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The case-by-case approach to privatization
Techniques and examples

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Contents

Case-by-case privatization is of interest to all privatization practitioners. As the technique best suited to privatizing medium-size and large enterprises, it forms the basis of privatization programs worldwide. It has been used extensively in industrial countries as well as in Latin America and, to a lesser extent, Africa and Asia. And transition economies, most of whom recently completed voucher (mass) privatization, are starting to privatize medium-size and large state enterprises using case-by-case privatization.

Case- by-case privatization involves selling government shares in state-owned firms through public share offerings, trade (third-party) sales, or mixed sales. In the process the ownership and management of state firms are shifted to the private sector. The case-by-case approach allows governments to resolve the policy issues (such as regulation and labor concerns) surrounding privatization, lets governments sell firms for their fair market value, provides a transparent sales process, can improve corporate governance and attenuate insider influence, and, where required, can bring foreign management, skills, capital, and marketing know-how to the privatized firm.

The World Bank maintains a strong interest in fostering privatization as a way to restructure transition and developing economies, promote free markets, and increase economic efficiency The Bank considers case-by-case privatization of large state enterprises essential to economic reform. Moreover, it recognizes that this approach can deliver significant financial resources to governments while reducing the economic and financial risks posed by these firms.

The authors of this paper have extensive experience with case-by-case privatization. Dick Welch worked for many years as a senior executive in Canada's successful privatization program and has undertaken and advised a large number and wide range of privatization transactions. Olivier Fremond has extensive experience in merchant banking, where he participated in the sale of a number of state enterprises. He also was senior adviser to Morocco's privatization program during 1993-96. This paper is a practical guide for privatization practicioners, based on the authors' hands-on experience.

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Case-by-case privatization is of great interest to all privatization practitioners. Because it is the technique best suited to privatizing medium-size and large enterprises, it forms the basis of privatization programs worldwide, and has been used extensively in industrial countries and Latin America and, to a lesser extent, Africa and Asia. And transition economies, having recently completed voucher (mass) privatization, are starting to privatize medium-size and large enterprises and need to understand, design, and launch case-by-case privatization programs.

Drawing on global experience, this paper provides practical guidance to government officials charged with managing case-by-case privatization programs. It identifies the five key steps in case-by-case privatization, describes sale options and the processes for carrying them out, and examines special conditions, such as golden shares. It then outlines how governments should undertake case-by-case privatization, identifying basic principles and common challenges, describing various methods for valuing state enterprises, and explaining the role of financial advisers and sales agents in valuing privatization candidates and developing options for sale.

1. Why Case-by-case?

Most privatization programs outside the transition economies take a case-by-case approach. Governments move control of state enterprises to the private sector, usually one at a time, using domestic and international public offerings, trade (third-party) sales, or a combination of the two (a mixed sale). The case-by-case approach offers several advantages, allowing government to pay close attention to the policy issues surrounding privatization; structure privatizations to bring in needed foreign capital, knowledge, and market connections; and maximize the financial returns from privatization.

Many countries adopt privatization programs as part of structural reforms and to alleviate budget problems. Selling state enterprises to the private sector can substantially reduce the flow of public funds to these firms. It also can generate significant revenue for government in the form of sales proceeds and future tax revenues from the newly privatized firms.

Global experience

The global wave of privatization started in the United Kingdom in 19 79. The U.K. program is still under way, and has generated almost $100 billion in revenue from the privatization of such major state enterprises as British Telecom (the first large British privatization), British Gas, British Airways, British Petroleum, the electricity system, the water companies, and, most recently, the railways. Even the recently elected Labor administration has embraced privatization. Other OECD and developing countries have emulated the British model of case-by-case privatization, including Argentina, Canada, Chile, France, Italy, Germany, New Zealand, and Spain.

Many Central and Eastern European countries are starting to move beyond their initial privatization programs, which focused on small-scale privatization and mass (voucher) privatization. Thus case-by-case privatization of major infrastructure and medium-size and large (strategic) enterprises is taking hold there as well. Most of the world's privatization programs have been implemented on a case-by-case basis. In general, these programs seek to increase efficiency, expose state enterprises to market discipline and best practices, promote wider share ownership and entrepreneurship, reduce government interference in the economy, strengthen competition and weaken monopolies, develop domestic capital markets, cut budget deficits, and reduce public and external debt.

Global lessons

Considerable experience has been gained with case-by-case privatization, and consensus is emerging about the main requirements for successful programs.

There is no "right" approach

Case-by-case privatization must be tailored to the circumstances of the country and the enterprise. Although there are a number of best practices and generally accepted privatization methods, only careful packaging, timing, and sequencing can guarantee success. The focus should be on pragmatism, flexibility, and willingness to try new solutions and methods.

Strong political support and leadership are vital

Privatization must receive support from the highest levels of government to overcome inertia and resistance from the bureaucracy and special interests. Implementation should be the responsibility of pragmatic individuals with political clout, no vested interest in the status quo, and access to world-class technical expertise. The privatization agency should report to a senior minister.

Investors will respond to a well-prepared transaction

Naysayers often claim that investors—both domestic and foreign—have little interest in privatization. Yet heavy oversubscription of share offerings in Britain, Latin America, and Africa (Nigeria, Senegal) have taken many by surprise. often underestimate the informal savings and flight capital in developing and transition economies. With the right incentives, domestic and international investors are eager to buy equities. To that end, governments must avoid setting unrealistic reserve prices. Instead, market-based valuations (rather than replacement or book values) should be used.

Transparency, fairness, and a level playing field are essential

Transparency is crucial to successful case-by-case privatization. Third-party financial advisers must carry out asset valuations to ensure that prices are realistic, fair, and consistent, as are procedures for calling for bids and evaluating offers. Moreover, governments must carefully plan and execute privatization. Publicity campaigns help make potential investors aware of investment opportunities. In trade sales the contract terms should be included in investment bidding documents to discourage undesirable changes during contract negotiations. Finally, the privatization award process must be transparent to avoid corruption and controversy.

Outside expertise should be sought

Specialist consultants—especially financial advisers—have a clear role to play in case-by-case privatization. Although local experts can be used, governments should not hesitate to call on the growing body of foreign privatization experts. Investment banks, consulting firms, environmental experts, accountants, and lawyers are essential players in case-by-case programs. Many privatization programs have suffered because governments, lacking qualified personnel, could not manage the process.

Related structural reforms should keep pace with privatization

Governments should implement privatization programs within a framework of mutually reinforcing economic reforms, including macroeconomic stabilization, trade liberalization, financial sector reform, public sector reform, and regulatory reform. If other reforms lag, privatization will be unsustainable and unable to restructure the economy.

Pre-privatization restructuring should be brief and defensive

Pre-privatization restructuring should be limited to balance sheet and organizational changes such as closures, workforce reductions, and transfers of social services. Technology changes, capital investment, and major purchases should be left to the new owners, not to government officials.

Privatization programs should attract foreign investment

Governments compete fiercely for foreign investment in privatized assets. To attract investment, foreign investors should be treated the same as domestic investors. Without a conscious, consistent, and aggressive policy to attract foreign investors, privatization programs may fail to generate sufficient revenue or could discourage investors who could provide market access, new technology, and management expertise. The state must assure investors that it will not use its political power, residual shares, or golden share in a way that jeopardizes the company's ability to maximize profits and efficiency.

Privatization in tranches or through a mixed sale can help maximize government receipts

Emerging markets may be unable to absorb large packages of shares all at once. In such cases share sales should be broken into tranches and sold over time following a pre-announced schedule. Mixed sales can boost domestic and foreign demand and improve corporate governance by introducing a strong, controlling shareholder.

Governments should minimize the conditions attached to privatization

Elaborate conditions for sale will detract from the value and attractiveness of an enterprise and may undermine the deal. Governments should fix regulations, price controls, subsidies, and other problem areas before the sale.

Governments should not adhere to an artificially fixed timetable

Although constant pressure is needed for case-by-case privatization to proceed, unrealistic time constraints serve little purpose. One useful approach is to sequence several sales according to market conditions. Moreover, governments should bear in mind that not all transactions will be successful, and that it might be necessary to reject all bids and start the bidding process anew or change the method of divestiture.

Public information campaigns are crucial

Most successful privatization programs have placed a heavy emphasis on educating the public and advertising expected sales. Special efforts to inform institutional investors have encouraged them to participate in many privatizations.

Private monopolies may be worse than public monopolies

Before privatizing natural monopolies, governments should restructure the industry to promote competition, accompanied by clear regulations and credible enforcement.

The desire to maximize sale proceeds should be balanced with other priorities

Although the privatization agency has a duty to sell state assets for their fair market value, it must balance its desire to maximize sale proceeds with other priorities, such as broadening share ownership, deepening domestic capital markets, and promoting competition.

Privatization laws can be helpful but are not always essential

Countries with a civil law tradition tend to approach privatization by preparing a general privatization law. Such laws define the rules of the privatization program and establish and empower the institutions charged with executing it. Canada and the United Kingdom—and countries with a common law tradition—privatize without a privatization law, using specific legislation only where required. Countries with weaker institutions and law enforcement, however, may not be able to ensure the transparency of privatization. Such countries should draft a privatization law that clearly defines privatization procedures.

Privatization laws offer both advantages and disadvantages. When carefully drafted, they strengthen the state's capacity to carry out structural reforms. They also help make more transparent the transfer of state property to the private sector. Once ratified, however, a law cannot easily be changed. If procedures need to be revised in response to market conditions, an amended law or new regulations may be required.

Care should be taken in crafting a list of strategic industries

In selecting companies for privatization, many countries have drafted a positive list (containing enterprises that can be privatized) or a negative list (containing enterprises that cannot be privatized, because they are deemed strategic). A positive list is useful because it has the full power of the law behind it. Companies are committed to privatization within the deadline for the program, and can be privatized at any time by the institution in charge of executing the transfers. Such arrangements make it harder—though not impossible—for enterprise managers to stall privatization.

Although a negative list may provide more options for privatization, care should be taken in preparing such a list. As many countries have learned, private ownership does not necessarily imply a loss of state control over enterprises. Thus many state enterprises that were once deemed strategic—oil and gas companies, telecommunications firms, other utilities—are being privatized. Many governments have chosen not to have a positive or a negative list, preferring to privatize state enterprises without restriction, as and when market conditions appear favorable.

