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RECENT EXPERIENCES WITH ALTERNATIVE FORMS OF PRIVATIZATION:

CASE STUDIES AND A SYNTHESIS WITH A
FOCUS ON THE ROLE OF GOVERNMENT



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**RECENT EXPERIENCES WITH ALTERNATIVE
FORMS OF PRIVATIZATION;
CASE STUDIES AND A SYNTHESIS WITH
A FOCUS ON THE ROLE OF GOVERNMENT**

PREFACE

The present synthesis is based primarily on three case studies undertaken in 1994 as part of project TF/GLO/93/C10 Recent Experiences with Alternative Forms of Privatization; Case studies and a synthesis with a focus on the role of government, funded by the Japanese government under a trust fund arrangement with UNIDO. This project is part of an envisioned series of studies on actual and successful cases of privatization where "successful" is defined in terms of the explicit or implicit objectives of the privatization exercise. The purpose of the series is to learn

- ◆ what specific objectives, in addition to turning over assets to the private sector, can be achieved through or in connection with an act of privatization;
- ◆ what external, macroeconomic and other conditions are critical for the success of the privatization; and
- ◆ what macroeconomic conditions have to prevail before the privatization itself and the various associated objectives can be expected to be achieved.

The three case studies were authored by Mr. David M. Dornbusch and Mr. Pedro Vergara-Alvarez (Chile); Ms. Linda Layog and Ms. Scholastica Cororaton (the Philippines); and Professor Kathrin Marton and Mr. Joseph Barta (Hungary), respectively. To all of them UNIDO extends its thank you for a job well done.

This synthesis report was written by Caj O. Falcke, Senior Industrial Development Officer, Institutional Support and Private Sector Development Branch, Human Resource, Enterprise and private Sector Development Division. The three case studies were authored by Mr. David M. Dornbusch and Mr. Pedro Vergara-Alvarez (Chile); Ms. Linda Layog and Ms. Scholastica Cororaton (the Philippines); and Professor Kathrin Marton and Mr. Joseph Barta (Hungary), respectively.

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1. BACKGROUND

Economic development and the reduction of poverty remain major goals for most nations in the world. Whereas these objectives have been on the agenda for as long as any one cares to remember, the means to their achievement are—as they should—undergoing constant change although it can be said that, in general, the solutions are being sought on the macroeconomic, political and socioeconomic planes. Thus, in the past few years, it has been widely recognized that an efficient private sector can make significant contributions to the attainment of these goals. Therefore, a number of national governments—notably, in both developed and developing countries—have embarked on ambitious programs to turn over state owned production facilities to the private sector. And many of the international organizations and development banks, bilateral aid agencies, and Non-Governmental Organizations have geared up to offer their assistance in these matters.

It now is widely believed that the proper function of government is in creating an enabling environment within which mainly private, but also some quasi-private enterprises can thrive to the maximum benefit for the whole economy and the population of a country.

The effectiveness of a privatization program is enhanced when it is coupled with a (less common) policy of improved entry to markets. In fact, in most countries the latter policy has a far larger impact on expanding the private sector than does the privatization of relatively few state-owned enterprises (SOEs). Nonetheless, privatization, when carefully set up and done, promotes economic and technological efficiency, encourages investment and thus leads to employment and income growth. It generates revenue and frees public resources for investment in infrastructure and social programs, and allows civil servants to work on activities that are better performed by the public sector.

The arguments against privatization, if carefully examined, often reveal that not to privatize is a worse option: governments that have difficulties in regulating enterprises are probably even less apt at operating them; deficient capital markets that make sell-offs difficult make financing the deficits generated by the inevitable subsidies associated with SOEs even more difficult, and so on. In short, the same reasons that make privatization hard, likely make operating an enterprise even more troublesome.¹

Objections to divestiture has been voiced on the grounds that there may be adverse income and wealth distribution effects. Indeed, the immediate losers in a given privatization case may be employees at the lower end of the pay scale. But, if the former SOE becomes more efficient, its goods and services become relatively more affordable, and the income it is generating and the subsidies it no longer needs increase the national income. It is then a matter of general economic and social policies how these benefits are distributed in the society. Conversely, the privatization of a SOE may very well allow some already well-off individuals to benefit greatly. But to abstain from the privatization because of envy of the rich is not very rational when the potential for widespread, albeit smaller, individual benefits is significant.

How privatization is carried out depends on many factors. The initial position is important in that some governments are strong whereas other ones may have great difficulties in enforcing their policy; in some countries, there is already a thriving private sector whereas in other ones, the citizens may not be used to operating under market conditions; the financing possibilities for buy-outs differ with the prosperity of the country and its private citizens; different kinds of assets probably require different ways of transferring from public to private hands; and the legal and social context can either facilitate or hinder a given privatization process. Similarly, the specific aims of the policy must also, at least to some extent, influence the way it is executed. If the intention is to create a new, broad class of small shareholders and entrepreneurs, it may be most proper to proceed with wide, public offerings

1 Lawrence H. Summers in Ahmed Galal and Mary Shirley (eds.), *Does Privatization Deliver? Highlights from a World Bank Conference*, EDI Development Studies, The World Bank, Washington, D.C., 1994, pp. 14



or even give-outs whereas if the main objective is increased efficiency and/or revenue raising, a limited offering to corporate entities may be in order.

Through a policy of privatization and the actual sell-offs themselves many other objectives but turning over the assets to the private sector can be achieved. But what is theoretically and practically achievable depends on a variety of endogenous and exogenous factors such as fiscal means employed and macroeconomic conditions. Therefore, it is of great importance to governments in the developing countries to know what they could realistically expect to accomplish, and what conditions they should endeavor to establish in advance in order to reach certain policy goals.

Examples of many different kinds of privatization schemes under varying conditions abound. Some have been clearly successful, others less so. Still others have yielded mixed results or have stalled in their infancy. In these processes, governments have played different roles, and have had varying degrees of impact on the outcome. Enough empirical experience has been accumulating in order to undertake valid research on what went right in which situations; on what failed and why.



2. THE STUDY AND ITS AIMS

The direct, first hand aim of the project is to improve UNIDO's capacity to provide advice to the developing countries and economies in transition from a centrally planned to a market economy on how to efficiently conduct a privatization of their manufacturing industries and the role of government therein under varying circumstances. Ultimately, the project aims at enhancing the role of government in the privatization of industrial assets.

The empirical part of the study is based on a set of case studies to get at the underlying and contributing causes for success and failure in different circumstances. Through these studies, variances and commonalities should emerge that will enable UNIDO to deduce what all can be achieved through or in association with an act of privatization and what external, macroeconomic conditions are likely to impact the results in what ways. This knowledge will enable developing country governments to properly design a privatization policy and to increase the effectiveness of their own role in the implementation. By focusing specifically on the role of governments in this connection, the amounting knowledge will be valuable in UNIDO's policy-advising to developing country governments.

Given the present state of knowledge, it is impossible to say even approximately how many case studies eventually are required before robust generalizations can be made. However, to make a start, this project will study three carefully selected cases, one in Asia, one in eastern Europe, and one in Latin America. Thus, this first set of three case studies and the ensuing synthesis is to be seen as the beginning, or foundation on which further research can be firmly based.

To ensure conclusions that can be generalized, the cases were done according to a standard and simple study framework. A definite requirement for the cases are that the actual privatization must have occurred at least a few years ago in order for there to be a meaningful track record to be studied. A second requirement is that the UNIDO study teams must be allowed full access to the relevant information on both the circumstances that prevailed at the time of the actual act of privatization and the results thereof. Moreover, in order to keep the research as focused as possible, we decided to study only 'successful' cases by which it was meant that the privatized companies now operate profitably under market conditions.

Preparatory work at UNIDO HQ identified suitable cases in

- the Philippines
- Hungary; and
- Chile.

The Philippine Department of Finance, Committee on Privatization prepared for UNIDO a list of previously government-owned or controlled corporations with over P300 million in gross revenues that have been successfully privatized. Most of these cases are banks and airlines although manufacturing entities have also been turned over to the private sector. After preliminary scanning, we decided to analyze the returning in the late 1980ies of 13 cement companies to the private sector. Since these companies account for some three fourths of the entire cement industry in the Philippines (13 out of 18 firms in total), it allows us to look at the "mass effect" of privatization. Moreover, a most interesting item in this case is the Asset Privatization Fund, the government agency set up to oversee the privatization cases.

In Hungary, manufacturing cases with sufficiently long track records were identified by the Privatization Department in the Ministry of Industry and Trade. After examining three candidate cases, the privatization of Styl Ruhagyár Rt., a clothing manufacturing company was chosen for detailed study. Styl, having been restructured into a share holding entity already in 1989, is one of the first cases of privatization in Hungary and offers a sufficiently long track record to study.

In Chile, the path of CESMEC—Center for Studies Measurements and Quality Certification—from



having started under the umbrella of the government in 1969 and now operating since 1977 on private terms, is an interesting case. CESMEC was conceived as a service entity providing engineering services for quality certification, analysis, supervision and inspection. Although not itself a manufacturing company, it exists for the sake of the Chilean manufacturing industry. In addition to its Santiago headquarters, CESMEC has a network of regional units operating in ten other locations in Chile.

While the individual case studies focus on the details in each instance, the synthesis deals with such issue as (a) what objectives, in addition to turning over assets to the private sector, can be achieved through or in connection with an act of privatization, (b) what external macroeconomic conditions are critical for the success of the privatization, and (c) what macroeconomic policies and instruments ought to be in place before the privatization itself and the various associated objectives can be expected to be achieved.

Each case study focuses on the privatization of industrial assets and on the following questions:

- (a) what were the specific aims of the privatization;
- (b) under what institutional settings did the privatization process operate;
- (c) how was the privatization organized in terms of the government's role;
- (d) how was the privatization in actuality carried out;
- (e) what changes in the original design were found necessary, why, and how were they implemented;
- (f) in terms of its original objectives, how did the privatization do; and.
- (g) what were the key elements in any success or failure.

Each case study in the field was preceded by desk research by both international and national experts. In the field phase, particular attention was paid to uncovering hidden facts and details, unstated objectives, and obscure circumstances through investigative work and informal contacts with people who were in a position to know about such matters at the time of the actual privatization in question. Following the completion of all case studies, each case study author was invited to attend a three-day seminar to discuss with the other authors and UNIDO staff the case studies.

The governments in the case study countries contributed by facilitating full access to information and officials with first hand knowledge of the privatization act in question, the governments policy and objectives, as well as other external conditions that prevailed at the time.

3. THEORY

3.1 Short Overview

Public ownership of enterprises often has been the rational economic answer to a failure of private markets to secure efficient and equitable outcomes.² When, however, this response is carried too far and wide and when the majority of enterprises is state owned, the framework that brings forth competition and efficiency begins to disappear. The pendulum begins to swing back to increased private ownership.

The main objective of a privatization program usually is increased efficiency among hitherto state-owned enterprises (SOEs). The result is thought to come about through a variety of instruments and vehicles but ultimately aiming at giving managers an incentive to accept personal responsibility for business results and making owners bear the consequences of poor performance.

The main purpose is not to transfer ownership from one part of the society or national economy to another; the whole exercise of privatizing aims at making the SOE behave as if it were operating on a free market under competitive conditions. To achieve this, it is either necessary or more effective to privatize the company rather than trying some sort of re-education process.

Although private companies usually are perceived as more efficient than their public counterparts, efficiently and otherwise well managed SOEs are not unheard of. However, it is rare that a good performance on part of an SOE is sustained over longer periods of time. There is nothing 'natural' or physical in a SOE that explains why this is so, or could be expected to be so. A government steel mill is, after all, in its physical attributes identical to a private one. The answer, clearly, has to be sought in the SOE's behavior and in the variables that determine this conduct.

Axiomatically, the ultimate objective of any living system is survival. Theoretically therefore, inefficiency among SOEs must be due to circumstances that make such conduct irrelevant for their long term survival. Conversely, if efficient behavior were desirable, it would be forthcoming.

Now, why then isn't economically efficient behavior all that necessary for a SOE? Probably because it is being judged on other criteria such as non-predatory pricing, employment generation, or social equity. But judged the SOEs are, and evidently they are now widely found to come up short on what they are supposed to deliver while using up public resources. Hence, the current and widespread enthusiasm for privatization.

Equally one must pose the question why is economic efficiency not pursued even though it may not be an overriding concern for a SOE—after all, it can hardly be seen as something bad? Once more the answer must be sought in the variables that do determine a SOE's behavior, i.e. in what they actually try to achieve. The answer, generally, is a bewildering array of economic and non-economic objectives that have the tendency to scatter the focus of the SOE.

Although the World Bank claims that "Private ownership itself makes a difference"³ there is no evident theoretical reason why that should be so.⁴ If empirical research has shown that there is a positive correlation between economic efficiency and type of ownership, it probably is due to the latter

2 UNIDO, Industry and Development, Global Report 1992/93, Vienna 1992, Chapter IV, Privatization, pp. 199-201

3 Sunita Kikeri, John Nellis, and Mary Shirley, PRIVATIZATION The Lessons of Experience, The World Bank, Washington, D.C., 1992, p. 1

4 In fact, sound theoretical argumentation shows that it is behavior, not ownership or the morphological structure of the market that determines the course of economic process. See, for example, Erich Schneider, Pricing and Equilibrium, London 1962, pp. 58,....,60 or any other classic text on economic behavior and market structure.

See also UNIDO, Industry and Development, Global Report 1992/93, Vienna 1992, Chapter IV, Privatization and UNIDO, Economies in Transition: Restructuring of Large-Scale Industries, CPD.7 (SPEC.) Vienna 1994, p. 129

variable merely mirroring the effect of other, more fundamental determinants of behavior. This conclusion is supported by the observation that there now is a disillusion with privatization in Britain that probably has much to do with the fact that many of the SOEs (telecommunications, gas, and electricity) that were privatized went from a state of public monopoly to that of private monopoly, i.e. despite their change in ownership, they were not forced by markets to behave competitively.⁵

3.2 Privatization Objectives

Governments have sought to privatize SOEs for a multitude of reasons.⁶ Among such stated and unstated, but actual, goals (in no particular order) are:

- reduce government expenditures;
- improve the SOE's efficiency;
- depoliticize decision making;
- cut taxes;
- reduce budget deficits;
- shrink public borrowing;
- reduce inflation through reduced public spending
- reduce inflation through better cost containment;
- increase government receipts through sale of assets;
- enable the continuation of deficit spending;
- reduce the power of labor unions;
- safeguard employment;
- encourage employees to own shares in the companies where they work;
- raise worker and management production incentives;
- strengthen the capital markets;
- balance or strengthen weak private sectors;
- transfer technology to strategic sectors;
- make goods available at lower cost;
- accelerate economic growth;
- raise consumer welfare;
- bring about a permanent increase in GDP;
- improve competitiveness;
- lessen the state's administrative burden;
- ease the transition from a centrally controlled to a market economy ;
- attract foreign capital; and/or
- seek a wider distribution of enterprise ownership.

The list is by no means exhaustive and is meant merely to illustrate the wide range of objectives that governments have sought to attain through their privatization programs. At times, when there are

5 How to Privatize and Disgusted in *The Economist*, March 11th-17th 1995, pp. 16–17 and 37–38.

6 UNIDO, *Industry and Development, Global Report 1992/93*, Vienna 1992, Chapter IV, Privatization, pp. 221-225; UNIDO, *Economies in Transition: Restructuring of Large-Scale Industries*, CPD.7 (SPEC.) Vienna 1994, Chapter 4, Privatization and Industrial Restructuring, and UNIDO, *Private Sector Development and Privatization in Developing Countries: Trends, Policies and Prospects*, CPD.6, Vienna 1994



multiple objectives, they are mutually supportive but at times they are also mutually exclusive. Increasing government revenues through the sale of assets, for example, will clearly enable a continuation of deficit spending whereas improving SOE efficiency may well entail the lay-off of redundant workers. Encouraging wide-spread ownership may well require the selling of shares at a discount that would have a dampening effect on a revenue objective. Selling off a public monopoly without endangering its monopoly position will maximize the proceeds from the sale but will have no positive impact on efficiency through competition, or on consumer surplus. Finally, there can be windfalls in terms of, for example, increased efficiency although it was not a stated aim of a given divestiture.

A favorite political artifice is to state objectives that are in fact, although perhaps not transparently, self-fulfilling. Shrinking public borrowing, for example, is almost surely going to lead to less inflation. A further, common mistake in stating multiple objectives is forgetting the dictum of Hansen's first rule: it takes (at least) as many instruments to carry out a policy as there are (linearly) independent goals.⁷

At times privatization have been undertaken not so much to attain something specific. Rather, it has been done in recognition that past programs and practices of establishing SOEs had reached their useful limits or were right out unsustainable.

A 1992 World Bank conference on the welfare effects of privatization concluded that "Privatization can bring substantial gains" in terms of permanent increase in GDP (as the chosen measure of system-wide impact). "These gains are only attainable, however, if privatization is properly done. And "properly done" means that policymakers [sic] provide no special concessions or privileges when selling public enterprises, introduce competition wherever possible, and regulate monopolies."⁸

7 Bent Hansen, *Lectures in Economic Theory, Part II; The Theory of Economic Policy and Planning*, Lund, Sweden 1967, p. 5.

8 Ahmed Galal and Mary Shirley (eds.), *Does Privatization Deliver? Highlights from a World Bank Conference*, EDI Development Studies, The World Bank, Washington, D.C., 1994, pp. 1 and 2

4. SUMMARIES OF THE CASE STUDIES

The annexes to this report present the full text of the case studies.

4.1 Chile

4.1.1 BACKGROUND

Chile had a large state enterprise sector already prior to the socialist Allende government that assumed power in 1970. Still, from 1970 to 1973, the public sector expanded significantly, when hundreds of private companies were nationalized. By 1973, when the military took over the government, nearly the entire economy was under state control through either majority or partial ownership, including the whole banking system.

The military government had politically very conservative views. Advised by a team of foreign trained Chilean economists known as "The Chicago Boys,"⁹ it embarked on an ambitious, very serious and far reaching macroeconomic reform program well before any attempts at privatization were made. In fact, privatization was a logical extension, or an instrument of the government's reform policy that, once it got going, went far. Chile's public enterprise sector accounted for 39 percent of GDP in 1973; by 1989 it had been reduced to 16 percent, or less than seven percent if copper mining is left out.¹⁰

The Allende government had instituted extensive price controls as well as monetary, fiscal, foreign trade, and social welfare policies that had severe negative impacts on the economy. Although the price controls succeeded in lowering the Consumer Price Index (CPI) by about 30 percent between 1970 and 1971, the prices were often set lower than the costs of production. It was reported that the fixed price of a bag of flour was less than the cost to produce only the bag without the flour.¹¹ Goods became extremely scarce, and a large black market economy developed. The CPI rose by more than five times in 1972, and again by more than four times in 1973. Many government-owned enterprises, in an effort to conserve cash, paid their workers in manufactured goods, expecting them to sell or barter those goods for their living.

High tariffs and non-tariff protections blocked imports and lead to inefficient performance among the Chilean enterprises. Large expenditures on domestic programs were financed by monetary expansion, foreign loans, and payroll taxes. All of the banks were controlled by the Allende government, and the interest rates paid to savers were lower than the rate of monetary inflation, thereby yielding negative savings income. (Real interest was negative in each year of the Allende regime, reaching a reported minus 57 percent in 1972 and minus 80 percent in 1973.) During the 1960s, Chile's Gross Domestic Product (GDP) growth averaged 4.5 percent. But by 1972, it had turned negative, and in 1973 the GDP decreased by as much as 5.6 percent.

According to Pan A. Yotopoulos in "The (Rip) Tide of Privatization:"

"Following the military takeover in 1973, Chile began a policy of liberalization, which to a large extent relied on the free market to allocate resources. This led to an attendant retrenchment in the public sector, with the size and role of the government greatly reduced. Commodity prices were freed by dismantling the protection system and eliminating the widespread price controls. Financial markets

9 The "Chicago Boys" got their name from the fact that many of them had received graduate degrees in economics from the University of Chicago, and all were proponents of the conservative principles for which the University of Chicago's Economics Department has become known. Whereas the government itself hardly had an economic program—except that it knew it did not want socialism—the Chicago Boys did, inscribed in a book that became known as "the Brick".

10 Ahmed Galal in Ahmed Galal and Mary Shirley (eds.), *Does Privatization Deliver? Highlights from a World Bank Conference*, EDI Development Studies, The World Bank, Washington, D.C., 1994, p. 47

11 Gen. Luis Danus Covian, CORFO Director 1974-1979, in an interview on 1994-05-19.



were progressively liberalized until, in 1980, virtually all quantitative restrictions on external capital flows were eliminated. There was a de facto deregulation of the labor market due to the trade unions' loss of power. A monetarist price stabilization program was introduced which relied heavily on eradicating chronic fiscal deficits. Foreign trade liberalization culminated in 1979 with the introduction of the uniform 10 percent nominal tariff (except for large automobiles) and the elimination of all export subsidies."¹²

These drastic reversals in economic policy provided the necessary environment for a private economy to function effectively. However, these changes also threw the newly privatized enterprises into a very competitive world economy, in which many of these enterprises were ill-prepared to compete and did not survive. Some key enterprises were preserved by bringing them back under public control and later were reprivatized when they were considered to be healthy enough to survive on their own. Others were allowed to go bankrupt.

Some state enterprises were functioning in areas where they had little or no technical or management skill. As a result, public managers often made poor business decisions.¹³

In Chile, the responsibility for promoting the development of production activities had historically been in the hands of the Corporation de Fomento de la Produccion de Chile (CORFO) or Production Development Corporation of Chile. Prior to the Allende government, CORFO held partial ownership of 46 companies. By the end of the Allende government's term in 1973, CORFO controlled approximately 500 companies, having nationalized, acquired, or created over 450 enterprises. The privatization effort initiated shortly after the military government took control succeeded so well that by 1978 CORFO retained control of only 19 enterprises.

This ambitious and rapid privatization program was implemented mostly by giving back many of the previously nationalized enterprises to the former owners, direct sale of the enterprises through public bid and negotiation, and the sale of enterprises' shares through the stock market. In addition, a large amount of capital equipment owned by the public enterprises was sold, and many services previously provided by SOEs were contracted out to private suppliers.

During the 1960s, Chile's economic policy emphasized import substitution. An important component of that policy was the partial manufacture and assembly of automobiles. CORFO felt that it was important to monitor and control the quality of those automobiles. So in 1969, CORFO formed a publicly-owned and operated company, and gave it the initial responsibility of specifying the design and quality of spare parts to be manufactured for the country's automobiles and trucks. CORFO paid for the land and construction of the buildings, and the United Nations Industrial Development Organization (UNIDO) contributed \$481 thousand worth of capital equipment to initiate the enterprise.¹⁴ Within a year, the company's responsibilities were expanded to include specifications of all of the materials and parts used in Chile's automobile and truck manufacturing. It was named Centro de Estudios Medicion y Certificacion de Calidad, Ltd. (CESMEC) or Center for Studies, Measurements and Quality Certification.

By the mid-1970s, CESMEC was one of nine technical institutes having responsibility for natural resources prospecting, technical research and development, quality analysis, quality control and certification of various industrial products. By then, CESMEC had expanded its services further into quality analysis and certification with its main focus being non-destructive and operational testing of products manufactured in Chile, geochemical (minerals) analysis, and product failure analysis.

12 Yotopoulos, Pan A., *The (Rip)Tide of Privatization: Lessons from Chile*, World Development, Vol. 17, 1989, p. 685.

13 Gen. Luis Danus Covian, CORFO Director 1974-1979, in an interview on May 19, 1994.

14 Note that all U.S. dollars are indicated by the symbol "\$". Chilean pesos are indicated by the symbol "P".



In 1975, at the beginning of the military government's privatization program, CORFO's director¹⁵ was not impressed with the contribution that the country's nine technical institutes were making to meet the country's technological needs. He concluded that none of the institutes were necessary to the economic well-being of the country, that the state should close six immediately and continue operations of the other three only if they could be sold as operating entities to the private sector. If they could not be so sold, they were to be liquidated. CESMEC was selected as one of the three for privatization.

Within six months, CORFO's Director was replaced¹⁶, and the CESMEC closure policy changed as well. CORFO was still considering closing CESMEC and selling its assets, since there was no evident interest in acquiring it as an operating entity. CORFO was willing to continue to operate CESMEC as a public entity, but only under the condition that all subsidies to CESMEC would be eliminated by 1978. This meant that CESMEC had to become self-supporting although still operating under the burden of CORFO's regulations and restrictions. The central problem was that CORFO tied CESMEC to operating budgets, prices, and employment regulations that resulted in the company operating at a deficit. If its subsidies were eliminated, it would be forced to compete with other enterprises whose operations were to remain subsidized, such as universities that absorbed a substantial portion of their costs elsewhere in their budgets. Therefore, CESMEC would only be able to operate profitably if CORFO also released CESMEC from its controls.

Faced with the alternatives of CESMEC's closure or a requirement for self-sufficiency as a public entity, Pedro Vergara (CESMEC's Director) was encouraged to lead a private acquisition of the enterprise. His concept was for the employees to purchase the enterprise themselves from the government, and he organized support for the idea among CESMEC's workers.

CORFO agreed that CESMEC should be preserved, feeling that it provided an important economic function and that its management might be able to operate it profitably. CORFO also recognized that CESMEC had been conceived as a UNIDO project and felt a need to continue its commitment to the UNIDO objectives of technical and economic assistance. The equipment that UNIDO had installed in CESMEC, although already substantially depreciated but still fully operational and expensive to replace, was to remain with the company. Thus, on October 6, 1977, CORFO decided to privatize CESMEC despite strong opposition from highly placed people in the government. It rejected the first proposal for the employees to purchase 51 percent of CESMEC and for CORFO to continue as a minority partner. It insisted that the sale would be for all of CORFO's ownership, or the company would be closed and the assets sold. This was to be the first case in Chile when an entire company was sold to its employees.

Although CORFO normally sold its enterprises through public auction, it found that a direct sale was desirable in CESMEC's case. Such direct sales were often used to divest smaller enterprises, especially when an auction process would be relatively expensive, when only one bidder was expected, and/or when CORFO expected the negotiated price to be higher than the highest bid received through auction.

A management team within CESMEC was appointed to determine the formula by which the 100 000 shares of stock would be offered to CESMEC's 87 employees. The formula provided that the number of shares would be a function of the employee's current salary, level of responsibility, and number of years with the company. The management team determined a quantitative measure for an employee's level of responsibility and for the relative weightings to be applied to each of the three components.

Of the 87 employees offered the opportunity to purchase stock, 83 exercised their option. Some chose to buy less stock than the amount offered, and the unpurchased options were then redistributed

15 His name was Francisco Soza.

16 by General Luis Danus.



to the employees according to the same formula. Most of the principal stockholders viewed the purchase as a very difficult and risky choice. The cost of the stock offered to the key managers was on the order of half a year's salary or more. Many of them could not make such an acquisition without borrowing the money, making significant sacrifices in their living expenditures, or both. The interest costs to borrow the money necessary for the purchase were very high and dividends were uncertain. Significantly, however, the managers had confidence in the company, its Director, and they welcomed the opportunity to participate in the company's management although they had never worked in or managed a private enterprise.

On the other hand, some CESMEC employees perceived that if they did not purchase the company, it would be closed and they would be out of work. Some key managers felt that despite CESMEC's unprofitable history, the recent trend was positive. They foresaw that aggressive cost-cutting and marketing of services could raise revenues and reduce costs enough to earn profits in the future. And, they felt that owning the company would provide them with the incentives to implement such measures. They also understood that they were not personally responsible for the CORFO loan and that CESMEC had sufficient assets to repay the loan, if it became necessary to liquidate the company. So, their financial risk, though substantial, was limited to the money they would invest in their share of the equity.

When the stock was fully subscribed in early 1978, six principal managers controlled 36 percent of the equity. Under the rules of the corporation, those six also comprised the Board of Directors, and as such, were responsible for all strategic and operating management decisions. The six members of the Board, together with four other members of the senior management team, controlled 50.4 percent of the original equity subscription.

Prior to the privatization, CESMEC had experienced major operating losses. In 1973, CESMEC's incurred an incredible loss of P409 million on total sales of only P59 million, and sizable losses continued in 1974 and 1975. The small profits reported in 1976 under public ownership were suspect because of the dubious accounting methods. In 1977, just prior to privatization, CESMEC's reported operating at break-even.

