OECD Working Group on Privatisation and Corporate Governance

of State Owned Assets

Occasional Paper:

THE ROLE OF INCUMBENT BOARDS AND MANAGEMENT IN THE PRIVATISATION PROCESS

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EXECUTIVE SUMMARY

This paper addresses the challenges of overseeing the board and management of state-owned enterprises (SOEs) in the course of a privatisation process. The report identifies areas in which incumbent managers and boards have different interests from those of the state and the general public. It also suggests options that these groups have for stalling privatisation or biasing the process in their favour.

The viability of a privatisation process partly depends on the political costs involved and these costs are generally related to a firm's restructuring during privatisation. In this case, the basic incentive that board and managers may have to deviate the privatisation process involves fear of losing their jobs ex post privatisation. Moreover, they have a crucial role in this process for several reasons:

- In order to avoid the high political costs involved in a radical restructuring, governments can choose to perform a more modest restructuring that focuses on the firm's top management. In fact, top management replacement before privatisation has become a relatively common policy and tends to receive comparatively broad political support. Thus, managers and board can foresee that there are more chances of losing their jobs due to privatisation and may try to instigate against it.

- Managers and board may in practice have been picked in a somewhat "politicised" way, and due to this they might have influence over other government agencies that are against privatisation. Moreover, they generally have bargaining power to convince trade unions to cooperate in its favour.

Managers and the board have influence over the firm's labour force and also control media and communications inside the firm.

In situations where management and the board have significant bargaining power to instigate other employees, trade unions and public opinion against privatisation, governments usually set compensation packages to offset the influence of management and the board and to ensure that the privatisation process will succeed.

For instance, where large-scale redundancies are involved, a mix of restructuring options is available to minimize labour opposition and make privatisation feasible. One politically and socially attractive way to reduce the size of the labour force is through natural attrition. Sometimes other restructuring options such as early retirement, voluntary departure programs, contracting arrangements and layoffs need to be considered. However, in companies with minimal levels of overstaffing, labour restructuring can and should be left to new investors who are in a better position to judge the level of employment and kind of skills needed in a privatised enterprise. Even in these cases, in order to reduce political pressure governments sometimes set conditions on sale obliging the privatised firm to keep the existing work force for a defined period (that is, an explicit employment guarantee).

Governments may choose to partly privatise a firm in order to keep some degree of control over the enterprise after privatisation. Indeed, in many cases newly privatised firms are still expected to fulfil special responsibilities and obligations for social and public policy purposes and, consequently, the relationship between government and SOEs board and managers may become fraught with agency problems. Multiple social and political pressures can distract board and managerial attention from maximizing benefits within the specific privatisation process and in order to avoid this behaviour, governments should create or design a special entity to take care of the privatisation process.

Centralisation can be a major force if it separates the exercise of ownership functions from other activities performed by the state.

Along the same lines, once the privatisation process begins the government should ensure that the process will focus on the maximisation of the SOE value and give strictly commercial, profit-maximizing mandates to the board and managers. The contracts should include specific incentives for managers or workers, such as bonuses linked to the firm's performance. Finally, during the privatisation process governments should avoid electing an excessive number of board members from the state administration.

The dichotomy between government and management preferences regarding privatisation methods is also addressed by the paper. On one hand, the government's goal is to maximize the privatisation proceeds and to achieve this objective, trade sales seems to be the most appropriate method. On the other hand, managers see trade sales as a threat to their jobs and can try to stall privatisation or deviate the process through the application of other methods such as public offerings and MBOs. These methods create options for management and board to bias the privatisation process in their own favour.

The paper argues that the best way to offset such dichotomy is through the application of a mixed sale privatisation method. In this sense, a mixed sale can combine a trade sale, a public offer and a MBO. However, as mixed sales are more structurally complex, its application must be carefully designed to avoid potential conflicts of interest. Experience worldwide suggests that the trade sale for the strategic investor should come first followed by the public offering in conjunction with the MBO. Indeed, if the trade sale and MBO are executed together, it is easier for management and investor to collude as their incentives are fully aligned - they both wish to buy equity as cheaply as possible.

To avoid such conflict of interest, governments may find it appropriate to sell in a first stage only a minority shareholding to a strategic partner, thereby allowing it to realise the majority of any future financial gains. This measure may help to mitigate the impact of any undervaluation of the business as it ensures that the government would also benefit from the resulting growth.

In addition, governments should not allow management to make very large returns simply by virtue of the privatisation process, as excessive returns could turn public opinion against privatisation. However, there should be an employee share scheme to incentivise management to increase the value of the equity, as long as the returns made by management are proportionate with the growth in the value of the business.

