

## 4. Sales methods and special concerns

Public offerings	<b>24</b>
Secondary offerings	<b>28</b>
Trade (third-party) sales	<b>28</b>
Conditions attached to privatizations	<b>35</b>
Role of foreign investors	<b>35</b>
Privatizing natural monopolies	<b>38</b>

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

### Public offerings

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

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

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

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

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

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

The success of a share issue and the share prices obtained partly depend on the size of the share offer and on market capitalization in the countries where the issue is sold. Capital market imperfections, low market capitalization, and factors such as political risk can depress asset values below

the level indicated by standard valuation techniques. Measures to broaden share ownership—including targeting groups of investors, selling in both domestic and foreign markets, and offering shares in small denominations (so that more people can afford them)—can increase market capitalization, and thus ensure adequate prices for share offers. Governments should also consider whether they want their public share flotations to be under-written—that is, whether to have the sales agents assume the risk of sale. Underwritten sales are more expensive but are less risky for government.

### Financial advisers and sales agents

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

### Increase in capital

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

### Steps in a public offering

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

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

**Box 4 Privatizing British Telecom and British Gas**

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

*British Telecom*

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

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

The \$4.8 billion share flotation, offered domestically and abroad, was nearly nine times oversubscribed. Up to 10 percent of the offered shares (301 million) were reserved for British Telecom employees and pensioners. The government allowed 2,000 U.K. institutional investors to apply for 2.6 billion shares on a priority basis together with the general public. The remaining 415 million shares were allocated to buyers in Canada, Japan, and the United States. All told, 47 percent of the shares went to U.K. and Swiss institutional investors, 14 percent to Canadian, Japanese, and U.S. investors, 5 percent to British Telecom employees and pensioners, and the balance to

just over 2 million U.K. investors. The issue created 2.2 million new shareholders in the United Kingdom. Before privatization, British Telecom had 250,000 customers waiting to have a telephone installed. Now it installs lines within two days. The government continues to regulate British Telecom and holds a special rights preference share (golden share) in the company.

*British Gas*

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

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

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

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

---

continued...

**Box 4 Privatizing British Telecom and British Gas  
(continued)**

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

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

---

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

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

**Prospectus, share instrument, and timing**

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

**Management and employee participation**

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

**Residual shareholdings**

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

### Pricing and distribution

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

### Secondary offerings

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

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

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

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

### Trade (third-party) sales

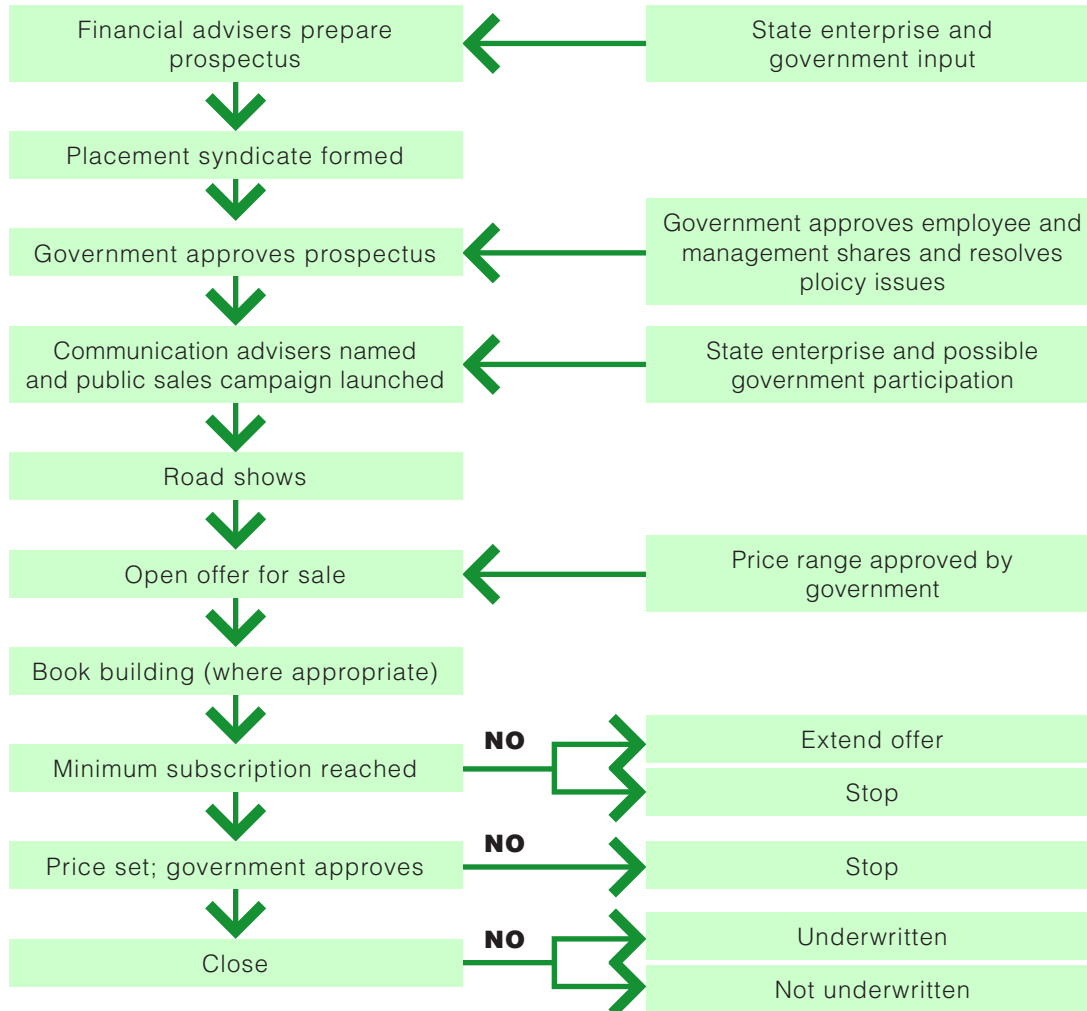
There are two types of trade sales for privatizations: auctions (open bidding) and negotiated sales (figure 4).