CESMEC was unable to avoid entirely the effects of Chile's economic decline in the early-1980s. In response, CESMEC made some strategic changes in its operations and financial arrangements. It renegotiated its CORFO loan to extend the payment schedule, diversified its quality analysis services into new technical areas, and began to offer processing industries with assistance in managing quality control. CESMEC became more involved in product quality certification for exports of Chilean goods to Europe, Japan and the United States. And, it expanded the provision of its services geographically into Chile's provinces and to Bolivia.

CESMEC also achieved significant labor cost savings by imposing salary reductions, seeking voluntary departures, and making a few selective dismissals. Overall, salaries were reduced by an average of 10 percent, with the greatest reductions of 20 percent taken by the highest paid managers. The lowest paid workers were not asked to accept any decrease in wages.

These strategic and operational changes were effective and enabled CESMEC to survive the economic crisis of the early-1980s, at a time when many recently privatized enterprises went bankrupt or had to be renationalized by the government. It is particularly noteworthy that CESMEC made profits during 1980 and 1981, given the extremely difficult economic conditions of the time.

4.1.2 OBJECTIVES

The overall primary objectives of the military government's privatization efforts that also applied to the case of CESMEC were to:

1. promote economic efficiency, by having the state withdraw from all

- enterprises that could be better run by the private sector;
2. promote economic democratization through increased participation by private individuals in ownership of national enterprises; and
 3. raise revenues and reduce costs for the government from the sale of enterprises and state-owned capital assets.

In addition to the above, generally applicable goals, with respect to CESMEC CORFO specifically wanted to

4. either sell (privatize) the company or close it down;
5. terminate its subsidies to the company; and
6. in case the company was going to continue to operate, maintain its high technical standards in quality analysis services to the Chilean industry.

Enterprise privatization was implemented in two main stages (1974-1978) and (1985-1989). All of these objectives were considered to be important throughout both stages. Indeed, all three were sought in CESMEC's privatization.

In addition to the above economic objectives, the military government also sought to achieve political and ideological objectives by its privatization efforts. In following the recommendations of "The Chicago Boys", the government endeavored to assume what was felt to be its appropriate role and to place the economy on a track that would increase savings, investment, and growth.¹⁷ The military government may have also seen an opportunity to break the political hold of powerful interest groups, thereby allowing it to increase its control over the country.

4.1.3 SUCCESS RATE

With respect to promoting economic efficiency (by having the state withdraw from all enterprises that could be better run by the private sector), the privatization of CESMEC must be judged an extraordinary success. Through the mid- and late-1980s, CESMEC achieved a very impressive growth in sales and even more impressive increases in operating efficiencies and income. By 1985, CESMEC's sales were back up to the 1980 level, and over the next five years increased to P3 482 million, nearly tripling. The growth in sales was matched by an equally large improvement in operating efficiencies. After-tax income, as a percent of total sales, grew from a low of 2 to 5 percent during the extremely weak economic period of 1980-81 to 9 percent by 1986 and then to 12 to 14 percent in 1987-89. After-tax income, as a percentage of ownership equity (total assets less total liabilities) also increased dramatically. Except for a slight dip in 1981, it grew from 12 percent in 1980 to almost 19 percent in 1985 and then to over 40 percent in both 1989 and 1990. In 1991 and 1992, high payroll costs brought the company's income nearly to break-even but since then, both sales and income have recovered, and are returning to their previous levels.

With regard to the second objective, to promote economic democratization through increased participation by private individuals in ownership of national enterprises, the success must again be seen as all but complete. Of the 87 employees offered the opportunity to purchase stock, 83 exercised their option although some chose to buy less than the amount offered; the unpurchased options being then redistributed to the other employees.

Since the initial offering, the principles that apply to CESMEC's stock transactions are that no shareholder is ever obligated to either buy or sell his/her stock. Management desires that when an employee leaves CESMEC that he/she sell his/her stock. In this way, ownership is retained by the

¹⁷ Andres Concha Rodriguez, General Director of ProChile and Advisor to the Ministry of Foreign Affairs on Exports during CESMEC's privatization, in an interview on 1994-05-25.



current employees. But no sale is a requirement, and there are a number of ex-employees who still own CESMEC stock. To provide all employees with up-to-date information about the company's plans and expectations, a three-person team that represents the employees attends all Board of Directors' meetings. In addition, one of the employee representatives is a highly placed member of the company's accounting department who has access to all of the company's accounting records and information on budgeting for the future.

It is interesting to note that as of 1994, CESMEC had 84 stockholders, about the same number as when it was privatized, despite the fact that its work force has grown to about 500. Two members of the original key management team and Board of Directors have been replaced. Both sold all of their stock. The present Board controls nearly 48 percent of the company's stock. However, CESMEC itself has bought 8.9 percent of its own stock. Therefore, the Board controls 52 percent of the outstanding shares. Or, looking at it another way, considering that the Board has the power to vote the company's stock, it controls 56.6 percent of the equity, and the initial success with respect to "popular capitalism", as it was called in Chile, has lost some of its gild.

The government's third overall objective entailed the raising of revenues and the reduction of costs for the government from the sale of enterprises and state-owned capital assets. Notably, no qualifiers such as maximizing or minimizing were attached to this goal. Thus, nearly any achievement on these scores could be interpreted as a complete success. But even a less formalistic interpretation points to a highly successful result in the case of the privatization of CESMEC. Although CORFO set its asking price at the estimated asset value in CESMEC of approximately P11 million minus the cost of about P3.8 million in severance pay and benefits it would have to pay the workers in case it were to close down CESMEC, it probably maximized the revenues by selling CESMEC as a going concern rather than liquidating it. Through negotiations, the agreed final price was P7.0 million. Furthermore, by removing the State completely from the ownership of CESMEC and terminating all subsidies to the company, the government also achieved everything possible in terms of reducing its costs directly related to CESMEC.

With respect to CORFO's two first specific objectives in the case of the privatization of CESMEC, that is either sell (privatize) the company or close it down and terminate its subsidies to the company, there is no question that the government achieved its goals. The last objective, in case the company was going to continue to operate, to maintain its high technical standards in quality analysis services to the Chilean industry, the continued commercial success of CESMEC in the area of quality control services to the Chilean industry speaks for a very high rate of success on this score as well.

4.1.4 FACTORS CONTRIBUTING TO THE SUCCESSES

The military government, that replaced the Allende government in 1973, sought to stabilize the economy and adopted principles of free market competition. Advised by the "Chicago Boys", the military government instituted:

- monetary control,
- fiscal discipline,
- deregulation of prices,
- opening of the economy to external trade and capital movement, and
- privatization of most economic functions—including selling off the numerous public enterprises that had either been nationalized or created during the Allende government.¹⁸

These drastic reversals in economic policy provided the necessary environment for a private

¹⁸ Andres Concha Rodriguez, General Director of ProChile and Advisor on Exports to the Ministry of Foreign Affairs during CESMEC's privatization, in an interview on 1994-05-25.



economy to function effectively. Equally important, the private sector in Chile had full confidence that the government would persist in its efforts to stabilize the economy and keep the market free. This macroeconomic stability together with the prosperity of the entire Chilean economy was vital for the success, indeed the very survival of CESMEC as it depended entirely on the domestic economy for business.

At the time, the privatization process was highly controversial. Despite the disastrous economic performance of the previous socialist government, many Chilean economists felt that the state needed to continue to exercise strong control over the nation's enterprises. There was especially strong public opinion against privatizing enterprises that were considered to be important for national security. However, several factors combined to ensure that Chile continued resolutely toward privatization. They included:

- The government's immediate need for funds,
- The recent memory of the disastrous consequences of state enterprise operation and socialist policies,
- The firm resolve and power of the military government, and
- The government's faith in the honest intentions and economic skill of "the Chicago Boys".

The government aimed at a speedy privatization process. Without stopping the hemorrhage from the loss-making SOEs and raising revenues quickly, the government would soon have lost its ability to govern. It appears that the speed of the process also contributed to the success of CESMEC's privatization. It minimized the period of uncertainty about CESMEC's future, thereby keeping the enterprise's key management team intact during the transition and assuring its clients of continued operations and quality of service.

It appears from this case study, as well as from Chile's overall privatization experience, that people with entrepreneurial talent will emerge and assume control of privatized enterprises when sufficient financial incentives to reward their efforts are provided. CESMEC's new managers, although none of them had any prior experience in managing a business, demonstrated their entrepreneurial skill in conceiving and implementing the successful survival strategies that helped the company to weather the economic crisis of the early-1980s which many other Chilean firms did not manage to do. And, it was their entrepreneurial and management skills that generated the impressive increases in sales and return on net assets in the mid and late-1980s. Clearly, CESMEC's management and workers were the company's main asset, and selling the organization to them was a key to CESMEC's success.

CESMEC's relatively cautious financial decisions in the late-1970s proved to be a key factor enabling the organization to survive the difficult climate during the early-1980s. This financial conservatism was largely related to the relatively high financial stake in the company that each member of the management team possessed. It seems to have instilled a healthy caution about assuming too much risk in managing the enterprise.

In addition, the narrow distribution of equity among the management team enabled them to exercise sufficient control to direct CESMEC effectively. The company was structured so that the top management team, by controlling a large portion of the stock, would also be the Board of Directors. This arrangement allowed the management team to maintain control and direct the company even in the midst of the harsh economic climate of the early-1980s.

A vital factor in an organization's successful privatization is the development of management's confidence in its ability to succeed. All of the members of CESMEC's top management, including Mr. Vergara, confessed that they lacked confidence in their abilities to manage CESMEC in the beginning. All admitted that they were uncertain that they would be able to bring the company through the very difficult period of the early-1980s. Businesses were failing all around them, including 25 percent of their own clients. However, when they succeeded in keeping the company running into the mid-1980s,



CESMEC's management gained the confidence that they could continue to succeed. This appears to have been a major factor contributing to the management's success in the late-1980s, when CESMEC's sales, income and operating efficiencies increased dramatically.

The strategy of selling the SOE to its workers and managers, called "popular capitalism" in Chile, created owner-workers with a greater stake in the success of the enterprise, thereby inducing them to work harder and to change labor-management relationships so that more productive decisions and agreements could be reached.

Nearly all of CESMEC's capital equipment had been provided by UNIDO. The latter regarded the capital equipment as a contribution to the government of Chile which it could use as it saw fit. In effect, UNIDO agreed to allow CESMEC to use the equipment, but with the condition that the equipment not be sold until the book value was zero, at which time it might be transferred to CORFO for sale. (To this date, it is still in use at CESMEC and UNIDO's decision to let CESMEC continue to use the equipment even after it had been privatized, is credited with having a great deal to do with CESMEC's ensuing success as a commercial entity.)

Thus, the agreement with UNIDO for the continuous use of the capital equipment provided under a technical assistance project was important to CESMEC's privatization. Although at the time of privatization, the equipment had a depreciated value of only about \$47,000 (equivalent to approximately P1,316,000 at the then current rate of exchange of about P28/\$), the equipment was still operational and would have been expensive to replace.¹⁹

4.1.5 COMMENTS

In 1973, Chile was virtually bankrupt, and the government sought immediately to lower its expenditures and obtain whatever revenues it could from both domestic and foreign private sources. Some economists criticized the speed at which the government sold its enterprises, calling it a "fire sale."²⁰ These critics contended that privatization could have raised more money for the treasury had it proceeded at a more deliberate pace.

However, other economists contended that change was needed immediately. The country was in serious financial difficulties, revenues were needed as quickly as possible, and any delays would have had significant negative economic consequences. They felt that, among economic objectives, economic efficiency was the main purpose of privatization and that raising revenues for the government was of lesser importance.

4.2 Philippines

4.2.1 BACKGROUND

The two decades between 1950 and 1970 in the Philippines saw the rise of state owned enterprises in nearly all areas of economic activity. Encouraged by the prevailing import-substituting industrialization strategy, cheap credit, foreign borrowing, not to mention rampant political cronyism, these corporations were generally inefficient, highly leveraged and ill-prepared to cope with financial difficulties. Indeed, by 1984 there were 303 such SOEs that were financially dependent on the government in the form of subsidies, equity contributions, and loan accommodations. This support was substantial: between 1975 and 1986, the State spent an average of Pesos 10 billion per year on these corporations.²¹

19 This was repeatedly asserted by Mr Pedro Vergara, the long-time Director of CESMEC, during several interviews in May 1994.

20 Joe Ramos, CEPAL's Division of Economic Development, in an interview on 1994-05-13.

21 Privatization Policy in the Philippines: An Update. Philippine Development Corporation, January-February 1989



During the 1950ies and 1960ies a boom in the construction industry as post-war infrastructure programs flourished spurred the establishment of cement plants all over the country. This was made very easy for anyone with the right political connections who could borrow from the Development Bank of the Philippines (DBP) and set up a plant with very little equity.²² During this period of glut, the cement plants reaped monopolistic gains through a cartel agreement that discouraged one plant from selling on someone else's "natural" market. The arrangement also meant that the relatively inefficient producers could survive and industry capacity remained too high.

By the early 1970ies there were already some 17 cement plants in the country. By then signs of overcapacity started to show. The first oil crisis hit and the Philippine economy followed those of the rest of the world into a global recession. Construction was down and demand for cement dried up. Capacity utilization dropped to 40 percent, net losses climbed to 25 percent of sales as interest rates soared and repayments on foreign loans ballooned with the falling value of the Philippine currency. The position of DBP became precarious considering its huge exposure of Pesos 6 billion in the cement industry.

The inherent structure of the cement companies prevented them for coping effectively with the crisis. Firstly, the small capacity and outdated technology of most of these plants prevented them from cutting losses and protect themselves from rising costs. Secondly, the industry was highly import-dependent with foreign inputs accounting for nearly 40 percent of the ex-plant cost.²³ Thirdly, the price control policy adopted in 1972 severely tightened their working capital. But, most important, their capital structure—high foreign debt and low equity—made them very vulnerable to high interest rates and depreciation of foreign exchange rates.

Eventually the situation deteriorated so badly that the cartel crumbled and cutthroat competition took over. The government created the Philippine Cement Industry Authority in 1973 to regulate the entry of new plants or adding of capacity, allocate sales quota and undertake the subsidized exportation of excess production. A 50 percent import tariff was introduced in 1979. This protected the industry but also nurtured inefficiencies in the cement plants and had negative effects on consumer welfare. To help contain increases in cement prices, price controls were introduced already in 1972. As a result, the companies' working capital suffered and further limited their ability to maintain and upgrade their production facilities. According to industry sources, the price control served as an irrelevant ceiling during periods of depressed demand and hindered the recovery during economic upturns. The controls were finally lifted in 1991.

In 1976, DBP's exposure in 13 cement companies, representing a significant part of the total industry, exceeded one billion pesos in the form of loans and guarantees. The loans were restructured to allow for longer repayment periods. Further accommodations by the DBP allowed some of the companies to convert from oil to coal and to install dust control equipment to meet new environmental regulations. In some instances, this required the conversion of loans to equity in order to lower the debt ratio. Thus, investments in the industry by the State continued even though the companies were making minimal or negative returns to assets.

In short, the story above is one of easy entry into a highly cyclical industry, made even more effortless by cronyism and an implicit 'guarantee' (through continued favoritism) of a state bail-out when things turn sour with the next turn in the business cycle. The 'wisdom' of such practices need not be discussed here but it is important to keep this background in mind when considering the 'success' of the ensuing privatization policy.

The final stage before the privatization of the cement companies took place between 1983 and 1985 when the DBP, itself also in financial straits, implemented a pay or close shop policy requiring

22 Interview with Magdalena Albarracin, PHILCEMCO President, on 1994-06-21

23 Industrial Restructuring Studies, Development Bank of the Philippines, 1991

delinquent cement companies to start paying their monthly amortization or face closure. Likely, however, the true motive was just as much helping out friends by reducing excess supply as to reduce the drain on public funds to inefficient plants. At any rate, six plants were mothballed and the supply was trimmed considerably.

In 1986, the 13 cement companies on DBP's books, now classified as non-performing assets, were transferred by the newly created Committee on Privatization (COP) to its implementing arm, the Asset Privatization Fund (APT) in order to shore up the financial situation of the government's main development bank, the DBP.

Recognizing the defects of the previous policies, the new Aquino government in 1986 moved to deregulate the cement industry as part of a fundamental macroeconomic change that liberalized trade, the fiscal system, and the foreign investment climate. The APT was charged with privatizing, quickly, the 13 cement companies under its control. Public bidding and direct-buy-out schemes were used to dispose of the assets. No pre-qualification of bidders were used.

However, because of the thin market and the precarious political situation, only existing cement companies and interests with their intimate knowledge of the industry and ability to relate to any political setup could realistically move to take advantage of the offered opportunities.

4.2.2 OBJECTIVES

APT' objectives for the privatization of the cement companies were clear:

1. to dispose to the private sector within the shortest time possible those assets transferred to it by COP;
2. to generate maximum cash recovery for the government; and (implied by the COP's mandate),
3. to ensure adequate local supply of cement to support the country's increased construction activity; and
4. to enhance efficiency in the industry.

In practice, both COP and APT were to abide above all by the first directive, i.e. speedy disposition as both organizations were only given a term of five years.

4.2.3 SUCCESS RATE

So how well did the Philippines do in meeting these objectives?

On the first objective, the speedy disposition of assets, the result must be judged as more than good. All of the cement companies, except two cases that are still pending, were transferred back to the private sector within within a time span of five years after commission, most within only two years.

With respect to generating maximum cash from the transactions, the objective facts are: Pesos 2 159 million was attained as against the appraised value of Pesos 2 417 million and one half of the aggregate transfer price was recovered. In judging the success in terms of these numbers, account has to be taken of the unfavorable political climate that prevailed at the time, the possibility that appraised values were influenced by accounting valuations rather than market values, and that the primary objective of the exercise was speed. Against this background, the success rate must again be seen as good. However, the very limitation of the number of domestic bidders and the threat of a coup d'état that scared away foreign investors must have had an unfavorable impact on the proceeds. Thus, the net success can perhaps best be described as fair, but probably as good as could be expected under the prevailing conditions (some of which were self-inflicted).

The implied, third objective of ensuring an adequate domestic supply has been fully met. The 1994

demand is projected to be 9.6 million metric tons while the production is expected to reach 10.2 million metric tons. Further expansion in capacity is now coming from the setting-up of new plants, encouraged by recent developments.

Efficiency in the industry has increased through the mobilization of idle capacities. But, this is thanks to the deregulation of industry in general and the opening up of foreign trade under the ASEAN Free Trade Area agreement that has increased competition on the Philippine markets rather than to the privatization of the cement companies in itself. Nonetheless, without the privatization the efficiency gains would probably not have been forthcoming. Thus, we are justified in saying that here, too, we had a success albeit very much conditioned on macroeconomic changes.

4.2.4 FACTORS CONTRIBUTING TO THE SUCCESSES

The speedy disposal of the assets was achieved because APT operated solely as a disposition entity with a clear execution but no policy mandate, sufficient autonomy, ready access to top decision makers in COP, and a qualified staff. The direct-debt-buy-out mechanism used to attract investors and a valuation done according to the market (rather than to book values) aided significantly in the speedy disposal. The firm resolve of the government to proceed with a general liberalization of the economy contributed to the investors confidence.

The recovery rate was negatively affected by the desire to proceed quickly that then reduced the number of bidders. The threat of a coup d'état and the still existing price controls deterred potential foreign investors, despite a growing demand for cement. Undoubtedly there was also a substantial reduction in the assets' market value due to the physical and technological deterioration of the plants that, in turn, was due to the fact that APT neither had the financial resources nor the technical expertise to manage and conserve the assets.

The sufficient growth in the supply of cement was, in part, in response to favorable macroeconomic and industry prospects in 1987-1989 that led to a substantial increase in current and projected demand for cement. The adequate domestic supply objective, as well as the speed objective, were aided by a new debt conversion program. Using a central bank circular, companies were allowed to avail of debt-equity and debt-asset swaps to finance the acquisition of APT assets. Under the debt-to-equity scheme, any investor could purchase, at a discount, unmatured Philippine private or public sector debts in foreign currency and with local currency proceeds, buy acquired assets from APT. The debt-for-asset scheme allowed any investor to buy Philippine treasury debt papers at a discount. The peso proceeds could then be used for the purchase of acquired assets from APT.

4.2.5 COMMENTS

By aiming primarily at a quick sale of the state owned cement companies, the government clearly sacrificed other objectives that could have been easily achieved at the same time. For example, a sufficiently low price would also have led to a rapid divestiture, attracting buyers in no time, including interested parties from outside the group of existing cement companies. Likely, this would have led to increased competition in the cement industry in the country, with ensuing benefits to the consumers. Of course, the revenues to the state might have been lower, but since revenues was less of an issue, this would not have mattered much.

The very limitation of the numbers of bidders allowed the existing cement companies and the families behind them to buy without great difficulties the cement companies to be privatized. This led to further market concentration and probable negative welfare effects. The Cabinet was aware of this possibility but opted, after seeking guidance from the President, to be primarily concerned with the speedy disposal of the assets.²⁴ and believing it could take care of any negative effects by opening up

24 Interview with Mr Diosdado Macapagal Jr., former Head of the Technical Committee of the COP on 1994-06-08.

the domestic markets to foreign competition.²⁵ What actually happened, however, does not correspond to this plan: the tariff protection was removed only several years after most of the privatization acts had taken place.

In the final analysis, the government did manage to rid itself of its non-performing cement industry assets but, it is hard to escape the conclusion that it managed in the process to put itself back in the position where it was shortly before it had to come to the rescue of the failing companies. Moreover, it even aided this outcome by allowing the buyers access to cheap credit. All the elements for yet another repetition of the process are in place.

4.3 Hungary

4.3.1 BACKGROUND

In Hungary, privatization has been less of an end in itself than a means for establishing a true market economy, or put differently, get the then existing social market economy working. Thus, the effect of privatization in Hungary must be seen in the context of a transition from a socialist (albeit an atypical one) to a market economy. Furthermore, the adopted policy of spontaneous privatization²⁶ has transferred only a small proportion of state assets to genuinely private hands. Thus, some cases of 'privatization' has been undertaken probably more for narrow political interests than economic reasons, and 'insider deals' between the State, the existing management and the new owners may have lead to an unusually high degree of managerial control remaining in the hands of the existing managers.

Mostly privatization has been a gradual process through certain changes in the law (the Hungarian Company Law of 1988 and the 1989 Transformation Law are the most important ones) that has allowed the transformation of a SOE into a new legal entity whose owners, however, typically are other state institutions. In this sense, the case to be reviewed below is atypical: private (foreign) ownership of the company now is almost total.

Since 1968, the Hungarian economy had become gradually more and more decentralized, local authorities received greater autonomy from the central administration and managers of SOE were allowed to exercise increased decision making powers in respect to investment, production, and distribution. Incentives for greater operational efficiency were in place. The extent of intervention by the ministries was largely confined to approval of budget and production plans that were prepared by the enterprises themselves.

In 1989, the first democratically elected government in Hungary committed itself to the transition of the country to a market economy and policies were adopted towards this objective. At first, the major economic policies focused on economic liberalization as they did in several other eastern European countries. Free pricing of goods and services and wages was sought through deregulation of industry, liberalization of foreign trade and withdrawal and reduction of price subsidies. The legal infrastructure and institutional system required for private sector growth, private ownership of property, and development of a market-oriented economy were established. Macroeconomic measures were adopted to stabilize the economy and initial steps were taken to increase and improve the competitive conditions in the economy. It was also recognized as essential to adopt stabilization measures as a pre-requisite for a market economy. Finally, the transfer of state-owned property to the private sector was to play a key role in the transformation of the centrally-planned system in Hungary to an increasingly market oriented economy.

The cases of spontaneous privatization took place with limited supervision, control or intervention

25 Interview with Mr Virata, Prime Minister at the time of the privatizations, on 1994-06- and Interview with Finance Undersecretary Romeo Bernardo on 1994-06-08

26 The first instances of privatization, based on the 1989 Transformation Law, are referred to as spontaneous.



by the government. In response to the problems which arose from this situation, the State Property Agency was established by the new government in 1990, and was entrusted with the supervision of the privatization of SOEs and to ensure that they took place with proper and adequate protection of the interests of the state.

During 1990-92, the privatization laws and procedures were expanded and further refined in the light of the accumulating experience. The requirement of tenders for major divestitures and, therefore, the achievement of a fair market price under competitive bidding procedure became an important element. Transparency of transactions was to be a key requirement in order to contribute to the fairness of the process. A distinctive feature of the Hungarian practice, as distinct from privatization in several other East European and Central Asian countries, has been that privatization of state-owned assets was meant to be achieved at the market value of the operation, and against payment. Free distribution of shares and voucher type of privatization has not been utilized in Hungary. Foreign investors have been welcome to participate (with a minimum of 30 percent equity share); in fact, they have been encouraged through the granting of major tax concessions.

Foreign direct investment (FDI) was expected to play an essential role in the modernization of the economy. FDI was to ensure much-needed capital inflow, and to bring about increased inflow and application of new technologies and production expertise, and advanced managerial know-how in various fields of industry and to perform a critical and catalytic role.²⁷ The participation of foreign investors was considered essential in order to integrate the Hungarian economy with other industrialized economies in Western Europe, both through trade and through investment, technological and marketing relationships. Moreover, increased linkages with foreign companies was considered vital for the expansion of the country's exports to western markets.

The Styl Clothing Factory (henceforth Styl for short) at Szombatheley in western Hungary, only some 30 miles (50 km) from the Austrian border, was selected as a case largely because its privatization took place already during the first wave of such actions in Hungary during the 1989-91 period and therefore, there is a track record covering four years of operations under private ownership that can be analyzed.

Thanks to both its geographical location and subcontracting arrangements with firms in the West, Styl was already prior to its privatization heavily engaged in exporting to countries with convertible currencies. As such it enjoyed considerable privileges from the government, especially in terms of access to foreign exchange and importation of equipment. Consequently, the company's technological capabilities were competitive and comparable with those in western Europe. Such international competitiveness was not usual among the Hungarian manufacturing enterprises.

In 1988, Styl entered into a five-year subcontracting arrangement with the Bäumler company of (then West) Germany for an annual value of Ft 84.3 million. This, as well as other similar subcontracting agreements, entailed the production of men's jackets for which all the material, components, designs and labels were supplied by the foreign company from abroad. Styl provided the labor on the basis of the gross price of one labor hour, which comprised the direct labor costs and all the allocated indirect costs of the company. In the agreement, the number of hours required to prepare one jacket was specified. The profit of the company accrued from the difference between the agreed upon gross labor hours (assessed as revenue in the Income Statement) and all the direct and indirect costs of the company. The gross labor price was quoted and agreed upon by Styl and its foreign subcontractor in foreign currency. Consequently, the forint profit of the company realized was significantly influenced by the rate of inflation in the country and the foreign exchange rates. In the case of long term arrangements, such as with Bäumler and Maitland Ltd. of the UK, where the prices are fixed for a five-year period, actual revenues and costs may deviate substantially from the projected levels.

27 See Amendment of Act XXIV of 1988 on the Investment by Foreigners in Hungary.

The Styl Clothing Factory is the third largest clothing manufacturing enterprise in Hungary. Since its establishment, it has been a profitable company, and it is generally recognized that it produced the highest quality clothing in Hungary. As part of its expansion in the 1970s, the company installed a considerable range of imported, modern production equipment.

The company has been engaged in four major activities: firstly, export to countries with convertible currency, based largely on export financing from the buyer; secondly, subcontracting arrangements where the material was provided by the foreign buyer; thirdly, the company's own production directed to the domestic market and sold through four company-owned retail outlets; and fourthly, exports to the Middle East and to the Soviet Union. In addition, the company was also engaged in trading, and imported ready-made clothing from the Far East and sold it through its own stores.

The successful operation of the company, even preceding its privatization, is largely attributable to sound and efficient management that achieved full utilization of the plant's capacity. The company invested in new technology and equipment, that was imported from western countries and that enabled high-quality production and operational efficiency. As a result, the company was able to develop an active export program to Western markets and to the Middle East. Due to the high quality of its production, the company received subcontracting export orders from producers of well-known, high-quality brand names. During periods of low orders—usual for the industry between the two seasons—production capacity was utilized effectively to produce for the large and steady market of the Soviet Union. During such periods, the company also increased its production for the home market.

In the mid-1980ies, exports to the Middle East markets had all but disappeared but the company was successful in making up for this loss by expanding its exports to western European countries. In the mid 1980ies and up to 1989, exports to the Soviet Union also remained significant.

The privatization of the company took place in different stages. The initial step was the legal transformation of the state-owned enterprise to a joint stock company which allowed the sale of shares of the company to outside investors. In a second phase, the company was transformed to a joint venture with a minority holding by a foreign investor. Finally, the shares that were still held by the government were sold partly to the foreign partner and partly through a public offering.