2. First phase—getting ready

Case-by-case privatization is a five-step process. Many case-by-case practitioners separate these steps into two phases (box 1)—both for conceptual reasons and for ease of contracting when designing terms of reference and hiring financial advisers and sales agents (box 1)

This section deals with the first phase of case-by-case privatization—getting ready This phase begins with the government identifying potential privatization candidates. It ends with the completion of a feasibility study and the government's decision on the privatization option and sale. The second phase of the process—moving to sale—is examined in the next section.

Step one: Identifying privatization candidates

Identification and selection of privatization candidates is the first step in case-by-case privatization (figure 1). Selection criteria depend on a country's privatization objectives and legal framework. At a minimum, these criteria should include a policy test to establish what should be privatized and what should remain in government hands. For example, in Canada the policy test is whether a state enterprise's activities are core to government—that is, where there is a need for government ownership or delivery of the enterprise's services or products. If an enterprise does not pass this test, it becomes a candidate for privatization or shutdown. Worldwide, many governments are narrowing their definition of what is considered a core government service and broadening the types of enterprises and services eligible for privatization.

Box 1 The five steps in case-by-case privatization

First phase Getting ready-steps one and two

Step one: Identification and selection, where the government chooses its candidates for privatization.

Step two: The feasibility study, where the government identifies policy issues and develops options for resolving them and financial advisers value the enterprise and provide options on timing and method of sale.

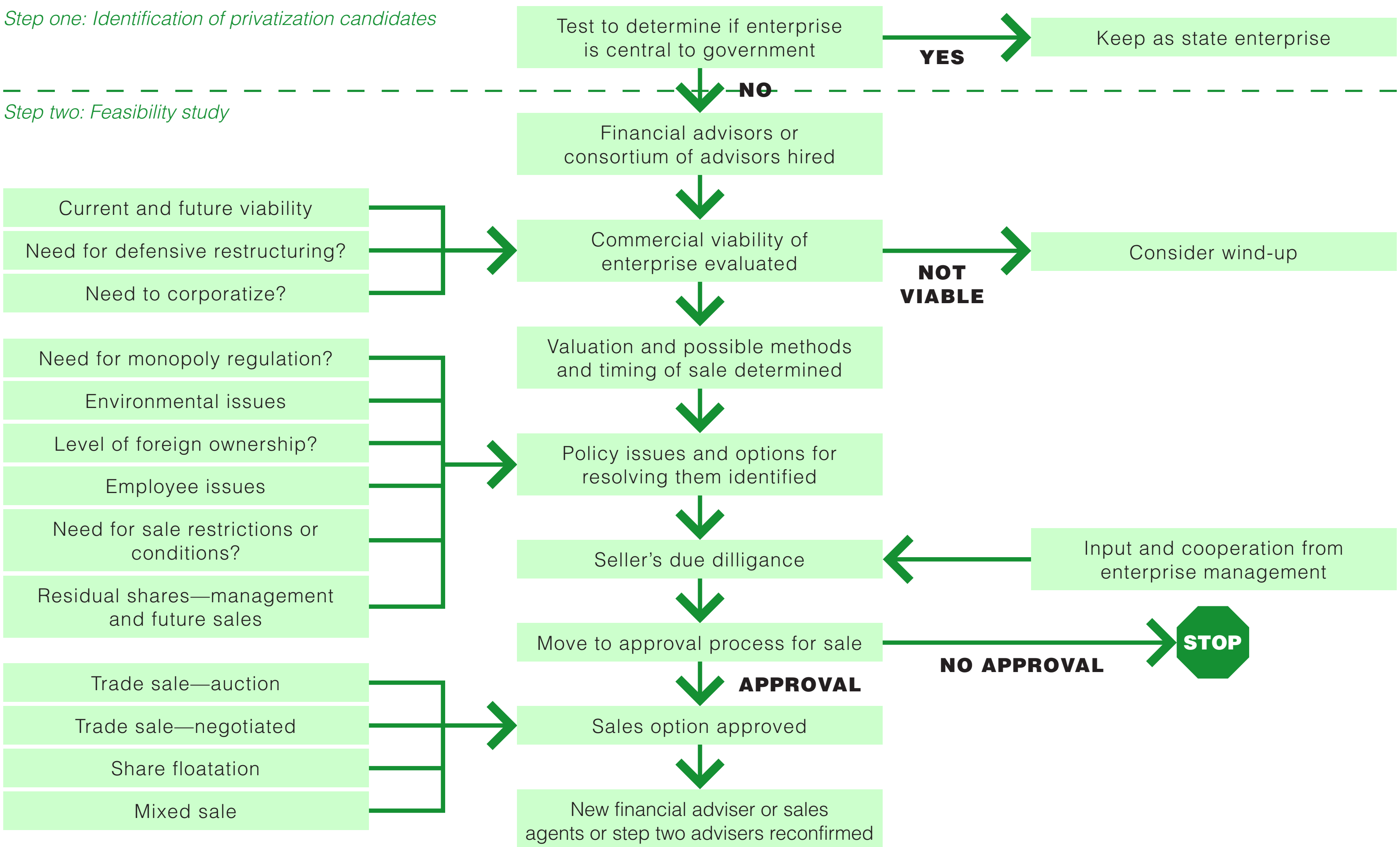
Second phase Moving to sale-steps three, four, and five

Step three: Privatization planning, where the government resolves policy issues and, with its financial advisers, plans the sale.

Stepfour: If required, the legislative or approval phase.

Step five: Implementation or transaction, where the government and its advisers make the sale through a bidding or public offering.

Figure 1 First phase—getting ready



Governments should consider all state enterprises in this initial analysis. Those that clearly perform core government functions will not be privatization candidates once the analysis is complete. Moreover, governments should avoid making a list of "strategic" industries that are exempted from privatization. Doing so only provides an opportunity for firms that are reluctant to privatize to lobby for inclusion on the list.

Once the government has compiled a list of candidates, it should decide, with ministers and senior officials, which enterprises will proceed to the second step of the process, the feasibility study As it identifies candidates, the government will find that some state enteprises have excellent commercial potential, a number are attractive, and some will be difficult to privatize. Governments should choose more candidates than are needed over the short term-all privatizations are difficult, and having a number of good candidates in the pipeline increases the likelihood of success. Moreover, the government should be trying to build an inventory of privatization candidates.

Step two: Feasibility study

During the second step the government and its financial advisers analyze the feasibility of and options for privatizing the enterprises identified in step one (see figure 1). This analysis should examine:

- The enterprise's economic performance, efficiency, profitability, and earning potential.
- The enterprise's internal structure and management.
- The need to corporatize the enterprise before privatization (box 2).
- The need for restructuring and rationalization. As noted, governments should limit privatization restructuring to legal, accounting (balance sheet), and organizational changes. Any workforce reductions should take place before an enterprise is sold. Technology changes, capital investments, and major purchases should be left to the new owners.
- The environmental aspects of the privatization, including past and future pollution and the need to establish environmental legislation or regulation (box 3).
- The market situation in which the enterprise should be working, including an evaluation of whether a monopoly should be broken up. If new regulations are required, the government and its advisers should identify them and set a timetable for implementing them. To avoid conflicts of interest, the advisers who do the regulatory review should not be the same ones selling the enterprise.
- The characteristics, concerns, and requirements of potential buyers and investors.
- The policy issues that need to be resolved before privatization —for example, what level of foreign participation is acceptable and what role employees will play in the privatization.
- Any restrictions on sale-for example, government shares, golden shares, or special terms and conditions. For marketable enterprises, the financial advisers will value the firm and report on privatization options. This report will help the government decide whether and how to proceed.

Box 2 Corporatization in New Zealand

Corporatization reduces government control over a state enterprise by giving it the organizational form and management structures characteristic of a commercial private business. New Zealand's experience shows that corporatization can be a prelude to privatization.

When a labor government was elected in mid-1984, New Zealand faced serious economic, financial, and structural problems. Extensive government regulations, intervention, and subsidies hobbled the economy. In response, the new government implemented economic and social reforms to move New Zealand toward a free market economy. Corporatization and privatization were part of these reforms. The State-Owned Enterprises Act, passed in 1986, established a framework for the operation of government-owned businesses and provided for their corporatization. Corporatization of state enterprises sought to:

- Separate commercial and noncommercial activities. State enterprises would continue to engage in commercial activities, while the government would fund noncommercial activities.
- Make state enterprises more market-oriented. Corporatized state enterprises are treated the same as private businesses. They pay taxes, receive no subsidies, and must operate at a profit. Moreover, the government will not guarantee their debt.
- Establish real balance sheets for state enterprises. (Most state enterprises receive their capital through direct government transfers, subsidies, or debt injection.) A debt-equity ratio was established for each balance sheet based on the experience of similar firms in the industry.
- Bring in executives from around the world to manage the newly corporatized firms, to boost their performance prior to privatization.

Corporatization was a successful tool in the financial and organizational restructuring of New Zealand's public sector. It also facilitated the later sale of assets to the private sector: about half of the entities privatized by December 1995 had first been corporatized.

Source: World Bank staff.

Box 3 Environmental aspects of privatization

Many transition economies have suffered significant environmental damage from industrial activities. Privatizing industries that cause damaging pollution will require addressing environmental issues in order to reduce uncertainty for investors and the state. Failure to do so has delayed and even derailed many privatization transactions.

The government should develop transparent and predictable regulations and incentives to reduce the risk and costs associated with environmental problems. In most cases this means the govemment will have to assume some known environmental risks and indemnify the buyer from unknown risks. Approaches that have been used include allowing private owners to set aside part of the purchase price for cleanup (the Czech Republic, Poland), indernnifying private owners for costs incurred during cleanup (Bulgaria, Germany), and lowering the purchase price but making the buyer responsible for cleanup (Argentina).

Investors in OECD countries and Central and Eastern Europe try to control their financial exposure when they acquire environmentally problematic enterprises. Measures include:

- Environmental audits, to help identify an enterprise's envirornnental liabilities and reduce the uncertainty of valuation.
- Environmental and risk assessments, to determine the environmental consequences of a proposed development.
- Remedial actions, depending on the health risks posed by environmental problems.
- Contractual arrangements.
- Pre-closing conditions (government can release a buyer from the purchase agreement if the environmental audit identifies serious problems).
- Indemnification (for costs incurred fixing specified problems).
- Warranties (a type of indemnification if defects are discovered only after ownership).
- Private insurance.

Source: World Bank staff.

