION NOTES

STATE'S ROLE

- HOLD "GOLDEN SHARE" (VETO) IN EACH COMPANY
- REGULATION THROUGH ENERGY OFFICE AND MINISTRY OF INDUSTRY

REGULATION

ELECTRICITY DISTRIBUTION (SUPPLY) - OPERATIONAL LICENSE BY THE ENERGY OFFICE

- SCOPE OF SERVICES
- GEOGRAPHIC BOUNDARIES
- TERMS OF LICENSE
- SERVICE STANDARDS AND AUTHORITY
- MONITOR CONTRACTS BETWEEN TRANSMISSION COMPANY AND SUPPLY COMPANIES
- COST COMPONENTS OF ENERGY RATES AND RATE CONVERSIONS

RATE SETTING

- MINISTRY OF INDUSTRY
- ENERGY OFFICE

RATE REGULATION

• TRANSMISSION COMPANY	RECOVERS CAPITAL, AND OPERATING COST, PLUS A RETURN
• DISTRIBUTION COMPANY	RECOVERS CAPITAL AND OPERATING COSTS, PLUS A RETURN. COST OF ELECTRICITY PURCHASED WOULD BE PASSED THROUGH.

CASE STUDY

STRATEGIC PRIVATIZATION CONCEPTS

TELECOMMUNICATIONS	• MINORITY SHARE TO STRATEGIC BUYERS WITH OPTIONS TO EXPAND. MANAGED BY INVESTMENT BANK • FLOAT PUBLIC SHARES. MANAGED BY BROKER • FRANCHISE LOCAL SERVICES
TELEVISION TRANSMISSION	• STATE OWNERSHIP • FRANCHISE OR AUCTION CHANNELS
GAS DISTRIBUTION	• STATE-CONTROLLED SUPPLY • PRIVATIZE DISTRIBUTION • OPEN TENDERS MANAGED BY INVESTMENT BANKS • MINORITY SHARES TO EMPLOYEES
OIL PRODUCTION AND PROCESSING	• LONG-TERM VIABILITY • MAJOR INTERNATIONAL OPERATOR • LONG-TERM STATE OWNERSHIP • MARKETABLE SHARES TRADED

Privatization Seminar

Day 4: Valuation of Businesses

Contents:

- Valuation and value
- Business valuation premises
- Generally accepted valuation approaches
- Valuation methods

Valuation of businesses

- Concepts and principles
- Methods
  - *Theories*
  - *Use*
  - *Limitations*

Why businesses are appraised

Purpose of the appraisal

- Transaction pricing (mergers, acquisitions)
- Privatization/post-privatization
- Financing
- Management buy-out
- Joint venture investment
- Other

What is appraisal ?

An Appraisal (valuation) is either a supportable opinion as to value, usually in writing, or the process of estimating the value of an asset, asset groups, or all of the assets of a business or an investment in a business.

What is "value" ?

Quality of a thing according to which it is thought of as being more or less desirable, useful or important.

Religious value
Philosophical value
Social value
Moral value
Economic value

Economic value is that kind of value according to which a thing is capable of producing economic benefits for its owner or user.

Price, cost and value

Value refers to the worth of something, according to some standard of worth. The measurement or estimation of value, specifically economic value, is what appraising is about.

The term price refers to the amount of some medium of exchange, frequently but not necessarily money, that is needed to acquire a thing or that has actually been expended to acquire it.

Cost refers to the amount of one or more commodities - such as money, labor, or material - that is needed or expended to create or acquire a thing.

What is economic value?

- Common types of economic value
  - Fair market value
  - Investment value
  - Going concern value
  - Liquidation value
  - Book value

- The definition of value affects the valuation engagement

Fair market value

Definition

- The price at which property would exchange hands, between a willing buyer and willing seller, neither being under any compulsion to buy or sell, each being aware of the relevant facts, and with equity to both.

- Assumes a hypothetical sale between two unrelated parties without regard to a specific buyer.

Fair market value
Further discussion

- Is intended to be a reasonable estimate of the price at which property may change hands between two willing parties (i.e. the Government and prospective investor).

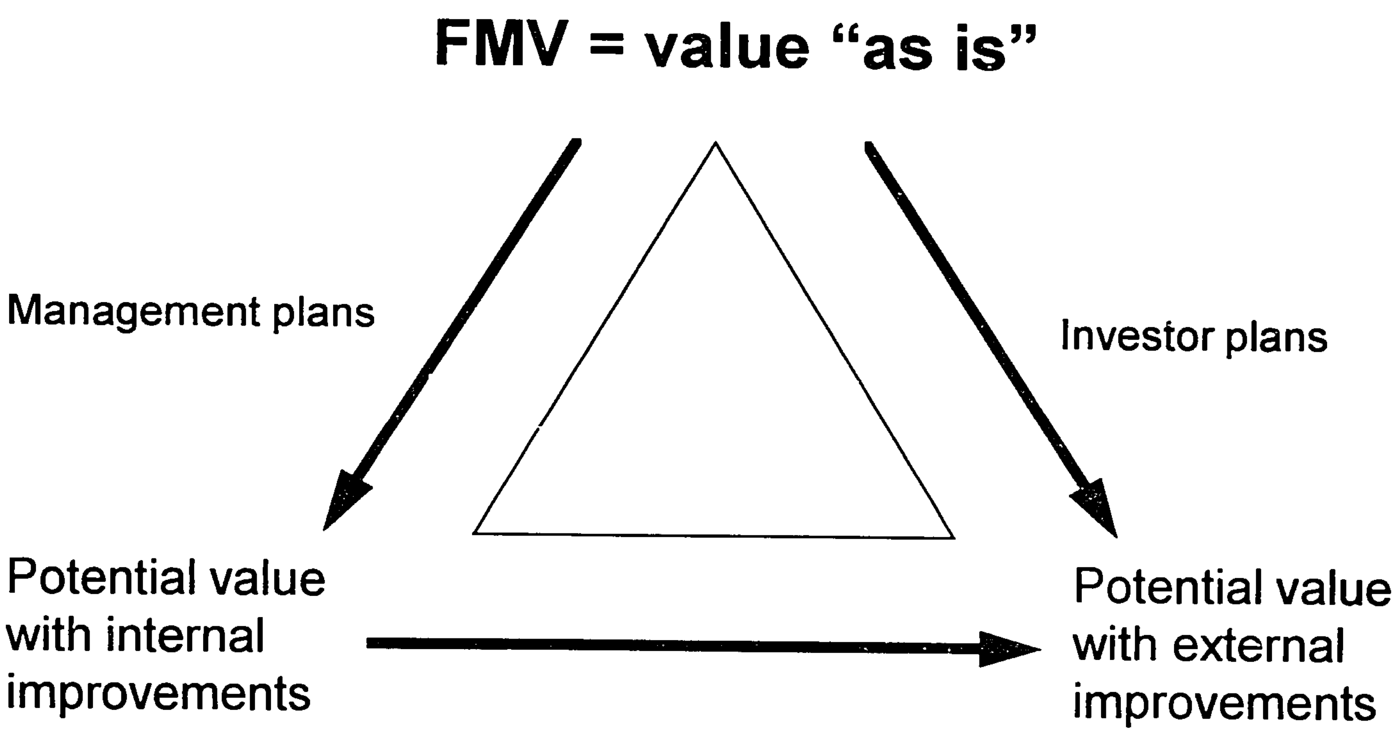
- The actual price paid in a transaction may differ from FMV due to such factors as: the motivation of the parties, the negotiating skills of the parties, the structure of the transaction (e.g. financing) and other factors unique to the transaction.