In preparation for the privatization, the Styl management undertook an initial valuation of the company based on the book value of machinery, equipment, land and buildings,²⁸ arriving at a total value of Ft 400 million. A separate valuation was prepared by Ernst and Young Co., the US accounting firm, that set the value of the company at Ft 505 million.²⁹ These two estimates were submitted to the Ministry of Industry and Trade (the State Property Agency did not exist at that time), and constituted the basis for the subsequent negotiations. The participants in the negotiations were the Hungarian Ministry of Industry and Trade representing the interests of the Hungarian government, the Hungarian management of the company, and the prospective foreign investors in the company. As the outcome of lengthy negotiations, in 1989, the joint stock company was valued at Ft 334 million.

The divestiture of the company commenced in 1989 and was completed by 1992 when 97.4 percent the ownership was in the hands of foreigners and the remaining 2.6 percent was held by domestic, private investors.

4.3.2 OBJECTIVES

The aim of the Styl management in transforming the company was to

28 Styl, Vagyongertekelés, Szombathely, 1990-10-02.

29 For an analysis of the company valuation see: Tulajdon Alapítvány Privatizációs Kutatóintézet, A Styl Ruhagyár Reszvenytársaság Atalakulása és Privatizációja, Budapest, November 1992. (mimeo).



1. sell the company to its principal foreign suppliers;
2. ensure the continuing commitment of such suppliers to investment in the technological modernization of the plant and its continued access to markets in western Europe; and
3. realize certain tax savings through operating as a joint venture with a foreign partner.

In addition, the following government objectives can be inferred from the governing party's program:

4. protect the value of state property;
5. broaden ownership among the population;
6. return nationalized property to its former owners; and
7. restructure large entities into smaller units functioning independently; as well as the overall government objective to
8. use privatization as a vehicle to transform the economy into a market economy.

4.3.3 SUCCESS RATE

In general, the privatization of the Styl Clothing Factory has been viewed by the Hungarian authorities as a success because of the subsequent good performance of the company and its positive contribution to the Hungarian economy. However, in terms of the specific goals set for the privatization of Styl, not everything, although a great deal has come to pass.

As far as the objectives set by the company management are concerned, the rate of success is very high. Already in the first phase of the divestiture, the German company Bäumer GmbH acquired 19.8 percent of the company. Styl's British partner, Maitland Ltd. acquired four percent of the shares, and between one and three percent of the company's shares were bought by two other German companies. By 1993, 99.2 percent of the ownership was in the hands of foreigners with Bäumer GmbH having the absolute majority with 52.1 percent. Thus, objective 1 was achieved.

In the first phase of the divestiture, Bäumer GmbH, paid for its shares partly in the form of new but also reconditioned machinery, and partly in cash. It also continued its long term subcontracting relationship with Styl under which it continued to supply Styl with advanced machinery and equipment.

In the second phase of the divestiture, the government sold Ft 100 million worth or 38 percent of its share capital to the foreign owners of the company. They in turn agreed to use the proceeds that went to the company according to the law (20 percent of the total) for the expansion of the company's capacity and modernization of selected production lines and partly to finance a stock offering to the workers of the company. The graph below shows that the growth in annual investments has been substantial and nearly constant since 1986; although the figures for all of 1994 were not yet in at the time of the case study, the growth appears to have continued at the same pace in that year.

By mid 1994, the major investments for the modernization of the plant were mostly completed and during the next few years the investments are scheduled to be significantly below the 1990-1993 level. By now, the company's production facilities are only marginally different from the German investor's home operations in Ingolstadt, Germany and the labor force productivity of Styl is only some 5 percent less than at the Ingolstadt plant. Thus, the second management objective has also been reached.

Achieving the third objective of tax savings was never in doubt as the provisions for these savings are written in the law. According to the 1989 legislation on foreign direct investments, companies with a minimum of 30 percent foreign share are eligible for a 60 percent corporate tax deduction for three

years to be followed by a tax deduction of 40 percent for the subsequent five years. Therefore, Styl has enjoyed tax concessions and its tax payments have been modest.

Turning to the implied but specific government objectives, the picture is not quite as good as it is with respect to the management's goals. Initially the State owned share capital worth Ft 5 million, representing less than one percent of the total share capital, was sold at face value to the Hungarian management of Styl. In the second phase of the divestiture, when the government sold Ft 100 million worth or 38 percent of its share capital, it received 170 percent of the face value. Of the proceeds, 80 percent went, according to the law, to the government and the rest to the company. In absolute terms, however, this may have been less than what could have been realized for the State. Namely, the initial valuation of the company that provided the basis for the sale of shares to the foreign investors appears to have been low. The company was valued significantly below its book value and in terms of its earnings, the price/earning ratio was less than three which is substantially below international standards. Furthermore, the company's tax contributions have been low because it enjoys significant tax concessions for the present and will continue to do so during the next few years.³⁰

In the third phase of the divestiture, the remaining 60 percent of the State's holdings in Styl were sold through a public offering of shares on the Budapest Stock Exchange. The offering was over-subscribed five times, and trading indicates that the offer price was approximately 10 percent below the market price. In sum, the government appears to have had only a limited success with respect to 'protecting the value of state property'.

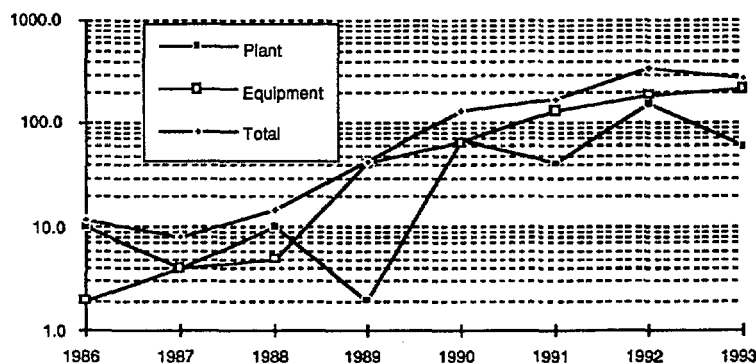
Broadening of ownership among the population was not achieved through the privatization of Styl. The workers of the company were offered shares with a face value of Ft 55 million but, rather than keeping their shares in the hope of future dividends and appreciation, most of them (95 percent) chose to accept an offer from the management to buy back their shares.

The return of nationalized property to its former owners was not an issue in the privatization of Styl since it had been a SOE from its inception.

Restructuring of Styl into smaller, independent units was never attempted. This, however, was not an issue since Styl is a relatively small company.

The privatization of Styl is one of several successful transfers of state-owned assets to the private sector that has contributed to the transformation of a centrally-controlled economic system to a market-oriented economy. With regard to this major economic and political objective of the Hungarian government, the case of Styl must be viewed as successful, although the cost-effectiveness of the operation can be questioned.

Styl Investments, 1986,...,1993; in million Forints



³⁰ Tax revenues are, of course, generated from personal income tax but that was not one of the specific goals set for the privatization of Styl.

4.3.4 FACTORS CONTRIBUTING TO THE SUCCESSES

The privatization of Styl was largely facilitated by the favorable policy of the Hungarian government towards foreign direct investments. In 1989, when the joint venture was formed, Hungarian legislation towards foreign investments was advantageous by international standards and provided greater incentives than in most other countries in the region. In addition to guarantees against expropriation and permission for full profit repatriation, it also provided significant tax benefits for such investments. The early adoption of a duty-free system for imported material that is used in production for export provided an important incentive for efficient subcontracting arrangements.

The export-oriented and import-dependent production of Styl is highly sensitive to the foreign exchange rate policy of the government. With the latter's policy to overvalue the forint, Styl have been affected unfavorably. However, with progress in stabilization of the economy and full convertibility of the forint over a period of time, these disadvantages will tend to decrease and can be considered to be of a short term nature.

The privatization of Styl was undertaken during 1989-90, when the legislation on privatization was at its earliest stage and did not provide for adequate safeguards for the valuation of state property. Political uncertainty in the country at the time might also have been an important factor in the valuation of the State owned assets. It was only in 1991, with the establishment of the State Property Agency that increased transparency and bidding requirements have enabled a more adequate valuation process.

4.3.5 COMMENTS

In its eagerness to get the transformation to a market oriented economy going, and in choosing privatization as a major means towards this end, the government may have deliberately undervalued especially the initial offerings in order to sell them off quickly. It may thereby have unwillingly or willingly allowed foreign investors to go 'cherry picking', i.e. pluck only the best values. On the other hand, this could also be seen as the equivalent of feeding a pawn in chess in order to gain the queen—the latter being the fundamental transformation of the economy through (foreign) investment in modern technology. One must not forget that during the many years of socialism, the nation's stock of capital had been almost completely depleted and its ability to generate new investment all but stymied. Therefore, the marginal (meaning additional, not small) economic value of new investment to the economy may have far outweighed most any financial costs.

This said, the evidence—the process through which the privatization of Styl was carried out and the undervaluation of the assets—does not rule out the possibility that certain deals were struck between the principal parties to the process, to the possible detriment of the national economy and contributing to, on the one hand, the high rate of success in the management objectives and, on the other hand, relatively low rate of success as far as the national goals were concerned.

The relatively many stated and unstated objectives—eight identified in this study—may well have contributed to the low achievement with respect to some of them. The result illustrates the general rule of Bent Hansen, recalled above, that states that each policy objective, when seen in the context of a fully identified economic system, requires one policy measure, no more, no less.

5. FINDINGS

5.1 Auxiliary Objectives Sought

The multitude of objectives sought through privatization efforts by the governments in this study can be grouped into the following categories:

1. promote economic efficiency throughout the economy;
2. raise revenues and reduce costs for the government;
3. broaden ownership among the population (except in the Philippines);
4. enhance technological capabilities;
5. achieve political and ideological objectives; and
6. ensure continued domestic supply (Chile and the Philippines) and access to export markets (Hungary).

In all cases, a speedy disposition of the assets was of essence but mainly for fiscal reasons. A second common theme was a genuine desire of the governments to withdraw from the role of producer and to yield (return) this function to the private sector.

5.2 Conditions for Success³¹

The evidence contained in the three case studies reviewed above suggests that there are three major factors affecting the desired outcomes. The first one is the mode of behavior the privatized SOE is adopting; this is often closely associated, but not always, with the morphological form of the market in which it is going to operate. Efficiency and related or similar microeconomic objectives are achieved when the privatized company is forced to become competitive; other, non-economic or social objectives are more readily achieved under protected conditions. The attainment of political and/or macroeconomic goals tends to be independent of the ensuing behavior of the privatized SOE and hence of the market conditions.

The second major factor is the policy environment of the country and the ability of the government to implement its policies. The more market friendly the policy environment and the stronger the government is, the better are the chances of achieving virtually any type of goals of a privatization act or program. Most likely, although it cannot be unambiguously derived from the three case studies here, privatization stands its best chance to succeed when it is part of an overall macroeconomic restructuring process or an entire policy reform. The political commitment has to be non-wavering and strong, there has to be public consensus and understanding for a policy of privatization, and the proceedings have to be transparent in order to avoid the impression that it all is (once more) a matter of political cronyism.

The third major factor is the decision making structure of the SOE after it has been privatized. Privatization can succeed in terms of efficiency and other microeconomic goals if the sale of the enterprise brings in owners with resources and skills and, most important, a direct stake in the success of the newly privatized company. This conclusion is akin the Bank's finding that "ownership matters". Our point, however, is that it is behavior that matters although a competitive mode is apparently (empirically, that is) more probable when the owners are private and hence have a stake in the success of the company.

To put (former) bureaucrats in charge of former SOEs seldom leads to true competitive behavior. They can become skilled in using business tools to run the companies but more often than not, for their own purposes rather than for the financial gain of the company and its owners. However, they can

31. See also UNIDO, Industry and Development, Global Report 1992/93, Vienna 1992, Chapter IV, Privatization, Section C.5 Constraints to privatization, pp. 235-241.

provide short term stability in an economy in turmoil.

If monopolistic behavior is likely to continue after privatization or, paradoxically, results from such an act, the attainment of both efficiency and welfare goals requires that a strong regulatory framework is in place before the privatization.

Relatively minor conditions for success have to do with the complexity and speed of the privatization process. The liquidation of small and medium-sized SOEs to competitive markets are simple and quick, require little if any other action, and are low-risk politically. Conversely, the sell-off of large entities that are and will be dominating on the markets is likely to be both legally and financially complex, take a long time, and involve large political constituents. Any of these factors can easily derail the process.

An appraisal that corresponds to a market valuation (as opposed to book or other actuarial evaluation) as well as realism in other expectations speeds up the process of privatization. Indeed, unrealistic valuations that bear no resemblance to what the potential buyers are willing to offer may postpone the act of privatization indefinitely. On the other hand, selling off too cheaply may attract buyers who have no intentions to operate the privatized SOE and any other objectives but revenue raising may therefore be jeopardized.

All three cases show that the privatization process must be well prepared in terms of legal and organizational structures, managerial arrangements, and absolutely clarity of purpose on part of the government.

The successful privatization of natural monopolies or SOEs that after the privatization will be operating on oligopolistic markets, is likely to require other than the above conditions such as, for example, a strong and fair regulatory framework. However, since no such cases were examined in the current study, no further comments on this issue are here warranted.

In implementing its privatization efforts, the Chilean government initially made an important fundamental mistake. It permitted the privatization sales to be heavily financed with debt. On the positive side, this allowed competitors for the ownership of those enterprises to bid up the purchase prices to levels that were higher than had they been unable to obtain as much debt. But, it also burdened the winning bidders with large debt service costs. High returns were then necessary to cover the high interest costs. And to achieve high returns, management often had to invest in projects with higher risks.

5.3 Generalizations

The case studies reviewed here are, of course, few and by themselves do not warrant far-reaching or detailed conclusions. Coupled with previous research on related issues as well as anecdotal evidence, however, the sum total of the evidence leads us to believe that

- (a) auxiliary objectives of privatization when they are of a macro- or microeconomic nature, require that the company or companies turned over to private interests **behave** competitively after the act;
- (b) other auxiliary objectives require specifically designed instruments or pre-conditions for their success; and
- (c) significant lessons can indeed be learned from carefully designed case studies.

Two further observations regarding the quest to achieve “popular capitalism” through a wide distribution of share ownership may be warranted. Often, this objective means that an enterprise could be controlled by owners holding a relatively small portion of the equity, frequently purchased at only moderate personal risk and therefore, generally more willing to assume higher business risks.



Furthermore, the high cost to service the loan used to purchase the enterprise pressures these entrepreneurs into higher risk asset management. Such leveraging of the equity is advantageous when returns to investment are above the interest cost. But, when risky investments turn sour, especially under the pressure of a significant downturn in the overall economy, (as occurred in Chile during the early-1980s), and return on investment goes below interest costs, it can (and did in Chile, and could do so—again—in the Philippines) lead to bankruptcies.³²

The second observation comes from Yotopoulos who observed "... access to finance is the decisive factor that determines if privatization becomes a vehicle for further economic democratization, or rewards instead local elites ... Privatization that takes place in the absence of well functioning domestic capital markets is likely to lead to increased concentration rather than increased competition."³³

More case studies of the sort undertaken in this project would allow us to firm up as well as expand on the above conclusions. Clearly, these results cannot be used to predict the results of other privatization—the individual circumstances differ too much—but, they can be used to prescribe policies and measures that are required to reach certain goals auxiliary to the direct privatization objectives. This, indeed, is the essence of UNIDO's activities in the area of industrial policies and strategies.

32 Rolf Luders, Minister of Finance and Minister of Economic Affairs 1982-83, previously a senior executive with the conglomerate corporation Javier Vial, and presently Chief Economist with the International Center for Economic Growth and Research Program Director, Economic Institute, Catholic University of Chile, at an interview on 1994-05-30.

33 Yotopoulos, Pan A., *The (Rip)Tide of Privatization: Lessons from Chile*, World Development, Vol. 17, 1989, p. 699.



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ANNEX A:

25 October 1994
ORIGINAL: ENGLISH

**A CASE STUDY OF CESMEC LTD.
CHILE**

Technical Report: An Experience in Successful Privatization

PREPARED FOR
United Nations Industrial Development Organization
Vienna

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ABSTRACT

Title: Case Study of CESMEC Ltd., A Successful Privatization in Chile

Objective: To provide information about the economic and political background, particularly the macroeconomic conditions existing at the time of privatization, the considerations addressed, and methods used to privatize a technical services enterprise in Chile.

Conclusions: For a privatization program to be successful, it is critical that macroeconomic policies be clear and that the private sector have confidence that the government will persist in its efforts to stabilize the economy and keep the market free. Particularly important are monetary control, fiscal discipline, deregulation of prices, and opening of the economy to international trade and capital movement.

People with entrepreneurial talent can be found to purchase and manage the privatized enterprise by providing them with sufficient financial incentives. Confidence in their ability to successfully manage the enterprise will evolve as they experience success.

An enterprise's top management should be provided with a significant portion of the enterprise's equity to provide them with (1) sufficient caution about assuming too much risk, (2) adequate control over the enterprise, and (3) sufficient financial incentive to succeed.

Governments should be very careful about allowing entrepreneurs to finance an enterprise's privatization acquisition with too much debt. While such debt/equity leveraging will enable the government to obtain a high sales price for the enterprise, the high debt service requirement may exceed the enterprise's profit capacity, ultimately driving the enterprise into bankruptcy. Governments should require bidders to demonstrate an ability to provide additional equity capital, when and if the enterprise might need additional capital and/or lower its debt service costs.

On the other hand, government assistance facilitated a speedy privatization process, and it appears that the speed of CESMEC's privatization contributed to its success. It minimized the period of uncertainty about CESMEC's future, thereby keeping the enterprise's key management team intact during the transition and assuring its clients of continued operations and quality of service.

In selecting future case studies, UNIDO should select only those enterprises where access can be assured to key decision-makers' opinions and to complete information characterizing the enterprise's conditions before, during and following the privatization. Important information may be old and/or unpublished, and local assistance by a person with clear authority to access informants and information is critical.

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I also wish to thank Ana Maria Ramirez who arranged and scheduled my interviews, facilitated communications, and provided or coordinated all clerical support. Her assistance made it possible for me to focus exclusively on the technical aspects of the work and to expedite its completion.

Mr. Vergara particularly wishes to acknowledge John McCulloch's contribution to CESMEC's success. UNIDO appointed Mr. McCulloch to be CESMEC's International Manager in 1970, at a time when CESMEC was still seven years away from privatization. Between 1970 and 1974, Mr. McCulloch worked behind the scenes, helping Mr. Vergara to understand the principles of good entrepreneurship and management techniques and especially the importance of applying human values in implementing those techniques. Mr. Vergara is especially grateful to John McCulloch for his inspiration and help in developing the confidence he needed to conceive and lead the privatization effort and to manage the enterprise toward the success it has achieved.



INTRODUCTION

Chile's economic history during the past 25-30 years is a fascinating story, of which enterprise privatization is an important aspect. Others have told portions of that story, but mainly from the "top down," a point of view that examined the macroeconomy and effects of privatization portrayed in terms of aggregated data for numerous privatized enterprises. The following paper describes privatization from the "bottom up," that is, from the point of view of one of Chile's enterprises, CESMEC Ltd., a technical services company that was privatized in January 1978.

CESMEC was not selected to be a representative example of a particular type of privatized enterprise or privatization process. It does, however, highlight many important features of Chile's privatization effort and particularly of what it took to succeed in the context of Chile's economic conditions. Indeed, at the time of CESMEC's privatization, and during a critical period in its development, the economic environment was extremely hostile. Many privatized enterprises failed during those periods. The reasons for CESMEC's survival and ultimate success were a particular focus of this research.

The information presented was extracted from the facts and opinions obtained through interviews (with the individuals listed in Appendix A) during three weeks of May 1994, and from published sources (listed in Appendix B). This report presents a summary and synthesis of that information, relying on the author's judgment about the relevance and consistency of the information and opinions obtained. A number of conclusions have been derived about how (and how not) to proceed with privatization. Clearly, these conclusions would be strengthened and supplemented by additional case studies drawn from Chile's and other nations' privatization experience.

The research was performed by David M. Dornbusch in association with Pedro Vergara, CESMEC's Chairman, under contract with the United Nations Industrial Development Organization (UNIDO). The work was administered for UNIDO by Caj O. Falcke, Senior Industrial Development Officer.

I. ECONOMIC BACKGROUND

A. Socialism to a Free Market Economy

Prior to the socialist Allende government, which assumed power in 1970, Chile had a large state enterprise sector. But, from 1970 to 1973, the public sector expanded significantly, when hundreds of private companies were nationalized. By 1973, when the military took over the government, nearly the entire economy was under state control. More than 500 companies were controlled by the government through either majority or partial ownership, including the entire banking system.

Moreover, the Allende government had instituted extensive price controls as well as monetary, fiscal, foreign trade, and social welfare policies that had severe negative impacts on the economy. Although the price controls succeeded in lowering the Consumer Price Index (CPI) by about 30% between 1970 and 1971, the prices were often set lower than the costs of production. It was reported that the fixed price of a bag of flour was less than the cost to produce only the bag without the flour.¹ Goods became extremely scarce, and a large black market economy developed. The CPI rose by more than five times in 1972, and again by more than four times in 1973. Many government-owned enterprises, in an effort to conserve cash, paid their workers with manufactured goods, expecting them to sell or barter those goods for their living.

High tariffs and non-tariff protections blocked imports and led to inefficient performance of Chilean enterprises. Large expenditures on domestic programs were financed by monetary expansion, foreign loans, and payroll taxes. All of the banks were controlled by the Allende government, and the interest rates paid to savers during the period were lower than the rate of monetary inflation, thereby yielding negative savings income. (Real interest was negative in each year of the Allende regime, reaching a reported minus 57% in 1972 and minus 80% in 1973.) During the 1960s, Chile's Gross Domestic Product (GDP) had grown by an average of about 4.5%. But by 1972, it had turned negative, and in 1973 the GDP decreased by 5.6%.

The military government, that replaced the Allende government in 1973, sought to stabilize the economy and adopted principles of free market competition. Advised by a team of foreign trained Chilean economists that became known as "The Chicago Boys,"² the military government instituted:

- monetary control,
- fiscal discipline,
- deregulation of prices,
- opening of the economy to international trade and capital movement, and
- privatization of most economic functions - including selling off the numerous public enterprises that had either been nationalized or created during the Allende government.³

According to Pan A. Yotopoulos in "The (Rip)Tide of Privatization:"

"Following the military takeover in 1973, Chile began a policy of liberalization, which to a large extent relied on the free market to allocate resources. This led to an attendant retrenchment in the public sector, with the size and role of the government greatly reduced. Commodity prices were freed by dismantling the protection system and eliminating the widespread price controls. Financial markets

1 Gen. Luis Danus Covian, CORFO Director 1974-1979, in an interview on May 19, 1994.

2 The "Chicago Boys" received their name because many had received graduate degrees in economics from the University of Chicago, and all were proponents of the conservative principles for which the University of Chicago's Economics Department has become known.

3 Andres Concha Rodriguez, General Director of ProChile and Advisor to the Ministry of Foreign Affairs on Exports during CESMEC's privatization, in an interview on May 25, 1994.

were progressively liberalized until, in 1980, virtually all quantitative restrictions on external capital flows were eliminated. There was a de facto deregulation of the labor market due to the trade unions' loss of power. A monetarist price stabilization program was introduced which relied heavily on eradicating chronic fiscal deficits. Foreign trade liberalization culminated in 1979 with the introduction of the uniform 10% nominal tariff (except for large automobiles) and the elimination of all export subsidies."⁴

These drastic reversals in economic policy provided the necessary environment for a private economy to function effectively. However, these changes also threw the newly privatized enterprises into a very competitive world economy, in which many of these enterprises were ill-prepared to compete and did not survive. Some key enterprises were preserved by bringing them back under public control and later were reprivatized when they were considered to be healthy enough to survive on their own. Others were allowed to go bankrupt.

At the time, the privatization process was highly controversial. Despite the disastrous economic performance of the previous socialist government, many Chilean economists felt that the state needed to continue to exercise strong control over the nation's enterprises. There was especially strong public opinion against privatizing enterprises that were considered to be important for national security. Indeed, some firms were retained in the public sector, and even today CODELCO, a very large copper mining enterprise, is still publicly owned. However, several factors combined to ensure that Chile continued resolutely toward privatization. They included:

- The government's immediate need for funds,
- The recent memory of the disastrous consequences of state enterprise operation and socialist policies,
- The firm resolve and power of the military government, and
- The government's faith in the honest intentions and economic skill of "the Chicago Boys."

B. Privatization Objectives

The primary objectives of the military government's privatization efforts were to:

1. Promote economic efficiency, by having the state withdraw from all enterprises that could be better run by the private sector.

Some state enterprises were functioning in areas where they had little or no technical or management skill. As a result, public managers often made poor business decisions. For example, the national petroleum company was building highways. The company proved unable to build the roads cost-effectively, despite its ability to produce asphalt. Also, while construction equipment was purchased from the Soviet Union at low prices, it was obtained with no service or technical support, ultimately resulting in very high operating costs.⁵

2. Promote economic democratization through increased participation by private individuals in ownership of national enterprises.

This notion of private ownership, called "popular capitalism," involved the sale of portions of enterprises to its workers. It was felt that this strategy would

⁴ Yotopoulos, Pan A., "The (Rip)Tide of Privatization: Lessons from Chile," *World Development*, Vol. 17, 1989, p. 685.

⁵ Gen. Luis Danus Covian, CORFO Director 1974-1979, in an interview on May 19, 1994.

create owner-workers with a greater stake in the success of the enterprise, thereby inducing them to work harder and to change labor-management relationships so that more productive decisions and agreements could be reached.

3. Raise revenues and reduce costs for the government from the sale of enterprises and state-owned capital assets.

In 1973, Chile was virtually bankrupt, and the government sought immediately to lower its expenditures and obtain whatever revenues it could from both domestic and from foreign private sources. Some economists criticized the speed at which the government sold its enterprises, calling it a "fire sale."⁶ These critics contended that privatization could have raised more money for the treasury had it proceeded at a more deliberate pace.

However, other economists contended that change was needed immediately. The country was in serious financial difficulties, revenues were needed as quickly as possible, and any delays would have had significant negative economic consequences. They felt that, among economic objectives, economic efficiency was the main purpose of privatization and that raising revenues for the government was of lesser importance.

Enterprise privatization was implemented in two main stages (1974-1978) and (1985-1989). All of these objectives were considered to be important throughout both stages. Indeed, all three were sought in CESMEC's privatization.

In addition to the above economic objectives, the military government also sought to achieve political and ideological objectives by its privatization efforts. In following the recommendations of "The Chicago Boys," the government endeavored to assume what was felt to be its appropriate role and to place the economy on a track that would increase savings, investment, and growth.⁷ The military government may have also seen an opportunity to break the political hold of powerful interest groups, thereby allowing it to increase its control over the country.

C. Privatization Process

Responsibility for promoting the development of production activities had historically been in the hands of the Corporation de Fomento de la Produccion de Chile (CORFO) (Production Development Corporation of Chile). Its activities included:

- Providing loans and loan guarantees to the private sector,
- Conducting research, and
- Implementing its own development projects.

Prior to the Allende government, CORFO held partial ownership of 46 companies, including public utilities, fishing, construction, agro-industries, forestry, and mining. By the end of the Allende government's term in 1973, CORFO controlled approximately 500 companies, having nationalized, acquired, or created over 450 enterprises. The privatization effort initiated shortly after the military government took control succeeded so well that by 1978 CORFO retained control of only 19 enterprises.

6 Joe Ramos, CEPAL's Division of Economic Development, in an interview on May 13, 1994.

7 Andres Concha Rodriguez, General Director of ProChile and Advisor to the Ministry of Foreign Affairs on Exports during CESMEC's privatization, in an interview on May 25, 1994.



This ambitious and rapid privatization program was implemented mostly by giving back many of the previously nationalized enterprises to the former owners, direct sale of the enterprises through public bid and negotiation, and the sale of enterprises' shares through the stock market. In addition, a large amount of capital equipment owned by public enterprises was sold, and many services previously provided by public enterprises were contracted out to private suppliers.



II. CESMEC'S PRIVATIZATION

A. CESMEC's Origins

During the 1960s, Chile's economic policy emphasized import substitution. An important component of that policy was the partial manufacture and assembly of automobiles. CORFO felt that it was important to monitor and control the quality of those automobiles. So in 1969, CORFO formed a publicly-owned and operated company, and gave it the initial responsibility of specifying the design and quality of spare parts to be manufactured for the country's automobiles and trucks. CORFO paid for the land and construction of the buildings, and the United Nations Industrial Development Organization (UNIDO) contributed \$481 thousand worth of capital equipment to initiate the enterprise.⁸ Within a year, the company's responsibilities were expanded to include specifications of all of the materials and parts used in Chile's automobile and truck manufacturing. It was named Centro de Estudios Medicion y Certificacion de Calidad, Ltd. (CESMEC) or Center for Studies, Measurements and Quality Certification.

