Emerging institutional order? National Investment Funds in Poland

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This paper analyses the mass privatisation programme (MPP) implemented in Poland in the mid-1990s from the perspective of transition reforms and the development of corporate governance systems. Although the programme covered only 512 companies the collected evidence provides a unique opportunity to compare the Polish MPP to the schemes implemented in other post-socialist economies of the Czech Republic, Slovakia and Russia as well as to other privatisation methods applied in Poland. The Polish MPP created intermediaries in the form of National Investment Funds (NIF), which were granted the leading and minor status in the ownership of their portfolio companies. The clear ownership and the incentive structure appeared to be important mechanisms that helped minimse the control vacuum and stimulated restructuring and privatisation of the portfolio companies. Despite the restructuring efforts the financial results remain relatively blurred and the performance of privatised companies as well and the funds appear to be disappointing.

Introduction

Since 1989 Poland has been grouped with the transition economies shifting from central planning to a market economy. The transition process includes significant changes in the political, social and economic system. Although the political changes are indisputably an important part of the transition, the development and direction of change can be only sustained and reinforced by economic success, or at least improvement. It is agreed that the creation of more efficient governance mechanisms is a crucial aspect of transition reforms.

The privatisation process is one of the most important reforms from the perspective of transition as well as for the development of corporate governance structures. At the end of 2006 the private sector generated 80% of GDP. Out of 8,453 state owned companies in 1990, 7,147 were privatised by the end of 2004.[2] A total of 2,885 companies were privatised via direct privatisation, which appeared to be the dominant ownership transformation scheme, 1,545 companies were commercialised, 352 underwent indirect privatisation, 512 were included in the mass privatisation programme and 1,853 were covered by liquidation procedures. However, in the register of January 2005 there were 1,306 state enterprises and the state still is involved in 15% of privatised companies in Poland.

The goal of this paper is to present the mass privatisation scheme introduced in Poland in mid-1995 in the form of National Investment Funds and on the basis of collected evidence to answer questions on the effectiveness of the mass privatisation programme in Poland. The assessment of the Polish MPP will include two levels of analysis: a comparative analysis of the NIF programmes versus other privatisation methods applied in Poland such as direct sale to foreign and domestic investors,

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[2] Ministerstwo Skarbu Państwa (State Treasury), Ocena przebiegu prywatyzacji majatku Skarbu Panstwa w 2004 roku (The report on privatisation reforms in 2004), Warsaw 2005:10.

Management and Employee Buyouts (MEBO) and sub-stage of commercialisation; and an international comparative analysis of mass privatisation programmes implemented in other Central and East European countries: Russia, the Czech and Slovak Republics as well as East Germany and Estonia. On the basis of previous research as well as the most common problems of transition economies the criteria for assessing the NIF scheme will be the following:

1. Shifting ownership of assets from state to private hands;
2. Enhancing the performance of companies by privatisation to strategic investors, restructuring of the companies and reducing the control vacuum and looting carried out mostly by powerful opportunistic insiders;
3. Acceleration and increasing the scope of the privatisation process;
4. Reducing the costs of ownership change from the perspective of the state;
5. Distribution of, at least part of, the ‘national’ wealth to Polish citizens;
6. Development of corporate governance mechanisms;
7. Boosting public interest and participation in the stock market.

The remainder is organised as follows. In the first section the paper discusses the programme designing process, the goals and the stages of the programme. The second section analyses the functioning of the NIFs and their role in corporate governance. The third section discusses the results of NIFs restructuring activity. The fourth section concludes the paper with an overall assessment of the mass privatisation and its contribution to the development of the corporate governance system in Poland.

1. The mass privatisation programme

After 1989 Poland applied the radical approach to macroeconomic reforms (so-called shock therapy). The mass privatisation programme was, however, significantly delayed. The main reasons behind this delay were rooted mostly in political changes and the unwillingness of political parties to formulate the goals of the mass privatisation scheme precisely[3]. The authors of the Polish MPP could rely on the experience of other countries, especially Russia, Slovakia and the Czech Republic and prevent the privatised companies from mushrooming and expropriation by insiders. Political turmoil and insecurity, however, did not provide a good environment for foreign investors. The delay also affected the attitude of workers in the companies chosen to join the programme and led to the further deterioration of NIFs portfolio companies, which were in desperate need of capital and restructuring.

The main goal of the programme was to assist the shifting of assets from state-owned companies to private ones and to intensify and extend the range of ownership transformation. The initial plan was to create open public investment funds for the mass privatisation programme, which would then become private funds. The mandate of the NIFs was to promote the development of profitable and valuable companies operating in Poland and to permit the public to participate by enabling them to acquire shares in the NIFs. Moreover, selling companies through an intermediary and not directly by the state reduced the costs of the ownership change. Finally, in many cases the government realised there were not enough investors with substantial capital interested in buying out state-owned companies.

