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ENGLISH

FINANCING OF MANUFACTURING COMPANIES IN A STATE SHAREHOLDING SYSTEM 1/

by

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CONTENTS

[illegible]

1. [illegible]

Industry [illegible] policies [illegible] attribute [illegible] governments' [illegible] the [illegible] objective [illegible] has [illegible] reasons [illegible] utilities [illegible] the result [illegible] and the "private [illegible] opposite [illegible] the two.

In [illegible] the control of [illegible] stimulating [illegible] initiative [illegible]. This is [illegible] public [illegible] to which [illegible] market they are [illegible].

This [illegible] for finance [illegible] discrimination [illegible].

It is [illegible] in the [illegible] controlled by IRI [illegible] only that IRI [illegible] manufacturing [illegible] competitive [illegible] represents one of the principal instruments of Italian government policy [illegible] the development [illegible] most backward [illegible] the country, the [illegible] [illegible]. This area exhibits an underdevelopment [illegible] certainly the largest in [illegible] Western Europe; it may [illegible] inhabitants, whose [illegible] of the remaining 32 million [illegible] country.

[illegible] THE ITALIAN [illegible]

[illegible] "State [illegible]" in industry arises [illegible] system. Each [illegible] and regulated by [illegible] of private manufacturing [illegible]. The State [illegible] are at the same [illegible] by a public law [illegible] sector, IRI, ENI [illegible] twofold functions: (a) [illegible] control over [illegible] of subsidiary companies [illegible] public policy.*

[illegible] concept which aims at safeguarding [illegible] capacity of public [illegible] for pursuing public [illegible] considered indispensable [illegible] important [illegible] State Share- [illegible] must ensure:

[illegible] from the operation of [illegible];

b) [illegible] firm itself by the management agency [illegible] part of the share capital;

c) [illegible] acceptable to a company, i.e. which

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* The [illegible] agency–company link can in practice be indirect, by way [illegible] companies (these are also constituted [illegible] the head of sub-groups of [illegible] industrial sectors. This arrangement does not [illegible] pattern described in the text.

market prices cannot cover, but which the firms controlled by the agency incur because they are instrumental in pursuing objectives of general interest.

For the coverage of requirements as in a) above it is obviously possible and normal for there to be direct access to the capital market. This takes place both directly by the firms themselves and by the management agency which contributes to the financing of companies it controls by filling up the gap between requirements and what the companies can obtain from the market on the strength of their own creditworthiness.

Clearly, however, the activities of the industrial groups under the management agencies could not be expanded indefinitely solely on the basis of the capital provided by the market without impairing the condition under b) above. Furthermore, by definition, requirement c) cannot be financed by the market.

To satisfy this body of demands on it, the management agency is provided by law with an endowment fund passed to it by the Treasury. The existence of the management agency's endowment fund is the precondition for the raising of capital on the market both by the agency itself and ultimately by the companies under its control. Indeed the creditworthiness of the subsidiary companies is itself founded on the companies' own capital, in the formation of which the management agency has participated directly or indirectly[3]. At the same time, the endowment fund - which plays a role in the financial management of the agencies analogous to that of the share capital for a joint stock company - constitutes a resource which is permanently at the disposal of each management agency and, moreover, by its nature, does not entail <u>obligatory</u> remuneration, even though such remuneration remains a constant objective of the agencies' action.

It can therefore be concluded that the non-remuneration of the fund (or its remuneration at a rate lower than the market rate) constitutes the resource on which the agencies can draw for covering the extra costs referred to in c) above; these costs, being such as to be unacceptable to companies

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[3] In those cases where a sectoral holding company stands between the operating company and the management agency... (See footnote 2, page 2)

operating in a competitive environment are currently shifted through the management agencies on to the Treasury.

In order to illustrate the functioning of the mechanism outlined above, reference will be made to the actual experience of two of the largest groups of public manufacturing companies in Italy. The two groups are headed respectively by the sectoral holdings Finmeccanica and Finsider, both controlled by management agency IRI. The analysis will cover the period [illegible]-1967 and will be preceded by a brief outline of the two groups and their main activities in the period under consideration.