- This definition assumes the consideration is paid in cash. Consideration paid in the form or installment payments, seller financing, or contribution of intangible assets by the buyer, could affect the price paid.

Investment value
Definition

- Represents the value to a specific owner or prospective owner. Accordingly, the methods used to value the business in this case consider the owner's or prospective owner's know-how, management plans, cost savings and risk analysis.
- Differs from FMV which does not assume a specific buyer.
- Often a point of negotiation in a joint-venture or privatization transaction.

Relationships of value
FMV and investment value



Going concern value
Concept

- Not a definition of a value, but rather a concept.
- Refers to the intangible elements of a business arising from such factors as having in place a trained qualified workforce; an operating plant; and the required licenses, systems and procedures.
- The premise underlying going concern value is that there is no uncertainty (e.g. continued losses) about future events that calls into question the fundamental assumptions that the entity can continue to operate as a going-concern.
- The lack of a going concern business may indicate that liquidation value is the appropriate standard of value to use.

Liquidation value
Definition

- Assumes that a company's operations are expected to be discontinued and that its assets will be sold on a "piecemeal" basis.
- Thus the "going concern" value assumption no longer exists.
- Two levels of liquidation value:
  - *Orderly liquidation:* assumes assets are sold over a reasonable time period (6 months to 1 year) to get the highest price,
  - *Forced liquidation:* assumes assets are sold as quickly as possible, perhaps on an auction basis.
- Liquidation value also considers the costs incurred to sell the assets, such as selling fees.
- Typically represents the lowest value indication for a business excluding its real estate.

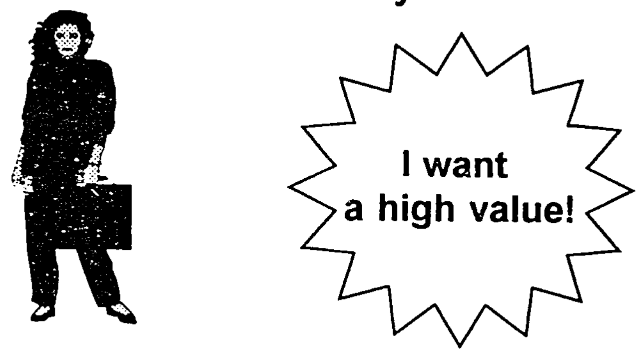
Book value
Definition

- Book value is an accounting term, that typically refers to one of the following:
  - *For an asset:* its historical cost reduced by any allowances for depreciation,
  - *For a business:* the excess of total assets over total liabilities, or "stockholder' equity" or "net asset value".

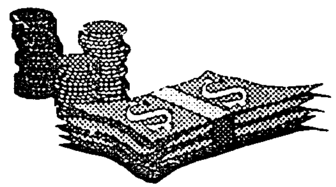
- It is only a coincidence when book value is the same as fair market value or investment value.

What is value?

Value is not based on what the client says to a valuation consultant.



Value is not based on how much the client pays to a valuation consultant.



Valuation opinion should be an independent, objective conclusion based on the facts and circumstances of each case.

The role of the consultant in a business valuation engagement

- The consultant serves as an independent consultant, performing an objective valuation of the company (or a specific part of the company), or

- The consultant serves as an advisor, determining a value that is most beneficial to the client's position
  - in this role, the consultant will typically assist the buyer or seller in establishing a range of acceptable values
  - the consultant can provide invaluable assistance in the negotiations, pointing out factors that should lower seller's expectations or raise the buyer's offering price.

Objective of the appraisal
What is being valued and when?

- Valuation date:
  - As of a specific point in time
  - Current vs. historical
  - Differs from report date
  - Based on information available through valuation date

- What is being valued?
  - Total assets
  - Specific assets
  - Invested capital
  - Owners' equity
    - controlling vs. minority

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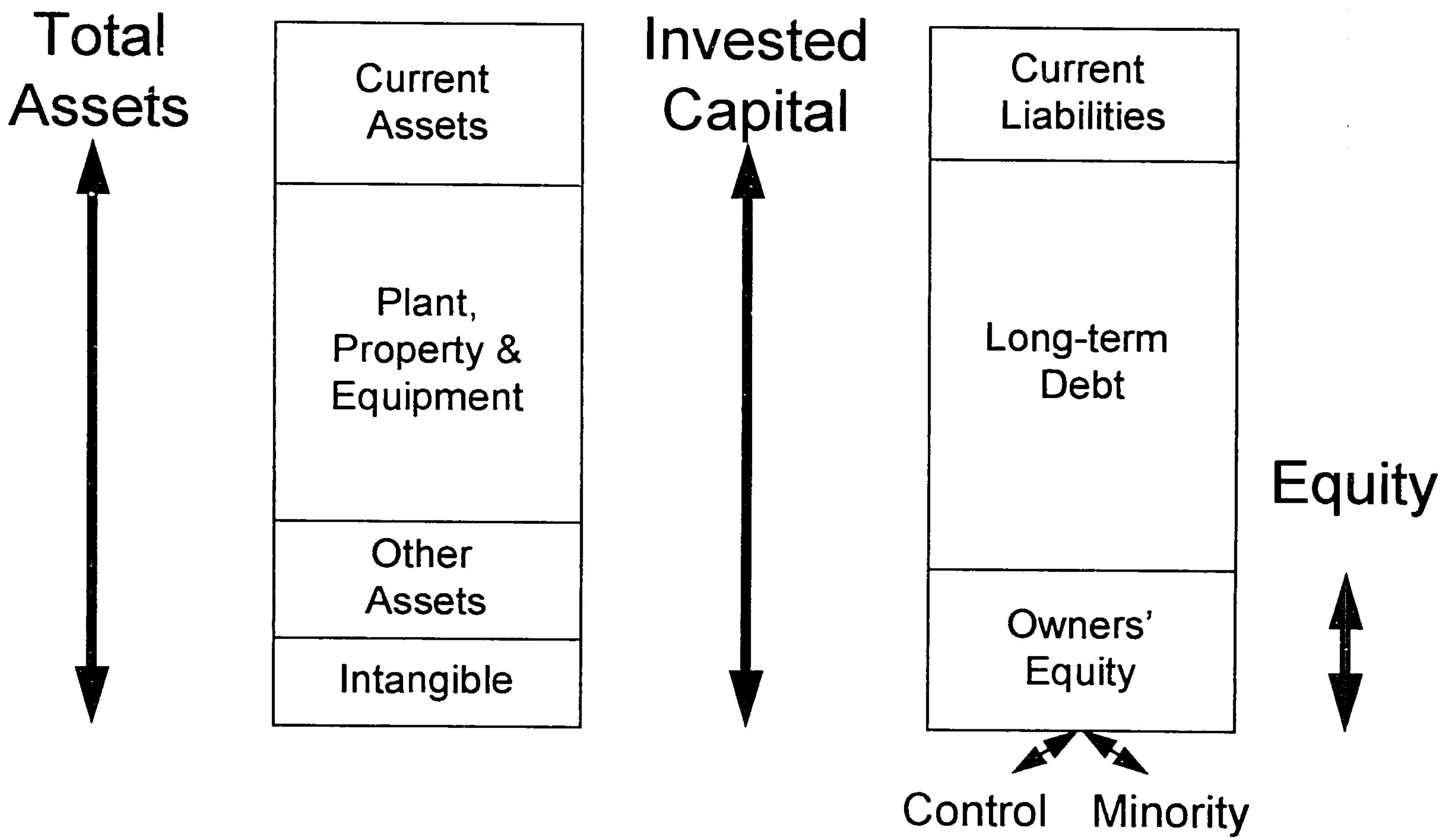
Objective of the valuation
What is being valued?



