# How do countries privatize?

**Lecture 3**

18 February 2025

# Aims of Lecture

- Understand the theoretical background of how countries privatize the state-owned enterprises (How do countries privatize the state-owned enterprises?)
- Recognize the primary methods used to privatize SOEs (Which methods are employed to privatize SOEs?)
- Identify critical objectives and trade-offs in the privatization process (What are the key objectives?)
- Describe the advantages and disadvantages of trade sales and share issue privatization.

# How do countries privatize?

- This chapter covers the practical aspects of privatizing state-owned enterprises.
- We have seen that, beginning in the late 1970s, increasing numbers of people worldwide concluded that state ownership was not working and that private ownership was much more productive.
- This realization inevitably raised the difficult question of shifting society from an economic model stressing government ownership and state direction to one based primarily on private ownership and decision-making.
- Exactly how do countries privatize the state-owned sectors of an economy?

# How do countries privatize?

- **Exploring the Practical Aspects of Privatization:** This chapter examines how state-owned enterprises (SOEs) are privatized in practice.
- **A Shift in Economic Thinking:** Since the late 1970s, many countries have recognized that state owned enterprises often leads to inefficiencies, while private firms tends to be more productive.
- **A Complex Transformation:** Transitioning from government-intervention to market-based economies requires legal reforms, economic restructuring, and careful planning.
- **The Key Question: How Does Privatization Happen?** - How do governments privatize state-owned enterprises? - What methods are used to sell state owned assets? - What challenges arise in the privatization process?

# How do countries privatize?

- A government must decide:
  - Whether to restructure an SOE before sale.
  - Find an acceptable and transparent method to value the company and set an asking price.
  - Whether or not to regulate a newly privatized company after it is divested.
  - Whether to sell an SOE to private investors for cash or to essentially give the SOE away in a mass privatization program.

# How do countries privatize?

- **Pre-Sale Restructuring:** Should the SOE be restructured to improve efficiency before sale? Will this maximize firm value and attract investors?
- **Valuation and Pricing:** How should the SOE's market value be determined? Which pricing method should be used (e.g., discounted cash flow, market comparables)?
- **Post-Privatization Regulation:** Should the privatized firm be regulated to prevent monopolies? How can the government ensure fair competition and public interest protection?
- **Privatization Method Selection:** Should the SOE be sold for cash or distributed in a mass privatization program? What are the trade-offs between government revenue, capital market development, and equity distribution?

# Commercializing and Restructuring SOEs Prior to Sale

- The first step a privatizing government must take is to decide which state-owned enterprises and sectors should be slated for privatization.
- Some sectors, such as retail trade and light industry operating in (at least potentially) competitive industries, will be relatively easy to sell off,
- while other sectors—cumbersome industry and infrastructure assets—will be far more complex and require much more excellent preparation before sale.
- Bornstein (1999) categorized the scope of privatization of SOEs.

# Commercializing and Restructuring SOEs Prior to Sale

- **Selecting SOEs for Privatization:** Governments must determine which state-owned enterprises (SOEs) and sectors should be privatized.
- **Ease of Privatization by Sector:**
  - Competitive industries (e.g., retail trade, light manufacturing) are easier to privatize.
  - Large industries and infrastructure require extensive preparation before sale.
- **Privatization Scope (Bornstein, 1999):** Privatization strategies depend on industry characteristics and economic impact.

# Commercializing and Restructuring SOEs Prior to Sale

TABLE 3.1. Sector/Branch Characteristics Affecting the Scope and Sequence of Divestiture of State Assets

| | *Characteristic* | | | | | |
|---|---|---|---|---|---|---|
| Branch | Already Partly Private | Small Capital Investment Required | Substantial Restructuring Needed | Foreign Direct Investment Crucial | Possibly Deemed Strategic | Special Regulatory Framework Essential |
| Retail trade | ? | ? | | | | |
| Consumer services | ? | ? | | | | |
| Housing | ? | ? | | | | |
| Agriculture | ? | ? | ? | | | |
| Light industry | | | ? | ? | | |
| Heavy industry | | | ? | ? | ? | |
| Banking | | | ? | ? | ? | ? |
| Electricity | | | ? | ? | ? | ? |
| Telecommunications | | | ? | ? | ? | ? |

*Source:* Table 1 in Bornstein (1999).

