

SRI International

WORLDWIDE EXPERIENCE IN ALTERNATIVE PRIVATIZATION FINANCING METHODS

FINAL REPORT

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PREFACE

The objective of this report is to examine the various types of financing instruments that can be used to finance privatization transactions. The study was commissioned by AID's Global Bureau's Office of Economic and Institutional Reform (G\EG\EIR) through a buy-in from the Africa Bureau's Office of Sustainable Development (AFR/SD) under the Privatization and Development Project (Contract No. DPE-0016-Q-1002-00). Under the PAD contract, SRI is a sub-contractor to Price Waterhouse.

This report examines the following privatization financing mechanisms: (i) initial public offerings (IPOs); (ii) private sales of shares; (iii) mass privatizations; (iv) employee/management buyouts; (v) investment funds, pension funds and other institutional investors; and (vi) other unconventional financing techniques including bond financing, debt-equity swaps, and venture capital funds.

The report examines different types of financing available, how they work, who is involved, what the conditions are for their success. Each chapter addresses the main advantages of a privatization financing method and the principal players involved in its implementation. The different privatization financing techniques are assessed as to extent that they promote capital market development as well as broader share ownership.

The project was undertaken by Ophelia Yeung, Tonia Callender, and Peter Boone of SRI International under the supervision of John Mathieson, Executive Director of SRI's Economics Practice. The report synthesizes information collected from literature reviews, interviews with representatives of official and government organizations, and field work by project team from other past projects. The findings and recommendations of the report, as well as any errors and omissions, are solely the responsibility of the study team.

EXECUTIVE SUMMARY

Worldwide privatization activities over the past decade have yielded a rich source of experience in alternative techniques to finance the gradual, partial, or total divestiture of state-owned enterprises. Given the shortage of capital and liquidity in many developing countries, particularly in Africa, it is necessary to develop and utilize the most effective and useful financing mechanisms to both finance privatization transactions and deepen capital markets.

It is estimated that between 1988 and 1993, 2655 non-voucher-based privatization transactions have taken place in 95 countries worldwide, yielding US\$271 billion in revenues. Developing countries accounted for 85 percent of all sales and 35 percent of revenues generated. In terms of privatization techniques, direct sale was by far the most widely-used financing method, accounting for over 80 percent of the transactions. As a distant second, initial public offerings accounted for another 12 percent. Other methods such as joint ventures and management/employee buyouts accounted for less than 2 percent each.

Privatization, which involves the transfer of management and/or ownership of formerly state-owned enterprises to the private sector, is essentially a financial transaction. While some privatization financing mechanisms require less initial involvement in capital markets than others, most practitioners would agree that overall, capital market development provides an important vehicle for supporting and sustaining the privatization process. Experience has shown that the presence of even a rudimentary capital market can help nurture the privatization progress by providing a means to broaden share ownership among citizens, as well as to mobilize resources to finance privatization.

Without a functioning capital market, governments may be forced to sell SOEs to groups such as wealthy family groups or foreign investors, which may run counter to the goals of privatization or may be unacceptable from political and equity standpoints. On the other hand, privatization can serve to stimulate and deepen nascent capital markets in developing countries by providing an increasing number of new securities to the market, introducing new concepts such as buying and selling shares, and creating a new class of capital owners.

There are several important, direct linkages between the use of privatization financing instruments and the development of capital markets. Most of the conventional and unconventional financing methods discussed in this report contribute to the development of capital markets by: offering investors additional long- and short-term instruments which provide different returns, while simultaneously helping to complete privatization transactions and providing cash to the government. The instruments discussed in this report offer individuals and institutions the opportunity to make reasonable judgements about the risks and reward of their investments. These instruments also allow countries to classify risks and opportunities better than in the past.

Public offerings help develop the securities market, which in turn provides private companies access to the capital resources of the broad market. This will help meet the investment and working capital requirements of the company before and after privatization. Another linkage between privatization and capital markets relates to the need to induce company managers to make essential measures to enhance company performance. Enterprise managers are more likely to change their behavior and actions to maximize earnings when they are held accountable by an active, informed group of shareholders with a vested interest in enterprise performance.

Mass privatization encourages the development of capital markets in many countries by offering a medium of exchange for the sale of state owned property to the private sector. Voucher coupons under mass privatization allow privatization transactions to take place quickly and efficiently and permit widespread participation.

Most of the financial instruments discussed in this report also help to broaden share ownership by making purchase feasible to buyers who might otherwise be excluded. Those instruments which have the greatest impact on encouraging widespread local ownership of shares are initial public offerings, bond issues, mass privatization, pension funds, ESOPs, and special government financing schemes offering concessional financing or deferred payments to small local investors.

Privatization Instruments That Can Be Used in Africa

Most successful privatization programs in Africa use a variety of privatization methods and range of financing instruments, thereby maintaining a diversified "privatization portfolio". The financing of privatization transactions is constrained in many African countries because capital markets are generally narrow and underdeveloped. Relatively few local companies and individuals have accumulated enough capital to

provide sufficient equity in their privatization bids. In addition, in many countries conventional long-term debt financing is not available from the commercial banks.

In many African countries, financing constraints stem from weak financial systems including banking systems without sufficient capital and liquidity to finance the privatization acquisitions. When long-term capital is available through African banking systems, it is usually offered at very high nominal interest rates. In other African cases, the governments put SOEs on the market through public offerings while simultaneously offering high-yield, low-risk government bonds. In these cases, the poor timing of the sales dampens the market for some of the SOE share sales.

If local investment is to be tapped, creative use of new financial instruments may be required. The shortage of capital and liquidity in many African countries will make the privatization process more difficult, but solutions can be found to facilitate buying. There is no one method of sale or financial instrument that is appropriate for all situations. African privatization agencies should be creative in finding the most appropriate methods of sale and financing instruments to fit the circumstances.

Public flotations are appropriate for larger, usually more profitable and well-managed companies that can attract large number of investors from the general population. Public flotations encourage broad shareholding, and facilitate distribution of wealth. They are generally characterized by openness and transparency and accessibility to small investors. Public share offerings have the disadvantage, however, of being technically complex, time-consuming, and requiring significant technical input from lawyers, investment banks, and accounting firms.

When significant management or technical expertise is sought for a company, private share sales, through competitive bidding or direct negotiations, might be the most appropriate privatization method. These types of sales are usually financed by the existing equity capital or access to debt finance by the purchaser. However, in the case of a private placement, specific investors (usually institutional investors) are offered shares in a company (often for a minority ownership position) after the strategic investor has already been identified.

Institutional investors such as pension funds and overseas mutual funds are an excellent source of portfolio capital that can be tapped for privatization investment. Most often these institutions are interested in investing in well-known "blue chip" type companies through public flotations or private placements. Overseas mutual funds are

most interested in investing in a country that has several companies for sale with some depth to the market so that they are not constrained if they want to resell their shares.

Management/employee buyouts are a useful means of transferring ownership to SOE management and employees. MBOs and EBOs are often undertaken for small companies that would otherwise have trouble attracting buyers and financing. Many existing SOE managers lack the savings and capital necessary to purchase shares with cash. Because of their low capitalization situation, many commercial banks, particular in Africa, are reluctant to finance these transactions. In many African countries (e.g., Ghana, Zambia, Tanzania, Kenya, etc.), M/EBOs often emerge as highly-leveraged transactions that must be financed through some sort of government assistance, including concessional loans or deferred payment schemes.

Mass Privatization is common in Eastern Europe and the former Soviet Union, but has not been utilized to date on the African continent. The main appeal of mass privatization is the speed, widespread ownership, and volume of companies that can be transferred to the private sector under this "Big Bang" approach. The main drawbacks of this approach in the African context are the limited amount of revenue to the governments from the sale of companies, and the inability of the system to target strategic investors who may be best qualified technically and financially to run the company. However, this problem may be circumvented in Africa by combining mass privatization with IPOs, strategic sales, or other more conventional forms of privatization to raise revenue.

With the exception of government financing, most unconventional financing techniques, such as debt-equity swaps, bond financing, and venture capital funds have been rarely used to finance privatization transactions in Africa. However, unconventional financing methods can be utilized in countries where the existing financial markets are weak, investors have limited liquidity, and long-term financing is not widely available.

Medium-term bond instruments can serve to mobilize private domestic capital to finance privatization even in countries where the capital markets are rudimentary and underdeveloped. However, issuing bonds involves fairly high fixed transaction costs and is thus more appropriate in cases where large sums of money need to be raised. In countries where large debt overhang would significantly deter investors from buying privatized SOEs, debt-equity swaps can serve the dual objective of privatization and debt reduction, thereby enhancing a country's investment climate.

Unconventional financing techniques are used to encourage local ownership, direct ownership to certain ethnic groups, or to target some type of buyers such as foreign investors, who may be otherwise not interested in purchasing the company.

Recommendations for Overcoming Capital Constraints in Africa

In many African countries, the shortage of capital and liquidity is making the privatization process more difficult, but solutions can be found to facilitate buying. The following strategy is recommended for African privatization programs as a means of overcoming the severe capital constraints and encouraging local ownership:

- ▶ Encourage buyers with limited capital to find financial partners, either national or foreign.
- ▶ Utilize public offerings to encourage broad shareholding and facilitate distribution of wealth. IPOs are accessible to small investors and help tap wider capital resources than most other financing instruments.
- ▶ Pursue measures to widen share ownership (discounting and set asides on shares, establishment of mutual funds, ESOPs).
- ▶ Be cautious of deferred payment schemes and seriously consider action for payment arrears or default.
- ▶ If few qualified buyers emerge at the valuation price level, reduce price and/or clean up balance sheet to encourage buyers.
- ▶ Utilize unconventional financing techniques such as bond issues, debt-equity swaps, and venture capital funds, to fit the right circumstances and provide additional untapped capital to fund privatization transactions.
- ▶ Try to establish or tap venture capital funds through such sources as donors, private financial institutions, or from the proceeds of privatization sales.

WORLDWIDE EXPERIENCE IN ALTERNATIVE PRIVATIZATION FINANCING METHODS

I. FINANCIAL MARKET DEVELOPMENT AND PRIVATIZATION

Linkages between Financial Systems and Economic Development¹

Effective capital markets are indispensable to the pursuit of sustained, broad-based economic growth. Financial systems play a critically important, central role in the activities of all economies, principally, the aggregation and allocation of financial resources. They continually change to meet evolving patterns of savings, fiscal conditions, institutional arrangements, and availability and demand for funds. In the broadest sense, an efficient, well-developed financial system offers many benefits to a country and its citizenry. These include:

- Making a country's financial system and its political and economic environment more stable.
- Helping to promote growth and employment by expanding the range of financial instruments, offering investors different combinations of risk and reward, which in turn, help raise the total volume of domestic savings and investment.
- Helping to promote greater public participation in economic growth by opening up opportunities for more people to be involved in the financial system.
- Facilitating access to international capital. Foreign investors are encouraged by efficient financial markets, because they generally prefer to invest in countries where their funds are complementing, rather than replacing domestic savings.

The primary role of the financial system is to mobilize resources for productive investment. It provides the principal means for transferring savings from individuals and companies to private enterprises, individuals and others in need of capital for productive

¹ For a detailed discussion of financial sector reform and privatization, see *Reforming Financial Systems* by Zank, Mathieson, Nieder, Vickland, and Ivey, 1991.

investment. Any domestic financial system is composed of three sets of activities: *saving, borrowing, and intermediation*.

□ ***Mobilizing Domestic Resources: Saving.*** Well-functioning and well-developed financial systems encourage savings and allocate resources to higher-yielding investments. Savers can make their surpluses available to investors by, in effect, purchasing financial assets. The financial system mobilizes savings and increases liquidity by providing asset holders with attractive (in terms of yield, risks, and liquidity) financial claims. In the absence of developed financial systems, only investments financed by individual savers or close-knit groups of individuals would be possible (as is evident in many developing countries).

□ ***Employing Capital Productively: Borrowing.*** Financial systems provide users of capital with access to funds at reasonable terms and conditions. If conditions placed on the borrowers are excessively onerous, the capital formation process will be retarded or adversely biased.

□ ***Facilitating Savings and Borrowing: Financial Intermediation.*** Financial intermediation is the important function of aggregating savers and borrowers and transforming financial assets into financial liabilities. In the credit market, financial institutions “intermediate” between, or match, the assets preferences of savers with the liability preferences of borrowers. Another way to mobilize domestic resources through intermediation is through the development of equity and securities markets. Equity financing provides an alternative to debt financing. It also offers new opportunities for investors and for broadening the ownership of economic assets.

The size and the strength of financial systems are the cumulative result of a large number of variables. Among economic factors, capital markets are often a mirror image of a country’s absolute level of development, since the supply and demand for capital rise with increasing incomes and production. Very few developing countries have sophisticated capital markets because financial system evolution is a lengthy process that tends to lag behind the development of other sectors.

The lack of effective, “formal” financial systems in developing countries creates a vacuum that often is filled by “informal” financial markets. Informal markets are those that operate outside conventional rules and institutions, and typically consist of professional and nonprofessional money lenders, extended family investment “clubs,” merchants, private pawnshops and finance firms. Compared to formal markets, informal

markets are less efficient because savers tend to receive lower interest rates and face higher risks, while borrowers generally pay much higher rates of interests. Thus, both savers and borrowers ultimately benefit from the development of a legal, effectively regulated financial sector. The following table summarizes the typical financial sector constraints facing developing countries.

<i>Factors Constraining Financial Market Development in Developing Countries</i>		
<i>Economic Factors</i>		<i>Results</i>
Low per capita income	☛	Low marginal savings rate
Skewed income distribution	☛	Concentration of capital
Economic concentration in few sectors	☛	Limited lending/investment opportunities
Inflation	☛	Reduced incentives to save and invest in financial assets
High debts	☛	Limited capital availability
Management inexperience in financial and other sectors	☛	Inhibited performance of banks, reduced ability of borrowers to repay loans
Lack of real assets	☛	Decreased supply of funds
Family ownership	☛	Fear of losing control
<i>Policy Factors</i>		<i>Results</i>
Government ownership	☛	Reduced efficiency
Interest rate ceilings	☛	Lowered ability of banks to attract funds
Excessive regulation	☛	Decreased freedom to seek investment diversification
Portfolio selection restrictions	☛	Limited investment alternatives
Excessive taxation	☛	Reduced financial returns to investment
Budget deficits/mandated bank purchases of government paper	☛	Crowding out of the private sector
Barriers to entry	☛	Reduced competition and efficiency
Overvalued exchange rate	☛	Reduced export returns; capital flight.
<i>Source: Reforming Financing Systems, by Zank, Neal S., Mathieson, John A., Nieder, Frank T., Vickland, Kathleen D., and Ivey, Ronald, J., Greenwood Press, 1991.</i>		

While the factors and policies described in the above table are not present in every developing country, more often than not they represent a reasonably accurate picture of the operational characteristics of money and capital markets in many nations undergoing privatization. Often, the end result of these and related variables is a "repressed" and underdeveloped financial market, characterized by the following:

- ◆ The formal capital market is "thin and narrow." It offers a limited pool of capital and few financial instruments to fund productive ventures of private enterprises or large-scale privatization.
- ◆ The stock market consists of several large firms, and trading activities are dominated by a small number of wealthy individuals or groups. Equity ownership is not disseminated among the broad public.
- ◆ Small, domestic investors are suspicious of the local capital market and tend to hold their savings in cash, gold, precious metals, foreign currencies, and low-risk investments such as short-term government savings bonds, which usually yield below-market returns.
- ◆ Low rates of return and capital flight reduce levels of capital stock and rates of capital formation.
- ◆ Small and medium-sized private firms have limited access to credit and equity capital from foreign sources.

Often it is within this type of environment that many developing country governments have to devise a financing strategy for their privatization programs. While underdeveloped capital markets pose enormous challenges to privatization financing, country experiences have demonstrated that a variety of innovative methods can be employed to implement a successful privatization program. Many of the principal methods will be discussed in this study.

Linkages Between Capital Market Development and Privatization

There are several important, direct linkages between capital market development and the ultimate success of the privatization process.

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The need for a medium of exchange of share ownership. The success of privatization will depend on the ability of capital markets to provide a medium of exchange between the government and the private sector, as well as among private shareholders after privatization. This is especially important in the case of mass privatization and in developing countries where there is little liquidity in the market. Very often, public support for mass privatization has been garnered on the premise that citizens will eventually benefit from the ownership of private enterprises. As privatization transforms citizens into shareholders, there will be rising expectations that shareholders can trade their shares in a liquid capital market and convert them into tangible, monetary gains.

Lagging capital market development could jeopardize such public support for the overall privatization process. This problem has been evident in several NIS states where the slow development of the capital market has prevented the establishment of voucher and share trading. The illiquid secondary market has led to discontent among some segments of the public in those countries.

The need for privatized companies to have access to capital. Many new owners of privatized companies, especially those achieved through mass privatization, have limited cash resources to meet the working capital and investment requirements of their enterprises. Lack of both short-term liquidity and long-term capital are some of the greatest constraints hindering the success of post-privatization restructuring in many countries, particularly in the NIS. A well functioning capital market can contribute to privatization and the overall transition to a market economy by channeling savings of individuals and institutions to finance viable long-term and short-term investments which support enterprise restructuring and expansion. In addition, a financial system which effectively mobilizes savings and channels them to promising investments intensifies competition among firms to develop viable business plans and contributes to improving the overall efficiency in the economy.

