

The crossroads of privatisation

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In the quest for modernisation, it has become quite fashionable in the last 10 or 20 years for many countries to reject the set of principles generally known as the “Washington Consensus.” Perhaps no single tenet of those ideas has come under more attack than the belief that the privatisation of state-owned companies is beneficial to the health of an economy.

In some cases, this rejection stems from perceptions of corruption associated with privatisation. Russia's disastrous experience with privatisation, for example, introduced into the language of the public-private debate the terms “kleptocracy” and “crony capitalism.” In many cases, however, the rejection of privatisation is largely driven by fear of the political pain associated with such privatisation policies. In countries with politically unacceptable levels of unemployment, the consensus needed to undertake an active privatisation policy – a policy likely to itself trigger still higher unemployment – is just not there for fear of yet higher unemployment. Socialism and a mistrust of business and the profit motive are also woven into the mentalities of many countries. This is true despite clear evidence of gross inefficiency in many such state-owned enterprises (SOEs) and the associated day-to-day rhetoric criticising them.

Regardless of a country's misgivings regarding the process of privatisation, the record is quite clear: the public sector is not terribly good at providing social goods and services. The private sector is far more efficient, innovative and cost-effective, both in terms of time and resources. The public sector, on the other hand, plays the essential element in providing the right enabling legal and regulatory environment to allow the private sector to function properly. Society is best served when both sectors play their respective roles effectively.

While these principles remain true, they are however fraying at the edges as they encounter contemporary market realities; in the real world, the picture is far more complicated than this simple model. Moreover, the economic patterns of 10 or 20 years ago are looking like ancient history, with both the public and private sectors exhibiting dynamics and patterns that were hardly imaginable in the not-too-distant past.

The privatisation prescription

The conventional wisdom among most economists and development banks around the world is still that

the privatisation of SOEs is an essential element of economic modernisation. To be truly efficient, such firms must be privatised, which typically implies being listed on the host country's stock market and being publicly traded. SOEs are viewed as slow, inefficient, bureaucratic, over-staffed (often for political reasons) and lacking in innovativeness. While there is a very wide cultural gulf between the public and the private sectors, there is a wide admiration in the public sector for the discipline and efficiency of the business community.

Thus, governments are consistently counselled by internal and external advisors to resist political pressures, sell off their SOEs, and get them listed on the host country's stock markets.² It should be noted that, although privatisation without public listing is theoretically possible, in most countries, the deep pockets required to purchase SOEs do usually not exist. Where they do exist, there is the peril of creating an objectionable monopoly situation and / or concentrating too many important industries in the hands of a small ruling elite. Thus, public listing often emerges as the only way of privatising SOEs.

For the most part, the privatisation policy prescription has historically also been supported by much of the business community. Indeed, privatisation and public listing fit very comfortably within the broader set of values and norms associated with the private sector. A well established measure of success among entrepreneurs is that, after their companies reach certain thresholds of size and profitability, they go public, i.e. list them for trading on the public markets.

The privatisation prescription, however, is often too simplistic to match day-to-day realities. The actual economic and political conditions in a country may make privatisation impossible or suboptimal. What if, for example, capital markets simply do not exist in given country? What if a country's capital markets are not deep enough and cannot make large sums available? What if there is no one buyer or group to cleanly buy a large state enterprise? What

if the state-owned monopolies are playing a critical role in such areas as electricity generation, transmission and distribution, water treatment, etc? Are they to be broken up, thus abandoning economies of scale at a time when massive shortages are the norm? Who will provide the technical and managerial expertise to run the new entities? What if external investors are not present to supplement the critically needed services? Are external investors even allowed to make investments in the country? Are new regulatory bodies to be established to regulate the newly privatised entity or entities? How long will that take? Is privatisation, i.e. having the old companies publicly traded even all that beneficial? What if the political consensus within a country will just not allow for further privatisation?

In those countries with open, transparent governments, these sales have gone well and their economies are undoubtedly better off for such sales. This cannot be said, however, of many, if not most, emerging countries. Arguably, the privatisation prescription needs to be rethought in light of current realities and the practical requirements of the times. Privatisation is a means to an end, not just an end unto itself. The question is not “who owns the provider or goods and services?” but rather “how well managed and efficient are they?”

