

2. First phase—getting ready

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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.

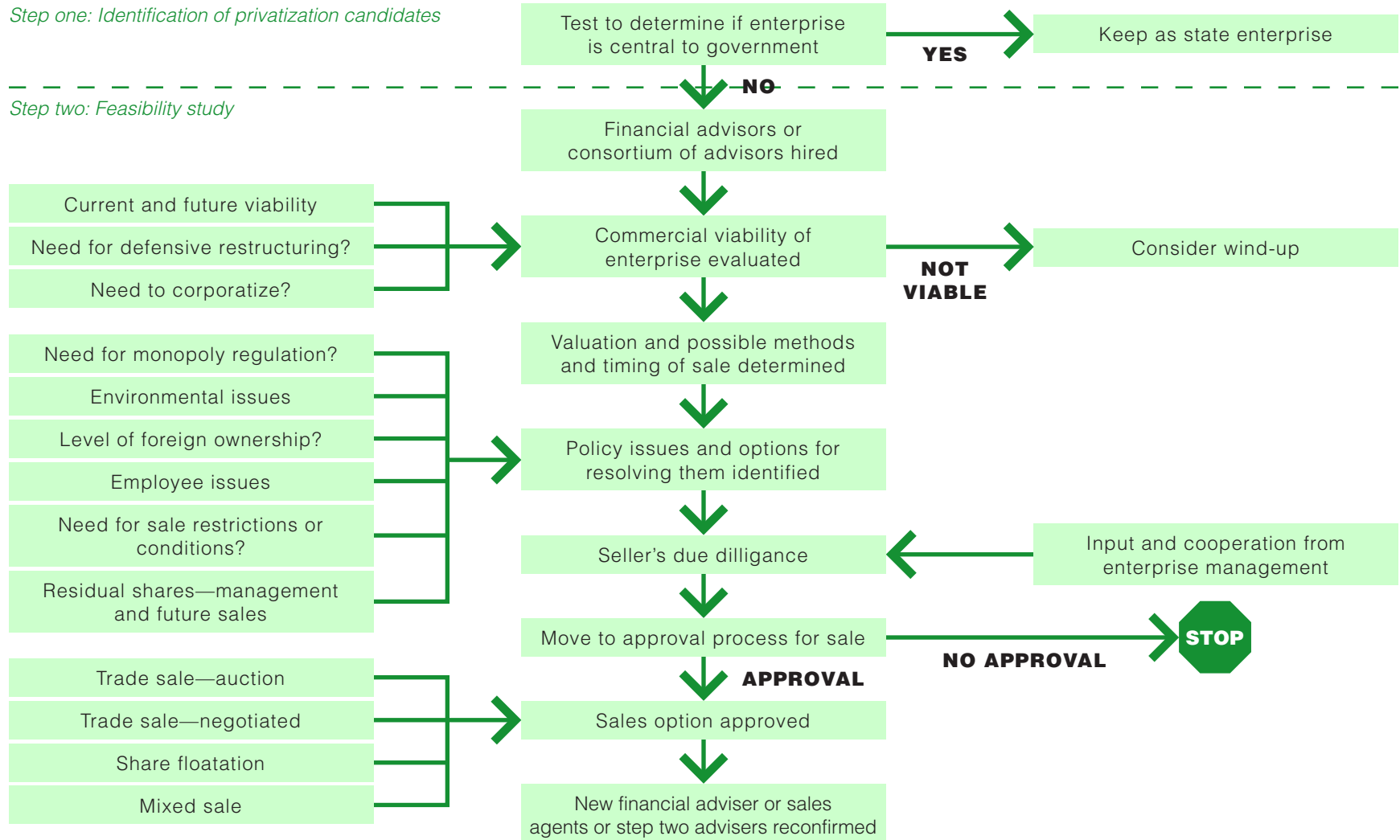
Second phase Moving to sale—steps three, four, and five

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

Step four: 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 enterprises 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 government 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), indemnifying 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 environmental 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 advisory 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.