The need to establish corporate governance and carry out necessary post-privatization restructuring. It is not uncommon for enterprise managers to resist painful, but essential, restructuring measures which would enhance enterprise performance following privatization. Managers are more likely to change their behavior and actions to maximize earnings when they are held accountable by an active, informed group of shareholders who have a vested interest in enterprise performance. However, shareholders can only exercise effective ownership control if they can monitor enterprise performance and select top management. In a functioning capital market, dissatisfied

shareholders are free to dispose of their shares as a recourse, thereby reducing share prices and sending a strong message to management.

In addition, private companies themselves rely on capital markets for financing capital and other investment, the cost of which will depend on the market's perception of the firm's performance, reflected in its share price. This pressure to raise funds in the capital market should ultimately encourage management to perform or be replaced.

IFC's Experience with Privatization and Capital Market Development

As of mid-1995, the International Finance Corporation has implemented 22 advisory assignments and 76 investments worldwide which have resulted in privatization sales. Around 35 of those have been the first privatization in the country, or in a key sector such as infrastructure or banking. About 10 transactions have featured first-time or early uses of foreign direct or portfolio investment or joint ventures in the country. Overall, there have been around 20 examples of IFC-facilitated capital market developments new to the country related to those privatization transactions.

Source: Privatization: Principles and Practice, IFC, 1995.

There are also other symbiotic relationships between capital market development and privatization. In many cases, privatization introduces new concepts in corporate governance and brings private voices to the board room of enterprises for the first time. Borrowing from banks becomes more commercial and depends less on political pressure. Often new forms of financing are raised in domestic or international capital markets for the first time. Large privatization will have a more dramatic effect on the capital market by providing a large supply of securities and a variety of corporate assets to the capital market. This not only increases a country's access to international direct portfolio investment and finance, but also stimulates domestic savings and investment. The success of a privatization program ultimately rests on the capability of domestic savings and investment and the viability of the capital markets to support it.²

² IFC, 1995.

Privatization Using Capital Markets in Morocco

The Moroccan privatization program, which began in 1989, is notable for its use of the Casablanca Stock Exchange. All the initial public offerings implemented have been extremely successful from the perspective of widening share ownership within Morocco. Most of the offerings were heavily oversubscribed.

Privatization IPOs have stimulated activities in the Casablanca Stock Exchange, the capitalization of which expanded almost ten times in just five years. During the same period, the daily transaction volume rose from Dh0.5 million to Dh25 million. In addition, four mutual funds are expected to come into existence in the near future, and the Ministry of Privatization intends to give these institutional investors a key role in financing future privatization through IPOs or secondary offers.

Observers have pointed to several key factors accounting for Morocco's successful privatization program. First, political support was given by the highest level of authority - the King himself. An effective institutional framework also contributed to efficient implementation. In addition, the appropriate use of the Casablanca Stock Exchange helped mobilize domestic and international resources to finance privatization. It served to ensure transparency and wide participation in the privatization process. The Ministry of Privatization also worked closely with the stock exchange regulatory agency to minimize fraud and abuse.

Source: "Privatization in Africa: Lessons and Opportunities," Price Waterhouse and Abt Associates, 1994.

Achieving Broad Share Ownership through Privatization

An important objective of privatization in many countries has been to widen share ownership among small local investors. Broadening share ownership can serve several important social and economic goals:

- ✓ Widespread share ownership helps to spread gains of privatization and contributes to a more equitable distribution of wealth in the society. In some countries, privatization is viewed as an opportunity for redistributing wealth. In Malaysia, for example, a collective investment scheme was designed to redistribute wealth to members of an ethnic group which was economically under-represented.

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- ✓ Spreading gains of privatization helps to safeguard privatization progress by transforming a large segment of the public into stakeholders in a market-oriented economy. It also leads to greater public participation in the privatization process, increasing its political acceptability. The United Kingdom, for example, trebled the number of shareholders through privatization, while France's goal was to quintuple it and spread ownership so widely that companies cannot be re-nationalized.
- ✓ Privatization may help stimulate capital market development by increasing the supply of assets available to domestic savers, which may lead to increased saving and to the substitution of shareholding in privatized enterprises for cash holdings, and real and foreign assets.³

To broaden share ownership through privatization, some countries have set limits to participation on particular groups, delineated by nationalities, residencies, and ethnic or social groups. For example, Japan did not allow the foreign purchases of NTT shares, and the French privatization program restricts foreign share ownership to 20 percent.⁴ Concerns for increasing local participation are one of the principal reasons why privatization has proceeded so slowly in several African countries, such as Cameroon, Nigeria, and Kenya.

Several mechanisms have been employed to encourage widespread ownership, including: employee discounts and stock ownership plans; share allotment plans and share restrictions; voucher systems; special incentives; and extensive publicity and promotion in public offerings. All of the above mechanisms will be discussed in detail in this report in the context of privatization financing methods. Overall, several important lessons have been learned on those methods in promoting widespread ownership:

- ☛ *Employee discounts and stock ownership plans* create profit sharing opportunities for labor and have proven to be effective in spreading ownership across wider classes of investors and, in some, cases, have even won labor support for the privatization process. However, experience in several NIS states, including

³ The lack of savings and liquidity in the local capital market have often made it difficult to encourage local participation and wider shareholding via the stock market. To circumvent this constraint, some countries have adopted voucher-based privatization programs which did not require a large amount of upfront cash from small investors.

⁴ Mamadou Dia, 1992.

Russia, also shows that relying on an ESOP as a principal privatization method may lead to problems in imposing corporate governance or inducing restructuring in privatized firms.

- ☛ *Individual shareholding restrictions* which apply on a case-by-case or an industry basis are more flexible and less cumbersome than enacting special legislation which restricts shareholding across sectors and industries. For example, flexibility in the Malaysian approach has allowed the creation of holding companies which comprise an ethnic Malay majority together with less “acceptable,” but financially more powerful, domestic and foreign interests to purchase major stakes in SOEs.
- ☛ *The voucher system* (usually under the auspices of mass privatization), while popular in Eastern European countries due to the choice of investment that it offers to the beneficiaries, is time-consuming and involves high administrative costs due to its scope and comprehensiveness.⁵
- ☛ *Special incentives* such as pricing shares at a discount, low interest loans, and payments in installments have been successfully used in ensuring the participation of small local investors. Financial incentives have been utilized to encourage small investors to hold on to their shares for at least several years, to prevent speculation and to reduce the risk of reversing the widespread ownership achieved.
- ☛ *Publicity, promotion, and distribution mechanisms* are the key to achieving widespread share ownership, especially in countries where the public has little knowledge and understanding of the concept of public shareholding. *Ad hoc* share distribution mechanisms have been successfully organized to improve the accessibility of the public offering to small investors.

Broad share ownership can only be sustained and be meaningful to shareholders if their rights are protected by appropriate legislation and enforcement mechanisms. Effective ownership also requires that shareholders monitor the conduct and performance of enterprises. Unfortunately, excessively diluted share ownership may preclude effective management oversight and ownership control. It has been observed that financial

⁵ Voucher systems are often used in environments where hundreds or even thousands of enterprises are privatized at once. The high administrative costs and time involved are primarily related to the sheer volume of companies being privatized. The privatization transaction costs per enterprise is not necessarily higher, but is possibly lower in voucher privatization compared to most other privatization methods.

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institutions (mutual funds, investment funds/trusts, pension funds, etc.) are often more effective in monitoring investments for their owners or participants. This is a major reason for financial institutions to become more active participants in privatization worldwide. However, the increasing use of financial institutions has raised concerns as to how the rights and interests of small shareholders can be protected in some developing countries. The ultimate challenge of a privatization program lies in the ability to achieve a balance between broad-based widespread ownership and effective corporate governance in privatized firms.

Privatization and Capital Market Reform in Turkey

To support its privatization efforts, the Turkish Government embarked upon a comprehensive capital market development effort in the early 1980s. The Government hoped that a more developed capital market would provide financing for its privatization program while the supply of public enterprise shares would jumpstart its underdeveloped and stagnated securities markets.

To lay the foundation for reactivating its capital market, the Turkish Government enacted a capital market law in 1981, which established the Capital Market Board to supervise overall capital market development. The law regulates primary capital market activities and establishes the principles of security issues and the duties and qualities of intermediaries. It authorizes banks and stock market brokers to act as intermediaries in the primary issues market, and allows the formation of investment trusts and mutual funds. To activate secondary markets, regulations have been introduced to govern listing and trading procedures, and the Istanbul Stock Exchange has been reactivated.

The Government's capital market reform in conjunction with its privatization efforts has yielded visible success. Before 1980, gold and real estate represented the main instruments for people's savings during periods of low or negative real interest rates. Since the capital market reform, a major portion of those savings has shifted back into the formal financial system. By 1986, 200 billion Turkish lira worth of revenue-sharing bonds had been issued, and the last issue, worth 60 billion, was sold in a matter of hours. The rejuvenation and development of the capital market has provided an important source of broad-based privatization financing in Turkey.

Source: Privatization & Development, Steve H. Hanke (ed.), International Center for Economic Growth, 1987.

II. INITIAL PUBLIC OFFERINGS

What is an Initial Public Offering?

Under public share offerings, the government sells to the public all or part of the stock it holds in an SOE which are going concerns in public limited companies. Public flotation of SOE shares is the most commonly used privatization method in developed countries. It is also increasingly common in developing countries where there are functioning capital markets and mechanisms for distributing and trading shares. A broadly targeted initial public offering (IPO) taps into the savings of the general investment public to finance privatization and is aimed at dispersing the ownership of former SOEs among a wide segment of the population. IPOs are the primary method of privatizing enterprises in Western Europe and they have been widely used in the most economically advanced Latin America countries.

Who is Involved in an IPO?

IPOs are complex transactions involving a host of players in their implementation and participation. The services of accounting firms are required for the initial valuation of SOE assets and share prices. For large IPOs which are open to international investors, the host government often chooses to utilize the services of international accounting firms. Investment banks are usually required to prepare the prospectus, and to underwrite⁶ the offering itself. Legal experts and attorneys are needed to ensure that the SOE attains the appropriate legal status as a public limited company, and to prepare the necessary legal documents for the IPO. For large public offerings, financial intermediaries are utilized to ensure a wide and fair distribution of shares. In countries where capital market infrastructures are not well-developed, other temporary distribution mechanisms can be organized, such as using bank branches or local post offices (e.g. National Commercial Bank of Jamaica). Finally, IPOs usually involve a large number of buyers, many of which could be small, first-time investors.

⁶ When an investment bank underwrites a security, it guarantees to buy or find buyers for all or part of the security, in return for a fee.

Why IPO?

While their implementation can be difficult in countries with less developed capital markets, IPOs offer several key advantages:

- ❑ They generally target a large segment of the investment public and permit widespread shareholding, which helps *meet the goal of an equitable transfer* of capital from the government to the private sector.
- ❑ In developing countries in particular, IPOs often add a considerable supply of securities and *stimulate capital markets activities*. They also help to create a new class of capital owners and participants in the domestic financial markets. The flurry of privatization activities in Chile was the principal reason for the rapid expansion of the Santiago stock exchange, the capitalization of which multiplied nearly fivefold in US dollar terms between end-1989 and end-1993.⁷
- ❑ IPOs are usually characterized by *openness, transparency, and accessibility to the general public*. Those characteristics help diffuse suspicion that the government is transferring state-owned assets to powerful interests or wealthy individuals at below market prices, at the expense of the majority of its citizens.
- ❑ The proceeds generated from IPOs can be a *significant source of revenue* for the governments to finance privatization related activities or other general development projects, structural adjustment, and social programs.
- ❑ Successful IPOs and the subsequent gains in share prices serve to *create a constituency* which will preserve the privatization transactions accomplished and garner support for future privatization. Such was the case of the British Telecom's privatization, which was so popular with the general public that the Labor party, which had initially threatened to take back the shares if they returned to power, subsequently retracted its threats.

How is an IPO Implemented and Financed?

While technically this transaction amounts to a secondary distribution of existing shares held by the government, it is commonly handled as a primary issue. If the SOE

⁷ International Finance Corporation, 1995, p. 55.

Typical Tasks Required for IPOs

- ✓ *Conduct audit of financial position*
- ✓ *Assess commercial prospects*
- ✓ *Restructure balance sheets/transfer liabilities*
- ✓ *Design protection for minority shareholders*
- ✓ *Prepare prospectus*
- ✓ *Set par value and issue stock*
- ✓ *Promote and market share sale*
- ✓ *Transfer stock to executing agency*
- ✓ *Implement stock sale*

Source: Reforming Financial Systems: Policy Change and Privatization, Zank, Neal S., Mathieson, John A., Nieder, Frank T., Vickland, Kathleen D., and Ivey, Ronald J., Greenwood Press, 1991.

shares have never been listed or traded in the stock exchange, a valuation will be necessary to determine the initial offering price of shares. The offering may be on a fixed price or on a tender basis. A prospectus will be prepared for the offering, providing necessary financial and management information on the company, as well as explaining the procedures involved in the bidding process. The financial, legal and disclosure requirements in the country of offering must be met. These requirements are usually enforced by the securities and exchange commission of the country of offering. To ensure that the IPO is accessible to a broad segment of the public, an effective mechanism also needs to be in place to distribute shares to small investors and those in more remote regions.

Using IPOs, a government can tap into the liquidity and investment savings of the public to finance privatization using the capital markets. In some countries where

the capital markets are thin and domestic savings are limited, SOE shares can be marketed internationally to attract foreign investment. For example, the simultaneous flotation of AGC on both the Accra and London Stock Exchanges reinforced each other and helped boost confidence of Ghanaian investors in domestic securities (See case study in this Chapter). IPOs may also involve incentives for employee participation, often in the form of a closed subscription at a discounted price.

Privatization through conventional IPOs requires several preconditions, some of which may be difficult to satisfy in developing countries. Some basic requirements for a successful IPO include:

- A critical mass of investment savings in the domestic economy, either in the formal or informal financial systems in the country.

- The SOE under consideration must be a viable going concern with earning potential or record, as well as sufficient financial, management and other information available for disclosure to potential investors.
- Basic securities legislation regulating the issuance and trading of shares, including transfer, clearing and settlement procedures, and the operations of financial intermediaries (banks, brokers, underwriters, etc.).
- A regulatory framework to protect the interest and rights of investors (e.g. reporting and disclosure requirements) and to minimize undesirable securities practices such as share price manipulation, speculative trading, and insider trading. Basic institutional mechanisms also need to be in place to enforce these regulations.
- A functioning secondary market to accommodate the second-round trading of shares following the IPO. Shareholders will not be able to realize their gains from share ownership unless the secondary markets are liquid. At a minimum, the secondary market could operate as an organized trading mechanism such as an Over-the-Counter (OTC) market, governed by uniform and transparent rules.
- Ideally, privatization through IPOs should be implemented in markets where investors are sufficiently sophisticated to understand the rights, responsibilities, risks and rewards of share ownership, and where securities markets personnel are trained and experienced.

Obviously, these conditions don't always exist in developing countries undergoing privatization, particularly in Africa. Senegal, for example, encountered a number of constraints in its initial privatization program, which had employed IPOs as the principal privatization method. In Cote d'Ivoire, the privatization program faced a host of challenges, including an underdeveloped financial sector, the absence of a secondary securities market, a banking sector in disarray, as well as competition with surrounding countries for foreign capital.

What are the Linkages between IPOs and the Capital Markets?

While a public offering often presupposes a liquid and functioning capital market, worldwide experience has demonstrated that the lack of organized and sophisticated capital markets does not necessarily preclude successful IPOs, if they were implemented with compensatory measures aimed at existing capital market deficiencies. The well-

publicized success of Jamaica's NCB privatization demonstrates that an aggressive public education campaign can help overcome public ignorance and suspicion of share offerings. The transaction also illustrated how an innovative and well-organized share distribution network can distribute shares quite efficiently in the absence of other conventional financial intermediaries (brokers, investment banks, etc.).

Several African countries have used IPOs selectively as part of their privatization program. In Kenya, five SOEs have been privatized using IPOs as of 1993, including the Housing Finance Corporation of Kenya (oversubscribed by three times) and Uchumi Supermarkets. These two firms were successfully privatized within three months by the sale of \$15 million in shares.⁸ In Nigeria, public offering has been employed as a principal privatization financing method since 1988. The extensive use of IPOs has generated "significant revenue for the Government and a growth in Nigerian capital markets from N8 million to over N22 million in 3 years."⁹

Countries with less developed capital markets have used IPOs in combination with a private sale to finance privatization transactions. In such cases, IPOs help to broaden share ownership among the general public while drawing on the managerial and technical expertise as well as the capital of strategic investors to finance post-privatization restructuring. Zambia, for example, has used the 70-30 formula (divesting 70 percent through private sale and 30 percent via the stock market) to privatize several large SOEs, including Northern Breweries and Premium Oil Industries.

Elsewhere, other African countries with underdeveloped capital markets such as Togo, Mali, Ghana, and the Gambia have had partial success in their privatization experience using IPOs.¹⁰ In fact, some might argue that the process of raising funds for privatization can be the vehicle for organizing existing unofficial markets and removing the legal and regulatory obstacles to the emergence of official ones. In reality, the infusion of large amounts of new securities has often stimulated capital market activities and encouraged the development of new financing instruments. The CIB privatization in Egypt featured the first new listing on the Cairo Stock Exchange in many years. In Poland, the privatization of the SFM furniture company involved the first underwritten

⁸ Abt Associates, 1994, p. B-7.

⁹ Ibid, p.B-8.