Typically, management will be offered the opportunity to invest personal money in an equity stake in the business. Sometimes this is structured with a ratchet mechanism that can increase the return significantly, subject to certain performance targets. The choice of target will depend on the main focus of the investor; for example, growth in equity value or growth in profitability. Moreover, financial investors usually offer share schemes for all employees with two-tier and even three-tier structures.

THE ROLE OF INCUMBENT BOARD AND MANAGEMENT IN THE PRIVATISATION PROCESS

1. Introduction

Privatisation is defined in this paper as the introduction of private investors as claimants of a company's future cash flows. Since privatisation implies a change in a firm's ownership, one would expect changes in both board and management behaviour during the privatisation process. This paper addresses the challenges involved in overseeing the boards and management of state-owned enterprises (SOEs) in the course of a privatisation process. The main objective of this report is to identify and remove obstacles to privatisation from the perspective of a state ownership entity. As such, it will identify areas in which incumbent managers and boards have different interests from those of the state and the general public as well as determine options that these groups have for stalling privatisation or biasing the process in their favour. Obviously, the different incentives that managers and boards might have during the privatisation process will depend on government objectives regarding privatisation, differing privatisation methods and their characteristics, interaction with other agents in the process and so on. Thus, in order to place the board and management incentives into context it will be necessary to discuss the issues stated above, taking as the foundation for this discussion the constituent parts of the privatisation process. In a simple structure, a privatisation process consists of three interdependent stages: an assessment of the feasibility of privatisation, methodology design and its execution. All phases are equally important to align incentives and drive board and managers to embrace the privatisation process.

This paper is organized as follows: In Section 2 the relationship between the privatisation's feasibility and management and board incentives will be addressed. It will be seen that political costs can halt or reverse privatisations plans with management and board playing crucial roles in this process. In Section 3, the interaction between the design and execution of privatisation and management and board incentives will be analysed. In subsection 3.1, the role of politicisation and management incentives will be discussed. It will be seen that when governments choose to partly privatise a firm in order to keep some degree of control over the enterprise after privatisation, a special entity should be created to take care of the privatisation process. Along the same lines, once the privatisation process begins governments should ensure that the process will focus on the maximisation of the SOE value and give strictly commercial, profit-maximizing mandates to the board and managers. Subsection 3.2 will discuss the impact that several privatisation methods may have on management and board's behaviour during the privatisation process. It will be seen that there is a dichotomy between government and management preferences regarding privatisation methods. Further, in light of incentives that management and board may have to stall privatisation or bias the process in their favour, subsection 3.3 provides a road map for policy makers regarding the design and execution of privatisation.

2. Assessing the feasibility of privatisation

2.1 SOE restructuring and management incentives

In this subsection, the conditions under which it is viable to privatise a SOE and the relation between these conditions and employees' incentives (in particular, management) will be analysed. Basically, the viability of a privatisation process depends on the political costs involved, which usually impact during restructuring of the SOE prior to this process. As will be seen below, if there is high political cost related to a specific privatisation case, it is almost certain that this operation will be delayed or even cancelled.

Indeed, labour adjustments are one of the most sensitive aspects of privatisation. The process is not easy and the challenges are many. Perceiving the threat of unemployment and loss of benefits, labour unions and state enterprise workers are among the most vocal and organized opponents of privatisation and often take actions that threaten or delay reform. While many privatisations have been carried out with minimal labour protests, labour opposition to privatisation has been significant in countries and enterprises where over-employment and wages are high, where state enterprise workers form a base of political support and where unions are influential in the sector and in the economy as a whole. Examples are plentiful (see Box 1).

Box 1. Employees, trade unions and privatisation cases

Aborting privatisation: When the Mexican government embarked on an ambitious privatisation program in 1996, "a number of unions and civil-society groups joined together…to protest the sale of Petroleos de Mexico, the state-owned oil company, forcing the government to revise its privatisation plans" (http://www.50years.org/factsheets/telmex.html).

There is also a strong, long-running campaign against water privatisation in the U.S which has led to many cities rejecting or reversing privatisation. For example, Atlanta terminated a private water concession run by Suez and re-municipalised the service. Similar campaigns in a number of European cities have successfully resisted proposals to privatise water. Numerous other campaigns around the world have halted or reversed water privatisation plans; for example, in Argentina, Brazil, Bolivia, Paraguay, Thailand, India, Philippines, South Africa and Tanzania. In Uruguay, a coalition between unions, social organisations and a political party succeeded in passing a constitutional amendment making water privatisation illegal.

