

A GUIDE FOR DIVESTING GOVERNMENT-OWNED ENTERPRISES

by
Henry Gibbon

EXECUTIVE SUMMARY

Governments at all levels in the United States own commercializable enterprises—in such fields as electricity, water and wastewater services, parking facilities, insurance, hotels and convention centers, mail delivery, etc. Interest by public officials in privatizing such enterprises is growing, fed in part by knowledge of the large volume of such transactions overseas. Yet because actual sales of government enterprises in the United States have been very few, most public officials have little idea how to actually carry out such a sale.

The mechanics of privatization are complex, and each case raises its own problems. The main options are: 1) a trade sale, where a company is sold to a single firm or a consortium; 2) a public offering on the stock exchange, either by a fixed price offering or by a tender offering with a minimum price; 3) a management/employee buyout; or 4) placement with a group of investors. A range of important issues need to be addressed in preparing a business for privatization. This guide focuses on some of the principal issues which arise and explains some of the techniques and solutions developed over the past decade in thousands of transactions around the world.

Privatization exercises are as individual as they are complex, but fundamentals generally include consideration of industry structures, commercial and regulatory regimes, capital structures, sales arrangements, and the nature of the continuing relationship between the government and the divested enterprise. Decisions must be made on methods of sale, special arrangements for employees and customers, marketing, logistics, timing, and the structuring and management of overseas syndicates.

For most small and medium-size enterprises (especially those owned by municipalities), a trade sale is relatively quick to execute and works well if the company to be sold is perceived to need the benefit of an alliance that brings with it skills and know-how. However, public offerings make more sense for larger enterprises and when the company to be sold has a reasonably strong skill base, and capital markets are liquid. For national-scale privatizations, combining large retail and institutional offerings and ensuring competition between banks and regions of the world within the international offer are now conventional features of privatizations by public share offering all over the world.

I. INTRODUCTION

This guide is addressed to public officials at federal, state, and local levels of government. At all three levels, the sale of government enterprises has reached beyond merely the discussion stage.

At the federal level, the 1980s saw only one major divestiture: the sale of Conrail in 1987 for \$1.65 billion via a public stock offering. But in 1995–96, Congress has approved the sale of the Alaska Power Marketing Administration, the helium and naval petroleum reserves, and the U.S. Enrichment Corporation (as well as auctions of electromagnetic spectrum). Bills were also introduced to sell Amtrak, the other four Power Marketing Administrations, the air traffic control system, the U.S. Postal Service, and the Tennessee Valley Authority.

Recent sales at the state level include the trade sale of the Michigan Accident Fund, the Port Authority of New York and New Jersey's Vista Hotel (at the World Trade Center), and a number of commercial properties of the state of New York. Several governors have considered or proposed the sale of state-owned airports, insurance funds, turnpikes, and water systems.

Recent municipal sales have included golf courses, power plants, and wastewater treatment plants. A number of mayors and other local officials have proposed the sale of airports, electric and gas utilities, parking facilities, sports arenas, and water and sewer systems.

A privatization exercise demands the coordinated application of a wide range of skills and expertise, from broad conceptual sweep to logistical minutiae. While the sale of government enterprises has taken place in nearly 100 countries, the United Kingdom has established a clear reputation as the leading source of expertise in the field.

Working with financial advisors, U.K. public officials devised innovative privatization procedures, starting with little or no historical precedent. From legalities to logistics, from the wide vision of large-scale marketing activities to the fine detail of documentation, the United Kingdom has spent over a decade and a half refining privatization processes. The level of expertise developed in privatizing industries—in sectors ranging from airports to water supply, from electric utilities to rail services, from telecommunications providers to R&D laboratories—has lent itself to wider application.

Almost every country in the world is now following the British lead in privatizing its state-owned industries. Hence, this guide understandably relies heavily on the case histories from Britain to illustrate some of its points. Investors and consumers have rarely done as well with offerings in other countries as they have done on U.K. issues. In France, the share price of every company privatized since 1993 but two is trading below its issue price. Italy has an even worse record. Only a handful of other western European countries besides Britain have actually begun to privatize utilities. Nor has privatization in emerging markets been clear sailing. The crucial distinction lies in the fact that in Britain—as in many former Communist countries in eastern Europe eager to build a solid foundation for newly regained freedoms—privatization has been pursued as a matter of conviction by governments committed to the program. Among other western industrialized countries only Canada has set precedents for public offerings, by recently privatizing its air traffic control system and rail services, and in these cases has closely followed the precedents for privatizations set in the United Kingdom.

II. PRIVATIZATION OBJECTIVES

In their privatization programs governments around the world commonly share three objectives:

- to promote efficiency by exposing businesses and services to the greatest possible competition, to the benefit of the consumer;
- to spread share ownership as widely as possible among the population; and
- to obtain the best value for each industry or service the government sells.