[3] Stanisława Teresa Surdykowska, *Prywatyzacja,* Wydawnictwo Naukowe PWN, Warszawa 1997: 140.

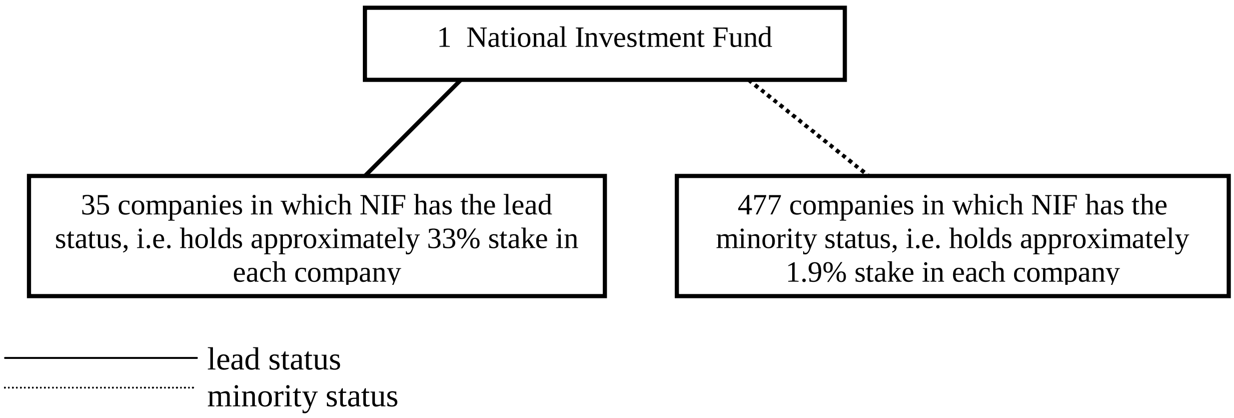
1.1. The scheme

The Polish MPP covered 512 large and medium, mainly manufacturing, state-owned enterprises (SOEs) with about 10% of industrial sector sales to participate in 15 National Investment Funds. Each SOE was incorporated as a joint stock company, 60% of the shares were allocated to the NIF scheme, 15% was given free to employees and 25% was retained by the state[4].

The NIF privatisation stage

In December 1994 the supervisory boards of NIFs were officially appointed and started negotiations with management companies. By July 1995, NIFs established as companies by Company Act with capital of 100,000 PLN provided by the state as subsidy selected their fund management companies and signed 10-year agreements with them[5]. In March 1995 portfolio companies were distributed amongst NIFs on a random basis to ensure that all funds would end up with approximately equal amounts of assets under their control. The distribution of the share was carried out in a number of rounds on four occasions. As a result many funds ended up with diversified portfolios not concentrated on any particular industry. In the end each NIF gained the lead status in 34-35 firms and minority status (of 1.93% shares) in around 477 firms. NIFs held 60% of a company's shares and were to manage the sale of the shares[6]. In order to ensure that NIFs would play an active role in the companies they had in their portfolios, provisions in the MPP stipulated that leading stakes had to be sold only as a whole, whereas the minority stakes were the subject of unrestricted trading. Figure 1 illustrates the structure that each NIF ended up with.

Figure 1: Illustration of the initial NIF structure



Source: based on www.magnapolonia.com.pl

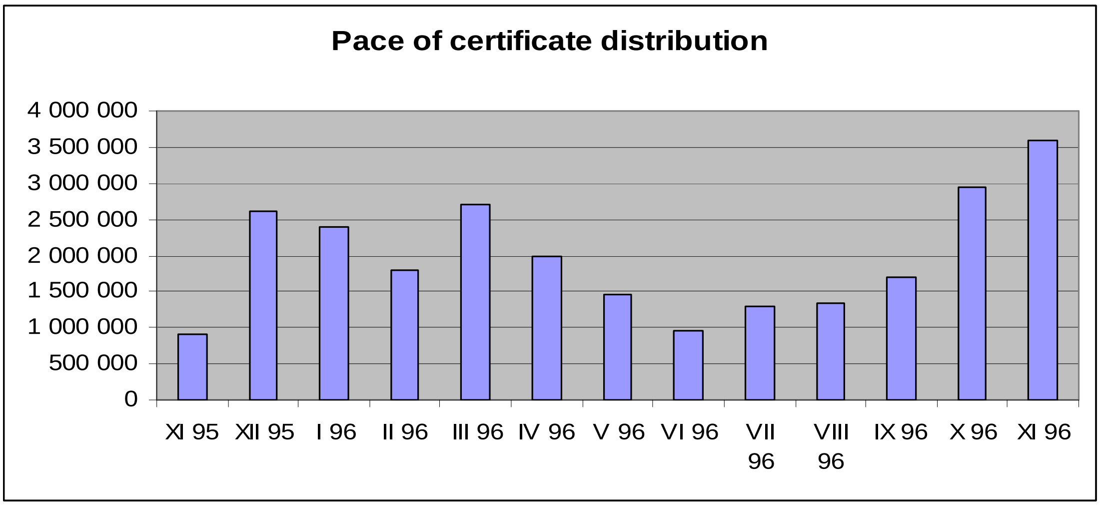
[4] Wolfgang Aussenegg, 'Going public in Poland: Case-by-case privatisation, mass privatisation and private sector initial public offerings', William Davidson Institute Working Paper, no. 292, 1999, http://wdi.umich.edu/files/Publications/WorkingPapers/wd292.pdf, [accessed on 2 April, 2002] (para. 8 of 44).

