Bespoke Portfolios
In 10 Clicks, 10 Minutes, 1/10th Cost

www.ActiveAllocator.com

Sameer Jain, Co-Founder
sameer.jain@activeallocator.com
(312) 498-1903

Brian Jones, Co-Founder
brian.jones@activeallocator.com
(415) 999-3591

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Privatization
Executive Summary

Governments often advocate trade liberalization, create divestment programs and aspire to attract foreign investments.

- Privatization refers to the transfer of ownership, either wholly or partially of public sector assets to the private sector

- The efficiency of social and economic infrastructure is a critical factor in the development of an economy

- State owned enterprises are sometimes inefficient, burdened by the past, and can constitute a drain on the public treasury. A long-run commitment to privatization provides an anchor for repositioning and reinvigorating an economy through improved efficiency and fostering the competitive spirit

- Apart from fostering efficiency and competitiveness, privatization promotes local and foreign investments, improves the quality of goods and services and promotes the growth and development of infrastructure and social programs
Privatization Overview
The public sector’s ownership of central industries comes with the usual rights as well as a unique social responsibility.

- In a proactive stewardship role, government agencies overseeing SOEs have opportunity to improve corporate governance:
  - Promote values, support sustainability and help to develop and select quality governance boards and improve overall supervisory functions.

- Governments also behave like any other institutional investor trying to maximize the value for the shareholder (State):
  - Seek advice on strategy and reforms, consult and invest in human capital to develop an international competitive cadre board and management; decide on strategy for divestiture.
Why do Governments Privatize?

Governance and Business Focus
Governments seek to achieve the financial discipline and commercial focus of private sector firms operating a range of services

Globalization
Globalization has created opportunities for companies to provide service across borders. Government ownership has increasingly become an impediment to the building of strong, transnational competitors promoting privatization trends

Debt Reduction
A desire to reduce public sector borrowing continues to make debt reduction through privatization attractive

<table>
<thead>
<tr>
<th>State Ownership</th>
<th>VS.</th>
<th>Public Ownership</th>
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</thead>
<tbody>
<tr>
<td>• Controlled information</td>
<td></td>
<td>• Transparency</td>
</tr>
<tr>
<td>• Accountability to the State</td>
<td></td>
<td>• Protection of minority interests</td>
</tr>
<tr>
<td>• Often a soft budget constraint</td>
<td></td>
<td>• Financing based on credit quality and earnings prospects</td>
</tr>
<tr>
<td>• Multiple objectives</td>
<td></td>
<td>• Focus on shareholder value subject to legal and regulatory constraints</td>
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<tr>
<td>• State control</td>
<td></td>
<td>• Contestable control</td>
</tr>
<tr>
<td>• Bureaucratic compensation</td>
<td></td>
<td>• Incentive compensation</td>
</tr>
<tr>
<td>• Complicated structure</td>
<td></td>
<td>• Transparent structure/focus</td>
</tr>
</tbody>
</table>
Privatization Best Practices

1. Clearly define motives for privatization to ensure best execution
2. Need for a Political Champion: Quantum changes require leaders that signal intent
3. Analyze potential for competition and increase choices for citizens
4. Consider need for legislation (e.g. determine the support of the consensus; consider the impact on voting base)
5. Leverage experiences from other regions/countries
6. Restructure enterprise for privatization and provide performance record
7. Create transparency within business and in privatization process
8. Key lies in success transfers for execution / decide on execution strategy (e.g. large IPO/ quick trade sale)
9. Spread share of ownership (IPO/sponsors/partners) and draw attention to shareholder value
10. Achieve best value for each industry and service in concordance with strategic goals
Determine Privatization Objectives

Successful Privatization: Clearly defined objectives; Sound legislative framework and corporate governance structure; Evaluation of privatization options; Strategic offering structure; Focus on execution

Financial
- Valuation
- Capital raising
- Capital and financial restructuring
- Profit / cashflow enhancement

Strategic
- Strategic alliance
- Protection of core market positions
- Restructuring of operations
- Reduce operating subsidies

Operational
- Productivity
- Cost saving measures
- Revise service offerings
- Enhance quality
- Improve sales and marketing

Management & Employee
- Protection of employment
- Incentives for management
- Employee ownership position

Strategic Options
- Status Quo
- Strategic Sale
- Equity Placement
Determine Privatization Strategy

Preliminary Restructuring
- Appoint advisors
- Finalize restructuring plans
- Start auditing
- Start due diligence and preparation of offering memorandum

Strategic Investment Process
- Solicit preliminary interests
- Initiate discussions with selected potential strategic investors
- Due diligence by strategic investors

Restructure
- Begin drafting prospectus
- Auditors continue audit work
- Management prepare financial projections and use of proceeds

IPO Process
- Go ahead with IPO without strategic investor, or
- Go ahead with IPO process with concurrent strategic investment, or
- Go ahead with strategic investment and delay IPO

Final Stage

Starting Dual-track
Decision Point

Stage 1  Stage 2  Stage 3

Privatization Overview
Objectives of Various Constituents

Constituents in the privatization program have different objectives, which Government needs to consider.