Similar campaigns against the privatisation of electricity have been run in a number of other countries. In Canada, the Canadian Union of Public Employees succeeded in preventing the privatisation of a major electricity company in Ontario. In South Korea, the unions demanded that the government, management and unions conduct an international study of experiences with privatisation, as a result of which the government agreed to suspend the privatisation programme. In Indonesia, a campaign brought a case to the constitutional court which ruled that the privatisation plans in electricity were illegal (PSIRU 2007).

Undermining the privatisation process: The resistance of Peruvian employees to privatisation of two local utilities companies to Belgian and French investors in Arkipe (the second largest city in Peru), led the Peruvian government to announce at the end of August 2002 that it was aborting plans to privatise another four utilities companies in the region because of "lack of interest" (Karni, 2002). In some African countries, resisting employees have been joined by student activists, academics and businessmen in their effort to stop privatisation with the result that "privatisation has been cited as one factor in the ousting of incumbent governments, either through election or through military coup" (Harsch, 2000).

Higher compensation and other concessions for acquiescing in privatisation: After resistance sabotaged a privatisation attempt in 1995, French Telecom was finally privatised in 1997, the employees receiving exceptionally hefty shares of purchase-offering programs (see Degeorge et al., 2003). Another example is the privatisation of Telemex, a Mexican telephone company. The consent of employees was bought by awarding them 4.4% of the shares in a company that was sold by the government for US$ 6.2 billion (selling a controlling interest in December 1990 and the rest in 1992). (www.50years.org/factsheets/telmex.html).

Generally, besides a non-restructuring choice, governments have two restructuring options prior to privatisation. In the first option, governments can choose to restructure labour force through all its segments, including top management. According to the restructuring view, the labour force of a state-owned enterprise is good in terms of political ability but not good at actually running the firm. The rationale here is that the current work force has the wrong human capital to face competition and the new market conditions that the firm will soon encounter once it is privatised. A new work force with appropriate human capital is needed in order to implement all necessary restructuring and run the firm efficiently until privatisation takes place (Barberis et al., 1996). Thus, it is expected that labour force replacement before privatisation will yield higher privatisation prices as the prospective buyers will value the restructuring done before privatisation. However, as this type of restructuring involves a significant proportion of the labour force, it will probably lead to high political costs.

The other option is that the government can choose to focus on top management replacement. For instance, replacing the often politically-appointed manager of the SOE with a professional businessperson should lead to performance improvements. In these terms, Lopez-de-Silanes (1997) points to a positive relation between a change in the CEO and the market value of the privatised firm.

The rationale of this action is that a change in management before privatisation sends an unequivocal signal to prospective buyers on the seriousness of the privatisation process and also eliminates incentives for corruption of the old management that otherwise may try to maximize rents before the firm is privatised. Clearly, if managers view privatisation as an end-game situation (they foresee that they will probably lose their jobs at the end of the process), they can deviate the process to bring about failure. Thus, top management replacement before privatisation will contribute to the increase in privatisation prices once the firm is for sale (Kikeri, 1999). However, as will be seen below, the political costs involved will depend on top management bargaining power.

From a policy perspective, if the role of a newly installed top management before privatisation is mainly to provide a signal to prospective buyers, then governments will not need to focus on potentially costly restructuring activities that may otherwise have appeared advisable to undertake before privatisation. This includes not only monetary expenses, but as indicated above, the high political cost of radical restructuring actions which may undermine the privatisation process. The political difficulties of using radical restructuring policies and the problems it might cause in terms of the overall objective of achieving privatisation should be considered, but if the restructuring view is the predominant one, governments may choose to establish a radical restructuring prior to privatisation. In this sense, governments willing to provide the new top management with a mandate regarding restructuring may also be willing to tolerate the economic and political costs of streamlining, as such actions may be rewarded with higher privatisation prices (Chong and Galdo 2007).

However, as seen above, both methodologies involve some degree of replacement amongst top management and in the latter view this replacement tends to be more severe. As a consequence, restructuring can lead management to influence public opinion and trade unions against privatisation with even the board colluding in this matter. Thus, management and board play a crucial role in this process for several reasons:

- As said before, in order to avoid the high political costs involved in a radical restructuring, governments can choose to perform a more modest restructuring that focuses on the firm’s top management. In fact, top management replacement before privatisation has become a relatively common policy and tends to receive comparatively broad political support. Given an increased chance of losing their jobs due to privatisation, managers and the board may try to instigate political groups against privatisation.

- Managers and the board of SOEs are usually appointed for political reasons and because of this they could influence other government agencies that might be against privatisation. Moreover, they generally have bargaining power to convince trade unions to cooperate in its own favour.

- Managers and board have influence over the firm’s labour force and also control media and communications inside the firm.