Business valuation premises

- The principle of substitution
  The value of thing tends to be determined by the cost of acquiring an equally desirable substitute.

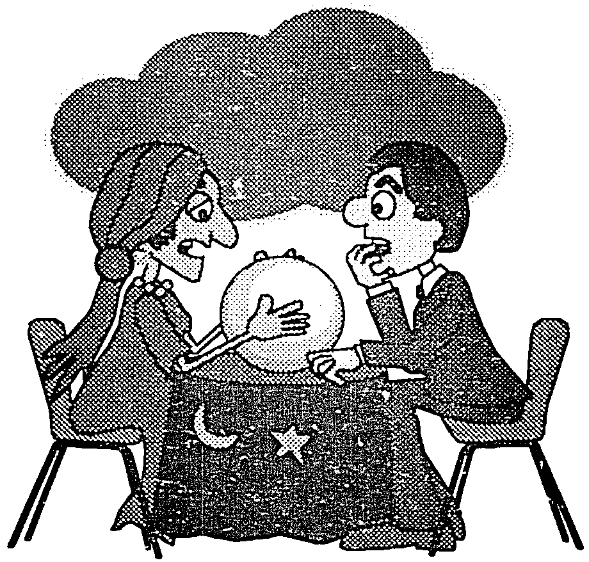
- The principle of future benefits
  The value of a business is equal to the present worth of the future benefits of ownership.
  - *A rational buyer normally will invest in a company only if the present value of the expected benefits of ownership are at least equal to the purchase price.*
  - *Conversely, a rational seller normally will not sell if the present value of those expected benefits is more than the selling price.*

- Value is not always a single number!
  - *A company's value depends on each potential investor's assessment of the benefits and risks relating to a company. Generally, the valuation consultant's task is to determine the most likely conclusion where the buyer and seller will meet.*

- Value is based on a specific point in time - the valuation date.

Valuation premises

Valuation is not magic!



Value is based on acceptable methods, which are applied using the data available, along with the appraiser's professional judgment and experience, to arrive at *a reasonable estimate of value.*

Data gathering
Company data

- Company data
  - *company background & history*
  - *company products & markets*
  - *balance sheets/income statements (up to 5 years)*
  - *balance sheet account detail*
  - *facilities (land & building)*
  - *fixed asset listings (machinery & equipment)*
  - *management interviews & asset inspections*
  - *information regarding management & personnel*
  - *operational data (capacity, product mix, etc.)*
  - *financial forecasts*
  - *strategic plan*
  - *business plan*

- Objective: to gain a thorough understanding of the company's history, current and projected financial position, products, markets, strengths, weaknesses, etc.

- Inquiries should also be made concerning: environmental issues, social assets and asset ownership.

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Economic & industry data
General comments

- A company does not operate in a vacuum. It is affected by external factors such as economic and industry trends.
- Thus the company's value cannot be determined by just financial statement data - the external factors and their impact on value must be considered.
- However, the type of valuation method used determines the amount and relevance of economic and industry data.
- For example, a valuation based on net asset value would not require as much economic analysis as a valuation based on the discounted cash flow method.

Financial analysis
Importance to the appraisal process

- Is a key factor in assessing the risk of investing in the business
- Provides a basis to analyze trends and identify unusual items for further analysis
- Impacts the discounted cash flow methodology in assessing *growth, costs, margins, working capital, debt and of most importance - the discount rate*
- Provides a basis for comparison to industry or similar company data
- Is a key factor in selecting the appropriate valuation multiple in the guideline company approach
- Can provide a basis for assessing economic obsolescence

Financial analysis

Importance to the appraisal process (con't)

- In summary, the financial analysis affects many phases of the appraisal process, including each of the valuation methods
- Thus, the financial analysis is probably the most important part of the appraisal process
- A lack of data from which to perform the financial analysis increases significantly the risk of investing in the business
- The financial analysis should focus on the factors important to the valuation of the company

Financial analysis of the company
The process

- Transformation of the accounts
- Financial statement adjustments to normalize operations
- Ratio analysis: liquidity, leverage and operating ratios and common size balance sheets and income statements
- Comparable company or industry financial data
- Analysis of trends or unusual items
- Focus on issues affecting the value of the company

Generally accepted valuation approaches

- Guideline company approaches
  - *Capital Market Method*
  - *Market Transaction Method*
- Discounted future net cash flow approach
- Capitalization of earnings/cash flow
- Asset accumulation approach & excess earnings
- Industry multiples & guidelines

Discounted future cash flow
Theory

- This method is based on the theory that the value of an investment in a business depends on the future benefits (e.g. cash flow) that will accrue to the owner or investor in that business

- These future cash flows are then discounted back to their present value equivalent using a discount rate that matches the investor's required rate of return.

- The investor's required rate of return is based on his analysis of the risk of investing in the business and in the risk receiving the expected future cash flow.

Discounted future cash flow

Present value theory

- Present value theory:
  - *is based on the fact that one can invest \$1 today and through investment return on that \$1, receive more than \$1 in the future.*

- Example: *if you invested \$1 today to earn 10%, in one year your investment would be worth \$1.10. The future value in this case is \$1.10 and the present value is \$1.00.*

- Conversely, if you knew that you would receive \$1.10 in the future, and your required rate of return was 10%, what amount would that future \$1.10 be worth to you today? (\$1.00).

