APEC PRIVATISATION FORUM

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THE GOVERNMENT OF INDONESIA

"PRIVATISATION AND CAPITAL MARKET DEVELOPMENT IN ASIA: A COMPARATIVE PERSPECTIVE AND LESSONS FROM THE INTERNATIONAL EXPERIENCE"

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SUMMARY RECORD

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Introduction and Summary

After the Asian crisis, privatisation has emerged as one of the most important policy priorities in the region, expected to propel structural reforms. As stated in his opening remarks by Rozy Munir, Minister for Investment and State-Owned Enterprises (MISOEs), the discussion of privatisation and capital market development is important and timely for Asia, as most countries of the region are currently focusing on accelerating privatisation and implementing financial sector reforms.

This summary record outlines the main issues discussed at the senior experts meeting on *Privatisation and Capital Market Development in Asia*, held in Denpasar, Indonesia on 11 and 12 May. As a result of the meeting, it appeared that Asian policy makers can draw important lessons for the design and implementation of their privatisation strategies from the nearly twenty-year OECD experience with privatisation via the capital market.

This meeting was organised by the OECD Centre for Co-operation with Non-Members, jointly with the APEC Privatisation Forum, the Asian Development Bank (ADB) and the Indonesian MISOEs. The meeting brought together more than 50 officials from 19 countries, as well as academics and representatives of the ADB, the World Bank and the private sector (see list of participants). The meeting was also intended as the first joint activity of the OECD Privatisation Network and the APEC Privatisation Forum, which was established in 1999. The presence of high level experts and officials, including deputy ministers, directors and deputy directors of key privatisation bodies (mainly treasuries) from OECD and APEC economies attests for the importance of the subject and the need for inter-regional dialogue and co-operation on privatisation.

The discussions took place in six sessions, devoted to the following topics: *(i)* privatisation in Asia, *(ii)* impact of privatisation on capital markets, *(iii)* impact of privatisation on corporate finance and governance, *(iv)* privatisation through market: the transaction, *(v)* privatisation through market: methods and techniques, *(vi)* the Indonesian privatisation programme. The six sections of this summary record attempt to summarise the important policy issues, which were raised during the lively discussions and in the meeting materials and outline a number of conclusions. The last section discusses some general prerequisites for successful privatisation.

Privatisation in Asia: Main Issues

Privatisation in the region to date has taken place mainly through trade sales. However, there have been also some transactions through initial and secondary offerings at local and foreign stock exchanges. Currently, many Asian governments are increasingly relying on privatisation via the capital market, as the most transparent and politically acceptable method.

- Boosted by the remarkable economic success since the late 1980s, privatisation has been on the policy agenda of many Asian countries. It slowed down in the second half of the 1990s, due to deteriorated markets and economic difficulties caused by the recent financial crisis. Revenues from privatisation in Asia from 1990 - 1998 are equal to 25 per cent of the total raised by emerging economies, or approximately half of the privatisation proceeds of Latin America.

- Enterprise reform and privatisation are crucial in order to reduce the fiscal burden for Asian states and increase profitability and efficiency of the SOEs, hit by the recent crisis. The cost of SOEs for governments is significant and in some countries it is many times higher than the costs of education or housing. In Indonesia, for example, it equals 4 times the expenditures for housing, 5 times the expenditures for education and 8 times the health expenditures.

- Restructuring is an important element of enterprise reform and privatisation in Asia and is mainly directed in focusing companies on their core activities, reducing excess staff, increasing accountability and providing incentives for achieving productivity targets. It is also an element of the preparation of large SOEs for floatation in order to ensure a successful transaction and revenue maximisation. Restructuring and introduction of competition are also key for utilities and infrastructure, which are on the privatisation agenda of most APEC economies. The introduction of competition and the reduction of entry barriers are also important for the latter sectors. It was also emphasised that competition is difficult to introduce without private sector. State ownership suggests a handicap, as the state is often tempted to use its regulatory power to favour its own companies.