3. THE STATE SHAREHOLDING MANUFACTURING GROUPS FINSIDER AND FINMECCANICA

Finsider, one of the five sectoral holding companies in the IRI group, embraces a group of companies which, for the size and modernity of their plant, are the main strength of Italy's steel industry. In 196[illegible] the Finsider companies produced about 7.[illegible] million tons of pig iron (almost [illegible]% of the national total), 10.1 million tons of crude steel (5[illegible]%) and [illegible] million tons of finished products (48%). The presence of public enterprise in the steel sector can be attributed to two main reasons. On the one hand the need for developing ore-based steel making, neglected by private enterprise because of the scale of capital and risk involved compared to scrap-based production. Already before the war IRI considered the ore-based process indispensable - and this judgement was to be confirmed by post-war events - for a balanced long-term growth of the Italian steel industry parallel with a vigorous expansion in demand. On the other hand the steel sector was among those which offered concrete possibilities for locating in the underdeveloped Mezzogiorno area an important share of the new production capacity required.

The whole of Italian ore-based steel output is concentrated in the Finsider group. Most recent expansion - in the face of a growth in domestic fuel consumption of up to 17.[illegible] million tons in 1968 - has entailed, besides the extension of the three previously existing centres in the Centre-North (Liguria and Tuscany) and South (Campania), the creation of a new major centre in the South (Taranto, in the Apulia region). The latter centre in the Mezzogiorno is one of the largest and most modern steel plants in Europe (the current production capacity is about 3 million tons) and has raised - together with the concomitant expansion of the other southern steel plant of the Finsider group [illegible] to 28.5[illegible] in [illegible]. There was [illegible] important growth [illegible] this period in collateral products [illegible] over the last four years, [illegible] were in the South of Italy).

At the end of [illegible] number of more than 7[illegible] [illegible] L.it 860,[illegible] million [illegible].

Finmeccanica, [illegible] under IRI control, including [illegible] at the end of [illegible] force [illegible] companies [illegible] 30[illegible] was from export sales. [illegible] of the Finmeccanica group [illegible]:

- Alfa Romeo, operating in the motor vehicle manufacturing [illegible] ($200 million [illegible])
- ASGEN and Ansaldo [illegible] respectively operating [illegible] electrical [illegible] engineering) and industrial [illegible]
- Selenia [illegible] (miscellaneous engineering).

The remaining Finmeccanica subsidiaries [illegible] machinery and equipment [illegible].

The presence of public enterprise in I[illegible] its origin, to no small extent, in the problem of [illegible] strengthening industrial complexes [illegible] either the great crisis of [illegible] war, [illegible] considered potentially important for [illegible]. In this case too it appeared important to grasp every opportunity for extending such activities to the Mezzogiorno.

The Finmeccanica group has committed itself in two main directions over the years. One objective has been that of rationalization involving a number of companies, often relatively small in size and for the most part with activities broken down among many production lines. Here the problem is that [illegible] firms fully capable [illegible] competitive market [illegible] ventures [illegible]

[illegible]

[illegible] rationalization [illegible]

[illegible] restraints [illegible]

[illegible] system, [illegible]

[illegible]

[illegible] the [illegible]

[illegible] four- [illegible] about [illegible] In the [illegible]

[illegible] total [illegible] million [illegible] million.

[illegible] for [illegible] million [illegible] million) made up of depreciation allowances. These [illegible] little more than 20% of [illegible] requirements. [illegible] to be [illegible] the [illegible] are [illegible] taken [illegible] steel [illegible] however, [illegible] Company [illegible] domestic [illegible] profit [illegible]

[illegible] (1967), [illegible]. The figure [illegible] by the company [illegible] made by [illegible] extent of [illegible] the company [illegible].

[illegible] examined, [illegible] are [illegible] the [illegible] the [illegible] viewed [illegible] in [illegible] with [illegible]

[illegible] to gain [illegible] in the Finance [illegible] million, [illegible]

[illegible] term operations. [illegible]

1/ The total flow of [illegible] share issues fell from [illegible] million in 1967.

easy and cheap terms because of the high degree of liquidity in the banking system, partly due to short-term business conditions and partly because of the depression of the equity market.