By the mid-1970s, CESMEC was one of nine technical institutes having responsibility for natural resources prospecting, technical research and development, quality analysis, quality control and certification of various industrial products. By then, CESMEC had expanded its services further into quality analysis and certification with its main focus being non-destructive and operational testing of products manufactured in Chile, geochemical (minerals) analysis, and product failure analysis.

B. Policy Toward CESMEC'S Privatization

In 1975, at the beginning of the military government's privatization program, CORFO's director was Francisco Soza. He was not impressed with the contribution that the country's nine technical institutes were making to the country's technological needs. He concluded that none of the institutes were necessary to the economic well-being of the country, that the state should close six immediately and continue operations of the other three only if they could be sold to the private sector. CESMEC was selected as one of the three for privatization. He also concluded that whichever of those three could not be sold as operating entities should also be liquidated.

Within six months, Francisco Soza was replaced by General Luis Danus as CORFO director, and the CESMEC closure policy changed, as well. CORFO was still considering closing CESMEC and selling its assets, since there was no evident interest in acquiring it as an operating entity. CORFO was also willing to continue to operate CESMEC as a public entity, but only under the condition that CORFO would eliminate all subsidies to CESMEC by 1978. This policy required CESMEC to become self-supporting while still operating under the burden of CORFO's regulations and restrictions. The central problem was that CORFO tied CESMEC to operating budgets, prices, and employment regulations that forced CESMEC to operate at a deficit. If CESMEC's subsidies were eliminated, it would be forced to compete with other enterprises whose operations were still subsidized, such as universities, which absorbed a substantial portion of their costs elsewhere in their budgets. Therefore, it was clear that CESMEC would only be able to operate profitably if CORFO also released CESMEC from its controls.

C. Concept and Approach

Faced with the alternatives of CESMEC's closure or a requirement for self-sufficiency as a public entity, Pedro Vergara (CESMEC's Director) was encouraged to lead a private acquisition of the enterprise. His concept was for the employees to purchase the enterprise themselves from the government, and he organized support for the idea among CESMEC's workers. In a letter to General Danus, dated July 26, 1977, he outlined the principle points of the CESMEC workers' acquisition proposal. First, he expressed their feeling that:

⁸ Note that all U.S. dollars are indicated by the symbol "\$". Chilean pesos are indicated by the symbol "P".



1. CESMEC's services were beneficial for the country and, in particular, for the industrial sector.

Next, he confirmed what he and the CESMEC employees believed CORFO's objectives to be, namely that:

2. CORFO desires to privatize those public operations that have the capability to be operated as private enterprises.
3. CORFO no longer wishes to subsidize public operations which are unable to be operated efficiently.

He then asserted what he felt should be the principles of the acquisition, namely that:

4. The real asset of an enterprise like CESMEC is its employees, who have become highly qualified through their extensive experience in the enterprise's operation.
5. CESMEC's employees wish to maintain their working efficiency and believe that if the enterprise were to continue under CORFO's control that such efficiency would be difficult to sustain.
6. So, if CESMEC's subsidy were to be removed, CORFO's control must also be removed. This would be vital to enable CESMEC to compete effectively.

And last, Mr. Vergara identified some of CESMEC's unique aspects that should be considered in the sale and during its continued operation, namely that:

7. CESMEC was created to help Chile's industries maintain high technical standards. Therefore, its own technical excellence must not be compromised while seeking operational economies.
8. In the past, CESMEC had not received the same advantages granted to the other technical institutes. Therefore, the sale conditions should reflect and correct for those differences. In particular, CESMEC was established as, and would remain, a limited company, and as such was not entitled to special tax reductions available to the other institutes. Also, unlike the other institutes, CESMEC did not have the ability to provide services directly to CORFO, or therefore to receive compensation for those services that were priced to cover budget deficits.

D. Terms of the Purchase Agreement

On October 6, 1977, CORFO replied to Mr. Vergara's proposal stating its final decision regarding CESMEC's privatization. The decision was not reached easily. In fact, CORFO decided to privatize CESMEC despite the strong opposition from highly placed people in the government. CORFO agreed that CESMEC should be preserved, feeling that it provided an important economic function and that its management might be able to operate it profitably. CORFO also recognized that CESMEC had been conceived as a UNIDO project and felt a need to continue its commitment to the UNIDO objectives of technical and economic assistance.

Although CORFO normally sold its enterprises through public auction, CORFO determined that a direct sale was desirable in CESMEC's case. Such direct sales were often used to divest smaller enterprises such as CESMEC, especially when an auction process would be relatively expensive, when



only one bidder was expected, and/or when CORFO expected the negotiated price to be higher than the highest bid received through auction.

Attempting to set a fair price, CORFO estimated that it held an asset value in CESMEC of approximately P11 million. It also estimated that it would cost about P3.8 million in severance pay and benefits to fire the workers. Therefore, CORFO determined that it would be willing to sell its ownership in the enterprise for its net liquidation cost (equal to the difference) of about P7.2 million. Through negotiations, CORFO agreed to lower this price to P7.0 million.

In addition, nearly all of CESMEC's capital equipment had been provided by UNIDO, and CESMEC's management understood that it would be necessary to negotiate an agreement with UNIDO for continued use of that equipment. Fortunately for CESMEC, UNIDO regarded the capital equipment that it had provided to CESMEC as a contribution to the Government of Chile which it could use as it saw fit. In effect, UNIDO agreed to allow CESMEC to use the equipment, but with the condition that the equipment not be sold until the book value was zero, at which time it might be transferred to CORFO for sale.

In agreeing that controlling ownership in CESMEC should be sold exclusively to its employees, CORFO was persuaded by Mr. Vergara's assertion that CESMEC's main asset was its employees, and it was important to provide those employees with the incentive to succeed as well as the power to control the destiny of their enterprise.

Mr. Vergara's first proposal was for the employees to purchase 51% of CESMEC and for CORFO to continue as a minority partner. CORFO rejected this proposal and insisted that the sale would be for all of CORFO's ownership, or the company would be closed and the assets sold.

In agreeing to sell CESMEC entirely and exclusively to its employees, the sale was unique in Chile. Through its implementation of "popular capitalism," CORFO had previously managed sales of portions of large national utilities or monopolies to those companies' employees, but the portions sold had not previously consisted of more than 4% to 10% of the equity.

CORFO's terms for CESMEC's sale to its employees was as follows:

- The employees would purchase all of CESMEC's equity for cash, amounting to 10% of the P7.0 million total sale price, or P700 thousand⁹;
- CORFO would loan CESMEC (not the employees) the remaining 90% of the P7.0 million (or about P6.3 million);
- Collateral on the loan would be CESMEC's land and buildings;
- Interest on the loan would be at an annual real rate of 11%. This real rate of interest would be imposed by adjusting the outstanding principal on the loan each year by the inflation index;
- The loan principal would be repaid over a period of 8 years, with payments of 5% of the total purchase price in each of the first 3 years, and payments equal to 15% of the total purchase price in each of the remaining 5 years; and
- CESMEC would continue its operations and provide its services.

UNIDO's provision of the capital equipment was important to CESMEC's privatization. Although at the time of privatization, the equipment had a depreciated value of only about \$47,000 (equivalent to approximately P1,316,000 at the then current rate of exchange of about P28/\$), the equipment was still operational and would have been expensive to replace.

9 CESMEC's privatization was the first case in Chile when an entire company was sold to its employees.

In addition to the price for the company set by CORFO, CESMEC's employees also agreed to pay for the legal and administrative costs to organize the company, which brought the total cost of the equity to P1,000,000.¹⁰ Shares were priced at P10/share, and therefore a total of 100,000 shares were offered to the employees.

E. Employee Participation in and Perception of CESMEC's Privatization

A management team within CESMEC was appointed to determine the formula by which the 100,000 shares of stock would be offered to CESMEC's 87 employees. The formula developed provided that the number of shares would be a function of the employee's current salary level, level of responsibility, and number of years with the company. The management team determined a quantitative measure for employee's level of responsibility and for the relative weightings to be applied to each of the three components.

Of the 87 employees offered the opportunity to purchase stock, 83 exercised their option. Some chose to buy less stock than the amount offered, and the unpurchased options were then redistributed to the employees according to the same formula.

When the stock was fully subscribed in early 1978, six principal managers controlled 36% of the equity. Under the rules of the corporation, those six also comprised the Board of Directors, and as such, were responsible for all strategic and operating management decisions. The six members of the Board, together with four other members of the senior management team, controlled 50.4% of the original equity subscription.

Most of the principal stockholders viewed the purchase as a very difficult choice. At the time of privatization, the cost of the stock offered to the key managers was on the order of half a year's salary or more. And, many of the key managers interviewed could not make such an acquisition without borrowing the money, making significant sacrifices in their living expenditures, or both. The interest costs to borrow the money necessary for the purchase were very high at the time and dividends were uncertain. Therefore, the purchase was perceived to be very risky, even though the managers had confidence in the company and a greater ability to participate in its management.

Prior to the privatization, CESMEC had experienced major operating losses. In 1973, CESMEC's incurred an incredible loss of P409 million on total sales of only P59 million, and sizable losses continued in 1974 and 1975. The small profits reported in 1976 under public ownership were suspect because of the dubious accounting methods. In 1977, just prior to privatization, CESMEC's reported operating at break-even.

Some employees were not entirely confident that CESMEC could be operated profitably. Although highly skilled, these people had never worked in or managed a private company, and they were concerned about their ability to develop the necessary management skills. Also, at least a few of CESMEC's managers had been offered jobs elsewhere, which they would obviously have to decline to participate in the CESMEC privatization. For example, Eugenio Ossa, CESMEC's current General Manager, had been offered "good jobs in the United States" and also had "opportunities to teach at one or more of Chile's universities."¹¹ Mr. Vergara had been offered similarly attractive positions, including one with the United Nations in Geneva.¹² Moreover, Chile's economy was engaged in a major restructuring, of which the outcome was far from clear.

On the other hand, some CESMEC employees perceived that if they did not purchase the company,

10 Normally, organization costs would be capitalized into the total cost of the company, which was acquired with an investment consisting of 10% equity and 90% debt.

11 Eugenio Ossa Soffia, CESMEC's General Manager and Member of the Board of Directors, in an interview May 18, 1994.

12 Pedro Vergara, CESMEC's Chairman of the Board of Directors, in an interview on May 23, 1994.



it would be closed and they would be out of work. Some key managers felt that despite CESMEC's unprofitable history, the recent trend was positive. They foresaw that aggressive cost-cutting and marketing of services could raise revenues and reduce costs enough to earn profits in the future. And, they felt that owning the company would provide them with the incentives to implement such measures. They also understood that they were not personally responsible for the CORFO loan and that CESMEC had sufficient assets to repay the loan, if it became necessary to liquidate the company. So, their financial risk, though substantial, was limited to the money they would invest in their share of the equity. One of the smaller shareholders indicated a feeling of being unable to influence the course of the company's operations.¹³ But of course, management's specific objective was to keep significant control in their own hands.

Despite the various expressions of caution and concern, all of those interviewed said they liked their work at CESMEC, felt its functions were very important for Chile's economy, and expressed enthusiasm for the concept of being a part owner in their own business. Further supported by Mr. Vergara's firm belief in his ability to lead the management team and make success a reality, the employees agreed to purchase the enterprise from CORFO. Employee purchase of CESMEC's stock was completed and the privatization formalized on January 13, 1978.

13 Luis Fernandez Canobra, CESMEC's new Manager of Quality Control, in an interview on May 18, 1994.

III. CESMEC'S OPERATING RESULTS FOLLOWING PRIVATIZATION

A. Early Challenges (1978 through 1985)

The very weak economy immediately following the Allende government of 1970-1973 was described above. However, economic conditions had improved significantly by early 1978, the time of the CESMEC privatization. Growth in the GDP went from a negative 12.9% in 1975 to a positive 3.5% in 1976 and 9.9% in 1977. Unemployment, was at 13.2% in 1977, down from 16.8% the previous year. Real interest rates were still very high, on the order of 50%-60% in 1977. And, while inflation declined by about 50% between 1973 and 1976, it was still reported at 230% in 1976.¹⁴

Because of the turbulent economy during the Allende government, the very high rate of inflation, and some reportedly questionable accounting practices, CESMEC's reported operating results prior to privatization cannot be considered too reliable. However, it is fairly clear that prior to privatization, CESMEC operated at significant losses and depended heavily on support from government subsidies. During the years just prior to privatization, the trend in CESMEC's sales was relatively flat. However, during this period management was bringing costs down, so that by 1976 and 1977, CESMEC was operating at close to or over break-even. (See Exhibit 1.)

During the years immediately following CESMEC's privatization, Chile's economy grew significantly. But CESMEC experienced a much larger growth. From 1978 through 1980, the nation's GDP grew by 8.2%, 8.3%, and 7.5%, respectively. But CESMEC's sales increased from P401 million to P991 million, or by more than 120% in the same period. Although CESMEC incurred after tax losses in 1978 and 1979, by 1980 it was operating in the black with an after tax profit of P49 million, representing nearly 5% of sales revenues.¹⁵

The large growth in the Chilean economy just prior to 1980 presented CESMEC with a significant managerial test in the early-1980s. Chile's economic growth induced an influx of large private capital investment, and much of this investment came in the form of dollar loans from abroad. The terms of the loans were very tempting, with average real annual interest rates of an incredibly low 0.22% in 1979 and even a negative 10.12% in 1980.¹⁶ However, CESMEC made a critical decision not to finance its diversification and the expansion of its operations with these very attractive dollar loans. Pedro Vergara feared, and thus avoided, the problem that arose in 1982, when there was a significant unfavorable change in the exchange rate, and the number of pesos required to pay off dollar loans rose so high that the real annual interest rate on dollar loans rose to over 30%.

However, CESMEC was unable to avoid entirely the effects of Chile's economic decline in the early-1980s. Many of CESMEC's clients replaced their domestic production with imports that had become relatively inexpensive due to the favorable peso-dollar exchange rate. CESMEC depended upon that Chilean production as a market for its quality analysis services. Moreover, many of CESMEC's clients used dollar loans to finance their operations and were severely hurt when the cost of servicing those loans rose dramatically.

In response, CESMEC made some strategic changes in its operations and financial arrangements. It renegotiated its CORFO loan to extend the payment schedule, diversified its quality analysis services into new technical areas, and began to offer processing industries with assistance in managing quality control. CESMEC became more involved in product quality certification for exports of Chilean goods to Europe, Japan and the United States. And, it expanded the provision of its services geographically into Chile's provinces and to Bolivia.

14 Yotopoulos, Pan A., "The (Rip)Tide of Privatization: Lessons from Chile," World Development, Vol. 17, 1989, p. 692.

15 All figures are expressed in constant pesos as of December 1993.

16 Yotopoulos, Pan A., "The (Rip)Tide of Privatization: Lessons from Chile," World Development, Vol. 17, 1989, p. 686.



CESMEC also achieved significant labor cost savings by imposing salary reductions, seeking voluntary departures, and making a few selective dismissals - mainly of workers with no dependents, women with working husbands, and others from well-to-do families that could provide those employees with temporary financial support. Voluntary departures accounted for 90% of the work force decrease. Overall, salaries were reduced by an average of 10%, with the greatest reductions of 20% taken by the highest paid managers. The lowest paid workers were not asked to accept any decrease in wages.

These strategic and operational changes were effective and enabled CESMEC to survive the economic crisis of the early-1980s, at a time when many recently privatized enterprises went bankrupt or had to be renationalized by the government. Unemployment rose to a reported rate of close to 30%, and might have actually reached 35% or more, if the government had not instituted large public works projects.¹⁷ It is particularly noteworthy that CESMEC made profits during 1980 and 1981, given the extremely difficult economic conditions of the time.

B. Dramatic Growth (1986 through 1990)

Through the mid- and late-1980s, CESMEC achieved a very impressive growth in sales and even more impressive increases in operating efficiencies and income. By 1985, CESMEC's sales were back up to the 1980 level, and over the next five years increased to P3,482 million, nearly tripling. The growth in sales was matched by an equally large improvement in operating efficiencies. After tax income, as a percent of total sales, grew from a low of 2%-5% during the extremely weak economic period of 1980-81 to 9% by 1986 and then to 12%-14% in 1987-89. After tax income, as a percentage of ownership equity (total assets less total liabilities) also increased dramatically. Except for a slight dip in 1981, it grew from 12% in 1980 to almost 19% in 1985 and then to over 40% in both 1989 and 1990. (See Exhibit 1.)

Because of the sharp decline in sales and profits in the early-1980s, CESMEC was unable to pay off all of the CORFO loan by 1985 according to the original schedule of the agreement. Two extensions were granted. CESMEC paid off nearly all of the CORFO loan by 1991 and the remainder in 1993.

C. Growing Pains (1991 and 1992)

Except for a loss in 1979, after tax income was consistently positive and increased steadily until 1991. Ironically, the decline in 1991 and 1992 was due to the very large increase in sales in the prior year. In 1990, the company won a very large contract that resulted in a sales revenue increase of nearly 35% in that year and which required a significant increase in payroll. Unfortunately, when the contract ended, the management did not lay off its workers quickly enough, and the high payroll costs brought the company's income nearly to break-even by 1992. Both sales and income have since recovered, and are returning to their previous levels.

D. Stock Price Appreciation and Dividends

1. METHODS FOR DETERMINING RIGHTS TO PURCHASE AND PRICING OF CESMEC'S SHARES

The principles that apply to CESMEC's stock transactions are first, no shareholder is ever obligated to either buy or sell his/her stock. Management desires that when an employee leaves CESMEC that he/she sell his/her stock. In this way, ownership is retained by the current employees. But no sale is a requirement, and there are a number of ex-employees who still own CESMEC stock.

Second, when stock is offered for sale, the options to buy that stock are awarded to current employees according to the same formula that was used to allocate the original stock subscription,

¹⁷ Andres Concha Rodriguez, General Director of ProChile and Advisor to the Ministry of Foreign Affairs on Exports during CESMEC's privatization, in an interview on May 25, 1994.



described above. Employees are not obligated to exercise their options. And, if they so decide, their options are then distributed among those who do wish to purchase the available stock, again according to the option distribution formula.

Third, the buyers and sellers are free to negotiate whatever price they feel is appropriate. CESMEC's shares are not traded in an open market. Therefore, a key problem is how to price the shares. Two types of transactions occur, those between two stockholders and those between the company and a stockholder. To help guide the parties in determining an appropriate price for their shares, the company has issued a set of guidelines. However, the guidelines are merely advisory not obligatory. Either may use the guidelines or not as they see fit and buy or sell at any price they feel is fair.

The guidelines are based upon the following principles. First, they suggest that the user consider the company's performance history, particularly with regard to (1) payment of shareholder dividends, (2) capital reinvestment, and (3) net asset value. Historical information is provided by management on each factor. Second, the guidelines indicate how the user might assign his/her own weighting to each factor, according to his/her perception of their relative importance. Third, the guidelines suggest that the user consider the recent behavioral history of all stocks in the national stock market relative to their longer term history. Specifically, the company's guidelines suggest that if the overall market index for the month has been depressed recently compared with the overall stock index for the year, a similar difference should be considered when pricing CESMEC's stock. The guidelines provide a qualification, however, that if the difference is greater than 10%, the difference should be disregarded.

According to Mr. Vergara, however, the guidelines are seldom used. Indeed, he acknowledged that their obvious shortcoming is that they do not seek to anticipate future company earnings. However, the accuracy of such forecasts would be a major concern, being highly subjective. Therefore, forecasts are not provided for the purpose of pricing shares.

On the other hand, the management feels strongly that the shares can only be priced fairly with the provision of full and accurate information about company performance. It feels that full "transparency" is a management obligation. To provide all employees with up-to-date information about the company's plans and expectations, a three-person team that represents the employees attends all Board of Directors' meetings. In addition, one of the employee representatives is a highly placed member of the company's accounting department. Therefore, this person also has access to all of the company's accounting records and information on budgeting for the future. Through direct access to this person and the other employee representatives, the company intends for all shareholders to be able to access the best and most recent available information necessary to price their shares.

2. HISTORY OF STOCK PRICES

Expressed in December 1993 pesos, the price paid for CESMEC's stock rose from P224 (adjusted from the original P10 privatization subscription price in January 1978 pesos) to a high of P6,171 in 1992. The most recent transaction price in 1993 was P5,000. (See Exhibit 1.)

Therefore, the value of the original stockholders' investment has evidently appreciated over 22 times since the beginning of 1978, or at an average annual rate of over 21%. Of course, with the market for CESMEC stock being so small, it is unclear how much stock could be sold at the most recent transaction price.

3. STOCK DIVIDENDS

The dividends that CESMEC paid its shareholders per share of stock from privatization in 1978 through 1993 (in terms of December 1993 pesos) is presented in Exhibit 1. In terms of constant pesos, the original investment in CESMEC's stock has yielded dividend income to its initial subscribers having an average annual return of over 63%.



IV. CESMEC'S PRESENT CONDITION AND STRATEGY FOR THE FUTURE

A. Ownership Structure

As of 1994, CESMEC had 84 stockholders, about the same number as when it was privatized, despite the fact that its work force has grown to about 500. Two members of the original key management team and Board of Directors have been replaced. Both sold all of their stock. The present Board controls nearly 48% of the company's stock. However, CESMEC itself has bought 8.9% of its own stock. Therefore, the Board controls 52% of the outstanding shares. Or, looking at it another way, considering that the Board has the power to vote the company's stock, it controls 56.6% of the equity.

The remaining shares are distributed primarily among CESMEC's present employees. A few have left the company while retaining ownership of their stock.

B. Labor Relations

In Mr. Vergara's opinion, CESMEC experienced excellent management-labor relations during the first fourteen years following its privatization. In the early years, he and the other key managers knew every employee personally. Moreover, Mr. Vergara encouraged the workers to establish a union. He wanted the workers to be informed about the details of the company's operations, both because they were shareholders and entitled to that information, but also because he wanted management and workers to jointly understand and accept company goals, objectives, and operating strategies. He sought a team approach to decision-making, wanted to incorporate labor's objectives into CESMEC's overall business strategy, and felt that the best way for the workers to participate in the process was through union representation.

From the beginning, the workers benefited financially from the company's success. Whenever possible, all workers receive a bonus based upon the company's performance, which is independent of the dividends issued on the company's stock. To inform workers about the company's financial condition, management issues monthly statements of the company's operating results. Mr. Vergara said that this "transparency" of the company's financial performance has always been considered a critical aspect of its management-employee relations.

As the work force has grown, Mr. Vergara and the other key managers were less able to maintain the close personal relationships they previously had with the workers. Presently, CESMEC has about 500 workers in its Santiago headquarters as well as in ten field offices. Members of the company are increasingly looking to their fellow workers instead of to management for leadership. And, some of these leaders have significantly different perceptions of their relationships with top management. As a result, labor relations became somewhat strained in recent years, and union contract negotiations have sometimes been difficult. This has been especially true since the workers now have divided leadership and management negotiates labor agreements with two unions.

Mr. Vergara is concerned about the problem, but feels that in many ways this is healthy. He wants the workers to participate in setting company policy, and feels that it is important for all to feel committed to the company's goals and high quality performance standards. Management understands that those standards are fundamental to CESMEC's primary service, namely that of providing testimony of product quality. Management intends for that principle to guide all management decisions as well as its relationships with the company's labor. (See Exhibit 2.)

C. Strategy for the Future

At present, CESMEC provides its services from its headquarters in Santiago and from ten regional units dispersed along the length of the country through the following six divisions:



-
- Engineering Services and Technical Assistance
 - Capital Goods and Structures Inspection
 - Chemical Analysis
 - Food Analysis
 - Forestry
 - Civil Engineering

The particular services provided in each division are listed in Exhibit 3.

In 1991, Mr. Vergara initiated an aggressive plan to reorganize the company. His objective is to enable CESMEC to succeed in an increasingly competitive business environment. CESMEC's primary traditional services (that of providing quality testing, analyses, certification, etc.) are facing growing pressure from competitors, such as universities, which can effectively subsidize those services by absorbing much of their costs elsewhere in their budget. As a result, those institutions are able to price their services somewhat lower than CESMEC. CESMEC still enjoys a competitive advantage with such institutions, since CESMEC's clients perceive a greater value in CESMEC's services, and CESMEC is currently able to retain those clients even while charging higher prices. However, at present, CESMEC's traditional quality analysis and certification services provide about 80% of its revenues. Mr. Vergara is concerned about the company's vulnerability to increasing competitive pressure in this area. His strategy is to seek ways to diversify the quality analysis services into new product areas and related services that are not so competitive.

Mr. Vergara would also like CESMEC to diversify into new activities, first focusing on areas in which it already has some experience. Specifically, management has found that CESMEC can manage and service its extensive vehicle fleet more economically than through leasing or other arrangements. This internal services division has grown rapidly, and if examined as a separate division it would presently account for about 18% of CESMEC's total revenues. CESMEC has also been fabricating an increasing amount of its electronics equipment, finding that it can design and produce this equipment more economically than by acquiring it from outside suppliers. This division presently accounts for about 2% of CESMEC's revenues. CESMEC plans to spin off both its transportation and electronics divisions into separate limited companies, selling their services to outside customers. In just a few years, Mr. Vergara expects the revenue contributions of these divisions to grow to 50% and 10%, respectively.

A third company will assume ownership of CESMEC's real estate holdings. This new company will insulate the value of CESMEC's real estate from CESMEC's other operations through the protection of a separate limited corporation. The value of CESMEC's real estate has grown substantially over the years, and Mr. Vergara plans to borrow against this value to invest in other profitable enterprises. In particular, he plans to invest in construction projects, an area that CESMEC has come to understand through design and construction of its numerous buildings.

Not all of CESMEC's Board of Directors share Mr. Vergara's confidence. One expressed the opinion that they should not feel too proud of their entrepreneurial abilities, commenting that they did not create CESMEC from nothing, but rather that they assumed control of a fully operating enterprise. Though he conceded that they have succeeded in making CESMEC profitable, and in expanding its operations considerably, he feels that they should not be too aggressive in starting entirely new enterprises.¹⁸

It remains to be seen if Mr. Vergara will be able to induce his Board to follow his lead and achieve the management success they have in the past. The company's balance sheet shows that it is well positioned to embark on his program. Current assets are nearly four times current liabilities, and

¹⁸ Edwin Party, CESMEC's Director of Engineering Services and a Member of the Board of Directors, in an interview on May 18, 1994.



accounts receivable are kept to within 45 days with an aggressive collections program. Long term debt is only about 28% of total capital, and would be much less if the market value of real estate holdings were added to the book value. Mr. Vergara indicated that the market value of CESMEC's real estate holdings is about P500 million more than the value shown on the company's books.¹⁹

CESMEC appears to be well positioned to participate in the country's industrial growth and export trade. If Chile's recent economic history is a good indication of its future prospects, those prospects are bright indeed. Chile's economic growth between 1984 and 1993 averaged 6% annually, ranking it eighth in the world, and ahead of Hong Kong and Indonesia. Inflation in 1993 was 12.3%, and unemployment was down to 4.8%.

¹⁹ Pedro Vergara, CESMEC's Chairman of the Board of Directors, in an interview on May 26, 1994.



V. POLICIES RELATED TO WOMEN AND THE ENVIRONMENT

A. Hiring and Promoting Women

CESMEC does not have a specific policy that seeks to hire or promote women as a proportion of its work force. However, during a number of visits to the main office in Santiago, it was clear that women comprise a large portion of the headquarters work force. Company records indicate that women represent about 25% of the total workers, and about 50% of the work force in the chemical and foods analysis divisions. Although no women are represented in top management, a woman heads the foods analysis division and the firm's senior internal auditor is a woman. These senior officers have been with CESMEC 24 years and 20 years, respectively.

National law provides for women to take two months paid leave for pregnancy and early child care and for their jobs to be guaranteed when they wish to return to work. CESMEC's policy is to provide a reasonable amount of additional paid time to women for delivery and early child care and to take a few hours off each day to nurse children at home.

Mr. Vergara expressed very strong feelings that women are particularly "gifted" with the skills necessary to perform the type of services required at CESMEC. Specifically, he feels that women are usually "very well-organized, methodical, especially careful with sanitation procedures, good with details, and do not get bored easily with routine or repetitive work." He said that they were particularly skilled and interested in the chemical and food analysis areas.²⁰

However, he also expressed some reservations about hiring women, because they often leave to have children just when they have become very familiar with their job. And, when they do return after having children, their highest priorities are with their families and not their jobs. Despite the problems, he said that he considers women to be very valuable to the firm and has a conscious policy to seek women employees.