Present value formula

For $1

$$PV = \frac{1}{(1 + r)^n}$$

Where:

PV = Present value
r = Discount rate
n = Number of periods

Discount rate table

Discount rate	Year: (period) 1	2	3	4	5
15,0%	0,870	0,756	0,658	0,572	0,497
16,0%	0,862	0,743	0,641	0,552	0,476
17,0%	0,855	0,731	0,624	0,534	0,456
18,0%	0,847	0,718	0,609	0,516	0,437
19,0%	0,840	0,706	0,593	0,499	0,419
20,0%	0,833	0,694	0,579	0,482	0,402
21.0%	0,826	0,683	0,564	0,467	0,386
22,0%	0,820	0,672	0,551	0,451	0,370
23,0%	0,813	0,661	0,537	0,437	0,355
24,0%	0,806	0,650	0,524	0,423	0,341
25,0%	0,800	0,640	0,512	0,410	0,328

Example calculation

CASE 1 - A			
DISCOUNT RATE	20,00%		
YEARS	3		
YEAR	1996	1997	1998
CASH FLOW	100	100	100
PRESENT VALUE FACTOR	0,833333	0,694444	0,578704
PRESENT VALUE OF CASH FLOW	83,33	69,44	57,87
SUM OF PRESENT VALUES FOR 3 YEARS	**210,65**		

CASE 2 - A			
DISCOUNT RATE	20,00%		
YEARS	3		
YEAR	1996	1997	1998
CASH FLOW	50	100	150
PRESENT VALUE FACTOR	0,833333	0,694444	0,578704
PRESENT VALUE OF CASH FLOW	41,67	69,44	86,81
SUM OF PRESENT VALUES FOR 3 YEARS	**197,92**		

CASE 3 - A			
DISCOUNT RATE	20,00%		
YEARS	3		
YEAR	1996	1997	1998
CASH FLOW	150	100	50
PRESENT VALUE FACTOR	0,833333	0,69444	0,5787037
PRESENT VALUE OF CASH FLOW	125,00	69,44	28,94
SUM OF PRESENT VALUES FOR 3 YEARS	**223,38**		

Example calculation

CASE 1 - B			
DISCOUNT RATE	40,00%		
YEARS	3		
YEAR	1996	1997	1998
CASH FLOW	100	100	100
PRESENT VALUE FACTOR	0,714286	0,510204	0,364431
PRESENT VALUE OF CASH FLOW	71,43	51,02	36,44
SUM OF PRESENT VALUES FOR 3 YEARS	**158,89**		

CASE 2 - B			
DISCOUNT RATE	40,00%		
YEARS	3		
YEAR	1996	1997	1998
CASH FLOW	50	100	150
PRESENT VALUE FACTOR	0,714286	0,510204	0,364431
PRESENT VALUE OF CASH FLOW	35,71	51,02	54,66
SUM OF PRESENT VALUES FOR 3 YEARS	**141,40**		

CASE 3 - B			
DISCOUNT RATE	40,00%		
YEARS	3		
YEAR	1996	1997	1998
CASH FLOW	150	100	50
PRESENT VALUE FACTOR	0,714286	0,5102	0,36443
PRESENT VALUE OF CASH FLOW	107,14	51,02	18,22
SUM OF PRESENT VALUES FOR 3 YEARS	**176,38**		

Discounted future cash flow approach

Steps involved

- Select definition of cash flow
- Revenue forecast analysis
- Expense analysis
- Investment analysis
- Residual value analysis
- Discount rate analysis
- Adjustments
- Review

Discounted future cash flow approach

Defining cash flow

- Definition of cash flow
  - *debt free or equity cash flow*
  - *nominal vs. real (with or without inflation).*

- Factors to consider:
  - *hyperinflationary environments*
  - *effects of inflation on each component of cash flow*
  - *level of capital expenditure programs.*

- Generally, equity cash flows on a nominal basis are preferred.

- In emerging markets, however, the debt free cash flow on a real basis may be more appropriate.

Cash flow
Various definitions

Equity	Debt - free
Net income + Depreciation, Amortization + Increases in long-term debt - Incremental working capital Capital investment Decreases in long-term debt = Equity cash flow	Net income (excluding interest) + Depreciation, Amortization - Incremental working capital Capital investment = Debt-free cash flow
Discount rate: Equity cost of capital	**Discount rate:** Weighted average cost of capital

Cash flow
Various definitions (con't)

Valuation conclusion:	
Equity value	Invested capital (Interest bearing debt + equity) Interest bearing debt must be subtracted to reach equity value

Nominal vs. real
Nominal includes the effects of inflation on pricing and costs The equity discount rate must also include investor's inflation expectations
A forecast on real terms excludes the effects of inflation The equity discount rate must also be based on a real rate of return

Discounted future cash flow
Forecasting revenues

- Revenue forecast analysis
  - *forecast units and prices*
  - *export vs. domestic sales*
  - *capacity considerations*
  - *impact of capital investment*
  - *long-term growth*
  - *what growth will a buyer pay for?*
  - *consider historical growth, economic outlook, management plans, competition, etc.*

Discounted future cash flow
Expense & Investment analysis

- Expense analysis
  - *consider historical trends*
  - *variable vs. fixed*
  - *inflation considerations*
  - *consider unusual & non-recurring expenses that may be included in historical figures, but not in the future*
  - *depreciation should be based on existing levels plus analysis of additions & retirements in the future*
  - *interest expense excluded if a "debt-free" definition of cash flow is used*

- Investment analysis
  - *future working capital needs*
  - *future capital expenditure needs to maintain current production capacity or increase capacity*
  - *borrowings and repayments if using an equity cash flow basis*

Discounted future cash flow

Residual value analysis

- Residual value analysis
  - *based on continued ownership*
  - *assume sale of business*
  - *depreciation & capital expenditures must equal in the residual period*
  - *length of forecast period must be until stable operations are achieved*
- Gordon model
- Example

Residual value calculation

Gordon model

Formula:

$$\frac{\text{CF in following year}}{\text{(Discount rate - Long-term growth rate)}}$$

Example:

Cash flow in year 5	1000
Long-term growth rate	3% per year
Discount rate	20.0%

Residual value calculation:

$$\frac{(1000 * 1.03)}{(.20 - .03)}$$

Is equal to: 6,059

Comments:

This represents the value of all cash flows remaining beyond the end of the forecast period

The value is as of the end of the forecast period, thus it must be discounted to arrive at the present value today

It assumes a constant growth in cash flow

The conclusion should be fairly close to the same answer as if continuing the cash flow model into infinity

Discount rate analysis
Basis

- Basis for the discount rate must match that of the cash flow being used
- For example, an equity cash flow would be discounted using an equity discount rate
- A debt free cash flow must be discounted using a weighted average cost of capital (WACC)
- If the forecast is on a "real" basis (i.e. excluding inflation) then the equity discount rate must also be calculated on a "real" basis
- Two basic methods to estimate the equity discount rate
- Difference between a discount and capitalization rate

Discount rate analysis
CAPM

- Formula: R = Rf + b(Rm - Rf)
  Where: R = required rate of return
  Rf = risk free rate
  b = beta
  Rm = return on the market
  Rm - Rf = market premium

- Rf is based on the risk free rate, either nominal or real, typically for long-term government bonds' represents a rate of return to an investor that is risk free and liquid.

- Beta is a risk measure based on the volatility of the price of the company compared to the movement in the market as a whole; a higher beta = higher risk. Calculated based on the betas for the industry of the subject company.

