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Privatisation in Belarus: Improving the Implementation Framework

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Privatisation in Belarus: Improving the Implementation Framework

Executive summary

In 2007 the authorities recognized the huge importance of privatisation for restoring external stability and for promoting investment and efficiency in the country. As a result, in 2007 and 2008 several privatisation deals took place and necessary legislative steps were taken. But with the arrival of the international financial crisis to Belarus at the end of 2008, the privatisation process came practically to a standstill. Without doubt, the present situation regarding privatisation cannot be considered as being satisfactory.

The current standstill can partly be explained by external factors, i.e. by the international financial crisis. But domestic factors also play a major role. The strategic decision not to sell assets "under value", i.e. at prices below those observed during the recent asset price bubble, is at best debatable. But also significant implementation obstacles for conducting privatisation deals are to be blamed for the current lack of progress. In this paper, we focus on such obstacles.

Four major implementation obstacles can be identified. First, potential buyers face a multiplicity of counterparts from the side of the authorities, with no clear distribution of labor between them. As a result, negotiations are complex and require a lot of time and money. Second, there is a clear lack of professional experience at the government, a fact which also makes negotiations more difficult. Third, the authorities seem to focus too heavily on the book value of companies while formulating the lower bound for the price of an asset. As a result, potential and truly interested buyers are confronted with unrealistic prices, which bear little correspondence with reality, i.e. with the market value. Fourth, lots of strings are attached to privatisation deals, concerning the level of employment, investment and sustention of social infrastructure.

In order to improve the situation these obstacles need to be removed. A crucial step involves the creation of a new privatisation agency. We support current government plans in this respect. At the same it should be noted that the new agency needs wide ranging competences and a high degree of operational independency in order to be effective. Furthermore, the goal of (greenfield) investment attraction, which is also to be pursued by the new agency, should not overshadow the goal of conducting privatisation deals. Regarding the price resp. the valuation of companies, methods based on expected cash flows seem much more appropriate than book values. Last, the authorities should restrain from overloading the investors with a wide range of economic and social obligations.

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1. Introduction

After noticeable progress in 2007, the process of privatisation came to a standstill at the end of 2008, with only a few exceptions. This standstill is highly problematic, since privatisation is a prerequisite for the necessary restructuring and modernisation of the Belarusian economy, which is still widely dominated by state conglomerates.

Without doubt, the arrival of the global financial and economic crisis to Belarus played an important role for the lack of progress. During the crisis, the appetite of companies for new acquisitions as well as the readiness of banks to finance new deals decreased dramatically. But in our view, also domestic factors are partly responsible for the standstill. While the macroeconomic response to the economic crisis, consisting mainly in a restrictive fiscal policy and the devaluation and flexibilisation of the Belarusian Ruble, was highly appropriate and successful, the policy reaction regarding privatisation was less appropriate. The unwillingness of the authorities to sell companies "under value" is highly questionable, since the inflated prices of 2007/2008 will certainly not come back for many years and should thus not be used as a benchmark. Furthermore, the highly appropriate instrument of pre-privatisation has not been used so far. Consequently, as we extensively explained in a recent policy paper¹, also the inadequate privatisation strategy pursued the authorities is to blame for the lack of progress.

But also a further domestic factor seems to be responsible for the low number of privatisation deals. There is evidence, as shown by complaints from foreign companies, that the actual implementation framework regarding privatisation is far from being perfect, thus preventing substantial progress. The relevant conditionality in the recently expired IMF stand-by programme regarding the establishment of a privatisation agency, the adoption of a privatisation law and the transparent execution of a number of privatisation deals seems to support these observations.

This paper tries to address these implementation issues. Specifically, it provides answers to the most pressing questions policy makers currently face in this field: What are the necessary steps to be taken by the authorities to remove existing obstacles? How should the framework be changed to achieve a transparent, competitive and professionally executed privatisation process?

The paper is organized as follows: In the second chapter we present an overview of recent activities in the process of privatisation. This will mainly deal with developments during 2007-2010. The following chapter 3 tries to identify key implementation obstacles for privatisation transactions. The analysis will concentrate on a selected number of issues, which in our view are the main obstacles for increasing the number of transactions. Chapter 4 presents our policy recommendations on how to improve the implementation framework. The final chapter 5 concludes.