¹⁰ Vuylsteke, 1988, p.142-3.

public offering, the first primary capital increase in a private company, and a new mechanism for allocating shares to small and large investors.

In addition, innovative and unconventional privatization and post-privatization financing mechanisms can help introduce novel financing instruments and deepen capital markets. Shortly after its divestiture, CTC (Chile Telecommunications) undertook the first Latin American equity issue in international capital markets since the 1960s and raised US\$ 92 million through American Depository Receipts on the New York Stock Exchange. In 1993, CTC also became the first Chilean company to issue convertible bonds abroad.

The Successful Flotation of AGC in Ghana

Financing has been an key issue in Ghana's privatization effort. While over 100 SOEs have been divested since 1988, much of the proceeds due GOG has not been collected due to the lack of funds and the ability to pay by the purchaser. The recent, successful flotation of the Ashanti Goldfields Company (AGC) on both the Accra and London Stock Exchanges was thus a major boost to Ghana's privatization program. The stock issue raised over \$400 million as of April 1994. Of the 25 percent equity sold, 5 percent was offered directly to Ghanaian investors, and 18 percent was offered to major international institutions (primarily U.S. and U.K.). Another 2 percent was offered at a fixed price to individual investors from Ghana and other countries.

The privatization IPO of Ashanti also attracted the interest of international investors in Ghana's capital markets. In anticipation of Ashanti's successful placement, a foreign investor consortium purchased the GOG's entire interest in public corporations listed on the Ghanaian Stock Exchange for \$25 million, which was one-quarter of the total market capitalization of the GSE. Those SOEs include three breweries, one tobacco company, one insurance agency, a multinational bank and a trading company. As of July 15, 1994, four additional Ghanaian SOEs had received bids from international investors.

Source: "Privatization in Africa: Lessons and Opportunities," Price Waterhouse and Abt Associates 1994.

In countries with rudimentary capital markets, one important issue which needs to be addressed concerns the level of capital market regulation which should be established as a prerequisite to undertaking IPOs. Disclosure and reporting requirements may vary from one country to another. To be sure, basic securities regulation and enforcement

mechanisms must be in place to prevent securities manipulation, insider trading and fraud. However, it is often a challenge to balance the needs for protecting inexperienced investors with stimulating securities market development. For example, it is not uncommon for the prospectus issued in developing countries to omit the cautionary statements on investment risks found in standard developed country investment prospectuses, as that language may scare off new investors unnecessarily. On the other hand, some developing country governments may be predisposed to overcompensate the absence of experienced financial intermediaries by imposing excessive regulation, stifling the growth of a nascent market.

What are the Linkages between IPOs and Broadening Share Ownership?

By seeking to transfer SOE shares to a large segment of the investment public, IPOs help encourage broad-based share ownership. In countries where share ownership has not been prevalent before privatization, IPOs may also help create a new class of private sector equity holders. Some countries have adopted restrictions on share purchase to prevent the concentration of shares in the hands of a few wealthy individuals.

In Nigeria, for example, privatization IPO transactions are structured such that individuals are restricted to purchasing a limited number of shares. Since the inception of its privatization program in 1988, 80 percent of the shares of privatized SOE shares have been sold to small investors who purchased 1,000 shares or less, and 400,000 new shareholders have emerged from the process. The Nigerian government has also implemented measures which restrict the transfer of shares for the first five years.¹¹ While such restrictions may help prevent speculation and share concentration, they may inhibit liquidity which is essential for African small shareholders and may act as a disincentive to broad participation. Overly dispersed share ownership may also present problems of effective corporate governance.

Instead of rigid restrictions, some countries have used financial or tax incentives to discourage speculative trading and reward small investors for holding on to SOE shares as long-term investments. In a number of privatization IPOs in the United Kingdom, investors were encouraged to retain their shares under an incentive system which paid bonuses at the end of three years. In Chile, loan advantages would be withdrawn if the initial buyers sell the shares to a third investor before a certain period of time.

¹¹ "Privatization in Africa: Lessons and Opportunities," Price Waterhouse and Abt Associates, 1994, p.C-3.

Some governments have targeted IPO sales to small investors using other methods. In Cote d'Ivoire, the Government included educational information in the prospectuses for IPOs targeted at "first time" investors. In the privatization of the National Commercial Bank (NCB) of Jamaica, an unconventional distribution network consisting of bank branches and local post offices was utilized to ensure wide accessibility of the IPO. The share offering was preceded by an extensive public education campaign which familiarized the public with the concept of shareholding. The prospectus for the offering was also reprinted in its entirety in the national newspaper one week prior to the offering. The offering was oversubscribed by 170 percent and was a widely recognized success.

The Privatization of IBUSZ in Hungary

The privatization of IBUSZ in 1990 involved the first public offering (and first increase in capital) in the Budapest Stock Exchange (BSE) in decades. IBUSZ is a broadly diversified financial services group as well as Hungary's leading travel agency. It had been a profitable company, but management of the transformed company felt a pressing need to invest in a long-term diversification strategy for the company. Thus, the main goal of the public offering was to raise IBUSZ's registered capital by 50 percent as well as dispose of a portion of state-held shares. The management also wanted to tap into small investors in the international capital markets, and planned to conduct a parallel issue of shares in Vienna. IBUSZ's management selected Vienna because Hungary receives a large number of Austrian (and German) tourists, who became familiar with the name of IBUSZ. The Government had also hoped that the participation of international investors would encourage Hungarian citizens to invest in the newly established stock exchange.

To comply with the Law on Securities, IBUSZ was required to publish a prospectus prior to the public offering, disclosing detailed information on the company's activities and financial position, including data on sales, investments and audited financial statements, as well as details of the proposed share issue. IBUSZ also had to provide annual reports. To calculate the initial price of shares, a complete market valuation of IBUSZ was conducted by an international accounting firm. Due to the parallel offering planned in Vienna, financial reporting has had to adapt to the international accounting standards, which has proven to be challenging.

IBUSZ shares were listed in both the BSE and Vienna Stock Exchange in June 1990. The offering stirred considerable interest in Vienna during the first weeks, and share prices rose precipitously. This has led to criticisms that the shares were priced too low initially. However, such criticisms were proven immature, as demand fell subsequently and share prices plummeted to below the original price.

...continued

One of the main goals of privatization in Hungary is to support the formation of a share-owning middle class. In order to mobilize domestic savings and to accelerate the privatization process, two special, preferential privatization credit schemes were being developed at the time. However, neither one of them were in operation during IBUSZ's share offering. To facilitate and encourage the participation of small investors, the Government has also allowed a maximum of 30 percent of personal income to be exempted from incomes taxes if it is used for purchasing state-owned enterprise shares.

IBUSZ's public offering provided a boost to the new stock exchange in Budapest, where initial trading activities were quite successful. Nonetheless, the major players in the Budapest Stock Exchange had been foreign institutions or private investors, and the number of Hungarian investors was estimated at only one percent of the population. Due to limited interest, the second share issue by IBUSZ in 1991 was sold by means of a private placement directed at foreign investors.

The demand for shares by the Hungarian public has been limited primarily because of the small amount of private savings available. In addition, high inflation rates and competition from more conventional forms of savings and investments (such as convertible currency deposits, banks accounts, etc.) have reduced the attractiveness of stocks. Further development of the securities market would require more stable and lower inflation rates, and rising incomes to raise private savings. The low volume of trading also means that stock market investments are relative illiquid. No real Over-The-Counter (OTC) or other secondary existed, and liquidity of stocks is of primary concern to the public. For more domestic and international investors to become more active on the BSE, the establishment of a more sophisticated and upgraded trading infrastructure would be essential.

Source: Methods of Privatizing Public Enterprises, OECD, 1993.

III. PRIVATE SALE

What is a Private Sale?

In a private sale, the state sell, all or part of its shareholding in an SOE to a pre-identified purchaser or purchasers. As one of the most commonly used methods of privatization, the private sale can assume several different forms, including *direct acquisition* by a single buyer and a *private placement* involving a specific group of purchasers. It can be used alone, in conjunction with, or prior to other methods such as a public offering. The SOE being privatized via a private sale must be a going concern in the form of a corporation represented by shares.¹² These shares may be wholly or partially owned by the government and they may or may not all be sold to a private corporate entity.

Governments use various techniques to execute the private sale of an SOE. Two of the most common techniques are an invitation to bid through public tendering and direct negotiations. Governments usually prefer using direct negotiations when conducting a private sale to a corporate entity which already holds shares of the SOE. Public tendering provides the selling entity with a larger group of potential buyers and a wider range of offers to choose from. However, the public tendering process may be more costly and time consuming than direct negotiations.

Who Is Involved in a Private Sale?

A private sale has fewer players than some of the other privatization methods. It involves the seller (usually a government agency), and a single purchaser or group of purchasers as well as negotiating teams which may contain professional negotiators. Another player which may have an important role is the valuation agency. Often the purchaser will hire a company to value the enterprise. Rather than simply value the SOE, this company may make key suggestions on the future operations and structure of the enterprise.

¹² Nankani, 1989.

Why Choose a Private Sale?

In the absence of developed equity markets, a private sale can provide a viable alternative. Often countries in the process of privatizing various enterprises have no means for implementing IPOs because no developed equity markets exist and creating such mechanisms for using the resources of the general investing public would take years.

The private sale allows the seller to examine the potential purchaser closely. In some instances, the government may want an owner that has certain management skills, technology, access to certain markets, or benefits system. In a private placement, the government invites individual investors or institutions with solid financial positions as minority shareholders. The government can identify possible candidates, and submit them to fairly rigorous scrutiny to determine whether they meet its privatization goals.

Flexibility is one of the main advantages of the private sale. A government can offer a private sale by itself or as the first step in a privatization process which might conclude with another method. For example, several Guinean privatizations began with private sales in the form of joint ventures with a major private party assuming 51 percent interest in the company, and concluded with the gradual disposal of the remaining shares to the general public.

A private sale can be partial or whole, and occur at once, or in stages. It can take different forms and involve many potential purchasers or just a few. This flexibility makes private sales the ideal method for SOEs which have had less than satisfactory performance or which require owners with certain experience and resources. The private sale allows governments to choose the most appropriate buyer and influence how that buyer operates the enterprise. For example, a government can require a capital contribution within a certain period after the sale, or stipulate how a purchaser must structure employee benefits, or place restrictions on pricing or other operational aspects of the company.

In the case of a private placement, the government may deal with less uncertainty in terms of the demand for shares, share prices and sales proceeds, compared to a public offering. Purchasers may also find private placement more attractive than public offerings because by nature of being a group deliberately sought out by the government, they have more flexibility in negotiating the terms of purchasing shares with the government.

Case Study: Private Sale to an Outside Investor in Hungary

In 1990, Petofi Printing House, a profitable Hungarian printing and packaging firm, sought an outside investor to purchase a controlling interest in the company. Although it had conquered the local market, the company sought to increase its presence in the larger European market, and eventually become a dominant player. To do so, it needed to ally itself with an outside investor which could contribute marketing and management expertise, as well as provide the enterprise with capital and access to new markets.

Compagnie Hongroise Financiere S.A. (COHFIN), an investment group established by the Italian financier, Carlo De Benedetti, as a holding company for the purchase of controlling interests in Hungarian companies with growth potential, had identified Petofi as a possible investment. COHFIN approached Petofi and proposed a sale.

After a careful examination of Petofi's financial health, COHFIN offered to pay more than the company's estimated value. COHFIN agreed to purchase shares in the amount of 389 HUF. Also, COHFIN added 100 million HUF in additional capital and agreed to add 77.8 million HUF to finance a "free workers' shares" program. This agreement provided COHFIN with roughly 50 percent of the new enterprise's capital and the workers with 7.87 percent. While it did not provide the government with substantial revenue, the purchase did give Petofi the necessary management expertise and financing for its intended expansion. It also allowed Petofi to achieve its strategic objective of having a largely multinational client base.

Finding post-privatization capital was an important goal for COHFIN. For the first few years following the privatization, COHFIN actively sought new financing for Petofi, often using innovative methods. Petofi was able to obtain the first EBRD loan to a private firm. The loan period was for five years at a rate of two percent above Libor. Several months after obtaining the EBRD loan, Petofi raised equity capital through Morgan Stanley International. It raised roughly \$8 million, mainly from the original institutional investors. This transaction was one of the first private placements for a Hungarian firm in London.

After devaluations increased the cost of its EBRD loan, Petofi was forced to look for alternative means to raise capital for post-privatization restructuring. Rather than assume more debt, it chose an innovative way to raise the capital. It issued a "dividend bond" or redeemable preference share. The unique quality of this bond lay in it how the interest payments were made. Petofi (which had a 5 year complete tax holiday followed by a 60 percent tax exemption) paid interest to investors in after-tax earnings. This effectively provided bond holders with payments on a tax-free basis (because dividend earnings are not taxed in Hungary) and allowed Petofi to issue the bond at a lower interest rate but remain competitive with other commercial bonds. This innovative financing method helped Petofi to maintain the capital necessary for the company's growth after the privatization.

Sources: Price Waterhouse, Case Studies on Privatization, 1991; Carana Corporation Petofi Printing and Packaging II, prepared for USAID, 1994.

A private sale limits the amount of information which potential buyers can obtain about their competition in the bidding process, because proprietary information concerning the SOE may only be given to a select group of potential buyers which could have no knowledge of each other's bids. This provides the government with more control over the process and a better negotiating position, allowing it to pursue its agenda more easily.

Finally, private share sales are much simpler and less costly than other methods, especially public offerings, in terms of disclosure, legal requirements, and transaction costs.

When considering a private sale, a government must weigh these advantages against the problems associated with this method. Private sales may give rise to criticism about the lack of transparency in the selection of buyers and to concerns about fairness and equity. Individuals and companies denied the bid may question the methods used to select the purchaser as well as the price paid.

If private sales represent a significant percentage of the government's privatization program, concern about concentration of the country's enterprises in the hands of a few powerful investors also might arise. The public may feel that the government has 'sold out' to strategic investors. A government can address these issues by using a structured privatization process. If the public can observe every stage of the process, concerns about fairness are less likely to arise.

Private sales can also take more time than other methods. The prequalification process, valuation, negotiations and sale, can take more than a year. This represents not just lost time but also lost money. If a government is searching for a quick privatization method, it may want to consider other options.

How is a Successful Private Sale Implemented?

Set Goals and Priorities

A private sale provides the government with the opportunity to push for other concessions in exchange for a lower bid. If a government first can determine its privatization goals, and then weigh them against the need for revenue, it can set its priorities and criteria in selecting the ideal purchaser. The government can select a buyer

which has good management techniques, or technical and market expertise, rather than an investor with the highest bid.

Identify Procedures to Follow

The government or selling entity must determine what privatization rules or guidelines to follow. Rules for executing private sales which outline the government's goals and have clear, open procedures for achieving the government's goals will permit the public to observe and comment on how well a sale has achieved these goals, whether the process was fair, and whether the price was reasonable.¹³ Loose guidelines offer flexibility but hurt transparency. The public may end up distrusting the rationale and terms of a sale executed under loose guidelines. Consequently, most governments, have laws which outline strict procedures for private sales. Senegal is a good example among African countries for maintaining strict guidelines for private sale.

Flexibility vs. Transparency in Canada

The government of Canada found a highly structured process more time consuming than its previous free-form flexible approach. However, it stuck to the structured regime because it satisfied transparency needs and helped the public to accept its choices for the privatized enterprises.

Assess the Enterprise

To properly value the enterprise and to determine what type of buyer can best meet the enterprise's operational needs, the government must carefully scrutinize the enterprise's structure and performance, as well as the market within which it operates. If the company is not structured as a share company, it must be reconstituted as a share company in anticipation of selling shares. The government's assessment must include an examination of the company's assets and liabilities to determine the financial health of the enterprise. It will also have to look at operational issues including input and product pricing, market demand, competition etc.

¹³

International Finance Corporation, 1995.

Case Study: Lack of Transparency in the Gambia

The privatization of the Gambia Marketing Board (GPMB), Gambia's largest parastatal, illustrates the importance of transparency in a private sale. After outstanding performance from its inception in the 1970's, the GPMB experienced financial difficulties in the 1980's. By 1985, it was saddled with large amounts of debt, and in 1986, the USAID called for privatization of the GPMB. Towards this end, the GPMB underwent several restructurings to improve its financial situation but failed to become profitable.

At the end of 1992, after producing documents describing the proposed privatization, GPMB began to solicit bids. It placed ads in various international publications such as *The Economist* and *The Financial Times*, and sent out 100 copies of its information document to local and foreign entities expressing interest in bidding.

The entity in charge of the bidding evaluation and selection process was a Task Force made up of various government agency representatives. The Task Force searched for companies which met the following criteria:

- ✓ engaged in the same types of operations as the GPMB;
- ✓ intended to continue GPMB's Gambia processing facility;
- ✓ could bring technical, managerial and commercial resources to the company; and
- ✓ would have, either via ownership or management, participation by Gambian interests.

The response to the request for bid submission was extremely poor. The GPMB extended the submission deadline three times and still ended up with only five bids to consider.

The Task Force interviewed the bidders. One group, consisting of a joint venture between a large international company and the largest Gambian buyer of groundnuts, changed the terms of its bid twice. Eventually the Task Force chose the joint venture group and concluded a contract with them.

A month following the privatization, the joint venture collapsed and the local Gambian group was excluded from the operation. This event, coupled with the lack of transparency in the process and a sale price well below the enterprise's net book value, caused the public to view the transaction as corrupt and damaging to the nation's interests. Several accusations of favoritism were made and rumors of bribes between bidders and government officials abounded, severely damaging the integrity of Gambia's privatization process. This privatization taught the Gambian government that a more formal and well publicized process would have decreased public perceptions of wrong-doing and may have led to a different outcome.