In situations where the government is willing to replace top management and the latter have significant bargaining power to instigate action amongst employees, trade unions and to incite public opinion against privatisation, governments usually set compensation packages for employees to offset management actions and to ensure that the privatisation process will succeed. Indeed, broadly speaking, political costs involved as a consequence of restructuring in privatisation processes can be offset by intense campaigns and marketing that explain the advantages of privatisation, as well as through the establishment of compensation packages.

3. Privatisation's design and execution

It is clear that the choice of a privatisation method influences the board and management incentives and that the analysis of this impact is quite complex. Indeed, the corporate governance during the privatisation process is impacted by several variables such as the ownership structure that will result after the privatisation is executed, collusion between inside and outside parties and so on. The main goal of this subsection, then, is to address the relationship between privatisation methods and board and management incentives.

3.1 Ex-post government ownership

In addition to governance concerns, there are many factors that drive the choice of a privatisation method. Political factors - including such issues as concerns about foreign domination or the concentration of excessive economic power in the hands of already powerful domestic groups - make it difficult to adopt private governance chains (Dyck 2001). Indeed, in many cases newly privatised firms are still expected to fulfil special responsibilities and obligations for social and public policy purposes. When such factors are considered, a government usually choose a privatisation method that allows it to maintain a certain degree of control over the firm after privatisation. Such control can be achieved through the maintenance of a significant proportion of the firm's shares or even through golden shares.

The choice of a privatisation method in which the government continues to be a controlling shareholder can result in significant lowering of market discipline. Moral hazard cannot be fully alleviated by a government that wishes to remain a shareholder in the long run. In such cases, the relationship between government and SOEs board and management prior to privatisation can lead to loss of control with multiple social and political pressures distracting board and managers' attention from maximizing benefits within the specific privatisation process.

Indeed, it is known that the problem of managerial incentives is less serious in the private sector than in the public sector, because private sector managers are responsible to one master - the shareholders - and the shareholders, in turn, care primarily about profits which provide a fairly clear yardstick for judging managerial performance. By contrast, the public sector manager is responsible (formally or informally), to the head of the executive branch of government, to the legislature that establishes his agency's powers and approves its budget and to the various interest groups that seek to influence the agency's performance. Moreover, each of these constituencies is typically interested in a variety of objectives that are often hard to measure and conflicting, so that even a well-intentioned and informed manager may not know what to do (Gomez-Ibanez 2007).

Examples are plentiful. For instance, it is unlikely that during the pre-privatisation period the incumbent board will agree to a company policy that will generate a high political cost for the government, no matter what its impact might be on firm's performance. The second problem with politicisation during the pre-privatisation period is that the preponderance of a culture of political clientelism within the enterprise is a direct enemy of meritocracy, competence and performance. In addition, because profitability is largely irrelevant to them and to their principals, SOE managers might have every incentive to seek other types of benefits that are much more politically visible (Stilpon 2005). In the pre-privatisation period or in partly privatised companies, the supervising ministry is often in a position to hire and fire the CEO at will (for instance, through golden shares after privatisation). This approach can create serious alignment problems, as the CEO's interests are not allied with the privatisation process and the company as a whole (as this interest is collectively interpreted by the board of directors, but with the interests of its largest shareholder, the government.

In light of the OECD Guidelines of Corporate Governance and independently of which method is chosen, in cases where there is post privatisation ownership by the government there should be a clear separation between the state's ownership function and its other functions. As seen above, in the absence of separation mechanisms this can easily result in confusion over, and conflicts of interest between, social policies and the goal of privatisation. However, this separation can be achieved by creating a special entity to take care of the privatisation process.

Indeed, centralisation can be a major force if it separates the exercise of ownership functions from other activities performed by the state. For instance, in some countries a specialized supervisory agency has been established to buffer an SOE from political forces during a privatisation process. The power to appoint the board of directors and exercise other shareholder rights is often moved from the technical ministry in charge of the sector to a body more sympathetic to commercial objectives, such as a separate public enterprise unit or holding company reporting to the ministry of finance.

Regarding the nomination and election of board members during the privatisation process, it is clear that the government should avoid electing an excessive number of board members from its state administration in order to minimize possible conflicts of interest, thus removing the possibility of intervention in the SOE's business or management during privatisation. The boards of soon-to-be privatised enterprises need to develop a capacity to establish their own profile and culture. The "crack" team for the creation of board culture is usually an active, independent corporate governance/nomination committee of the board. The nominating committee of the board should be in a position to screen candidates nominated by any party and opine on their profile and competence. Such an advisory role provides for some continuity of board practice and culture even in the event of cumulative or constituency voting. This continuity is likely to make direct attempts to politicise appointments more difficult by making them more transparent and open to scrutiny. The board in these circumstances is much more than a monitor of management - it is a key change agent that sets new values and is closely involved in strategy. The leadership of a soon-to-be privatised enterprise will, however, have very few supporters within the company, which as Stilpon (2005) points out, is often run by political fiefdoms.