[5] Malwina Szczepkowska, 'Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na przykładzie Narodowych Funduszy Inwestycyjnych', Uniwersytet Szczeciński 2001: 5.

[6] Szczepkowska, 'Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na prezykładzieNarodowych Funduszy Inwestycyjhnych': 6.

From November 1995 until November 1996 the state-owned bank PKO BP started to distribute the ownership certificates for a fee of PLN 20 ($7-8). The certificate functioned as a claim to the ownership of funds. Each adult Pole could take a certificate and then convert it into 15 shares (1 share per each NIF)[7]. Figure 2 presents the pace of certificate distribution.

Figure 2: Pace of certificate distribution



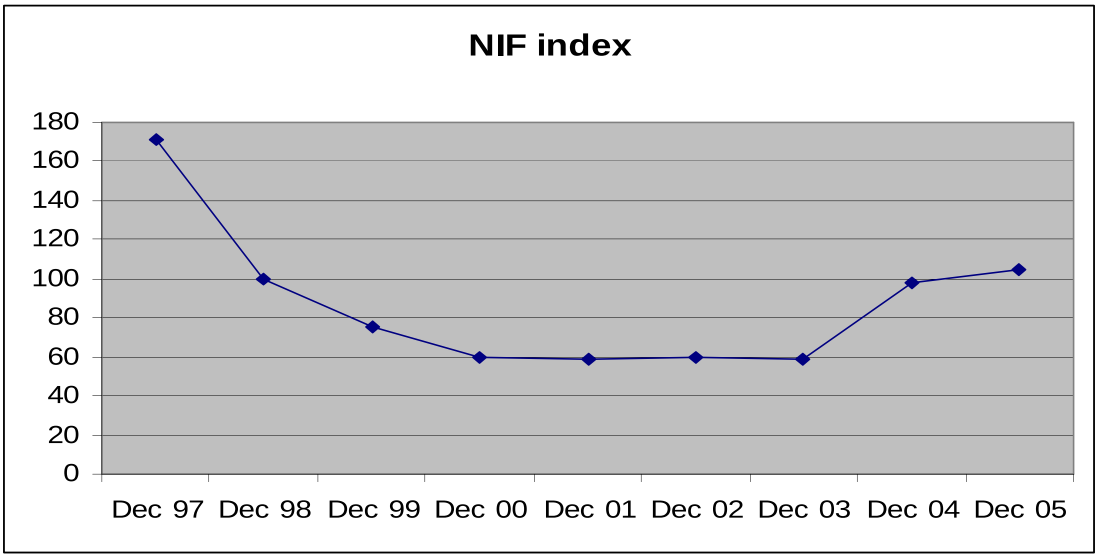
Source: Source: Ministry of State Treasury, 'Report of NIF programme 1997-2003'

Funds commercial phase

In March 1997 NIFs shares were listed on the Warsaw Stock Exchange. The Treasury, which held 100% of shares of NIFs at this point, began to transfer 85% of these shares to certificate holders who applied for the conversion of their certificates through a brokerage house. The remaining 15% was kept by the Treasury for the payment of performance and loyalty fees by the fund management companies. In June 1997 the certificates and shares of NIFs were listed on the Warsaw Stock Exchange. Certificate prices went significantly up starting from PLN 50, reaching PLN 175 (the highest price) by February 1997 and then falling back to about PLN 150 by June 1997. During the last day of quotation (last session in December 1998) a certificate was worth 62 PLN which makes it 40% lower than the IPO price. The NIF index reached its top value during the first weeks of quotation and since then NIF shares prices fell reaching around 1/3 of that value in 2005. Figure below presents NIF index 1997-2005.

[7] The initial public interest in the mass privatisation programme was striking: 25 855 417 out of 27 395 000 eligible Poles (94.5%) took part in that programme, although the authors of the MPP predicted a far lower participation of about 10 million citizens.