*Note:* A "?" in a cell denotes that the characteristic significantly influences the divestiture of state enterprises in the branch.

Figure: Categorization of Sectors for Privatization

- The basics of the categorization procedure are presented in Table 3.1.
- At the start of privatization, retail trade, consumer services, and housing operate in partially private sectors.
- These industries require minimal capital investment to become competitive.
- As we move down in Table 3.1, privatization becomes more complex, especially for large industries and infrastructure assets

# Commercializing and Restructuring SOEs Before Sale

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| Agriculture | ? | ? | ? | | | |
| Light industry | | | ? | ? | | |
| Heavy industry | | | ? | ? | ? | |
| Banking | | | ? | ? | ? | ? |
| Electricity | | | ? | ? | ? | ? |
| Telecommunications | | | ? | ? | ? | ? |

*Source:* Table 1 in Bornstein (1999).

*Note:* A "?" in a cell denotes that the characteristic significantly influences the divestiture of state enterprises in the branch.

Figure: Categorization of Sectors for Privatization

- **Easier Sectors to Privatize:** Retail trade, consumer services, and housing are partially private and need minimal capital investment.
- **L**arge industries and infrastructure require significant restructuring before privatization.
- **Privatization Complexity:** As we move down in Table 3.1, the privatization process becomes more difficult.

# Establishing a Privatization Agency and a Framework for Divestment

- National governments almost always create dedicated administrative bodies to oversee various aspects of the privatization process-
  - from initially selecting and commercializing SOEs for divestiture,
  - Through actually selling the asset to private investors,
  - To regulating the privatized company and acting as a fiduciary for the state's residual ownership stakes after partial privatizations.
- The optimal action will depend on each country's traditions and political environment.

# Establishing a Privatization Agency

- Governments create specialized agencies to manage the privatization process.
- **Key Responsibilities:**
  - Selecting and preparing SOEs for divestiture
  - Selling assets to private investors transparently
  - Regulating privatized firms and overseeing state-owned shares.
- **Country-Specific Approach:** The best strategy depends on each country's legal, economic, and political environment.

# Commercialization of SOEs Before Sale

- The next step in preparing an SOE for ultimate sale is known as commercialization.
- It means converting the enterprise's mission from maximizing social welfare to maximizing economic profits and developing new private-sector operating procedures and policies.

# The Role of Corporate Culture in SOE Commercialization

- Corporate culture is acknowledged to be instrumental in determining:
  - How well private business enterprises meet their corporate objectives,
  - To inculcate profit-oriented values into a workforce of public-sector employees, and
  - To incorporate private-sector accounting, information processing, supply-chain management, and human resource management policies into an SOE's daily operating rhythms.

# Commercialization of SOEs Prior to Sale

- **Commercialization of SOEs:**
  - Transforms SOEs from social welfare objectives to profit maximization.
  - Adopts private-sector management practices and operational policies.
- **Role of Corporate Culture in Commercialization:**
  - Ensures firms achieve profitability and efficiency.
  - Embeds profit-driven values in former public-sector employees.
  - Implements private-sector accounting, supply-chain, and HR policies.

# Types of SOE Restructuring

- There are broadly two types of restructuring:

  1. **Financial Restructuring:** This usually involves reducing an SOE's total indebtedness, possibly by forgiving claims owed to the government and transferring critical financial obligations, such as unfunded pension liabilities, from the SOE to the government.
  2. **Operational Restructuring:** This involves selling off or closing down unproductive divisions of an SOE, reconfiguring the company's manufacturing process, changing suppliers and customers, and, most painful of all, laying off redundant workers.

# Types of SOE Restructuring

1. State-owned enterprises (SOEs) require restructuring before privatization to improve efficiency and financial stability.
2. Financial restructuring reduces debt by canceling government claims and shifting financial obligations, such as pension liabilities, to the state.
3. Operational restructuring enhances productivity by selling off or closing inefficient divisions, optimizing supply chains, and adjusting manufacturing processes.
4. In some cases, operational restructuring leads to layoffs, making it a politically sensitive but necessary step for privatization.
5. Both types of restructuring aim to make SOEs financially viable and competitive in the private sector.