Along the same lines, once the privatisation process begins governments should ensure that the operation will focus on the maximisation of the SOE value. Indeed, Perotti (1995) and Jones, Megginson, Nash and Netter (1999) note that uncertainty about a government's commitment to privatisation affects the manager's incentives to restructure the privatised firm. By signalling its commitment to capitalism, the government should be able to convince managers that it will not expropriate profits through policy reversals and thus motivate managers to maximize value.

Governments should, through contracts, give strictly commercial, profit-maximizing mandates to the board and managers. Lack of market value makes it very difficult to align the incentives of the shareholder with those of the managers, but this can be achieved by linking the remuneration of managers and directors to long-term value creation.

It is worth mentioning that countries use different names for these contracts including 'contract plans', 'memoranda of understanding', 'statements of corporate intent' and 'performance agreements'. The generic term, however, is 'performance contracts' since their essential feature is that they specify the measures by which the firm's performance will be judged. In some cases the contracts also establish specific incentives for managers or workers, such as bonuses linked to the firm's performance. Without explicit incentives there is always the implicit threat that the board or the management will be sacked if it does not meet the privatisation targets.

A concern raised by performance contracts is that SOE managers are usually much better informed about possibilities for improving their enterprise's performance than the government officials they are negotiating with. The fear is that managers will take advantage of their superior information to negotiate performance targets that are soft (easy to reach) or otherwise better suited to the objectives of managers than those of officials. In economic terminology, this problem can be defined as information asymmetry between principals and their agents. The principals - in this case the firm's government supervisors - are interested in improving the performance of the enterprise in the pre-privatisation period while their agents – the managers - may be interested in not exerting themselves. The problem for the principals is that they can never know whether their agents are doing as much as they could to improve firm performance. The classic solutions to the problem involve the use of stock options and similar devices to align the incentives of the agent with those of the principal and to motivate the agent to reveal information.

To sum up, it follows that aligning the board and top management with long-term shareholder value is a key mechanism to advance depoliticisation if a company continues to be partly owned by the state after the privatisation process. Also, as seen above, the creation of a government agency that manages state shares by applying commercial criteria is one step towards more proper alignment.

3.2 Managers and board preferences regarding privatisation methods

This report now turns to the government's choice regarding the privatisation method and its relationship with management and board incentives. As mentioned above, there are many factors that drive the choice of a privatisation method. Although privatisation's goals comprise, for instance, the promotion of competition and the development of domestic capital markets while keeping the state's national sovereignty, it is reasonable to assume that the major objective of the state regarding a privatisation process is the maximization of the operation proceeds. In fact, privatisation is frequently supported on the grounds that the sale of a SOE will improve the government's financial position in terms of reducing the size of its budget deficit (or increasing its budget surplus) and the public sector borrowing requirement. To achieve this objective, the most appropriate privatisation method takes the form of a trade sale.

Briefly, there are two types of trade sales for privatisation: auctions (open bidding) and negotiated sales. Auctions are more common and more transparent than negotiated sales. First, the financial adviser or sales agent, working with state enterprise managers and government officials, prepare an information memorandum containing general information for potential investors. The memorandum is sent to potentially interested parties. Then, nonbinding expressions of interest are received from interested buyers. Based on these expressions of interest and a review of the financial capacity of potential bidders, a short list of potential buyers is selected. These bidders then move to the second stage of the process. During the second stage, the government signs confidentiality agreements with the short-listed bidders, gives them much more detailed, commercially confidential information on the state enterprise, access to management and a draft sales agreement. Bidders that wish to proceed then submit a binding offer (bid) and a deposit. Finally, the government and its advisers choose the best offer and the sale closes with payment for the shares (or in special cases, assets) of the state enterprise. Negotiated sales are a variant of the open bidding process. Once the government has chosen a buyer, it negotiates an agreement that is attractive to the buyer and protects the government's interests. Negotiated sales are used when there is only one bidder or a bidder has a marked advantage over other bidders in the view of the government.

Indeed, a trade sale seems to be the most appropriate privatisation method to maximize the operation's proceeds. For instance, a trade sale to an investor seeking a strategic advantage from investment in a privatised firm may produce a higher sale price than a public float. In addition, a trade sale will usually involve considerable savings in transaction costs. On the other hand, the transaction costs involved in public float privatisations will include the costs of preparing and printing the prospectus, advertising, processing application for shares, as well as payments to lawyers, accountants, bankers, advertising and marketing consultants and other intermediaries.

