Recent Trends in Privatisation

Although the current wave of privatisation reflects changes in economic thinking and economic policies that have been gathering force for nearly two decades, privatisation programmes are now larger and being pursued in a larger number of countries than ever before. Even in the 1980s, as policy-makers increasingly concluded that governments should emphasise a small number of "core" activities which inherently belong to government (maintenance of public order, defence, market regulation, etc.) while leaving a greater number of decisions concerning resource allocation to the private sector, attitudes toward public ownership only changed slowly - at least within OECD countries. There were, however, two main exceptions. First, in 1979 the British government embarked on a far-reaching effort that lasted through the 1980s and during which nearly all state-owned enterprises in the competitive sector were privatised. In later stages, public utilities, and to some degree activities involving government services, were privatised. The United Kingdom by its persistent action over a decade created a framework for the planning and execution of privatisation programmes in an advanced industrial economy with well-developed capital markets, which would sever as a model for other countries at later times. Second, in 1986-87 the French government undertook a large-scale privatisation effort that was planned to last through 1991. This effort, which followed an earlier large-scale programme of nationalisation, was discontinued following the change in government in 1988.

It is worth mentioning that in the late 1980s, privatisation was pursued far more vigorously by developing countries than by OECD countries, usually as part of broader programmes of stabilisation, deregulation, and structural reform. These programmes, often implemented with the support of the IMF and the World Bank, sought to substitute market discipline for the previous static-protectionist development regimes, which were seen as having led to unsatisfactory economic results. Similarly after 1989, the post-Communist countries of Central and Eastern Europe concluded that privatisation was essential for successful transition to market economies.

This current period of rolling back state ownership in the economy follows a long period in the post-war years, when the government in many countries expanded its role in the economy through public ownership and control. Several motivations appear to have played a role in this change of policy attitudes:

• First, policy makers and academics have slowly become convinced that **state ownership tends to lower internal efficiency of companies in product markets**. While it had generally been recognised that privately owned companies were more efficient than publicly owned enterprises, academic studies from the 1970s and early 1980s tended to conclude that it was the lack of competition and the sectoral concentration of public companies, and not so much the ownership structure, which explained the differences in efficiency between private and public owned companies. However, most of these studies were based on a comparison of cost between different companies in public and private ownership, and more recent studies, which have looked at the same company before and after privatisation have demonstrated the emergence of significant efficiency gains.

• Second, the general process of **internationalisation and economic integration of economies has made cross-border mergers and acquisitions and strategic alliances all the more important**. In particular, this may be the case in sectors where agreements have opened up scope for international competition, perhaps most notably in telecommunications and air transport. In this respect, privatisation is important for two reasons. First, relieved from the restraints of government budget financing, privatised companies may be more free to target new business areas and to make new investments by tapping directly into the capital market. Second, private companies may be more willing to undertake joint ventures with an enterprise that is not state owned.

• Third, a specific aim of most privatisation programmes is to **widen share ownership** and to **create a "share holder" culture** in the population at large. A closely connected motive is the development of further expansion of capital markets. In particular, large scale privatisation should lead to increased capitalisation, to more liquid markets, and to closer scrutiny of companies by the capital market.

• Fourth, governments are increasingly coming under **budgetary strain**. In this respect, the privatisation of state companies is attractive by removing the need to transfer resources to companies running deficits and/or by generating revenues from the sale of companies. However, by selling off companies, the government gives up the future dividend stream from these assets, leaving the net effect on government wealth difficult to assess. Also, it is crucial that the proceeds from privatisation are not utilised to relieve pressure for taking measures against structural budget deficits.

An often raised question is **how far can privatisation go**? It is now a widely held view that the government should generally not be the owner of companies in competitive sectors, such as industry or financial services. The opinion is more divided when it comes to the supply of public services, such as energy and transport. Some would argue that these sectors are natural monopolies which should be government owned in order to avoid the abuse of monopoly power. Others would maintain that, given a right regulatory framework, there is no reason why these sectors should not be privately owned. In part reflecting this difference in thinking, public ownership of utilities varies markedly across OECD countries. It should also be noted that the issue of public ownership and privatisation is part of the wider discussion on corporate governance.