B. Promotion of Environmentally Sustainable Industrial Development

While CESMEC does not have a specific policy to promote environmentally sustainable industrial development, many of its services address environmental issues. Specifically, the firm performs analyses of contaminants in industrial products and studies of ecological impact.

Management feels that they have a moral responsibility to promote environmentally sustainable industrial development and implementing such a policy "makes good business sense."²¹

20 Pedro Vergara, CESMEC's Chairman of the Board of Directors, in an interview on May 27, 1994.

21 Pedro Vergara, CESMEC's Chairman of the Board of Directors, in an interview on May 27, 1994.



VI. CONCLUSIONS

In all of the reviews and analyses of Chile's privatization, a recurring theme is the importance of the government's macroeconomic policies being clear and the private sector's confidence that the government would persist in its efforts to stabilize the economy and keep the market free. Certainly, the fact that Chile had succeeded in imposing monetary control, fiscal discipline, deregulation of prices, and an opening of the economy to international trade and capital movement created the economic environment for CESMEC to compete and succeed. Otherwise, CESMEC may have been defeated by forces beyond its control.

In implementing its privatization efforts, the Chilean government initially made an important fundamental mistake. It permitted the privatization sales to be heavily financed with debt. On the positive side, this allowed competitors for the ownership of those enterprises to bid up the purchase prices to levels that were higher than if those bidders were unable to obtain as much debt. But, it also burdened the winning bidders with large debt service costs. High returns were then necessary to cover the high interest costs. And to achieve high returns, management often had to invest in projects with higher risks.

Indeed, 90% of the CESMEC purchase was financed with debt, and because CESMEC's earnings were not high enough during its early years to cover the debt service, that debt was repaid over a considerably longer period than was originally agreed. If the time period had not been extended, CESMEC would most likely have gone bankrupt like so many other privatized enterprises.

In many cases, Chile made a second mistake that compounded the first. In the nation's quest to achieve "popular capitalism," it sought a wide distribution of share ownership for a number of enterprises. Often, this meant that an enterprise could be controlled by owners holding a relatively small portion of the equity, frequently purchased at only moderate personal risk. With a moderate personal investment at stake, such owners were generally more willing to assume higher risks. And, the high cost to service the loan used to purchase the enterprise pressured these entrepreneurs into higher risk asset management. Such leveraging of the equity is advantageous when returns on investment are above the interest cost. But when risky investments turn sour, especially under the pressure of a significant downturn in the overall economy, as occurred in Chile during the early-1980s, and return on investment goes below interest costs, it can (and did) lead to bankruptcies.²²

On the other hand, government assistance facilitated a speedy privatization process, and it appears that the speed of CESMEC's privatization contributed to its success. It minimized the period of uncertainty about CESMEC's future, thereby keeping the enterprise's key management team intact during the transition and assuring its clients of continued operations and quality of service.

It appears from this case study, as well as Chile's overall privatization experience, that people with entrepreneurial talent will emerge and assume control of privatized enterprises when sufficient financial incentives to reward their efforts are provided. Prior to CESMEC's privatization, none of the CESMEC leadership including Mr. Vergara could have been characterized as an entrepreneur. Admittedly, part of CESMEC's early success derived from freeing it from government imposed regulations, which had severely constrained personnel management and kept costs high. But CESMEC's management demonstrated their entrepreneurial skill in conceiving and implementing the successful survival strategies that helped the company to weather the economic crisis of the early-1980s that many other Chilean firms did not. And, it was their entrepreneurial and management skills that generated the impressive increases in sales and return on net assets in the mid and late-1980s.

²² Rolf Luders, Minister of Finance and Minister of Economic Affairs 1982-83, previously a senior executive with the conglomerate corporation Javier Vial, and presently Chief Economist with the International Center for Economic Growth and Research Program Director, Economic Institute, Catholic University of Chile, at an interview on May 30, 1994.



Clearly, CESMEC's management and workers were its main asset, and selling the organization to them was a key to CESMEC's success.

CESMEC's relatively cautious financial decisions in the late-1970s proved to be a key factor enabling the organization to survive the difficult climate during the early-1980s. This financial conservatism was largely related to the relatively high financial stake in the company that each member of the management team possessed. It seems to have instilled a healthy caution about assuming too much risk in managing the enterprise.

In addition, the narrow distribution of equity among the management team enabled them to exercise sufficient control to direct CESMEC effectively. In fact, the company was structured so that the top management team, by controlling a large portion of the stock, would also be the Board of Directors. In effect, the managers report to themselves. This arrangement allowed the management team to maintain control and direct the company even in the midst of the harsh economic climate of the early-1980s.

A vital factor in an organization's successful privatization is the development of management's confidence in its ability to succeed. All of the members of CESMEC's top management, including Mr. Vergara, confessed that they lacked confidence in their abilities to manage CESMEC in the beginning. All admitted that they were uncertain that they would be able to bring the company through the very difficult period of the early-1980s. Businesses were failing all around them, including 25% of their own clients. However, when they succeeded to keep the company running into the mid-1980s, CESMEC's management gained the confidence that they could continue to succeed. This appears to have been a major factor contributing to the management's success in the late-1980s, when CESMEC's sales, income and operating efficiencies increased dramatically.

Although CESMEC is not a monopoly, the subject of privatizing monopoly enterprises was discussed during a number of interviews. It was the uniform opinion of those involved in Chile's privatization and regulation of monopolies that it is much harder to effectively regulate privatized monopolies than it is to break them up, privatize them and allow the competitive market to regulate the disassembled enterprises.

A final conclusion addresses UNIDO's selection of enterprises for future case study. It became very clear that the insights obtained during the CESMEC case study were a direct result of the author's excellent access to information and particularly to key informants. CESMEC was privatized in early 1978, and much of the relevant information and key informants familiar with the conditions of the time, would have been difficult to find and access, if it had not been for Mr. Vergara's influence and eager assistance. UNIDO is encouraged to choose future case studies only where similar local assistance can be assured.

Exhibit 1

CESMEC Limited, Chile

Selected Financial Data, 1973—1993

(All currency shown in terms of December 1993 pesos)

	Year	Sales Revenues (Million\$)	After Tax Income (Million\$)	Net Worth (Million\$)	Income/ NetWorth (%)	Income/ Revenues (%)	Stock Price end of Year (\$)	Dividends PerShare (\$)
Prior	1973	59	-409					
To	1974	244	-113					
Privatization	1975	327	-236					
	1976	269	80					
	1977	401	1	318			224	
	1978	681	-4	497			2 580	0
After Privatization	1979	685	-113	493			2 724	243
	1980	991	49	408	12.00%	4.90%	3 114	141
	1981	1 070	22	479	4.60%	2.10%	3 187	278
	1982	845	78	439	17.80%	9.20%	2 854	366
	1983	782	61	355	17.20%	7.80%	2 492	87
	1984	922	66	385	17.10%	7.20%	2 167	187
	1985	1 085	69	368	18.80%	6.40%	1 938	148
	1986	1 492	138	379	36.40%	9.20%	2 222	186
	1987	1 967	268	704	38.10%	13.60%	2 562	634
	1988	2 396	336	1 093	30.70%	14.00%	4 640	709
	1989	2 594	315	762	41.30%	12.10%	5 351	861
	1990	3 482	382	893	42.80%	11.00%	4 953	928
	1991	3 428	163	1 197	13.60%	4.80%	5 693	1 148
	1992	2 771	3	1 169	0.30%	0.10%	6 171	473
	1993	3 122	159	1 044	15.20%	5.10%	5 000	612

Source: CESMEC Ltd.





Exhibit 2

CENTRO
DE ESTUDIOS
MEDICION
Y CERTIFICACION
DE CALIDAD
CESMEC LTDA



POLITICA DE CALIDAD DE CESMEC

Los servicios que preste CESMEC deberán satisfacer o exceder los requerimientos de sus clientes y usuarios, estén éstos expresos o implícitos en el respectivo Contrato o Convenio.

Aún reconociendo que la función empresarial privada es una actividad económica, CESMEC mantendrá una política que permita confiabilidad, evaluando permanentemente su nivel de competencia, capacidad y experiencia, comprometiéndose su participación cuando tales atributos puedan ser satisfechos.

Este compromiso de CESMEC con la Calidad está fundado además en su misión como Empresa, orientada al desarrollo integral de su personal y a la creación y desarrollo de servicios tecnológicos que colaboren con la sociedad en la protección y mejoramiento de la calidad de vida de las personas, de sus bienes y del medio ambiente. Asimismo, procura responder a las crecientes demandas de Calidad de mercados cada vez más globales e interdependientes.

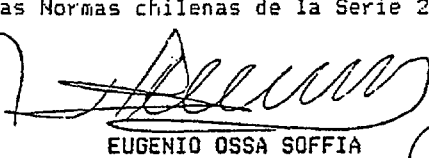
Para conciliar sus propias posibilidades de sustentación y crecimiento con estas demandas, CESMEC orientará su gestión y políticas de desarrollo a conseguir y consolidar un nivel de excelencia en todos sus servicios y áreas de actividad, incluidas aquellas que incidan en su eficacia y eficiencia global. Esto es un reconocimiento expreso de que la Calidad es materia propia y esencial de la gestión empresarial y, como tal, exige y compromete la acción decidida y enérgica de la Dirección de la Empresa.


Se reconoce, asimismo, el papel esencial de las personas, especialmente en sus valores éticos y atributos de competencia técnica y dedicación profesional. Por lo tanto, la acción de la Dirección será enérgica y consistente en la selección, evaluación, capacitación, desarrollo y promoción del personal.

Para conseguir estos objetivos, CESMEC desarrollará, implementará y mantendrá en operación un sistema de Gestión de Calidad sustancialmente de acuerdo con los requerimientos de las normas de la Serie NCh-ISO 9000, cubriendo todas sus áreas de actividad.

Adicionalmente, sus Laboratorios de Análisis y Ensayos, así como los Departamentos de Inspección y Certificación, serán organizados y dotados para cumplir o exceder los requerimientos de las Normas chilenas de la Serie 2400.


PEDRO VERGARA ALVAREZ


EUGENIO OSSA SOFFIA


MANUEL VALDES GONZALEZ


JORGE TORRA VERGARA


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EDWIN PARTY DUBOIS

Santiago, Abril de 1993

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Exhibit 2A



T R A N S L A T I O N

QUALITY POLICY AT CESMEC

Services being rendered by CESMEC must satisfy or exceed clients expressed or implicit requirements as derived from the contract.

In spite of the fact that private entrepreneur activity is commercially oriented, CESMEC will maintain a policy that allows for the development of reliability through continuous evaluation of its performance, skills and experience. CESMEC will only commit to its participation when such conditions can be fulfilled.

CESMEC's commitment to quality is also founded on its mission as an enterprise to promote personal development, and protect and improve the quality of life, goods and environment. CESMEC will respond to the growing demand for quality in the world's interdependent markets.

In order to harmonize its technical capabilities and the progressive growth of these demands, CESMEC will orient its management and policies to enrich and consolidate an excellence in all of its services and areas of endeavour. It is recognized that quality is a fundamental element of entrepreneurial activity, and as such requires diligent and continuous action from management.

Valuable aspects of people's role in the company are their particular ethic values, technical skill and professional dedication. Therefore, management will be consistent in the selection, evaluation, training, development and promotion of its personnel to enhance this attributes.

In order to attain the above mentioned objectives, CESMEC will implement a quality management system consistent with the requirements of the NCh-ISO-9000 Standards Series.

CESMEC's testing laboratories, certification and inspection departments, will be organized and equipped so as to fulfil or exceed the requirements of Chilean Standards Series 2400.

PEDRO VERGARA A.

EUGENIO OSSA S.

MANUEL VALDES G.

JORGE TORRA V.

JULIO CONCHA R.

EDWIN PARTY D.

Santiago, April 1993.-

CESMEC'S TECHNICAL SERVICES

1. ENGINEERING SERVICES AND TECHNICAL ASSISTANCE DIVISION

- Evaluation of operating conditions of structures, equipment and machinery
- Certification of high capacity scales
- Volumetric calibration of high capacity storage tanks
- Failure analysis of machinery, equipment and installations
- Certification of electric appliances for safety
- Calibration of measuring instruments
- Technical assistance in:
 - Product development and import substitution
 - Prescription and implementation of tests for new products
 - Implementing quality control

2. CAPITAL GOODS AND STRUCTURES INSPECTION

- Technical inspection of manufacture and installation of metal structures, pressure vessels and boilers
- Non-destructive testing for preventative maintenance and quality control, applying x-ray, radioactive isotopes, ultrasound, magnetic particles and penetrant liquid techniques
- Supervision, inspection, and assessment of welds and welding procedures

3. CHEMICAL ANALYSIS

- Water, effluents, and electrolytes
- Fuels, lubricant oils, paints, plastics, and rubber products
- Bacteriological analyses
- Mining ore samples, concentrates, gold and silver (by cupellation), alloys, pure metals, scrap, and slags
- Inorganic materials, such as cements, refractory clays, kaolins, limestones, fertilizers, and soils

4. FOOD ANALYSIS

- Inspection, sampling analysis and quality certification of agricultural products
- Inspection, sampling, analysis and quality certification of hydrobiological products
- Chemical and bacteriological analysis of foodstuffs
- Sanitary quality certification of foodstuffs This division focuses on fruits, vegetables, cereals, seafood (fresh, dehydrated and frozen), dairy products, meat, and byproducts (protein, oils, and fats).

5. FORESTRY

- Inspection of pulp and paper mill construction
- Assistance in managing quality control

6. CIVIL ENGINEERING

- Inspection of construction materials and projects
- Engineering studies, surveys, and support services
- Soils and concrete laboratory testing



Appendix A

PERSONS INTERVIEWED

Aracena, Hugo Alfonso;	CORFO - Chief, Department of Fiscal Studies
Concha Riquelme, Julio;	CESMEC - Member of the Board of Directors and Financial Manager
Concha Rodriguez, Andrec;	General Director of ProChile and Advisor to the Ministry of Foreign Affairs on Exports during CESMEC's privatization. Presently Director of Chilgener.
Cordura, Joaquin;	Fundacion Chile, Manager of Development and Marketing
Danus Covian, Luis;	CORFO Director, 1974-1979
De Bonnafos G., Roberto;	ASTER S.A. - Manager (Telecommunications Subsidiary of CAP S.A.)
Fernandez Canobra, Luis;	CESMEC - Manager Quality Control
Luders, Rolf;	Minister of Finance and Minister of Economic Affairs 1982-83, previously a senior executive ~with Javier Vial, and presently Chief Economist with the International Center for Economic Growth and Research Program Director, Economic Institute, Catholic University of Chile
Mark, Imogen;	Correspondent, The Economist
Naveillan, Juan;	Member of the President of Chile's Economic Committee and Consultant to the Ministry of Finance during the CESMEC privatization. Presently President of Universus S.A.
Ossa Soffia, Eugenio;	CESMEC - General Manager and Member of the Board of Directors
Party, Edwin;	CESMEC - Head of Engineering Services and Member of the Board of Directors
Ramirez, Ana Maria;	CESMEC - Secretary to Pedro Vergara
Ramos, Joe (with Cominetti, Rosella);	CEPAL/ECLAN - Div. of Economic Development
Trebilcock, Glen;	CAP S.A. - Executive Vice President, Development and Planning
Valdes Gonzalez, Manuel;	CESMEC - Manager of Operations and Member of the Board of Directors
Vergara, Jose Pedro;	CESMEC - Marketing Manager
Vergara, Pedro;	CESMEC - Chairman of the Board of Directors

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ANNEX B:

18 July 1994
ORIGINAL: ENGLISH

**A CASE STUDY OF THE PRIVATIZATION
OF THE CEMENT COMPANIES
PHILIPPINES**

PREPARED FOR
United Nations Industrial Development Organization
Vienna

BY

Erlinda C. Layog
International Expert

and

Scholastica D. Cororaton
National Expert

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SUMMARY

The success of the Philippine privatization effort on the cement industry owes as much to the stable economic condition at the time of its implementation as to the decisiveness of the national leadership in pushing for the speedy disposition of non-performing assets held by its two state-owned banks.

For their part, the cement industry leaders responded by acquiring and operating the idle plants bid out by the Asset Privatization Trust (APT), the government's disposition arm. Other companies with financial difficulties settled their arrearages under a direct-debt-buy-out scheme.

Thus did the government achieve its two-fold objective of speedily disposing of its non-performing assets and recovering part of its financial exposure even as operating efficiencies were enhanced industry-wide.

In summary, the privatization effort made a definite impact on the industry through the "mass effect" generated by the disposition of 13 of a total of 18 cement companies. Chief among these is the visible increase in productive capacities of the rehabilitated cement plants, which coincided with a shortage in supply of this basic construction material.

Interestingly, while the breakup of monopolies is generally a desired impact of privatization, the Philippine experience yielded the contrary result of concentrating ownership of the privatized companies in the hands of a few industry players. This had the effect of creating allocation inefficiencies due to lack of competition, which the government has overcome through complementary reforms in the form of relaxation of trade barriers, among other measures.



I. INTRODUCTION

Privatization in the Philippine context goes beyond the usual notion of divestiture of state-owned enterprises. While divestiture does take place, in most cases the process is really one of REPRIVATIZATION where privately-owned companies fall into government control, ownership or receivership for failure to meet their financial obligations with the state-owned banks; then when these banks themselves face financial difficulties, government rehabilitates them by transferring their non-performing assets to a trust called Asset Privatization Trust (APT) which is also tasked with disposing of these assets.

In 1987, a total of 399 non-performing assets were transferred to APT. Among them were 13 cement plants.

Cement was chosen for the Philippine case study because of the fact that all but 2¹ of the 13 cement companies transferred to APT were successfully privatized. Specially significant is the "mass effect" privatization had on the industry: 13 out of a total of 18 plants. The government was also afforded the opportunity to simultaneously deregulate the industry, albeit slowly.

A critical question to explore, therefore, is the complementarity with and the phasing or timing of privatization with deregulation. Were there conflicting impacts? Could the phasing have been done differently to achieve government objectives?

In broad terms, we seek answers to the following questions: What economic conditions brought about the failure of so many cement plants in the 80's? What were the necessary conditions, opportunities and obstacles that attended the privatization process? What was the success of privatization relative to its objectives? Finally, what other associated economic objectives were achieved with the mass privatization of cement companies.

This case study, therefore, attempts to understand the interplay of the impact of economic conditions and government policies (controls and decontrols) on the privatization process and the overall performance and structure of the cement industry.

1 The privatization of these companies has been delayed by court litigations.

II. ECONOMIC AND POLITICAL BACKGROUND

A. The Beginnings of Government Participation in the Private Sector

The two decades between the 1950's and 1970's saw the rise of state-owned corporations in nearly all areas of economic activity: agriculture, power generation, transportation, retailing, commercial banking and manufacturing.

Encouraged by the government's import-substituting industrialization strategy, cheap credit, foreign borrowing, not to mention political cronyism, these corporations were, however, generally inefficient, highly leveraged and ill-prepared to cope with economic difficulties.

By 1984, there were 303 such corporations financially dependent on the government for budgetary support in the form of subsidies, equity contributions and loan accommodations.

Between 1975 and 1986 alone, the government spent an average of 10 billion pesos per year, or 122 per cent of the national government budget deficit, on these corporations.²

B. The Crisis Years

The early 1970's and early-to-mid 1980's saw the Philippine economy reeling under the adverse effects of the oil crisis and the global recession that followed. Higher oil prices, weak export markets and larger debt service payments severely strained the country's foreign exchange reserves.

August 1983 marked a turning point in the country's economic and political life with the assassination of oppositionist Senator and then President Ferdinand Marcos' chief rival, Benigno Aquino. The event triggered enormous capital flight and a foreign exchange crisis that resulted in a moratorium on the payment of foreign debt in October 1983.

Widespread dollar scarcity led to massive retrenchment, lowered output and employment, reduced investment, and debilitating inflation :

- The national economy shrank by a total of 16 per cent in 1984-85
- The peso was devalued to 40 per cent of its 1983 US dollar equivalent
- Inflation peaked at 50 per cent in 1984, and
- Interest rates soared to 27 per cent.

Ultimately, the crisis hit the two state banks- the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP)- both of which were heavily involved in rescuing distressed and ailing government and private corporations. Besides currency adjustments, both were saddled with non-performing assets.

For instance, DBP's foreign exchange losses amounted to 1.35 billion pesos in 1984 and another 920 million in 1985. From 1984 to 1986, DBP lost roughly 18 billion, PNB, a total of 11.9 billion.

However, with the assumption of the Aquino administration in 1986, and with the economy having "bottomed out", the economy started to recover. From the economic contraction of 7 per cent on the average over the period 1984 to 1985, the economy grew by an average of 5 per cent over the period 1986 to 1990.

Politically-induced economic setbacks, nevertheless, continued to be experienced, such as the attempted coup d'etat in August 1987 and December 1989. Subsequent efforts of the government to restructure its organization did not help convince foreign investors to participate in privatization.

2 Privatization Policy in the Philippines: An Update. January-February, 1989. Philippines Development Corporation of the Philippines.

C. The Cement Industry in Retrospect

The 1950's and 1960's saw a boom in the demand for cement as post-war infrastructure programs spurred the establishment of cement plants all over the country. The government encouraged this development to ensure adequate supply of cement for the ongoing reconstruction work and anticipated rapid expansion of the economy.

At that time, anyone with the right political connections could borrow from DBP and set up a cement plant for very little equity³. Cement plants proliferated until the early 1970s, by which time the industry was already composed of 17 plants.

In 1970's and 1980's, however, the industry began to have excess capacity, the widest glut occurring in 1973 when capacity utilization dipped to a low 40 per cent. Net losses as high as 25 per cent of sales were experienced as interest rates soared and repayments on foreign loans ballooned.

Most of the cement companies found themselves unable to pay their obligations to DBP such that their arrears mounted to 2 billion pesos. This placed DBP in a precarious situation considering its huge exposure of 6 billion in the industry.

FACTORS CONTRIBUTING TO FAILURE

The inherent structure of cement companies prevented them from coping effectively with the crisis.

Firstly, their capital structure - high debt and low equity - made them vulnerable to higher interest rates and depreciation of foreign exchange rates.

Secondly, the small capacity and outdated technology and equipment of most of the plants further prevented them from cutting losses especially in an environment characterized by increasing costs.

Thirdly, the industry was also highly import-dependent, with imports accounting for almost 40 per cent⁴ of ex-plant cost.

Further, the price control policy adopted in 1972 severely tightened their working capital.

Under this scenario, the industry suffered from excess capacity for almost 15 years until 1985. No new plant was built except Davao Union Cement in 1983.

COPING WITH THE CRISIS

During the period of glut, cement plants sustained themselves through an explicit agreement among themselves to sell only to their geographic markets. Cement plants were discouraged from selling to the "natural" market of other companies except in cases of shut down or other problems. Surpluses were channeled to "common" markets where companies which had excess production were given monthly allocations.

As to distribution, a common industry practice is to distribute mainly through their exclusive distributors. These distributors, usually carrying diversified construction materials, were generally sister companies of the cement companies or spin-offs of the cement companies' marketing departments.

The practice of dividing the country by sales territory was implemented by the Philippine Cement Manufacturers' Corporation (Philcemcor), the industry trade association composed of all cement companies as members. Although not all companies were entirely in favor of this arrangement, it was

3 Interview conducted with Magdeleno Albarracin, PHILCEMCO President on June 21, 1994.

4 Industrial Restructuring Studies, Development Bank of the Philippines, 1991.



carried out as a necessary measure at that time to prevent cutthroat competition. While this promoted cooperation rather than competition in the industry, the ultimate effect was to sustain and prevent the exit of relatively inefficient plants that were operating on fully depreciated machinery, anyway.

GOVERNMENT INTERVENTION

Responding to the distressed state of the industry and the prevailing cutthroat competition among its members, and given its huge exposure to the industry, the government created the Philippine Cement Industry Authority (PCIA) in 1973. The PCIA was tasked to regulate the entry of new plants or capacity, allocate sales quota, and undertake exportation of excess production.

1. Subsidized exportation. Since world prices were lower than local production costs, exports were subsidized by domestic sales at 50 centavos levy per bag. Acting as a relief valve for the excess supply, this scheme kept the local demand-supply situation balanced, thus stabilizing local prices. As a result most cement plants found themselves operating when, otherwise, shutdown was inevitable.
2. Fifty per cent tariff protection. Enjoyed by the industry since 1979, this proved to be successful in discouraging imports. However, while tariff protection was deemed crucial to the industry's survival, it also nurtured inefficiencies as the cement companies were not compelled to compete. These inefficiencies were further reinforced by the lack of flexibility to meet rising costs as a result of price controls.
3. Price control. Price controls were instituted in 1972 to contain the increase in cement prices as production costs escalated. The cement companies claimed that this cost-price imbalance led to disastrous results: inadequate funds for working capital and expansion capital and inability to meet debt service obligations. This affected their capacity to undertake plant repairs and regular maintenance, thus impairing efficiency. The main problem with price control, according to industry sources, was that it served as an irrelevant price ceiling during periods of depressed demand but limited the recovery of the industry's past losses during the economic upturn.

Despite the clamor of industry leaders for 15 years, it was only in 1991 that the government finally lifted price controls as part of an overall program of liberalization of the economy.

4. DBP's continued assistance. In 1976, the exposure of the DBP in 13 cement companies exceeded one billion pesos in the form of loans and guarantees. This prompted the DBP to restructure the cement loans to allow for a longer repayment period. Further accommodations granted by the DBP enabled the cement plants to convert to coal and install dust control equipment in order to reduce the industry's dependence on oil and comply with new environmental regulations. For some companies, this required the conversion by DBP of some portions of the loans to equity in order to raise the company's debt ratio. This continuous large investments were made even though the companies were making minimal or negative returns on assets.

From 1983 to 1985, however, with DBP also in financial straits, it implemented a "pay-or-close-shop" scheme requiring delinquent cement



companies to start paying their monthly amortization or face closure. This move was made to reduce excess supply by closing down inefficient plants. The plants that were mothballed were Midland, Universal, Mindanao, Continental, Filipinas and Island. As a result, excess supply was trimmed down to tolerable levels.

5. Informal market-sharing arrangements implicitly allowed by the government.
6. Transfer of the DBP's non-performing assets, including 13 cement companies, to the Asset Privatization Trust.

The end result of all these interventions was an inefficient industry. On the one hand, it did not have the flexibility to raise funds for working and expansion capital that led to a reliance on debt that was government guaranteed anyway. On the other hand, there was no incentive to become efficient as the industry was protected from imports and new entrants.

RECOVERY PERIOD

With economic recovery, the construction sector also recovered. In 1987, perked up by new government's spending on infrastructure projects, the demand for cement soared to 4.4 million tons, a dramatic increase of 42 per cent from the previous year's level. The cement industry, lagging for the past 10 years and hampered by the closure of several plants, was ill equipped to handle the sudden increase in demand. Faced with a cement shortage, the government resorted to costly importation.

Although importation alleviated the shortage, strong demand and scarcity of supply jacked up the local price from 42 per bag to a controlled ceiling of 52.30 per bag. The black market dealers demanded more than 50 per cent premium over the ceiling price. Over the long term, the government and industry leaders both recognized that the hectic pace of the construction industry was not going to slow down and would gobble up cement faster than it could be made available.

The industry growth opportunity set the stage for both the government and the industry to come to terms quickly on the reactivation of the idle plants and the settlement of the accounts. On the part of the government, this meant assuring that cement would not pose as a bottleneck to the construction boom. On the other hand, industry leaders saw this as a way to strengthen their foothold in the market. It now became necessary that the mothballed plants be reactivated at the least cost to the government.

LIBERALIZATION AND DEREGULATION

Recognizing the defects of the previous policies, the Aquino government in 1986 moved towards deregulating the cement industry. The deregulation was part of a deep structural change that liberalized trade, the tax system, and foreign investment climate.

In 1987, the PCIA was abolished. Its regulatory functions were given to the Philcemcor, the association of cement producers while price control was assigned to the Department of Trade and Industry.

Under the Tariff Reform Program⁵, import restrictions were lifted in March 1989 removing all quantitative restrictions. Tariffs on imported cement were reduced from 50 percent in 1979 to 40 per cent in 1988 to 20 per cent in 1989 and finally to 5 per cent in 1992. Producers, traders, and end-users were free to import cement; unlike before where importations needed government approval.

5 Philippine Tariff Reform Program aims to effectively lower the prices of imported goods, thereby forcing the industrial sector to sell their products closer to the prevailing world market prices.