¹ See our Policy Paper PP/02/2009 "Privatisation in Belarus during the Global Financial Crisis: No Time to Lose".

2. Overview of recent privatisation record

2007

The year 2007 can be considered a major turning point in the attitude of the authorities towards privatisation. Faced with a number of external challenges, policymakers pursued a policy of selective privatisation that was targeted at attracting foreign currency inflows, necessary to finance the growing current account deficit. This was accompanied by a clear change in the rhetoric of the authorities, who made privatisation an important goal of economic policy.

As a result, a sudden increase in privatisation deals and revenues took place. While in 2006 total revenue from such transactions amounted to a mere USD 0.03 m, the corresponding number for 2007 was USD 1.2 bn. Furthermore, the foundation for significant further privatisation revenues arriving in the following years was achieved through the sale of 50% of shares of "Beltransgaz" to Russian "Gazprom" for USD 2.5 bn. This deal was structured in a way that payments of USD 625 m are to be made every year between 2007 and 2010 (in total USD 2.5 bn)

As a result, while in 2007 no privatisation of large Belarusian enterprises on a massive scale took place, this year must be considered a very promising start.

2008

The beginning of 2008 saw a continuation of the newly gained momentum in privatization. A three-year plan of privatization of state property for 2008–2010 was adopted² in 2008. It assumes the corporatisation³ of 519 enterprises and the following privatisation of 147. However, while in 2008 the corporatisation of 158 enterprises occurred, the shares of only two (!) of them were finally sold.

This apparent difference between plan and execution can be blamed partly on the arrival of the global financial crisis, which put naturally a brake on many transactions in the wider region. At the same time, the government showed clear signs of being unwilling to sell state enterprises at lower prices than were achieved before the crisis. Lowering their price demands in response to the crisis and the drop in valuations did not suit the Belarusian authorities. As a result, few noticeable transactions took place, and the privatization proceeds amounted to USD 0.9 bn for the year 2008, which is significantly less than the amount in the previous year. Excluding the annual

² Presidential Decree No 7 from 14 April 2008.

³ Corporatisation refers to the legal transformation of state-owned unitary enterprises into "Joint-Stock Companies" (JSC). The state remains the sole owner of the enterprise after the change in its legal form; however, this might be considered a first necessary step in the process of (material) privatisation.

payment of USD 625 m for the sale of Beltransgaz agreed in the previous year, the only major transaction that took place was the sale of the mobile operator "BeST" for USD 266 m⁴.

2009

The standstill in the process of privatization continued in 2009, as the authorities refrained from selling major assets, despite significant external pressure. This pressure came mainly from two directions, and for different reasons: While Russian companies were interested to gain access to strategic sectors of the country, the loan agreements with the IMF and the World Bank included relevant conditionality in terms of laying the foundations for a broad-based privatisation programme.

Privatisation proceeds in 2009 amounted to USD 1 bn, a roughly similar figure to the previous year. But once again, one must keep in mind that this amount includes the USD 625 m tranche for Beltransgaz due in that year. At the same time, a new trend appeared at the end of the year – the possibility of lower price demands for specific assets to be sold. Despite repeated statements by the authorities to sell BPS-Bank for USD 500 m, this deal brought only USD 280 m, which shows increased flexibility from the side of the state.

2010

In 2010, Belarusian authorities declared their plans to earn about USD 1 bn from privatisation deals from foreign investors, i.e. a figure similar to the disappointing 2009 results when accounting for the Beltransgaz deal. As of now, the only major transaction that took already place was indeed the payment of the last tranche for Beltransgaz (USD 625 m).

The main declared reason for the privatisation of some public enterprises -apart from the obvious needs for covering the current account deficit- is the intention to cover the budget deficit, which could reach nearly USD 900 m this year according to forecasts (1.5% of GDP). Currently, about 118 enterprises are in the process of corporatisation, according to the State Property Fund of Belarus. At the same time, the declared objectives for 2010 should be taken with a certain degree of caution, as the government can introduce adjustments to the privatisation process at any time. Reluctance of the authorities to increase the public debt further or new negative shocks regarding the conditions of Russian oil and gas imports may actually intensify the processes of selling strategic companies to (foreign) investors. If the currently optimistic expectations of the government on improvements in the external trade conditions in major export markets of the country do not materialise, foreign investors probably will be offered a larger number of enterprises on more favorable terms. However, in February 2010 the President made it clear once

⁴ The final price for the sale of 80% of the shares of "BeST" was actually USD 500 m. However, the company had a credit debt outstanding to China that amounted to USD 234 m. Due to the changes in legislation, payment for this credit was included in the final price of the BeST sale. Therefore, the amount actually received for 80% of BeST shares was only USD 266 m.

again he considers selling further state property only as a last resort and only at a very high price. Thus, the standstill observed in the previous year seems to continue.