Discount rate analysis
CAPM con't

- Beta can also be estimated using specific company analysis of the economic, industry and financial risk factors
- Rm - Rf is based on a historical analysis of returns from stock markets compared to returns from risk free government bonds
- Adjustments: company specific

Worldwide risk free rates

	Nominal			Real	Real
	Long-term government	Consumer prices		Real rate based on:	
Country	bond yields	Historical 1 Year	Projected 1995	Historical 1 Year	Projected 1995
Australia	10,1%	2,6%	3,5%	7,5%	6,6%
Austria	7,4%	2,7%	2,5%	4,7%	4,9%
Belgium	8,2%	1,9%	2,3%	6,3%	5,9%
Britain	8,7%	3,3%	3,4%	5,4%	5,3%
Canada	8,9%	0,2%	2,1%	8,7%	6,8%
Denmark	8,7%	2,2%	2,5%	6,5%	6,2%
France	7,9%	1,7%	1,9%	6,2%	6,0%
Germany	7,3%	2,3%	2,3%	5,0%	5,0%
Holland	7,4%	2,4%	2,5%	5,0%	4,9%
Italy	12,1%	3,8%	4,1%	8,3%	8,0%
Japan	4,5%	0,7%	0,7%	3,8%	3,8%
Spain	11,3%	4,4%	4,7%	6,9%	6,6%
Sweden	10,5%	2,5%	3,5%	8,0%	7,0%
Switzerland	5,2%	1,0%	2,5%	4,2%	2,7%
USA	7,4%	2,8%	3,4%	4,6%	4,0%
Average	8,4%	2,3%	2,8%	6,1%	5,6%
Median	8,3%	2,3%	2,7%	6,0%	5,6%
Europe only	8,6%	2,6%	2,9%	6,0%	5,7%

Scurce: The Economist (Feb. 25, 1995)

Analysis of betas
Selected industries

	General building contractors	Electric utilities
Number of companies	210	156
Average beta	1,88	0,75
Number of companies above 1.00	85,00%	29,00%
US	1,44	0,51
UK	2,00	NA
Europe (excluding UK)	2,12	1,07
Japan	1,78	1,20

Other industries:	Beta
Concrete (56 companies)	1,76
Telecommunications (32)	0,79

Privatization Seminar

Day 5: Organisation of privatisation

Privatization 1989-1991

- **November 1989 - Political and economical turn**
  1,2% of people employed in the private sector which produced about 4,1% of GNP; private persons owned only 2% of total fortune
- **1990- Preparation of privatization concepts**
  The Ministry of Privatization established; planning system abolished; the first restitution and privatization laws passed
- **1991 - Transformation of state owned assets**
  Formation of the National Property Fund; state owned assets (houses, administrative and industrial buildings, agricultural facilities, forestry) given back to original owners; small scale privatization commenced

National Property Fund

- The NPF of the Czech Republic was established by the law approved by the Czech National Council on May 2, 1991.
- The NPF is a juridic person whose activities are aimed at administration of the national fortune and its privatization in accordance with valid laws and regulations.
- 10.821 privatization projects of 2.170 companies were decided upon as at December 31, 1992.

Privatisation - A Integral Part of Economic Reform in the Czech Republic

Main directions of the property rights changes

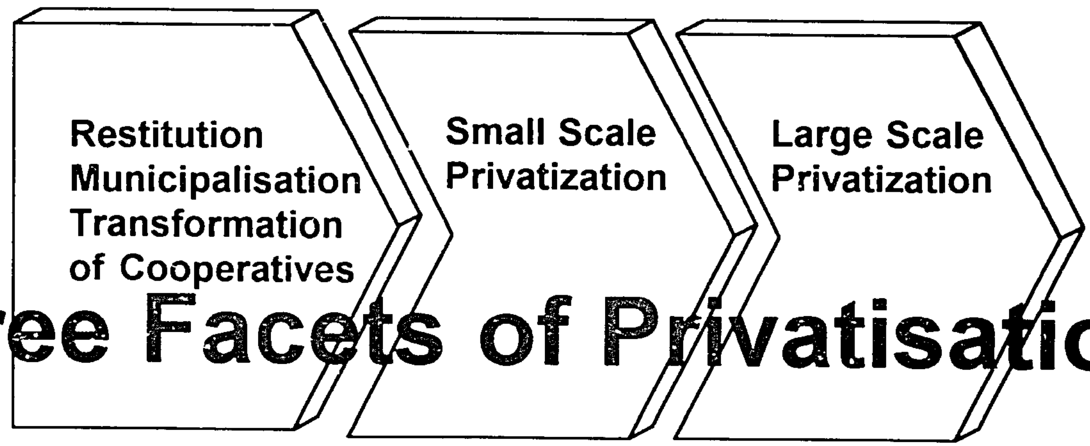
- Restitutions
- Municipalisation
- Transformation of Cooperatives
- Small Scale Privatisation
- Large Scale Privatisation
- Voucher Privatisation

Main Directions of the Property Rights Changes

- 1989 - Political breakpoint
- 1990 - Formation of the market reformpolicy
  - Restitution and small scale privatisation legislation
- 1991 - Implementation of the market reform policy
  - Small scale privatisation auctions
  - Large scale privatisation legislation and organizational network
- 1992 - Large scale privatisation started
  First wave of the voucher privatisation
  - Transformation of cooperatives
- 1993 - Second wave of voucher privatisation

Privatization Process Defined

While the three facets of privatization included restitution of property to former owners, municipalisation - transfer of selected assets and lands to the municipalities and transformation of cooperatives international attention has focused on small and large scale privatisation. . . . .



Three Facets of Privatisation

Small Scale Privatization

- Primary objective was the quick restoration of private ownership of small, entrepreneurial businesses
- Involved primarily shops, restaurants, services and small workshops
- Executed by means of auctions held by 85 municipal privatisation commissions
- Up to date over 23,000 businesses had been sold with total proceeds exceeding US$ 1 bn.

Large Scale Privatization

- Privatization of medium and large scale companies of all industries (agriculture, trade and services, health care)
- All privatisable companies were divided into the two main lists of companies determined for privatisation
- These lists were published and a deadline was given for every citizen to submit a privatisation proposal for any piece of companies listed
- First list contained: the number of submitted companies (2,700 from all branches), proposals (11,000) and deadline (January 1992)
- Second list contained: the number of submitted companies (1,000 from all branches), proposals (5,000) and deadline (June 1992)

Institutions

Ministry

- prepares rules & legislation framework
- makes privatisation decisions (approves proposals)
- responsible to the government