Source: Price Waterhouse and Abt Associates, *Privatization in the Agricultural Sector in Africa: The Case of the Gambia Produce Marketing Board*, November, 1994.

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Identify and Select Buyers

Selecting the purchaser involves close examination of all aspects of the interested parties to determine how they match the government's goals. The examination might include investigating the potential buyers' financial capabilities, their general business reputation, areas of expertise and performance record. If the government seeks the most appropriate buyer and does not have time constraints, it may well want to begin its search with a public request for bids. However, if the government already has identified a few potential buyers, it might forgo the time-consuming and expensive procedure of placing a public request for bids.

Negotiation and Sale

Private sales allow the parties to negotiate aspects of both the sale and the future operation of the enterprise. Negotiations over price, methods of financing and future operating plans may continue with all or just one of the potential buyers until the government can decide on a purchaser and both parties are satisfied with the terms and price of the sale. The more information the government has about the nature of the purchaser and how it intends to finance the sale, and about the needs of the SOE, the greater the effectiveness it will have in negotiations, and the more successful the private sale.

How Is a Private Sale Financed?

Debt Financing

One of the choices available to the purchaser or purchasers in a private sale is to finance the transaction using debt. One way to do so is by issuing bonds. In another common debt financed transaction, the leveraged buy out (LBO), the purchaser will approach a financial institution and borrow the necessary funds using the privatized enterprise, or other assets, as collateral.

In order to finance a sale via debt financing, the purchaser must have access to funds from either financial institutions or the bond market. While large international investors have a range of options for debt financing, finding domestic financial resources in the countries most actively involved in privatization may be difficult. The banking sector may not be able to provide the necessary capital and the bond markets in some nations may not be sufficiently developed. Consequently, local investors interested in

purchasing the privatized enterprise may not have access to sufficient funds. A government engaged in the privatization of an important national industry may find itself forced to seek an international investor to either singly purchase the enterprise or form a joint venture with a local investor.

Loan Financing

How an investor guarantees a loan can be of major importance, and governments should examine how the potential purchaser intends to structure the loan. For example, if a purchaser uses the enterprise itself as collateral, it will place the enterprise and its assets in jeopardy. If the purchaser defaults on the loan for any reason, the enterprise and its assets may be lost.

The source of the loan and the nationality of the purchaser also will affect the purchaser's stake in the new enterprise. For example, if the buyer is a foreign company which structures the loan such that only a local holding company must answer to the bank in the event of default, their stake in the success of the enterprise will be minimal. To combat this problem and increase the foreign investor's stake in the enterprise, governments sometimes insist that the foreign investor obtain all or part of the loan from outside the country.

Equity Financing

There are many ways in which an investor can use equity financing in a private sale. In some instances, a purchaser or group of purchasers can rely on existing capital. In others, a stock company wishing to obtain more cash for its purchase of the privatized enterprise can issue new shares from the parent company. Another option is for the purchaser to offer to give the privatized enterprise shares in its company in lieu of cash.

Equity financing has certain advantages over debt financing. Equity financing does increase the level of financial interest which a purchaser has in the privatized enterprise. However, it may be difficult to find a purchaser, either local or international, with both the available capital and the willingness to entangle it in a privatized enterprise. Existing investment law and foreign exchange restrictions may also create disincentives for a potential buyer to place equity capital into a newly privatized enterprise. Often, it is easier to find an investor or group of investors willing to use a mixture of both debt and equity financing to purchase the enterprise.

Case Study: Innovative Financing of a Private Sale in Poland

In 1992, the Government of Poland made a public tender for a strategic investor to purchase Huta Szkla Jaroslaw S.A., one of the largest glass factories in Poland. After a long bidding and selection process, the government chose Owens - Illinois (O-I), an American company, which could purchase 36% of Jaroslaw's shares. O-I made other concessions to the government. Twenty percent of Jaroslaw's shares were to be set aside for purchase by workers at preferential terms. O-I and several partners which included the New Europe East Investment Fund, the Polish-American Enterprise Fund, the Polish Private Equity Fund and the East Europe Development Fund, planned to acquire the remaining shares in four to five years.

As part of the share purchase agreement, O-I agreed to provide both employment and social benefits guarantees for an 18 month period. Perhaps most importantly, O-I and its partners also committed to invest no less than \$25 million in the company during the five year period after the share purchase. Beyond that commitment, O-I also indicated interest in making an additional capital investment of \$16 million, depending on market prospects. O-I had obtained a commitment from the European Bank for Reconstruction and Development (EBRD) for a loan of up to \$43 million to fund a capital investment program. This innovative financing allowed O-I and its partners to purchase the shares of the company over time and Jaroslaw to obtain a strong investor willing to make a serious capital commitment.

Source: SRI International, 1994.

Debt/Equity Financing

Many private sales have both debt and equity financing. Using a hybrid of the two financing methods allows the parties to avoid the problems associated with debt financing and overcome the constraints of limited capital resources. The exact mix depends upon several factors, one of which includes the government's interest in the success of the enterprise. A government may push for less debt and more equity financing in order to both insulate the privatized enterprise from the financial health of the purchaser and increase the purchaser's financial stake in the new company. Some governments are even willing to accept a lower sale price or longer payment schedules in exchange for a financing mix which best preserves the interests of the privatized enterprise.

Seller Financing

In some cases, the government itself may provide financing for the purchase. In this method, the government forgoes resources in exchange for a purchaser which best suits its goals for the privatized enterprise. A government needs to examine its priorities and carefully weigh the importance of raising revenue against achieving other privatization goals to determine whether financing the privatization presents the best option.

After a government decides it is in its best interests to assist in financing the transaction, it needs to determine the type of financing it should provide. The purchaser can guarantee the government a certain sum or a certain percentage of the company's profits on a yearly basis. Another option is for the government to provide some money directly via grants (although this is highly unlikely), or to dispense the funds at market or below market interest rates. For example, in Brazil, one government agency financed 80 percent of a private sale. It made its loan payable in 12 years at a below-market interest rate of 12 percent per annum.

Rather than a certain rate of interest, a government could agree to receive lump sum payments over a period of years. Bangladesh, Togo and Chile, for example, all agreed to receive payments over time. The Central African Republic allowed one company to make payments over a seven year period.

For a government-financed private sale, public support can be crucial. If the public is not properly informed about the procedures and terms of the sale, it could view the transaction as a "sell out". Public anger and distrust concerning one sale can create difficulties for the nation's entire privatization program. The government must ensure that the public is aware of the tradeoffs involved and why the government chose to finance the sale.

What Are the Linkages Between Private Sales and Capital Markets?

The domestic capital market can act as a source of funds for an investor seeking to finance a private sale by either issuing bonds or new shares. However, the capital market in many developing countries cannot provide the funds necessary for such endeavors. Consequently, investors must go to other sources of funds, either domestic or international, to execute the private sale. In fact, often governments will choose the private sale method because it does not require the presence of developed capital markets.

What Are the Linkages Between Private Sales and Broadening Domestic Ownership?

The very nature of a private sale precludes it from widening the domestic ownership of an SOE. Often, enterprises privatized under this method must be sold, in whole or in part, to an international investor without any type of domestic ownership. Even if domestic purchasers become involved in a private sale, their level of involvement is usually slight. The exception occurs when a government uses a private sale as the first step in a privatization which will conclude with another type of privatization. For example, a government may first execute a private sale to a company with the understanding that within a certain period of time, the purchaser will offer a certain amount of the shares to the public.

IV. MASS PRIVATIZATION

What is Mass Privatization?

While not a privatization financing method *per se*, mass privatization can be broadly defined as a privatization approach using standard systems and procedures to divest bundles or groups of SOEs. It usually involves a simple, automatic and sometimes mandatory process of enterprise transformation (mass corporatization) to prepare a large number of enterprises for privatization. Corporatized SOEs are then sold in a series of closed subscriptions or auctions to individuals or institutions. Pioneered by Poland and the Czech and Slovak Republics, mass privatization has since been adopted by many formerly centrally-planned economies such as Russia, Lithuania, Romania, Ukraine, Kazakhstan, and Mongolia.

Who is Involved in Mass Privatization?

Mass privatization is a process by which a selected group of state-owned property is distributed to the public in an automatic and equitable manner. By definition, mass privatization involves the entire citizenry of a country, who will participate either directly in the bidding process or indirectly through financial institutions. Similar to IPOs, mass privatization may require the services of accountants, financial advisors and attorneys to advise SOEs in the transformation of legal status, asset valuation, and preparation of privatization and business plans. However, due to the requirements for speed and simplicity, the burden of preparing SOEs for privatization primarily falls on the managers and employees of the enterprises themselves. Compared to other privatization methods, mass privatization requires a much deeper and more extensive administrative involvement and support in the country undertaking it. In Russia, for example, the roles of state and regional property committees (GKIs and KIs) as well as the local auction centers are critical to the success of its program. In countries where mass privatization is driven by the participation of investment funds, fund managers are also active players in the process.

Why Mass Privatization?

Mass privatization was originally conceived in Poland where the principal methods of privatization -- IPOs, employee buyouts and leasing -- were considered ineffective in meeting the goals of privatization, particularly the speed objective. The success of IPOs was limited by the expenses (valuation, underwriting, listing, etc.) and implementation time involved, while employee buyouts and leasing have not proven effective in inducing the necessary restructuring after privatization. Mass privatization was devised to carry out a speedy transfer of state-owned assets to the private sector in a transparent and inexpensive manner, as well as to encourage broad participation of the public in the privatization process.

Compared to the more traditional case-by-case approach used in Latin America and Asia, mass privatization offers the key advantage of *speed* at which privatization transactions are accomplished. Speed is an important privatization criterion particularly in transitioning economies which need to establish the basis of a market economy as quickly as possible. Countries which fail to privatize quickly may watch their SOEs suffer further deterioration and continually strain their fiscal resources in order to keep those SOEs afloat. Often, the pressure to privatize was kept up by means of ambitious targets and deadlines to complete the transactions. At the height of its mass privatization program, over 1,100 enterprises were auctioned off per month across Russia. The speedy implementation was the key to the success of the Russian and Lithuanian programs.

In some countries, mass privatization has also been employed to impose management discipline through more active supervision and monitoring by shareholders. In addition, governments may also want to achieve certain social and political goals using mass privatization, such as *distributing state property to its citizens in an equitable manner, engaging the broad participation of the public, and attracting widespread support* for the privatization process. Since mass privatization is by nature an ambitious, comprehensive and extensive privatization approach, its success greatly depends on the political, economic, legal and institutional environment in which it is carried out. The supporting environment for mass privatization is highlighted in the box below.

Supporting Environment for Mass Privatization

- ✓ **Political Will and Leadership:** Mass privatization involves mobilization of vast state resources as well the participation of the entire citizenry, and thus requires solid commitment from the highest levels of the government. Failure can seldom be attributed to technical reasons.
- ✓ **Institutional Support:** At the take-off stage, mass privatization is a logistically complex process, often requiring extensive support and advice from professionals such as investment bankers, lawyers, accountants, and consultants. Due to the expenses involved in procuring these services as well as in preparing and implementing the voucher systems and auctions, many countries have sought financial assistance from multilateral agencies and from industrialized country governments.
- ✓ **Legal Definition and Protection of Property Rights:** Since privatization transfers property ownership and rights to private citizens and groups of citizens, it is not viable unless investor rights are recognized and protected by law and institutions. These rights include the rights to buy, sell, dispose of and profit from direct and indirect share ownership in enterprises.
- ✓ **Foundations of Effective Corporate Governance:** To induce responsible financial management and effective corporate governance prior to privatization, corporatized SOEs should be subject to hard budget constraints and encouraged to develop viable business strategies and privatization plans. Procedures and institutions should be in place to enforce bankruptcy.
- ✓ **Protecting Competition:** Pro-competitive measures should be implemented prior to or in conjunction with mass privatization, especially of heavily concentrated industrial sectors. Generally this would require the establishment of regulatory bodies for natural monopolies and anti-monopoly measures to safeguard market competition. Barriers to entry should also be removed.
- ✓ **Financial Sector Reform:** Well-functioning financial markets serve two important functions in mass privatization: (i) provides the necessary capital for restructuring and expansion; and (ii) induce financial discipline by punishing poorly managed enterprises with high borrowing rates. Thus it is critical that financial sector reform be carried out in tandem with a mass privatization program.
- ✓ **Public Support and Participation:** An aggressive public relations campaign and public information program is necessary to communicate to citizens the benefits of mass privatization, as well as the mechanics of voucher distribution and auctions. Public information is critical in keeping a privatization program transparent and maintaining support and participation from citizens.

Source: *Mass Privatization, An Initial Assessment*, OECD, 1995.

How is Mass Privatization Implemented and Financed?

➤ **Corporatization.** The key to implementing a mass privatization program is to create an effective supply of firms to be privatized. Country experiences indicated that such a supply can be secured by means of mass corporatization, after determining the universe of SOEs¹⁴ to be included in the program. Corporatization is a procedure which transforms the legal, financial and management structures of SOEs into those of a joint stock company, the ownership of which can be transferred to the private sector. The speed of mass privatization demands that corporatization be simple, automatic and non-judicial. Some countries have induced quick corporatization by tying scheduled, closed subscription with corporatization.

The most challenging aspect of corporatization is asset valuation. Income-based methods (using discounted cash flows) would be difficult in a highly uncertain economic environment, while market-based methods (using comparable enterprises in the market) are often impractical in a nascent market economy.¹⁵ In some cases, valuation can also be complicated by the vast amount of social and other non-revenue-generating assets owned by SOEs. Governments usually determine the valuation method to be used in mass corporatization to avoid confusion and speed up the process. In Russia, the book value as of December 31, 1992 was used as the standard during mass corporatization.

➤ **The Use of Vouchers.** Vouchers have been integral to the mass privatization program in many Eastern European and NIS states. Vouchers are usually distributed to the public through an allocation scheme. Vouchers can be denominated in either points or currency, and can be used to purchase SOE shares directly (Russia) or indirectly through share ownership in investment funds (Poland and Kazakhstan). Some countries allow the use of the same vouchers to purchase apartments (Lithuania). In Poland and Russia, vouchers became tradable immediately. In contrast, voucher trading was forbidden initially in both Lithuania and Kazakhstan. Since vouchers are distributed either free of charge or for a nominal fee only, governments usually receive no proceeds from the voucher auctions under mass privatization. However, most governments initially

¹⁴ Countries have taken a variety of approaches to determine the core group of firms to be privatized. Poland included 460 large firms on a voluntary basis. The Czech and Slovak Republics and Russia adopted compulsory participation of all large SOEs. Lithuania, in contrast, has included housing, and both small and large firms in its mass privatization program.

¹⁵ SRI, 1993, p.21-22.

retain a portion of share ownership, and those shares can be sold off to investment funds or strategic investors in the future.

There are several advantages to using vouchers:

- ◆ It helps to overcome the lack of private savings and liquidity in the economy.
- ◆ It ensures a transparent, fair and equitable distribution of state-owned properties.
- ◆ It involves the participation of the entire citizenry and garners support for the privatization effort.
- ◆ A voucher privatization system pushes the government towards developing a secondary market for trading vouchers as well as enterprise shares, thus stimulating overall capital market development.

Several Key Considerations in the Design of a Voucher System

<i>Eligibility</i>	☛	<i>All citizens? Age limits? Residency requirements?</i>
<i>Issuer</i>	☛	<i>Privatization agency? Pensions system? Banks?</i>
<i>Issuance</i>	☛	<i>In series? Tied to auctions?</i>
<i>Denomination</i>	☛	<i>Points? Local currency?</i>
<i>Tradability</i>	☛	<i>Immediately tradable? Rules and regulations for trading?</i>
<i>Conversion into Shares</i>	☛	<i>Auction? "Football" pool? Share registration procedures?</i>
<i>Coverage</i>	☛	<i>Large and/or small enterprises? Land and/or apartments?</i>
<i>Links to Other Preference Schemes</i>	☛	<i>How can vouchers and distribution of preference shares to employees be linked?</i>
<i>Infrastructure</i>	☛	<i>Can the computer and accounting control system for vouchers be developed for alternative usages such as share registration and trading?</i>

Source: Mass Privatization in Central and Eastern Europe and the Former Soviet Union. A Comparative Analysis, edited by Lieberman, Ewing, Mejstrik, Mukherjee and Fidler, World Bank, 1995.

➤ ***The Auction Process.*** Mass privatization programs have made extensive use of auctions to transfer share ownership of corporatized SOEs to the public. Auctions can be carried out in “waves” of a series of several firms at a time in each region if the country is very large (Russia), or centralized if the country is relative small (Kazakhstan). Some countries employed a simple bidding algorithm, using priced bids to clear the market and guaranteeing shares to the unpriced bids. The keys to an effective auction process are transparency and accessibility to the public.

➤ ***Investment Funds.*** In many countries, investment funds have been used as intermediaries for share purchase during the mass privatization process. Some countries have allowed investment funds to be formed spontaneously (Czech and Slovak Republics, Russia, and Lithuania) while others created them through active intervention (Poland, Romania and Kazakhstan). Investment funds, with their share concentration and professional management, have been viewed as a potentially powerful vehicle for inducing corporate governance in privatized firms. However, the early *laissez-faire* approach adopted by the Czech and the Slovak Republics has led to anti-competitive behavior and abuse by some investment funds, and has served as valuable lessons on the importance of implementing appropriate legislation to regulate behavior of investment funds (See Chapter VI on investment funds).