Figure 3: NIF index (points) 1997-2003



Source: own calculations based on reports of NIF programme and database of Bank Ochrony Środowiska (available at www.bossa.pl)

As shown in figure 1 the value of the index fell after the listing date. The increase in 2004 and 2005 was connected to the dividend payout and the upward trend of the stock exchange. Since 2006 the Warsaw Stock Exchange has not produced a NIF index due to the end of the programme.

1.2. Companies selected for MPP

According to the estimates of the Ministry of Ownership Transformation there were around 1100 companies, which could join the programme at the time the scheme was under construction. However, the anti-privatisation lobby was strong and many companies were not included in the scheme due to political reasons. Additionally, the delay in the introduction of the programme also affected the number of companies selected. Some of the potential company candidates were being privatised or had a different status including large companies such as PKP (Polish railways) or LOT (Polish airlines) and therefore did not qualify for the programme[8]. Additionally, alcohol and tobacco manufacturers, power plants, wood processing companies and sugar manufacturers were excluded from the MPP mostly for political reasons and the pressure of the anti-privatisation lobby. In August 1992 an estimated 600 companies valued at PLN 150 billion (15% of the value of state-owned companies) were to join the programme since that number was meant to be the 'breakeven point' of the scheme. Since the 16 largest companies were excluded, the value of companies in the MPP dropped to 6.56% of state-owned companies. As a result, many companies selected for the programme represented "problematic" sectors such as food processing or textile industries.

Companies selected for the NIF programme were, by Polish standards, large and medium, though not the largest in size and were recruited mostly from the industrial sector.

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[8] Szczepkowska, 'Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na przykładzie Narodowych Funduszy Inwestycyjnych', 6; Surdykowska, *Prywatyzacja*, 239-40.

Table 1: Characteristics of companies involved in NIF programme

Sector	Percentage	Number of employees			
		Up to 200	201-500	501-1000	More than 1000
Industry	80.5	9.2	23.6	25.8	21.9
Construction	14.6	1.4	6.1	5.9	1.2
Others	4.9	2.8	0.9	1.1	0.2
Total	100	13.4	30.6	32.8	23.2

Source: Szczepkowska, Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na przykładzie Narodowych Funduszy Inwestycyjnych", Uniwersytet Szczeciński, p. 7

In terms of financial conditions the bottom line was profit equal to zero, with a minimum turnover of $10 million. As a matter of fact, however, the financial position of the companies varied significantly ranging from highly profitable to loss making: while 1/5 of the portfolio companies were sound enough to be listed on the Warsaw Stock Exchange in a short period of time, 31% of them were recording losses[9]. The approximate book value of their assets was over PLN 7 billion ($3 billion at the end of 1994) although varying again from more than $43 million to $4.3 million.

1.3. Fund management companies

Fifteen case fund management companies sponsored by institutional investors, both Polish and foreign, were usually contracted for two years with the option of contract extension for up to 10 years. The compensation of the fund managers was based on:

1. One fixed fee paid annually in dollars and adjustable annually for inflation and certain changes in the portfolio of the NIF. It was fixed for the 10-year life of the fund management agreement. The management fee was fixed for each fund separately via negotiations between the supervisory board and the fund management company and it usually accounted for 2-3% of the asset value. The aggregate fee for all funds was $42 million per annum[10].
2. Fees for a performance-based bonus included the annual performance fee from the sale of 1% of the NIF's assets and a loyalty fee of 5 % of the NIF's assets at the end of the 10-year contractual period.

The total remuneration of fund managers accounts for approximately 3.5-4.5% of the value of the assets, which by Western standards is rather generous,[11] to enable the fund managers' to focus on the value of their portfolio companies and on value-increasing policies.

[9] Iraj Hashi, "The Polish National Investment Fund Programme: Mass privatisation with a difference", Working Paper no. 99.5, Staffordshire University, 1999, http://www.staffs.ac.uk/schools/business/economics/papers/ec1999-05.pdf, [accessed 15 April 2002] (para. 10 of 37).

[10] Hashi, "The Polish National Investment Fund Programme: Mass privatisation with a difference", (para. 15 of 37).

[11] Hashi, 'The Polish National Investment Fund Programme: Mass privatisation with a difference', (para. 16 of 37).