Assessment: The rapid increase in privatisation activity during 2007-2008 in comparison to the previous years came to a sudden standstill with the arrival of the global financial crisis to Belarus. Since the end of 2008, the process of privatisation is basically put on hold, and only very few new deals are agreed. It is crucial for the authorities to bring new momentum to the process.

3. Implementation obstacles for privatisation transactions

The key implication from the last chapter is how the privatisation process can be revived. One direct recommendation is that a fundamental change in strategy is needed, i.e. the authorities must rethink their policy to insist on inflated, pre-crisis asset prices and use the instrument of pre-privatisation more actively. We have dealt with these issues in our previous policy paper.

At the same time, the removal of implementation obstacles is of crucial importance. The current framework for carrying out privatisation deals is highly problematic and in many cases prevents the conclusion of successful transactions deals, as experienced by a number of interest companies from abroad. While the "boom" years of 2007 and partly 2008 were to some extent hiding these underlying weaknesses, they appear during times of crisis in full force.

In the following sections, we identify 4 key obstacles for the implementation of a broad-based, fair, transparent and professionally executed privatisation process in Belarus.

1) Institutional aspects

Institutional aspects can be broken down in two different, but interrelated problems:

The first problem deals with the current multiplicity of counterparts for potential buyers. Interested potential investors are usually surprised by the number of different state institutions and counterparts in charge of privatisation and the apparent lack of clear distribution of competencies and coordination between them. Examples of such institutions are the State Property Fund, the Presidential Administration, the respective Ministry, concerns, regional and local governments, the employees and the management. The resulting effect on potential investors is often a state of confusion as there is usually no clarity on whether commitments from counterpart 1 are also valid in negotiations with counterpart 2 and so on. Furthermore, talking to these institutions costs a lot of time and money, and thus raises transaction costs.

A second problem relates to the extremely limited competences for the institution formally in charge of privatisation, namely the State Property Fund. In particular, the lack of competences for

taking final decisions, even for very small deals (the limit is currently USD 116,000) is worrisome. As far as bigger transactions are concerned, under current legislation, the decision to sell state property which cost more than USD 116,000 (10,000 basic units) shall be taken only after consultation with the Presidential Administration. For investors, the result often is that after long talks with the formally responsible partner, a new institution (Presidential Administration) enters the negotiations, and a situation as described above (several counterparties, delays, contradictions) develops.

2) Lack of professional experience

Due to the lack of progress in the implementation of broad-based privatisation in the past, the circle of experienced government officials is naturally very small. Since the relevant state institutions have relatively little competencies, this is a negative factor for attracting qualified people and institutional capacity building in general. This implies there are relatively few competent counterparts for foreign investors available, which are able to deal with such complex transactions according to best international practices.

3) Valuation framework

Another reason for the lack in progress in privatisation is the frequent disagreement on the asset price between state and potential buyer. While a certain disagreement on the asset price between the authorities and investors is rather natural, given the different interests of both parties, this should not be due to different concepts of valuation. Specifically, the Belarusian authorities insist in their price negotiations on the application of valuation techniques that use the book-value⁵ of the assets, and do not take any forward-looking information into account. In fact, the book-value is considered a legal minimum price during negotiations. At the same time, investors who are interested in enterprises as a going-concern, are mainly interested on the expected future cash-flows of the enterprise, and base their price suggestions on this value, after adjusting for the risky operating framework in Belarus.

In general, using the book value as a proxy or at least as a lower bound for the market value (i.e. showing the liquidation value of the company) can be justified for broad orientation purposes, since book and market value can be indeed related. However, there are many cases where huge differences between the two concepts arise, especially when book values are grossly inflated and do not correspond to the ability of the company to generate future earnings and growth. Severe problems with local accounting and valuation standards in relation to international standards support the hypothesis that such differences are in Belarus the norm, rather than the exemption.