While *Share Preference for Employees* varies among different mass privatization programs, many countries have slated a portion of shares for closed subscription to the employees. Under Poland’s mass privatization program, up to 15 percent of shares were reserved for employees. In Mongolia, families have pooled vouchers to become employee-owners of small enterprises purchased through vouchers. Various options available under Russia’s mass privatization program allowed employees and managers to acquire up to 51 percent of share ownership. These employee preferences and pre-emptive rights were often accompanied by share price discounts, credit facilities, installment plans etc.

The following case study on Kazakhstan will illustrate some of the issues raised in the mass privatization process.

Mass Privatization in Kazakhstan

The main objectives of the 1993 mass privatization program in Kazakhstan are to divest state assets rapidly and systematically, and to achieve more effective enterprise governance and socially fair distribution of ownership. The GOK has adopted a centralized, top-down approach to the privatization process, giving investment funds a key role in developing effective corporate governance. Kazakh citizens are given points-denominated vouchers, which they could invest exclusively in a number of approved investment funds. The funds will in turn bid for shares in SOEs which are being privatized. To ensure proper conduct of the investment fund managers and to enhance their stake in good performance, licenses for the funds are sold at substantial fees.

Privatization vouchers. *While it is envisioned that the shares held by investment funds will eventually result in a market value for the vouchers, as of April 1995 the vouchers were not tradable. Share and voucher trading has been delayed mainly due to the slow development of the capital markets. The current restriction on voucher trading causes two problems: (1) It limits the investment choices of individuals and reduces the direct participation of citizens in the privatization process; and (2) It precludes the Kazakh public from realizing material gains from the sale of shares, and may run the risk of eroding support for privatization.*

Share allocation. *In determining the share allocation structure under its mass privatization program, the GOK has to balance the interests of employees against the need for establishing corporate governance. It was decided that employees could obtain up to 10 percent of authorized capital at a discount, and 51 percent of the shares of each SOE are sold to investment funds in centralized, exclusive auctions. While share allocation in Kazakhstan is less generous to employees than in, say, Russia, it is hoped that this ownership structure will induce effective enterprise control. Earlier experiences have demonstrated that an ownership system biased towards employees is not conducive to painful but necessary restructuring.*

Investment Funds. *The central role of investment funds has raised some contentious issues in Kazakhstan. The first is related to the share restrictions on the funds, which, until recently, have been limited to owning no more than 21 percent of shares in any enterprise. The rationale for this restriction was to prevent the monopolistic structures which could emerge with excessive share concentration in a sector. However it has been argued that unnecessary restrictions may prevent investment funds from exercising real ownership control over newly privatized enterprises. Recently, the ceiling has been raised to 31 percent.*

... Continued

The second issue is related to the participation of financial institutions in investment funds. The central role played by investment funds precludes financial institutions such as banks and insurance companies from becoming dominant players in the emerging securities market. This has drawn criticism from those who view the Czech-type approach, in which financial institutions play a major corporate governance role, as a more appropriate model for the emerging securities market in Kazakhstan.

The third issue concerns the regulation of investment funds to ensure that they are accountable to their shareholders. As the exclusive, initial buyers of shares, investment funds have been placed in a position to wield enormous power vis-a-vis individual investors. In addition, the non-liquid capital market has reduced the right of shareholders to walk out when they are dissatisfied with fund management or performance. Early audits have identified fund errors such as insufficient evidence of paid-up Charter Capital, failure to pay licensing fees, and the lack of founding charters and agreement according to the law. Anti-fraud and truth-in-advertising regulations will be required to regulate operations of investment funds in the future.

Source: "Mass Privatization Issues in Kazakhstan," Ophelia Yeung, SRI International, 1995; Mass Privatization, An Initial Assessment. OECD, 1995.

What Are the Linkages Between Mass Privatization and the Capital Markets?

The development of a viable capital market is critical to the success of mass privatization, given the widespread share ownership and the speed at which private firms emerge from mass privatization. Functioning secondary markets allow the new shareholders to buy and sell shares and offer the potential for a real return on their share ownership. The capital markets will also impose market discipline on management and provide the means for mobilizing resources to finance enterprise restructuring and expansion.

Mass privatization stimulates the development of secondary markets by creating a core group of private firms, many of which will have widespread share ownership through individual shareholding or intermediaries such as investment funds. The Russian mass privatization program created some 14,000 medium and large firms by July 1994, while the Czech program has privatized close to 2,000 SOEs thus far. Secondary markets are natural outgrowths of mass privatization as shareholders begin to exercise their trading rights. In the Czech Republic, a vibrant secondary market emerged initially in the form

of over-the-counter trading, followed by the development of a larger, more conventional equity market - the Prague Stock Exchange. In Russia, regional stock exchanges have developed in the major municipalities (Moscow, St. Petersburg, Vladivostok, etc.) following mass privatization. In addition, several investment companies which originally brought and sold vouchers have now developed into mutual fund-type companies with large and growing portfolio holdings in a wide range of companies.

To support the development of strong and efficient capital markets, governments must put into place regulations and institutional mechanisms to pre-empt anti-competitive behavior and prevent undesirable securities practices such as insider trading or share manipulation. Shareholders' rights also need to be protected through well-defined disclosure rules and regulations governing minority shareholder rights. Well-functioning capital markets need to be facilitated by infrastructure such as intermediaries (brokers and dealers), efficient clearing and settlement systems, and information and research services.

What are the Linkages Between Mass Privatization and Broadening Share Ownership?

One important objective of mass privatization is to transfer state-owned property to the majority of a nation's citizens in a transparent, equitable and efficient manner. The process is designed to involve extensive citizen participation and achieve widespread share ownership, mostly through distribution of vouchers. Thus, mass privatization is an important first step in establishing broad-based share ownership in a country. In the long-term, however, widespread share ownership can only be assured in a viable capital market in which effective ownership can be exercised and protected.

Mass Privatization and Capital Market Development in the Czech Republic

The mass privatization program in the Czech Republic has been explicitly linked to capital market development. The program involved extensive participation from the Czech public, particularly through the spontaneously formed investment funds. The first wave of privatization, completed in December 1992, brought nearly 1,000 companies into the secondary market with a total book value of US\$7 billion. Trading activities soon began after the Prague Stock Exchange was reopened in April 1993.

The Prague Stock Exchange has been one of the most active in Eastern Europe. Trading activities have been vibrant, and the market capitalization of the Czech Republic reached 50 percent in 1994, a level comparable to advanced industrialized countries. To a considerable extent, trading activities have been stimulated by the interest of foreign investors, both active and passive (portfolio investors through emerging market funds). It is estimated that level of foreign capital in the Prague Stock Exchange stood between 50 and 90 percent in mid-1994. Parallel to the official stock exchange, an active over-the-counter market (RM-S) also developed. Four hundred outlets have been established and by January 1994 trading volume reached US\$100 million.

As in most emerging markets, the Czech capital markets suffered tremendous volatility in 1994, with the Prague Stock Exchange index plunging to 40 percent of its peak value by December 1994. The weak financial sector and the lack of transparency further slowed exchange activities. The volatility has drawn attention to the existing deficiencies in the Czech capital markets. For example, infrastructure constraints have forced an estimated 80 percent of all trades to take place outside of the official exchange, creating information lag in share prices and volumes. Inefficiencies in the RM-S system have also led to lags in bidding and settlement. In addition, the lack of an independent securities exchange commission has led to suspicions of insider trading and share manipulation.

Recognizing the deficiencies in its initial capital market structure, the Czech government has moved to implement regulations on trading practices and institutions. Steps are being taken to institute more stringent regulation and supervision on trading activities. An on-line computer link has also been established between the Centralized Securities Center and the Prague Stock Exchange to clear transactions quickly.

Source: *Mass Privatization in Central and Eastern Europe and the Former Soviet Union, A Comparative Analysis*, edited by Lieberman, Ewing, Mejstrik, Mukherjee and Fidler, World Bank, 1995.

V. EMPLOYEE/MANAGEMENT BUYOUTS*What are Employee/Management Buyouts?*

Buyouts are a generic term covering a variety of transactions involving the sale of corporate assets to the so-called "insiders" of the firm, i.e. the workers and managers who would have the technical expertise and financial incentive as new owners to ensure profitable operations. Distinct but related buyouts include management buyouts (MBOs) in which current management acquires ownership of the firm; employee buyouts (EBOs) in which current employees obtain the majority of the firm's equity; and employee stock ownership plans (ESOPs) in which employees acquire stock, usually with the assistance of a corporate trust fund, but do not accumulate a majority of the voting shares.

The buyout options differ in other important ways as well. An MBO represents the transfer of ownership to a relatively small and homogenous group of existing managers, a move which may encourage efficient operations because managers now share in the potential profits of a firm they now own. EBOs attempt to garner the same corporate governance advantages of an inside buyout while promoting broader ownership of the company's assets. In cases where individual workers may lack the private resources to acquire stock in their company, ESOPs can subsidize share purchases via a company-established trust fund. In practice MBOs, EBOs, and ESOPs are often combined and are therefore referred to as management/employee buyouts (M/EBOs) in this chapter.

Who is Involved in M/EBOs?

The enterprise's employees, managers, lending agencies or financial institutions, and the enterprise itself comprise the main players in M/EBOs. Which employees are involved depends upon the type of buyout. Management buyouts can contain different groups of managers. Some MBOs entail just the top management: often only two to five players. Others will consist of a wider range of management and include mid- and lower level management as well. EBOs may be limited to share purchases for current employees or offered to future employees, or even eventually, to other private individuals. Regardless of the group of employees involved, (the workers, management or both), all of the buyers are insiders and have a significant interest in the successful operation of the privatized enterprise.

How are M/EBOs Financed?

Perhaps the most challenging aspect of an M/EBO is that the transfer of ownership often is financially prohibitive for both management and employees. In the best case scenario, managers or employees might finance a buy-out through private sources such as savings, pension funds, or other liquid assets. However, few managers or employees possess the financial reserves to purchase any but the smallest companies entirely from their own resources. Whereas in the OECD context, banks and venture capital funds are the most common financing sources, other means must be found in countries characterized by shallow financial markets which lack commercial banks or other financial intermediaries to supplement private resources. Thus, in the developing country context, many M/EBOs emerge as highly leveraged transactions which must be financed through some sort of government assistance, including loans or deferred payment schemes.

The range of financing options to support M/EBOs could include subsidized investment loans, installment payments, pre-privatization financial restructuring, or use of vouchers or leasing arrangements on assets with the option to buy. As the following examples and subsequent case studies illustrate, financing mechanisms are far from universal and vary considerably by country in terms of the services offered. Often, two or more financing options are often bundled in order to facilitate management/employee stock acquisition. Recent financing measures implemented in various countries include:

- Germany's privatization agency (THA) has accepted up to 50 percent of the purchase price in installments over a three-year period, the first of which can be interest free, and the remaining two at reduced interest rates. The THA is also willing to extend its guarantee on existing loans for a period of up to two years, thus permitting the new owners to use the company's assets as collateral for additional loans.
- Under the Russian mass privatization program, employees have the option of purchasing 50 percent of the voting shares at a price set by the Committee for State Property, with the remainder sold at public auction.
- The Moroccan Privatization Law stipulated that shares of up to 10% of privatized companies could be reserved for discounted purchase by employees. By the end of 1994, eight companies had successful employee tranches.

- In Romania, insiders may receive a 10% discount on up to 10 percent of an enterprise's shares.
- In Poland, employees of an SOE privatized through corporatization can buy up to 20 percent of available shares at a 50 percent discount. In the case of B&C Enterprises, a special privatization fund was capitalized using about 125 percent of the company's yearly after tax profits. These funds were then lent out to employees with at least 3 months of seniority at a two percent rate, repayable in three years. Workers with more seniority could borrow higher amounts.¹⁶
- In Benin, almost all privatizations have included a 5% share tranche reserved for employees. Although each transaction in Burkina Faso's privatization program has included a reserve set aside for employees, none of the transactions had been completed by 1994. In Cape Verde it is expected that all transaction will include a percentage set aside for employees.¹⁷

How are M/EBOs Implemented?

Most successful M/EBOs begin with sound financial and operational restructurings. To have a successful M/EBO, the management or workers involved must be able to create and maintain a profitable enterprise without an inflow of new investment capital. The government usually receives either solicited or unsolicited bids from one or several groups within the enterprise professing to have these abilities. It then selects the bid which best meets the new enterprise's needs. Sometimes a small group of managers will bid against a larger group of employees. When this occurs, the government can face a difficult choice. While it may prefer to have wide employee participation from a social standpoint, in actuality a team of

Examples of Constructive African M/EBOs

- ☛ Côte d'Ivoire: The water exploration and drilling company Forexi was privatized through an MBO.
- ☛ Benin: The privatization of a brewery involved spinning off the distribution branch of the company and giving retrenched workers priority in stock acquisition.

¹⁶ OECD, "Trends and Policies in Privatization", Vol. 1 No. 3, 1994

¹⁷ USAID, 1994

management owners may provide the enterprise with the leadership and skills necessary to survive. Thus, the government may have to choose the success of the enterprise over wider participation.

After the selection of the buyers, the important, and sometimes difficult task of finding financing begins. Because the parties involved in M/EBOs usually do not have the necessary funds to execute the purchase, the government often must help to finance a portion of the buyout. Once the government has determined how it can assist the purchasers to obtain financing, the actual negotiations and sale can take place. Sometimes, bidding and negotiations concerning the actual privatization and business plan can take a significant amount of time. In some cases, these negotiations can take more than a year. However, their successful completion results in a profitable, privatized entity, with interested, committed, owners.

Why Choose M/EBOs?

The prime advantage of M/EBOs lies in their ability to create a group of owners with significant interest in the success of the enterprise. In practice, M/EBOs often are undertaken for small companies which may have difficulty attracting outside buyers and financing. In addition to the incentive structure created by M/EBOs, buyouts present an additional advantage in terms of speed. Since M/EBOs target an organized and sometimes homogenous investor group, this financing method facilitates rapid ownership transfer and avoids the often expensive and time-consuming process of preparing companies for an initial public offering. (See Chapter on Public Offerings.)

From a political standpoint, M/EBOs can generate widespread public support for and participation in the privatization process, especially in countries where labor has a strong influence in the political process. Due to the preponderant role of labor councils in the former socialist countries, M/EBOs have been common practice in Eastern Europe (Eastern Germany, Poland and Romania) and the former Soviet Union (notably in Russia and Lithuania). The method has been employed to a lesser extent in other countries such as Chile. For example, M/EBOs constituted nearly 20 percent of privatizations in Germany and 33 percent of those in Poland, mostly for small and medium-sized enterprises. The governments of Romania, Estonia and Belarus have sold over 80 percent of state-owned enterprises through M/EBOs. However, this method has been less frequently used in the Czech Republic and Hungary, where M/EBOs constitute less than 10 percent of transactions. (OECD 1994). In other regions, the Egyptian government has

also used EBOs to encourage employee ownership during privatization (see example of the ESOP in the Alexandria Tire Company in this chapter).

Despite their popularity, M/EBOs present several complications. A buyout by a small group of insiders may increase financial risk and engender suspicions that managers are exploiting an information asymmetry in order to acquire the most profitable firms for themselves and exclude the citizenry from a potentially profitable investment opportunity. Due to these suspicions, pure MBOs have not been a common financing mechanism for privatization in most countries. Given that most SOEs operate as loss-making firms, many require technological and managerial infusions in order to operate profitably. In such cases identifying an outside investor (domestic or foreign) would be a more strategic move to increase the long-run profitability of the firm. Thus M/EBOs as a financing mechanism would be most appropriate for small and medium enterprises whose capital intensity is relatively low (such as service sector firms) and which may not be in need of massive capital infusions for restructuring and modernization.

What are the Linkages between M/EBOs and Capital Markets?

While few direct linkages exist between M/EBOs and the development of capital market, the privatization of an enterprise and the creation of a small or large group of interested insiders with shares in the new company does affect the capital market in a country indirectly. By converting a public entity to a private corporation, a government removes itself as a future source of investment capital. In the future, the newly privatized enterprise will have to find the funds for investment in the private capital markets, either the domestic or international. Thus, M/EBOs will indirectly lead to increased demand for capital. In addition, M/EBOs have the potential to increase the number of shares traded publicly. If the government structures an ESOP such that the employees may eventually trade their shares in the capital market, it will increase the supply of shares in the local capital market over time.

What are the Linkages between M/EBOs and Broadening Share Ownership?

The main advantage of M/EBOs lies in their ability to create a group of new owners who are direct stakeholders in the privatized enterprise. This usually results in broader share ownership. An MBO to one or two top managers represents the exception. This type of buyout does not broaden shares but concentrates them in the hands of a few individuals. Moreover, it can produce negative publicity. People may view this type of MBO as an attempt to concentrate the financial wealth in the hands of a few insiders.

The new stakeholder has an intense interest in the success of the privatized enterprise. This financial interest by a broader group of employees can be beneficial for both the enterprise and the country, as well as the new stakeholders. Some studies have shown that gain-sharing and participatory management via EBOs can improve a corporation's performance.¹⁸

If a government wishes to benefit the residents of a community which depends upon the privatized enterprise, an EBO will allow it to do so. EBOs have the potential to distribute the new enterprise's shares to a large number of people, especially if the employees can resell their shares to others after a certain period of time. This increases economic participation and future ownership opportunities for a wider group of citizens.