2. Corporate governance in the MPP

Mass privatisation by definition leads to diffused ownership (shares/ vouchers distributed amongst millions of citizens) and results in a vacuum of monitoring and supervision and the increased discretion of managers who are likely to pursue self-dealing at the expense of shareholders. The Polish mass privatisation programme was designed to create a dominant owner for enterprises and to provide the appropriate incentives for them which would in turn lead to the restructuring of the companies and speeding up their transfer to the private sector. Thus the Polish MPP tried to overcome the potential problems of investment funds identified in the case of Czech and Slovak MPPs.[12] The characteristics and the role of investment funds participating in mass privatisations in Central and East European counties received harsh criticism for lacking incentives to restructure. Funds in the Czech and Russian MPP, during the early stages before concentration in hands of insiders, usually owned 20-30% of the company and were likely to utilise their power without restructuring. The fund management companies went for self-dealing such as tunnelling and siphoning.[13] This was done through a set of special contracts and non-transparent side deals with firms related to the fund management companies. In Poland the leading funds were monitored by other minority funds and were considered important to the reputation of the fund management company. Governance as well as the incentive structure of the MPP was believed to reduce the principal–agent problems at the company level and thus in the Polish programme the corporate governance problem was partly shifted from the ‘enterprise level’ to the ‘fund level’, in other words, how funds monitored and controlled themselves[14].

2.1. The ownership of the portfolio companies

Portfolio companies faced significant differences between the initially dispersed and those with more concentrated ownership, in enabling funds to pursue their strategies. To improve the efficiency of their governance structure NIFs decided to enter into mutual agreements for the consolidation of shares:

- The first consolidation took place in October 1996 and six funds joined the agreement[15]– V NIF SA Victoria, VI NIF SA Magna Polonia, VIII NIF SA Octavia, X NIF SA Foksal, XI NIF SA, XII NIF SA Piast. It referred to shares of leading companies – the exchange included five different packages of 1.93% in different companies for one of 9.65% of one company focusing on sectors in which they already owned companies. All together 162 companies were subject to this exchange process. As a result the six funds had two types of minority stake: 9.65% (the so called super-minority) in 27 companies and

[12] Coffee John C. Jr., ‘Inventing a Corporate Monitor for Transitional Economics: The Uncertain Lessons from the Czech and Polish Experiences’ in Frydman Roman, Gray Cheryl W., Rapaczynski Andrzej (eds.), *Corporate Governance in Central Europe and Russia* , World Bank/CEU Press, 1996, 1, chap. 4, 134.

[13] David Ellerman, ‘Voucher privatisation with investment funds: An institutional analysis’, World Bank, 1997, http://www.worldbank.org/html/dec/Publications/Workpapers/WPS1900series/wps1924/wps1924.pdf [accessed on 11 April, 2002] (para. 3 of 12).

[14] Hashi, “The Polish National Investment Fund Programme: Mass privatisation with a difference”, (para. 17 of 37).

[15] Szczepkowska, ‘Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na przykładzie Narodowych Funduszy Inwestycyjnych’, 10.

1.93% in the rest of them. The ownership structure of these 162 companies underwent significant concentration: one leading NIF (33%), one fund with 9.65% stake and nine minority fund-owners with stakes of 1.93%. From the perspective of NIFs super-minority holdings were expected to have a premium value over minority holdings as they would reduce the monitoring as well as transaction costs. The reduction was probably insufficient as they still had minority holdings in about 350 companies and as a result funds tended to sell these minority stakes.

- In February 1998 the same six NIFs signed another agreement for share consolidation aimed at further reducing the number of minority companies in their portfolios.

2.2. The ownership of the NFIs

Additionally there was a trend towards ownership concentration at the fund level.[16] Financial institutions appeared to prefer the gradual purchasing of NIFs' shares and opted in many cases for concentrated ownership in the NIFs. One move toward the trend was the merger of III NIF SA and XI NIF SA into Jupiter NIF on 31 December 2000. Researchers note that it is expected that over time the ownership of NIFs will become more concentrated. The NIF formula created financial intermediaries managing entrusted shares in the privatised companies in the name of the owners and the costs of heavily dispersed ownership were substantial.[17] As a result, NIFs were controlled by powerful financial groups.

Table 2: The dominant shareholders of NIFs

The dominant shareholder	Shares in NIF	The management company
PEKAO SA	NIF Jupiter – 32,76%	Trinity Management
BRE BANK SA	I NIF – 14,2% V NIF – 15% XIII NIF – 9,8% XIV NIF – 5%	BRE Private Equity
PZU S.A.	II NIF – 20,2% IV NIF – 21,34% IX NIF – 21,71%	PZU NIF Management
WBK AIB CA IB	VI NIF – 21,57% XV NIF – 53,73%	AIB WBL Fund Management CA IB Management
Copernicus/ NIF Fund Holdings	VIII NIF – 32% XII NIF – 25,5%	KP Consortium Ltd.

Source: Hashi The Polish National Investment Fund Programme: Mass privatisation with a difference', p. 8 and own research.