Going [illegible] that the capital requirements [illegible] four year period 1964-67 to more than lit. 132,000 million [illegible] as [illegible] lit. 81,[illegible] million referred [illegible].

The [illegible] circumstances, both outside and inside the [illegible] hand, [illegible] business conditions [illegible] during the four years under review [illegible] investment in the two years [illegible] which, however, still in 1967, [illegible] machinery [illegible] greater part of the Finmeccanica [illegible] suffer the effects of the economic recession [illegible] of [illegible] demand. The [illegible] expansion of investment [illegible] phase of recovery, [illegible]. Only the motor car industry, [illegible] than [illegible], [illegible] vigorous growth in demand in the following years.

On the other hand, within the Finmeccanica [illegible] investment programme was in the motor car sector, [illegible] the construction [illegible] plant on the outskirts [illegible] of the previous production [illegible] four years of about Lit. 70,000 million [illegible]. [illegible], Finmeccanica was chiefly engaged in [illegible] complex [illegible] concentration and [illegible] electrical engineering, heavy [illegible] rolling stock ordnance. [illegible] European Common Market, [illegible] and in

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5/ A survey covering [illegible] Italian [illegible] on the Stock Exchange shows [illegible] years 1964-67 [illegible] 35-40% of their capital requirements from the banks. It [illegible] already during 1965 the Finmeccanica group's short-term [illegible] about Lit. 55,000 million, bringing the [illegible] from [illegible] of total indebtedness.

part by the economic recession which was mentioned earlier.

As is shown by Table [illegible], self-financing in the period under review provided [illegible] Lit. [illegible],000 million [illegible] to [illegible]% of [illegible] financial requirements of the companies [illegible]. [illegible] the [illegible] between [illegible] the combined depreciation allowances [illegible] during the period and [illegible] the operating lo[illegible] of [illegible] in the Group. It should be added that [illegible] over the four years to Lit. [illegible] million, [illegible] 0. [illegible]; then there were undistributed profits [illegible] retirement funds and other provisions [illegible] for [illegible] Lit. 17,000 million. [illegible] against [illegible] total of Lit. 44,000 million, [illegible] to the figure of Lit. [illegible]9,000 million, [illegible].

[illegible] viewed in the context of the unfavourable [illegible] conditions [illegible]. This had the effect of eroding [illegible] still positive operating result [illegible] companies in the Group[2], [illegible] reorganisation underway in other companies.

It should [illegible] were concentrated in a limited number of firms, [illegible] suffered by five companies [illegible]. However, apart from [illegible] political nature [illegible] also affect [illegible] firms, given [illegible] Italian engineering industry is [illegible] several years.

IRI's [illegible] to which, though [illegible], [illegible] for passed on [illegible] Treasury. [illegible] indeed incurred [illegible] entrepreneurial responsibility [illegible] political [illegible].

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2 [illegible] in 1967 made a profit, [illegible] of [illegible], owing to [illegible] difficulties [illegible] of [illegible] firm was created in 1966.

The consequences of this situation can be easily seen from the figures of Table 1, showing the group's recourse to external sources of finance. In the period considered the market's contribution, equal to almost Lit. 64,000 million, was proportionally much smaller than in the case of Finsider (43% of requirements against 31%). The [illegible] amount included a very marginal injection of risk capital by private minority shareholders, since these are virtually absent in the case of Finmeccanica companies. The sum of Lit. 2,100 million indicated in Table 1 actually refers to a number of new joint ventures started in the engineering sector with an equal shareholding by Finmeccanica and private groups, both Italian and foreign, who already possess well-proven technical and commercial experience in the fields in which they operate and can therefore contribute to a more rapid success of such new ventures.

IRI was therefore called on to make a relatively large contribution through its subscription to capital increases amounting to more than Lit. 30,000 million, making about 23% of requirements. At least in part, these funds went to cover the above mentioned losses by the subscription afresh of the share capital of certain companies, after its having been written down.