Organization

Financial advisers may be useful during the identification stage, but they are essential for the feasibility study (See the section on hiring financial advisers, below.) At the same time, it is essential that the government appoint a competent official to manage these and future stages of privatization.

Identifying and resolving policy issues

The feasibility study should examine the policy issues surrounding the possible privatization and propose solutions that are compatible with the sale of the enterprise. It should, for example, address regulation and competition and, if necessary, employee issues—particularly downsizing and buyouts. It also should examine the need for restrictions on sale (golden share) and study the management of any residual shareholding.

Valuing the enterprise

Valuation is of paramount importance because it establishes a market price range for the enterprise. Valuations based on market principles are essential to stifle criticisms that the state is not receiving a fair price and to ensure that there is sufficient investor interest. In Western market economies valuation is based on discounted cash-flow projections of future earnings and comparisons of similar firms' market prices (when sold through trade or negotiated sales) or stock market offer-valuations (if publicly traded).

Replacement value and book value are not measures of market value. Book value may understate real value because it is based on historical costs, and replacement value may overstate value because firms are often sold below replacement cost. In addition to the valuation, financial advisers often prepare a sensitivity analysis that models the purchase price under changing conditions prior to the closure of the transaction.

Options for sale and timing

In most cases privatization officials submit a privatization proposal to the political authorities at the end of the feasibility study. In case-by-case privatizations such proposals contain the valuation (usually a price range) of the firm, the options for sale (trade sale, public offering of shares), and the timing options (immediate sale, sale after restructuring).

Minimizing the risk of choosing poor candidates for privatization

Governments are often concerned that the feasibility study will find that a state enterprise is not suited to privatization, and that significant costs will have been incurred without identifying a viable privatization candidate. This risk can be reduced by dividing into two phases the financial advisery for the feasibility study. In the first phase the financial adviser quickly evaluates a state enterprise's potential for privatization. If the potential is low, the adviser can be terminated before valuing the enterprise and developing options for privatization.

3. Second phase—moving to sale

As noted, the second phase of privatization involves three steps: preparing a privatization plan, obtaining legislative approval (if needed), and selling the enterprise (figure 2).

Step three: Privatization plan

Once a government decides to privatize a state enterprise, it should prepare a privatization plan with its advisers. This plan should include a communications plan (to build public support and attract investors); a plan to resolve the public policy issues surrounding the privatization; a plan outlining the method of sale, the steps required to reach sale, and a timeline; and draft legislation or executive orders. In addition, if the government is using different financial advisers for the sale than it used to prepare for privatization, those advisers (sales agents) should be hired at this point.

Communications plan

The government should develop a communications plan before it starts the sale process. This plan should be designed to build public support for the privatization and teach the public about features of the privatization that require public participation (for example, how to purchase shares). The plan also should provide ministers, public officials, and company executives with question and answer material so that the government can provide coherent, coordinated, and accurate information to the media and public on the aims, rationale, and progress of the privatization.

Public policy issues

Before the privatization can proceed to the sale phase, the government must resolve any public policy issues the privatization raises. These may be wide-ranging, but common ones include:

- The regulatory regime, if any, that the government needs to put in place.
- An environmental statement identifying who will bear environmental liabilities (if any).
- Restrictions or conditions on foreign participation in the sale.
- The role of employees in the privatization—for example, participation in an initial public offering, preferential subscription rights, discounts to sale price, and so on.
- Restrictions or conditions on the sale—for example, golden shares.
- The government's plan for managing residual share-holdings.

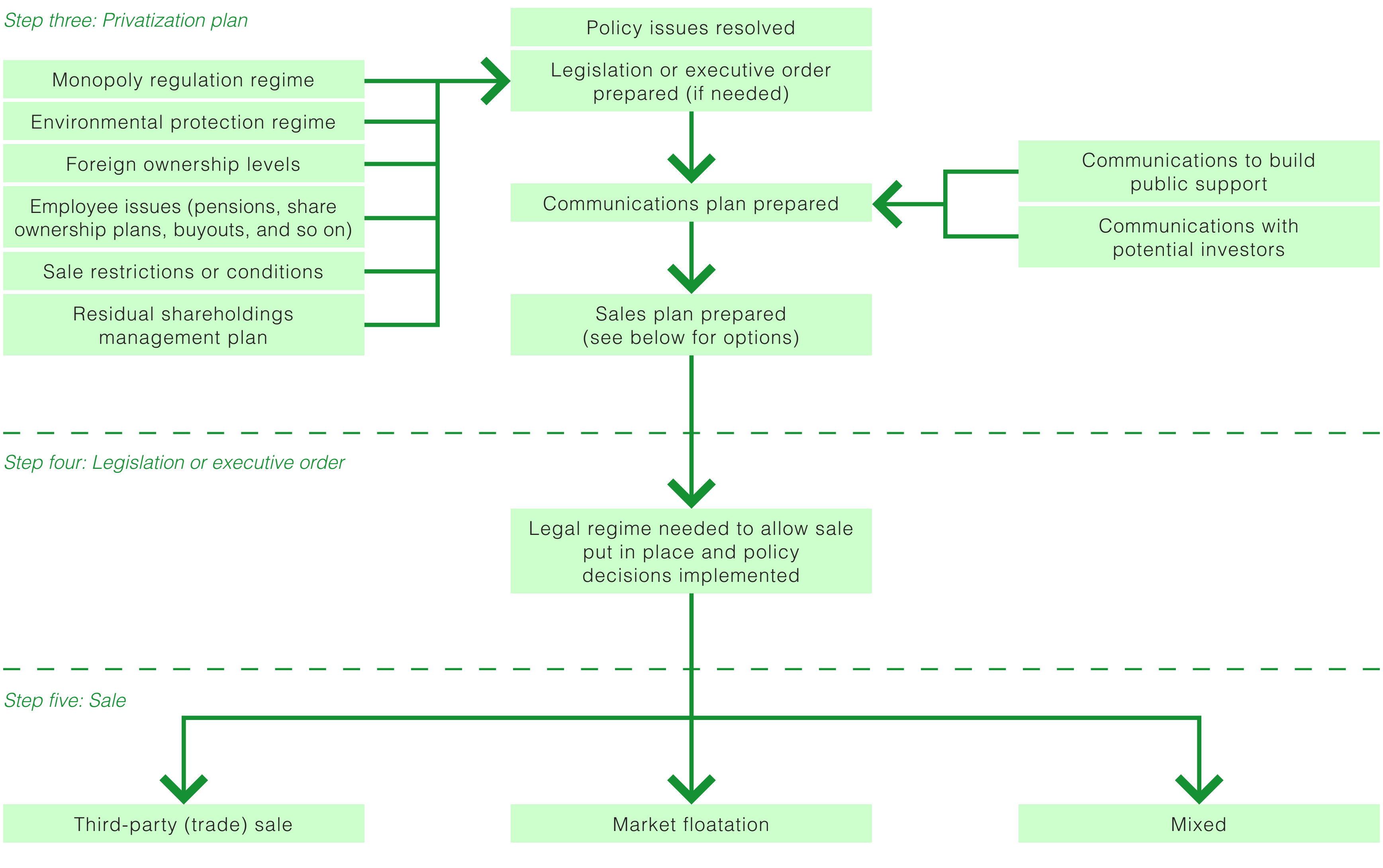
Sales plan

The sales plan should state how the government and its financial advisers or sales agents will carry out the sale. The plan should contain the steps and timeline for the sale, covering the timing and method of sale, responsibilities of government officials and advisers, production of sale documents (for example, information memorandums prospectuses), legal tasks and timeline, and the composition and hierarchy of the placement syndicate and underwriting syndicate (if an initial public offering is being used).

Draft legislation or executive orders

If legislation is required for the privatization, including for matters such as regulation, it should be drafted at this point. Any executive orders or decrees needed for the sale of the state enterprise should also be prepared.

Figure 2 Second phase—moving to sale



Step four: Obtaining approval

If legislative or government approval is required, the government should obtain it at this stage. Legislation should be passed before the sales transaction starts; the sales process becomes needlessly complex if legislation is pending when the company is brought to market. A communications exercise is needed to provide parliamentarians with objective information on the aims of the government and the reasons for privatization.

Step five: Sale

The issues that arise during the sales transaction will vary according to whether the privatization is a public offering, trade sale, negotiated sale, or mixed sale. An initial public offering requires the enterprise being privatized to be of sufficient size and quality to justify a public sale of shares. (In addition, the markets in which the shares are being sold must be mature enough to absorb them.) Enterprises that do not meet these requirements are sold through a trade sale (third-party sale) of assets or shares using an open bidding (auction) process. A negotiated sale to a strategic buyer is another alternative, though in most cases the government will receive less than it would through an active, open bidding process. Finally, governments can use a mixed sale, combining a trade sale with a public share offering, particularly if a strategic buyer is being sought for a significant block of shares.

4. Sales methods and special concerns

Case-by-case privatizations generally involve public offerings, secondary offerings, trade (third-party) sales, or mixed sales. In addition, attention must be paid to any conditions attached to privatizations, to the role of foreign investors, and to the steps involved in privatizing natural monopolies.

Public offerings

Public share offerings on stock markets can be used for large, profitable, relatively well-known state enterprises. In addition to transferring ownership, share offers often raise additional capital for an enterprise through the issue of new shares. Share offers can also meet a government's objective of broadening share ownership by allocating a portion of shares to small investors. Shares can be offered on the domestic market as well as in international markets using American depository receipts (ADRs) or global depository receipts (GDRs).

Shares are offered to retail and institutional investors, usually at a fixed price. In most cases shares are sold by stockbrokers overseen by government regulators. Public share offers are generally transparent because of advertising (if permitted) and disclosure requirements. This approach is especially suitable if the size of the sale justifies the costs involved.

Variations on this form of divestiture relate to the fixing of the offer price for the shares, which can be a fixed price offer, a tender offer, or both—as in the United Kingdom, which pioneered an international and domestic pricing arrangement when it sold shares of British Telecom (box 4). Shares were sold at a fixed price to domestic retail investors but were auctioned to foreign and domestic institutional investors.

Another variation, targeting small investors, is to offer incentive schemes. France and the United Kingdom, for example, have offered bonuses to encourage small investors to hold onto shares. Investors typically were given one free share for every ten shares bought and held for three years. Other schemes have allowed shares to be paid for in installments so that small investors can participate.