The **term privatisation** is not always **precisely defined**. In this paper, privatisation is considered to be the full or partial transfer of ownership of public assets to the private sector. In recent years, there has been a sharp rise in activities which may be viewed as closely related to privatisation, such as contracting-out, franchising, and leasing. Other areas not considered here are private finance for infrastructure projects, which in some countries is becoming of growing importance, and mass privatisation.

Global privatisation in 1995

In 1995, the estimated amount raised globally from privatisation was some $ 62 billion, down from $ 69 billion in 1994. Privatisation offerings by OECD countries amounted to $ 46.8 billion in 1995, as compared with $ 51.6 billion in 1994.

In the OECD area, the largest amounts raised in 1995 were in Australia ($ 9.4 billion), Italy ($ 7.2 billion), and France ($ 5.7 billion). Developments varied significantly across the area, with some Member countries experiencing a market set-back to their initial privatisation programmes while privatisation actively picked up in other countries. In particular, the sale of government companies in some European countries proved to be difficult and privatisation fell short of expectation, with the aggregate volume of privatisation in Europe posting a decline from some $ 42.5 billion in 1994 to $ 33 billion in 1995. By contrast, vigorous privatisation was undertaken in a number of OECD countries outside Europe.

Privatisation methods

The choice of privatisation methods depends on several factors such as, for example, the state of development of the domestic capital market and the need for restructuring of the company being privatised. Generally speaking, a deep national capital market and a company with little need for restructuring will favour a **public offering**. As these two conditions are generally met in the OECD area, it is not surprising that a public offering with sale of equity in the capital market to investors has normally been the preferred method of OECD privatisation, either in the form of an **Initial Public Offering (IPO)** or through a **secondary offering**.

In the OECD area, the amounts raised by IPOs and secondary offerings have traditionally been around twice as large as the amounts raised through **trade sales and other methods of privatisation**. However, primarily as a result of a drop in public offerings, trade sales and other methods of privatisation accounted for a somewhat higher share of total privatisation in the OECD in 1995. Presumably, the decline in public offerings reflected the weak performance of some stock markets in countries with large privatisation programmes.

In establishing the offer price, privatisations in OECD countries - as well as elsewhere - increasingly utilised **book-building**, where investment bankers engage in an extensive dialogue with possible investors in order to determine the amount of equity that is likely to be purchased at various prices. While the book is being built, the replies given by investors on price and quantity are only indicative and do not constitute firm purchase orders. From the sellers' point of view, this implies risks to be considered when opting for book-building. First, the investment banks which are managing the offerings may from the outset have miscalculated the extent of demand for the issue. In this situation, the government may have to reduce the price and/or the size. Alternatively, the offering may be withdrawn. Second, even if demand is correctly gauged, serious adverse developments may occur during the phase of book-building, again leaving the government with less revenue than expected. This uncertainty about the funds eventually raised from the offering may to some extent be alleviated if the issue is fully or partly underwritten at a certain minimum price. The process of price determination involves a dialogue with institutional investors but, in principle, the method could also be used to determine the offer price on the retail tranche.

Another privatisation method is **fixed-price underwriting** where a group of investment banks underwrite the equity at an initial (fixed) offer price and where (usually) heavy trading subsequently takes place. Previously, many privatisations used fixed-price underwriting, but now book-building is clearly dominating. The reason for this development is that book-building normally leads to a markedly smaller premium between the offer price and the price in the market immediately after privatisation (*i.e.* to less underpricing) and to less earnings for managers of the deal.

In recent months there has been a number of privatisations in the United Kingdom, and subsequently in France, done through **block-sales or bought deals**. Following a competitive bidding process, a block of shares are sold to an intermediary, which subsequently places the shares in the market. The key to a successful block sale is to take the market by surprise. Thus, the time from when the bidding process begins to when the shares are placed in the market is just over 12 hours. This method has proven cost-effective for the sale of small residual government holdings of equity in previously privatised companies.