[16] Considering the depth of Polish financial markets and the relatively small size of investment funds, the law has provided some degree of protection against hostile takeovers in the first four years of NIFs public trading. According to the provisions no single shareholder may own more that 5% of shares of a fund in the first two years of the programme. The proportion was increased to 10% and 20% in the third and fourth year. Some institutions predicted takeovers of many NIFs within six months after listing funds on the Warsaw Stock Exchange. However for the whole period of time, there was no sign of a takeover attempt.

[17] Izabela Koładkiewicz, 'The institutional shareholder – best practice: the National Investment Funds' experience, *Corporate governance*, 10, 2002, 3, 183.

2.3. Supervisory boards of portfolio companies

The funds together usually controlled the supervisory boards of the companies since the two other stakeholders who were entitled to representation on the board had a modest number of seats. It was in their interest if NIFs coordinated their actions and in that way gained an effective voice on supervisory boards. Thus, from the beginning, there was an implicit agreement amongst NIFs that the lead fund should also nominate the representative of minority funds. Since the Treasury was a passive investor, the likelihood of opportunistic behaviour by the lead fund increased. Although the role of the minority NIFs might seem to be marginal, they appeared to monitor the lead funds to some extent and therefore enhanced the governance structure, demanding for instance the disclosure of detailed financial information about portfolio companies. Their importance decreased as the funds disposed of minority shareholdings.

3. Assessment of the programme

The results of the NIF scheme with respect to the restructuring and enhancement of the companies' value remains relatively blurred and inconclusive. The research evidence differs significantly: some researchers criticise the scheme heavily claiming that the Polish mass privatisation programmes failed to provide the expected results,[18] while others, however, express positive opinions towards the goals that were to be achieved.[19] The assessment of the programme is analysed below according to the criteria listed in the introduction to the paper.

3.1. Shifting the ownership form state to private hands

From the beginning of the programme until the end of 2001 the State Treasury sold its stakes in 115 companies for over $195 million and in the case of 112 companies the state withdrew completely. At the end of 2001 the state was still involved in 381 companies, standing at 74.4% of the initial portfolio with an average stake between 10.7%-16.1%. This number is far from impressive and in the opinion of some researchers it contributed to the negative aspects of the Polish MPP. The Table shows state involvement in NIF at the end of 2004.

[18] Irena Grosfeld, Thierry Tressel, 'Competition and corporate governance: Substitutes or complements? Evidence from the Warsaw Stock Exchange', William Davidson Institute Working Paper, no. 369, 2001, http://wdi.umich.edu/files/Publications/WorkingPapers/wd369.pdf [accessed on 10 April 2002], (para. 20-1 of 41).

[19] Simon Commander, Mark Dutz, Nicholas Stern, 'Restructuring in transition economies: Ownership, competition and regulation', World Bank, 2001, http://www.worldbank.org/research/abcde/washington_11/pdfs/stern.pdf [accessed on 6 April, 2002] (para. 30-2 of 43).

Table 3: State involvement in NIFs (December 2004)

Fund	Number of shares	Stake (%)
Fund I NIF	471,800	3.14
Jupiter NIF	2,972,527	5.71
NIF Progress	591,314	2.49
V NIF Victoria	917,036	6.10
NIF Magna Polonia	1,947,719	6.48
NIF Octava	4, 418,755	18.36
NIF Foksal	3,018,153	14.06
NIF Fortuna	1,071,922	7.13
Zachodni NIF	1,297,141	6.08

Source: Source: Ministry of State Treasury, 'Report of NIF programme 1997-2003', p. 52-3.

3.2. The privatisation to strategic investors and restructuring of the companies

Fund management companies carried out restructuring by assigning each 5-6 portfolio companies to a small team of their employees. Each team was directed by an investment director or a portfolio manager who assisted the companies in preparing their strategic plan[20]. As far as the restructuring activity is concerned evidence shows that labour shedding amounted to 10 and 20% between 1996 and 2000. Fund teams pursued significant changes especially in strategic management, production lines and product designs as well as budgeting, accounting and the compensation system. Approximately 300 companies that joined the NIF programme were subject to deep organisational and financial restructuring, including debt conversion, the reorganisation and implementation of new accountancy rules and improvements to the top management teams.

The NIFs' investments in portfolio companies between 1996-1997 is estimated at PLN 293 million in lead companies and PLN 203 million in minority companies. Additionally, strategic investors invested PLN 173 million. The data as of 30 September 2001 shows that NIFs invested 898.2 million PLN in the restructuring programmes in leading companies and 241.8 million PLN in minority companies. Altogether NIFs invested 1,140.3 PLN million which accounts for 62.4% of the gains realised from the sale of the companies. Meanwhile the sale of companies to strategic investors generated around 639 million PLN for NIFs, whereas the average income of NIFs from the disposal of portfolio companies in 1996-98 is estimated at PLN 143 million.