If domestic markets cannot absorb the entire share issue at once, governments should consider issuing shares in several tranches. In Canada, for example, the government let state enterprises go to market with new shares during the first tranche in order to establish a market for the shares. The government then offered some or all of its remaining shares at a later date.

There are also variations involving the treatment of small investors relative to institutional or "core" investors. In France and the United Kingdom, for example, some offerings use the "claw back" method, which allows the number of shares allocated to small investors to increase (at the expense of institutional investors) when there is high demand. In France the subscriptions of small investors often receive priority treatment and a 20 percent price discount for shares held more than four years. In other countries, like Sri Lanka, the allocation to small investors is a fixed percentage of the public offering.

The success of a share issue and the share prices obtained partly depend on the size of the share offer and on market capitalization in the countries where the issue is sold. Capital market imperfections, low market capitalization, and factors such as political risk can depress asset values below the level indicated by standard valuation techniques. Measures to broaden share ownership-including targeting groups of investors, selling in both domestic and foreign markets, and offering shares in small denominations (so that more people can afford them)—can increase market capitalization, and thus ensure adequate prices for share offers. Governments should also consider whether they want their public share flotations to be under-written-that is, whether to have the sales agents assume the risk of sale. Underwritten sales are more expensive but are less risky for government.

Financial advisers and sales agents

Governments must hire financial advisers or sales agents (brokers) to underwrite (if required) and sell shares. The lead broker will lead the syndicate of brokers involved in the offer. For issues with a significant foreign component, governments should hire foreign brokers to co-lead the issue (or at least the foreign component). Brokers should be selected through competitive tender so that the comparative strengths of competing firms can be evaluated.

Increase in capital

If there is an increase in capital, the state enterprise will want to manage the sale. In this case the government will need independent advisers—preferably some who are not involved in any aspect of the sale. A privatization may, however, consist of a sale of government shares and a company share issue. In such cases both the company and the government will need financial advisers. The sales agents will normally work for the government.

Steps in a public offering

Officials involved in privatizing an enterprise through an initial public offering must oversee a number of steps (figure 3):

- Choosing sales agents (brokers or underwriters), lead brokers, and placement syndicate members.
- Drafting of the prospectus, which is done by the financial advisers or sales agents in cooperation with state enterprise managers and government officials. The prospectus must address dividend policy, environmental issues, the regulatory regime, employee and management participation in the issue, management of government residual shareholdings (if any), and government intentions toward the firm and industry.
- Selecting shares and, the share instrument—for example, common or preference shares, installment receipts, convertible bonds, warrants, convertible preference shares, and so on.
- Resolving policy issues.
- Implementing the public sales campaign.
- Organizing "road shows" where company officials and sales agents travel to key securities markets (New York, London, Zurich, Tokyo) to showcase the company and share issue.
- Setting the subscription period (and book building, where appropriate).
- Determining pricing (retail and institutional) and distribution (domestic and foreign), with government approval.

Box 4 Privatizing British Telecom and British Gas

The United Kingdom kick-started the global wave of privatization in 1979. Since then it has privatized a vast number of state holdings worth more than $100 billion. Two of the most successful offerings have been for British Telecom and British Gas.

British Telecom

The privatization of British Telecom was the first large divestiture of a public utility in the United Kingdom and was among the most successful in the world, maximizing sales proceeds and achieving widespread share ownership. Employee participation was also substantial.

The British government announced plans to deregulate the telecommunications industry in 1979 and in 1981 passed an act creating British Telecom and separating it from the General Post Office. During 1981-84 British Telecom cut staff, improved it ratio of debt to equity, and improved service levels. In 1984 the government converted British Telecom into a public limited company and sold 51 percent of its shares in an initial public offering.

The $4.8 billion share flotation, offered domestically and abroad, was nearly nine times oversubscribed. Up to 10 percent of the offered shares (301 million) were reserved for British Telecom employees and pensioners. The government allowed 2,000 U.K. institutional investors to apply for 2.6 billion shares on a priority basis together with the general public. The remaining 415 million shares were allocated to buyers in Canada, Japan, and the United States. All told, 47 percent of the shares went to U.K. and Swiss institutional investors, 14 percent to Canadian, Japanese, and U.S. investors, 5 percent to British Telecom employees and pensioners, and the balance to just over 2 million U.K. investors. The issue created 2.2 million new shareholders in the United Kingdom. Before privatization, British Telecom had 250,000 customers waiting to have a telephone installed, Now it installs lines within two days. The government continues to regulate British Telecom and holds a special rights preference share (golden share) in the company

Brtish Gas

The privatization of British Gas was the second divestiture of a public utility in the United Kingdom. The govemment followed the same pattern of privatization as in the British Telecom privatization.

In 1985 the government announced its intention to privatize British Gas and in 1986 passed the necessary legislation. The Cabinet considered selling British Gas in tranches, starting with a 51 percent offer. Eventually, however, it decided to offer all shares at once. It gave first priority to U.K. individuals, second to U.K. institutions, and third to foreign investors.

In November 1986 the government offered 4 billion ordinary shares representing 97 percent of the ordinary capital stock. It retained 125 million shares to meet the requirements for bonus shares, employees, and pensioners. The offer allocated 1.6 billion shares to U.K. institutional investors, 1.6 billion shares to the British public (including British Gas customers, employees, and pensioners), and 800 million shares internationally.

Because the offer was four times oversubscribed, the government reduced allocations to foreign and domestic institutional investors in favor of individual investors. In the end 62 percent of shares went to the U.K. public,

continued…

Box 4 Privatizing British Telecom and British Gas (continued)

23 percent to U.K. institutional investors, and 11 percent to foreign investors. The government retained the remaining 4 percent. Total adjusted proceeds from the sale totaled $8.6 billion. In May 1997 shares of British Gas were trading at a premium of 138 percent over the initial offering price.

Although the government achieved its fiscal goals, increased short-term efficiency, and broadened share ownership, some critics argued that it sold British Gas to the private sector as a fully fledged monopoly and that the regulatory agency, Ofgas, had insufficient powers. Thus some believe that the efficiency of the British gas industry and the quality of service have been less than optimal. Given the uniqueness of the transaction, it is hardly surprising that increasing competition was not a high priority.

Source: Privatisation International, various issues; Euromoney, various issues.

- Closing, payment, and share delivery. Argentina's successful public offering of its state-owned oil company is described in box 5.

Prospectus, share instrument, and timing

The government should work closely with the lead broker on issues relating to the prospectus, its contents, and contributions from the enterprise being privatized. Of particular importance to the success of the issue will be the choice of share instrument (usually common shares) and the timing of sale and payment. Installment receipts, for example, can spread payment over time.

Management and employee participation

Public offerings offer an opportunity for managers and employees to buy stock in their enterprise. An employee share ownership plan can provide shares and often share financing for employees. A recent analysis of European flotations found that these plans account for 3-5 percent of the shares sold in initial public offerings.

Residual shareholdings

If a public offering leaves the government with a residual shareholding, the market will want to know how the government plans to manage its shares (actively or passively) and how and when the government plans to divest its remaining holdings. The government should address this concern in the prospectus for the share flotation. For example, the government may decide to hold onto its residual shares as an investment but not exercise its voting rights.

Pricing and distribution

Pricing and distribution are two of the hardest issues to manage in a share flotation. The government may want to maximize price; brokers may want a lower price to make the issue easier to sell. Moreover, the government may want a wide retail distribution of shares for policy and political reasons; brokers may find it more efficient to sell to institutional investors. The government and its brokers should agree early in the sales process on how pricing will be managed. Because pricing is usually set late in the sale—after book building or other sales processes have been completed and the sale of shares is about to begin—officials must be able to react quickly and obtain senior approval. Meanwhile, the financial advisers or sales agents must be able to provide the government with the trade-off costs of changes to the sales structure (for example, if the government wants to increase the share of retail shares or sell more shares domestically).

Secondary offerings

The sales process for a secondary offer—that is, a public offering of shares already traded on domestic or foreign markets—is less complex than, but shares a number of steps with, the process for an initial public offering. Setting a price for shares is less difficult because the shares are already trading and have a market price. Brokers sell a secondary issue to individuals and institutional investors in much the same way as an initial public offering.

Officials involved in a secondary share issue must oversee a number of steps (see figure 3):

- Preparing a prospectus, although it may be shorter and simpler than a prospectus for an initial offering. Working with their financial advisers or sales agents, the government and the former state enterprise should help draft the prospectus.
- Organizing road shows.
- Book building.
- Setting the share price. Price setting will usually revolve around the discount from the market price required to sell the shares.

Once the government approves the price, the brokers will sell the shares and the deal will close. In some jurisdictions it may be possible to sell shares directly into markets, releasing small lots over a period of time. The process, however, lacks transparency and may depress share prices.

Trade (third-party) sales

There are two types of trade sales for privatizations: auctions (open bidding) and negotiated sales (figure 4).

Auctions or open bidding

Auctions are more common and more transparent than negotiated sales. First, the financial advisers or sales agents, working with state enterprise managers and government officials, prepare an information memorandum containing general information for potential investors. The memorandum is sent to potentially interested parties. In most cases the financial advisers or sales agents will have compiled a list of potential investors and will discuss it with the government prior to use.