Generally speaking, capital markets in countries outside the OECD area are less developed that in OECD countries, which presumably should limit the possibility for privatising through public offerings. Also, in selling off companies, governments in non-OECD countries will often actively be seeking a foreign strategic investor who will bring know-how and increased efficiency to the company sold and to the economy in general. This being said, it is all the more striking that privatisations in non-OECD countries have roughly the same distribution between public offerings and trade sales as is found in OECD privatisations. Strong interest on the part of international investors in privatisation offerings in many non-OECD countries must be seen as a major explanation for the relatively large amounts raised through public offerings in these countries. Also, the use of a public offering has the attraction that the privatisation operation may act as a catalyst for the development of the domestic capital market.

Some offerings by non-OECD countries have included the listing of **depository receipts** that represent evidence of ownership of underlying shares, but which remain in custody with a bank in the domestic market. Depository receipts have several attractions. In some cases, they are a way to overcome general restrictions on direct foreign involvement in the national market. In other cases, where capital markets are in their infant stage, depository receipts are essential in providing market infrastructure, such as reliable clearing and settlement.

Privatisation by sector

In recent years, the sectoral distribution of privatisation has changed markedly. Back in 1993, global privatisations were roughly equally distributed between industrial, telecommunication, financial, and other sectors. Since then, privatisations in the financial sector have generally been declining. By contrast, industrial privatisation rose significantly in 1994 and remained at the same level in 1995. However, the share of industry in global privatisations is expected to fall in 1996.

Undoubtedly, the single most interesting sector is **telecommunication**. Looking briefly at the background, there has been a marked trend in both OECD countries and elsewhere towards liberalising market entry for basic telecommunication services and infrastructure. Two developments stand out as notable shifts in telecommunication policy. First, the move to eliminate monopoly restrictions on service provisions and, second, the increasing consideration being given to partial privatisation of incumbent monopoly operators and at the same time allowing new entry for facilities-based operators. Countries that for some time have allowed more competition in telecommunications include the United States, the United Kingdom, and Sweden. Also, the European Union has passed legislation which will increase competition in the years ahead.

The opportunity for investing in a sector previously closed and the notion that the sector represented either a stable investment with solid earning growth (in mature markets) or a high-growth stock (in emerging markets) have both worked to make telecommunication stocks look very attractive in recent years. However, in 1995, equity prices for the sector generally performed poorly. At least two factors seemed to have played a role. First, uncertainty appears to have risen, with investors increasingly raising questions about the future impact on the sector coming from deregulation, new technologies, and competition from new entrants. Second, equity prices were affected by the large number of privatisation offerings in 1994 and 1995, and by the prospect of even more issuance in 1996.

The **market share of telecommunication privatisations** amounted to some 19 per cent in 1995, down from some 28 per cent in 1994. In value terms, telecommunications privatisations dropped from 1$ 19.5 billion in 1994 to $ 11.7 billion in 1995. This year, telecommunication privatisations are expected to reach $20 billion and a market share of some 23 per cent. The declining share of telecommunications in total privatisations is explained by the very rapid growth in privatisations in other sectors, which mostly cover utilities and transport (including air transport), and which is expected to account for almost half of global privatisations this year.

The explanation of these shifts in relative importance of various sectors can be found in what could be called **"the life-circle of a privatisation programme"**. Thus, the declining share of privatisation in the financial and industrial sectors reflects the fact that most governments tend to sell first those companies which least need fundamental restructuring and those in competitive sectors, *i.e.* financial and industrial companies. Later in the privatisation programme, governments will privatise in sectors which require more restructuring and often the adoption of a regulatory framework, such as public utilities.

Impact on capital markets

In the years ahead, the implementation of current privatisation programmes will result in a significant **increase in equity market capitalisation** and to **higher market liquidity** both in the OECD and elsewhere. Also, the practice of listing some of the major privatisations on more than one exchange should contribute to the **internationalisation of equity holdings** and to the **globalisation of stock markets**.

An important question is **how this flood of new equity issues coming from privatisation will be absorbed by the market**? In this respect, it should be emphasised that, with an unchanged government financing need, a privatisation offering will increase the supply of equity while at the same time reducing the supply of government bonds. With a high level of substitution between these two types of assets, capital markets should, in principle, be able to absorb the equity offerings without major effects on either equity prices or interest rates. Fundamentally, the level of substitution depends on the ease and willingness of investors to switch from holding bonds to holding equity. Also, notwithstanding that expected privatisations are huge in absolute terms, they still constitute a relatively small fraction of equity market capitalisation and of aggregate savings. On the other hand, even though the level of substitution may be quite high in aggregate terms and privatisation offerings are relatively small compared with capitalisation savings, it should be noted that privatisations are expected to be concentrated in relatively few industries and countries so that there may be noticeable sectoral - and perhaps even country - effects.