Governments have also sought to ensure that success in each privatization generated momentum for succeeding sales.

A. Competition

Competition is the best way to ensure that goods and services desired by the customer are provided at the lowest economic cost. Giving customers freedom of choice enables market forces to provide sustained pressures on companies to increase efficiency. Privatized companies generally operate in a competitive market environment. In Britain the government did not wish to confine the benefits of privatization to businesses in competitive areas of the economy. Therefore privatization was extended to utility monopolies—airports, electricity, gas, telecoms, and water—where competition is either unworkable or very limited in scope. To the extent regarded as necessary, regulatory arrangements have taken the place of the market in holding down prices, ensuring good service for the consumer and in certain markets to help foster competition.

Privatization is intended to benefit customers, employees and the economy as a whole. Customers benefit when the greater efficiency that can be achieved through privatization is passed on to them, for example, in the form of prices which are lower than they would otherwise have been, wider choice and better service. Privatized businesses are likely to be more responsive to changing customer demands, and more innovative in introducing new products to the market.

For employees, privatization means working in a company with clear objectives, the means to achieve them, and rewards for success. This reinforces the concern for the customer that is at the heart of any successful business. The economy benefits through higher returns on capital in the privatized industries, which can no longer pre-empt resources from elsewhere in the economy (via taxation), but must compete for funds in the open capital markets. Moreover, as the products and services of privatized industries underpin much activity elsewhere in the economy, there are substantial benefits for other businesses.

B. Wider Share Ownership

The promotion of wider share ownership—among both employees and the general public—has been a major objective of the privatization program in Britain. This is part of a broader government policy of extending the ownership of wealth more widely in the economy, giving people a direct stake in industrial success, and removing distinctions between “owners” and “workers”. In Britain this has resulted in the number of shareholders roughly tripling since 1979. There are now 10 million individual shareholders compared to 3 million in 1979. About 90 percent of eligible employees became shareholders in their companies on privatization. In France privatizations have quadrupled the number of shareholders, from 1.5 million before 1986 when the process began to 6 million. Special arrangements made to encourage small investors and employees to participate in privatization sales have contributed to this extension of share ownership.

C. Obtaining Best Value

Valuing a company is always a difficult matter of judgement, whether it is a state-owned or a privately owned company that is being sold, especially when the company's shares have not been traded before or where there are no directly comparable companies. Moreover, it is impossible for any seller to anticipate accurately the movements of the stock market between price fixing and the receipt of applications.

Governments throughout the world have always sought professional advice, both on pricing and on other aspects of a sale. Investment banks, lawyers, accountancy firms, public relations and other advisors have proved essential for achieving successful privatizations at a fair price for the taxpayer and the investors. Advisors are hired because of the professional judgement and technical skills required to determine the value of the company to be sold. The range of expected values can be significantly affected by what assumptions are made about future earnings of the company and the level of investor interest. In addition to assisting with the complexity of the exercise, the hiring of advisors gives the selling government a line of defense in the face of subsequent criticism of the sales process. It is not uncommon to build into sales processes an obligation on the part of the newly privatized company to reimburse the government a portion of any unanticipated profits that accrue from the sale of surplus property. This “clawback” of gains is used to protect the government (and hence, the taxpayers) against under-valuation of assets.

The standard way of organizing a large privatization is to appoint an investment bank as advisor and organizer of the sale. Most countries in the world have handled their public offerings in this way; in fact there are few precedents without the involvement of a investment bank. However, over the last few years there is an increasing trend for the Big Six accountancy firms to challenge banks on their territory by undertaking lead financial advisory roles in addition to their traditional accounting and consulting work. This is especially the case with smaller-scale transactions. Also accounting firms have developed sector specializations—for example Coopers & Lybrand has a well-developed franchise in telecommunications and Price Waterhouse expertise in water systems and toll road projects—and are understood to charge lower fees than investment banks. Specialized consulting firms should also be considered; for example Fieldstone Private Capital in the power sector and Babcock & Brown and Infrastructure Management Group more generally in infrastructure privatization.

The best way to decide on the type of advisor for a transaction is to issue a tender inviting investment banks, accounting and consulting firms to provide indicative quotations for a range of tasks. If properly designed, this approach not only gives an indication of the market place rate for this type of work, but also provides many “free” ideas on how to organize a sale. Submission of written proposals should be followed by interviews with shortlisted candidates. The government will need to find advisors with a track record and a sensitivity to the particular requirements of the transaction.

In any size or type of transaction, it would be foolish to proceed from first base without legal advice. Again an open competition should be held. One way to keep control of costs—which applies also to financial advisors—is to set a cap on fees and expenses for each month. The advisor will need authorization from the client to exceed agreed limits.

Assigning the full responsibility for a privatization to a financial advisor has the important advantage that the government can expect the work to be handled by experienced professionals; and barring disasters there is little risk of a failure of a “bundled” sale. In any event, the government can deflect blame for any failure on the advisor.