Figure 3 Case-by-case process—market flotations

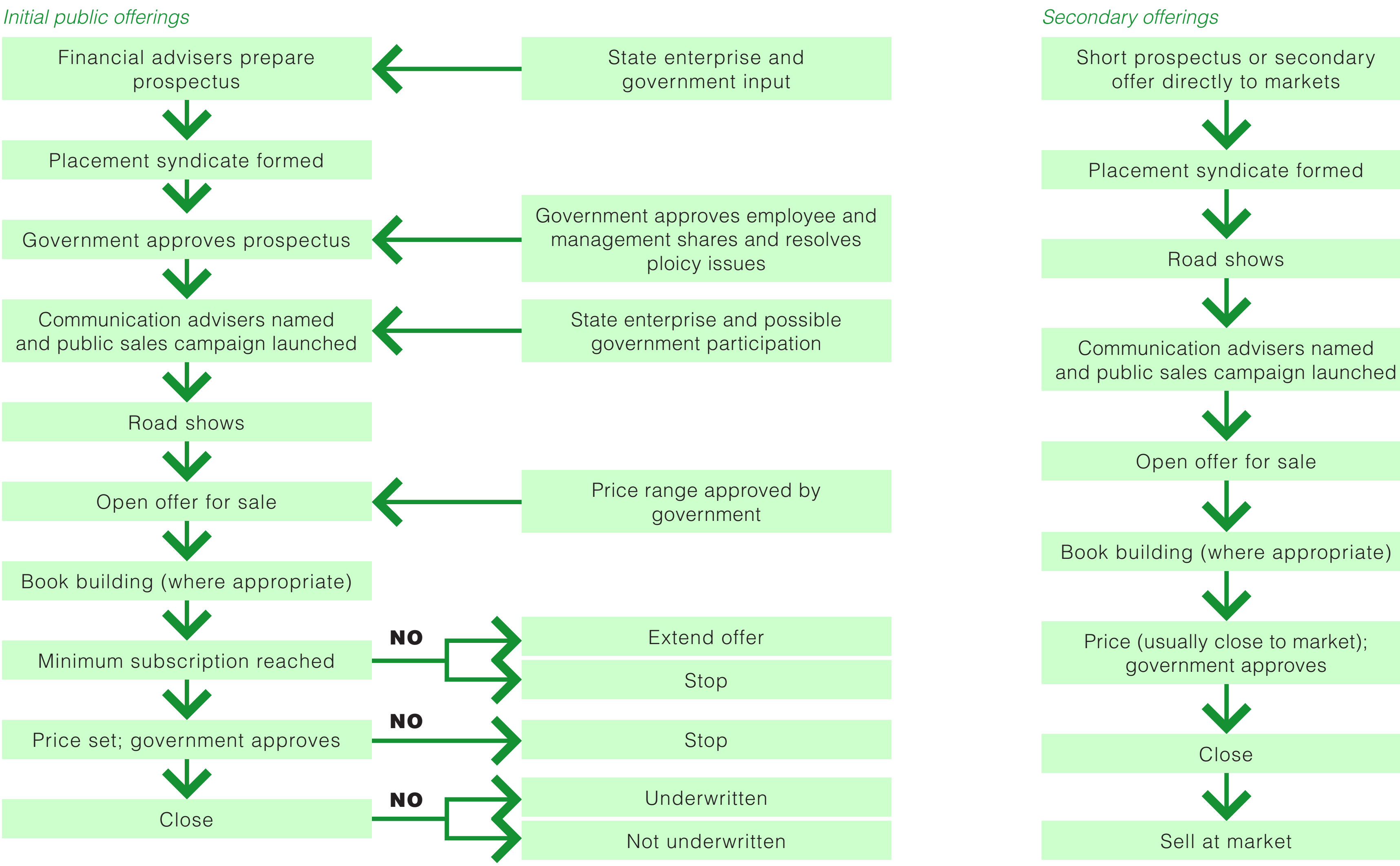


Figure 4 Case-by-case process—trade (third-party) sales

Auctions

1. Information memorandum sent to potential buyers
2. Expressions of interest recieved containing nonbinding price
3. Short list of bidders moves to next step
4. Confidentaility agreement signed with bidders
   Confidential information memorandum sent to bidders
   Bidders visit state enterprise and confidential data room
   Bidders recieve draft sales agreement
5. Bidders submit binding offers
6. Open bidding process (auction)
7. Buyer chosen
8. Buyer's due diligence
9. Payment and closing

Negotiated sales

1. Confidentiality agreement signed with buyer
2. Confidential information memorandum sent to buyer
3. Buyer's due diligence
4. Price and terms negotiated
5. Price and terms agreed and approved by government
6. Final buyer's due diligence
   Reps and any warranties
7. Payment and closing

Box 5 A public offering for Argentina's oil company

The Argentine government set up Yacimientos Petroliferos Fiscales (YPF) as an integrated oil producer in the early part of this century. By 1991 it was Argentina's largest company, generating sales of more than $4 billion a year and accounting for 13 percent of public employment. Until 1989 YPF had an almost absolute monopoly in the oil industry. The government decided to privatize YPF to make it an efficient, competitive, integrated oil and natural gas producer.

During 1989-91 the government deregulated and introduced competition into the hydrocarbons industry, lifting all restrictions on the exploration, development, and sale of crude oil, gas, and petroleum products. After the Privatization Law was passed in 1992, many of YPF's assets were sold or given (under concessions) to private companies, raising $1.4 billion by 1994. To compete in a deregulated environment and prepare for privatization, YPF's new management, appointed in 1990, initiated comprehensive organizational, workforce, and financial restructuring. This included significant additional sales of noncore assets, the creation of two strategic business units (one for upstream operations and one for downstream), and a cost reduction program that cut the number of employees from 51,000 in 1990 to 8,000 in 1993. Financial restructuring included clearing YPF's balance-sheet—writing off accumulated losses and having the government assume company liabilities. To make its shares more attractive, YPF paid special dividends.

The sale was preceded by a valuation and marketing of YPF's assets. Independent consultants, whose decisions were binding on the bidders, carried out the valuations. The initial $19 a share public offering price was set by the Ministry of Economy, YPF's managers, and the underwriters based on demand and supply conditions, financial and operating data, dividends, sales, earnings, operating information, price-earnings and price-cash flow ratios, and the market price of shares of foreign companies with similar activities and assets. The marketing of YPF's assets and activities included promotional events such as a series of targeted investor presentations and a four-week investor road show in twenty-nine of the world's financial centers. This campaign helped build confidence in Argentina's capital markets and persuaded international institutional investors to allocate funds to Argentina. Even skeptical Argentine retail investors were moved by a major advertising campaign, as well as by bonus shares for holding the original investment for two years.

When the multitranche global offering of YPF concluded. in July 1993, it represented the largest privatization to emerge from Latin America to that date. Cash proceeds exceeded $3 billion. Of 160 million shares sold, 40 million were in Argentina, 74 million were in the United States, and 46 million were in the rest of the world. The final two tranches were in the form of American depository receipts (ADRs) because international regulations did not permit a direct promotion of the initial public offering.

The structure of the initial public offering was extremely effective. Because all tranches were four to five times oversubscribed, the government had to increase the issue size to 160 million shares from the original 110 million. Within three months YPF shares traded at $27-50 percent more than the initial price-strengthening investor interest in Argentine privatization and stocks.

continued…

Box 5 A public offering for Argentina's oil company (continued)

YPF's privatization generated $5.1 billion in cash and incurred $13.5 million in costs. The upstream strategic business unit's joint ventures, concessions, and sales brought $1.8 billion, and the downstream strategic business unit's direct sale brought $272 million. In addition, the new YPF paid $109 million in taxes in 1993 and $99 million in 1994. Dividends rose from $239 million in 1992 to $587 million in 1994. Profitability more than doubled, and productivity improved.

Source: Privatisation International, various issues; World Bank staff.

Then, nonbinding expressions of interest are received from interested buyers. Based on these expressions of interest and a review of the financial capacity of potential bidders, a short list of potential buyers is selected. These bidders then move to the second stage of the process.

During the second stage the government signs confidentiality agreements with the short-listed bidders gives them much more detailed, commercially confidential information on the state enterprise, access to management, and a draft sales agreement. Bidders that wish to proceed then submit a binding offer (bid) and a deposit. Finally, the government and its advisers choose the best offer, and the sale closes with payment for the shares (or in special cases, assets) of the state enterprise.

Open bidding procedures have evolved in response to government concerns about the buyers of privatized assets. Governments often try to ensure that privatized enterprises will continue to be going concerns. They are wary of asset strippers, and concerned that new owners may lay off large numbers of employees. Thus governments seek buyers with sufficient resources to invest in the enterprise, transfer know-how, and increase employment.

To achieve these objectives, some governments have used two-part open bidding procedures: a technical bid and a financial bid. The financial bid cannot be evaluated unless the technical bid meets the requirements of the tender. The terms of reference for the technical bid often require bidders to commit to investing capital in the enterprise over five years, and to describe their plans for the workforce. If the technical bid is satisfactory, a weighted average of the technical and financial bids of all retained bidders is calculated to determine the winning bid.

Worldwide, many buyers of privatized enterprises have failed to fulfill their contractual commitments. When that happens, a government's options are limited and the risks of pursuing them are significant. It is better to carefully screen potential buyers-based on reputation, financial capacity, and technical competence-before starting final bidding. Once firms are prequalified, final bids can be judged based solely on price.

Negotiated sales

Negotiated sales are a variant of the open bidding process (see figure 4). Once the government has chosen a buyer, it negotiates an agreement that is attractive to the buyer and protects the government's interests. Negotiated sales are used when there is only one bidder or a bidder has a marked advantage over other bidders in the government's eyes. It is difficult to get the highest price in such sales, however, and they are less transparent than open bidding (box 6).

Mixed sales—trade sales combined with share offerings

Mixed sales combine two or three sale methods to transfer the state's shareholdings to the private sector. These sales allow several types of investors to participate in the privatization transaction.

Trade sales are usually used when an enterprise is sold to a strategic investor bringing capital, know-how, and market connections to the privatized firm. Depending on the objectives of the government and the requirements of potential investors, the level of control offered for sale may range from a supermajority (66 percent of voting rights), to an absolute majority (51 percent of voting rights), to a relative majority (the strategic investor becomes principal shareholder with, say, 35 percent of shares).

Initial public offerings are often used to allow the public, together with domestic and international institutional investors, to participate in privatization. The shares reserved for the stock market can be sold in several tranches, depending on the absorption capacity of domestic and international markets at the time of the offering. In addition, in developed markets the share price offered to retail investors is often slightly lower than the price offered to institutional investors, which is lower than the price paid by the strategic investor.

Finally, negotiated sales or private placements are used to transfer shares to the employees of the privatized entity, including retirees and former employees who worked for the company for a minimum cumulative period of, say, five years. The shares reserved for employees are generally sold at a discount to the offer price for retail investors at the time of the initial public offering-provided the shares are not sold in the secondary market for, say, 18 months to three years.

These three sales methods can be combined in several ways. However, experience from around the world suggests that the trade sale for the strategic investor should come first, followed by the initial public offering or the negotiated sale to employees. Indeed, if the initial offering comes first the market value of the shares in the secondary market may exceed the

Box 6 Selling the Skoda Automobile Company to a strategic buyer

Until 1990 Czechoslovakia's automobile industry was uncompetitive and failed to keep pace with technological developments in the global automobile industry. One state-owned company, Skoda, accounted for almost all production—about 200,000 cars a year. In 1990, however, Skoda reached an agreement with Volkswagen, the German automaker, under which Volkswagen gradually assumed ownership of Skoda. Volkswagen's bid price and ten-year investment plan for Skoda totaled $6.5 billion.