**Government Objectives**
- Improve competitiveness and enable successful development as an independent commercial entity
- Stimulate further development of the sector
- Maximize proceeds from stake sale
- Timely execution
- Fair and transparent process

**Company Objectives**
- Create a solid foundation for future growth and raise capital to achieve growth and strategic ambitions
- Enhance market profile and create valuation benchmark
- Attract high quality strategic investors and benefit from investor know-how and expertise
- Attract a high quality and diversified investor base
- Maintain control
- Minimize disruption to the company’s operations and management

**Investor Objectives**
- Acquire an attractive asset with solid fundamentals
- Participate in future growth sector and country

**Private Market**
- Potentially seek control or path to control
- Strategic fit and/or returns
- Fair and transparent process

**Public Market**
- High returns/attractive pricing
- Opportunity to diversify portfolio
- Flexibility and liquidity
- Disclosure and corporate governance
### Key Ingredients and Considerations for a Successful Privatization

#### Macroeconomic Outlook
- Strong macroeconomic outlook usually helps
- Political stability
- Opportunity to acquire an attractive asset in a growing sector of the economy

#### Quality of the Asset
- Leading market position in attractive sector
- Operational/financial results and capital discipline
- Strong and experienced management team

#### Clear Legal and Regulatory Framework
- Clear rules and intentions for the privatization process
- Clarity on sector regulatory environment

#### Significant Investor Interest
- Understanding of potential investor interest and concerns prior to launch of process

#### Seamless Execution
- Full sell-side process detailed IM, data room, management meetings and site visits, if applicable
- Timely execution

#### Competitive Auction Process
- Widely marketed transaction
- Winning bidder decided in a highly competitive auction process

### Key Issues to Consider
- Government's intention towards its share in the company being privatized
- Importance of creating a “National Champion”
- Political implications of selling to a single strategic international investor or group of international institutional investors and
- Degree of political support for potential restructuring prior to sale
- Clarity of strategic ambitions of the company, taking into considerations management position
- Maximize proceeds at the outset or maximize overall exit over time?
- Importance of technical know-how and expertise of a potential investor for the company and the sector as a whole
- Importance of further development of domestic capital markets
- Envisioned time-line for exit
Institutional Framework
First Steps towards Commercialization

Improving Management of SOEs

- Although the privatization of the state-owned sector is expected to increase the efficiency and competitiveness of the country’s economy, empirical results suggest that success of privatization programs is mixed (Blanchard and Aghion, 1996; Blanchard and Schleifer, 2000)
  - Conflict of Interests, i.e. efficiency vs. social goals
  - Wrong incentives may lead to privatization when this is not efficient
  - Interest groups strengthened through privatization might oppose further reforms (monopolies)

Efficiency Factors

- Competition: Removal of barriers to entry, the elimination of price controls, liberalization of foreign trade, the abolition of preferential regulations, and the break down of monopolistic structures
- Hard Budgets: The government should eliminate monetary subsidies and privileges
- Market-Based Controls and Discipline: Market mechanism to be the main regulator
- Restructuring: Should the public goods component of the enterprise remain in the company?
Corporate Governance

Corporatization

- Best Practice: Roles of State and SOE manager should be clearly separated per legal status
  - Solution: Are laws on Joint Stock Companies in place?

Agent Representing the State

- Best Practice: Line ministries should be dismissed from managing SOEs as it can involve conflicts of interest, possibility of patronage, and corruption
  - Solution: Special amendment on functions of the line ministries could be possible

Role of Board of Directors

- Best Practice: Board of Directors should serve as intermediary between the State and the enterprise managers
  - Solution: Clearly spelled out objectives, responsibilities and authority of the Board. Consider barring of State officials from serving in the Boards, to avoid political interferences in management

Management Arrangements

- Best Practice: Risk/return performance metrics for managers should be like those in private companies
  - Solution: Various management arrangements are available, i.e. performance contracts, management contracts, leasing and concessions
Success Transfer

- Common feature of successful management of SOE is a clear distinction between the rights and the responsibilities of the government on State enterprises.