One alternative which has been used successfully in the Baltic States is for the government to assume full responsibility for the sale and to appoint a full-time project manager—from among several candidates—who would recruit a small team of advisors. This approach should save the government significant fees and ensure some transfer of know-how and skills which can be available for future sales (assuming that a number of enterprises are planned for divestiture). However, it does mean that the government assumes responsibility for the downside.

III. RESTRUCTURING GOVERNMENT ENTERPRISES FOR PRIVATIZATION

The first steps a government needs to take will be as follows:

- to set its objectives for the sale;
- to consider the need for legislation;
- to decide whether the business should be reorganized to create a viable unit or to raise performance standards by introducing competition into the industry.

In the early stages of a national privatization program, viable government enterprises in competitive sectors of industry are routinely transferred to the private sector in their existing form. In other cases, a break-up proves necessary in order to achieve a successful sale or the promotion of competition. To take examples from the U.K. program:

- In 1982, the exploration and production assets of the state-owned oil company British National Oil Corporation were separated out and sold in the Britoil flotation.
- In 1984, the telecommunications functions of the former General Post Office were separated out and sold as British Telecom.
- The oil assets of British Gas were separated out and sold in 1984 as Enterprise Oil and Wytch Farm.
- National Bus was split into over 60 separate businesses, prior to a program of sales in 1986–88, in order to stimulate competition among bus operators in a largely deregulated environment.
- The electricity industry in England and Wales was restructured to encourage greater competition in the generation and supply of electricity following privatization in 1990. Three generating companies were created. Two of them—National Power and PowerGen—and 12 electricity distribution companies were transferred to the private sector. The bulk of the third—the nuclear industry—is to be sold in July 1996.
- In the current privatization of British Rail, track and train operations are being separated. Operation of passenger transport services is being transferred over time to the private sector through competitive franchising. Private-sector operators will be able to introduce new services for both passenger and freight through open access. Railtrack—the rail infrastructure company—was sold in May 1996.

The wider competition which may follow restructuring can have a significant impact on an industry's efficiency. Regulation and the greater competition in the generation and supply of electricity following the U.K. privatization have reduced household electricity prices by seven percent in real terms and industrial prices by ten percent in the last two years. Some businesses have seen even larger reductions.

IV. PROVIDING A PERFORMANCE RECORD

Once the organizational structure has been settled, the next priority is to ensure that the enterprise to be privatized has an appropriate trading record and a suitable balance sheet before it is offered to investors. The business must be seen as a credible entity with correct positioning in the marketplace and the financial structure to enable it to achieve its goals. This is particularly important in the case of a public share offering.

The government therefore needs to consider:

- **Strengthening the Management Team.** The existing management may well need to be complemented by the infusion of private-sector skills, especially at senior management level.
- **Introducing New Working Practices.** The previous noncommercial corporate culture may not have focused on maximizing the workforce's productivity and may, in fact, have resisted the substitution of new equipment for labor or making use of best-practices from the private sector. This should be remedied.
- **Turning a Loss-making Enterprise into a Profitable One.** Expert advice on an appropriate capital structure is an essential part of this process. The enterprise to be privatized must be left with sufficient capital to meet its business requirements but not over-capitalized as this might lead to poor investment decisions and reduce government proceeds.
- **Articulating a Clear Business Purpose.** Because of the often conflicting mix of social, political, and business objectives previously imposed on a government enterprise, its identity as a business venture might not be readily apparent to potential investors.

Accounting adjustments and improvements in the quality of information-gathering and reporting may be needed. These might include changing the accounting convention under which the business reports, reassessing asset values or altering capitalization policies.

Informed decisions on preparing a business for sale can contribute significantly to its saleability and subsequent performance in the private sector.

V. REGULATION

In the case of some privatized industries, especially utilities and other enterprises (e.g. airports or toll roads and bridges) which may have some monopoly characteristics, some form of independent regulation will be needed until a fully competitive market has developed or to achieve the benefits of competition. The government will need to address this need at an early stage in the sale preparations.

The desire to distance the privatized utility industries from political control, to provide market credibility, and to separate ownership and regulatory functions has often led to the development of regulators who undertake their responsibilities independently of government. In Britain, since the utilities were privatized at different times and have distinctive regulatory requirements, a separate regulatory office has been established for each industry—telecoms, gas, water and power.

In the U.K. model each office is headed by a regulator appointed for a fixed term, normally five years. There is also a separate body with regulatory duties in relation to airports and air traffic control. Broadly the aim of a regulatory regime is to put in place a framework of regulation which is explicit and transparent in nature and which operates

through incentives on managers of the business rather than through the complex administrative arrangements which has characterized control under government ownership.