However, as a trade sale privatisation is the direct sale of a business in state ownership to another business or financial purchaser (resulting in a concentrated ownership structure), it is likely to result in a rout of the incumbent management and board or, at least, in more monitoring pressure over them.

Indeed, concentrated ownership is often considered to be the main corporate governance mechanism which through improved monitoring can alleviate the conflict of interest between self-interested managers and value maximising owners. Basically, this can be explained by a higher probability of adopting a contingent compensation scheme that would transfer the risk of uncertain results to managers. Also, as agency theory suggests, the existence of 'core' shareholders who hold a sufficiently high proportion of a company's shares implies some degree of board control in contrast to the dispersed shareholding and 'free-rider problem' of other firms.

Thus, it is clear that a prospective trade sale privatisation may create a perverse incentive on management and board to stall privatisation or, at least, to deviate the process through the application of other privatisation methods. In fact, in a trade sale environment, incumbent management may see privatisation as an end-game and along the same lines the board may foresee a prestige loss. Take, for instance, the privatisation of the defence technology business QinetiQ in UK. As it can be seen in Box 2 top management was clearly dissatisfied with the prospect of the introduction of a future shareholder due to a privatisation method that involved a trade sale.

Box 2. Incumbent management and the prospect of a strategic partner

The Department believed that the introduction of a strategic partner would assist in developing the business, provide access to private capital to help fund growth and allow QinetiQ to develop a commercial track record in advance of a flotation. Sir John Egan, who was QinetiQ's chairman at the time, was unhappy with the prospect of the introduction of a strategic partner. He told us that the poor markets presented an opportunity to get the business in shape ahead of privatisation and could not see what value could be added by private equity houses or the trade partners who were likely to bid. Sir John Chisholm, who was the chief executive at the time, was also concerned about the impact of an outside investor on the future direction of the business (NAO 2007).

Thus, it is clear that there is a strong preference by managers for other privatisation methods such as public offerings (an initial public offering (IPO) or a voucher scheme) or a Management Buy-Out scheme (MBO). There are two reasons that explain the preference for these methods. First, management and board are more likely to keep their jobs ex post privatisation. As Anderson and Hill (1996) point out, during the Czech privatisation there was a strategic reliance on public offerings by inside managers who felt that dispersed ownership offered the opportunity to protect the status quo. Second, public offerings and MBOs create options for management and board to bias the privatisation process in their own favour. In other words, in such cases managers and board will inevitably attempt to use their inside information to rig the reform process to favour their economic interests. In fact, because equity is widely dispersed in public offerings, shareholders do not have appropriate incentives to monitor managers who, in turn, can expropriate investors and maximise their own utility instead of maximising shareholder value.

Moreover, if managers foresee the absence of a strategic, private shareholder to control them in the future, they may try to maximize rents before the firm is privatised. It means that privatisation will lead to lower prices and, ex post, minority shareholders will be exposed to opportunistic behaviour by poorly monitored managers. Indeed, they have ample opportunities to expropriate shareholder value, especially when they foresee that shareholder's oversight ex post privatisation will be defective and the discipline of the corporate control market very weak. The only mechanism that could limit opportunism by managers is a strong board that can claim independence from them. However, in a dispersed ownership structure ex post privatisation there may be the problem of 'constituency' boards.

In terms of management buy-out schemes, it is well known that in such methods the incumbent management would like to buy shares as cheaply as possible. While prior studies have found evidence that managers, on average, manipulate earnings downward prior to an MBO offer in an attempt to convince shareholders that their offer is fair, boards with more independent directors and higher levels of incentive based compensation for the CEO can act to discourage such manipulation.

In addition, ex post privatisation problems arise in MBOs when some managers implement their management buy-out by offering the purchased shares in their company as security for a bank loan. By taking advantage of a majority control in the company they may force the firm to repay their personal loan, thereby using company profits for their own benefit and discriminating against minority shareholders.

Thus, management may try to convince shareholders represented by the board that public offerings or MBOs are more adequate than trade sales. Take for instance the U.S, where a board, in some cases, has the power to decide if it is better for the firm to be privatised as well as the privatisation method that will be adopted. In this situation, management could collude with the advisor to convince the board to adopt a specific methodology. For instance, it may try to convince the board to use methods such as an IPO. Management may also find it easier to collude with a financial advisor, especially if it is an investment bank that has other divisions that may be interested in an IPO operation (leading, for example, to insider trading problems).