# Identifying Key Objectives for the Sale of SOEs

- After selecting and commercializing the SOE slates for divestment, the decision-making process begins with identifying the primary objectives the government wishes to accomplish.

- Key objectives are to:

  1. Privatize as many companies as possible
  2. Privatize as rapidly as possible
  3. Raise as much revenue as possible
  4. Privatize without firing any employees of the SOEs being divested
  5. Privatize in an open and transparent sale process free of corruption
  6. Ensure that ordinary citizens benefit financially from the sale process

# Identifying Key Objectives for the Sale of SOEs

- Governments define objectives before privatizing state-owned enterprises (SOEs).
- Key objectives include:
  1. Privatizing many companies quickly and efficiently
  2. Maximizing revenue from sales
  3. Ensuring job security for SOE employees
  4. Conducting a transparent, corruption-free process
  5. Allowing ordinary citizens to benefit financially.

# Identifying Trade-offs in the Privatization Process

- The key trade-offs in designing a privatization program involve choosing between the following objectives:

  1. Speed of sale versus revenue maximization and transparency.
  2. Revenue maximization versus favoring citizens and ensuring domestic ownership.
  3. Promoting economic efficiency versus preserving SOE employment levels and maximizing political benefits for the government.
  4. Promoting the development of the national stock market versus divesting state assets rapidly and completely.

# Identifying Trade-offs in the Privatization Process

1. **Speed vs. Revenue and Transparency:** Governments must decide whether to sell SOEs quickly for economic reforms or take more time to maximize revenue and ensure transparency. Rapid sales may lead to undervaluation, while slower processes attract better offers.

2. **Revenue Maximization vs. Citizen and Domestic Ownership:** Selling to the highest bidder raises more funds but may result in foreign dominance. Prioritizing local investors ensures national control but may reduce revenue.
3. **Efficiency vs. Employment and Political Stability:** Privatization improves efficiency but can cause job losses and social unrest. Governments must balance profitable enterprises with the political impact of layoffs.
4. **Stock Market Development vs. Fast and Complete Sales:** Selling shares on the stock market supports financial market growth but takes time. Direct sales to strategic investors are faster but limit market development.

# Valuing SOEs Prior to Sale

- Valuation is essential even for private (nontraded) companies in market economies—especially for taxation and inheritance purposes.
- There are four primary methods of valuing a nontraded company for sale:
  1. The earnings capitalization approach, which is also known as the P/E ratio method.
  2. The discounted cash flow method.
  3. The market entry method (or determining the Tobin's Q value for the company).
  4. The comparable-firm approach.

# 1) The Earnings Capitalization Approach

- The capitalization approach involves determining the equilibrium level of total profits that a privatized company will likely generate and then applying a multiple (i.e., ten times profits) to determine total firm value.

- This method estimates a SOE's value based on its expected future profits.

- The approach involves determining the SOE's equilibrium level of total profits.

- A multiple (e.g., ten times profits) is applied to determine the total firm value.

- Example: If a SOE's annual profit is $10 million and the multiple is 10, its estimated value is $100 million.

# 2) The Discounted Cash Flow (DCF)

- This involves predicting the future stream of earnings a company will generate and determining the present value of each cash flow by discounting it to today using an appropriate discount rate.

- This rate is determined based on the industry the firm is operating in, plus an adjustment for country and political risk.

- **Key Steps in DCF:**
  1. **Forecast Future Cash Flows:** Estimate the company's expected earnings over several years.
  2. **Apply a Discount Rate:** Future cash flows are discounted to account for the time value of money. The discount rate depends on industry stability and country-specific risks.

# 2) The Discounted Cash Flow (DCF)

3. **Calculate Present Value:** Each future cash flow is discounted using the formula:

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

where $PV$ is present value, $FV$ is future cash flow, $r$ is the discount rate, and $n$ is the number of years.

4. **Sum Up the Present Values:** Adding the discounted values provides the estimated worth of the company today.

**Example:** If a company expects to generate \$100 million in one year and the discount rate is 10%, the present value is:

$$PV = \frac{100}{(1 + 0.10)^1} = 90.9 \text{ million}$$

Repeating this for multiple years gives the total company valuation. The DCF method is widely used as it considers both risk and the time value of money, making it a reliable valuation approach.