Where competition cannot be introduced or will take some time to develop, the regulator's role is to protect consumers from abuses of monopoly power. This requires controls on both the price and the quality of output. In addition, regulators are generally responsible for promoting competition and, in certain cases, social and national objectives—such as the provision of an emergency (police, fire and ambulance) telephone service.

The U.K. regulators control relevant prices through a price-cap regime. This operates by fixing the rate at which the regulated industry is permitted to raise the prices of certain of its products or services for a pre-determined period of time. (Other prices may be outside the regulator's scope because the services are already subject to full competition—e.g. cellular phone services or airport-terminal concessions). The starting point for allowable price increases is usually the retail price index (the RPI), a generally available and widely recognised index which is beyond the influence of the companies being regulated. When fixing the price cap the regulator looks ahead and makes an estimate of the efficiency gains the business is expected to be able to achieve over the coming period (the so-called “X” factor). This forecast is generally subtracted from the RPI to produce the individual utility's price cap formula. Account may be taken of major capital investment programs when calculating the price cap.

The main advantage of this approach—in contrast to traditional U.S.-type public utility regulation—is the efficiency incentive for the industry concerned. With no specific controls over profits, the industry has every incentive to reduce costs as far as possible. If it achieves efficiency gains which exceed “X”, it retains the benefits of its efforts during the time period in which the cap remains in force.

In a lecture to the Centre for the Study of Regulated Industries on January 10, 1986, Michael Jack, Financial Secretary to the U.K. Treasury, reflected that in the United States there are currently widespread moves to strengthen the incentives of regulatory arrangements. “US regulators are discovering that weak cost control incentives lead to overcapitalization and their response to these problems has been to bolster the incentive properties of their arrangements,” he said.¹

VI. PRIVATIZED COMPANY'S RELATIONSHIP WITH GOVERNMENT

Governments have tended to seek a clean break with each privatized enterprise at the point of sale so that its management and employees are free to pursue the best commercial strategy for the business, subject to free-market pressures or, where appropriate, independent regulation. Nevertheless, for various policy reasons, in certain cases there may be some degree of continued government involvement.

A. Golden Share

Governments may wish to consider whether a special (or “golden”) share would be appropriate in certain limited circumstances where there is a clear need to protect a newly privatized business from unwelcome take-over on national security grounds or, as a temporary measure, to provide an opportunity for management to adjust to the private sector. The special share requires that certain provisions in the Articles of Incorporation of a company may not be changed without the specific consent of the special shareholder. The details of those provisions vary according to the circumstances of each company, but they typically include a prohibition on any one person, or group of persons acting in concert, from controlling more than say 15 percent of the equity of a company. If a government welcomes overseas investment, this limit need not make a distinction between overseas and domestic

¹ Michael Jack MP, *Utility Regulation—A Political Perspective* (London: Chartered Institute of Public Finance and Accountancy, 1996), pp. 5–6.

investors. In the case of defense-related industries, it is common to place a (higher) limit on the proportion of the company that may be held by overseas investors. In the U.K. this ruling has applied to Rolls Royce and British Aerospace.

The presence of a special share is a useful tool but is not intended to be a government straitjacket on the management. The management, and not the government, are generally responsible for ensuring that the special share's provisions are observed. In order to develop a free market in shares, special shares should be, as far as possible, time limited. For example, in Britain special shares in 10 water companies and 12 electricity distribution companies expired five years to the day after privatization. Also the provisions attached to a special share may be amended or waived where the government deems the circumstances to warrant it.

B. Residual Shareholding

Since the purpose of privatization is to remove the government from ownership of the enterprise, it may seem strange to talk about residual government shareholding. But in some cases, especially where there are major uncertainties about the probable market value of the business, U.K. and other governments have sold their ownership interest in several tranches over a period of years. If the initial, say, 40 percent stake is priced conservatively, the price of subsequent tranches sold over the next several years may be higher (as the firm establishes a track record of good performance). Hence, the government (i.e., the taxpayers) will realize a higher value from sale of the subsequent tranches than if 100 percent of the shares had been sold at the initial price. In such cases where government sells less than 100 percent of an enterprise initially, it generally undertakes not to exercise voting rights attached to its residual shareholding.

VII. ORGANIZING SALE PROCESSES

Once the enterprise has been prepared for privatization, any needed regulatory and other control issues have been addressed, and any required legislation passed, the usual practice is for advisors to manage the sale process on the government's behalf. The main options are a trade sale, where the company is sold to a single firm or a consortium (including the option of a management/employee buyout); a public offering on the stock exchange; or a placement with a group of investors.