This ensured adequate supply of cement at competitive prices since imported cement prices serve as natural ceilings in the pricing of local cement. One major reason that favored the removal of import restrictions was the prevailing cement shortage.

Price controls were also lifted in November 1991. Six months later showed some dealers charging as much as 160 per bag- more than double the previous year's controlled price. Industry sources attributed the increase to cement shortfall due to the power crisis. By year-end, prices had stabilized at around 90 to 100 per bag. Annex 1 shows the historical prices of cement.

To date, the cement industry has been freed from all forms of restrictions, including dismantling of their agreed-upon geographic market exclusivity.

III. PRIVATIZATION OF THE CEMENT COMPANIES

A. Objectives of the Philippine Privatization Program

Privatization as spelled out in the 1987-1992 Medium Term Development Plan (MTDP) of the Aquino government and Proclamation 50, sought to achieve a two-fold objective :

1. Improve the business climate and promote private enterprise; and
2. Generate cash to control the budget deficit.

Proclamation 50 of President Aquino formalized the implementation of the Philippine privatization program (Annex 2) and launched a program for the speedy disposition of certain government corporations and assets. It also created the Committee on Privatization (COP) as the policy making body and its implementing arm, the Asset Privatization Trust (APT).

APT's mandate was clear: To dispose within the shortest possible period those assets transferred to it by COP, and to generate maximum cash recovery for the government.

COP's objectives were also defined:

1. "Divest to the private sector in the soonest possible time through the appropriate disposition entities, those assets with viable and productive potential as going concerns, taking into account where appropriate, the implications of such transfers on sectoral productive capacities and market limitations, and
2. Dispose of such other assets as may be transferred to it, generating the maximum cash recovery for the National Government in the process."

In practice, COP and APT were to abide more by the first objective, i.e., speedy disposition, since both were only given a term of five years.⁶

B. GUIDELINES

The APT operates within guidelines set by the COP whose approval is required for all privatization transactions and asset sales (as to buyer and price). The COP has 30 days to advise APT after which time the APT may proceed with its recommendations. The basic guidelines are:

1. Priority is given to cases yielding maximum cash in the shortest possible time.
2. Assets may not be rehabilitated before they are disposed.
3. Where the realizable price is equal, preference is given to buyers who intend to rehabilitate the asset and use it within the country, or to nationals or corporations owned by nationals.
4. For each asset, the disposition strategy must consider availing of public securities markets, employee stock ownership plans, debt-equity-swap plans and other sources of capital.
5. Public bidding is the preferred way of selling.

⁶ This term has been extended by RA 7181 (December 1991 - December 1993) and RA 7661 (December 31, 1993 - June 30, 1995).



6. Standard formulae are used to establish a range of values for the physical assets or financial form assets to be privatized.
7. Selling on installment or deferred payment basis is discouraged and, if resorted to, must be guaranteed by an acceptable financial institution.
8. Previous asset owners may participate in the bidding for their former assets if there are less than three bidders.

C. Privatization of 13 Cement Companies

STATUS BEFORE PRIVATIZATION

Thirteen (13) cement plants were transferred in 1986 to the Asset Privatization Trust. Consistent with its mandate, APT's objectives for their privatization were:

- quickly offer the idle plants to private sector and settle the debts of the non performing companies; and
- realize maximum proceeds for the government.

TABLE 1-A: DBP/APT-HELD COMPANIES

Company	Transfer Price (million pesos)	Owner/Debtor 000 tons per yr. (as of 1986)	Capacity	Age
1. Northern	915	Cojuangco	620	15
2. Central	58	Bacnotan Ind. Inc.	139	17
3. Hi	152	Bacnotan Ind. Inc.	310	18
4. Continental	385	Lim Group	(330)	14
5. Island	997	DBP-PNB (60-40)	620	19
6. Filipinas	17		(435)	22
7. Midland	1001	DBP	(310)	12
8. Universal	336	DBP	212	26
9. Apo	54	Plaza Family	82	62
10. Pacific	291	Cortes/Garcia	216	19
11. Floro Cement	919	Floro Group	411	15
12. Iligan	232	Alcantara Group	308	15
13. Davao Union	141	Bacnotan Ind. Inc.	438	18
TOTAL	5,498		3,356	

Note: () means not operating



With some of its loans converted, the DBP gained equity position in Filipinas, Iligan and Pacific, acting as their creditor and part owner at the same time. In the case of Midland, Universal and Northern, the DBP had earlier acquired full ownership of their plants through foreclosure. Island was a wholly owned government corporation, having been incorporated by the DBP and PNB to operate a cement plant which it had earlier acquired from a mining company. For the other companies, the only role of DBP was that of a major creditor.

Immediately before privatization, more than 76 per cent of the industry capacity was directly or indirectly held by the DBP; the rest by other privately held companies.

The remaining five companies in the industry were owned and operated by business groups with diverse business interests in the Philippines. These groups emerged as the major players in the privatization process.

TABLE I-B: OTHER COMPANIES COMPRISING THE INDUSTRY

Company	Ownership 000 tons p.a. (as of 1985)	Capacity	Year
1. Bacnotan Consolidated	Philippine Management Association	241	32
2. Rizal Cement	Madrigal Group	274	72
3. Republic Cement	Zobel, Araneta, Montinola	433	29
4. Fortune Cement	Zobel, Araneta, Montinola	376	16
5. Mindanao	Floro Group	169	21
Total Capacity			1,493

MODES OF PRIVATIZATION: CASE EXAMPLES

The first accounts to be offered to the private sector were the physical assets of Island Cement Corporation, Midland Cement and Universal Cement. Given the non-operating status of these companies and their long history of accumulated losses which would make public offering of shares not feasible, APT decided to invite bids for the sale or lease of their assets. Their combined plant capacities was 1,545 metric tons per year corresponding to 17 per cent of the industry capacity in 1986.

1. Public Bidding

Island Cement Corporation was a wholly owned government corporation incorporated in 1984 by the PNB and the DBP out of the foreclosed assets of Marinduque Mining and Industrial Company (MMIC), a corporation previously owned by the Cabarus family.

The facilities of Island were designed to produce high quality portland and pozzolan cement at a nominal capacity of 620 metric tons per year using the wet process. It was rated as one of the biggest plant in the industry, but also one of the least efficient cement plants in the country requiring as it did 30 per cent more fuel to produce clinker and obtaining its power from Metro Manila which was more expensive than other power sources in the country.

The plant operated briefly until it was mothballed in 1986 as required by the rationalization plan



for the cement industry. The DBP paid the separation pay of Island employees and other labor claims associated with the shutdown and also assumed the cost of monthly maintenance.

The first attempt of APT to privatize Island was to offer the plant for a 5-year lease; the rationale being that by starting up Island, the plant would fetch higher prices as opposed to a shutdown condition. At that time Island did not have the funds to finance start-up and working capital to operate the plant.

A lease arrangement was also thought to give time for Island and APT to resolve a major legal problem on the assets of Island. Earlier, the Cabarrus family had filed a case in court questioning the authority of the DBP and PNB to foreclose the assets of MMIC.

Of the original 33 groups that expressed interest to bid, only 9 actually participated in the bidding held in May 1987. The top two bids were tendered by Rizal Cement and Richmond Construction, a trading company associated with the owners of Continental Cement. The bidding was won by Richmond Trading. However, the succeeding contract negotiations resulted in failure prompting the APT to withdraw the lease offer.

After four months, APT called for another bidding involving Island assets, this time inviting bids for the outright sale of the company's plant, machinery and equipment at a target price of 655 million. The target price was equal to the appraised value of the assets.

The decision to put the assets of Island on a bid track was based on the indicated willingness of interested parties to bid-to-buy - provided APT warranted a refund of the purchase price in case of a negative judgement on the Cabarrus case. Consequently, APT assured prospective bidders that the winning bidder would not be obligated to acquire the properties, and payments would be returned in case the court ruled against the DBP/APT.

Island was bid out at 77 per cent of target price. Despite the interest expressed by numerous private investors before the bidding, only one party- Solid Cement Corporation (owned by the Madrigal family of Rizal Cement)- submitted a bid for 503 million. The rest, particularly foreign investors, claimed that the ongoing reorganization of the Philippine cabinet at that time discouraged them from participating. However, a more serious reason could be the perceived threat to national security posed by the attempted military takeover which happened in August just a month before the bidding.

Although one foreign and two other investors expressed intention to bid if a re-bid were conducted, APT decided not to call for another bidding. The late APT Chief Executive Trustee David Sycip, referring to the possibility of a better outcome in case of a re-bid, indicated that "a bird in hand is worth two in the bush - and few persons can hang on to the bird in hand and catch another bird with the other hand." Hence, the sole bid of Solid Cement was accepted by APT. Upon completion of the sale, Island was renamed Solid Cement Corporation.

Concerns were raised over the probability that future bidding would be dominated by industry members themselves and result in owner concentration in the industry. Faced with choosing between speed of implementation and more competition in the industry, APT and COP sought policy guidance from the President who voted for a speedy implementation of the privatization program to meet timetable and target proceeds.⁷

Midland Cement Corporation and Universal Cement Company were bid out in March 1989 and in May 1991, respectively.

Midland operated a single- kiln wet process cement plant with a rated capacity of 310 MT per year while Universal ran a combination of semi-dry and wet process rated at 212 MT per year.

The DBP took over Midland in 1972 by converting its loan to equity. In the case of Universal, the

⁷ Based on interview with the Diosdado Macapagal Jr., former Head of the Technical Committee of the COP on 08 June 1994.



DBP foreclosed the non-operating assets of the corporation in 1978. Its extreme deteriorated condition and unfavorable plant location were considered as major obstacles to selling the plant as one whole lot.

In an attempt to recover its financial exposure in Midland, APT had on several occasions leased the facilities of the plant to private cement operators. When the lease arrangements failed to produce the desired results the plant was shut down in 1984. Since then, the assets deteriorated quickly due to theft and exposure to the elements.

Upon its takeover of Midland and Universal, APT had repeatedly tried to bid out the assets of these two corporations as a whole or in sub-lots. The series of bidding were actively participated in by members of the cement industry, who, however, failed to meet either the price criteria or bid requirements set by APT.

In March 1989, APT offered the assets of Midland as a whole lot at an indicative price of 130 million based on the latest asset appraisal value of 185 million. Two bids were received : one for 91 million tendered by Hi Cement and the other for 172 million from Titan Cement, a new company formed by the Zobel, Araneta, Montinola Group of Fortune and Republic Cement. Since the highest bid was 27 per cent higher than the indicative price, the APT awarded the sale to Titan Cement Manufacturing Corporation.

The non-operating assets of Universal were successfully bid out in May 1991 after two attempts at selling them in whole or sub-lot basis. The highest bid offer of 109 million translated to more than 100 per cent of appraised value. The sale was awarded to Lloyds Richfield Management Corporation formed by the Araneta, Urrutia and Lopez-Vito group.

Midland is now Titan Cement while Universal is now Lloyds Richfield.

APT adopted its more realistic market-oriented approach in selling the above assets within the appraised value levels rather than at book value. Island was for example sold only at a 50 per cent recovery rate based on the transfer value but was sold at 81 per cent based on the appraised value, Midland was sold at only 15 per cent of the transfer value but at 91 per cent of the appraised value, while Universal was sold only at 32 per cent of the transfer value but at 103 per cent of the appraised value.

A major factor that APT considered in moving quickly on these transactions were the hidden costs that were not accounted for in the transfer price. This included the rapid loss in market value of the assets due to physical deterioration and the high maintenance costs that had to be incurred if the disposition was delayed in anticipation of better offers. Given the escalating value of these costs, APT felt that their swift and decisive action could have in fact maximized the net recoveries of the transfer price.

The bidding of these cement companies was considered successful in achieving APT's objectives. The quick-paced manner by which the assets were put into bid tract met general approval. Further, the proceeds of P 874 million was more than one third of the transfer price. This compared favorably with APT's indicative target of 25 per cent.

2. Direct-Debt-Buy-Out

The second round of privatization consisted of those cement corporations the debts of which had fallen in arrears with the DBP. The accounts transferred were those of Davao Union Cement Corporation, Central Cement Corporation, Iligan Cement Corporation, Hi Cement Corporation, Pacific Cement Company, Apo, and Floro Cement Corporation.

Since the transferred assets were in financial form, APT opted to use DDBO because it was the most logical way to dispose of the assets. While the collateral could have been foreclosed and then

sold through public bidding, APT then felt that this would have created a long and tedious legal process. Hence APT chose the "path of least resistance" which resulted in a speedy settlement of the debts.

The transfer of the delinquent cement accounts to APT sent strong signals to the debtors to settle their arrearages or face foreclosure. Clearly, continued restructuring of their loans appeared to be no longer possible since APT was only concerned with the immediate disposition of their non-performing accounts and had nothing to do with their rehabilitation.

This situation, coupled with the very bright prognosis for the industry, prompted the owners of the cement companies to approach APT and signify their intention to settle their obligations under the direct-debt-buy-out (DDBO) scheme. This method allows debtors of transferred assets to re-acquire their collaterals by paying to APT the price equivalent to the amount of liabilities transferred by DBP plus interests and other charges.

The DDBO mechanism was used to pay for 1.9 billion of transferred debts owed by the seven cement companies. Total proceeds amounted to 1.3 billion, representing a recovery rate of 70 per cent of the transfer price. The DDBO transactions were carried out from 1988 to 1990.

The settlement of these transactions helped restore the good credit standing of the cement companies, this being a critical element to their future rehabilitation and expansion plans.

D. Opportunities Supporting Privatization

Two conditions basically supported the privatization process:

- Positive macroeconomic and industry prospects, and
- Debt conversion schemes.

To a very great extent, privatization of cement companies was carried out swiftly because of the pick-up in the economy in 1987-1989 which resulted in brisk construction activities. Industry sources said that the increased demand for cement which could not be met by existing companies was the single biggest factor which led the major industry groups to bid for more capacity.

A policy that supported the privatization effort was the debt conversion program. Apart from the economic recovery, this was one of the most auspicious events that promoted the speedy disposition of the cement companies. Using a Central Bank circular, companies were allowed to avail of the debt-equity and debt-asset swaps to finance the acquisition of APT assets. Under the debt-to-equity scheme, any investor may purchase at a discount, unmatured Philippine private or public sector debts in foreign currency and with the local currency proceeds, buy acquired assets from APT. The debt-for-asset scheme allowed any investor to buy Philippine treasury debt papers at a discount. The peso proceeds could then be used for the purchase of acquired assets from APT.

All of the cement companies, except for Pacific Cement⁸, availed themselves of the debt-to equity or debt-asset swap.

The debt swaps were financially profitable to buyers with the discount at about 40 per cent. Initially, the discount fully accrued to the Cement companies. Later, the discount was shared with the National Government. According to an interview with Mr. Marietto Enecio, an Assistant Vice President of DBP who was involved in the restructuring program for the cement companies, the debt swap was a breakthrough in the privatization of the cement companies.

8 The DDBO transaction of Pacific was approved on installment with an 18 per cent down payment, the balance payable between June 1991 and December 1994. This was an exceptional arrangement due to inherent technical and legal problems of the company.

IV. THE EFFECTS OF PRIVATIZATION

Two criteria may be applied in assessing the success of privatization of the cement companies.

The first is whether APT met its two-fold objectives of speedily disposing of the assets and recovering maximum cash to support government finances.

The second is whether privatization has helped ensure adequate local supply of cement to support the country's increased construction activity.

Privatization should also be assessed as to its having enhanced efficiency in the industry.

A. Speedy Disposition of Assets

When the decision was made by COP to proceed with the privatization of the cement companies, APT moved as swiftly as possible with the process. With idle assets deteriorating rapidly and carrying costs rising, the cost of not privatizing quickly, was high. In addition, the mandate specified that privatization should be carried out as quickly as possible provided sufficient time was allowed for proper preparation. For these reasons, APT tried to dispose of the assets within 2 to 3 years.

All of the cement companies - except for two with pending cases - were transferred back to the private sector within 3 of the 5 years given the COP and APT, with most of the transactions completed in less than 2 years.

Experience from the case showed that speed was achieved by APT because it operated solely as a disposition entity with a clear mandate, sufficient autonomy, ready access to top decision makers (the COP), and quality staff. This would not have been achieved had the disposition been carried out by another government institution with some form of attachment to the assets, as their attitude towards the process would tend to differ from those expressed by the government.

One of the major causes of privatization delay encountered by APT was opposition from previous owners of assets foreclosed by DBP. Despite the immunity conferred to APT under Proclamation 50, local courts still allowed the passage of injunctions to stop the sale of assets. Cases like this dragged on for years; in the case of Island Cement, the case filed by Cabarrus was settled only through compromise, five years after the assets were sold to Solid Cement. This obstacle was, however, overcome by APT when it issued a guaranteed refund to buyers in the event APT lost the case.

B. Maximum Cash Recovery

APT may be said to have realized maximum amounts given the unfavorable political climate prevailing at the time of privatization. Notwithstanding, the total proceeds was more than the appraised values and well in excess of 25 per cent of the transfer price (Annex 3).

APT could have maximized the proceeds had there been more bidders. As to attracting foreign investors, threat of coup d'etat which lingered for almost two years, scared off local businessmen but more so foreign investors.

The opportunities then existing in the industry, notably the dynamic growth in demand, failed to interest new investors as the industry remained under price control. A clear lesson, therefore, is the necessity of political stability and free markets for a comprehensively successful program.

Since the majority of the assets transferred to APT were in physical form, APT was also given the responsibility of conserving them to preserve their market values. But APT had neither the financial resources nor the management expertise to manage and to conserve. This led to further deterioration of some assets as in the case of Midland and Universal, where substantial reductions in market values were incurred. APT then was left with no choice but to sell these assets "as-is", as one lot or in sub-lots, at the best price possible and as quickly as possible.

C. Concentrated Ownership Distribution

One impact of privatization that was foreseen but not considered in the decision process was the concentration of ownership. At that time, while COP foresaw such a situation, the thinking was to use other policy instruments to diffuse ownership.⁹

Concentrated ownership was the result of a thin market. Only existing players could grab the opportunities with their intimate knowledge of the industry and ability to relate to any political setup. Moreover, they already had existing physical facilities, management and financial resources as well as the technical know-how needed to succeed in the business. By acquiring and rehabilitating an existing plant, the incumbents were able to immediately expand their capacities and market share at the least cost. Setting up a new plant would have taken at least three years and an investment close to 3 billion.

Before privatization, the idle assets of Island, Midland and Universal held by the government accounted for 17 per cent of industry capacity in 1986.

With the acquisition of Island by the PHINMA-Madrigal group coupled with the buildup in the capacity of its other companies, its share of the industry capacity increased from 29 to 48 per cent.

The Araneta-Zobel group managed to keep its share within the 20 per cent level, despite its sale of Fortune to a newcomer in the industry, mainly by acquiring Midland and Universal. On the other hand, the Alcantara group strengthened its foothold in Mindanao by acquiring Floro, thus increasing its industry share to about 11 per cent.

A breakdown of the ownership and management structure of the industry before and after privatization is shown in Annex 4.

The resulting consolidation of ownership became the focus of public attention in 1990 when persistent shortage of cement caused prices to escalate to over Pesos 100 per bag, disregarding the 77 government-imposed price. Thus, in 1993 the Ramos government expressed its policy of breaking up cartels and monopolies, including that of cement.

D. Increased Capacity and Utilization

The freer market policies of the government and continued growth in demand encouraged the newly privatized cement firms to undertake rehabilitation, modernization and expansion plans.

The period 1987 - 1988 saw a 50 per cent improvement in industry capacity due to the reopening of Island, and Filipinas, and to increased utilization rates of the other companies. While most reprivatized plants undertook rehabilitation and expansion, only the PHINMA managed companies expanded their operations significantly. The other family-owned plants remained basically small.

The reopening of Midland in 1989 and Universal in 1993 and the opening of a new plant, Grand Cement in 1994 increased the present industry capacity by 62 per cent bringing the total to 10.2 metric tons per year. With 1994 demand level projected at 9.6 million metric tons and production at 10.2 million metric tons, it can be said that the supply is now adequate to meet demand (Annex 5). The projected increase in capacity in the next five years, on the other hand, will come not just from the existing plants' undertaking further expansion projects but mainly from new investors putting up new cement plants.

Encouraged by the bright outlook for the industry and government liberalization measures, new investors have started to join the industry, including two of the country's major retail giants, John Gokongwei of JG Cement Corporation and Henry Sy of Fortune Cement. Foreign investors are likewise seeking joint-venture partnerships.

⁹ Interview with Finance Undersecretary Romeo Bernardo on 08 June 1994.



Between 1985 and 1994, a total of 16.5 million tons were registered under the new Investments Priorities Plan. Thus far, the realized capacity has come only from Grand Cement (owned by Benedicto, a new entrant - with a rated capacity of 1 MTPY) and the expansions of Davao Union, Solid, and Hi-Cement of the PHINMA group. See Annex 6 for industry capacity buildup.

These developments may have the effect of checking industry ownership concentration among its members.

E. Improvement in Efficiency

By mobilizing idle capacities, privatization has set the stage for implementing the government's plan to create an efficient cement industry.

However, the increase in efficiency has been mostly driven by the complementary reform of deregulating the industry and opening it up to foreign competition under the Asean Free Trade Area (AFTA) and eliminating trade barriers. Improvements in efficiency might not have been attained without deregulation.

An officer of Phinma sums up the industry position, said: "Our group of companies is maintaining a positive view of the economy's long term growth prospects. Thus we are taking a strategic stance in anticipation of an increase in competition from new entrants into the Philippine cement industry and from cement producers in the ASEAN region. We have actually begun significant investments to increase capacity and maximize cost competitiveness."

The investments for the resumption of operations, rehabilitation/modernization and addition of new capacity were put up mainly by existing investors in the industry. With the lifting of price control, the cement companies became eligible to borrow under the new Industrial Restructuring Program (IRP) of the local commercial banks and DBP to finance their rehabilitation and expansion plans. Denominated in local currency, this loan will not carry any foreign exchange risk, hence making the company less vulnerable to sudden cost increases.

To date, the following have availed themselves of the IRP credit facility: Bacnotan, Davao Union, FR, Hi-Cement, Lloyd's Richfield, Rizal, Solid, and Republic. Recently, owing to the hike in their capital base, these companies have been looking at public stock offering as a source of capital to finance their expansion programs.

For example, Davao Union has successfully carried out an initial public offering of its shares and raised capital for its \$ 110 million expansion and modernization program. If the present trend in construction activities continue, other companies are expected to similarly raise capital through public stock offering.

Most of the privatized cement firms showed a remarkable turn-around in their current financial performance from a dismal record in the early 1980s as shown in Annex 7.

V. CONCLUSIONS AND POLICY IMPLICATIONS

The following lessons and conclusions may be drawn from this case study on privatization. Also suggested are directions for setting down future policies on the subject.

A. Complementary Reforms

Although privatization brought about improvements in production efficiency through better management and rehabilitation/expansion, it resulted to further concentration of ownership. This may have resulted in allocative economic inefficiency due to lack of competition. Here is where reforms that open up the industry to greater competition either through investment laws or reduction of trade barriers and the timing of reforms are critical.

While the industry was reprivatized beginning in 1987, high tariffs protected it until 1992 when rates were brought down to 5 per cent. This effectively supported industry inefficiency at a cost to the consumer. Thus, allocative efficiency could have been gained by opening up the industry to competition earlier on.

B. Stable Economic and Political Environment

The Philippine experience shows economic and political stability are necessary for successful privatization. Under such conditions, buyers have an incentive to rehabilitate bought assets on their own.

C. Prioritized Objectives

In practice, speedy disposition, maximum revenue generation, and efficiency are conflicting objectives. A useful lesson from the Philippine privatization experience is that the authorities focused on the objective of speedy disposition and chose the policy instrument of deregulation to attain the efficiency objective. The government may have lost in getting maximum revenues in the short run. In the long-run, however, the tax collections from the performing assets may make up for the initial short-term opportunity loss.



Annex 1

HISTORICAL PRICES OF CEMENT

(In Pesos/40 kg. Portland Bag)

Period	Ex-Plant Price Control in Effect	Retail Price
Aug 01/76-Jun 30/78	13.95	14.70
Jul 01/78-Apr 19/79	13.30	15.35
Apr 20/79-May 06/80	20.00	24.50
May 07/80-Jul 19/81	25.00	29.50
Jul 20/81-Dec 26/83	29.00	33.80
Dec 27/83-Jun 14/84	35.00	40.00
Jun 15/84-Apr 21/86	42.50	48.50
Apr 22/86-Apr 15/87	42.50	48.50
Apr 16/87-May 27/88	49.50	52.30
May 28/88-Feb 03/89	49.50	55.30
Price control lifted¹⁰		
Feb 04/89-Jul 05/89	54.50	60.30
	55.00	65.00
Price control re-imposed		
Jul 06/89-Apr 11/90	60.00	71.00
Apr 12/90-Oct 27/90	65.00	77.00
Oct 28/90-Feb 20/91	72.00	85.50
Price		
Control lifted		
1st semester 1992	160.00	
End 1992	100.00	
End 1992		
End 1993	90.40	

*Source: Philcemcor Center for Research and Communication,
Trends in Industry Performance*

¹⁰ Lifting of the price ceiling was untimely as it fell in the middle of the construction peak season. Cement price increased to as much as P 80 per bag. Because of this opportunism, the Department of Trade and Industry restored the price ceiling last July 6, 1989.



Annex 2

THE PHILIPPINE PRIVATIZATION PROGRAM

A. Objectives of Privatization

Privatization, as spelled out in the 1987-1992 Medium Term Development Plan of the Aquino government and Proclamation 50 sought to achieve a two-fold objective:

1. Improve the business climate and promote private enterprise, and
2. Generate cash to control the budget deficit.

Proclamation 50 formalized the implementation of the Philippine privatization program and launched a program for the speedy disposition of certain government corporations and assets. It also created the Committee on Privatization (COP) as the policy making body and its implementing arm, the Asset Privatization Trust (APT).

APT's mandate was clear: to dispose within the shortest possible period those assets transferred to it by COP and to generate maximum cash recovery for the government.

COP's objectives were also defined:

1. "Divest to the private sector in the soonest possible time, through the appropriate disposition entities - those assets with viable and productive potential as going concerns - taking into account where appropriate, the implications of such transfers on sectoral productive capacities and market limitations, and
2. Dispose of such other assets as may be transferred to it, generating the maximum cash recovery for the National Government in the process.

In practice, COP and APT were to abide more by the first objective, i.e., speedy disposition, since both were only given a term of five years.¹¹

To note, the initial objectives under Proclamation 50 did not specifically include a consideration for broad ownership. This objective was to be included later under RA 7661 where the law explicitly states that there be due regard for the creation or perpetration of monopolies and cartels (Sec 2e) and that a minimum of 10% of the sale of assets in corporate form shall first be offered to small local investors (Sec 2f). This is in recognition that in certain cases privatization has contributed to the consolidation of ownership, including cement, as this case study shall show.

The revenues generated would in turn fund the Comprehensive Agrarian Reform Program - the centerpiece program of the Aquino government.

B. Organization

In contrast to the models of other countries, the Philippines created two entities to undertake the privatization process. One was a policy-making body and the other the disposition entity. The objective was to create some kind of a check and balance to ensure transparency.¹²

Responsibility for policy making and program implementation was placed in the hands of the COP.

¹¹ This term has been extended by RA 7181 (December 1991 - December 1993) and RA 7661 (December 31, 1993 - June 30, 1995).

¹² Interview with ex-Trustee Ramon Garcia on 20 June 1994.



This is a cabinet-level committee. It is headed by the Secretary of Finance and has the following members: the Secretary of Trade and Industry, the Director General of the National Economic and Development Authority, the Secretary of Budget and Management and the Minister in Charge of the Presidential Commission on Government Reorganization. The fact that it is headed by the Secretary of Finance with the budget secretary as member is consistent with the objective of revenue generation.

The APT, on the other hand, became an instrument to facilitate the rehabilitation of DBP and PNB. It was then deemed by the Aquino government that both institutions had a role to play and that they needed to be rehabilitated if they were to operate without government support under a competitive business environment.¹³ The APT thus acted as Trustee of the government to sell or dispose the non-performing accounts of these two banks.

The APT is composed of an Executive Trustee and three Associate Trustees. These Executive Trustees have all had extensive experience in the private sector and bring with them a market-oriented approach that has facilitated the implementation process.

The accounts covered by APT include 130 GOCCs (out of 301 GOCCs) and Transferred Assets (TAs) from PNB and DBP. In 1987, APT took title to the 399 non-performing assets of DBP carrying a transfer price of 137 billion. As of 1994, 419 TAs have been transferred to APT for disposition.