An overall picture of the asset, liability and capital situation of the two groups examined is given in Tables 2 and 3. These tables show the consolidated balance sheet figures as at the end of 1963 and 1967 for Finsider and Finmeccanica respectively [7].

Examination of the two balance sheets suggests some interesting points. On the assets side for the Finsider group a preponderant place is held by the item relating to "plant, equipment and other fixed assets", which at the end of 1967 accounted, net of depreciation, for 61% of total assets. This item nearly doubled over the four years, a circumstance which goes a long way in explaining why the ratio of accumulated depreciation to fixed assets fell from 29% to 22% over the period under review.

Turning to Finmeccanica, one notices that the value of plant and other fixed assets less depreciation, increased by only 37% in the same period. In

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[7] Note that, in order to bring out the financial role of the management agency IRI, which controls both groups, the latters' debts towards the Institute are shown separately from liabilities; moreover each group's capital and surplus are broken down between the share belonging to IRI and that pertaining to outside shareholders.

this case the increase in gross fixed assets (+54%) was about two fifths less than that in accumulated depreciation (+95%), so that the amortized proportion of fixed assets rose from 29% to 37% over the four-year period. At the end of 1967 the balance sheet value of plant stood at less than Lit. 4.4 million ($7,100) per employee (compared with Lit. 18.8 million ($30,000) per employee in the Finsider group) 3/. This is an indicator of the cautiousness with which balance sheet values have been calculated in the engineering sector of the IRI group.

From the balance sheets shown it can be seen that:

		Finsider group		Finmeccanica group	Total
		(billion lire)			
At the end of 1967 net fixed assets of the two groups amounted to		2,346.3		475.9	2,822.2
Deducting from these amounts:					
- for Finsider					
- current indebtedness	210.0				
- staff retirement funds and other provisions	112.0	322.0			
- for Finmeccanica					
- current indebtedness			88.9		
- staff retirement funds and other provisions			61.3	150.2	
Total to be deducted					472.2
Net investment in the two groups therefore was equal to		2.024.3		325.7	2.350.0

3/ Net fixed assets per employee refer only to consolidated companies of the two groups (employing 75,000 and 42,000 persons respectively in the Finsider and the Finmeccanica groups).

The above net investment appears to have been financed as follows

	Finsider group	Finmeccanica group	total	%
		(billion lire)		
Short-term borrowing	715.8	147.5	863.3	37
Medium and long term borrowing	692.8	78.5	771.3	33
Total borrowing from third parties	1,408.3	226.3	1,634.6	70
borrowing from IRI	119.6	4.5	124.1	5
Total borrowing	1.527.9	230.8	1.758.7	75
Equity, surplus and profits	496.4	94.9	591.3	25
Total	2,024.3	325.7	2,350.0	100

The figures given above bring out that, at the end of 1967, the capital invested in the two groups under consideration was financed by outside loans to the extent of about 70% (of which more than half was short-term debt), if borrowing from IRI is also included, the proportion rises to about 75%.

The two groups own means (share capital, surplus, undistributed profits), amounted therefore to 25%, more than one half of this (Lit. 312,000 million) was represented by the private shareholders interest in the capital and surplus of the two groups.

It should be stressed that private shareholdings were concentrated in the Finsider group, which in the period examined offered good earnings prospects, in this case third parties hold shares not only in the holding company (40% of the stock, divided among more than 90,000 shareholders), but also in the operating companies controlled by Finsider (Italsider, Dalmine, Terni and other smaller firms, which in their turn had about 100,000 minority shareholders). This circumstance explains why IRI's share in the equity of the Finsider group is less than 50%, though the Institute retains full control. As has been said, private shareholdings in the Finmeccanica group are very limited and mostly refer to the already mentioned joint ventures with outside groups.

As to IRI's contribution, it is worth mentioning that the Institute has obtained [illegible] market rate [illegible] group, both the holding company [illegible] IRI holds shares [illegible] IRI's shareholding in the [illegible] except in the [illegible] onwards). IRI's loans [illegible] current market rates [illegible] when it borrowed from IRI Lit. [illegible] million [illegible] part of the new steel plant [illegible] applied in the case of [illegible] group.