A. Trade Sale

1. Sale to Trade Purchasers

Sales of smaller government enterprises tend to be targeted at trade purchasers. When a trade sale is used, competitive bidding is by far the most desirable method of sale. Although "marketplace" auctions on the floor of the stock exchange have taken place in countries such as Portugal and Brazil, far more common is a properly organized tender where participants submit bids in sealed envelopes. In addition to price, the auction needs to take into account factors such as capital investment to which the bidder is willing to commit, and guarantees the bidder makes to employees and customers. Some examples follow:

- When Ameritech and Deutsche Telekom purchased a 30 percent stake in the Hungarian state telecommunications company MATAV in 1994, they committed themselves in the concession agreement to a mandatory 15 percent annual increase in the number of new lines installed.
- Portugal's state-controlled Banco Fomento & Exterior (BEF) is to be privatized via a competitive bid for a controlling stake. The winner will have to retain a 51 percent stake for five years. Key assets are to be protected for a similar period. The selection process takes into account factors such as the financial strength and size of the bidder, in addition to the price offered.

- PTT Telecom Netherlands and Swiss Telecom were selected in 1995 as the strategic investor in the Czech telecoms utility SPT Telecom by several factors including price, the estimated value of services which the investor would contribute to SPT, offered time schedules and the technological means that the investor will be able to use to modernize Czech telephone lines.
- Interested buyers for the Italian dairy company Centrale del Latte di Ancona in 1995 needed to provide employment guarantees, ensure that the dairy remain in the city, and undertake to maintain product quality.

As these examples make clear, the total amount offered by the prospective purchaser is an important factor in the auction. But, especially in the case of utility-type enterprises, there is an obvious trade-off for the government between: 1) obtaining the maximum amount of sales proceeds, and 2) ensuring that charges to the utility's customers remain at affordable levels. The higher the purchase price (and hence sales proceeds), the higher the customer charges must be, in order that those financing the purchase can realize a competitive return on their investment. Yet another factor, in cases where the government has failed to properly maintain the infrastructure and significant new investment in facilities will be required by the purchaser, is the amount the buyer is prepared to invest in modernization, versus the amount it will spend to obtain ownership of the existing (run-down) facilities.

For these reasons, governments frequently develop a number of selection criteria, rather than simply awarding the bid to the company offering the highest price for the enterprise. In Australia, the Victoria government included the following as selection criteria for shortlisting bidders for the Yallourn Energy power station:

- Indicative bids (i.e., dollar amounts offered)
- Strengths and capabilities of prospective power station operators
- Financial strength and credentials of bidders
- Any special conditions or assumptions attached to the bids.

In selling SPT Telecom, the Czech government stated that the offered price would be an important but not decisive factor in the selection of a [strategic-investor] partner. The overall merit of individual offers in ensuring the company's future development was to be the principal criterion.

Where prospective "rate shock" is a major concern (e.g., in cases where utilities have, for political reasons, held prices far below market levels for many years), it may be advisable to spell out in advance the extent to which rate increases will be permitted over a transition period (e.g., of five to ten years). Prospective purchasers can then be evaluated on the basis of how much they will pay for the enterprise (and possibly on their commitment to a schedule of needed modernization) given the known constraint on future pricing.

A negotiated sale is another possibility. Financial advisors may advise this course when an offer from one particular bidder or set of bidders is unlikely to be equalled in open competition; hence the expense and time of the competitive process can be avoided. Alternatively, a government may opt for a negotiated sale after a failed bidding process, offering in turn bidders a right to submit a buy offer at a reduced price. For instance, this happened when the Philippine government sought to privatize a stake in the National Steel Corporation in 1994. Occasionally a public offer is combined with the negotiated sale of a tranche to a strategic investor. Negotiated sales are also used in countries where transparent processes are not the order of the day, a process sometimes termed "crony capitalism." To avoid concerns about favoritism and the like, there need to be very persuasive arguments in play for a government to opt for a negotiated sale rather than a competitive selection process.

Compared to a public offering, a trade sale is generally regarded as a quicker option to execute. It is appropriate if the enterprise to be sold is perceived to need the benefit of an alliance that brings with it skills and know-how. The Victoria government in Australia chose to sell its five electricity distribution businesses by trade sale. This probably reflected a preference for a rapid introduction of outside expertise into the electricity sector and also their view that businesses such as power supply are not well understood by Australian markets, and thus a better price was likely to be obtained through trade sales.

By contrast, public offerings make more sense when the company to be sold has a reasonably strong skill base, and capital markets are liquid. To take another example from Australia, a public offering for the large telecommunications company, Telstra, may well be more suitable for that industry than sale to an existing operator, due to the level of expertise already in place at the company and the gradual emergence of competitors.