The transfer price represents the booked exposure of the transferred loans, equity investments, accrued interest receivables, acquired assets and other assets as reflected in the books of the DBP and the PNB.

To ensure that both APT and COP perform their functions effectively and without delay, Proclamation 50 provided that the decisions of COP were conclusive (Sec 32). Under Proclamation 50-A, no court or administrative agency shall also issue any restraining order against APT or against any purchasers of the assets. The COP and APT members were also protected from civil suits (Sec 32). These provisions are however being contested by previous owners of foreclosed assets as the case of one cement company would show.

C. Guidelines

The APT operates within guidelines set by the COP whose approval is required for all privatization transactions and asset sales (as to buyer and price). The COP has 30 days to advise APT after which time the APT may proceed with its recommendations. The basic guidelines are:

1. Situations that would yield maximum cash in the shortest possible time are given priority. Exceptional cases would be where carrying costs or deterioration of the assets are high, rehabilitation by new owners could immediately generate employment or positively contribute to development of other industries, or project had strategic importance as being sole provider of employment in a particular locality.
2. Generally, the rehabilitation of assets prior to disposition is avoided. However, in cases where rehabilitation could not be avoided, APT had to refrain from incurring additional government exposure.
3. In cases where the realizable price was equal, preference was given to buyers who intend to rehabilitate the asset for utilization within the country and to nationals or to corporations majority-owned by nationals.
4. In developing the disposition strategy for each asset, due consideration is

13 Interview with Dr. Jesus P. Estanislao, ex-DBP Chairman and ex-Secretary of Finance on 09 June 1994.

given to the availment of public securities markets, employee stock ownership plans, debt equity swap plans and other possible sources of capital.

5. The preference is to sell via public bidding. Negotiated offers would be resorted to if bidding should prove unsatisfactory, impractical or inappropriate under the individual circumstances.
6. Standard formulae are used to establish a range of values for the physical assets or financial form assets to be privatized. This includes appraised value, replication cost, capitalized earnings approach and other accepted methods which suit the characteristics of the particular asset being sold.
7. Selling on installment or deferred payment basis is discouraged but in cases where it has to be resorted to, a covering guarantee from an acceptable financial institution was required.
8. Previous owners were qualified to participate in the bidding of their former assets if there were less than 3 bidders.

D. Market Oriented Approaches

New approaches were used by APT to meet the challenge of rapidly transferring assets to the private sector. These approaches were successfully applied in the privatization of the cement companies.

1. USE OF DEBT-ASSET SWAPS

This mechanism was developed to attract foreign capital to reduce external debt. At that time, investments could be made with Philippine debt paper at around 60 percent of face value. Debt-asset swaps were important features of APT's earlier transactions and had definitely encouraged investors to participate in APT's offerings. It resulted in a cancellation of a substantial amount of external public debt.

2. APPLICATION OF FLEXIBLE GUIDELINES

APT approached the issue of valuation from the market perspective. Given this view, APT was not constrained to take substantial write-down from the "official" transfer prices of those assets acquired from the DBP and the PNB in cases where they far exceeded the market appraised values.

3. UTILIZATION OF CREATIVE METHODS

Physical assets which were acquired by the DBP or APT through foreclosure were generally sold through bidding. Different forms were employed, base price, open price, indicative and target price bidding. Base price was normally used for attractive assets with definitive market price. The rules of award were straightforward, highest bid in excess of base price would be recommended to COP for approval. When APT would like to "test" the market and generate price proposals, open price, indicative or target price bidding were the desired methods. Under these methods, bidders were free to submit any bid price, however, the highest bid meeting or in excess of the ballpark figure cited under the bidding rules would be submitted to the COP for Approval. Since bidders were encouraged to submit their price idea, APT was able to get a more realistic feel of the market perception for the assets to be sold.

To further increase the bid price, a "clustering" system was added to all of the above bidding modes. Clustering occurs when the second highest bid is within 10 per cent of the highest bid. Once this occurs, an open auction between the two bidders follows which increases the bid price until one



of the parties give up.

On the other hand, the disposition of financial form assets (promissory notes backed by mortgages, shares of stock in debtor enterprise, lease agreements, receivables and others) utilized the Direct Debt Buy- Out (DDBO) method. Under DDBO, owners of financial form assets were given the chance to pay off their obligations at an amount equivalent to at least the transfer price plus accrued charges before the start of any foreclosure proceedings by APT. Owner-debtors used this scheme in combination with a debt-swap arrangement for maximum benefit.

APT also initially accepted Lease with Option to Purchase bids and bid out sub-lots although its preference was for whole lot buyers.

E. PRICING POLICY

To dispose of its physical assets speedily, APT adopted a market-oriented or investor approach in setting its price formula. Given the unstable political conditions from 1986-1989 and the state of the assets, the APT indicative target was that the settlement price should not fall below 25 per cent of the transfer price.

The COP/APT price setting formula for asset sale was based on market appraisals while debt buy out price used the transfer price. Also, for a number of accounts, the debt buy out price was arrived at on the basis of the average of two market appraisal values.

Annex 3

ANALYSIS OF PRIVATIZATION PROCEEDS: CEMENT COMPANIES

Company Type	Transaction	Price in Pesos	Appraised Value (AP)	Transfer Price (TP)	% Recovery to	
					AP	TP
1987						
(1) Island	Bidding	503	620	997	81	50
(2) Midland	Bidding	172	189	1027	91	15
1988						
(3) Apo	DDBO	47	63	54	75	87
(4) Central	DDBO	56	112	58	50	97
(5) Davao Union	DDBO	216	-	216	-	100
(6) Hi-Cement	DDBO	152	330	152	46	100
(7) Iligan	DDBO	230	420	232	55	100
1989						
Pacific	DDBO	138	116	291	119	56
1990						
Floro	DDBO	509	461	919	110	55
1991						
Universal	Bidding	109	106	336	103	32
1992						
Filipinas	Bidding	27	-	17	-	159
TOTAL		2159	2417	4299	80	50

Source: Asset Privatization Trust

	FINANCIAL INDICATORS (in %)									
	1969	1978	1985	1986	1987	1988	1989	1990	1991	1992
CEMENT COMPANIES REPRIVATIZED										
Davao Union Cement Corporation										
Net income/Net worth			-52.873	-16.898	1.26	8.21	6.71	18.28	13.08	21.54
Net income/Net sales			-20.763	-31.418	2.41	10.34	7.97	18.14	12.83	20.88
Liabilities/Net worth			863.596	202.551	200.77	186.5	155.32	119.8	110.86	81.47
Solid Cement Corporation (formerly Island Cement)										
Net income/Net worth						17.48	39.78	31.45	26.02	27.36
Net income/Net sales						4.66	10.57	10.79	13.03	14.21
Liabilities/Net worth						235.5	166.42	118.06	78.21	156.01
Hi-Cement Corporation										
Net income/Net worth	4.61	0.01	-4.291	-2.838	12.95	33.69	14.17	31.81	19.24	10.91
Net income/Net sales	3.86	0.001	-2.298	-0.896	2.18	11.56	11.98	29.96	22.44	8.94
Liabilities/Net worth	3.67	6.89	293.046	478.627	634.86	177.81	56.22	110.02	105.93	142.55
Iligan Cement Corporation										
Net income/Net worth		-0.02	-32.385	-87.529	61.39	23.16	29.93	32.98	41.87	19.81
Net income/Net sales		-0.02	-21.923	-32.87	15	5.34	8.42	7.63	10.2	7.68
Liabilities/Net worth		1.5	208.3	469.964	335.54	264.81	233.95	166.33	91.52	114.25
Central Cement Corporation										
Net income/Net worth		0.03	-4.421	-7.887	-3.52	5.81	13.16	7.68	21.72	29.45
Net income/Net sales		0.01	-3.69	-6.725	-2.62	3.73	7.74	3.93	11.34	15.34
Liabilities/Net worth		5.37	157.062	146.112	178.88	107.36	67.15	78.47	79.49	58.13
FR Cement Corporation (formerly Filipinas Cement)										
Net income/Net worth	3.51	0.06				0.68	1.71		1.38	0.56
Net income/Net sales	4.23	0.07				0.18	0.37		0.22	0.23
Liabilities/Net worth	1.36	0.36				129.09	201.71		357.33	214.72
Alsons Cement Corporation (formerly Floro Cement)										
Net income/Net worth		0.91							33.17	40.85
Net income/Net sales		-0.09							3.81	6.52
Liabilities/Net worth		26.1							606.53	483.58
Titan Cement Manufacturing Corp (formerly Midland Cement)										
Net income/Net worth									-54.99	-70.97
Net income/Net sales									-19.11	-17.7
Liabilities/Net worth									486.28	911.63



ANNEX 4

2/2

	FINANCIAL INDICATORS (in %)									
	1969	1978	1985	1986	1987	1988	1989	1990	1991	1992
Universal Cement (now Lloyds Richfield)										
Net income/Net worth	4.68									
Net income/Net sales	6.14									
Liabilities/Net worth	3.57									
Pacific Cement Company Inc										
Net income/Net worth	12.11	0.07								
Net income/Net sales	15.18	-0.17								
Liabilities/Net worth	2.17	219.27								
CEMENT COMPANIES NOT REPRIVATIZED										
Bacnotan Cement Industries										
Net income/Net worth	8.72	0.09	4.912	3.11	7.31	9.29	6.21	6.91	21.63	22.24
Net income/Net sales	11.48	0.05	4.131	3.321	6.16	10.62	6.37	6.94	21.67	25.68
Liabilities/Net worth	1.35	0.83	44.795	34.824	39.82	26.16	24.4	30.96	41.27	50.79
Rizal Cement Co Inc.										
Net income/Net worth	-10.21	0.05	-5.178	-11.1	30.78	38.75	46.74		36.74	34.02
Net income/Net sales	-0.96	0.04	-2.251	3.127	10.77	16.05	29.85		12.53	49.15
Liabilities/Net worth	20.11	0.89	180.288	156.131	210.65	110.29	56.75		128.45	29.59
Republic Cement Corp										
Net income/Net worth	3.82	0.07	-0.505	-0.475	9.92	10.11	2.28	4.03	-0.54	6.27
Net income/Net sales	5.48	0.03	-1.104	-0.742	10.08	8.91	3.23	4.79	-0.68	6.76
Liabilities/Net worth	0.63	0.76	37.79	47.134	52.94	52.46	61.46	63.28	57.62	55.04
Mindanao Portland Cement										
Net income/Net worth	-1.93	0.03			19.45	-44.58			2.53	0.18
Net income/Net sales	-5.95	0.006			2.19	-3.28			0.98	0.11
Liabilities/Net worth	1.22	3.56			566.38	1009.35			78.29	71.28
Fortune Cement Corporation										
Net income/Net worth		0.14							-9.86	
Net income/Net sales		0.03							-1.89	
Liabilities/Net worth		3.49							348.03	
Continental Cement Corporation/a										
Net income/Net worth							-9.57	1.44	3.01	4.09
Net income/Net sales							-6.04	0.58	0.82	0.82
Liabilities/Net worth							314.72	258.31	238.88	440.36

a/ transferred to APT but not yet privatized
Source: SECsTop 1000 Corporations





Annex 5

DEMAND-SUPPLY SITUATION 1986-1993

(In Million 40 kg. Bags)

Year	Demand	Supply	Surplus (Shortfall)
1886	78.2	82.0	3.8
1987	110.2	106.5	(3.7)
1988	133.9	132.6	(1.3)
1989	153.4	150.7	(2.7)
1990	185.6	164.1	(21.5)
1991	172.3	172.3	0.0
1992	183.7	166.5	(17.2)
1993	202.2	201.3	(0.9)

Note : Shortfall met by importations

DEMAND-SUPPLY FORECAST 1994-1998

(In Million Bags)

Year	Demand	Supply	Surplus (Shortfall)
1994	239	263	21
1995	275	286	11
1996	316	310	(6)
1997	364	335	(29)
1998	418	335	(83)

Note : Demand forecast is computed at 15 per cent annual growth rate using 205.0 million bags for 1993 as base demand and considering the safe capacity level which is at least 10 per cent of the incremental demand per year.

The supply forecast considered the incremental capacity from the expansion projects of Bacnotan, Continental and Davao Union, which are expected to be in operation in January 1994, June 1995 and January 1997, respectively. Likewise, the forecast took into account the operation of a new project of Grand Cement in January 1994, and the full operation of Lloyds Richfield's project.

Source of Basic Data: DBP Industry Situationer-Cement, May 19,1994

ANNEX 6

INDUSTRY CAPACITY BUILD-UP 1983-1993

(In '000 Metric Tons Per Year)

Year	Installed Capacity	% increase (Decrease)
1983	5,657	—
1984	6,043	6.8
1985	5,563	(7.9)
1986	4,854	(12.7)
1987	4,226	(12.9)
1988/a	6,296	49.0
1989/b	6,737	7.0
1990	6,737	—
1991	7,368	9.4
1992/c	8,552	16.0
1993/d	10,200	7.6

Notes : a/ Solid and FR Cement started operations in 1988; other plants expanded their capacity

b/ Titan Cement started operations in 1989

c/ Lloyds Richfield commenced operations in 1992.

d/ 1993 capacity includes Grand Cement at 1.0 million metric tons per year.

Annex 7

Comparative Ownership/Management Groupings
1986-1993

Grouping	Companies Owned	1986		1993	
		Capacity (000 MTPY)	% to total	Capacity (000 MTPY)	% to total
1) Bacnotan Consolidated Industries and Madrigal Group (managed by Philippine Investment Management Consultants-PHINMA)	Central	139		260	
	Davao Union	438		720	
	Hi-Cement	310		864	
	Solid (formerly Island)	-		1587	
	Rizal	274		400	
	Bacnotan	241		612	
	Subtotal	1402	29	4443	48
2) Alsons/Alcantara Group	Iligan	308		480	
	Alsons (formerly Floro) /1	-		520	
	Subtotal	308	6	1000	11
3) Araneta/Zobel/Montinola Group	Lloyds Richfield (formerly Universal)	-		480	
	FR Cement	(435)		480	
	Republic/2	433		640	
	Fortune	376		-	
	Titan (formerly Midland)	-		240	
	Subtotal	809	17	1840	20
4) Floro Group	Floro /1	411		-	
	Mindanao Portland	169		120	
	Subtotal	580	12	120	1
5) Government (DBP/PNB)	Island	620		-	
	Midland	(320)		-	
	Universal	212		-	
	Subtotal	832	17	-	-
Independents	Northern	620		800	
	Continental	(330)		280	
	Apo	82		173	
	Pacific	216		160	
	Fortune /2	-		384	
	Subtotal	918	19	1797	20
GRAND TOTAL		4849	/3 100	9200	100



1/Floro sold to Alsons/Alcantara Group

2/majority share holding sold to SM Holdings, a new entrant to the industry

3/Subtotals and totals include only the operational capacity



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PERSONS INTERVIEWED

1. Hon. Romeo Bernardo
Undersecretary of Finance and Chairman, Technical Committee, Committee of Privatization, Department of Finance
2. Hon. Gonzalo T. Santos, Chief Executive Trustee, APT
3. Ms. Crisanta S. Legaspi, Executive Officer, Committee on Privatization and Director IV, Privatization Office, Department of Finance
4. Ms. Bernice A. Syquia, Executive Officer, APT
5. Mr. Marietto A. Enecio, Assistant Vice-President, DBP
6. Ms. Aurora C. Maghirang, Bank Executive Officer I, DBP
7. Dr. Magdeleno Albarracin, President, Philippine Cement Manufacturers Corporation (PHILCEMCOR)
8. Mr. M.B. Acosta, Jr., Finance Manager, PHILCEMCOR
9. Mr. Mario M. Yambot, Vice-President for Administration and Finance Pacific Cement Company, Inc.
10. Mr. Eduardo Sahagun, Comptroller, Davao Union Cement Corporation
11. Mr. Ramon Garcia, Ex-Chief Executive Trustee, APT
12. Dr. Jesus P. Estanislao, Ex-Chairman, DBP & Ex-Secretary, Department of Finance
13. Mr. Vicente Jayme, Ex-Secretary, Department of Finance
14. Dr. Cesar E.A. Virata, Ex-Minister, Ministry of Finance
15. Mr. Diosdado Macapagal, Jr., Ex-Undersecretary, Department of Finance
16. Mr. Juan Moran, Ex-Associate Trustee, APT
17. Atty. Jose C. Sison, Ex-Associate Trustee, APT
18. Mr. Brad P. Wallach, Chief, Private Enterprise Support Office, USAID
19. Ms. Carla del Prado, Executive Assistant, APT
20. Ms. Malou Vitorio, Administrative Assistant, APT

ANNEX C:

September 1994
ORIGINAL: ENGLISH

**CASE STUDY OF PRIVATIZATION:
THE STYL CLOTHING FACTORY
(SZOMBATHELY, HUNGARY)**

PREPARED FOR
United Nations Development Organization, Vienna.

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INTRODUCTION

This case study is an analysis of the impact of privatization through foreign direct investment (FDI) of a clothing manufacturing enterprise in Hungary and is part of a comparative analysis undertaken by UNIDO of privatization of enterprises in different sectors in selected countries and regions. The effects of such privatization have necessarily to be viewed in the context of the transition to a market economy in Hungary, trends in privatization in Hungary and the role expected from foreign investments, and the special features, advantages and constraints of clothing production in Hungary in relation to the forms and impact of privatization on this particular enterprise.

The Styl Clothing Factory at Szombathely, Hungary was selected for the purpose of the UNIDO study, largely because the company's privatization, which took place during the 1989-1991 period, is among the first wave of privatizations in Hungary. The four years of operations of the company subsequent to its privatization also enables an assessment of the effects and pattern of change in the company's operations under private ownership. At the same time, the company had certain distinctive features which differentiated it from most state-owned enterprises in the Hungarian manufacturing sector. Whereas the Hungarian industrial activity, particularly the heavy industry, is located around the capital at Budapest, the Styl plant is located in the Western area of the country, about 30 miles from the Austrian border. This gave the company certain locational advantages with respect to location to Western export markets and availability of labor. Secondly, the company had been producing predominantly for export markets to countries with convertible currencies and as such, it had enjoyed considerable privileges from the government, particularly in terms of access to foreign exchange to purchase imported equipment. Consequently, the company's technological capabilities were competitive and comparable with those of enterprises in European industrialized countries. Such international competitiveness has not been characteristic for most subsectors of the Hungarian manufacturing industry.

This case study is based on material which was provided by the company, including annual reports and investment plans and activities. Material was also obtained and analyzed which was submitted by the underwriting syndicate to the Budapest Stock Exchange for public offering of the shares; valuation of the company prepared by the company; the Underwriting Agreement; Quarterly Reports of the company submitted to the Budapest Stock Exchange and reviews by the Hungarian press and academic publications. Published material was supplemented with information obtained through personal interviews conducted by the international and national experts with the management of the company at its head office in Szombathely during July 26th and 27th. These interviews at the company included the marketing and business manager, the technical director and representative of the union.

The assessment of the Hungarian macro-economic environment, and the country's privatization policies are based on an analysis of respective legislation, publications of the Hungarian State Property Agency and the Hungarian Ministry of Industry and Trade. Detailed interviews were also conducted with staff members of the Privatization Office of the Hungarian Ministry of Industry and Trade and the State Property Agency during the week of July 25-29. The study also draws on publications of the Hungarian Academy of Sciences and interviews which were conducted with researchers of the Academy during May 1994.

I am grateful for the assistance of Mr. Jozsef Barta, the National Expert for the study, for compiling information on the company and on the Hungarian legislation and privatization policies as well as for arranging the company visit. The preparation of this study was greatly facilitated by Mrs. Károlyne Szilágyi of the Privatization Office of the Hungarian Ministry of Trade and Industry who gave generously of her time to discuss the role and participation of the Ministry in the privatization of the company, and the government policy towards privatization at that time. I am also thankful to Mr. László Bajor of the Ministry of Industry and Trade who accompanied us to the company visit and greatly assisted us in the assessment and analysis of the company's technological capabilities. I must also express my appreciation and gratitude to Mr. Caj Falcke, the director of this project on behalf of UNIDO who established the contact with the Hungarian authorities and guided the implementation of the project through its various phases.

I. THE TRANSITION PROCESS IN HUNGARY

In 1989, democratically elected governments replaced the communist leadership in Eastern and Central Europe. The rapid and unprecedented historical change in the political system and in the socio-economic transformation to a market-oriented economy was preceded in Hungary by gradual economic liberalization which commenced as far back as in 1968. Within the framework of the New Economic Mechanism at that time, the extent of centralized planning was significantly loosened in favor of a more decentralized economic system. Local authorities received greater autonomy from the central administration and managers of state-owned enterprises were authorized to exercise increased decision making powers in relation to investments, production and distribution. The management of state-owned enterprises (SOEs) were also provided incentives for greater efficiency by permitting them to retain part of their earnings for internal usage. While operationally, state-owned enterprises continued to remain under the administration of branch ministries, the extent of intervention by the ministries gradually decreased over the last two decades and was often largely confined to approval of budget and production plans which were prepared by the enterprises themselves.

Since the early 1980s, in Hungary, the government had permitted the establishment and growth of private-sector businesses and industry, though there were major restrictions on the field of activity, the number of employees, wages and other operational aspects. Privately-owned enterprises, for example, were permitted to be established in selected industrial subsectors, with a maximum of 10 employees. As a result, a small but growing private sector comprising of a wide range of businesses, and production and marketing activities developed during the 1980s. By 1985, it was estimated that there were about 100,000 enterprises operating in the private sector.

It was during the second part of the 1980s, a period which is often referred to as "reform communism", that a two-tier banking system was introduced, which separated central banking from commercial banking activities; new personal and enterprise taxes and a consumption taxation system was introduced; the organization of the stock exchange was initiated; and foreign investors were permitted to operate in joint ventures with domestic partners, though, still with major restrictions on fields of activity and other operational aspects.

Economic Liberalization

In 1989, the first democratically elected government committed itself to the transformation of the country to a market economy and policies were adopted towards this objective. In 1989-90, the major economic policies focused on economic liberalization, similar to several other Eastern European countries, particularly Poland and Czechoslovakia. Price liberalization of goods and services and wages was sought to be achieved through deregulation of industry, liberalization of foreign trade and withdrawal and reduction of price subsidies by the government. The necessary legal infrastructure and institutional system required for private sector growth; private ownership of property, and development of a market-oriented economy were established. Macroeconomic measures were also adopted to stabilize the economy and initial steps were taken to increase and improve competitive conditions in the economy. It was also recognized as essential to adopt stabilization measures as a pre-requisite for a market economy. Privatization, that is, the transfer of state-owned property to the private sector, also played a key role in transformation of a centrally-planned system in Hungary to an increasingly market-oriented economy, with private sector playing a growing role.

Foreign Direct Investment Policies

An essential role was expected to be played by foreign direct investments (FDI) in the modernization of the economy. FDI was expected not only to ensure much-needed capital inflow, but also to bring about increased inflow and application of new technologies and production expertise, and advanced managerial know-how in various fields of industry and to perform a critical and catalytic



role.¹ The participation of foreign investors was also considered essential in order to integrate the Hungarian economy with other industrialized economies in Western Europe, both through trade and through investment, technological and marketing relationships. Increased linkages with foreign companies was also considered vital for expansion of the country's exports to Western markets.

Industrial Production, 1989-1993

During 1989-93, the impact of price and trade liberalization, the effects of restrictive monetary policies and the collapse of the COMECON market resulted in considerable economic disruption and dislocation in Hungary, similarly to several other former centralized economies in the region. In Hungary, since 1989, the GDP continued to decline, with industrial production experiencing major and continuous decline.² Several factors accounted for this development. A major share of Hungarian industry was producing for other COMECON countries and, with the collapse of the COMECON, these markets tended to disappear. As a result of the withdrawal or reduction of government subsidies to state-owned enterprises and because of price liberalization, there were significant price increases, besides restructuring of production and narrowing of effective demand for locally-produced goods in the domestic market. Increasing unemployment and decline in the average disposable income also resulted in substantial reduction in the demand for local goods and services in a wide range of industrial subsectors.

1 See Amendment of Act XXIV of 1988 on the Investment by Foreigners in Hungary.

2 By mid 1992, for example, industrial production fell to 60 percent of that the 1985 level and unemployment rate was 13 percent. Capacity utilization decreased significantly. See Ministry of Industry and Trade, *Industrial Policy for the 1990s*, Budapest, January 1993, p. 7, Figure 1.



II. TRENDS IN PRIVATIZATION AND THE ROLE OF FOREIGN DIRECT INVESTMENTS

The Hungarian Democratic Forum, which won in the first election in 1989 in Hungary, stated its program as "Freedom and Property".³ The role of private ownership was viewed as a major element of the government program with privatization of state-owned enterprises was recognized as a basic and key feature in the transformation to a market economy. In the implementation of privatization, the following criteria were required to be followed:

- Protection of the value of state property, i.e. to ensure that despite possible negligence or abuse, the value of the state property is appropriately assessed and determined;
- Privatization should contribute to the broadening of ownership in the population and to the strengthening of self-managed institutions;
- Special attention should be given to the return of property to their former legal owners, whose properties were acquired or confiscated during the communist régime;
- It should be ensured that privatization of state property is based on appropriate valuation, and at a realistic price and this is determined in accordance with well-established criteria and regulations;
- Development of private property should also be promoted by the restructuring of large entities into smaller units functioning independently;

Evolution of privatization, 1988-1994

Privatization in Hungary was not initiated by the elected democratic government in 1989; in fact, privatization was initiated by the former communist régime. During the 1985-88 period, a number of legislative measures were adopted by the communist government which aimed to increase autonomy and self-management of local enterprises and granted important decision-making power to management. Among such legislation, in 1989, the Transformation Law, Law XIII. was adopted which entitled the management of a company to transform itself to a joint stock company, and make decisions concerning sale of partial sale of the company, to domestic or foreign investors.⁴ The first privatizations were based on this legislation, and are referred to as "spontaneous" privatization. This legislation continued to be utilized in the early stages of the new government and provided the legal basis for the first privatizations in the country (including that of the Styl Clothing Factory).⁵

The cases of "spontaneous" privatizations took place with limited supervision, control or intervention by the government. In response to the problems which arose from this situation, the State

3 For a review of the development of Hungarian privatization policy see State Property Agency, *A maganositas harom eve es elozmenyei*, Budapest, July 1993. Also, Ministry of Finance, *A kormány tulajdonosi es privatizacios strategija*, Budapest, August 1991.

4 Legislation: *A gazdalkodo szervezetek es a gazdasagi tarsasagok atalakulasarol szolo 1989. evi XIII. torveny*.

5 For a review of 'spontaneous privatization' see: Mora, Maria, "Az allami vallalatok (al)privatizacioja", *Kozgazdasagi Szemle*, XXXVIII. June, 1991, p.565-584, also, Stark, David, "Privatizacio Magyarorszagon. A tervtol a piachoz vagy a tervtol a klanhoz", *Kozgazdasagi Szemle*, XXXVIII. Sept. 1991, p.1121-1142.; Toth, Istvan, "A spontan privatizacio mint kormány politika", *Kulgazdasag*, XXXV.9. 1991, p.35-52.; Voszka, Eva., "Tulajdonosi szerkezet - tulajdonosi erdek", *Kozgazdasagi Szemle*, XXXVIII. January, 1991, p. 47-56.



Property Agency was established by the new government in 1990, and was entrusted with the supervision of privatization of state-owned enterprises and to ensure that such privatizations took place with proper and adequate protection of the interests of the state. Through such centralization of the privatization process, it was expected that privatization would take place under supervision and/or direction of the State Property Organization.⁶

During 1990-92, the privatization laws and procedures were expanded and further refined in the light of the experience of the process of privatization. An important element in the privatization process has become the requirement of tenders for major privatizations and, therefore, the achievement of a fair market price under competitive bidding procedure. Transparency of transactions has also become a key requirement and is intended to contribute to the fairness of the process. A distinctive feature of the Hungarian privatization process, as distinct from privatization in several other East European and Central Asian countries, has been that privatization of state-owned assets was aimed to be achieved at the market value of the operation, and against payment. Free distribution of shares and voucher type of privatization has not been utilized in Hungary. Foreign investors have been welcome to participate in privatization and the participation of foreign investors (with a minimum of 30 percent equity share) has been encouraged by major tax concessions.