¹⁸ Kurland and Kurland, (March 1990)

Employee Buy-Outs in Hungary

In 1990, the Hungarian State Property Agency (SPA) decided to privatize an information technology consulting firm in Budapest. The firm, employing some 400 people, dealt primarily in computer software development and training, research and information technology. Given that the firm dealt mainly in intellectual property production, the management was particularly concerned with retaining the most experienced employees and thought that giving them an ownership interest in the newly privatized firm would act as a strong incentive to keep them with the company following privatization.

To increase the incentives to retain senior employees, the company drew up a "qualification system" to determine the share allocations that each employee would be able to purchase. Under the rules of the system, employees were assigned points based on seniority and an evaluation of the employee's performance. The points ranking could then be used to determine each employee's priority in purchasing shares on a pro rata basis. Approximately 10 percent of the company's shares were set aside for employee purchase at a price of 5 percent of face value. An additional 15 percent of the company's stocks were reserved for employee purchase at 50 percent of face value.

However, even at reduced prices, many eligible employees were not in a position to assume the financial burden of share purchases. The SPA therefore allowed employees to purchase shares under an installment plan which granted employees up to three years to pay for the shares. By 1993, slightly over half of the company's shares had been purchased by employees.

This case illustrates several points about employee buyouts. The first is that a carefully constructed employee buyout plan can be leveraged to retain key employees who contribute to the long run profitability of the firm. Although the principle of basing share allocations on seniority violates the principle of equal access which promotes more harmonious workers relations, it was useful in retaining the most senior and experienced employees who otherwise might have left for other sectors or immigrated to neighboring countries. This ability of a firm to retain experienced workers is particularly important in industries where skilled labor is not easily substitutable and in countries where a "brain drain" of skilled workers is likely. Secondly, even at highly reduced share prices (5 to 50 percent of par value), many Hungarian workers could still not afford to purchase shares under the usual payment conditions of full up-front payment. As in many other countries, rapid buyouts, though well-intentioned, are often impractical without complementary financing mechanisms such as extended payment periods.

Source: OECD, "Trends and Policies in Privatization", Vol. 1 No. 3, 1994

Failed MBOs in Zambia

During the first tranche of its privatization program, the Zambia Privatization Agency (ZPA) received MBO bids for 15 of 19 companies up for divestiture. ZPA rejected some bids due to weak business plans, lack of a proven management expertise, unrealistic cash flow projections or inability to provide evidence of financing, and rejected other offers because of weak payment terms which specified only limited cash up-front.

When asked to submit revised bids, several potential investors responded by including foreign technical partners whose cash infusions would allow domestic bidders to meet the ZPA's desire for larger up-front payments. Against the counsel of expatriate advisors, the ZPA rejected the revised offers, claiming that foreign investors were "using" the managers to gain a controlling interest in domestic firms. In the end the companies were resubmitted for bidding, and to date no MBOs have been concluded.

The ZPA experience with M/EBOs lends several insights into the potential of M/EBOs to serve as useful financing mechanisms for privatization in Africa. First, the case highlights the notion that an M/EBO, though an expedient and often politically popular form of privatization, requires careful scrutiny for the potential long-run impacts on a company's earning potential. Maintaining the long-run profitability of the firm is the key objective of privatization, and to the extent that a management group cannot demonstrate the ability to maintain profitability, its offer is better rejected. Accepting an M/EBO solely to promote rapid asset transfer is counterproductive if the new owners provide no evidence of potential profitability under their direction.

ZPA also illustrates that even the most well-intentioned management buy-outs designed to retain valuable insider expertise will be frustrated by lack of financing. In countries with low capital resources, foreign investment may be the most readily available source of cash infusion and should not be summarily rejected under suspicion of losing control to outside investors. If a country is concerned about foreign domination of the privatization process, it can bundle financing mechanisms in order to promote both domestic participation and employee/management control. Some of the leasing and repayment schemes described earlier in this chapter highlight ways to mitigate the financing burden of asset sales while still garnering the political and incentive benefits of an M/EBO.

Source: "Privatization in Africa: Lessons and Opportunities," Price Waterhouse and Abt Associates, 1994.

Case Study: The Alexandria Tire Company in Egypt

The privatization of the Alexandria Tire Company (ATC), used an innovative method for financing an ESOP. The ATC underwent privatization in early 1990. First, the government restructured the company and formed an independent corporation. Then, it created an Employee Share Ownership Plan (ESOP) which provided 30.5 percent of the founding common shares for the new corporation to ATC's employees. Rather than reduce employee's savings or take home pay, the project used self-liquidating productive credit to conduct the ESOP. The authorities involved in the ESOP estimated that the share values eventually would equal over eight times an employee's annual wages.

To finance the ESOP, the Egyptian Government issued a loan of \$16.5 million. A newly created Employee Shareholders' Association (ESA) assumed the loan with only the workers' shares as security. The ESA has a grace period of six years, after which it has ten years to pay the loan, wholly out of projected dividends.

The Government did not issue the loan to ESA at reduced rates. However, it did offer an unusual repayment scheme. Rather than use the prescriptively high going rate of interest, it agreed to an innovative profit sharing agreement. Instead of paying the government interest and principal, the government agency issuing the ESA the loan receives 50% of the ESOP dividends over the ten year period after the six year grace period. This arrangement allows employees to obtain ownership and repay their loan only if ATC is profitable. In the event that ATC is unprofitable, the employees would earn nothing and not have to make payments on their loan. However, they would see their shares sold to the private sector.

This case demonstrates how creative financing can be used to engineer a privatization when the future shareholders have no capital to invest. The Egyptian Government successfully increased the share ownership of the ATC, providing disenfranchised workers with the opportunity to maintain their jobs and increase their incomes. It achieved this equitable outcome without heavily subsidizing the privatization, and it established mechanisms for the repayment of the loan without overburdening the ATC employees.

Source: Center for Privatization, The Scientex Corporation (March, 1990)

VI. INVESTMENT FUNDS, PENSION FUNDS AND OTHER INSTITUTIONAL INVESTORS

What is Privatization via Financial Institutions?

This is a privatization method which utilizes financial institutions as a vehicle to facilitate and/or mobilize resources to finance privatization. Financial institutions set up specifically to facilitate privatization may take the forms of closed-end funds (e.g. investment trusts), open-ended funds (such as unit trusts), or a warehouse-type institutions such as privatization trust funds. In recent years, financial intermediaries and institutional investors have played an increasing role in privatization, particularly in mass privatization in Eastern Europe and the NIS. The participation of pension funds has been instrumental in financing the privatization programs in several Latin America countries, most notably Chile, and is now being experimented within Bolivia as well.

Who is Involved in the Process?

Under this privatization method, the public is involved to the extent that they participate in the investment funds or pension funds which invest in privatized SOEs. In some countries such as Poland or Kazakhstan, individual citizens are not allowed to bid for enterprise shares directly using their coupons or points but are restricted to purchasing shares in investment funds. On the other hand, citizens in Russia or the Czech Republic have the freedom to choose between bidding for SOE shares directly or depositing their vouchers in investment funds. In any case, privatization using financial intermediaries gives *fund managers* a predominant role in the privatization process, allowing them to monitor enterprise performance and trade shares on behalf of fund owners and participants.

Why Privatize via Financial Institutions?

Worldwide country experiences have shown that financial intermediaries can be effectively used to facilitate privatization, promote corporate governance and stimulate capital market development. While voucher privatization or conventional IPOs may help

achieve widespread share ownership, they do not necessarily promote capital market efficiencies or the interests of individual shareholders, for the following reasons¹⁹:

- ◆ Small, first-time share owners, especially in developing countries, usually do not have the incentive, resources or experience to monitor management and enterprise performance. The lack of active share ownership does not promote efficient share pricing in the capital market.
- ◆ Widespread ownership resulting from IPO and voucher privatization may make it difficult to control corporate boards and management because dispersed shareholders lack the financial resources to back their judgment with massive sales or purchase of shares.
- ◆ Limited private savings, high transaction costs for share trading, and the lack of market knowledge often make it difficult for individual investors to diversify their portfolio and spread their risks among different types of investments. Even in industrialized countries, many small investors start investing with mutual funds. Diversification is even more important in developing and transitioning economies given the limited financial resources among individuals and their lack of investment experience.

Institutional investors such as investment funds or pension funds can help overcome these constraints by amassing sufficient shares to exert effective ownership control, providing skilled professionals to monitor and manage privatized firms, and allowing individuals to diversify investment risks among a large number of firms. In some countries, investment funds may perform the additional functions of facilitating the transfer of property from the government to the public, as well as raising capital to finance post-privatization restructuring.

In addition, investment funds or mutual funds can be a vehicle for attracting foreign capital to help finance privatization. The Polish Government, for example, has given consideration to establishing financial intermediaries specifically for attracting foreign capital.

¹⁹ Clague and Rausser, 1992, p.239.

How is Privatization via Financial Institutions Implemented and Financed?

Investment funds or mutual funds for privatization can be set up either by:

- (a) Allocating SOE shares to the funds, and then distributing fund shares to individuals; or
- (b) Allowing individuals to purchase shares in fund companies (with vouchers and/or cash), which will in turn bid for SOE shares through privatization auctions.²⁰

Some would argue that scheme (a) is preferable to scheme (b), which provides little basis or information on which individuals can bid for fund shares. In practice, some countries have allowed investment funds to form spontaneously to accumulate vouchers and bid for enterprise shares on behalf of individuals (Czech and Slovak Republics and Russia). Other countries have taken a more top down approach and explicitly gave investment institutions a dominant role in the privatization process (Poland and Kazakhstan).

Due to their special circumstances, the appropriate fund model for developing countries undergoing privatization is likely to be different from those in industrialized countries.²¹ Classic **open-ended funds** such as unit trusts and mutual funds are usually designed to protect small investors and often incorporate features which minimize risks. In most countries, regulations typically allow no more than 5 percent of a trust's portfolio to be invested in any one firm, and no more than 10-20 percent of the shares of any one enterprise to be held by a trust. In addition, open-ended funds are usually not actively involved in enterprise management. Given the risky nature of SOEs undergoing privatization and restructuring, an OECD-type open-ended fund may not be appropriate to facilitate privatization.

On the other hand, **close-ended funds** such as venture capital funds or investment trusts often involve a higher degree of management control. These funds typically draw large investors (individuals, institutions or companies) seeking high returns from higher-risk investments. Usually, the amounts placed by investors in venture capital funds are

²⁰ See Fischer, Clague and Rausser (ed.), 1992.

²¹ "The Role of Investment Funds in the Privatization Process" in **Trends and Policies in Privatization**, Vol.1 No.1, OECD Publications, 1993.

only a small part of their total portfolios. Thus, the characteristics of conventional close-ended fund may not be compatible with the goals of protecting small, first time, and unsophisticated investors in countries undergoing privatization.

Most funds which have emerged from mass privatization in Eastern Europe have the legal structure of an open-ended joint stock company, while operating as closed-ended funds. This means their shares can be traded on the market or between individuals, but are not subject to redemption upon demand, as are open-ended funds. Most of them were set up with the purposes of simultaneously transferring share ownership to the public, while providing professional management skills and some degree of enterprise control. Compared to their industrialized country counterparts, investment funds in Eastern European countries are often more involved in corporate management and enterprise restructuring, in the absence of a trained managerial class within the privatized enterprises. The hybrid nature of investment funds stems from the need to spread the ownership of economic assets among the public while simultaneously minimizing the negative impact of a dispersed ownership.

In some developing countries, **Privatization Trust Funds** have been established to "underwrite" or "warehouse" minority shares in SOEs which are to be sold to the public at a later date. Unlike units trusts or investment funds, privatization trust funds are usually state-owned holding companies where shares are "parked" temporarily. Thus, these types of trust funds essentially serve a bridging function and they differ substantially in their purpose and operations from typical private-sector financial intermediaries. Establishment of privatization trust/investment funds enables the shares to be removed from direct government control and creates a mechanism whereby the population can participate. However, experience has shown that these funds are best managed privately and decisions on whether to accept SOE shares by the fund should be made by fund managers based on the feasibility of the proposed investments.

Privatization Using Investment Trust/Funds in Africa

Investment trusts/funds have been increasingly used in the privatization programs of African countries. Tanzania and Uganda are currently developing privatization trust funds, while Kenya is considering the use of investment funds to finance its ongoing privatization program. In Cape Verde, the establishment of risk capital funds to finance both the privatization program and private sector development is being considered. Two of the funds will be designed to target Cape Verdean nationals living abroad.

Zambia is at a more advanced stage of privatizing using investment funds, having passed related legislation and established a regulatory framework for the funds. The Zambian Privatization Trust Fund (PTF) is being used to acquire shares in newly privatized enterprises, and function as a "warehouse" for minority stakes reserved for later sale to citizens through public offering. The PTF is not a unit trust or an investment fund, but a state-owned holding company for SOE shares in the transitional period between sale to core investor and sale to the public.

Source: "Privatization in Africa: Lessons & Opportunities," Price Waterhouse and Abt Associates, 1994; SRI International.

Several important issues must be addressed in using investment funds for privatization. One concerns *the potential conflict of interest among the fund managers* who have to balance the need of maximizing shareholders' profits as well as undertaking enterprise restructuring that might depress short-term profits. Furthermore, there is a risk that corporate control by government-organized investment funds may not be sufficiently market-oriented, and that investment funds could become yet another group of entrenched bureaucracies with corporate control becoming tantamount to political control.

The second is related to the *appropriate degree of regulation* to protect small and inexperienced shareholders and prevent anti-competitive behavior among investment funds, without impeding their ability to exert management control on privatized firms. Ideally, investment funds should be allowed to accumulate enough shares in individual firms in order to exercise ownership power, as well as achieve some form of specialization in the sectors in which they invest. However, individual funds or a family of funds may engage in anti-competitive practices if they achieve significant ownership concentration in one sector. Potential fund abuse can be intensified when the banking sector is allowed to operate investment funds, as in the case of the Czech Republic. Alarmed by the growing power of investment funds, the Czech and Slovak Republics have enacted a Law on Investment Funds in 1992 aimed at enhancing protection for fund

investors. The Law prohibits funds from owning more than 20 percent of one firm, and requires each fund to invest in a minimum of ten firms.

In addition, regulation in the areas of licensing, financial disclosure, prospectus, minimum capital requirements, prudential investment limits, management fee structure, etc., are important for investor protection. Regulation will have to be supported by effective enforcement mechanisms and institutions.

The Use of Investment Funds in Mass Privatization in Poland and the Czech and Slovak Republics

The mass privatization approaches in Poland and the Czech and Slovak Republics incorporated the use of financial intermediaries as a major component of their programs.

The Czech and Slovak Republics allowed investment funds to form spontaneously and provided little regulation or prudential supervision initially. Major domestic financial institutions such as banks and insurance companies formed the largest core of voucher investment funds. Despite the large number of funds formed (over 400), during the first wave of privatization in 1992 ten funds accumulated 40 percent of the vouchers in the Czech Republic. This concentration has transformed investment funds into dominant players in enterprise restructuring and corporate governance. There is also a considerable overlap of ownership between Czech banks and investment funds. Such entangled ownership raises important issues:

- *Do the investment funds have the managerial expertise to monitor the majority of privatized SOEs?*
- *Since a single fund is allowed by law to acquire only up to 20 percent shareholding in any enterprise, how effectively will the different institutional owners cooperate in undertaking enterprise restructuring?*
- *How would investment funds deal with the potential conflict of interest as they try to raise funds for restructuring from financial institutions which own those funds?*
- *How could the government prevent insider trading and self-dealing as investment funds of the same family act as both buyers and sellers of enterprises?*

...continued

The Czech government has just begun to deal with some of these issues which emerged with the evolution of the roles of investment funds. At a minimum, the Czech government needs to put into place a regulatory framework which protects the competitive and market-driven economic structures it has encouraged by its laissez faire approach to privatization.

In contrast to the Czech and Slovak models, the Polish approach to privatization is more top-down and cautious about the risks of a market-driven process. The Polish government encouraged the formation of 15 national investment funds, which would each take a lead shareholding of 33 percent in 30 state enterprises, as well as smaller, more diversified holdings. Management of the funds were contracted to "brand name" professional investment managers who would operate on the basis of financial incentives. After the first year of operation and an annual audit, Polish citizens were allocated shares in these funds through a conversion of their vouchers.

Realizing the pitfalls of the Czech model, the Polish program emphasized risk diversification for individuals, and the creation of financial intermediaries through state intervention. While the Polish model avoided some of the issues confronted by the Czech system (such as the interlocking interests of financial institutions and investment funds), some argued that it lacks the market qualities or dynamics of the Czech and Slovak approaches, and it has had some difficulties in attracting popular support among Polish citizens in its initial stages.

Source: Mass Privatization in Central and Eastern Europe and the Former Soviet Union, Lieberman, Ewing, Michal Mejstrik, Mukherjee, and Fidler, (ed.), 1995.

Institutional investors such as pension funds have also been utilized to finance privatization in countries where such savings vehicles exist. Very often, private institutional investors may emerge after financial sector privatization and reform in an economy. Private pension funds in Chile, for example, have played a significant role in the nation's privatization program since the mid-1980s.

While financial intermediaries would be a good source of liquidity to finance privatization, their participation in privatization should be encouraged and sought on a voluntary basis. In the case of Brazil, pension funds, insurance companies and other financial institutions were forced to provide equity to SOEs by converting a portion of their assets to "privatization certificates," which were used for purchase of SOE shares.