In the United Kingdom trade sales have generally only been used with smaller industries or enterprises. There has been concern among British voters about a state enterprise being sold to a commercial company, especially if this is a foreign-owned company. An attempt in the mid-1980s to sell Britain's loss-making state car factories to the U.S. firm General Motors collapsed in the face of intense public opposition. In the end, the company was sold to a privatized U.K. company in a deal which included guarantees about future production and special financial incentives for the workforce. In France, the vast majority of privatizations have been conducted through initial public offerings. However, there have been some exceptions. For example, there were four trade sales among the 29 companies sold between 1986 and 1988:

- Compagnie Generale de Constructions Telephoniques (CGCT) was sold to the Swedish company Ericsson who outbid AT & T and Siemens. The trade sale method was chosen because CGCT was deemed too small to compete on its own against domestic and international competition.
- Banque Industrielle et Mobiliere Privee, which operated much like a private Swiss bank, was not regarded as a suitable candidate for a well-publicized public offer and a majority of the company's shares were sold to a group of institutional investors.
- For the TV channel TF1, an operating group that would have management rights was first chosen. The general building company Bouygues purchased majority interest in TF1 at a 30 percent premium price compared with the public offering price.
- Instit de Developpement Industrial, a financial holding company specializing in venture capital, was privatized through a leveraged management buy-out.

In a trade sale or management buyout, the government's financial advisor will conduct negotiations on the basis of an information memorandum, a long form report prepared by reporting accountants, and sale agreements prepared by the government's lawyers.

2. *Management/Employee Buyout (MEBO)*

Many governments encourage management and/or employee buyouts, consistent with the policy of promoting employee-share ownership, and to increase competition for a sale. For smaller companies, particularly those which are highly dependent on their personnel, management/employee buy-outs are suitable privatization techniques. A large number of companies have been sold in this way, but because they are all fairly small enterprises, they tend to attract little public attention. Although most buy-outs are led by management, active participation by the workforce is a prerequisite of success. When considering a request from a government enterprise to privatize itself in this way, a government would be well advised to ensure that the workforce are brought along, are contributing some of their own money towards the enterprise, and face positive incentives to make their investment succeed.

During 1994, most of London's bus service was reorganized into companies which were purchased by their managers and employees. Belfast International Airport in Northern Ireland was sold, via a competitive auction, to a MEBO backed by the Bank of Scotland and fund manager Mercury Asset Management (with the MEBO holding about half the equity). Coal Products, one of British Coal's noncore subsidiaries, was sold to a MEBO in February 1995. And in April 1996 the U.S. Office of Personnel Management announced the impending purchase of its background-investigation functions; a MEBO called U.S. Investigations Service, Inc. will purchase the business, with financing from Marine Midland Bank.

3. Trade Sale Combined with Public Offering

Another form of privatization is the sale of a major stake to a strategic investor followed by a share offering at a later date. This is certainly appropriate when—before the public share offering—the company is perceived to need technological expertise to be provided by a major player in the market in return for management control. A strategic partner will help to boost the company's profitability as well as its attractiveness for public offering. A share offering to domestic and international investors is intended to follow a year or so later.

In Argentina most privatizations were conducted by trade sale, but the government generally retained a portion of the shares, typically 39 percent, to be sold later in a public offering. The Australian government is planning public share offerings of airport companies following the trade sales planned for 1996–97. In 1995 BankWest in Australia followed a trade sale with a public offering.

4. Placement with a Group of Investors

One additional sale technique, which has been little used in the United Kingdom but is utilized in some other European countries, is sale via a private placement with a group of selected institutional investors—generally for public-policy reasons.

For example, in September 1995 the Italian Treasury placed 18.4 percent of the state-owned insurance group INA with a group of investors. The three biggest buyers were Italian bank groups Cariplo with four percent and IMI and San Paolo with three percent each. They each agreed not to sell for three years. This followed the pattern previously adopted in privatizing the large financial institutions IMI and San Paolo. In February 1996 the Dutch government placed 20 percent of the chemical concern DSM in this manner.

A similar approach is used by the French with their “noyau dur” or stable shareholder concept. By creating a small group of shareholders that buy up to 30 percent of the shares via private placement before a public share offering (in exchange for agreeing to restrictions on near-term sale of their shares), the “noyau dur” is designed to foster stability.

5. Bids from Government-Owned Companies

In May 1996 the government of Brazil sold a majority stake in the electric utility Light Servicos de Eletricidade to a consortium of foreign firms. One of the members of the winning consortium for Light was Electricite de France, a government-owned company. Several years ago, Spain's state-owned airline Iberia was the winning bidder in the privatization of Aerolineas Argentinas, that country's largest airline. Because many such state enterprises receive government subsidies, their bids may be viewed by private-sector bidders as a form of unfair competition. And in point of fact, selling a government-owned enterprise to another government-owned enterprise cannot legitimately be considered privatization.

Governments seeking to sell enterprises via trade sales should decide at the outset what their policy will be with regard to bids from government-owned enterprises—and spell out such policies in their initial request for qualifications from potential bidders. One policy, of course, would be to reject such bids categorically as not representing legitimate privatization. Another approach would be to require that any such bidder be able to

demonstrate that it 1) does not receive any government subsidies and 2) pays taxes to the same extent as would an investor-owned company carrying out comparable business activities. This would permit bids from fully commercialized (or corporatized) government enterprises which operate as businesses but in which their government happens to be the sole or majority shareholder while ruling out unfair competition from subsidized government enterprises.