- Actual management of the SOE should be done by autonomous entities working under clear performance targets.

New Zealand, Norway, Sweden, Poland, Singapore
International Examples

New Zealand
- State enterprises are run as autonomous commercial entities with independent boards of directors
- Shares of each State enterprise are divided between the Ministry of Finance and different sector ministries
- SOE directors are legally bound to act only in the SOE’s best interest

Norway
- Norwegian government owns and regulates only a few SOEs, of which the biggest is Statoil
- The State has no power over Statoil other than the shareholder rights it exercises at annual general meetings
- The compensation of the management is based on the company’s performance

Sweden
- SOEs registered in Sweden produce about 9% of the Swedish GDP and secure 8% of the country’s total employment
- The Swedish Ministry of Industry, Employment, and Communications administers the country’s SOE
- Ministry has a special division

Poland
- Poland’s SOEs were assigned to national investment funds (NIF) for management supervision and control
- Each NIF was outsourced to professional asset managers based on the results of a public tender
- Each NIF became the lead shareholder in SOEs by receiving 60% of shares, while the remaining shares were distributed among the State treasury (25%), and enterprise employees (15%)

Singapore
- SOEs in Singapore are fully incorporated and controlled by a holding company Temasek
- The Temasek is fully owned by the Ministry of Finance
- Ministry appoints the chairman and members of Temasek’s board
- Every year, Temasek submits audited financial statements to the ministry for review
Monetization of public sector real estate: Why sell the family silver?
## Key Drivers of the Real Estate Monetization Trend

<table>
<thead>
<tr>
<th>Financial</th>
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</thead>
<tbody>
<tr>
<td>• Maximize value through sale of real estate assets</td>
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<tr>
<td>• Increase reported earnings</td>
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<tr>
<td>• Diversify funding sources</td>
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<tr>
<td>• Minimize real estate occupancy costs</td>
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<table>
<thead>
<tr>
<th>Budgetary / Accounting</th>
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<tbody>
<tr>
<td>• Deficit reduction</td>
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<tr>
<td>• Debt reduction</td>
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<tr>
<td>• Proceeds for investments in other projects</td>
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<table>
<thead>
<tr>
<th>Operational</th>
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</thead>
<tbody>
<tr>
<td>• Retain full operational control over real estate</td>
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<tr>
<td>• Contract rights</td>
</tr>
<tr>
<td>• Enhance flexibility through substitution and sublease rights</td>
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<table>
<thead>
<tr>
<th>Capital Investment</th>
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<tr>
<td>• Refurbishment</td>
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<tr>
<td>• New buildings</td>
</tr>
<tr>
<td>• Transfer residual value risk of real estate to outside investors</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Efficiency</th>
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<tbody>
<tr>
<td>• Space utilization</td>
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<tr>
<td>– Surplus space</td>
</tr>
<tr>
<td>– Lack of flexibility</td>
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<tr>
<td>• Real estate maintenance</td>
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<tr>
<td>• Recognition of occupancy costs</td>
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<tr>
<td>• Fragmented facility management services</td>
</tr>
<tr>
<td>• Increased focus on service, not real estate management</td>
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<tr>
<td>• Cost savings</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Market perception</th>
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<tbody>
<tr>
<td>• Perceived pro-active management of company’s assets</td>
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<tr>
<td>• Reach new investor base</td>
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<tr>
<td>• Potential for positive rating agency reaction</td>
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<table>
<thead>
<tr>
<th>Investment Climate</th>
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<tbody>
<tr>
<td>• Strong, broad-based investor demand</td>
</tr>
<tr>
<td>• Aggressive underwriting resulting in higher valuations / lower lease rates</td>
</tr>
<tr>
<td>• Seller’s market – top of the cycle</td>
</tr>
<tr>
<td>• Attractive secure long-term revenue streams</td>
</tr>
<tr>
<td>• Appetite for large investment size</td>
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</table>
The public sector can take advantage of the monetization trend, because a) real assets are transferred; b) monetization allows a degree of control consistent with public policies; and c) brings in cash.

**Key Questions**

**Strategic Objectives and Relative Importance**
- Occupational efficiency?
- Financing new assets?
- Ideology?
- Budgetary:
  - Deficit
  - Debt
  - Both?

**What Do You Own?**
- Which assets do you own?
- How do you own them (freehold/leasehold)?
- Who owns them (departments/agencies)?
- Are there any sacred cows?