# 3) The Market Entry Method

**(determining the Tobin's Q value for the company):**

- This approach involves determining how much it would cost to establish a new company with a market share equal to that of the existing firm. This is quite similar to determining the replacement value.
- This method evaluates whether the current market value of a company is aligned with the cost of creating a similar firm from scratch.
- This method is closely related to determining the replacement value of the firm, as it assesses the cost of replicating its assets, infrastructure, and competitive position in the market.
- If the cost of establishing a new company is higher than the market value of the existing firm, it indicates the firm may be undervalued.

# 4) The Comparable-Firm Approach

1. **The Comparable-Firm Approach:** It involves determining the value of a publicly traded firm in the same industry as the firm being valued and making adjustments as necessary for financial and operating differences between the traded and the nontraded companies.

2. The assumption is that similar firms will have comparable valuations in the market.

3. Differences in financial performance, risk levels, and operational structures between the traded and non-traded firms must be considered.

4. If a similar publicly traded company has a market valuation of \$500 million with a price-to-earnings (P/E) ratio of 10, a comparable private firm with earnings of \$40 million might be valued at:

$$\text{Valuation} = 40 \times 10 = 400 \text{ million}$$

# Selecting the Method of Sale

- Brada (1996) presents an excellent taxonomy of privatization methods.
- His classification of four principal divestment methods is quite general.

  A) **Privatization through Restitution:**

  B) **Privatization through sale of state property:**

  C) **Mass or voucher privatization:**

  D) **Privatization from below:**

# A) Privatization through Restitution

1. Restitution is a privatization method where the government returns previously expropriated property to its original owners or their legal heirs.
2. It Applies to land, buildings, and other identifiable assets taken by the state in the past.
3. It requires a legal framework to verify rightful ownership claims.
4. It can be complex if multiple generations have passed or historical records are incomplete.
5. Restitution aims to correct past injustices and promote private ownership, supporting economic growth.
6. **Challenges:** Legal disputes may arise if current occupants or the state resist property returns. Requires government commitment to transparency and fairness in implementation.

# B) Privatization through Sale of State Property

- The government trades its ownership claim for an explicit cash payment. This category takes two essential forms:

  1. **Trade Sale (or Asset Sale):** The government sells a state-owned enterprise or some parts of it to an individual, an existing corporation, or a group of investors.
  2. **Share Issue Privatization (SIP):** The government sells some or all of its holdings in an SOE to investors through a public share offering.

# B) Privatization through Sale of State Property

- Privatization through sale of state property occurs when the government transfers its ownership in an SOE in exchange for a cash payment. This process is intended to increase efficiency, attract private investment, and reduce the financial burden of state ownership.

- There are two primary methods of selling state-owned enterprises:

    1. **Trade Sale (or Asset Sale):** In this approach, the government sells an entire state-owned enterprise or specific parts of it to private investors, corporations, or investment groups. This method is often used when a company is not suitable for public listing.

    2. **Share Issue Privatization (SIP):** This involves selling shares of a state-owned enterprise to private investors through public stock offerings. This method is preferred for larger enterprises with potential capital market access, enabling broad public participation.

# B) Privatization through Sale of State Property

1. It improves efficiency and profitability by introducing private-sector management
2. It reduces the financial burden of inefficient state enterprises on government budgets
3. It encourages private investment and expands capital markets

# C) Mass or Voucher Privatization

- **Definition:** Mass privatization is a method where eligible citizens receive vouchers, either for free or at a minimal cost.
- **Purpose:** These vouchers allow holders to bid for stakes in state-owned enterprises (SOEs) or other privatized assets.
- **Advantages:**
  1. It ensures broad public participation in the privatization process.
  2. It reduces concerns of wealth concentration by allowing more citizens to become stakeholders.
  3. It accelerates the transition from state to private ownership.

# D) Privatization from Below

- Privatization from below refers to the emergence of new private businesses in formerly socialist economies. It means the startup of new private businesses.

- **Key Features:**
  1. Driven by entrepreneurs and small business startups
  2. Occurs alongside or independent of state-led privatization efforts
  3. Encourages competition and market development.

- This process has advanced rapidly in regions such as China, the transition economies of Central and Eastern Europe, Latin America, and sub-Saharan Africa.