B. Initial Public Share Offering

1. Methods of Sale

Privatization by initial public offering of shares has been the option adopted for larger government enterprises where the following conditions apply:

- there is expected to be a wide range of institutional and/or public demand;
- the forecast level of proceeds justifies the higher cost of a share offering; and
- where there is an opportunity to use a widespread public offering to promote wider share ownership.

The principal methods of sale have been a fixed-price offering of shares; a tender offering at a striking price (a recommended minimum price for shares set by the selling government); or occasionally a combination of the two. The U.K. government has pioneered the development of major retail offering structures from the privatization of British Telecom (BT) in 1984, then the biggest public offering in the world, to the 1991 sale of part of the government's residual holding in BT with its novel distribution, pricing and global tender arrangements.

Typically major flotations have comprised a fixed-price domestic offering aimed at the retail investor and an institutional offering. In some cases (BT in 1984, British Gas, water supply and electricity distribution companies), the international offering was at the fixed price available in the domestic offering. In some later sales (such as the sale of the two electricity generating companies in England and Wales and the sale of the two Scottish electricity companies), an international tender offering was used to secure additional proceeds in circumstances where trading was expected to open at a premium compared to the issue price.

The U.K. government went further in the 1991 sale of part of its residual holding in BT. In this sale there was no fixed-price offering of shares to the public or institutions. Instead the price of shares sold domestically was set at a discount to the strike price secured in an international tender offering. This was a wholly competitive tender conducted worldwide by a global coordinator. In a novel departure from previous sales, there was no underwriting, or protection for banks participating in the international offering.

The purpose of these sales arrangements was to preserve maximum responsiveness to market conditions. The use of "book-building", as this international global tender mechanism is known, has since been emulated in government sales around the world. Book-building refers to the period during which the syndicated banks register institutional investors' intents as to the quantity of shares they wish to buy at different levels of prices, without yet taking any firm orders.

2. Conduct of the Sale

An offering on the stock exchange will require a more sophisticated organizational approach than a trade sale. The government will usually take responsibility for directing strategy and taking decisions on the conduct of the sale but will also rely on its financial advisor, lead broker and global coordinator, lawyer and public relations advisor to:

- advise on the structure of the international and public offerings;

- prepare the prospectus required for the public offering and for territories in which the international offering is made, as well as a wide range of legal agreements and other documentation;
- market the offering to the public, through TV and press advertising and direct mail campaigns; and to institutions through research and road shows;
- manage the generation of demand in the international offering (book-building);
- advise on pricing and allocation of shares.

Most countries have seen considerable advantages in using a single investment bank with strong corporate finance and global distribution capabilities to perform all three roles of financial advisor, lead broker and global co-ordinator. The existence of a clear team leader for advisors simplifies the complex lines of communication that can arise in a major offering on the stock market. In 1995 there have been unsuccessful experiments with a team of global co-ordinators—two for the U.K.'s residual electricity generating company shares, four for Portugal Telecom and eight for Indonesia's PT Telkom. All suffered from the experience.

Demand from institutions in the international offering of a major share sale is a key component in maximizing the proceeds realized for the taxpayer. A successful outcome requires the appointment of firms with strong international distribution capabilities as global co-ordinator.

The usual structure for selling shares in an international offering has involved regional syndicates, led by a bank from the region concerned. In a refinement for the 1993 sale of shares in BT the U.K. government's financial and legal advisors developed a global structure in which 11 banks in the syndicate competed worldwide for demand from the 500 largest institutions. The greater competition introduced into the regional markets had the effect of generating substantially greater demand compared with previous offerings and saw more price-aggressive demand at the start of the transaction, hence boosting proceeds.

After the official selling, share prices may vary widely. One solution for stabilizing the market is for the government to make a supplementary offer of shares up to a certain maximum percentage of the initial subscription. This is known as the “greenshoe” option.

Governments often wish to give priority to serving the domestic individual investors. A “clawback” provision has been used by governments to cut down the quotas of shares allocated for international selling in order to increase the domestic offering of shares.

VIII. MAXIMIZING PARTICIPATION

Many of the issues involved in divestiture—such as the creation of the prospectus, the publication of research and the distribution of the shares—are common to both government and private-sector share offerings. However, government's objectives for privatization may require its advisors to develop new mechanisms for distributing the shares. Employee and utility customer participation are two examples of this.