⁵ Furthermore, it should be mentioned that the calculation of the book value of the assets follows Belarusian and not international accounting principles, which is a further drawback.

Thus, it is highly questionable whether the book value as it is used today contains any relevant information for determining the market value of a company. Basing the price demand on it leads to a completely unrealistic price and as a result no deal takes place. Thus, this issue must be considered a major impediment for privatisation.

4) Further conditions for selling of state companies

According to information from state authorities, there is a list with 25 conditions which a potential buyer of a state enterprise has to fulfill. Among factors mentioned by state officials, this list includes the preservation of workplaces of the enterprise (no dismissals), sustention of social infrastructure and production volumes and certain investment volumes. These conditions – which are not publicly available in full detail – may scare off potential investors as they limit their freedom to develop the asset according to their own views.

Coupled with the problems discussed in section three, i.e. often unrealistic price demands from the side of the authorities, such additional strings attached to the sale are clearly negative for potential buyers and may explain their reluctance to invest in Belarus.

Conclusion: While a number of reasons for the standstill can be identified, underlying weaknesses in the process of privatisation implementation are important factors in this respect. Reforming these barriers is a pre-condition for the privatisation process to accelerate.

4. Policy recommendations for improving the implementation framework

Having identified the main obstacles that currently block a transparent, competitive and professionally executed privatisation process, we proceed by presenting the necessary steps to be taken to remove these obstacles. Our policy recommendations correspond closely to the impediments in chapter 3.

1) Establishment of a privatisation agency

The current situation with many counterparts and unclear responsibilities and competencies was identified as a major impediment. A major reform needs to start here by setting up a completely new institutional structure responsible for the privatisation process. We support current plans⁶ to proceed with the creation of an agency with clear mandate and competences, which serves as the main or even exclusive partner for potential investors. Specifically, we are in favor of plans that a

⁶ The foundation of such an institution was also a specific IMF programme commitment, as part of a wider plan to accelerate the privatisation process (structural benchmark).

new "Privatisation Agency" shall be the sole responsible institution that prepares enterprises for privatisation through an open, international, transparent and competitive bidding process. The Presidential Decree⁷ on the creation of the official institution "National Agency for Investments and Privatisation" was signed to intensify the process of privatisation. The decree states that the agency is created "to improve the work on attracting investments" and to "improve the effectiveness of the privatisation process". However, while the legal framework is already in place, the agency is still not operational. The agency is based on the existing "National Investment Agency", which works under the Ministry of Economy.

Such an agency must be able to interact effectively with other government bodies and facilitate the efficient and timely interaction between potential investors and state, including regional authorities ("one-stop shop"). Furthermore, it is of critical importance that its dual mandates (investment promotion and privatisation) are to be equally pursued, and no hierarchical ranking between them takes place, in the sense that the agency pursues mainly a policy of attracting (greenfield) investments rather than privatising state-owned enterprises.

For this to happen, the governance structure is of key importance. The agency will be accountable to the government and controlled by a supervisory board. This board will be chaired by the Prime Minister and consist of ten members of the Presidential Administration, the Ministry of Economy, the Ministry of Finance, the State Property Committee and other government bodies. Best international practice shows that a purely state-run agency is not the best form of governance, and independent representatives of the private sector should be included in the supervisory structure of the agency. These representatives (including international specialists) should have a good reputation and a deep knowledge of the privatisation process. This helps to facilitate the monitoring, oversight, coordination and audit of the work of the agency.

A further important issue concerns the level of competences of the agency, specifically regarding the size of the privatisation deals to be concluded. As written in the previous chapter, a major problem with the institutions currently in charge relates to their extremely limited competencies in that respect. For the new agency to be successful, this limit must be considerably increased. Otherwise, apart from not making a material impact on the process of privatisation, this institution will also soon run into major trouble relating to internal capacity building. A low level of competences in terms of final decisions on individual deals implies a rather weak institution, which will hardly be able to attract able and well-qualified people.

⁷ On 25 May 2010, President Alexander Lukashenko issued Decree No 273 "On Establishing the National Investment and Privatization Agency State Institution".

Recommendation 1: We support the plans to establish a “National Agency for Investments and Privatisation”, but note that a number of issues need to be clarified. First, the supervisory structure of this agency must be structured in a way that guarantees the equal pursue of both declared objectives. In particular, independent private-sector representatives need to be included here. Second, the competences of this agency must be considerably increased in comparison to previous institutions. Third, the institution must be operational as soon as possible.