Box 3. Possible collusion between insiders and outsiders

In the U.S there was a lot of criticism after the privatisation of the United States Enrichment Corporation (USEC) during the Clinton administration. USEC's directors, led by board chairman William Rainer, approved the company's sale in June 1998 by a 3-to-1 vote (a fifth board member abstained). The privatisation took place through a public stock offering (IPO), an option drawn up by USEC's incumbent management. That plan won out over competing bids from General Atomics and Lockheed Martin to buy the company outright as well as a non privatisation option. It's no surprise that USEC's managers preferred the IPO route. Lockheed and General Atomics both had their own management teams, so USEC's senior officials were likely have been out of a job if the company had been sold to an outside bidder. Instead, at least six members of the old guard currently hold top positions at the new USEC. Also, William Timbers, CEO and president of the new and old company, requested Rainer for a waiver so he could participate in the privatisation debate, stating that he and other board members would protect the integrity of the process. Board meeting minutes obtained under the Freedom of Information Act show that Rainer authorized Timbers and a USEC lawyer to hear the ostensibly confidential presentations of competing bidders and subsequently allowed Timbers and other senior managers to critique those bids before the board. USEC's financial adviser, investment firm J.P. Morgan - which raked in more than $12.5 million in fees for its assistance -was also permitted to argue before the board in favour of management's IPO scheme.

Source : (http://www.thenation.com/doc/19991213/silverstein)

In addition, public offerings and MBOs seem to have broader political support compared to trade sales. As Anderson and Hill (1996) point out, the bias of the ministry of the Czech Republic in favour of public offerings was pronounced. This reflected a political decision to build public support for reform. In this sense, management may try to influence public opinion and trade unions to stall a trade sale privatisation.

To sum up, there is a dichotomy between the preferences of the state and management regarding privatisation methods. On one hand, the government's goal is to maximize the privatisation proceeds. To achieve such objective, trade sales seems to be the most appropriate method. On the other hand, managers see trade sales as a threat to their jobs. They can try to stall privatisation or to deviate the process through the application of other methods such as public offerings and MBOs. These methodologies create options for management and board to bias the privatisation process in their own favour.

3.3 Management incentives and privatisation's optimal design

As seen before, the advantage of methods such as public offerings and MBOs seems to focus on a higher political support regarding public opinion and trade unions. However, it does appear to be more difficult to control managers under this scenario who may try to maximize rents during the course of the privatisation process. Thus, the governance in the pre-privatisation period would depend more heavily on incentives introduced and adjusted by the board; however, in this case the problem of 'constituency' boards remains.

In fact, a board conceived as a congregation of representatives of different constituencies (often in competition with each other), will rarely play an active role in setting strategy and values. Their loyalty is likely to lie with the constituencies that have appointed them rather than with the company as a whole (Nestor, 2005).

On the other hand, sometimes public offerings will not be viable because there is no absorption capacity by domestic markets at the time of the offering. In such cases, governments may try to offset management's perverse behaviour by improving the trade sale methodology. Indeed, open bidding procedures in trade sale privatisations have evolved in response to government concerns about management and employees behaviour. Indeed, governments try to ensure that new owners will not lay off large numbers of management members and other employees. Thus, governments seek buyers with sufficient resources to invest in the enterprise, transfer know-how and increase employment. To achieve these objectives, some governments have used two-part open bidding procedures: a technical bid and a financial bid. The financial bid cannot be evaluated unless the technical bid meets the requirements of the tender. The terms of reference for the technical bid often require bidders to commit to investing capital in the enterprise over five years and to describe their plans for the workforce. If the technical bid is satisfactory, a weighted average of the technical and financial bids of all retained bidders is calculated to determine the winning bid. In this sense, the strategic partner and future shareholder can signal that managers will keep their jobs ex post privatisation. The prospect of being hired by the future shareholder gives incumbent managers incentives to restructure in the pre-privatisation period.

However, it seems easier to offset the dichotomy between government and management preferences regarding privatisations methods through the application of a mixed sale methodology. Mixed sales combine two or three sale methods to transfer the state's shareholdings to the private sector. These sales allow several types of investors to participate in the privatisation transaction. In this sense, a mixed sale can combine a trade sale, a public offering and a MBO.

These three sales methods can be combined in several ways. However, it is worth mentioning that because mixed sales are more structurally complex, their application must be carefully designed to avoid potential conflicts of interest. For instance, experience from around the world suggests that the trade sale for the strategic investor should come first and then be followed by the public offering in conjunction with the MBO. It is a given that when there is a trade sale in combination with a MBO, management and investor incentives are always aligned - they both wish to buy equity as cheaply as possible. Moreover, if the prospective buyer is a private equity and in order to satisfy their funds providers, these firms need to realise their gains within a particular time period. Management also may seek to exit the business after a buy-out privatisation because they too want to realise gains. Thus, if the trade sale and MBO are executed together it will be easier for management and investor to collude.