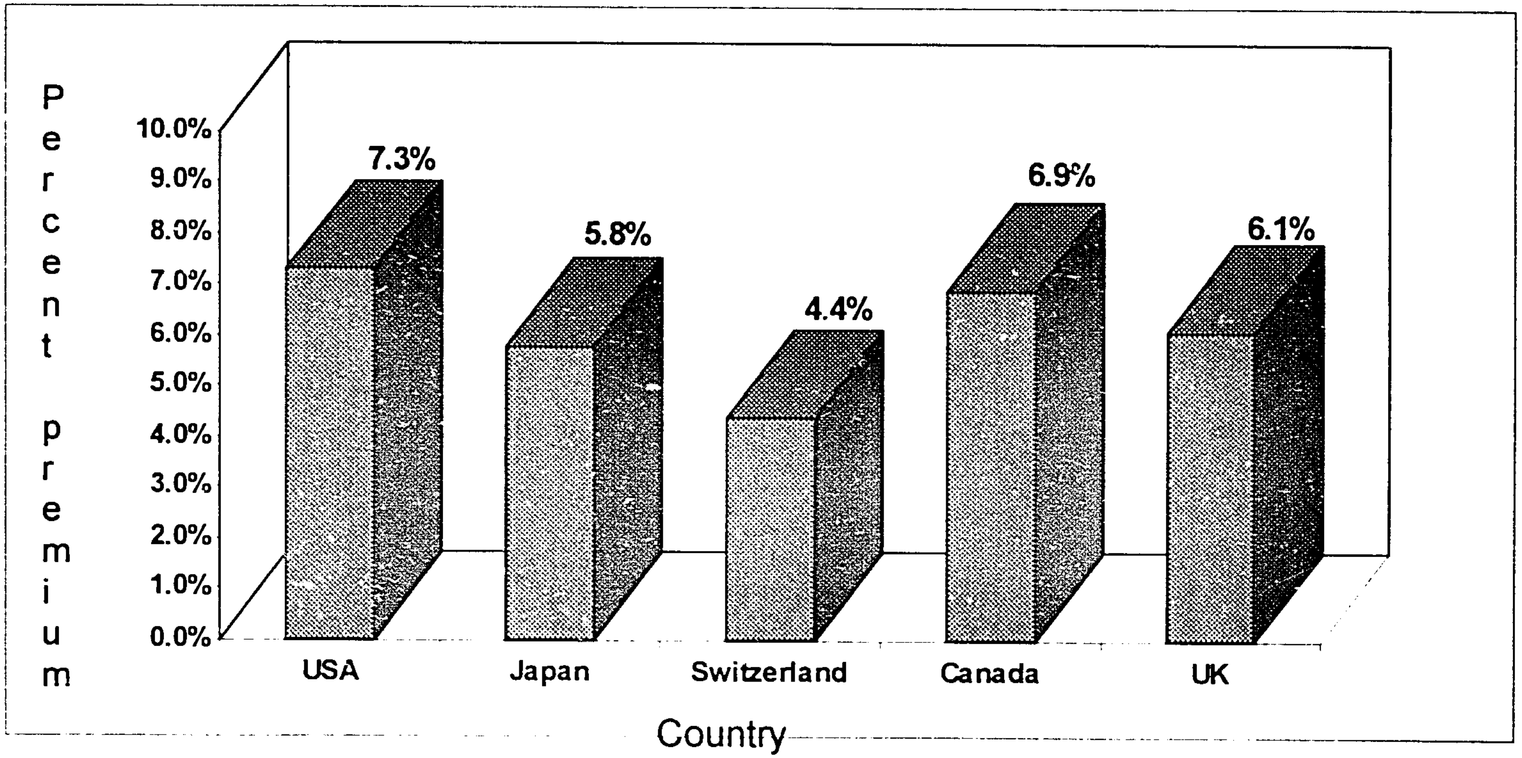
National Property Fund

- legal intermediary between the state and new owners
- realization of the privatisation decisions
- respons to the Ministry and parliament

Investment Privatisation Funds

- in Wave I 263 IPF
- 70% voucher points
- 10 IPF 40% of points
- strong owners with diversified portfolio
- IPF will play the key role in the post-privatisation period

Equity risk premiums



Source: Ibbotson & Associates

Sample equity rate of return calculations

	Low risk industry			Average risk industry			High risk industry		
	Large, public company	Medium	Small	Large, public company	Medium	Small	Large, public company	Medium	Small
Risk free rate	8,0%	8,0%	8,0%	8,0%	8,0%	8,0%	8,0%	8,0%	8,0%
Beta	0,75	0,75	0,75	1,00	1,00	1,00	1,50	1,50	1,50
Market premium	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%
Company specific risk	0,1%	3,0%	5,0%	0,1%	3,0%	5,0%	0,1%	3,0%	5,0%
Nominal equity cost of capital	12,5%	15,5%	17,5%	14,0%	17,0%	19,0%	17,0%	20,0%	22,0%
Real cost of capital (based on real risk free rate of 5%)	9,5%	12,5%	14,5%	11,0%	14,0%	16,0%	14,0%	17,0%	19,0%

Discount rate analysis
Build up approach

- As with the CAPM, begins again with an estimate of the risk free rate
- To the risk free rate is added a premium for investing in a closely held business instead of a risk free bond
- Guidelines for establishing premiums have been published in appraisal journals
- Examples

Expected rates of return

Type investment	Rate	Comment
Five year US government treasury bonds	8,0%	No risk, liquid
Thirty year US government treasury bonds	8,5%	No risk, liquid, longer term
BAA rated bonds	10,0%	Higher risk, slightly less liquid
Expected market return (per value line)	19,0%	Higher risk, liquid
Small, closely-held businesses	20-40%	Higher risk, little liquidity
Venture capital expected returns		
First stage	30-40%	Higher risk, little liquidity
Second stage	50%+	

This table shows that as risk increases, and liquidity decreases, the required rate of return increases.

The rates in this table include inflation.

Suggest premiums for specific company risks

Specific risk	Likely range
Key man; management quality/depth	0-5%
Size of the company	0-5%
Financial structure	0-5%
Product/geographical diversification	0-5%
Customer diversification	0-5%
Earnings: margins and historical predictability	0-5%
Other specific risks	0-5%

Source: Business valuation review, December, 1992.
"The adjusted capital asset pricing model for developing capitalization rates: An extension of previous build-up methodologies based upon the capital asset pricing model".

Example
Build up approach

Factor	Amount	Comment
Risk free rate	8,0%	
Key man; management quality/depth	2,0%	The company is not dependent on 1 key man; however there is no management depth
Size of the company	0,0%	The company is very large; enjoys a monopoly
Financial structure	5,0%	The company has a high amount of debt; twice the industry average
Product/geographical diversification	2,0%	The company relies on one product for all sales; however, it sells on both the domestic and export markets
Customer diversification	4,0%	80% of sales last year were to only 5 customers, with the largest accounting for 35%
Earnings: margins and historical predictability	3,0%	Lack of a history beyond 2 years old makes predictability difficult
Other risks	0,0%	No other specific company risks

Estimated equity discount rate 24,0%

(Before country risk)

Discounted future cash flow

Discount rate vs. capitalization rate

- A discount rate is defined as "a rate of return used to convert a monetary sum, payable or receivable in the future, into present value".
- A capitalization rate is defined as "any multiple or divisor used to convert income into value".
- Thus a discount rate is applied to future cash flows and represents the investor's required rate of return. The "cap" rate is applied to a single cash flow (e.g. last year's cash flow) to derive value.
- The cap rate can be derived from the discount rate by subtracting the expected annual average growth rate in cash flow from the discount rate. Thus the cap rate will be less than or equal to the discount rate.

Discounted rate analysis

Summary

- Two commonly used approaches
- Real rate of return for equity typically between 13 to 19 percent before country risk considerations
- Nominal rate of return for equity (in a stable inflationary environment) typically ranges from 16 to 22 percent before country risk considerations.
- Discussion so far focused on equity rate of return; if WACC is to be used as the discount rate, the cost of debt must be calculated, as well as the amount of debt financing as a percent of total capital (debt + equity)
- Adjustments to the equity discount rate: country risk

Discount rate

Country risk adjustment

- If the buyer is from a foreign country, then he faces additional risks including:
  - *foreign currency risk*
  - *loss of assets through expropriation/nationalization*
  - *restrictions on flows of capital*
  - *price controls*
  - *and many other factors.*
- Thus, the foreign buyer will account for this increased risk by adjusting:
  - *cash flow*
  - *the payback period (shorten)*
  - *or the discount rate (increase).*
- Studies of multinational companies have provided details regarding the amount of country risk.
- Country risk perceived by the local investor may be different compared to the foreign investor.