- Partial privatisation is implemented by different Asian economies in order to free assets and public funds for other services and to provide companies with access to markets. The discussion of different cases suggested that majority privatisations are a first best solution. The experience shows that minority privatisations have to be handled with caution as they may decrease the revenues for governments and lead to lower quality investors. Minority privatised enterprises attract less interest from investors and more attention to potential state interference, which can make management of the state stake particularly difficult. Minority privatisation may also result in moral hazard for corporatised state enterprises, benefiting from state guarantees for their debt.

- Corporate governance failures in Asia were, to a large extent, a cause of the 1997-1998 crisis in the region. In this respect, Asian governments have accepted the significant positive effects of listing SOEs in terms of corporate governance and capital market development. However, financial market supervision needs to be enhanced for this to occur. In some countries, credits given upon instructions from high level officials and in the absence of credit analysis created huge problems for the stability of the financial sector. Insider trading and share price manipulation are also among the major weaknesses of corporate governance in Asia. On the other hand, the judicial system is not in a position to enforce the existing rules and regulations.

Impact of Privatisation on Capital Markets

The privatisation process in OECD countries has changed their capital markets fundamentally and has also significantly contributed to the on-going globalisation of the financial landscape. Similar effects are emerging in some Asian economies.

- As a result of large privatisation programmes implemented in the OECD area, privatisation revenues have expanded at a pace that would have been hard to predict. Thus, OECD privatisation accounted for the majority of the US$ 1 trillion worth of assets, privatised world-wide in the period of 1981 - 1999. The largest part of privatisation revenues has been generated through public offerings and has led to an impressive growth of capital markets, especially equity markets. Equity market share in the national income are particularly noticeable in countries with large privatisation programmes. Privatisation and capital market development have, thus, proven to be mutually interdependent.

- Many privatisation related offerings have had a strong retail component, which resulted in enhanced equity culture and a multitude of small shareholders. The implementation of policies encouraging retail participation signals to the market/institutions a longer-term commitment by the government. High levels of retail interest have also proven useful in building momentum for the offering by creating an impression of scarcity that leads institutions to bid more aggressively. On the other hand, there have been notable developments in the field of institutional investors, particularly collective investment schemes. Many countries have developed their own institutions as a result of privatisation.

- The openness to foreign capital has been a major element of many OECD privatisation programmes. The participation of international investors in privatisation was considered important by policy makers, both from the narrow perspective of higher revenues and for the broader reasons of attracting foreign direct and portfolio investment in the country. Through privatisation related offerings, in certain countries stockmarkets opened up to a broad range of global institutional investors. On the other hand, a healthy foreign direct investment underpins and solidifies the demand for emerging market equity by signalling a longer-term commitment to the host country.

- The privatisation programme in Singapore, announced in 1985 comprised capital market development as an explicit policy objective. In order to allow the market to absorb the privatisation related shares, the programme was intended to take place over a period of approximately 10 years and rely on partial privatisations. Privatisation was also characterised by the participation of both retail and institutional investors, including foreign. An important feature of privatisation in Singapore was the profitability of the companies before their privatisation.

- The impact of privatisation on capital market development in Singapore was significant. As a result of the programme, so called government-linked companies (GLCs), account for 25 per cent of stock market capitalisation. The 3 largest listed Singaporean companies by market capitalisation, the top 5 by turnover and the top 4 by total assets are also GLCs. Privatised GLCs outperformed non-GLCs, while the initial underpricing was comparable to the one related to non-GLCs shares. The bulk of GLCs included in the initial programme was privatised by 1993 and since, only a few new listings took place. However, it is recognised that there are no compelling reasons for the government to hold controlling stakes in GLCs, which may lead to a further divestiture of state stakes in GLCs.

- In the general discussion it was pointed out that, according to the extensive privatisation experience in OECD countries, the depth of the capital markets has not proven an insuperable barrier. It was also stressed that there is a case for accelerating the process, in order to privatise enterprises when they are still competitive and profitable and thus, reach revenue maximisation objectives. Finally, privatisation is in the interest of the companies and the market, as it introduces market discipline, whereas residual shares retained by the state might depress the market.