2) Involve more expert advice (including foreign advisors)

Privatisation negotiations are relatively complex issues, which involve a high degree of specialist knowledge. The currently observed lack of such knowledge in Belarusian state institutions makes the inclusion of qualified, experienced and reputable consultants from the private sector (banks, accounting and consulting firm, to name but a few) indispensable. This includes first and foremost foreign advisors, as the experiences of other, more advanced countries in this respect can be fully utilised. Such experts, selected on a competitive basis, are a vital support for state officials.

While it is clear that hiring experts from the market, especially foreign ones, is more expensive, we think this is well-invested money. First, it demonstrates a clear commitment by the government to give new impetus to the process. Second, a funding by external donors might be possible. Third, this contributes to internal capacity building, and over time the reliance on expert advice (especially foreign one) might be less needed. It is interesting to note that transition countries which started the process of privatisation quite early in the 1990ies are now a major source of advice to other, less advanced countries.

Recommendation 2: The current lack of “know how” in relevant state institutions must be mitigated by the increased reliance on experts from the private sector, including foreign ones. As time passes, internal institutional capacity building will grow and substitute for this factor.

3) Application of modern valuation techniques

While hard and lengthy negotiations between sellers and buyers of assets are rather the norm than the exemption in business transactions, this is usually done within a commonly accepted appraisal or valuation framework. This has the advantage that both parties agree on a conceptual level on key value drivers, whereas the differences relate only to different assumptions regarding specific factors.

A commonly applied valuation framework applied both in business and in privatisation deals determines the market value of an enterprise according to the “Discounted Cash-Flow Method” (DCF). The approach focuses on the expected future cash-flows that the enterprise is able to

generate, and discounts this value back to the present day by the application of a discount rate, which represents the specific risks of the company. This approach is fundamentally different from the book value of the company, as this carries mainly information on the potential liquidation value of the company.

The introduction of such modern techniques will decrease the likelihood of extremely unrealistic ask prices from the side of the state authorities, and increase thus the probability of a successful conclusion of a transaction. While we admit that the full implementation of such methods will take time, and involve a lot of training, the authorities should in parallel also reform the valuation methods currently in place based on book value. Here, a calculation of the book value based on international standards would be a first step.

Recommendation3: The application of modern benchmark valuation techniques like the "Discounted Cash-Flow Method" (DCF) will decrease the likelihood of extremely unrealistic ask prices from the side of the state authorities, and thus contribute to a more successful conclusions of a transactions.

4) Reform the framework of further sale conditions

While it is a usual procedure to agree with investors on certain conditions apart from the price, this must be done in a way that balances the interests of the state with that of the new potential owner, which is currently not the case. Usually, it will be in his very own interest to manage the company in a way that provides clear benefits directly to him (i.e. profits) as well as indirectly (i.e. wages, jobs, taxes) to society. The commonly applied valuation framework (DCF, see above) is indeed based on the assumption of the enterprise as a going concern, i.e. a company that produces a steady stream of cash flows based on its productive activity. Restricting the freedom to develop the asset according to the plans of the new private owner will either lead to a lack of interest in the transaction, or a decrease in the price to be obtained (since the new owner will take this into account).

However, accepting the fact that in certain cases a number of conditions may well be reasonable and justified, a general list of such demands should be made publicly and transparently available to all interested parties. Only by doing so can investors estimate if these conditions are in principle acceptable to them and thus might proceed with the negotiations.

Recommendation 4: Regarding the imposition of specific sale conditions to a new owner, the authorities must strike a balance between public interests and the interests of new owner. In any case, a general list of such conditions must be made publicly available.

5. Conclusions

Strong and sustainable economic growth in the medium term can only be realised by significantly increasing the share of the private sector in economic activities in Belarus, as old growth drivers fade out. In turn, a higher participation of the private sector in economic activities can only be achieved by selling major parts of the still state-dominated economy. Privatisation is thus a key element in a broader structural reform agenda that Belarusian authorities need to pursue.

The current paper identifies a number of key weaknesses in the implementation framework and proposes a number of policy recommendations on how to fix them. Following the proposed path, Belarus has good chances to make up for the precious time lost and get back on the right track.