Costs of privatisation

While this debate rages, there is an emerging new reality in the financial markets and the private sector. Although policy advisors and development agencies still often support the broad privatisation prescription for emerging country governments, the business community has been steadily marching away from this view. Indeed, for years now, many of the larger and more sophisticated management consulting firms have been urging their small, though rapidly growing clients to avoid listing their shares on the public markets. Their perspective is that the cost of a public listing far outweighs the advantages. If the principal advantage had been a greater ability to raise large quantities of money for growth, then that advantage has largely evaporated in many developed economies.

In most advanced economies, the capital markets have developed to the point where private placements and private equity are very easily accessed, providing a real alternative to public listing. Indeed, this disenchantment with stock market listing (aka privatisation) has been around for a long time. The late entrepreneur and media mogul William Paley observed decades ago that taking his company, the Columbia Broadcasting Corporation, public was

one of the “dumbest” things he ever did. That sentiment has been growing rapidly and is at the background to the multi-trillion dollar “private equity” phenomenon that is sweeping the advanced economies.

Many large companies are now turning to the very deep pockets of the private equity firms for funds to repurchase their shares from their shareholders – at usually very high premiums to the market price. The widespread view, supported by a great deal of evidence, is that by delisting these companies, the managers are freed from the numerous constraints that inhibit their growth and the realisation of their full potential. Even though they are paying up to 50% premiums above market prices, they believe that NOT being listed is well worth it. The big advantage of being public is supposedly easy access to the financial markets. But if the markets are willing to finance you anyway (which they can and will), why suffer the burdens of being publicly traded?

The costs of being publicly listed are significant. The legal and compliance requirements of such public trading have companies drowning in a sea of legal bureaucracy and regulatory paperwork. For American companies in particular, the Sarbanes-Oxley requirements on audits and accounting firms, impositions on boards of directors, and cross-border compliance across multiple geographies are overwhelming. Though a rollback in these requirements is being discussed, it will not occur for years to come. Even then, one has no way of knowing what new rules and regulations might take their place. Nor is the US alone in these burdens: Japan is also encountering the same regulatory problems, and the private equity markets are also growing there in response. For smaller and even medium to moderately large companies, the cost-benefit analysis is even starker. Companies in this size range face huge problems in attracting the attention of the much needed equity market analysts. Since they cannot get the needed “coverage” in the financial markets by these analysts, they often get ignored, with even fewer advantages thus accruing to their publicly traded status.

Beyond the tangible burdens of listing requirements, the realities of modern investor behaviour also call into doubt the advantages of public listing. The simple day-to-day vagaries of the market can have a very inhibiting effect on business performance. Gone are the days when investors held their shares for years and patiently waited for “their companies” to generate dividends and capital appreciation. The advent of very large institutional investors, 24-hour media coverage and analysis,

investor blogs, internet trading, program trading, hedge funds, day trading, etc. has dramatically increased the depth and speed of scrutiny on companies and their management, and has dramatically increased their pressure to perform on a quarterly – if not hourly – basis. Today's investors are notoriously short term in their perspective and think nothing of selling a company's shares at the slightest hint of trouble.

Indeed, there is so much market chatter and discussion that even companies who have exceptional quarters can find that when they announce even stellar results, they can face a drop in their share price because they have not met the expectations of the market and the “whisper numbers” associated with those higher expectations. This is particularly onerous for those companies that require heavy capital investment. In such industries, the payback period may be considerably longer than the quarterly hyper-imperatives of the financial markets. Long-term planning and capital investment is exceedingly difficult in such an environment. For critically important, yet slow-growing, industries (like electric transmission and distribution, water treatment facilities, etc.) the results can be crippling – as California discovered several years ago in the midst of their brownouts and blackouts.

Managers are often very reluctant to invest into these conditions. In this environment, managements can become very risk-averse and short-term-oriented. Many large companies feel stymied by the pressures of day-to-day market scrutiny and are reluctant to maximise the wealth-generating strategies they should. As a result, with internal funds to spare, these conditions all too often produce misguided personal internal agendas such as maximising corporate perks, inflated severance bonuses, etc. If they are not rewarded for purely generating wealth for their shareholders, managers may then develop short-term agendas to pocket perks for themselves.