Impact of Privatisation on Corporate Finance and Governance

Market based privatisation in OECD countries has had profound effects on corporate governance and finance.

- Privatisation impacts on corporate finance by providing companies with access to equity finance. Investment of state-owned enterprises is largely debt financed, which might be problematic, as it exposes companies to cyclical downturns and might, therefore, require implicit state guarantees. On the other hand, more liquid and deeper capital markets have led to lower borrowing costs and created a shift from bank to market based financing -- a trend known as disintermediation. Experience has also shown that leverage in privatised enterprises has decreased; this trend is even stronger when taking into account financial restructuring prior to privatisation

- Privatisation changes not only individual company behaviour, but also the whole corporate environment. Corporate control patterns change with the exposure of companies to take-over threats and pressures from shareholders. The insistence on improved performance by investors and the enforcement of management discipline through take-over mechanisms, require adaptation with respect to information. Management focuses more on shareholder value and better transparency. Experience has shown that privatisation and improved corporate governance should go together. Corporate governance reform needs to be carried out before or in parallel to privatisation in order to achieve optimal results. In addition, empirical

evidence suggests that privatised companies perform better in markets with better corporate governance.

- It is worth noting that in some cases, SOEs exposed to global competition take the initiative of privatisation and try to persuade governments to let go. They need to tap the markets to ensure their survival and expansion. In the case of the new economy companies, growing part of intangible assets compels equity rather than debt finance. Privatisation in these sectors has often resulted in spin-offs and significant capital increases for subsidiaries.

- A few OECD countries have utilised techniques such as distributing parts of share offerings to stable groups of investors having some connections to the companies. To some degree, the use of this technique can be helpful in the early stages of privatisation, especially in countries where a strong domestic institutional investor community is absent and the capacity of domestic markets to absorb large amounts of equity is in doubt. However, with the maturing of capital markets, these groups tend to become a hindrance and are now fading away.

- Korean privatisation has yielded modest privatisation and corporate governance results. Industrial policy objectives have not been clearly defined and have often been used as an excuse to retain ownership in state hands. The government is implementing its objectives of industrial policy and exercises shareholders rights on the basis of a complex legal framework, allowing government institutions to intervene in SOE management until a special privatisation act was voted in 1997. The latter brought about dramatic changes for the companies subject to this act by decreasing the scope for state intervention in their management and operation.

- The insufficient development of capital markets and the state intervention to help families build their industries have been important obstacles for privatisation and good corporate governance. In Korea, it appears clear that at this stage, the options to retain ownership or to sell SOEs to the existing family conglomerates, called *chaebols*, are no longer acceptable and it is necessary to rely on other solutions. Focusing on capital market development can be instrumental in privatisation and in introducing better corporate governance. With respect to large privatisations, the use of institutional savings, independent from the *chaebols* is another important option to explore.

- The discussion of the Chilean experience has shown that privatisation policies in the 1980s and the early 1990s have not taken into account corporate governance and capital market development concerns. Managers and other shareholders were able to control companies only by retaining minority shares, as long as they provided them with special rights (e.g. multiple voting shares). New legislation has been adopted to protect minority shareholders and allow them to obtain a fair share of benefits in the cases of take-overs post-privatisation. This is considered as a major development in improving the corporate governance environment in Chile.

Privatisation through Market: Methods and Techniques

Valuable practical conclusions can be drawn from the OECD knowledge on how to run complex transactions and use different methods and techniques to ensure their success.

- Public offerings are transparent, enhance the development of capital markets, create broad ownership, and, if successful, may help the government build a reputation for future sales. Also, they are good mechanisms to attract foreign investment, both from institutional and direct investors. The main disadvantage of privatisation via the capital market is its cost. The process itself requires external marketing and technical knowledge. The direct costs vary and recent trends show that increased competition among investment banks has led to a decline of fee structures. The indirect costs, on the

other hand, have to do with underpricing, which is a way to establish a long-term relationship between the firm and the public. Experience has shown that underpricing has to be cautious in order not to lead to significant price fluctuations undermining the credibility of the state in pursuing its other objectives (e.g. revenue maximisation).