Volkswagen's initially offered DM 500 million ($340 per-million) for 31 percent of Skoda (later increased to 70 percent after two subsequent capital injections of DM 350 million apiece in 1993 and 1995). Volkswagen also agreed to pay DM 200 million to the Czech government for portions of its shares. Finally, Volkswagen committed to increasing Skoda's annual production capacity from 200,000 to 450,000 by 2000 and to managing Skoda separately as one of Volkswagen's family of automakers. The government, in turn, agreed to manage its shares as an investment and to refrain from interfering in the management of the company.

In 1993 Volkswagen scaled back its investment plans in Skoda as part of a general strategy to lower costs and investment in Germany and abroad. Planned investment in Skoda was cut by more than half, from DM 8.2 billion to DM 3.7 billion, through the end of the decade. The planned increase in production was also cut, from 450,000 to 300,000. After prolonged negotiations, the government agreed to these changes and allowed Volkswagen to increase its stake in Skoda to 60 percent in 1994. A year later, Volkswagen raised its stake to 70 percent. The government's 30 percent residual shareholding was eventually sold as shares without voting rights through a coupon scheme and initial public offering.

Skoda's experience offers a key lesson about selling state enterprises to strategic investors. Changing business conditions mean that it is unrealistic for governments to expect buyers, however reputable, to keep all their investment and restructuring promises—particularly if these are to be carried out over long periods. Thus governments should be prepared to renegotiate these commitments in a firm but realistic manner.

Source: Raj M. Desai, 'Organizing Markets,' Ph.D. dissertation, Harvard University, 1996.

price that strategic investors are willing to pay to take control of the enterprise. Even worse, the strategic investor may be unwilling to pay the price at which the shares were sold to retail investors at the time of the initial offering. It would be politically difficult for the government to sell a control stake for a lower unit price than the price offered to the public. Knowing this, the strategic investor might use the situation to obtain a series of concessions that the government otherwise might not have had to concede.

Mixed sales are particularly useful for developing countries with a nascent system of corporate governance (box 7). Indeed, trade sales to strategic investors safeguard the future of the privatized company by "'anchoring" its management with an international operator whose system of corporate governance can be transferred to the privatized entity. Where there is domestic sensitivity to foreign buyers, some governments have arranged consortiums of foreign and domestic buyers to bid (as in the privatizations of Argentina's and Mexico's national telecommunications companies). If the foreign operator acquires only relative control of the company, the core shareholding can be syndicated with domestic institutional investors, further improving the corporate governance of the privatized entity. In addition, if the shareholdings sold in this manner exceed 51 percent of voting rights, the government can expect to maximize proceeds because the bidders will likely offer to pay a control premium for the block of shares. Mixed sales also allow governments to broaden share ownership while ensuring that foreign investors do not take control of privatization.

Conditions attached to privatizations

Governments often attach special conditions to privatization sales, demanding a special or golden share to protect the enterprise from an unwelcome takeover (usually aimed at preventing a foreign takeover) or to give the government influence on company matters it considers of national importance. Golden shares normally involve the government's right to approve major corporate actions such as the sale of the majority of shares to a third party, sale of major assets, and liquidation or reorganization.

Governments also have used golden shares to privatize strategic enterprises that provide essential services to the public—for example, telecommunications companies—in a number of countries, including New Zealand and the United Kingdom. In France the government can hold a golden share giving it the right to approve any participation exceeding 10 percent of a privatized company's shares. As a rule, conditions attached to privatizations by government detract from an enterprise's value because they increase uncertainty or restrain privatized firms' commercial freedom of action (box 8).

Role of foreign investors

Governments in many transition economies encourage foreign participation in privatization, relying on foreign investors to bring capital, management skills, new technology, international links, and access to foreign markets. Foreign participation in trade sales, mixed sales, or public offerings ensures that government will receive a better price because of the increased competition for assets or shares. It also means that

Box 7 Privatizing Banque Marocaine du Commerce Exterieur through a mixed sale

At the time of its privatization Banque Marocaine du Commerce Exterieur (BMCE) was Morocco's second largest bank, with a balance sheet representing 19 percent of the country's banking credit and 17 percent of deposits. The bank's 176 branches and 2,778 employees were spread around the country. A minority interest was quoted on the Casablanca stock exchange. The government owned 50.01 percent of the bank, and its chairman and chief executive officer was a civil servant. Foreign commercial banks owned 12.55 percent of the BMCE; the rest (37.44 percent) was owned by private Moroccan investors. Net profits for 1994 totaled $29.5 million.

The privatization took the form of a mixed sale, combining an open tender for 26 percent of the bank's share capital and management control, a secondary offering on the stock market (targeted at small investors and mutual funds) for 14 percent, and a private placement with the bank's employees for 3 percent. The government retained 7 percent through the Caisse de Depot et de Gestion, a public agency overseeing Morocco's social security system. The tender started in December 1994 and was due to close at the end of February 1995.

Domestic institutional investors had showed strong interest in participating in the open tender. On the strength of this, the Ministry of Privatization launched and closed the secondary share offering before closing the open tender. Between 16 January and 20 January 1995 the shares were offered to the public at $38.35 per share. The offering was more than 6.1 times oversubscribed and attracted more than 51,000 subscribers.

The closed private placement to the bank's employees offered shares at a 15 percent discount. The BMCE also provided loans to help its employees buy these shares. The minimum price for the 26 percent of shares offered at open tender was the issue price of the public offer. The terms of reference for the open tender stipulated that the stake was reserved for bidders organized in consortiums of at least four parties. The shares offered for sale were structured in two tranches. Half of the 26 percent stake, or 13 percent of the banks share capital, was reserved for Moroccan investors—with two caveats. Banks and investors that owned 20 percent or more of the capital of a Moroccan bank or that were owned 20 percent or more by a similar institution were excluded from the tender. In addition, no more than one Moroccan insurance company was allowed in each consortium—and even then only insurance companies that did not own shares in the BMCE prior to the tender were allowed.

The remaining 13 percent of shares were open to domestic and foreign investors. Article 4 of the terms of reference stipulated that consortiums should include at least one foreign bank committed to buying at least 5 percent of the BMCE's share capital, and that the nationality of at least one such bank should not already be represented in the BMCE's share capital.

By the end of February 1995 two main consortiums were in competition. Both were having trouble finding a foreign commercial bank not already represented in the BMCE's share capital and willing to buy a 5 percent stake. As a result the tender period was extended until the end of March 1995, and various alternatives were considered to allow the transaction to close. Finally, instead of trying to motivate foreign commercial banks to buy

continued…

Box 7 Privatizing Banque Marocaine du Commerce Exterieur through a mixed sale (continued)

the 5 percent stake, either for themselves or on behalf of nominee accounts. Morgan Grenfell forged an alliance with one consortium and Citibank with the other, and the tender was successfully closed at the end of March 1995. The winning consortium was led by a Moroccan industrialist allied with Morgan Grenfell. The price paid for the 26 percent stake was at a 47 percent premium to the price of the secondary offering-or 19 times anticipated earnings for 1994.

The BMCE's experience offers an important lesson for countries contemplating mixed sales. Privatization officials should be wary of overengineering the terms of reference of their tenders. Simplicity is always preferable it allows the market to speak for itself, and it gives privatization officials some discretion in responding to market signals. It is misguided to assume that transparency will be compromised if privatization officials have some discretion in finalizing privatization transactions. Transparency is safe as long as the rules regarding the selection of the winning bidder are publicly disclosed from the outset and scrupulously observed by government officials. Imposing restrictions on the identity of potential bidders or on the use that they can make of their investment does not enhance the transparency of the selection process. In fact, it may hinder it.

Source: World Bank Staff.

Box 8 Golden share in action: The planned merger of Renault and Volvo

After three years during which they shared components, France's state-owned automaker, Renault, announced in September 1993 that it planned to merge with Sweden's Volvo. The merger was set for 1 January 1994. By November 1993, however, enough Swedish institutional shareholders had declared their intention to vote against the deal to postpone a general shareholders meeting.

The Swedish rebels had two main complaints. One was France's failure to set a date for the privatization of Renault. The other was the golden share that the French government planned to retain in the merged group even after privatization. Under the merger plan the French govemnment would directly hold 47 percent and Volvo 18 per- cent of the Renault-Volvo group. A holding company, RVC, 51 percent owned by the French government, would control the remaining 35 percent.

What this meant was that, directly and indirectly, Volvo would own 35 percent of the new automaker. The French state would hold the rest. But the golden share would give the French govemment the power to limit any shareholder—including Volvo—to just one-fifth of the voting rights in the company if Renault chose to dissolve the shareholder pact. There were fears in Sweden that, under such an arrangement, the French government would always put French interests first. The French govemnment's reversal on workforce reductions at state-owned Air France hardly helped. Some Swedes worried that if Renault-Volvo ever had to cut costs—as Air France's boss had tried to—it would be Swedish rather than French jobs that would go. But the French insisted that the golden share was a defensive weapon that would only be used if one of the big U.S. orJapanese automakers tried to take over the group. After protracted negotiations and with France's refusal to relinquish the golden share, the merger fell through.

Source: Privatisation International, various issues.

the company will move into the hands of a strong owner that can restructure the company.

The role of foreign investors in restructuring former state enterprises should not be underestimated. The world-class products and marketing that foreign investors bring are particularly valuable to former state firms in transition economies that are manufacturing products that do not meet international standards, are outdated or technically obsolescent, and have no international brand awareness. Strategic alliances are also important in high-technology industries (such as telecommunications) where global competition is strong and the costs of product development and research and development are too high for a single national carrier.

Privatization projects can be attractive to foreign investors who prefer buying an existing business with an established market share to setting up a new business or new manufacturing capacity in order to acquire market share. In some cases foreign investors have participated in a large portion of state enterprise sales. In Argentina, for example, foreign investors bought 60 percent of the assets sold through 1994.

Other countries have limited foreign equity participation in privatized enterprises. Russia, despite declared intentions to the contrary, has not allowed foreign strategic investors to participate in sales of strategic holdings in the state's major oil companies. The sale of Svyazinvest, the state telecommunications company, was a breakthrough in that foreign investors bid with large Russian banks to acquire a 25 percent stake in the company The Russian banks were unable to meet the minimum bid price without these investors.