Is it any wonder then that many of the best corporate managers are opting out of these situations by buying their shareholders out and taking their companies private? Undoubtedly, they increase the pressures on themselves to produce real economic and financial results. Their new masters – the private equity firms – are very tough customers indeed. Management either produces, or they are out on their ear. But they are working with a much more sophisticated set of investors, with far fewer government regulatory reporting and compliance constraints – and without the press, the public and financial regulators second-guessing every action with the end of the quarter in mind. The

upside financial rewards to management for success are also enormous.

Under such circumstances, stable, relatively low-growth businesses with high cash-generating capabilities and a strong asset base can also leverage the company's balance sheet significantly – and can thus reach high valuation multiples on their equity structures. In contrast with the publicly-traded companies where management is often rewarded for being more risk-averse, private structures allow for greater boldness and faster action – i.e. higher value-creating behaviour. It also enhances their ability to respond much more quickly to opportunities than a public structure will allow.

The preceding discussion draws primarily on the stock market dynamics of advanced economies. It is, however, highly relevant to developing countries where the dominant (perhaps only) mode of privatisation centres on public listing. For governments of developing countries that have long been encouraged to list their SOEs on the stock market as part of a privatisation, the experiences of more developed countries with the costs and burdens of publicly listed countries should be taken as a lesson.

Quasi-privatisation: A compromise

So with all of this in mind, how are we to navigate between the problems of privatisation without public listing (or the concentration of monopoly power within an elite group), and the problems of a public listing just described above?

Arguably, for many countries, a middle course may be the best way forward. What we are increasingly seeing is that countries that desire privatisation of key industries or enterprises, yet are unable for political reasons to fully deliver on those desires, are floating large portions of these enterprises in the market. In this way, the government retains ownership (satisfying the critics) while at the same time exposing the SOE in question to a more sheltered version of the imperatives of the market.

In addition, they can and have been forcing these enterprises to fund themselves through the capital markets for both debt and equity. The government can thus ensure that the free lunch that is often associated with government support is minimised or eliminated, and that the company can get the benefit of markets signals as to its performance without the full force of short-term market pressures. Partial privatisation, where say 49% of the enterprise is floated, will give a very good barometer of the efficiency of a company.

It can be highly effective for the state to

demonstrate that SOEs can and are functioning in effect as quasi-private sector firms. In some cases, where politics have intruded on progress towards privatisation, forcing SOEs to finance themselves through the private sector can be a very clear indicator of progress towards greater operating efficiency.

At the same time, the retention of ownership serves as an effective method of continuing the regulation of such businesses without the necessity of creating a new regulatory organisation with its own bureaucratic imperatives. The concept of the “golden share,” represented by senior officials (perhaps retired government officials, as frequently seen in US corporations) eliminates the need to create a larger, permanent regulatory body.

In short, the issue of privatisation does not have to be an either/or proposition. There is a middle course, with the best of the SOEs (such as India’s “Navratnas” i.e. jewels such as NTPC or the Korean companies such as KEPCO or KOGAS) allowed to float some percentage of their shares on the market.

One can engage in a lively debate as to the merits or demerits of full privatisation or what percentage of privatisation will produce the best use of production resources. A large part of the concern is also the broad desire to streamline the government, making it more efficient and less intrusive into the economic life of the country and the markets.

In the end, the question is not about ownership – it is about good corporate governance and performance. Pure government-owned SOEs rarely are as efficient as the private sector. The partial privatisation of SOEs will at the very least give the company market signals that are invaluable feedback (positive and negative) about their efficiency, growth prospects, competitive position, pricing, etc. It is very hard to see how any organisation can properly

function without this type of feedback.

Timing, the realities of the market itself, and the judicial environment, as well as political circumstances may and frequently do make privatisation very difficult, if not impossible, in the short- and medium-term. But particularly given the current dynamics of stock markets and investor behaviour, privatisation cannot be viewed as the panacea for all economic ills. Of course we want the providers of needed goods and services to be as lean, flexible and innovative as possible. But, if they are, who cares what the public/private equity distribution is?

Notes:

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² Ironically, the multinational financial institutions are themselves state-owned enterprises!

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