This raised objections in the financial sector, which argued that this obligation to invest in newly-privatized, high-risk ventures ran counter to their mandate of limiting the risk exposure of their investment. Forced acquisition schemes may also weaken the fiduciary obligations and sound business practices of these intermediaries. A better way to encourage participation of institutional investors in privatization is to offer tax and other financial incentives to make investment in privatized SOEs more attractive.

Using Pension Funds to Finance Privatization in Chile

Following the privatization of pension funds in the mid-1980s, the Chilean government has allowed private pension funds to participate in the privatization process. In order to reduce the risk exposure of individuals who participate in the pension funds, the Chilean Government created a special commission (Commission on Risk) to classify the risk of privatization investments and limited the amount of high-risk shares pension funds can hold. The new pension system eventually became a major vehicle for mobilizing financial resources for privatization in Chile.

To finance the privatization of the Chilean Telephone Company (CTC), the statutes of CTC were modified to permit access to the pension funds. CTC stocks were certified by the Commission on Risk and the Office of the Superintendent of AFPs (the private Pension Fund Administrators). In 1987, AFPs contributed US\$25 million to acquire 31 million shares of CTC to finance its privatization. The pension funds also participated in many major privatizations in Chile, including that of the Compañía de Acero del Pacífico (iron and steel company) and Empresa Nacional de Electricidad (ENDESA).

Through their participation in privatization and in the overall securities market, Chilean pension funds have accumulated holdings of over 50 percent of all corporate bonds and over 5 percent of all equities in the country as of 1990. The resources of the new, private pension system have been a major contributor to the rapid development of Chile's capital market over the past decade.

Source: "Five Cases of Privatization in Chile," by Hachette, Lüders, and Tagle in Privatization in Latin America, 1993.

What are the Linkages Between Capital Market Development and Privatization Using Financial Institutions?

One important issue which needs to be addressed in using pension funds for privatization concerns *the means by which liquidity is infused into the capital markets*. Mutual funds will eventually need capital to buy and sell shares with money rather than

with other shares. There are several potential sources of this capital. The state could provide funds with initial capital, as could institutional investors such as pension funds. Individuals could be allowed to invest in fund shares with money instead of just vouchers. Foreign portfolio investors, through venues such as emerging market funds, can also provide an additional source of liquidity.

However, such sources of liquidity may be difficult to come by in developing countries. Domestic private savings are often too small to provide any meaningful financial resources to support the privatization process. This is the reason why mass/voucher privatization has been adopted in NIS and Eastern Europe.

Overall, active participation by financial institutions in privatization is likely to enhance the development of the capital markets in developing countries. Professional management of the funds enables more active share ownership, thereby improving capital market efficiency. This is because small investors often do not have the financial clout to discipline bad managers by dumping unwanted shares on the market to lower share prices. In contrast, institutional investors often amass sufficient number of shares to affect market prices and exercise corporate governance on enterprises. Financial institutions also have the resources and expertise to conduct market research and monitor enterprise performance. In addition, private, professionally managed mutual funds or investment funds provide a vehicle by which foreign portfolio investment can be drawn to the newly emerging capital markets.

What are the Linkages Between Broadening Share Ownership and Privatization Using Financial Institutions?

Privatization using investment funds and pension funds helps to achieve broad-based share ownership in several important ways. First, privatization through investment funds and voucher distribution has instantaneously transformed the majority of the citizens in many Eastern European and NIS countries into stake holders in the new capital markets. The investment funds have acted as a principal medium of transferring state property to the broad public in an fair and equitable manner.

In addition, in countries where pension funds and insurance companies help finance privatization (e.g. Chile), individuals who are not actively involved in the capital market may benefit from privatization through their participation in such funds. Small investors are often risk-averse and may not be willing to bid for SOE shares as individuals due to transaction costs, risks and the lack of market knowledge. Investment funds may help

small investors reduce risk aversion by providing portfolio diversification as well as professional management.

Finally, participation of large financial institutions may help inspire confidence of small investors in the overall capital market. However, to ensure the continued participation of the broad public in investment funds and mutual funds, it is critical that investor rights are safeguarded by appropriate legislation and enforcement in licensing, prospectuses, financial disclosure and reporting, etc.

Privatization by Capitalization in Bolivia

Drawing on the popular appeal of voucher mass privatization and the strength of privatization through institutional investors, as well as responding to the need to capitalize ailing SOEs, the Government of Bolivia has designed a unique form of privatization which will incorporate all of the above features. Under the "Plan de Todos," six large state enterprises will be offered for sale by international tender. The sale proceeds will stay with the enterprise, essentially doubling their net worth and providing funds for future investments. Subsequent to the sale, the strategic investors and the state will each hold a 50 percent stake in those enterprises. The state will eventually transfer its share ownership to all Bolivian adult citizens (estimated at 3.2 million) via a newly created pension fund scheme. The pension accounts will be managed by a number of competing private pension funds.

While the infrastructure for share transfer and fund supervision is yet to be established, a capitalization law passed in 1994 specifically linked citizens' participation to a pension-based model. The government is currently establishing a citizen registration scheme for the pension accounts based on voter registration. The new pension law being drafted will closely control what pension funds can do with the resources entrusted to them. Shareholder interests will be represented by the pension funds on the boards of directors, who will be given a meaningful voice in important strategic decisions. It is envisioned that the pension funds will eventually be able to trade shares in capitalized companies in the domestic and international stock exchanges. If privatization through capitalization can be successfully implemented, the Bolivian model is likely to be emulated and adapted for use in other countries.

Source: "Privatization by Capitalization, The Case of Bolivia: A Popular Participation Recipe for Cash-Starved SOEs," Andrew Ewing and Susan Goldmark, Viewpoint, FPD Note No.31, World Bank, November 1994.

Broadening Share Ownership Using Privatization Investment Trusts in Zambia

The Government of Zambia is currently implementing an ambitious privatization program aimed at divesting some 150 SOEs over five years. The program is designed to encourage participation of a large segment of the public in the privatization process through direct or indirect ownership of shares in the SOEs which will be privatized. The GOZ is often placing majority stakes with strategic, private investors, while reserving a minority stake for some of the larger SOEs (up to a maximum of 30 percent) to be offered through IPOs on the Lusaka Stock Exchange. The Privatization Trust Fund has been set up for the purpose of warehousing shares reserved for Zambian shareholders in the transitional period. The PTF has been established by a trust deed which will last five years.

Priority in the sale of minority shares is being given to small Zambian investors through IPOs. To this end, share prices for the IPO are being deeply discounted and small investors are receiving bonus shares and other incentives designed to encourage them to retain their shares for a certain period of time. Small investors may utilize an installment plan to finance their share purchase. There are also ceilings on the number of shares an individual or an institution can purchase. If some shares remain unsold when the Fund expires, the remaining shares will either be sold or distributed to eligible citizens without charge.

Source: "Sharing the Wealth: Privatization through Broad-Based Ownership Strategies," Stuart W. Bell, the World Bank, April 1995; SRI International.

VII. UNCONVENTIONAL FORMS OF FINANCING PRIVATIZATION SALES

What Are Some of the "Unconventional Methods" of Financing Privatization Sales?

"Unconventional" financing methods are often utilized in countries where the existing financial markets are weak, investors have limited liquidity, and long-term financing is not widely available. In these situations, "unconventional financing" instruments are developed, because it is felt that in the absence of unconventional financing methods or techniques one or more of the following undesirable results would occur:

- the sale would not take place;
- the sale might take place, but at a lower selling price;
- the sale could take place, but local investors or some targeted group of local investors would not be able to participate.

There are several types of unconventional financing instruments that are utilized in developing countries. Although the burden of finding financing ultimately rests with the buyer, privatizing governments are often well aware that the availability of financing can be critical in determining whether the privatization transaction can proceed. The primary unconventional financing methods we will discuss in this chapter are the following:

- Venture Capital Funds
- Bond Financing
- Debt-Equity Swaps
- Informal Sector Credit Markets
- Government Financing

Venture Capital Funds

Traditional venture capital funds provide start-up or "seed capital" for new or existing high-risk businesses having high profit potential as emerging growth companies.

Returns to the venture capitalists are linked to company performance. Venture capitalists are able to exert some measures of financial control over the companies in which they are investing. A venture capital "fund" is simply a pool of investable resources, raised by a venture capital company or companies. Venture capital funds typically target risky ventures with high upside potential.

Bond Financing

Bonds are fixed income securities that promise the holder a specified set of payments over a period of time. Bonds can be issued by either national, state or municipal governments, or private corporations. For long-term financing of privatization transactions, investors in developing countries have mostly relied on loan capital from the banking sector, especially in cases where the bond markets are not very well developed. However, medium-to-long-term bond instruments have been successfully utilized, even in developing countries, to mobilize resources in the financial markets to finance the purchase and/or the additional investment necessary to carry out restructuring of newly privatized enterprises.

Although bond financing for privatization transactions usually entails higher transaction costs compared with direct borrowing from banks, this form of financing can allow the buyer to tap into the liquidity of a wider market which includes small individual investors and institutional investors. Due to the participation of most governments in the selling of treasury bills and bonds, bond markets in developing countries are usually deeper and more developed than the stock market. For example, in many countries where the stock market does not exist, there is still a market for trading domestic treasury bills and commercial and other debt papers. Bond financing also offers investors certain advantages over equities in the form of more stable returns and seniority in debt collection. Thus, it can be advantageous to tap into the financial resources available in the bond markets.

See the Boxes below for a successful leveraged buy-out of a tire company in Sri Lanka using bond financing.²²

²²

"Kelani Tyres: An Innovative Case of Privatization", SRI International, for AID/Bureau of Private Enterprise/Office of Investment, 1993.

The Privatization of Kelani Tyres in Sri Lanka

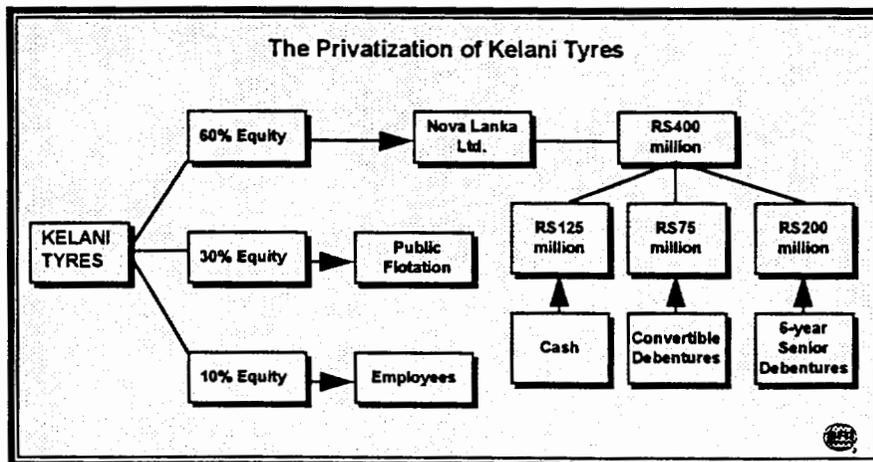
Kelani Tyres Limited was among the first batch of government companies selected to be privatized under Sri Lanka's current privatization program. The divestiture was carried out according to a "60-30-10" formula, whereby a majority shareholding of 60 percent is divested to corporate investors through competitive bidding, 30 percent is offered to the public, and 10 percent is distributed to the employees.

In March 1992, a local investor consortium named Nova Lanka purchased a 60 percent shareholding of Kelani Tyres, half of the costs of which was financed through the issuance of six-year debentures. While leveraged buyouts involving partial bond financing are common in countries with well-developed bond markets, the issuance of medium-term debentures to finance a privatization transaction is extremely uncommon in many developing countries, such as Sri Lanka. Local investors were not familiar with bonds with medium or long term maturities, since the longest Treasury Bill has a maturity of only one year.

To reassure skeptical investors of the viability of a new debt instrument, a consortium of several local banks provided a guarantee on the debentures, without which investors would have preferred to keep their funds in relatively risk-free Treasury Bills, despite their lower yield. In addition, USAID provided a partial guarantee to the debentures through its Privatization Guarantee Program, which was critical in helping the underwriters to reduce their risks.

The Kelani privatization is widely believed to have had a positive impact in the development of the financial market in Sri Lanka. The successful flotation of medium-term debentures has served to enhance the ability of financial institutions to raise domestic capital to finance upcoming privatizations in Sri Lanka. The transaction serves as a useful model by demonstrating that long-term private capital can be mobilized through the introduction of a new debt instrument, by means of innovative financing arrangements.

Source: "Kelani Tyres: An Innovative Case of Privatization", SRI International, for AID/Bureau of Private Enterprise/Office of Investment, 1993.



Debt-Equity Swaps

Debt-equity swaps are privatization financing mechanisms where the debt holder is interested in buying the enterprise. In a swap, the debt holder trades the debt worth a fraction of its face value, usually at a price somewhat above the usual secondary market price. Swaps can help to reduce financing constraints and improve a country's investment climate. Debt-equity swaps have proven to be useful in attracting additional investors, including foreign commercial banks, to privatization transactions that might have otherwise fallen through.²³

A substantial proportion of the swaps under privatization have involved the original commercial bank lenders. An example is the privatization of the state-owned telecommunications company in Argentina in November 1990, in which the SOE was sold for \$214 million in cash with a \$2 billion reduction in the face value of its debt. It was widely believed that the transaction, in particular the buyer's pledge of \$5 billion in capital improvements over ten years, would not have materialized without the swap, which induced the participation of commercial banks.

Some critics of debt-equity swaps argue that governments may receive more value for their SOEs by selling the enterprise and using the proceeds to repay or repurchase the debt at the prevailing secondary market prices. Critics also argue that the administrative costs of setting up a debt-equity swap are high compared to straight sales. However, many debtor countries face few alternative options, as a large debt overhang may deter investors from buying SOEs, especially when large amounts of new investments are required to restructure large companies. Under such circumstances, a debt-equity swap can be a useful tool to accomplish the dual objective of privatization and debt reduction (See Box below for a case study of debt-equity swaps in Chile).

²³

For a more detailed discussion, see Chapter 4 in Kikeri, Nellis and Shirley, *op. cit.*, p. 43.

Case Study: Debt-Equity Swaps in Chile

The Chilean debt-equity swap program from 1985 to present is one of the most successful in the world. The program's objectives are to reduce external debt, attract new foreign investment, and encourage the repatriation of Chilean capital held overseas. Several factors have contributed to its success:

- ➔ *Clear-cut swap rules were established in Chapters XVIII and XIX of Chile's Compendium of Rules on International Exchange, which respectively allow the conversion of foreign debt into a peso obligation, as well as equity investment by foreigners via debt cancellation. The consistent implementation of the established rules in Chile, compared to the occasional suspension or modification of conversion programs in other countries, was viewed as critical to Chile's success in inducing continued interest from potential investors in debt swaps.*
- ➔ *The debt conversion program in Chile has been carefully designed and implemented. A monthly quota for the use of Chapter XIX allows the Central Bank to ration approvals to control the exchange rates and inflationary effects of swaps. Stringent limits have been enforced on repatriation of profits and capital derived from the investment made. The program design has also reduced the opportunity for investors to take funds abroad and bring them back through swaps to maximize gains.*
- ➔ *Unlike the debt conversions in Argentina, Brazil, and Mexico, where the central banks would place the value on external debt conversions, it was the capital market in Chile that performed this task and created the possibility for intermarket arbitrage. Chile's stable and supportive macroeconomic policies since the mid-1980s, its well-developed, liquid capital market, and the free-market design of its swap program were critical in raising confidence and attracting long-term investment interest from both Chilean and foreign investors.*

Between 1985 and 1991, two swap schemes retired about \$7 billion in commercial bank debt, or 30 percent of the total commercial bank debt. The pace of conversion under Chapter XIX fell off sharply in 1991 as the secondary market price of eligible debt rose to 90 percent of the face value and the discounts on the declining debt stock became increasingly limited.

Source: Privatization and Development, Hanke (ed.), International Center for Economic Growth, 1987.

Informal Sector Credit Markets

Informal sector finance (ISF) refers to all unregulated and unrecorded financial activities including lending, borrowing, leasing, and remitting. In countries where the informal sector is active, many small and micro enterprises borrow funds in the informal sector or from unofficial sources of credit that operate outside of conventional financial institutions. Due in part to the lack of security and legal reinforcement, informal credit systems typically are considered to be risky ventures and consequently often charges high interest rates in real terms.

ISF markets are characterized by the following traits:

- Relative freedom from official regulation (except for licensing of professional lenders and pawn brokers in some countries).
- Small scale of operations with low overhead in most cases.
- Informality and secrecy of transactions.
- Minimal paperwork and short processing time.
- Short term repayment periods typically at high interest rates.

Government Financing

In countries where some of the SOEs are not attractive enough and equity markets are not deep enough to attract equity or bank financing, the governments have sometimes felt compelled to sell for debt rather than 100 percent cash payments.

Government financing can take different forms. One common form is to accept deferred payments. This essentially amounts to a loan because full cash payment is not required at the transaction's closing. Deferred payments can be made at commercial interest rates, at subsidized low interest rates, or can be interest free. Another form of government financing is to provide a cash disbursement loan at closing through a government owned commercial or development bank. Again the government can determine the terms and conditions of loan repayment under this type of scheme. A third type of government financing scheme is to offer the shares of the company through a public offering at a discount price to some class of buyers, usually small local investors. The box below provides a summary of some developing countries' experiences with government-financed privatization transactions.