Macroeconomic stability and a favorable business environment are required to attract foreign investment. Moreover, unnecessary restrictions on foreign investment should be lifted and discrimination between foreign and domestic investors eliminated.

Privatizing natural monopolies

Economists generally consider economic functions or services to be natural monopolies if the economies of scale are such that a single firm is the most efficient provider. Examples include telephone companies, electric power systems, municipal water systems, and municipal public transport. The opening of many countries to competition from abroad and changes in technology, however—for example, in telecommunications—have narrowed the definition of what is considered a monopoly.

Governments often own or regulate natural monopolies. In the past most such regulation guaranteed a rate of return on capital employed—providing few incentives for efficient performance. Modern regulation is moving toward a price cap-based system that ties changes in rates to a predetermined percentage of basic rates or to a price index. In economies where natural monopolies have been government owned and unregulated, regulations must be put in place before privatization. These regulations should encourage efficiency and give investors a chance to earn a reasonable rate of return. Regulators should be as independent as possible from political interference. Capricious or politically driven regulations detract from the value of an enterprise being privatized and, in extreme cases, can make privatization impossible.

5. Organizing government for privatization

A successful privatization program must be located at the center of government, receive support from the highest levels of government, clearly define its objectives, develop institutional competence and experience, and overcome the commitment problem.

Securing a central location and high-level support

Most privatization programs are at the center of government, attached to the president's or prime minister's office, the ministry of finance or treasury, or some other powerful central ministry or department. There are a number of reasons for this:

- Privatization inevitably encounters bureaucratic opposition and political resistance—because privatization changes the status quo. By locating the group responsible for privatization near the center of government power, bureaucratic opposition can be overcome and political issues effectively managed.
- Privatization programs are usually part of a structural adjustment program or result from the government's need to raise revenue. Central ministries are responsible for such initiatives and so have the strongest incentive to make privatization succeed.
- Because privatizations affect so many parties inside and outside government—including line ministries, the enterprise being privatized, labor unions, national and local politicians, and the employees, customers, and suppliers of the enterprise being privatized—they can be extremely contentious. Thus senior officials often must intervene to resolve issues and move the process forward.

Setting clear objectives

Privatization programs should have clearly defined objectives. The government can set these out in policy statements, laws, or decrees or in instructions to the officials administering the privatization program. If these objectives are missing, confusion will develop about why privatization is being pursued.

Given the wide range of interests affected by any significant privatization, trade-offs will need to be made between stakeholder and government wins and losses. Clearly defined objectives are required to make these trade-offs and to prevent privatization from being bogged down in a welter of unresolved issues. For example, governments must make tradeoffs between the interests of line ministries, which may be more concerned about how privatization will affect their policies and authority than about the government's need to restructure the economy or raise revenue.

Developing institutional competence and experience

Government institutions responsible for privatization must gain experience and develop competence with the process. Privatizing state enterprises is difficult, and often requires commercial skills that officials in developing and transition economies do not have. To develop this expertise, a single privatization body should be established to gain experience over time. Spreading the privatization effort over a number of institutions or ministries is a mistake, and will lead to conflicts and undermine the institutional capacity needed in privatization. Moreover, the privatization agency should be adequately funded so that it can hire financial, legal, and other advisers, as required.

In many countries efforts to centralize power, secure high-level support, and focus institutional capacity have been mutually reinforcing. For example, Canada's most successful privatization program was associated with the Department of Finance. Argentina and Mexico also relied on their ministries of finance. New Zealand and the United Kingdom centered their programs in the treasury.

Overcoming the commitment problem

The commitment problem arises because governments may be tempted to deviate from or reverse economic policies over time, and because institutions are not strong enough to prevent such reversals. Commitment problems increase the perceived risk of expropriation and drive out investment. In postcommunist economies, for example, governments face a particularly severe commitment problem because of the vast influence of state enterprises—the linchpin of a powerful coalition of beneficiaries with privileged access to public resources. In addition, governments in transition economies—as elsewhere—have encountered public hostility toward the sale of a country's "crown jewels" to foreign investors.

In some countries the commitment problem is exacerbated by two features of the institutional and legal framework: overlapping jurisdictions and excessive discretionary authority. Many countries have a proliferation of veto-holding agencies, each with the power to obstruct cash sales of state enterprises. For example, privatization powers are often divided between the line ministries responsible for an enterprise and the agencies responsible for the mechanics of the sale and (possibly in another body) the oversight of privatization programs and sales.

There are good reasons for policymakers to prefer discretion to rules if governments are fragmented. Discretion is flexible; rules are not. With discretionary powers, enterprises can be sheltered in friendly ministries or municipalities, offering useful leverage for parties or factions with uncertain political futures. Moreover, discretion is opaque, not subject to the oversight of regulators, courts, and the like.

Although good institutions cannot eliminate a large number of veto holders and an inclination toward discretionary policymaking, they can ameliorate them. Autonomy and rationality in institutional design are of particular importance. Autonomy is the extent to which an institution is insulated from outside interference, and thus from the veto power held by politicians or social groups. Rationality is the degree to which institutional procedures are based on uniform rules that must be followed.

6. Valuation methodology

A company ultimately is worth what people are willing to pay for it. Valuation is the process of estimating this value. Unlike in mass privatization, where the precise value of assets is not known and is not a crucial factor, in case-by-case privatization value is of fundamental importance to both buyer and seller (in this case, the government).

Buyers that overpay for an asset cannot meet their target rate of return from the acquisition, and share--holder value will decrease. The government, on the other hand, has a fiduciary responsibility to its citizens when it privatizes an asset. It is entrusted to sell privatizable assets at or above their fair market value, and must take every precaution to ensure that this happens. Agreeing to sell state assets below their market value is tantamount to favoring a buyer, and it deprives the state of needed financial resources. While this may sometimes be politically desirable—for example, in the case of employees of privatized companies—transparency is crucial. Thus the size of the discount offered should be determined and publicly disclosed.

Value is in the eyes of the beholder

Value may be a paramount concern, but it is also a relative concept. Valuation is more art than science. Buyers will value a company or set of assets differently, depending on the synergies they perceive between their own company and a potential acquisition. The greater are the synergies, the more they will be willing to pay.

Similarly, depending on the divestiture method selected by the government, the value of privatizable assets may differ significantly For example, all other things being equal, sale proceeds will likely be higher if the government chooses to sell an enterprise by open tender than if it chooses an initial public offering. The political benefits of popular capitalism have financial costs.

Stages

A valuation starts with a financial audit and a method of sale. The audit is important because certain valuation calculations cannot be completed without it. The method of sale determines the weight and level of detail that should be applied to the valuation methods used to estimate the assets' fair market value.

Next is the selection of the financial adviser who will carry out the valuation. The adviser should be selected by competitive tender from among several independent and reputable companies based on their terms of reference for various valuation methods. The financial adviser should be selected before the auditor so that the adviser can help prepare the terms of reference for the audit, which besides a financial review normally includes an operational and legal review.

Once appointed, the financial adviser undertakes due diligence—an exercise that differs from but complements the audit. Due diligence consists of gathering and verifying information about the privatization candidate, its organization, its finances and balance sheet, its national and (if relevant) international standing, and any other information that may be relevant to a valuation, such as a likely change in taxation or regulation. Past financial performance must be explained and projections made under several scenarios in cooperation with the existing management team. Future investments should be identified and estimated. During this period the financial adviser will also work with the government to explore options for privatization.

At the end of the due diligence process, the financial adviser should be able to submit a first valuation report to the government. After reviewing the report, the government can request further sensitivity analysis. In the end the government—and no one else—is responsible for setting the reserve price of the tender or the fixed price of the public offering. But the government's decision must be based on the objective data provided in the valuation report.

A valuation report is highly confidential. It is prepared for the exclusive use of the seller (or buyer) and under no circumstances should be disclosed to third parties. A leak to buyers could have adverse consequences for the divestiture: insiders would become aware of the most sensitive valuation parameters in the eyes of the seller, and would be able to use such information to lower the sale price.

Methods

All valuation methods estimate market value. Some methods are appropriate if the company is to be divested through an initial public offering; others if control is to be sold to a strategic investor. Whatever the method of sale, no valuation method is infallible. The market value of a company is best estimated by combining, in different proportions, six methods of valuation: the adjusted net assets method, the discounted cash-flow method, the comparable companies method, the comparable transactions method, the book building method, and the replacement value method. Combining these methods allows a range of probable values to be established, a process known as triangulation.

Adjusted net assets method

The adjusted net assets method tries to ascertain an enterprise's fair market value by estimating the market value of its assets (fixed assets and current assets) and then subtracting its balance sheet and off-balance sheet liabilities.

Buyers do not have much faith in this method because it fails to take into account the assets' capacity to generate revenues. It looks at the costs of purchasing them, then applies a depreciation factor to account for their obsolescence. Thus it ignores the fact that the seller may have paid too much for the assets in the first place. Ultimately, however, productive assets must pay for themselves and generate extra earnings; otherwise their purchase does not make economic sense.

Conversely, it is easy to understand why sellers often prefer this valuation method. It gives them a sense of the price at which they should sell the assets in order to "get their money back," after taking into account their use of them. This approach is often the cause of unreconcilable differences between buyers and sellers.

Discounted cash-flow method

The discounted cash-flow method is best suited to a sale to a strategic investor who will gain control of an enterprise's management and cash flows. It consists of estimating the company's free cash flows over a medium-long-term horizon, taking into account variations in working capital and future capital expenditures. A discount rate is then applied to these anticipated cash flows to calculate their present value. The discount rate reflects the enterprise's weighted average cost of capital and the political risk of the country where its operations are based. Present values are then totaled. A terminal value is sometimes added to this number. Finally, the total funded debt on the enterprise's balance sheet at the time of the transaction is subtracted to arrive at the net present value of the company's equity.

Potential strategic investors tend to prefer the dis-method, counted cash-flow valuation method. They verify these calculations by comparing them with the market values of comparable quoted companies, and with prices paid by other buyers in recent comparable transactions. Their discounted cash-flow valuation is generally a significant component of their offer.

Discounted cash-flow valuations require the construction of a spreadsheet model. These models are most useful when they include variables that can be modified to run sensitivity analysis. Such models can prove especially useful during negotiations. A good model can anticipate arguments or concerns that may be raised by potential buyers and can provide answers about the value of assets if certain conditions attached to the sale are modified-for example, the length of a period of exclusivity or the level of taxation on imported goods.