Governments must ensure that management will act in the best interests of the state as a shareholder, as well as to enhance the value of any future transaction. To avoid any conflict of interest, governments may find it appropriate to sell in the first stage only a minority shareholding to a strategic partner, thereby allowing it to realise the majority of any future financial gains. This measure may help to mitigate the impact of any undervaluation of the business as it ensures that the government would also benefit from the resulting growth. As private bidders also have no interest in restricting management returns as long as they are linked to their own returns, the government may consider that its interests are fully aligned with bidders in this respect.

Box 4. Two-stages privatisation

As an example, the privatisation of QinetiQ in UK was carried out in two stages – the sale of less than 40% for a strategic partner that included a management buyout scheme and a flotation on the London Stock Exchange. In addition, the government set ‘lock up’ arrangements that restricted the ability of the top ten managers to sell more than 15 per cent of their shares at the flotation and set limits on what they could sell for the following three years. This ensured that management continued to be incentivised to grow the value of the business (NAO 2007).

Another example refers to the fact that governments usually allow the prospective strategic investor to negotiate financial incentives with the incumbent management, including some of the MBO elements. The aim is to align management incentives to maximise the value of the business in the short to medium term. This may create the scope for a successful management team to make returns that are far in excess of the rewards available in the public sector. However, this is a politically sensitive issue. When management makes very large returns simply by virtue of the privatisation process, this output can turn public opinion against privatisation.

In this situation, the interests of the public sector in the privatisation process may not be fully aligned with those of the private bidders in terms of the potential scale of returns for management. If government wishes to limit the scope for such returns, then it should consider mechanisms such as capping arrangements as well as take appropriate professional advice if required. However, such mechanisms may diminish the attractiveness of the deal to potential investors. Thus, despite the fact that management should not make very large returns simply by virtue of the privatisation, there should be an employee share scheme to incentivise management to increase the value of the equity as long as the returns made by management are proportionate with the growth in the value of the business. Furthermore, it is important to note that governments should protect their interests by not allowing management to discuss incentive schemes with potential partners until the main principles have been agreed upon and a preferred bidder chosen.

Apart from initially ensuring that management is competent and has a credible business plan, the main objective of a financial investor participating in a privatisation process is to structure a deal so that management is incentivised to maximise the value of the business in the short to medium term. Typically, management will be offered the opportunity to invest personal money in an equity stake in the business. Sometimes this is structured with a ratchet mechanism that can increase the return significantly, subject to certain performance targets. The choice of target will depend on the main focus of the investor; for example, growth in equity value or growth in profitability. Moreover, financial investors usually offer share schemes for all employees with two-tier and even three-tier structures. For a more detailed example, see Box 5.

Box 5. Example of an employee share scheme

This box describes the privatisation of the defence technology business QinetiQ in UK regarding its employee share incentive scheme. The firm's privatisation was carried out in two stages – the sale of part of the business for a strategic partner including a MBO scheme and a flotation on the London Stock Exchange. The final share incentive scheme comprised four elements targeted at different groups of staff and is detailed below:

1. All employees received forty, free share options that were exercisable from the flotation onwards;
2. All employees could choose to invest a minimum of £500 in the co-investment scheme. This scheme was structured on the same basis as the shares held by the government and the strategic partner that consisted of non-voting redeemable preference shares and ordinary equity in a ratio of 9:1;
3. The top 245 senior managers were given the opportunity to invest in ordinary equity that benefited from a performance ratchet; and
4. The top 10 managers were given the opportunity to invest in ordinary equity that benefited from a double performance ratchet:

The first ratchet: This represented an additional allocation of 5.05 per cent of ordinary shares to the top ten (2.75 per cent) and the top 245 (2.30 per cent) senior managers if the value of strategic partner's and government's investment increased at flotation by more than three times and achieved an internal rate of return of 30 per cent.

The second ratchet: An additional 2.53 per cent of ordinary equity was allocated to the top ten senior managers if the value of strategic partner's and government's investment increased at flotation by more than four times and achieved an internal rate of return of 40 per cent.

It is worth mentioning that the board has an important role to play in safeguarding shareholder interests. This role is to limit insider expropriation and effectively monitor and incentivise managerial performance. Their participation in employee share schemes, however, could lead to a perception of a conflict of interest in that non-executive directors may anticipate the possibility of making significant financial gains. Clearly, any such expectation has the potential to create conflicts of interest. As there is no specific guidance to prevent non-executive directors from participating in share ownership schemes put in place as part of a privatisation, government should ensure that they are not offered an opportunity to participate and thus avoid any perception of a conflict of interest.

To sum up, it seems that a well designed mixed sale is more appropriate to offset perverse management incentives while allowing the government to realise the majority of any future financial gains due to privatisation.

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