A. Employees

The U.K. privatization program has sought to offer all who work in the industries and services concerned a direct stake in their future, new career opportunities and the freedom to manage their commercial affairs without interference from government. The success of restructuring in advance of privatization depends on labor relations and the cooperation of workers, both of which benefit from offering shares to employees. The U.K. government has

encouraged employee participation in both trade sales and public offerings of shares. A similarly motivated privatization program could emulate the U.K. experience by:

- Structuring long-term employee share ownership schemes in the business to be privatized. For example, BT and the gas, water and electricity industries were all privatized with such arrangements.
- Encouraging the participation of management and employee-buyout consortia in competitive trade sales and having regard to proposed employee participation in reviewing bids from trade purchasers.
- Developing incentives to encourage employees to participate in major share offerings. These incentives have included the free, matching and discount share offering in which employees may receive:
 - an offering of free shares (up to a limit);
 - an offering of free shares in proportion to shares bought by the employee;
 - a discount on the offering price of shares (up to a limit);
 - priority in allocation of shares.

These mechanisms have been very successful in encouraging employees to buy shares in the company in which they work. For example, 96 percent of eligible BT employees and 99 percent of the workforce of British Gas successfully applied for shares in U.K. public offerings. The vast majority of these applicants have continued to hold their shares in the longer term giving them a direct stake in the performance and profitability of the company concerned.

B. Utility Customers

There are two key reasons for ensuring that shares sold in a major public offering are distributed as widely as possible to private individuals:

- to maximize competitive tensions between the public and international offerings. Creating a perception of scarcity benefits the share price, maximizes proceeds and encourages a healthy market in shares after privatization;
- to increase the proportion of economic assets owned by private, rather than institutional, investors— an objective which aims to make privatized industries accountable to a wider constituency of shareholders to the benefit of the consumer.

These objectives are especially important when applied to the sale of public utilities, where customers in most cases will be faced with the prospect of price increases resulting from the transition from noncommercial to commercial management.

The following techniques have been used to promote customer share ownership:

- Giving the smallest investor priority in allocation of shares instead of following the traditional private-sector practice of scaling back to the benefit of the largest applicant;
- Making purchases more generally affordable through installment payments (typically three payments over 12–15 months), which also gives the investor a higher initial return on investment;
- Using public relations and other marketing advisors to develop a major advertising campaign to attract the small investor; and
- Offering incentives to encourage individual applications in the offering and retention of shares in the longer term.

In major initial public share offerings, shares have been available to private individuals who register their interest before the start of a public offering and who were subsequently allocated shares. These have typically included a choice of:

- **Customer Vouchers.** A voucher or vouchers of a given amount for domestic customers to set against the privatized utility company's bills.
- **Bonus Shares.** For example, one free share for every ten shares held by a successful applicant for three years; or
- **Installment Discounts.** A discount on the cost of the second and third installment payments at the time they are made.

These techniques were used in the U.K. sales of both water and electricity companies. In the case of the 10 water companies, shares were offered to individuals on an installment basis. Of the 240 pence offer price, 100 pence were due upon application, 70 pence six months later, and the remaining 70 pence 18 months later. A similar schedule was followed in the case of the 12 regional electricity companies. For both water and electricity, customers of a particular utility were also offered one free share for every 10 shares purchased at the outset and held continuously for three years (up to a maximum of 300 shares per shareholder). Water company customers were also offered a discount of 10 pence per share off the second and third installment payments, for up to 1,500 shares. And electricity customers were offered a choice between one free share for every 10 purchased and held for three years (as in the case of water customers) or electricity bill vouchers worth up to a maximum of L270 per person to apply against their electricity bills.

In the sales of its residual shareholding in BT in 1991 and 1993, the U.K. government sought to promote wider public knowledge and understanding of private sector share-dealing services by appointing eight main street banks, known as "share shops," to provide cheap and accessible buying and selling arrangements for a range of shares. This approach encourages individuals to buy shares through professional share-dealing services, thus fostering direct links between the public and the share investment industry in the longer term.

IX. CONCLUSION

This publication has examined the types of sales methods governments have used in their privatization endeavours. The size of the enterprise to be sold and development of the country's financial markets are the key determinants of whether to use a public offering or a trade sale method. The U.S. General Accounting Office in a recent report correctly summarizes the rationale for using public offerings: "Public offerings are generally used in fairly well developed financial markets and for the sale of large assets with established financial track records."² In contrary circumstances, where a trade sale is to be utilized, competitive bidding is strongly recommended.

Increasingly, privatization structures refined over the last 15 years are becoming conventional features all over the world. It is commonplace to combine large retail and institutional offerings and to ensure competition between banks and regions of the world within the international offering. The mechanisms of vouchers and bonus shares are used widely to promote customer share ownership. While public share offerings and trade sales need careful planning and transparent implementation, there are now well established techniques for arranging sales and the requisite expertise is readily available.

² *Privatization/Divestiture Practices in Other Nations* (Washington D.C.: GAO/AIMD-96-23, December 1995), p. 12.

ABOUT THE AUTHOR

Henry Gibbon is editor of *Privatisation International*, the monthly intelligence report on privatization and the private financing of infrastructure projects worldwide. He has worked on public share offerings and trade sales at the U.K. Treasury and at the investment bank Kleinwort Benson.