In recent years, virtually all OECD countries as well as many countries elsewhere have taken steps to **upgrade market supervision** and to **modernise domestic securities markets**, which should facilitate the absorption of the large privatisation offerings. Most OECD countries have, for example, taken or strengthened legislative action to define and penalise insider trading. These legislative moves reflect the increased concern among investors and other market participants over the damaging of cases of insider trading. It is also crucial to continue to promote the growth and involvement of institutional investors. In those countries where the institutional investor community is still in its infant stage, governments will have to consider measures to secure its growth. Steps towards a strengthening of the institutional market - and increasing the absorptive capacity of equity markets - could include a deregulation of the rules governing investments by institutions (especially insurance companies and pension funds) which at present often constitute a semi-captive market of domestic fixed-income securities.

With increasing **concern among citizens about the adequacy of public-sponsored retirements**, many individuals are taking out private pension plans as a supplement. The wide-reaching overhaul of the entire pension system in some countries and the growth of private pension funds should result in more demand for equity. However, in those countries where private individuals traditionally have preferred investing in bonds, governments may have to more actively promote the idea of equity investments. In this context it may be noted that there is evidence to suggest that historic returns on equity have been higher, and that a large number of private investors have discovered the professional management available through instruments for collective investment.

Privatisation and investors

A fundamental question is **what makes privatisation offerings attractive to investors**? The answer to this question appears to have several facets:

• First, investors normally make an immediate gain. In an initial public offering, **privatised companies are ordinarily underpriced**, *i.e.* the equity price in the fist days of free trading is higher than the offer price. It may be noted that this underpricing is generally found also in equity offerings by private companies. However, there is evidence to suggest that privatisation offerings have been sold at an even higher discount. Some researchers estimate that after considering the normal private sector discount, privatisations in the United Kingdom and France have, on average, been launched with an additional discount of around 10 per cent. One explanation for this is that the government underprices in order to signal a political commitment to - and to develop broad support for - the entire privatisation programme. Concerning secondary tranches in companies already trading on the stock exchange, it is normally the case that the offer price is set below the prevailing market price.

• Second, and probably more importantly, there is some evidence to suggest that over the long term **privatisation stocks have tended to outperform the market average**. The above average rise in equity prices of companies following privatisation reflects that efficiency gains appear to have been larger than investors and analysts expected before privatisation. A case in point here is the efficiency, profit, and equity price performance of privatised public utilities in the United Kingdom.

• Third, privatisation offerings are often huge compared to the existing domestic market, meaning that they will constitute an important part of the market index. Thus, investors seeking to track the index will be obliged to purchase the equity. Also, privatisation has in some cases opened up avenues of investment in sectors that hereto had been closed. Again, an investor seeking **to "buy the index"** or **to pursue a sector investment strategy** will purchase these shares. These arguments are mostly relevant for large institutional investors and much less so for retail investors.

• Fourth, **for retail investors**, privatisation offerings of equity have come with several special attractions not available to institutional investors. These **extra "incentives"** seek to secure a wide distribution of shares among the general public and aim to motivate the retail investor not to sell the stock right away. Thus, the offer price for retail investors is usually set below the price for the institutional tranche. Other features used in the retail offering have included bonus shares, if the equity is retained for a specific period, and partly paid shares, where full payment is made in several subsequent instalments. There have also been offerings where the investor was entitled to a price reduction on the services provided by the privatised company. Finally, within certain limits, retail investors have been insured against future price falls. All these extra incentives have supported the marked rise in the number of individuals owning shares in many countries.

• Fifth, privatisation operations have in many cases involved the **offering of shares to employees at a reduced price**. In Germany, for example, each privatisation package has, so far, included an offer of shares to employees at favourable conditions. Employee shares are seen as a means to support the privatised entity.