#### Auctions or open bidding

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

Figure 3 Case-by-case process—market flotations

*Initial public offerings*

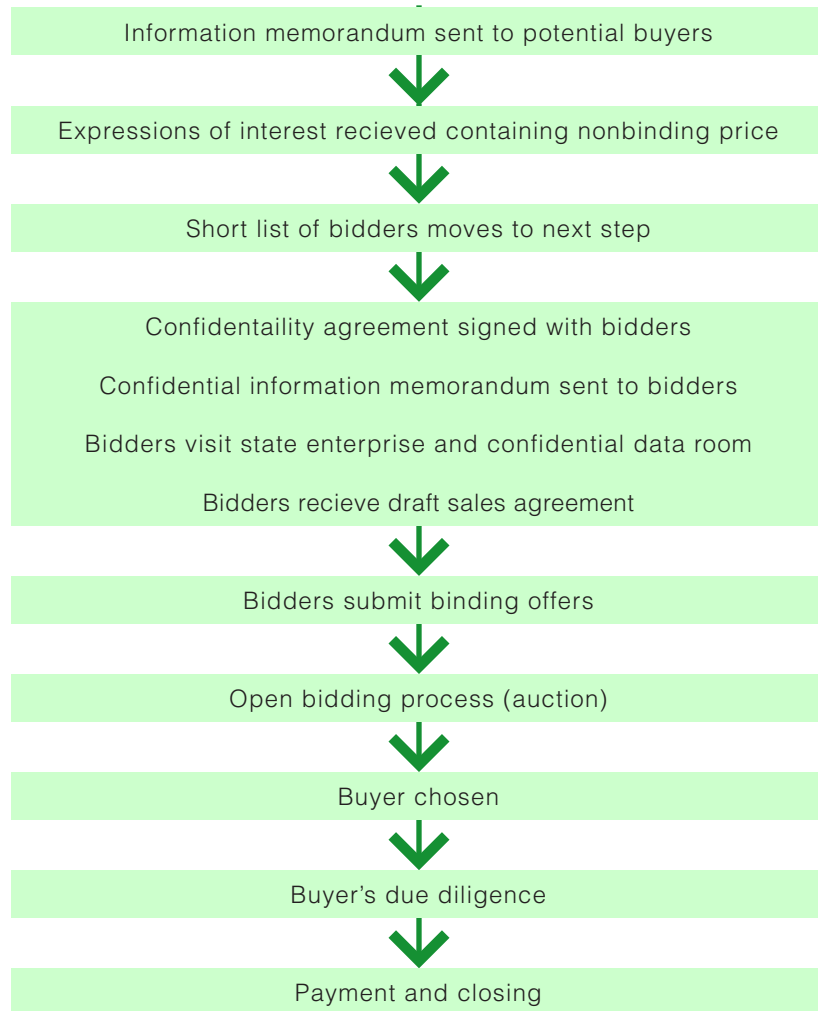


*Secondary offerings*



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

*Auctions*



*Negotiated sales*



**Box 5 A public offering for Argentina's oil company**

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

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

The sale was preceded by a valuation and marketing of YPF's assets. Independent consultants, whose decisions were binding on the bidders, carried out the valuations. The initial \$19 a share public offering price was

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

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

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

---

continued...

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

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

---

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

---

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

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

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

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

satisfactory, a weighted average of the technical and financial bids of all retained bidders is calculated to determine the winning bid.

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

### Negotiated sales

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

### Mixed sales—trade sales combined with share offerings

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

Trade sales are usually used when an enterprise is sold to a strategic investor bringing capital, know-how, and market connections to the privatized firm. Depending on the objectives

of the government and the requirements of potential investors, the level of control offered for sale may range from a supermajority (66 percent of voting rights), to an absolute majority (51 percent of voting rights), to a relative majority (the strategic investor becomes principal shareholder with, say, 35 percent of shares).

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

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

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

**Box 6 Selling the Skoda Automobile Company to a strategic buyer**

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

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

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

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

---

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

---

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

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

### **Conditions attached to privatizations**

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

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

### **Role of foreign investors**

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

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

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

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

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

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

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

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

---

continued...

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

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

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

---

*Source: World Bank Staff.*

---

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

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

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

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

---

*Source: Privatisation International, various issues.*

---

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

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

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

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

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

### **Privatizing natural monopolies**

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

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