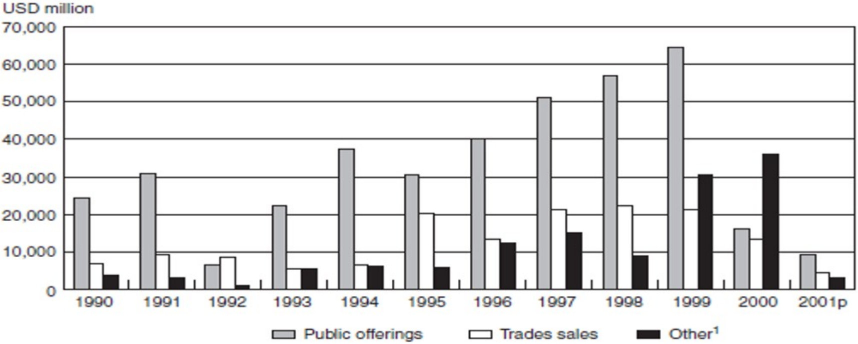


FIGURE 3.2. Privatization in OECD countries by type of sale transactions. 1 = includes management or employee buyout, asset sales and lease or management contracts; p = provisional. Source: *OECD Privatisation Database* info as depicted in Figure 2 of Mahboobi (2002).

Figure: Privatization in OECD countries by type of sale transactions (1990-2001). Source: OECD Privatisation Database, Mahboobi (2002).

# Selecting the Method of Sale

- The figure shows the the privatization trends in OECD countries from 1990 to 2001, categorized by public offerings, trade sales, and other methods.
- Public offerings dominated the privatization process, peaking in 1998 and 1999.
- Trade sales and other privatization methods also increased, with noticeable spikes in 1999 and 2000.
- The data indicate an overall rise in privatization activity during the 1990s, reflecting large-scale public sector divestment.

# Non-Cash Methods of Privatization

**Voucher:**

- Citizens were offered the chance to purchase, for a nominal fee, vouchers with investment points they could use to bid for shares in companies being privatized.
- The actual bidding and allocation of ownership resulted from a complex, five-round auction process.

# Why Have Voucher Privatizations Failed?

1. Voucher privatizations did not yield any cash inflows, either to the firm or the government, and thus, there were no transfers of technology, capital, and expertise from foreign investors or multinational companies to the privatized companies.

2. Voucher privatizations provided the new "owners," who were typically just the existing managers and employees, few incentives to restructure the firm's operations or trim excess staff effectively

# Why Have Voucher Privatizations Failed?

3. Governments rarely surrendered complete control of important privatized companies to private owners, other than managers, either because the state retained significant shareholdings in the firm or because they deemed the firm too "strategic" to be left unsupervised
4. Mass privatization programs proved ineffective because the government retained effective control of the banking sector in many countries, even after other sectors were privatized mainly. This continued politicization of the credit extension mechanism ensured that former state firms would face soft budget constraints indefinitely.

# Privatizing SOEs Using Trade Sales

- Once a government decides against mass privatization and opts to sell state assets for cash, it must determine the specific divestment method. This involves choosing between a trade sale and a share issue privatization (SIP).
- Trade sales are typically used for smaller and less profitable state assets and enterprises.
- SIPs are preferred for larger and more profitable companies.

# Key Decisions in Trade Sale Privatization

When designing a trade sale privatization program, the government agency must make four critical decisions.

1. The agency must decide whether to conduct all aspects of the sale in-house or delegate key tasks to third parties such as investment banks or auditing firms.
2. A government must decide whether to allow foreign investors to participate in specific asset sales.
3. It is whether (and how) to structure the selling terms to achieve political and economic objectives other than maximizing sales price.
4. It is whether to conduct trade sales through auctions or negotiations with selected potential buyers.

# Key Decisions in Trade Sale Privatization

**1) The agency must decide whether to conduct all aspects of the sale in-house or delegate key tasks to third parties such as investment banks or auditing firms.**

- The privatization process involves reputable financial advisers enhances the credibility of the sale and ensures transparency.
- However, third-party facilitators, particularly international banks and auditors, are costly and can slow down the sales process.
- Most governments use third parties only for large trade sales, typically those valued at $25–50 million or more, depending on the country.

# Key Decisions in Trade Sale Privatization

**2) A government must decide whether to allow foreign investors to participate in specific asset sales.**

- If the asset or enterprise offered for sale is considered 'strategic', most governments would choose to restrict or prohibit foreign participation in its sale.