Investors often have a "hurdle" rate of return on capital to help them decide whether to pursue an investment. The potential acquisition is actively pursued if the anticipated return is above the hurdle rate; otherwise it is discarded. Some investors calculate an internal rate of return to help value a potential acquisition. An enterprise's internal rate of return is the rate at which the sum of its future cash flows and acquisition price equals zero.

Comparable companies and comparable transactions methods

The comparable companies and comparable transactions methods are particularly appropriate when an enterprise is being partly or entirely privatized through a stock exchange. The principle underlying both methods is that companies' market values can be determined by applying a series of empirically derived valuation multiples to their latest (or normalized) financial results. The most commonly used multiples are the multiple of turnover, multiples of operating income (either the multiple of earnings before interest non-payments, tax, depreciation, and amortization or the multiple of earnings before interest payments and tax), and the multiple of net earnings (also known as the price-earnings ratio).

Valuation multiples are calculated by dividing the stock market capitalization of several companies in the same sector, of a similar size, and from various regions by their turnover, operating income, and net earnings multiples. Thus a series of multiples are derived, sorted, and treated mathematically to obtain a range (high, low, and arithmetic mean) that is applied to the financial results of the enterprise being valued. In addition, for capital-intensive industries like cement or oil and gas, operational ratios (such as dollars per ton of capacity or dollars per barrel of reserves in the ground) can be used to approximate market values.

As opposed to the multiples of operating income, which estimate the market value of total assets, the multiple of net earnings estimates the market value of equity. To deduce the market value of equity, the net debt on the enterprise's balance sheet is subtracted from the total assets estimate. The same operations are repeated using recent corporate transactions in the sector involving companies of similar size.

Of course, each company has its own idiosyncrasies, and markets differ from one country to the next. Valuation multiples should not be applied blindly: they often require a great deal of interpretation. But if carried out carefully, the comparable companies and comparable transactions methods provide a useful estimate of an enterprise's market value.

Book building method

The book building method (also known as circling) is used in public offerings and private placements of quoted securities to determine the price they should be offered for at subscription. It differs from the methods described above in that it does not involve calculations based on a set formula. Rather, the calculations take place before the book building operation.

The method involves pricing the shares of a forthcoming issue by constructing a book of orders from institutional investors based on different issue prices. In most cases the book is opened for about two weeks. During this period members of the placement syndicate contact their institutional clients and request non-payments, binding orders of shares that are linked to various offer prices. For example, how many shares would the institutional investor want to buy if they were priced at $18 apiece, and how many if they were $20?

Each member of the placement syndicate constructs an order book; every two days each book is transmitted to the lead manager of the issue, who constructs a consolidated book. By the end of the book building period the trends in the consolidated book resemble figure 5. The issuer is then able to determine the price at which the market will absorb the issue. In figure 5 the issuer will price the issue at between $19.4 and $20.0 per share.

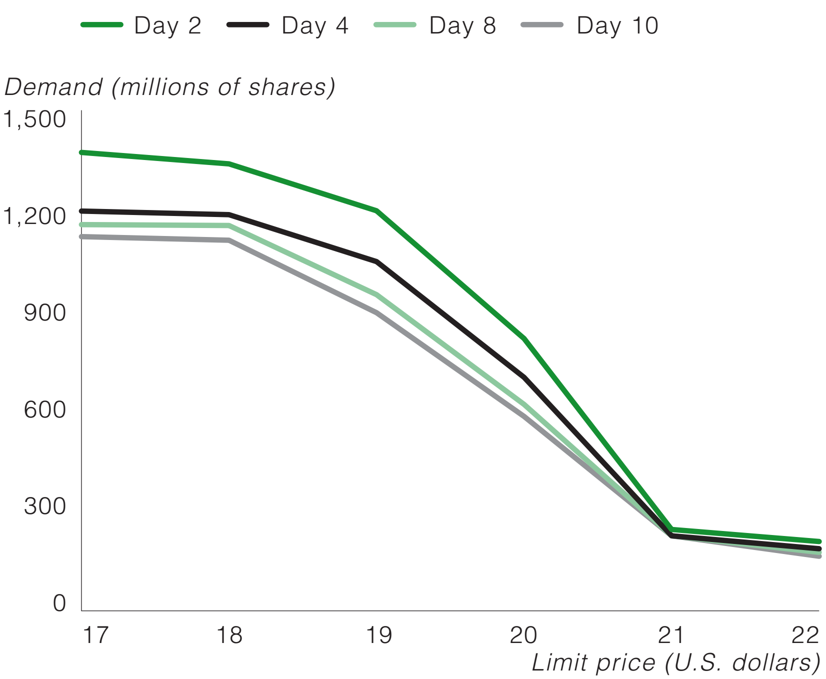
Order books are usually several times oversubscribed because investors typically request more than they want to receive, expecting their orders to be scaled down. It is important, however, that some unsatisfied demand remains in the secondary market to ensure that the share price continues to rise.

Book building operations are generally used to price shares reserved for global offerings to institutional investors. To be effective, this method requires a minimum number of independent institutional investors that are unlikely to collude with one another. In most emerging markets institutional investors are too small to fulfill this condition; thus the book building method cannot be used domestically Domestic issues are, however, sometimes priced relative to their global institutional offering. Governments often choose to price the shares reserved for domestic subscription at a discount to the price paid by international institutional investors.

Replacement value method

The replacement value method estimates how much it would cost to replace a company's assets if they were destroyed by

Figure 5 Book building—demand profile



an act of God. This mainly includes fixed assets (plants, machinery) but also covers startup costs and certain current assets (for example, a vehicle fleet). This valuation method often produces a much higher value than the methods described above. This is because the decision to form an industry may not have been motivated solely by economic considerations, particularly if it was made by government. Social or political considerations may have been equally important. For example, it may be politically desirable to build a medium-size petroleum refinery in a small developing country, but from an economic standpoint it makes more sense to import refined products.

Investors almost never take the replacement value method into account when valuing a company because

it does not measure the expected return from the proposed investment. Thus sellers should not use this method to determine the market value of assets. Still, the replacement value should be calculated and arguments should be prepared to explain why it has been discarded. Otherwise, critics of privatization may use this method to argue that an enterprise is worth far more or that it was sold for a fraction of its worth.

7. Hiring financial and other advisers

In the context of case-by-case privatization, financial advisers are investment bankers or merchant bankers that sell and advise on the sale of firms. The government may use a single financial adviser or a consortium of financial and other advisers. A foreign and a domestic adviser should be used if the government wants to attract both domestic and foreign investors.

Selecting financial advisers

Governments need financial advisers in case-by-case privatizations to value enterprises, advise on the timing and method of sale, and contact potential buyers. Advisers will suggest the price (usually within a range) that the government could receive for the enterprise. Advisers may provide several valuations based on different sales methods-for example, whether sale is through a stock flotation or a trade sale. Advisers will also suggest sales options. This advice will cover such issues as whether the company is salable, whether it should be sold now or later, and what sorts of sales choices are feasible, and at what cost.

Once the government has decided when and how to privatize, it will require a financial adviser (sales con-agent) to undertake the sale. The sales agent will help design the sales plan and will undertake the sale in cooperation with government officials. If a privatization takes the form of an initial public offering, a syndicate of investment banks or merchant banks will be formed to sell the enterprise's shares. The government must appoint a firm as the lead manager for the syndicate to manage the sale process. If a privatization takes the form of a trade sale, the sales agent will be responsible for preparing the sale documents, contacting potential buyers, and enticing interested parties to bid for the company.

If privatization involves a small enterprise that is unlikely to attract much international interest, accounting firms and financial consultants may suffice as financial advisers. But if the enterprise is larger or has an international dimension, valuation should be done by an investment bank or merchant bank. This is because valuation requires market awareness as well as technical skills. Unless the financial adviser is involved in buying and selling companies in the same sector as the privatization candidate, the results of the valuation may not reflect what the market is willing to pay for the assets. Furthermore, an investment bank is more likely to provide the government with timely market information on the corporate strategy of potential buyers. Accounting firms, by contrast, may not have a corporate relationship with potential buyers.

For the same reason, many analysts believe that valuation mandates should be combined with placement mandates-making the investment bank charged with valuing assets responsible for also identifying potential buyers. This approach guarantees that valuation reports are grounded in market reality. Others believe that valuation mandates and placement mandates should be dissociated because of the potential conflict of interest between the two tasks. Indeed, the investment bank charged with placing assets may want the sale price to be low to facilitate its task. Thus it may be tempted to undervalue the assets. Still, this argument ignores the fact that in most cases the structure of the placement mandate is such that the higher is the sale price, the higher is the bank's compensation. Thus conflicts can be avoided by properly structuring the compensation of financial advisers and ensuring that it is in their interest to maximize proceeds.

Selecting other advisers

Other professional advisers are also needed during privatization. Lawyers are required to manage due diligence activities, advise the government on the legal aspects of the privatization, draft and negotiate sales contracts and draw up confidentiality agreements. Accountants and auditors may be needed to undertake audits prior to sale. Technical experts with specialized industry skill and knowledge may be required as well. The government may find it convenient to tender for these advisers as a single consortium or may prefer to hire them separately.

Should the same financial adviser be used for both phases of privatization?

The literature on privatization often questions whether the same financial adviser that helped the government during the early stages of privatization should undertake the sale of the enterprise. The argument against using the same adviser is that there is an inherent conflict of interest in advising on whether and how to privatize an enterprise and helping with the sale of that enterprise. The best advisory firms, however, are often reluctant to participate in the first phase if they cannot participate in the second, which is usually more profitable.

One way to manage this issue is to tender for advice for both phases but not to restrict the winner of the first from participating in or winning the second. Alternatively, the adviser could be hired for both phases, but the government could be allowed to exit after the first phase if it is not happy with the adviser's performance.

Foreign advisers

Governments in transition and developing economies should probably use both domestic and foreign advisers. Foreign financial advisers are essential if the government expects participation by foreign investors or injections of foreign capital, or if it plans to sell shares on international markets. These advisers should work with domestic advisers, who should address more local issues.

Tenders for financial advisers

Governments should hire financial advisers through a competitive bidding process. But given the specialized nature of financial advice, officials may want to develop a "short list" of firms that have the experience and marketing capacity needed for privatization. As a rule the list should include at least 10 companies to avoid too few bidders if companies combine to bid or if several are uninterested. Interested firms should submit written proposals against broad terms of reference drawn up by the government. Interviews with key officials of the best firms should follow.