**Tactical Objectives**
- Timetable?
- Quasi debt or equity solution?
- Distribution:
  - Retail
  - Institutional
  - Domestic / International?
- Value vs. timing vs. certainty?

**Process**
- Players involved?
- Advisors needed?
- Timetable?
Global Privatization Trends
M&A privatization steadily increased over the last 3 years. 2018 volume increase slowed as stronger M&A increase was offset by a decline in Equity privatizations.
2018 Privatization by Sector

Equity Privatizations dominated by Utilities, Oil and Gas and Telecom. M&A Privatizations dominated by Financial Services, Transportation and Telecom.

Total Sector Breakdown

- Financial Services: 19%
- Oil & Gas: 17%
- Construction: 2%
- Consumer: 2%
- Utilities: 13%
- Transport: 18%
- Industrial: 6%
- Manufacturing: 5%

Total Market: $118.1bn

Equity Sector Breakdown

- Financial Services: 8%
- Telecom: 20%
- Transport: 10%
- Utilities: 28%
- Construction: 3%
- Consumer: 4%
- Oil & Gas: 27%

Equity Market: $42.8bn

M&A Sector Breakdown

- Financial Services: 28%
- Construction: 1%
- Consumer: 2%
- Utilities: 1%
- Transport: 22%
- Telecom: 16%
- Oil & Gas: 11%
- Industrial: 9%
- Manufacturing: 9%

M&A Market: $75.3bn

Source: ActiveAllocator
2018 Privatization by Region

Europe accounts for almost 3 quarters of all privatizations. Asia will become increasingly important.

Total Regional Breakdown

Equity Regional Breakdown

M&A Regional Breakdown

Source: ActiveAllocator
Privatization Alternatives: PPP/PFI
### Options

PPP/PFIs is a method of procurement of services that is more cost efficient than traditional procurement (i.e. delivers “value for money”), while retaining ownership of infrastructure assets.

<table>
<thead>
<tr>
<th>Conventional Procurement</th>
<th>Public Private Partnerships (PPP)</th>
<th>Full Privatization</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Procurement of assets by the public sector using government funding</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PPP</strong></td>
<td></td>
<td></td>
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<tr>
<td>- Umbrella term covering a variety of procurement initiatives</td>
<td></td>
<td></td>
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<tr>
<td>- Often Government shareholders</td>
<td></td>
<td></td>
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<tr>
<td>- Corporate or strategic reasons</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- May not involve investment. May be source of funds for Government; monetisation of assets</td>
<td></td>
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<tr>
<td><strong>PFI</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- One form of PPP is PFI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Essentially a concession / project finance where investment is required</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sale of Public Sector infrastructure assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Statutory regulation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets privately owned for fixed period or in perpetuity</strong></td>
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## Transfer of Risk, Responsibility and Ownership

<table>
<thead>
<tr>
<th></th>
<th>Conventional Procurement</th>
<th>PPP</th>
<th>Full Privatization</th>
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</thead>
<tbody>
<tr>
<td><strong>Government</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Contributions</td>
<td>G / PS</td>
<td>PS</td>
<td>PS</td>
</tr>
<tr>
<td>Construction Risk</td>
<td>G</td>
<td>PS</td>
<td>PS</td>
</tr>
<tr>
<td>Operating Risk</td>
<td>G</td>
<td>PS</td>
<td>PS</td>
</tr>
<tr>
<td>Demand Risk</td>
<td>G</td>
<td>G / PS</td>
<td>PS</td>
</tr>
<tr>
<td>Revenue Sources</td>
<td>G</td>
<td>G + User Pays</td>
<td>User Pays</td>
</tr>
<tr>
<td>Asset Ownership</td>
<td>G</td>
<td>G / PS</td>
<td>PS</td>
</tr>
</tbody>
</table>

G: Government  
PS: Private Sector
## Opportunities for Governments

<table>
<thead>
<tr>
<th>Relevant Government Ministry</th>
<th>PFI &amp; PPP</th>
<th>Privatization</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transport</strong> Road, rail, airports, ports</td>
<td>✔ ✔ ✔</td>
<td>✔ ✔ ✔</td>
</tr>
<tr>
<td><strong>Defence</strong> Accommodation, infrastructure</td>
<td>✔ ✔ ✔</td>
<td>✔</td>
</tr>
<tr>
<td><strong>Health</strong> Hospitals, aged care</td>
<td>✔ ✔ ✔</td>
<td>✔</td>
</tr>
<tr>
<td><strong>Education</strong> Schools, colleges, universities</td>
<td>✔ ✔ ✔</td>
<td>✔</td>
</tr>
<tr>
<td><strong>Petroleum / Energy</strong> Oil, gas, utilities</td>
<td>✔</td>
<td>✔ ✔ ✔</td>
</tr>
<tr>
<td><strong>Communications</strong> Fixed/mobile networks</td>
<td>✔</td>
<td>✔ ✔ ✔</td>
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</tbody>
</table>