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- If an asset or enterprise is considered **strategic**, the government may restrict or prohibit foreign investors from purchasing it to protect national security, economic stability, and public interest.

# Key Decisions in Trade Sale Privatization

**3) It is whether (and how) to structure the selling terms to achieve political and economic objectives other than maximizing sales price.**

- For example, should the government require bidders for the national telecom company to commit to making specific capital investments and meeting strict service improvement goals if they win the bidding contest.
- Should the government require the purchaser of the national airline to maintain staffing at current levels and preserve the current route system intact?
- Governments may impose conditions on privatization deals, such as requiring buyers to invest in infrastructure, improve services, retain employees, or maintain existing operational structures to protect national interests and ensure long-term benefits.

# Key Decisions in Trade Sale Privatization

**4) It is whether to conduct trade sales through auctions or negotiations with selected potential buyers**

- This is another case where the economic answer is obvious (auctions), but governments often prefer to conduct "beauty contests" in order to select specific buyers (almost inevitably domestic companies) for high-visibility state assets.

- Although auctions are the most efficient method, governments often prefer selective sales to choose specific buyers, usually domestic firms, for politically significant state assets.

# Advantages of Trade Sales

1. Trade sales can be executed much more rapidly than SIPs and, if properly designed, can yield comparable sales proceeds.
2. Trade sales can (and should) be used to attract foreign direct investment into a country, or, when necessary, they can ensure that strategic assets remain in domestic hands.
3. Trade sales allow governments to craft sophisticated terms to meet political and social objectives.

# Disadvantages of Trade Sales

- Trade sales typically yield significantly lower sale proceeds than comparable share issue privatizations.
- Trade sales do nothing to promote the development of the national stock market. These sales may retard the stock market's growth by reducing liquidity if controlling stakes in key SOEs (especially telecoms) are sold to foreigners and trading in those shares occurs mainly in foreign markets.
- Trade sales are far less transparent than SIPs, and the more complex and restrictive the sales process, the greater the opportunity for the process to become corrupt.

# Key Decisions in Public Share Offerings

- Any government that intends to privatize SOEs using public share offerings faces three sets of interrelated decisions:
  - How to transfer control
  - How to price the offer
  - How to allocate shares

# Key Decisions in Public Share Offerings

- Governments privatizing SOEs through public share offerings must consider three key decisions:
  - **How to Transfer Control:** Decide whether to sell a majority or minority stake and whether to retain government influence.
  - **How to Price the Offer:** Determine a pricing strategy that balances revenue, investor participation, and market stability.
  - **How to Allocate Shares:** Choose who will receive shares—domestic investors, foreign investors, institutional buyers, or the general public.

# Key Decisions in Public Share Offerings

- The control transfer decision includes whether to sell the SOE all at once or through a series of partial sales. If the government chooses the latter course, it must determine how large a fraction of the company's shares will be issued in the initial versus subsequent offers.

# Key Decisions in Public Share Offerings

- The government must also decide whether to insert any post-privatization restrictions on corporate control.
- The pricing decision requires that the government determine whether a tender offer, a book-building exercise, or a fixed price should set the offer price.
- If the latter, the government must decide whether the offering price should be set immediately prior to the offer or many weeks in advance.

# Advantages of Share Issue Privatizations (SIPs)

1. **Significant Revenue Generation:** SIPs can raise substantial funds. For instance, the Japanese government has raised over \$111 billion from six rounds of share sales of NTT while still retaining 46% ownership.
2. **Essential for Large-Scale Privatizations:** Multi-tranche share offerings are the only viable approach for privatizing massive state enterprises.
3. **High Transparency:** SIPs provide the most transparent method of privatizing state-owned enterprises.
4. **Stock Market Development:** SIPs offer governments a unique opportunity to strengthen and expand their national stock markets.

# Disadvantages of Share Issue Privatizations (SIPs)

- **High Costs and Time-Consuming Process:** SIPs are expensive and require significant time and resources to organize. Many of these costs must be covered regardless of whether the offering proceeds.

- **Only Suitable for Large Privatizations:** Due to the high fixed costs, SIPs are only viable for large-scale privatizations, typically valued at $50–100 million or more, depending on the country.