IRI's profit [illegible] average yield of the Institute's shareholdings [illegible] between 5.5% and [illegible] engineering sector.

The Institute, [illegible] four [illegible] 70 [illegible] its own requirements [illegible] an average cost [illegible] all four years. This [illegible] Finsider and Finmeccanica groups, [illegible] operating in various branches of industry [illegible] (telephones, airlines, etc.), derived from [illegible] sufficient income to cover [illegible] as the cost of its own administration, [illegible] IRI's [illegible] fund provided by the State remained unremunerated.

5. CONCLUDING REMARKS

The preceding analysis shows that, [illegible] the two groups of manufacturing companies considered [illegible] of assets valued Lit. 2,[illegible] million [illegible] IRI to the formation of [illegible] million, was equal to [illegible] capital contributed by third parties, [illegible] of firms, [illegible] same date six times that of IRI (four times, at the end of 1963) and so played a decisive role in financing the considerable growth in requirements of the two groups of companies over the period 1964-67. Of the total of about Lit. [illegible] million ([illegible] million) of liquid resources raised on the market, the proportion provided to the two groups by private shareholders (about 16% at the end of [illegible]) was appreciable.

IRI, as the "management agency" standing between the industrial companies and the State, achieved on the financial plane a number of results of great interest. The Institute - which is the prototype of other Italian public agencies responsible for the management of industries - thanks to its diversified field of activity and to the consequent spreading of risks, has shown itself to possess a credit-worthiness which is greater than the sum of the capacity for credit enjoyed by the individual subsidiary companies. IRI's balance sheet in fact shows that at the end of 1967 two-thirds of the resources available to the Institute came from the market, and only one third was derived from its "own means" (endowment fund and surplus) which include the financial contributions made by the State. These figures show that, thanks to the institutional formula adopted, it is possible to stand the heavy financial commitments entailed in a policy for the development of manufacturing industry (in particular during the running-in phase of new ventures or in tackling the problems of reconversion and reorganization of existing companies) with a limited commitment on the part of the State. That is the same as saying that IRI's action is, on the financial plane, largely freed from the restrictions traditionally imposed on the amount and the timeliness of Government expenditure.

At the same time the controlling position ultimately held by the State through its management agency is in no way compromised. It has already been shown, among other things, how the adoption of the joint stock form of company for the public industrial firms and the multi-tier structure obtained by placing sectoral holding companies between IRI and operating companies, has made it possible to attract a maximum of private capital prepared to run the risk of minority equity investment.

But perhaps still more important is the fact that the financing mechanism achieved, inasmuch as it maintains equality of operating conditions for public enterprise vis-à-vis private industry (and in Italy's case the context is that of a multinational common market) provides a stimulus to efficiency and enterprise. As a consequence the system enables one to assess much more closely than otherwise possible which are the specific extra costs that have to be incurred for the sake of the general interest pursued by the State through its industrial activities. Not only this, but it makes it possible to minimise these costs or, in other words, to maximise the achievement of the objectives of public action.

Finsider [illegible] Finmeccanica [illegible]
and coverage over [illegible] four-year [illegible] 1964-67

	Finsider Group		Finmeccanica Group	
	billion lire		billion lire	[illegible]
REQUIREMENTS				
Investment in plant	[illegible]	[illegible]	[illegible]	[illegible]
Increase in working capital	[illegible]	[illegible]	[illegible]	[illegible]
Total	1,07[illegible]	[illegible]	[illegible]	[illegible]
COVERAGE				
Self-financing (a)	[illegible]	[illegible]	[illegible]	[illegible]
Outside funds obtained through:				
a) market:				
- capital increases subscribed by minority shareholders	[illegible]	1.5	2.1	1.6
- Bonds and other medium and long term loans	326.6	30.5	[illegible]	1.5
- short-term operations	521.1	[illegible]	59.5	45.0
	863.5	80.7	63.6	48.1
b) IRI:				
- capital increases	15.6	1.4	30.6	[illegible]
- loans	-4.5	-0.4	[illegible]	-0.4
	11.1	1.0	[illegible]	22.7
	1,070.0	100.0	[illegible]	100.0

(a) Depreciation allowances, increase in [illegible] retirement funds and other provisions of a similar kind, [illegible] profits, net of losses.