- The rise of equity ownership as a result of privatisation has been particularly rapid in countries such as Italy where it represented a small share of income at the outset. By making domestic equity available and by taking positive steps to encourage equity ownership, privatisation in Italy promoted the development of equity markets, which was a policy objective in itself. The decision to utilise the capital markets for privatisation means that a significant part of the company must be sold to institutions or retail investors. Significant equity positions have been acquired by institutions and they now account for rising percentages of total investment in Italian companies. A considerable part of most privatisations has targeted retail investors, the participation of which has been encouraged by the introduction of special incentives. Privatisation has overall brought new retail investors to the market, as experience shows that a part of them retain the shares even after they have received the bonus share.

- The Czech presentation centred around one key message: the rapid ideological privatisation carried out in some countries in transition from a centrally planned to a market economy resulted in a poor quality of process and owners. In some countries, the main method used was the so-called *mass privatsation*, based on the distribution of SOE shares to the population at large for a symbolic fee. In the Czech republic it included approximately 2000 listed companies and resulted in the creation of millions of shareholders. Concentration and delisting started soon after the completion of the programme and it appeared that the approach did not achieve the main political aim of developing "national capitalism" and creating capital market from above. An important cause for this failure was the lack of any preparation for strong regulatory oversight and corporate governance rules. As a result of this initial experience and on the basis of the existing manufacturing based industry, the current privatisation efforts are focused on attracting strategic investors.

- Similarly, the legacy of central planning in the new federal states has led to the implementation of two models of privatisation in Germany. The German experience has emphasised the importance of the careful selection of the privatisation method and has shown that IPOs cannot be implemented for the privatisation of any company. Privatisation via the capital market was a good method for West Germany, but the companies of the former East Germany did not have a sufficiently good performance record to be floated on the stock exchange. Another characteristic of the German model was a step-by-step approach in privatising large SOEs. The type of enterprise, the demand, the readiness of the market to absorb the privatisation related shares determined the portions of shares to be offered at every step. This approach also helped reduce share price volatility for most sectors.

- Globalisation and regional integration have changed the perception of public interest. Most OECD countries including new members, such as the Czech Republic and Hungary have accepted that many sectors (including sectors, considered as strategic, such as banking) will be run by foreigners. The trend towards regionalisation of stock exchanges can again be related to the development of markets and globalisation.

Privatisation through Market: the Transaction

Privatisation is carried out under the close scrutiny of the public, as the enterprises, which are being divested are among the largest ones and sometimes considered as strategic. Therefore, political will and strong support at the highest level are major factors for its successful implementation, along with increased transparency and avoiding corruption. Additional elements of a successful privatisation transaction are discussed below.

- Governments carefully plan and execute privatisation transactions, often relying on publicity campaigns to help make potential investors aware of investment opportunities and explain the reasons for privatisation clearly to the public at large. Experience has shown that restructured commercial organisations, oriented towards shareholder value are most likely to attract investors in public offerings. However, many countries have chosen to carry out brief and defensive restructuring, limited to balance sheet strengthening and organisational changes, leaving technology changes and major capital investment decisions to the private owners.

- The offering terms are another element of the transaction, which requires serious attention. Fair pricing mechanisms can be difficult to define but have universally proven essential for the success of IPOs. In the first phases of a privatisation programme, pricing policies aim at confidence building among investors and issues are therefore priced rather cheaply. As the programme develops, the government's pricing strategy may focus more towards efficient pricing, as well as lowering related transactions costs in this area through book building or other similar arrangements. Support in the aftermarket may also be required to maintain investor enthusiasm in the process of stabilising prices. Too wide price fluctuations in both directions can be detrimental to the credibility of the privatisation process and can bring about a lot of criticism.