Guideline company approach

Overview of methods

- Capital market method - based on prices paid for shares of similar companies on the world share exchanges
- Transaction method - based on prices paid for acquisitions of similar companies locally or abroad
- Industry pricing method - based on special formulas or rules in certain industries

Guideline company approach
Capital market method - Overview

- Theory
- Sources of data
- Selection of "guideline" companies
- Financial analysis and comparison
- Selection and calculation of valuation multiples
- Application to the subject company
- Result - what level of value does it represent
- Final adjustments to consider

Guideline company approach
Capital market method

- *Theory:* based on the market prices of shares of similar public companies; an investor, under the principal of substitution, can invest in these companies or the subject company. The public companies, with proper adjustments, should provide guidelines for pricing a private company.

- *Sources of data:* Disclosure World Scope contains updated financial information on over 15,000 companies on 24 different world markets.

- *Selection of "guideline" companies:* should be similar in products offered; other considerations include size, geographic markets, profitability, growth, etc. At least 6 to 8 companies should be selected.

Guideline company approach

Selecting comparable companies

- How diversified are the operations of the subject company and the comparable companies?
- How comparable are the products that are manufactured or sold by the subject company and the comparable companies?
- Do the comparative companies have the same economic influences as the company being valued?
- At what stage of development is the subject company versus the comparable companies?
- How do the companies compare in size?

Guideline company approach
Capital market method (con't)

- *Valuation of the subject company:* the selected multiples should be applied to the appropriate financial data of the subject company, on a basis consistent with the way the multiple for the public companies was calculated.

- *Result:* the resulting value is the value of the company as if its shares were traded on a stock exchange, based on the financial comparison to similar companies.

- <u>The resulting value is the value of a minority ownership in the company, with freely traded shares - thus:</u>

- A control premium and marketability discount must be applied to estimate the value of a controlling, non-marketable (non-freely tradeable) interest in the subject company.

Guideline company approach

Capital market method - Conclusion

- *Final adjustments:* additions of excess, or non-operating assets; addition of (or subtraction of) excess (or deficient) working capital.
- *Country risk adjustment:* the multiple should be adjusted for the country risk, if any, if the buyer/investor is foreign.
- Studies have shown this is the practice observed by multinational companies.

Guideline company approach
Transaction method

- *Theory:* based on the sale of similar companies.

- *Sources of data:* Mergerstat Review, Acquisitions Monthly.

- Selection of "guideline" companies, financial analysis and comparison, selection of multiples, etc. - based on the same approach as used in the capital market method.

- *Result:* the major difference between this and the capital market method is that the answer is the value of a controlling interest in the subject company - thus only a marketability discount is required to estimate the value of a private company at a controlling level.

- *Other adjustments:* as with the capital market method, adjustments for non-operating assets, working capital, country risk, etc. must be considered.

Example
Transactions in the cement industry

XYZ CEMENT 1990-1992				
Selling company	**Country**	**Date**	**Percent purchased**	**Price to earnings**
Auxiliar de la Construccion SA	Spain	1990	50,0%	11,1
Minera, Financiera Y	Spain	1990	100,0%	19,4
Inveryeso	Spain	1990	65,0%	22,3
CH Industrials plc	UK	1990	100,0%	16,2
Ciments Francais SA	France	1991	70,0%	7,9
Ciments D'Obourg SA	Belgium	1991	40,0%	14,4
Lafarge-Coppeé SA	France	1991	5,0%	9,2
Origny SA, Group	France	1991	10,4%	10,8
Cementir Spa	Italy	1992	51,8%	40,3
Civil and marine Ltd	UK	1992	100,0%	10,0
Cementos del mar sa	Spain	1992	50,0%	9,4
Auxiliar de la Construccion SA	Spain	1992	92,0%	7,0
Valenciana de Cementos Portland SA	Spain	1992	100,0%	15,8
Noroeste SA, Corp	Spain	1992	100,0%	25,3
California Portland Cement Co	USA	1990	19,0%	28,2
Average				15,7
Median				14,4

Industry "rules of thumb"

- Primarily used for smaller companies
- Based on data collected by business brokers and certain pricing formulas in certain types of businesses
- Can serve as a guideline, but should not take place of careful analysis and application of other valuation approaches

Asset accumulation approach
Steps involved

1. Begin with historical balance sheet
2. Restate based on accounting adjustments
3. Restate financial assets to net realizable value
4. Appraise tangible property at fair market value
   - real estate & improvement
   - machinery & equipment
5. Identify and value intangible assets
6. Restate liabilities to current value
   - include liabilities that may not be recorded
7. Equity value = FMV of total assets - CV of liabilities

Asset accumulation approach
Financial assets

- Accounts receivable - usually are valued by examining an ageing schedule, with amounts over a certain number of days past due written off partly or entirely

- Inventory - obsolete inventory written down. Normal inventory valued based on expected selling price, less costs to dispose, less a profit split between the buyer and seller.

- Investments - depending on the nature and amount of ownership, may require a valuation of the company in which the investment is held

- Prepaid expenses generally left at face value if the benefit still exists

- Loans receivable typically valued by discounting future principal and interest to present value

Asset accumulation approach
Valuation of tangible assets

- Valuation of Real Estate & Improvements
  - *based on cost, market & income approaches*
  - *highest & best use considerations*
  - *performed by qualified real estate appraiser*

- Valuation of Machinery & Equipment
  - *based primarily on cost & market approaches*
  - *functional, technical & economic obsolescence*
  - *identification of excess capacity, non-operating assets and a requirement of high capital expenditures important to the other approaches*
  - *performed by qualified equipment appraiser*

Asset accumulation approach
Valuation of intangible assets

- Intangible assets enhance the value of tangible assets
- They exist if there is an excess return on assets
- They are separable from tangible assets
- There must be some tangible evidence of existence