So, there are a number of good reasons why privatisation offerings have generally attracted a lot of investor interest. However, not surprisingly, there are also special risks. Most importantly, there is the risk that the government continues to interfere in the management, strategy, and general working environment of a company even after privatisation. This risk is often referred to as **regulatory risk**. Naturally, investors' assessment of this risk will influence the price that can be obtained from the privatisation.

When discussing regulatory risk it may be useful to **distinguish between privatisation through public offering or by means of a trade sale**. In a trade sale, the investor will normally be interested in buying control of the company. A residual government share will ordinarily only be acceptable if the issue of control is clearly defined. By contrast, in a public offering, the investor is making a portfolio investment and is not seeking control over the company. In this case, the important issue is the extent to which investors are convinced that the company will behave as a private sector company, notably seeking to maximise profits, and that the strategy of management is viable.

Another **important distinction is between privatisation of companies in already competitive sectors and privatisation of public utilities**. For companies in competitive sectors there are, in principle, no reason why the government should interfere in the management of a company after privatisation. This being said, the government may still face a problem with convincing investors of that the company will, in fact, be free to operate on market terms and, if investors remain unconvinced, then there may be a price impact. In this connection, the structure of privatisation offerings has been widely debated. On the one hand, it has been claimed that privatisation structures where the government retains large, perhaps even a majority, stake have to be priced at a discount in order to compensate for the risk of government interference. Also, as noted above, some investors have been concerned with the existence of a stable core which has been considered as an indirect way for the government to keep control of the privatised company. Furthermore, the existence of a "golden share" has been seen as an opening for government interference in certain situations. On the other hand, other observers have argued that the credibility of a government's pledge not to interfere depends more on other factors, such as the governments general private sector policy, a clearly stated objective of full privatisation, a well-defined exit schedule, and its track record in previous privatisations, than on the structure of the offering in itself. This being said, it would appear that some structure draw more attention to the issue of regulatory risk than others.

For privatised companies in **sectors such as utilities**, where it is clear from the beginning that the company will continue to be regulated, the **situation is more complex**. In order to alleviate the problem of regulatory risk, the government will try to increase the credibility of its promise not to interfere, for example by having a clear regulatory framework with a regulator independent of the government. Nevertheless, the government may have an incentive to try to tighten regulation or taxation if the company performs unexpectedly well after privatisation. Knowing this, investors may require a discount. Thus, on the one hand, it may be argued that privatised companies in these sectors carry more regulatory risk than companies in general. Furthermore, it would seem that this type of risk increases when the privatisation programme is completed or as it draws to an end since the government will become less concerned with the successful sale of remaining companies. On the other hand, some utilities provide essential services and may be seen as too important to fail. If so, this will work to reduce the risk taken by investors.

Of course there is, as with any other investment, the **risk that the price falls below the purchase price**. For the prospects for the privatisation programme, this is, however, not a trivial point. Many of the retail investors have never owned equity before they buy into the privatisation offering and they are, generally speaking, not as “professional” investors as the large institutions. For the institutional investor, the most important parameter is the relative price development of privatisation equity. By contrast, many retail investors are concerned with the absolute price development. The lukewarm reception of several recent European privatisations by retail investors must be seen in this light.

The **relative importance of institutional investors and retail investors in privatisation offerings** has been extensively discussed. Some observers have argued that, in line with the general trend in capital markets, institutional investors are becoming increasingly important while the role of retail investors in privatisation is diminishing. However, other have argued that retail support will remain of paramount importance for successful privatisation offerings. In particular, it is held that strong retail investors demand is crucial in creating sufficient price tension between the different categories of investors, and that institutional investors will in some cases only come into an offering when they are confident that there is substantial demand from the retail side, thus promoting a liquid aftermarket. The creation of price tensions is often cited as one of the main reasons for giving special incentives to retail investors. A substantial retail tranche will also remain important for other reasons. Thus, the wide retail distribution of many privatisation offerings should be seen as an instrument for familiarising the public at large with equity investment. Over time this could lead to an increasing interest in mutual funds and other similar vehicles for private equity investment.