Table 2

Consolidated Balance Sheet of Finsider group companies, as of 31 December 1963 and 1967
(billion lire)

Assets	1963	1967	Change
Current assets	561.3	717.3	+ 156.0
Plant, equipment and other fixed assets, less accumulated depreciation	743.6	1,426.6	+ 683.0
Non-consolidated shareholdings	16.8	17.5	+ 0.7
Other assets	30.8	184.9	+ 154.1
Total	1,352.5	[illegible]	[illegible]

Liabilities and Capital	1963	1967	Change
Current liabilities	259.4	[illegible]	[illegible]
Short-term debts	207.2	715.[illegible]	[illegible]
Medium and long-term debts	35[illegible]	[illegible]	[illegible]
Personnel retirement funds and other provisions	[illegible]	[illegible]	[illegible]
Debts with IRI	[illegible]	[illegible]	[illegible]
Total liabilities	[illegible]	[illegible]	[illegible]
Minority shareholders' interest in capital and surplus of consolidated companies	[illegible]	[illegible]	[illegible]
Total outside resources	[illegible]	[illegible]	[illegible]
IRI's interest in capital and surplus of consolidated companies	[illegible]	[illegible]	[illegible]
Grand total	[illegible]	[illegible]	[illegible]

N.B. - The consolidated balance sheets include all companies controlled by IRI through the sectoral holding [illegible] Finsider, [illegible] shareholding is at least 50%. This criterion has led to the exclusion from consolidation of a few companies [illegible] included in the analysis of financial requirements given in Table 1.

"Current assets" include accounts receivable, inventories and sundry assets less advances from customers.

"Other assets" include special credits for the indemnity which the State Electricity Authority (ENEL) [illegible] nationalization of electric power plant, as well as securities, prepaid expenses, unamortized [illegible]

"Current liabilities" include accounts payable to suppliers and other creditors and sundry liabilities. "Short-term [illegible] of cash in hand and with banks.

Table 3

Consolidated Balance Sheet of Finmeccanica group companies, as of 31 December 1963 and 1967
(billion lire)

	1963	1967	Change
Assets			
Current assets	208.4	283.2	+ 74.[illegible]
Plant, equipment and other fixed assets, less accumulated depreciation	133.3	182.0	+ 48.7
Non-consolidated shareholdings	7.3	10.7	+ 3.4
Total	349.0	475.[illegible]	+ 12[illegible]

	[illegible]	[illegible]	Change
Liabilities and capital			
Current liabilities	[illegible]	[illegible]	+ 11.1
Short-term debts	88.[illegible]	147.[illegible]	+ 59.6
Medium and long-term debts	75.[illegible]	7[illegible]	+ 3.4
Personnel retirement funds and other provisions	[illegible]8.4	[illegible]	+ 32.9
Debts with IRI	[illegible]	[illegible]	+ 3.7
Total liabilities	[illegible]	[illegible]	[illegible]
Minority shareholders' interest in capital and surplus of consolidated companies	[illegible]	[illegible]	[illegible]
[illegible] resources	[illegible]	[illegible]	[illegible]
IRI's interest in capital and surplus of consolidated companies	[illegible]	[illegible]	[illegible]
Grand total	[illegible]	[illegible]	[illegible]

N.B. - The consolidated balance sheets include all companies controlled by IRI through the [illegible] when the shareholding is at least 50%. This criterion has [illegible] exclusion from consolidation [illegible] of which 49% [illegible] most important instance is Selenia with issued capital of Lit [illegible] however taken into account in the analysis of capital requirements given in Table 1.

"Current assets" include accounts receivable, inventories and sundry assets, less advances from [illegible].

"Current debts" include accounts payable to suppliers and other creditors and sundry liabilities.

"Short-term debts" are net of cash in hand and with banks.

26. I. 72