Due to the poor economic situation, portfolio companies entering the liquidation and bankruptcy process accounted for 20% of the overall number. At the end of 2001 16% of these cases were completed. Seven were revoked, whereas thirteen companies were subject to liquidation. The decisive strategy of the NIFs towards bankruptcy and liquidation proceedings may be linked to a more favourable position for the implementing of these politically unpopular procedures for companies that were considered to be financially unviable. The funds were simply better placed, as compared with the state, which was constrained by political pressures, to pursue the closure of unprofitable companies. Until 30 September 2001 NIFs sold 325 out of 512

[20] Hashi 'The Polish National Investment Fund Programme: Mass privatisation with a difference', (para. 24 of 37).

companies (63% of their portfolios). More than half of the NIF portfolio companies found strategic investors and in two thirds of cases these were industrial-related investors. Some companies, mostly those in poor financial conditions were sold to insiders while at the end of 2001 shares in 26 companies were traded on the Warsaw Stock Exchange and ten on off-exchange market (CTO). At the end of September 2001 187 companies were still under the management of NIFs. The recent report of the State Treasury (2005) summarised NIF privatisation scheme indicating that out of 512 companies covered by the programme at the end of 2004:

- in 232 companies (46%) privatisation was fully completed;
- 130 companies were liquidated;
- 5 companies were merged in other units;
- 135 were actively controlled by the state.

The table below presents the breakdown of all the NFIs portfolios.

Table 4: Leading companies in NIFs portfolios

NFI	Number of leading companies in portfolio as of 1998	Number of leading companies in portfolio as of Sept 30, 2001	Number of leading companies in portfolio as of Nov 2006
01 NIF	35	10	Closing its activity
02 NIF	34	19	Closing its activity
03 NIF	34	11	0 (fund holds bonds and shares in 4 companies)
04 NIF	35	16	Closing its activity
05 NIF	35	7	Closing its activity
06 NIF	35	10	5
07 NIF	34	28	4
08 NIF	34	8	0 (fund holds in 5 real estate-related companies)
09 NIF	34	11	Closing its activity
10 NIF	33	13	Closing its activity
11 NIF	33	11	0 (merged with 03 NIF)
12 NIF	34	10	New strategy specialising in real estate
13 NIF	34	4	0, fund is closing its activity
14 NIF	34	12	Closing its activity
15 NIF	35	13	New strategy specialising in management of non-food consumer brands

Source: own calculations based on data from NIF annual reports and websites.

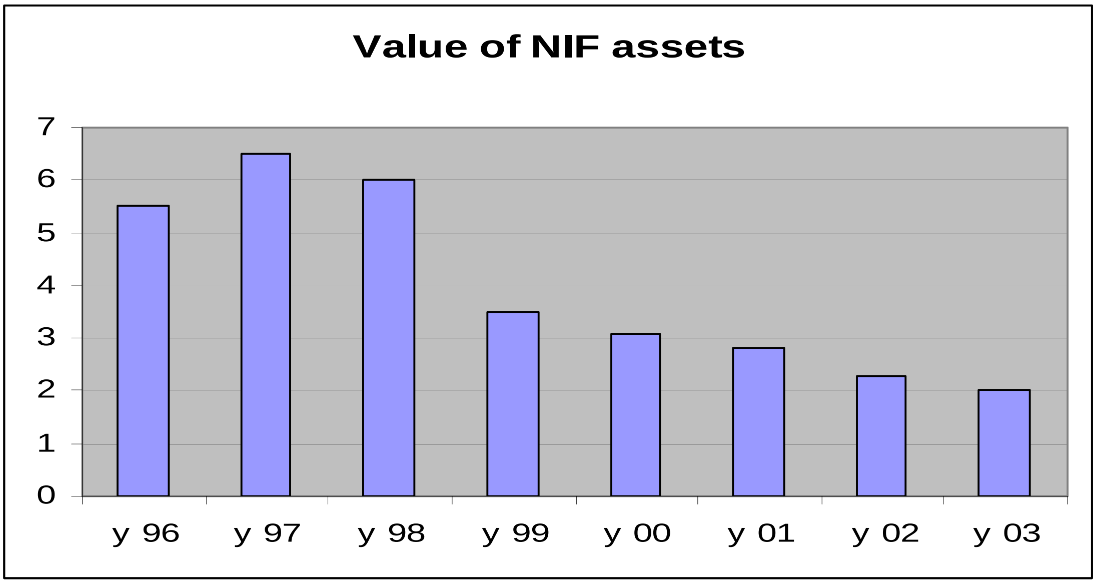
However, the strategy of the NIFs with respect to their role differs significantly. Some of the NIFs actively searched for strategic investors and carried out the reorganisation, whereas some others perceived themselves as purely financial investment funds focusing more on trading shares and other securities on domestic and foreign markets. As the evidence shows many funds decided to pursue a very easy strategy – instead of actively restructuring portfolio companies they sold the most attractive assets to other investors and purchased bonds or other financial instruments. The quick liquidation assets strategy is the biggest disappointment of the NIF scheme.