There is some evidence that **privatisation offerings are increasingsly being placed internationally**. In the OECD, some 50 per cent of privatisations brought to the market last year were sold to international investors as compared with 34 per cent in 1994 and 33 per cent in 1993.

Based on the preliminary data available for 1996, international placement is expected at around 40 per cent of offerings.

The explanation for the exceptionally high share of international placement last year is most likely the rather lukewarm reception by domestic investors, in particular on the retail side, to many important privatisations which left more of the offerings to international investors. More long-term factors that are promoting international placement include the fact that governments are becoming less concerned with selling minority or even majority stakes in domestic companies to foreigners. Also, as time passes with no major interference, governments' pledge not to discriminate against foreign investors is becoming more credible. Thus, as international investors have increasingly become convinced that governments do indeed welcome foreign investors, they have been more willing to invest in overseas markets. More generally, according to portfolio theory, **investors are increasingly seeking to diversify their investment** which implies greater emphasis being put on foreign securities in asset allocation.

Looking ahead

Given current plans and the number of companies deemed ready for privatisation, global volume of privatisations is expected to amount to some $ 85 billion in 1996. If achieved, this would represent an increase of $ 23 billion as compared with 1995. However, it should be emphasised that the figures for 1996 are best estimates, which may change as a result of several developments, such as changing market conditions, the need for more or less restructuring of companies than originally thought, or a change in government and political priorities. This caveat is, in particular, relevant for non-OECD countries, where the estimates for 1996 are markedly less reliable than for OECD countries.

The amount raised from privatisation in the OECD area is expected to reach $ 60 billion in 1996 as compared with $ 46.8 billion is 1995. European, and indeed global, privatisation activity in 1996 will be dominated by the offerings planned in Germany. The estimated amount to be raised from German privatisations is some $ 17 billion, with the bulk coming from an offering of equity in Deutsche Telecom, which is expected to raise up to $ 19 billion. This offering will take the form of a new share issue by the company. So although the government will not sell any of its shares in Deutsche Telecom, the stake of the government will be diluted. In France and Italy, which both have undertaken large privatisations in recent years, the expected amounts are $ 4.5 billion and over $ 6 billion, respectively.

It is evident that unless governments are willing to accept low sales prices, equity markets will clearly need to be strong in order to support the large amount of new equity. In the first four months of the year, stock markets have rallied in several of the countries with large privatisation programmes in 1996. In light of this, and considering the present macro-economic environment, it seems reasonable to assume that the near future will continue to entail favourable conditions for markets' reception of new equity offerings. However, this will not only attract public offerings by governments. Privatisation offering will increasingly have to compete for funds with private corporations, which will also be considering issuing equity. Indeed, recent months have witnessed several large offerings from private companies, in particular in Germany, Swede, the United Kingdom, and the United States.

Given the current plans, the amount raised from privatisation in non-OECD countries could increase from $ 15.5 billion in 1995 to $ 25 billion in 1996. In particular, a sharp rise in offerings from South America is expected to be a major driving force behind this substantial increase in estimated non-OECD privatisations. However, in view of experience thus far this year, governments in these countries will have to intensify their privatisations efforts considerably if the ambitious targets for 1996 are to be achieved.

In line with the trend of recent years, telecommunications should remain the most important single sector in 1996. Several countries are expected to bring telecommunications equity to the market, and global offerings in this sector are expected to rise from $ 11.7 billion in 1995 to some $ 20 billion this year.

In spite of the recent rises in many stock markets, some countries are in the situation that if they sell a second tranche in a company they will have to do so at a price significantly lower than the price for the first tranche. It is not certain that original investors, perhaps in particular retail investors, will look kindly at such an offering.

In response to this, some countries are reportedly considering issuing privatisation-related convertible bonds instead of equities. This would give investors a minimum return while keeping the upside on equity price developments.

Looking at investor interest, the factors described above that are making privatisation offerings appealing should continue to work in 1996. This should, in particular, be the case as some of the stock markets that performed less well in 1995, and where there are large privatisations expected, appear to be picking up. Probably the largest cloud on the horizon is the sheer amount of new privatisation equity coming to the market. Under these circumstances, the timing and size of the offering both in relation to the market situation, in general, and in relation to other offerings, in particular, will become even more significant.