### Potential features of a PPP

- Capital requirement
- Service component
- Competitive bid market
- Sensible risk transfer
- Ring-fence activities
- Regulation
- Long-term contracts
- Scope for innovation
Benefits and Issues with PFI & PPPs

Benefits

- Enhancement of services
- Optimizing/matching public sector resources to uses
- Optimized allocation of risk
- Minimise impact on State balance sheet
- Private sector expertise / Innovation

Issues

- Need to clearly define service output
- Not appropriate for all sectors
- Critical importance of infrastructure limits risk transfer
- Cost of procurement
- Cost increase associated with risk transfer
### Sale Structure Alternatives

<table>
<thead>
<tr>
<th>Strategic Sale</th>
<th>IPO</th>
<th>Combination of Strategic Sale and IPO</th>
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</thead>
<tbody>
<tr>
<td>A. Sale of &lt;50% stake</td>
<td>C. Gov’t stake sale via IPO</td>
<td>D. Sale of minority stake to Strategic buyer followed by IPO</td>
</tr>
<tr>
<td>B. Sale of &gt;50% stake</td>
<td></td>
<td>E. Sale of controlling stake followed by IPO</td>
</tr>
<tr>
<td></td>
<td></td>
<td>F. IPO followed by strategic sale of controlling or minority stake</td>
</tr>
</tbody>
</table>

### Key Evaluation Criteria

- Maximize proceeds
- Opportunity for the Government to share in upside potential
- Promotion of local capital markets
- Attract high quality investor
- Timely execution
- Employee incentivization
- Investment requirement for buyers
- Universe of potential investors
### Assessment of Sale Structure Alternatives

| A. Sale of Minority Stake to Strategic (<50%) | ▲ Reduced outlay for the investor  
▲ Government retains higher flexibility with regards to future options | ▼ Investor to likely require management control and path to majority stake  
▼ Sale proceeds not maximized  
▼ No control premium  
▼ Unlikely to be feasible without clear path to control  
▼ Universe and quality of potential investors would be impacted  
▼ If minority investor has any rights, may result in deadlock |
| --- | --- | --- |
| B. Sale of (>50%) to Strategic | ▲ Maximizes proceeds and valuation levels achieved  
▲ Full control premium  
▲ Quicker timetable to full privatisation  
▲ Maximizes universe of potentially interested parties | ▼ Limits Government’s sharing on upside potential  
▼ Does not promote development of local equity capital market |
| C. Gov’t Stake Sale via IPO | ▲ Establishes valuation benchmark  
▲ “Development of capital markets  
▲ Wealth participation for citizens  
▲ Promotes the incentivization of employees and management | ▼ Credibility of equity story without strategic investor?  
▼ Valuation likely to be lower than can be achieved through majority stake sale to strategic buyer (IPO discount)  
▼ Size of the offering to limit the amount of proceeds raised  
▼ Timing – normally longer process than a strategic sale |
### Assessment of Sale Structure Alternatives (cont’d)

| D. Sale of Minority Stake to Strategic Buyer followed by IPO | ▲ Reduced outlay for the investor  
▲ Government retains flexibility with regards to future options  
▲ Allows the Government to participate in upside through IPO | ▼ Investor will most likely require management control  
▼ Sale proceeds not maximized  
▼ No control premium  
▼ Unlikely to be feasible without clear path to control for minority investor  
▼ Universe of potential investors will be limited  
▼ Will likely require a shareholders’ agreement prior to IPO – adds complexity and may affect IPO timing  
▼ May result in deadlock situation with minority investor in case of conflicting objectives |
|---|---|---|
| E. Sale of Controlling Stake followed by IPO | ▲ Maximizes proceeds and valuation levels achieved  
▲ Full control premium  
▲ Allows the Government to participate in upside through IPO | ▼ Potentially longest timeframe to full privatization  
▼ Will likely require a shareholders’ agreement prior to IPO – adds complexity and may affect IPO timing |
| F. IPO followed by Strategic Sale of Controlling Stake | ▲ IPO sets benchmark price (minimum) for strategic sale  
▲ Development of capital markets | ▼ IPO lacks contribution from strategic buyer as “anchor” investor and process supporter  
▼ Overall proceeds likely to be lower than for 100% strategic sale |