- Specialist consultants -–especially financial advisers and co-ordinators – have a clear role to play in privatisation transactions through the market. Investment banks, consulting firms, environmental experts, accountants and lawyers are essential players in IPOs. It is noteworthy that privatisation programmes have had a strong impact on competition among advisors, which in some occasions have led to decline in fees paid by governments. On the other hand, the relations with advisors and co-ordinators should be handled with caution, because of the complexity of the transaction and the underlying information asymmetries. Conflict of interests issues should be carefully examined and addressed in the selection process.

The Indonesian Privatisation Programme

The meeting aimed also to provide senior policy makers from Indonesia with the opportunity to present and discuss their future plans in privatisation and capital market development and to benefit from the recommendations of the eminent group of experts from OECD and APEC countries.

- Privatisation is important for Indonesia in order to ensure sustainable recovery after the financial crisis. It is also a key ingredient of a more transparent and efficient corporate sector in Indonesia. Indonesia's state-owned enterprise sector includes several hundred enterprises. The majority of these are small, public service entities, owned by local and provincial governments. The national government owns numerous public welfare institutions, including hospitals, educational, research and cultural institutes. The state-owned banking sector is currently undergoing merger, restructuring and recapitalisation by the Indonesian Bank Restructuring Agency.

- A set of key enterprises (approximately 140) are currently managed by the Ministry of Investment and State-Owned Enterprises, established in 1998. These enterprises cover a range of industries and vary in size from large, national monopolies and public infrastructure enterprises to relatively small service companies. The main objectives of the MISOEs are to divest state enterprises and generate revenues for the budget, through a transparent and efficient privatisation process. The transparency of privatisation is particularly important in order to attract and retain international investors that will perform much needed restructuring before they come to the market. Another important objective of the MISOEs is to prepare many of the Indonesian infrastructure and utilities companies for privatisation / private sector participation.

- The challenges to the Indonesian privatisation programme are numerous. Political commitment by the government at the highest level and building momentum for privatisation are important. Synergies with other institutions, responsible for the largest loss-making enterprises and insolvent financial institutions need also to be explored. Some of the SOEs for which investors cannot be found, might need to be liquidated, as they represent a burden for the state budget. An important task in this context is to provide for a social safety net for their employees, possibly with the help of multilateral institutions.

- The consequences of the recent crisis represent a compelling case for a wide-ranging privatisation. The Indonesian authorities need to envisage selling control (majority or the totality) of shares in most enterprises in competitive sectors. This seems to be the only way to build the credibility of the privatisation programme and free some of the public resources, currently used to finance losses of SOEs. Only if the multitude of SOEs in competitive sectors of the economy is divested, can the current plan of minority floatations and better corporate governance in the larger, strategic SOEs be successful. Thus, the privatisation process needs to rely more on majority sales and on diversified privatisation methods. Enhancement of corporate governance rules and practices should also be among the privatisation objectives.

General conclusions:

Privatisation is an area in which best practices are set in real time. The existing common features of OECD and APEC economies allowed some important general preconditions for successful privatisation to emerge. According to the chairman of the OECD Privatisation Network and director of the Italian Treasury, Professor Grilli, such prerequisites for success imply the following tasks for governments:

- *Prepare the political and social policy agenda*:
  Through a decision
  - on which companies are to be privatised and which to stay in state hands,
  - on how to provide utilities and infrastructure services through the market,
  - on what special powers to preserve for the government;

- *Implement regulatory reform*:
  Through an effort
  - to introduce or enhance competition and
  - to create independent regulatory bodies;

- *Prepare SOEs for the market*:
  Through the introduction of
  - market oriented corporate governance,
  - the guarantee of full transparency and protection of minority shareholders and
  - better management culture;

- *Prepare the market for SOEs:*
  Through the implementation of policies to create a broad base retail and market institutions and the design of incentives for these purposes;

- *Prepare the transaction*:
  Through well thought-out procedure for selecting and working with advisers and underwriters;

- *Prepare the rules of the game post-privatisation*:

Through setting adequate rules for corporate control transactions, including for mergers and acquisitions in order to prepare the conditions for the post-privatisation development of companies.