Until 1992, foreign investors played a major role in privatization in Hungary. In 1990, approximately 95 percent of privatization revenues came from foreign investors; in 1991, foreigners accounted for 80 percent; in 1992 for 60 percent; and by 1993, for 45 percent of total privatization revenues.⁷ The lower extent of foreign participation in privatization has been related to two major factors; firstly, consequent on the privatization of the most viable state-owned enterprises, the demand by foreign investors has decreased; secondly, while during 1989-92, the shortage of domestic capital provided limited scope for participation of domestic investors, the picture gradually changed. In 1992, the government adopted a new policy to encourage the participation of domestic investors in privatization. It permitted, for example, the usage of compensation certificates to be utilized for privatization. The government also provided subsidized credit which has become available to domestic investors interested in acquiring privatized assets. Largely as a result of such efforts, by 1993, the share of privatized assets which was acquired by domestic investors increased to 55 percent of privatization revenues, compared with 5 percent at the beginning of privatization.⁸

In late 1993, government policy towards privatization shifted in its orientation and there was a reversal of its previous policy of granting incentives to domestic investors to participate in privatizations, such as through various subsidized credits. It has increasingly been recognized that newly-privatized enterprises require major investments for their modernization which would necessitate the participation of financially strong investors. The acquisition of privatized companies by investors which rely heavily on credits with subsequent major debt service requirements can serve as a deterrent for inflow of major new investments which are required by most privatized enterprises. The policy of the government which had encouraged participation of domestic investors through various subsidized credits was thus replaced by providing greater preference to investors who were in a position to provide substantial new and additional investments.

6 For a discussion of the role of the SPA see, for example, The Economist Intelligence Unit, "Boost to Hungarian Privatisation Plans", *Business Eastern Europe*, January 11, 1993, p.1-3.

7 Allami Vagyonugynokseg, *A maganositas harom eve es elozmenyei*, Budapest, July 1993.

8 Detailed statistics on privatization are presented by the Ministry of Industry and Trade, *Tajekoztato, Adatok a tarca szakmai felugyelete ala tartozo gazdalkozo szervezetek tulajdonosi strukturajanak valtozasarol*, Budapest, Juni 1994.

III. BACKGROUND AND OPERATIONS OF THE STATE-OWNED ENTERPRISE, THE STYL CLOTHING FACTORY, 1952-1989

The origins of the Styl Clothing Factory date back to 1952 when in Szombathely 15 tailors, under a government order, joined in a co-operative, and established the Women Clothing Enterprise, which primarily manufactured tailor-made clothing. In 1967, the company's name was changed to Styl Clothing Factory, and the enterprise subsequently expanded its operations in Kármend. In the 1970-72 period, the production facilities were expanded further in two smaller locations and production was commenced of men's clothing.⁹ In 1982, the company started with its first foreign subcontracting arrangement with the British company, Maitland Ltd. and in 1986, subcontracting arrangements were established with the German enterprise, Bäumlér Co. In 1988, the company entered into a five-year subcontracting arrangement with the Bäumlér company for an annual value of Ft 84.3 million.

Subcontracting

The subcontracting arrangements involved the production of men's jackets for which all the material, components, designs and labels were supplied by the foreign company from abroad. Styl provides the labor according to an agreement which specifies the gross price of one labor hour, which comprises the direct labor costs and all the allocated indirect costs of the company. In the agreement, the norm hour is also specified, which is the number of hours required to prepare one jacket. The profit of the company accrues from the difference between the agreed upon brutto labor hours (this is assessed as revenue in the Income Statement) and all the direct and indirect costs of the company. The gross labor price is quoted and agreed upon by Styl and its foreign subcontractor in foreign currency, e.g. in DM with Bäumlér. Consequently, the Forint profit of the company realized is significantly influenced by the rate of inflation in the country and the foreign exchange rate changes between the Forint and DM and the Forint and other convertible currencies with which the company has subcontracting arrangements. In the case of long term arrangements, such as with Bäumlér and Maitland, where the prices are fixed for a five-year period, actual revenues and costs may deviate substantially from the projected levels.

Products and Markets

Since its establishment, the Styl Clothing Factory has been a profitable company, and it was generally recognized that it produced the highest quality clothing in Hungary. In terms of its size, it was approximately the third largest clothing manufacturing enterprise in Hungary. As part of its expansion in the 1970s, the company installed a considerable range of modern production equipment, which was mostly imported from Germany, and to a lesser extent, from the United Kingdom and the United States of America. For cutting operations, the Gerber system, (Germany) has been utilized which is a computer-aided manufacturing system, based on digitalization of information for cutting the pattern. The machinery which has been used for sewing operations consisted of equipment such as Brother from Japan; Union Special from the United States, and Mayer, Pfaff and Durkopp from Germany. The company was able to obtain adequate foreign exchange for the import of machinery and equipment since the company exported primarily to countries with convertible foreign exchange. In the early 1980s, approximately one-third of the company's production and over half of its exports were to countries with convertible foreign exchange.

The company has been engaged in four major activities: firstly, export to countries with convertible currency, based largely on export financing from the buyer; secondly, subcontracting arrangements where the material was provided by the foreign buyer; thirdly, the company's own production directed to the domestic market and sold through four company-owned retail outlets; and fourthly, exports to the Middle East and to the Soviet Union. In addition, the company was also engaged in trading, and

⁹ For a brief review of the company's history see Styl Ruhagyár, Szombathely, 1992.



imported ready-made clothing from the Far East and sold it through its own stores.

The successful operation of the company, even preceding its privatization was largely attributable to sound and efficient management, which achieved full utilization of the plant's capacity. The company had also invested in new technology and equipment, which was imported from Western countries and which enabled high-quality production and operational efficiency. As a result, the company was able to develop an active export program to Western markets and to the Middle East. Due to the high quality of its production, the company received subcontracting export orders from well-known, high-quality brand names, such as Max Mara, Pierre Cardin, Laurel, Escada and Kleiderbauer. During periods of low orders, which is usual for the industry between the two seasons, production capacity was able to be utilized effectively to produce for the Soviet Union, which provided a large and steady market for the company's products. During such periods, the company also increased its production for the home market.

In the mid-1980s, exports to the Middle Eastern markets had all but disappeared but the company was successful in compensating for the loss of these markets by expanding its exports to West European countries. In the mid 1980s and up to 1989, exports to the Soviet Union also remained significant.

IV. PRIVATIZATION OF STYL CLOTHING FACTORY

The privatization of the company took place in different stages. The initial step was the legal transformation of the state-owned enterprise to a joint stock company which allowed the sale of shares of the company to outside investors. As the second step, the company was transformed to a joint venture with a minority holding by a foreign investor. As a third step, the shares which were held by the government, were sold partly to the foreign partner and partly through public offering. These steps are presented in detail in the following.

Transformation of the Company

In 1988, when the Transformation Law was in a draft form and pending its formal adoption, the management of the company decided to utilize the law for its transformation to a joint stock company once the law was enacted. The Transformation Law of 1989, Law XIII., authorized management to transform the enterprise legally into a joint stock company and subsequently, *inter alia*, to sell shares to outside investors. In the case of sale of shares, 80 percent of the proceeds would go to the state and 20 percent to the company. In June 1989, when the Transformation Law was adopted, Styl was among the first companies to transform itself to a joint stock company under the new law.

Valuation of the Company

An essential element of the transformation of a state-owned entity involves the valuation of the enterprise so that subsequently, when shares are offered to outside investors, these can be priced. The company prepared the initial valuation which was based on the book value of machinery, equipment, land and buildings.¹⁰ In cases when the equipment was depreciated to zero, adjustments were made. Based on this procedure, the management assessed the value of the company at Ft 400 million. A separate valuation was prepared by Young and Ernst Co, the United States accounting firm, which set the value of the company at Ft 505 million. The Ernst and Young valuation set a higher value for the land than the management of the company.¹¹ These two estimates were submitted to the Ministry of Industry and Trade (the State Property Agency did not exist at that time), and constituted the basis for subsequent negotiations. The participants in the negotiations were the Hungarian Ministry of Industry and Trade, which represented the interests of the Hungarian government, the Hungarian management of the company, and the prospective foreign investors in the company, including representatives of Bäumler GmbH and Kolozsváry Co. As the outcome of lengthy negotiations, in 1989, the joint stock company was valued at Ft 334 million.

Objectives of management

The aim of the management in transforming the company was to facilitate the sale of the company to its principal foreign suppliers and ensure the continuing commitment of such suppliers through investment in the technological modernization of the plant and its continued access to markets in Western Europe. Operating as a joint venture with a foreign partner has also enabled the company to realize significant tax savings. According to the 1989 legislation on foreign direct investments, companies with a minimum of 30 percent foreign share were eligible to a 60 percent corporate tax deduction for 3 years to be followed by a tax deduction of 40 percent for the subsequent 5 years.

Foreign participation

At the time of the transformation of the company, Baumler GmbH, the German company with which

10 Styl, Vagyonertekelés, Szombathely, October 2, 1990.

11 For an analysis of the company valuation see: Tulajdon Alapítvány Privatizációs Kutatóintézet, A Styl Ruhagyár Reszvenytársaság Atalakulása és Privatizációja, Budapest, November 1992. (mimeo).

Styl already had a subcontracting relationship since 1986, acquired 19.8 percent of the company. The acquisition of shares took place through an increase in the capital of the company to Ft 481 million. Its equity share was contributed partly in the form of machinery and partly in cash. The machinery consisted partly of reconditioned equipment which was shipped to Styl from Baumler's German production facilities in Ingolstadt, and partly of new equipment. 4 percent of the shares was acquired by Styl's British buyer, Maitland Ltd. Between 1 and 3 percent of the company's shares were bought by two other German companies, namely Rosner GmbH and Kolozsváry Company.

Motivation of foreign investors

Bäumler GmbH, the German company which purchased 19.8 percent of the company, was interested in securing a reliable source of supply from Styl. To ensure the high quality of the product, it contributed advanced machinery and equipment which enabled substantial modernization and enhancement of productivity of Styl's operations. It also continued its long-term subcontracting relationship with Styl which, by 1989, amounted to production and supply of 1000 men's jackets per day. For Bäumler, as well as the other foreign investors which participated with minority holdings in the company, including Maitland (United Kingdom) and Rosner (Germany) companies, sourcing from Styl, enabled these companies to take advantage of the low Hungarian wage level, which in 1989-90 was approximately one-fifth to one-sixth of German wages.¹² The production of men's jackets, despite the high level of automation of production, continues to be fairly labor-intensive and the lower wages in Hungary provide significant savings in costs of the final product. The work force of Styl is also well-trained, with about 56 percent having completed relevant technical schooling, and about 42 percent having received in-plant training with the company. Furthermore, the investment climate in Hungary had been quite favorable to foreign investors, with the 1989 foreign investment regulation not only according significant tax incentives to companies with foreign capital participation but also guaranteeing profit repatriation in foreign exchange.

Sale of shares held by the State Property Agency

In 1989, with the transformation of the company, share capital of Ft 264.6 million represented the ownership of the government in the company. In 1991, with the establishment of the State Property Agency (SPA), the shareholding of the government was transferred to the SPA which is the holding company for government-owned shares in enterprises with state ownership. (Shares of approximately 1 percent of total shares were allocated to local governments in compensation for the land on which the production facilities are located). The sale of government shares took place in three stages:

- Firstly, at the Annual Meeting of the company, on December 14, 1989, it was decided that share capital to the amount of Ft 5 million (representing less than 1 percent of total share capital), would be sold at face value (in units of Ft 1,000), to the Hungarian management of the company.
- Secondly, during the first half of 1991, an agreement was made between the foreign owners of the company, (including Bäumler, Maitland, and Rosner companies) and the State Property Agency, to sell share capital of the company in amount of Ft 100 million, held by the State Property Agency, to its foreign owners at 170 percent of the face value. According to the legislation at that time, 80 percent of the proceeds went to the government and 20 percent to the company. The foreign investors agreed to use the proceeds which went to the company partly for the expansion of the company's capacity

¹² According to a study by the United States investment bank Morgan Stanley, in 1991, the average hourly wage in the manufacturing sector in Germany was US\$ 22.49 while in Hungary, US\$ 1.38. "East Europe's low wages luring manufacturers from West Europe", The New York Times, May 11, 1993.

and modernization of selected production lines and partly, to finance stock offering to the workers of the company.

- Thirdly, in June 1991, the State Property Agency offered to sell its share of Ft 159.6 million at the Budapest Stock Exchange. The public offering was underwritten by Creditanstalt Bankverein, an Austrian bank. The shares were offered at Ft 2850 per Ft 1000 face value.¹³ The offering was oversubscribed five-times of the amount offered. According to the terms of the public offering, the shares were allocated to the subscribers in proportion of their application. (In accordance to the rules governing proceeds from privatization, 80 percent of the revenues from the public offering went to the government and 20 percent to the company.) In July 1991, when trading of the stock began on the Budapest Stock Exchange, the price was Ft 3,271, indicating that the valuation by Creditanstalt was approximately 10 percent below the market price. .

TABLE 1: OWNERSHIP STRUCTURE OF STYL CLOTHING FACTORY

Year	In Percentages			
	1989	1991	1992	1993
Bäumler GmbH	19.8	33.0	47.3	52.1
Österreichische Kreditbank	0	15.0	25.2	25.2
Rosner GmbH	0	5.0	11.4	11.4
Maitland	0	3.2	3.2	3.2
Hungarian Investment Ltd.		0	3.2	3.2
Other foreign	0	0	7.1	4.1
Total foreign	19.8	56.2	97.4	99.2
State Property Agency 1 a/	13.0	13.0	0	0
State Property Agency 2 b/	53.0	32.0	0	0
Other domestic investors	14.2	8.8	2.6	2.6
Total domestic	80.2	43.8	2.6	0.8
<i>a/ Share held by the SPA with independent decision-making authority.</i>				
<i>b/ Refers to shareholding for which the SPA and the foreign investors make joint decisions. This differentiation of the decision-making authority of SPA was part of the negotiated agreement between the SPA and the foreign investors.</i>				
<i>Source: Tulajdon Alapítvány Privatizációs Kutatóintézet, A Styl Ruhagyár Részvénytársaság AtalakuLása és Privatizációja, Budapest, November 1992, and; Styl Clothing Manufacturing Co., Report - 1993, Szombathely, July 1994</i>				

13 For details of the public offering See: Baker and McKenzie, Underwriting Agreement, Budapest, May 24, 1991.

Shares of the workers

According to the law, in the case of privatization, the company has to offer 10 percent of the shares to the workers of the company. In October 1991, the company offered shares with a face value of Ft 55 million to the workers of the company. This resulted in an increase of Ft 55 million in the share capital and was sourced from the allocated proceeds which the company received from the public offering. Management made an offer to the workers to purchase their share at the face value of Ft 1000. About 95 percent of the workers decided to sell their share and receive the Ft 1,000 in cash rather than retain ownership of the shares. Lack of familiarity with stocks, distance from the Budapest Stock Exchange and the modest income of the workers were important factors influencing this decision. Few workers benefited from the appreciation of the shares, which by 1992, reached a price of Ft 6000 on the Budapest Stock Exchange.

The change of ownership in the company from the first stage of its privatization in 1989 until its complete privatization can be seen in Table 1 which shows that privatization of the company has largely been achieved through a progressive increase in foreign ownership.

V. OPERATIONS OF THE COMPANY SUBSEQUENT TO ITS PRIVATIZATION, 1990-1993

Since the legal transformation of the company to a joint stock company and the formation of joint venture in 1989, the new top management has adopted major changes in the operations of the company. These included additional products and extension to new markets on the one hand and the introduction and application of new technologies on the other. As a result, there was an increased volume of production, which was accompanied by a major expansion of the labor force. The Hungarian management of the company has not been replaced subsequent to privatization but a new layer of top management, the Supervisory Board was added to the organizational structure. The Supervisory Board comprises of the new foreign owners of the company. In the subsequent section, these operational changes are further reviewed.¹⁴

Production and Markets

Under the new top management, the product range, the markets and the contractual arrangements governing exports have undergone important modifications. To meet the requirements of new export markets and distributors, the quality of products was upgraded. As can be seen in Table 1, in the years preceding privatization of the company, exports to Western Europe accounted for about 60 percent of total exports but by 1993, the share of such markets increased to over 85 percent of total exports. By 1992, exports were almost entirely undertaken through subcontracting arrangements with the foreign buyer supplying all the material and providing their brand names. By 1993, exports under the company's own brand name have all but discontinued.

TABLE 2: SALES, EXPORTS, SUBCONTRACTING PROFITS, 1987-1993

		In million Forints						
Year	1987	1988	1989	1990	1991	1992	1993	
Sales	859	896	1,043	1,249	1,570	2,046	2,211	
of which:								
Exports with convertible currency	453	474	620	762	1,163	1,569	1,757	
Subcontracting	153	262	579	605	982	1,234	1,719	
Profit before tax a/	80	112	137	243	361	456	249	

a/ In 1990, new accounting standards were introduced, and the measurement of profit is not consistent before and subsequent to 1990.

Source: Based on the Annual Reports of the company and information provided by the company.

¹⁴ These sections are based on the analysis of Styl's Annual Reports and the Quarterly Reports which are submitted by the company to the Budapest Stock Exchange.

Employment and wages

Subsequent to its privatization, the labor force of the company has increased constantly, and as can be seen in Table 3, by the end of 1993, was close to 2,400, approximately 50 percent above the 1989 level.

At the time of the company's transformation, wages were regulated by legislation. By 1990, with the liberalization of the economy, wages were deregulated and Styl increased the salary of its workers. By 1992, however, the company did not maintain wage increases in line with inflation, and the average wage of a worker at the Styl plant was approximately Ft 15,000 per month, which was at the low end in the Hungarian manufacturing industry. (In 1993, the average wage in the manufacturing industry was approximately Ft 23,000). By 1994, the company experienced difficulties in securing sufficient labor force for a second shift operation. Part of the growing labor shortage can be attributed to the establishment of a number of labor-intensive manufacturing activities in Szombathely which offered higher wages than Styl. Such new activities include, for example, an enterprise assembling electronics components and another, manufacturing auto parts.

TABLE 3: EMPLOYMENT OF STYL CLOTHING FACTORY

Year	Number of		
	Workers	Administration	Total labor force
1960	245	89	334
1968	755	125	880
1976	1,075	167	1,242
1982	1,363	200	1,563
1985	1,424	203	1,592
1986	1,390	202	1,586
1987	1,394	192	1,586
1988	1,395	191	1,586
1989	1,424	190	1,614
1990	1,525	184	1,709
1991	1,703	191	1,894
1992	2,000	216	2,216
1993	2,170	228	2,398

Source: Information provided by Styl and Annual Report, Styl

Investment and Technology

By the end of 1989 and early 1990, with the formation of the joint venture arrangement with Bäumler GmbH, the company undertook major investments. This involved mostly the installation and expansion of the production line for the daily production of 1000 men's suits for the foreign investor, Bäumler, which was contractually agreed for a period of five years. As can be seen in Table 4, in 1992, major investments continued both for expansion of the plant facilities and machinery and equipment. By early 1994, the company's production facilities were only marginally different from the German

investor's home operations in Ingolstadt, Germany and the labor force productivity of Styl was only approximately 5 percent less than at the Ingolstadt plant. By mid 1994, the major investments for the modernization of the plant were mostly completed and during the next few years the investment plan is scheduled to be significantly below the 1990-1993 investments.

TABLE 4: INVESTMENTS, 1986-1993

In Million Forints			
Year	Plant	Equipment	Total Investments
1986	10.0	2.0	12.0
1987	4.0	4.0	8.0
1988	10.0	5.0	15.0
1989	2.0	40.6	42.6
1990	67.2	65.7	133.0
1991	41.3	129.9	171.3
1992	153.6	187.6	341.2
1993	57.8	218.1	275.9
1994-first half	48.6	83.8	132.5

Source: Information provided by the company and Annual Reports

Profitability

Since the early years of its establishment, the company has been operating profitably. With the formation of the joint venture in 1990 and with its full privatization in 1991, however, the profitability of the company has increased significantly. While, during the years preceding privatization, the before-tax earning ranged between 10 and 13 percent of total sales, in 1991 and 1992, the before tax profit reached 23 percent of net sales. In 1993, however, profits dropped sharply, largely in response to the recession in Western export markets. The company's profits were also influenced unfavorably by the foreign exchange rate movements between the Forint and the German DM. The relatively high inflation rate in Hungary and the overvaluation of the Hungarian Forint have inevitably depressed the profit margin on exports.

In the 1990-1993 period, most of the profit was retained by the company and reinvested. Self-financing was the major source for financing new investments. The financial position of the company has been extremely sound, with a predominant share of the investments being financed through equity.

Management Structure

Managerial control of the company has undergone major changes with the privatization. These are related, on the one hand, to the change in ownership, and on the other hand, to the change of legal corporate form. The top management function is exercised by the Supervisory Board which is headed by the German majority owner, Mr. Bäumler, and includes two foreign investors with minority shareholding in the company, and an employee of the company which in compliance with Hungarian laws, has to be selected from the workers of the company. The Supervisory Board makes decisions concerning strategic decisions, such as investments, utilization of earnings, negotiation of major sales



TABLE 5: PROFITABILITY OF STYL CLOTHING FACTORY, 1988-1993

Year	Percentages	
	Before tax profit/Sales	After tax profit/Sales
1988	12.5	
1989	13.1	
1990	19.5	
1991	23.0	19.3
1992	22.3	18.6
1993	11.3	9.8

Note: In 1990, the accounting system was changed and profits in years preceding and subsequent to 1990 are not completely comparable.

Source: Annual Reports of Style, Report to the Stock Exchange, various issues.

arrangements, etc. The Hungarian management is entrusted with the implementation of the plan, such as the day-to-day operations of the plant.

Following the privatization, the Hungarian management of the company had continued to be retained. In mid-1994, however, when the director of the company reached 60 years, the retirement age in Hungary, he resigned from the position. For the Hungarian manager who had been the major decision-maker of the enterprise for close to 20 years, it was perhaps difficult to accept a subordinate role to that of the new owners. The foreign owners of the company announced that a new director would be posted from Germany. In July 1994, the appointment of a new German technical director was also announced. The current Hungarian technical director will remain in his post but will be under the new technical director.

Taxation

The foreign direct investment regulation of Hungary of 1989, provides that enterprises above a minimum capital and with a minimum of 30 percent foreign shareholding are entitled to 60 percent income tax reduction for the first three years, and a 40 percent reduction for the subsequent five years. Consequently, since 1990, when Styl became a joint venture with over 30 percent foreign shareholding, the company has enjoyed tax concessions and its tax payments were quite modest.

Share prices

At the time of the transformation of the company, in 1989, the face value of a share was established at Ft 1000. At the partial sale of the company to foreign investors and at subsequent sales to these investors, the price of the share was negotiated between the foreign investors and the Hungarian authorities. As can be seen in Table 6, at the initial sale to the foreign owners, this was set at 170 percent of the face value. Subsequently, in June 1991, Creditanstalt, the underwriter for public offering, set the price at Ft 2850 and by 1992, its price on the Budapest Stock Exchange ranged between Ft 2500 and Ft 4000; and by 1993, it reached Ft 6,000. The profitability of the company and the relatively high level of inflation in the country have contributed to the steady increase in the price of the shares. By 1992, the shares of the company were held by foreign investors and financial institutions and the circulation of Styl shares at the Budapest Stock Exchange has been extremely low.



TABLE 6: SHARE PRICE OF STYL CLOTHING COMPANY

Year	Event and Share Price
Early 1991	Foreign owners and the Ministry agree to sell shares to foreign owners at Ft 1,700
June 1991	Creditanstalt (Austria) underwrites the sale at FT 2850 per Ft 1000 face value
1992	Price at the stock market between Ft 3,446-6,029;
1993a/	Price at the stock market between Ft 2,550-5,750;
<i>a/ In 1993, the share capital was increased two-fold and for each stock an other was offered to shareholders. Consequently, the price of Ft2,500 in 1993, corresponds to a price of Ft 5,000 in the year before.</i>	
<i>Source: Listing, Budapest Stock Exchange, Budapest, various issues.</i>	



VI. CONCLUSIONS

The privatization of the Styl Clothing Factory has been successful because of the subsequent good performance of the company and its positive contribution to the Hungarian economy. Successful transfer of state-owned assets to the private sector has also been a step towards transforming a centrally-controlled economic system to a market-oriented economy which constituted a major economic and political objective of the Hungarian government.

The privatization of the company through foreign direct investments has also been consistent with the policies of the Hungarian government. Since the late 1980s, the Government encouraged inflow of foreign direct investments for the modernization of Hungarian industry. In the case of Styl, since the formation of the joint venture and with its full privatization through foreign investments, major investments have been undertaken in plant and equipment, software, and training of the labor force to utilize the new technology. There has been considerable employment creation, with about 2,400 workers now employed by the company, with wages of about 1 billion Forint paid in 1993. This has been a very positive development, particularly in the light of growing unemployment in Hungary.

Through improvement of its technological capabilities, Styl's production technology has achieved a similar level to that of the facilities of the foreign investor in Germany. Increased exports of manufactured goods to countries with convertible currencies has been a priority for the Hungarian government and the development of new export markets has become particularly crucial with the collapse of the COMECON market and with the heavy burden of the country to service its high foreign debt. With over 85 percent of the company's production exported to Western Europe, Styl's revenues have contributed to Hungary's foreign exchange supply. With the completion of the company's modernization, it is expected that the profits will be repatriated to the home country of the foreign investors but in terms of the net foreign exchange balance, the effect of the company are bound to remain positive.

With the privatization of the company, Styl provided an example of gradual transfer of a state-owned enterprise to the foreign private sector. Styl was also the first company which used the method of public offering to sell part of the shares which were held by the government to the private sector. The effectiveness of this method has demonstrated that public offering may be a viable and efficient means to privatize state-owned enterprises, even though this method is obviously feasible only under certain conditions.

In view of the above features, the privatization of Styl through foreign direct investments can be considered to have contributed positively to the Hungarian economy, particularly with respect to employment generation, foreign exchange revenues, increased investments and modernization of production. Despite these favorable effects, it would be desirable in retrospect, to highlight certain issues of concern. Firstly, the initial valuation of the company, which provided the basis for the sale of shares to the foreign investors tended to be low. The company was valued significantly below its book value and in terms of its earnings, the earning/price ratio was less than three, which is substantially below international standards. Political uncertainty in the country might have been an important factor in assessing the valuation at the time. Also, the privatization of Styl was undertaken during 1989-90, when the legislation on privatization was at its earliest stage (through the Transformation Law) and the existing legislation at that time had not provided for adequate safeguards for the valuation of state property. It was only in 1991, with the establishment of the State Property Agency that increased transparency and bidding requirements have enabled a more adequate valuation process. Secondly, the company's tax contributions have been low because it enjoys significant tax concessions for the present and will continue to do so during the the next few years. Tax revenues are, however generated, from personal income tax.

The privatization of Styl was largely facilitated by the favorable policy of the Hungarian government towards foreign direct investments. In 1989, when the joint venture was formed, Hungarian legislation

towards foreign investments was favorable by international standards and provided greater incentives than most other countries in the region. In addition to guarantees against expropriation and permission for full profit repatriation, it also provided significant tax benefits for such investments. Through the early adoption of a duty-free system for imported material which is utilized for export-oriented production, an important incentive has also been utilized for efficient subcontracting arrangements. At the same time, the export-oriented production of the company is highly sensitive to the foreign exchange rate policy of the government. With the government policy to overvalue the forint, export-oriented companies, such as Styl, have been affected unfavorably. However, with progress in stabilization of the economy and full convertibility of the forint over a period of time, these disadvantages will tend to decrease over time and can be considered to be temporary in nature.



Appendix 1

PERSONS INTERVIEWED

Ms. Mária Albert -	Trade union representative of Styl Clothing Factory
Mr. Lászlo Bajor -	Hungarian Ministry of Industry and Trade
Mr. Peter Bihari -	Budapest Bank, Department of Economic Analysis
Mr. Lászlo Báthory -	Staff member of the State Property Agency responsible for the negotiation of Styl's privatization
Mr. Gyárgy Csáki -	Researcher, Hungarian Academy of Sciences
Mr. Imre Hargitai -	Technical director of Styl Clothing Factory
Mr. Miklos Molnár -	Commercial director of Styl Clothing Factory
Mr. Tibor Pongrácz -	Director of State Property Agency
Mr. Miklos Szanyi -	Researcher, Hungarian Academy of Sciences
Ms. Károlyne Szilágyi -	Privatization Office, Hungarian Ministry of Industry and Trade

Appendix 2

INFLATION RATE IN HUNGARY, 1986-1993

annual percentage change

Year	Percent
1986	5.3
1987	8.6
1988	15.5
1989	17.0
1990	28.9
1991	35.0
1992	23.0
1993	22.5

Source: Ministry of Industry and Trade, Budapest. August 1, 1994.



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