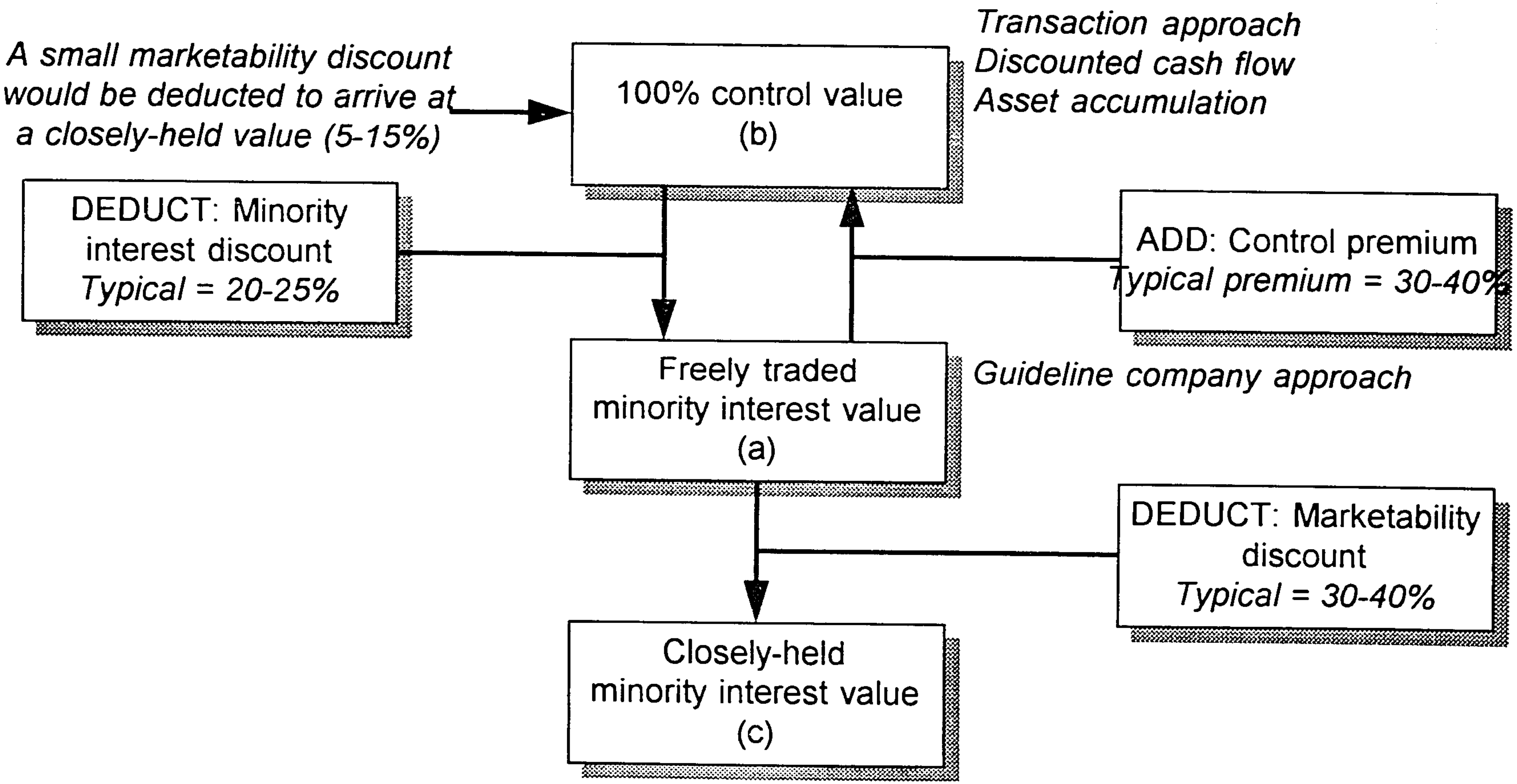
Asset accumulation approach
Identification of intangible assets

Contracts	Patents
Proposals	Going concern value
Favorable leases	Trained workforce
Non-compete agreements	Customer lists
Trademarks	Copywrites
Tradenames	Formulas
Computer software	

Asset accumulation approach
Valuation methods

- Cost approach
  - *depreciated replacement cost*
- Income approach
  - *capitalized incremental income*
  - *capitalized cost savings*
- Market approach
  - *comparable sales transactions*
  - *comparable royalty rates*
- Life of the intangible often a key issue

Relationship between minority & control levels of ownership



Valuation method

Discounted net cash flow

Consider using this method when:

- Earnings/cash flow potential contributes significantly to the company's worth
- Current cash flow levels are expected to differ significantly from future cash flows
- The company's future net cash flows can be reasonably estimated
- The company's net cash flow in the terminal year is expected to be significantly positive (that is, not negative or marginally positive)
- The company's total net cash flow during the forecast period is not expected to be significantly negative
- If valuing a controlling interest, owners' benefits can be reasonably estimated. (Such benefits include compensation, personal expenses paid by the company).
- The company is a start-up business
- The company is a potential acquisition

Valuation method

Net asset value

Consider using this method when:

- The company holds significant tangible assets, and there are no significant intangible assets
- There is little or no value added to the company's products or services from labor
- The balance sheets reflects all the company's tangible assets; that is, the company has not expensed any tangible assets that continue to benefit the company
- The company is expected to continue as a going concern
- The ownership interest being valued is either a controlling interest or has the ability to cause the sale of the company's assets
- The company has no established earnings history or a volatile earnings/cash flow history
- A significant portion of the company's assets are composed of liquid assets or other investments (such as marketable securities, real estate investments, mineral rights)
- The business depends heavily on competitive contract bids, and there is no consistent, predictable customer base

Valuation method
Liquidation value

Consider using this method when:

- Liquidation value is an appropriate definition of value for the company being valued
- The ownership interest being valued is either a controlling interest or has the ability to cause the sale of the company's assets
- The company is in bankruptcy, or there is substantial doubt about the company's ability to continue as a going concern
- The company's current and projected cash flows from continuing operations are low compared to its net assets
- The company may be worth more "dead" than "alive"

Valuation method

All methods using value multiples based on comparative company data

Consider using this method when:

- There is an adequate number of comparative companies and/or transactions to determine a value multiple
- If comparative public companies will be used, there is adequate data on the comparatives to allow the consultant to make appropriate analyses and adjustments
- If comparative transactions will be used, there is adequate data (e.g. terms of sales, assets sale vs. stock sale) on the comparatives to allow the consultant to make appropriate analyses and adjustment
- The company being valued is considering going public

Privatization Seminar

Day 6: Restitution

Restitution

The objectives and organization of the restitution process. Addressing issues raised by the group.

I. Forms of ownership before privatization

Socialist common ownership

- state property
- cooperative property
- property of common and other socialist organizations

Personal property
Private property

II. Forms of passage or transfer of property to the state or other organizations. Ownership right restriction.

- by a contract - of purchase, of donation
- by a decision - expropriation, decision enforcement
  dispossession of real estate leased by the organization
  penalty of forfeiture
- from the law - nationalization
  confiscation
  abandonment of property
- by inheritance

Ownership right restriction - National administration
- use of agricultural property

The privatization process in the Czech Republic causes an extensive transformation of proprietary relations and relations of use practically in every area (both production and non-production) and it is carried out in a number of ways. Rectification of wrongs and decisions on the method and extent of privatization were preceded by political rulings which resulted in a part of the governmental policy statement.

One of the privatization methods is also restitution, i.e. returning property.

III. Reduction of the results of some property injustice by restitution (returning property)

Characterization of areas in which restitution was applied:

- a decisive day for restitution
- property to which it is related
- division of the activity scope of individual resorts (ministries)

IV. Concrete contents of individual acts

- forms of restitution - property share
  - returning (giving away) an article
  - monetary or financial compensation

- restitution procedure - a claim for returning an article is considered by the organization by which it is possessed
  - a claim for compensation is considered by the ministry or by institutions constituted for this purpose

V. Consideration of restitution rights

Obligations of rightful and obliged persons:
- documents
- evaluation
- appreciation x depreciation of real estate (building)

Sources for provision of monetary and financial compensation.

VI. Consequences of restitution regulations

- a fast form of privatization
- restoration of real estate, extension of production, competition and market
- liquidation of organizations which gave away the property
- forced lease for health, educational and similar institutions
- disputes between renters and owners
- dissatisfaction with the extent of the restitution - all the wrongs cannot be covered and effectively removed
- a need for experienced officers to secure the course of the restitution
- individual disputes are resolved by the court.