Experience with Government - Financed Privatizations

Highly leveraged sales – regardless of whether the seller (the government) or commercial banks are the financing source -- can be risky. In Chile, the bankruptcy of privatized firms between 1974 and 1984 was partly due to the large debts to the government. The initial terms were attractive: buyers were to pay 10 to 20 percent down, with one year's grace period. Following the grace period, however, the companies faced five to seven year repayment periods at high real interest rates of 8 to 12 percent. The firms had a very thin equity position, and by 1986 seven of every ten firms privatized went into bankruptcy and reverted back to state hands when the banks were nationalized. In the second round of privatization which began in the late 1980s, the chastened government gave no credit to buyers (except through ESOPs), and buyers had to prove their financial solvency.

In Africa, there are cases of government financed privatization in countries such as Togo, Guinea, and Zambia. In Zambia, government financing has been reserved for small companies (selling price of less than \$1 million). Since most of the deferred payments in Zambia do not come due until 1996, it is too early to determine what the repayment rates will be. In Guinea, by the early 1990's total SOE assets sold amounted to 21 billion Guinean francs, of which only 2 billion were repaid to the government. This experience and numerous other country examples suggest that generally the government agencies responsible for privatization loan supervision are not effective in ensuring strict and prompt repayment.

Source: SRI International

Who is Involved in the Various Forms of Unconventional Financing?

Venture Capital Funds

The key players involved in venture capital include: investors who bring capital; entrepreneurs who bring business ideas, opportunities, and plans; and professional investment managers who bring management oversight, risk and opportunity assessment skills. Venture capital managers provide significantly more input to the venture capital companies they are investing in compared with conventional commercial lenders and institutional investors.

USAID has supported venture capital activities in African under the Africa Bureau's Africa Venture Capital Project. Two of the grants that have been awarded under

this project have been awarded to the Commonwealth Development Corporation (CDC) to start venture capital companies in Ghana and Tanzania.

Bond Financing

Bonds are issued by governments, companies, banks and other financial institutions. In the case of privatization, bonds are usually issued by the company buying the SOE, as part of a leveraged buy-out strategy. Banks are sometimes required to underwrite²⁴, distribute and guarantee the bonds in countries where the bond market is not very well developed. Buyers of the bonds include the general public and institutional investors, usually from the same country.

Debt-Equity Swaps

The key players in debt-equity swaps include the original lender of the debt (usually a commercial bank), the debtor (usually the country borrowing a commercial loan on behalf of an SOE), as represented by the Ministry of Finance and the Central Bank of the country), and sometimes a new equity partner who may buy the equity stake from the lender after the debt-equity swap has taken place. A substantial proportion of the swaps under privatization have involved the original commercial bank lenders.

Informal Sector Credit Markets

Informal sector finance comprises professional and non-professional money lenders, indigenous bankers, brokers, commission agents, private finance firms, pawnshops, savings and credit associations, merchant middlemen, and households.

Government Financing

In cases of government financing of privatization transactions, the key players typically include the privatization agency, the Ministry of Finance, and sometimes a government-owned development or commercial bank. Government-owned banks are involved in cases where the state actually makes a loan (cash outlay) to help finance the privatization transaction.

²⁴ The underwriting function for the issue of a bond typically includes a guarantee on the part of the underwriter to buy or find buyers for all or part of the bond issue.

Why Use Unconventional Financing Methods?

Unconventional financing methods are used by developing countries to mobilize additional financial resources to privatization transactions. Unconventional financing instruments help bring in buyers who otherwise might not be able to secure financing for privatization purchases. These techniques are important particularly in countries that have thin or underdeveloped capital markets. Unconventional financing techniques are used to encourage local ownership, direct ownership to certain ethnic groups, or to target some type of buyers such as foreign investors, who may be otherwise not interested in purchasing the company.

How Are Unconventional Methods of Financing Implemented?

Venture Capital Funds

The implementation of venture capital financing for privatization is similar to attracting other types of institutional investors. For venture capital fund financing, a pool of investable resources needs to be available, and the fund must be interested in investing in a privatized company. The venture capital fund can invest in a company through a number of privatization methods including private negotiated sale, private placements, public auction, or a public offering.

Bond Financing

In developing countries a merchant bank is often chosen to be the lead underwriter for the bonds issued to help finance the privatization transaction. If the size of the bond being issued is large, the lead underwriter often assembles a consortium of commercial and merchant banks to share the underwriting responsibility and spread the risk. Depending on the specific contractual arrangements, the underwriter's responsibilities may include: underwriting, distributing, and guaranteeing the bond being issued. The issue is marketed to potential investors large and small, similar to a public share offering.

Debt-Equity Swaps

In debt-equity swaps, if the debt holder for the SOE wants to buy the enterprise, it swaps debt worth a fraction of its face value, however usually at a rate that is higher than the secondary market price. A substantial number of swaps under privatization involve the original commercial bank lenders who become equity owners in the privatized enterprise. Before proceeding on a debt-equity swap, debt holders usually need to get approval from the government authorities such as the Ministry of Finance and the Central Bank. These authorities typically need to ensure that the debt is being traded at a higher (more favorable to the government) rate compared with the its secondary market value.

An alternative swap method is the creation of conversion funds that pool eligible debt paper from commercial banks, multinational investors, and individual investors. These funds have been successfully used in Argentina, Chile, and the Philippines.

Informal Sector Credit Markets

For privatization transactions that utilize finance from informal credit markets, government involvement is, by definition, minimal. Government officials, including privatization agencies, are uninformed about the terms and condition of informal finance transactions. If loans are obtained through these sources, government agencies may only become aware of the end result when the buyer has access to enough financing to purchase the company.

Informal sector credit decisions are usually made on the basis of firsthand knowledge of clients, usually in a secretive environment involving minimal paperwork and loan processing requirements.

Government Financing

Government financing is implemented in a variety of ways. Some countries organize formal financing incentive programs through special share discounts, ESOPS, special loan programs or purchase installment plans targeting small local investors. Other countries include financing as one of the items to be negotiated on a case-by-case basis in private negotiations with buyers.

More formal financing incentive programs -- where the terms and conditions are known in advance and are available to more than just a few random buyers -- are usually

preferable to *ad hoc* special "deals," because they help provide an atmosphere of fairness and transparency.

What Are the Linkages Between Unconventional Financing Methods and Capital Market Development?

The unconventional financing methods discussed in this chapter generally contribute to the development of capital markets by offering investors with additional short and long term instruments to help finance the privatization transaction, and at the same time providing the prospect of good financial returns to investors. The instruments discussed offer investors more choices than traditional treasury bills or savings accounts and certificates of deposit for investing surplus funds. They give individuals and institutions the opportunity to make reasonable judgements about the risks and rewards of investing their funds in specific companies through different instruments. Privatization transactions financed by these instruments can provide the opportunity for countries to begin to classify investment risks and opportunities more carefully and systematically than in the past.

Venture Capital Funds

Venture capital funds encourage the development of the higher risk/higher reward side of the equity market in developing countries. By bringing together promising entrepreneurs with experienced professional money managers with access to capital, these funds help create a more efficient capital market. With the availability of venture capital, the financial market is better able to assess and fund riskier proposals, some of which offer high returns to investment. Privatization may offer these venture capital funds with some of their first opportunities to invest their equity in new sectors formerly dominated by public enterprises.

Bond Financing

Bond financing brings additional depth to financial markets by offering lower risk and more stable returns than other alternatives such as equity shares. Successful bond financing can help enhance the ability of local financial institutions to raise capital to finance privatization or other transactions, at medium and long-term repayment periods. Bond issuers can gain new experience in financial intermediation. In the case of privatization, bond financing provides buyers of SOEs access to a wider pool of liquidity than through direct borrowing from banks.

Debt-Equity Swaps

Debt-equity swaps help develop capital markets by accomplishing the dual objectives of financing privatization transactions with little or no additional cash outlays, while simultaneously reducing a country's debt overhang. The debt reduction can significantly improve a country's credit rating, and thereby enhance its attractiveness as an investment site.

Informal Sector Credit Markets

The prevalence of informal sector financing (ISF) in African countries, even at high and variant interest rates, indicates that it is filling a market void that the formal market is not presently serving. In many African countries the variety of formal sector financial instruments and institutions is limited, both because of government regulation and because of lack of entrepreneurial experience in the sector. As a result, the formal African financial markets are not deep. Consequently a large number of potentially creditworthy borrowers are not served. In many African countries, this problem is compounded by the highly dispersed rural populations, which makes the costs of transactions higher to lenders and borrowers.

The principal linkage between informal sector credit markets and capital market development is that informal sector credit markets help to deepen financial markets and encourage greater savings and investment than would occur in their absence. Using ISF to help finance privatization transactions may also help to bring some of the financial resources in the informal credit markets into the formal financial system.

It is not known how many privatization transactions have been financed through informal sector finance sources in African countries. Anecdotal evidence in East Africa, however, suggests that informal sector finance particularly in the Asian communities has probably helped finance some of the privatization transactions in countries like Zambia, Kenya, and Tanzania.

Government Financing

Government financing schemes for privatization have a rather poor record on debt repayment performance. However these schemes may in some cases have a marginally beneficial impact on capital markets by providing loan finance or other access to capital to smaller local investors with otherwise limited access to loan and equity finance.

To What Extent Do Unconventional Methods Broaden Share Ownership?

Many governments have taken measures to broaden share ownership because they consider it to be unacceptable politically or uncompetitive in economic terms to have the ownership of companies concentrated in the hands of a few individuals or institutions. In many African countries, where governments are sensitive to ownership distribution among ethnic groups, a certain percentage of the shares are often reserved for specific ethnic groups or are pre-placed with specific institutional investors that are thought to represent a wide ethnic ownership composition.

All of the unconventional financing methods discussed in this chapter help to broaden share ownership to the extent that financing instruments help make the purchase feasible for buyers who otherwise were lacking in equity or loan capital access. Typically these buyers do not have well established credit histories or enough accumulated savings to purchase the companies without some unconventional or creative financing to encourage the transaction.

Each of the instruments discussed in this chapter is aimed at slightly different categories of investors, but all of the instruments help to broaden the ownership base, albeit in different ways. For example, venture capital funds help broaden share ownership, particularly when the venture funds are open to the wider public through such vehicles as mutual funds. Bond financing helps encourage widespread ownership since bond issues are open to the public including small individual investors and institutions. Debt-equity swaps are usually targeted at foreign debtors (usually banks) which otherwise might not be attracted to invest in the company or country.

Of all the instruments discussed in this chapter, the one the most targeted at small local owners is government financing schemes. Government financed schemes through installment payments, or low-interest loans, or pricing at a discount are used to target small local investors in a preferential way. Informal sector finance, while not targeted directly by government at small owners, does bring additional small investors into the market for SOEs by offering financing which is not usually available through the formal financial markets.

**VIII. CONCLUSIONS AND IMPLICATIONS FOR THE FINANCING OF
PRIVATIZATION IN AFRICA***Capital Constraints in African Countries*

Most successful privatization programs in Africa and elsewhere in the world use a variety of privatization methods and a range of financing instruments, thereby maintaining a diversified "privatization portfolio". The financing of privatization transactions is constrained in many African countries because capital markets are generally narrow and underdeveloped. Relatively few local companies and individuals have accumulated enough savings to finance their privatization bids. In addition, in many countries conventional long-term debt financing is not available from the commercial banks.

In many African countries, financing constraints stem from weak financial systems. For instance, in 1990-91, the five major commercial banks in Ghana, had a total of \$2.1 million for acquisition financing, while the estimated value of the SOEs for sale exceeded \$25 million-- more than the total net worth of the banking system. In other cases (Zambia, Nigeria) the governments put SOEs on the market through public offerings while simultaneously offering high-yield, low-risk government bonds. In these cases, the poor timing of the sales dampened the market for some of the SOE share sales.

Sensitivity about foreign ownership exists in all countries. Strong restrictions on foreign investment can narrow the range of financing options and can exclude countries from important sources of new capital, markets and technology. Political objections to foreign investment can be reduced in a manner consistent with social and political objectives by reserving a "golden share" or "warehousing" a certain percentage of shares until a subsequent time when the shares will be gradually floated to small local investors through the stock market.

If local investment is to be tapped, creative use of new financial instruments may be required. The shortage of capital and liquidity in many African countries will make the privatization process more difficult, but solutions can be found to facilitate buying. There is no one method of sale or financial instrument that is appropriate for all

situations. African privatization agencies should be creative in finding the most appropriate method of sale and financing instrument to fit the circumstances.

Financing Instruments That Can Be Used In African Countries

Public flotations are appropriate for larger, usually more profitable and well-managed companies that can attract large numbers of investors from the general population. Public flotations encourage broad shareholding, and facilitate distribution of wealth. They are generally characterized by openness and transparency and accessibility to small investors. Public share offerings have the disadvantage, however, of being technically complex, time-consuming, and requiring significant technical input from lawyers, investment banks, and accounting firms. In particular, the pricing of shares, preparation of the prospectus, information dissemination, and marketing the offering are all time-consuming tasks. In the African context, much of the expertise for these tasks tends to come from overseas.

When significant management or technical expertise is sought for a company, ***private share sales***, through competitive bidding or direct negotiations, might be the most appropriate privatization method. These types of sales are usually financed by the existing equity capital or access to debt finance by the purchaser. However in the case of a ***private placement***, specific investors (usually institutional investors) are offered shares in a company (often for a minority ownership position) usually after the strategic investor has already been identified.

Institutional investors such as ***pension funds*** and overseas ***mutual funds*** are an excellent source of portfolio capital that can be tapped for privatization investment. Most often these institutions are interested in investing in well-known "blue chip" type companies through public flotations or private placements. Overseas mutual funds are most interested in investing in a country that has several companies for sale with some depth to the market so that they are not constrained if they want to resell their shares.

Management/employee buyouts are a useful means of transferring ownership to SOE management and employees. MBOs and EBOs are often undertaken for small companies that would otherwise have trouble attracting buyers and financing. Many existing SOE managers lack the savings and capital necessary to raise sufficient capital for cash sales. Because of their low capitalization situation, many commercial banks, particular in Africa, are reluctant to finance these transactions. In many African countries (e.g., Ghana, Zambia, Tanzania, Kenya, etc.), M/EBOs often emerge as highly-leveraged

transactions that must be financed through some sort of government assistance, including concessional loans or deferred payment schemes.

M/EBOs are often politically popular especially in countries where labor has a strong influence in the political process. M/EBOs can help preserve jobs, and, if the new company remains in operation, avoid the substantial costs of closing down an enterprise.

Mass Privatization is common in Eastern Europe and the former Soviet Union, but has not been utilized to date on the African continent. The main appeal of mass privatization is the speed, widespread ownership, and volume of companies that can be transferred to the private sector under this "Big Bang" approach. The main drawbacks of this approach in the African context are the lack of revenue to the governments from the sale of companies, and the inability of the system to target strategic investors who may be best qualified technically and financially to run the company. These drawbacks notwithstanding, the speed and decisiveness of mass privatization are characteristics which are lacking in many African privatization programs. In the African context, mass privatization can also be combined with IPOs, strategic sales or other more conventional forms of privatization to raise revenue.

With the exception of *government financing*, most *unconventional financing techniques*, such as *debt-equity swaps*, *bond financing*, and *venture capital funds* have been rarely used to finance privatization transactions in Africa. However, unconventional financing methods can be utilized in countries where the existing financial markets are weak, investors have limited liquidity, and long-term financing is not widely available. In these situations, unconventional financing instruments are developed because it is felt that in the absence of these techniques, one or more of the following undesirable results would occur: the sale would not take place; the sale might take place, but at a lower selling price; or the sale could take place, but local investors or some targeted group of local investors would not be able to participate.

Medium-term *bond* instruments can serve to mobilize private domestic capital to finance privatization even in countries where the capital markets are rudimentary and underdeveloped. However, issuing bonds involves fairly high fixed transaction costs and is thus more appropriate in cases where large sums of money need to be raised. In countries where large debt overhang would significantly deter investors from buying privatized SOEs, *debt-equity swaps* can serve the dual objective of privatization and debt reduction, thereby enhancing a country's investment climate.

Although the burden of finding financing ultimately rests with the buyer, privatizing governments are often well aware that the availability of financing can be critical in determining whether the privatization transaction can proceed. Unconventional financing techniques are used to encourage local ownership, direct ownership to certain ethnic groups, or to target some type of buyers such as foreign investors, who otherwise may not be interested in purchasing the company.

Overcoming Capital Constraints

In many African countries, the shortage of capital and liquidity is making the privatization process more difficult, but solutions can be found to facilitate buying. The following strategy is recommended for African privatization programs as a means of overcoming the severe capital constraints and encouraging local ownership:

- ✓ Encourage buyers with limited capital to find financial partners, either national or foreign.
- ✓ Utilize public offerings to encourage broad shareholding, and facilitate distribution of wealth. IPOs are accessible to small investors and help tap wider capital resources than most other financing instruments.
- ✓ Pursue measures to widen share ownership (discounting and set asides on shares, establishment of mutual funds, ESOPs).
- ✓ Be cautious of deferred payment schemes and seriously consider action for payment arrears or default.
- ✓ If few qualified buyers emerge at the valuation price level, reduce price and/or clean up balance sheet to encourage buyers.
- ✓ Utilize unconventional financing techniques such as bond issues, debt-equity swaps, and venture capital funds, to fit the right circumstances and provide additional untapped capital to fund privatization transactions.
- ✓ Try to establish or tap venture capital funds through such sources as donors, private financial institutions, or from the proceeds of privatization sales.

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