3.3. Increase in firm value, improvement in productivity, investment, and sales

Approximately, 30% of portfolio companies were recording losses at the time of joining the programme. Most of them represented problematic sectors such as: meat, clothing, coal mining and steel. Despite significant restructuring efforts, improvements in profitability (or reductions in losses) and labour, the productivity of portfolio companies showed significant long-turn market underperformance.[21] However, other research evidence shows that the firms included in the mass privatisation programme showed rapid improvements in their profitability before these companies were virtually privatised.[22] The proportion of the leading companies recording losses increased in 1996 before dropping to 29% in 1998. 71% in 1999 and 48% in 2000 of the leading companies generated net profits.

Despite important restructuring efforts carried out by the NIFs, their performance has been rather disappointing. The dividend paid by the funds was very small if any. The net assets value of most NIFs has not kept up with inflation.[23] Compared to 1997 the net asset value plummeted significantly which is perceived as opposite to the goals of the programme and government laws (figure 4).

Figure 4: Value of NIF assets (bln PLN)



Source: Ministry of State Treasury, 'Report of NIF programme 1997-2003', p. 16.

[21] Aussenegg, 'Going public in Poland: Case-by-case privatisation, mass privatisation and private sector initial public offerings', para. 25 of 44).

[22] Commander, Dutz, Stern, 'Restructuring in transition economies: Ownership, competition and regulation' (para. 31-2 of 43).

[23] Hashi, 'The Polish National Investment Fund Programme: Mass privatisation with a difference', (para. 34 of 37).

The breakdown of the asset value of individual NIFs is presented in table 5.

Table 5: Net assets value of NIFs (million, PLN)

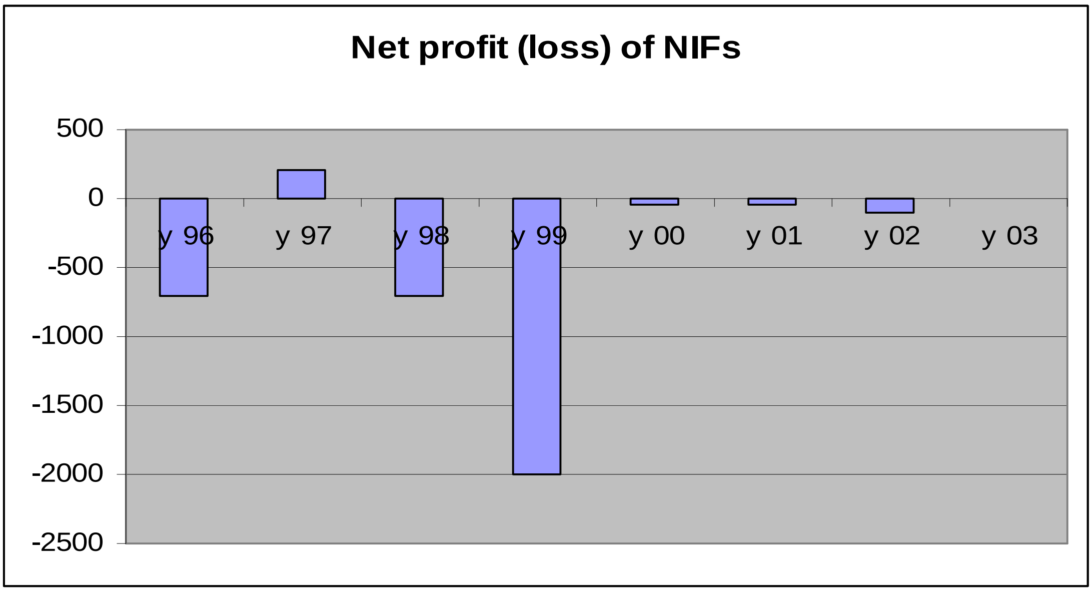
NIF	End 1996	1st quarter 1997	End 2000	End 2001	End 2003
I NIF S.A.	440	412	190	184	155
II NIF S.A.	470	459	155	146	140
IV NIF S.A Progress	390	405	230	190	175
V NIF S.A Victoria	340	299	150	135	120
VI NIF S.A Magna Polonia	350	328	240	200	180
VII NIF S.A im. Kazimierza Wielkiego	390	378	100	107	98
VIII NIF S.A Octava	380	347	340	331	250
IX NIF S.A im. E. Kwiatkowskiego	390	370	350	318	280
X NIF S.A Foksal	500	464	170	146	100
XII NIF S.A Piast	410	382	130	101	45
XIII NIF S.A Fortuna	500	378	200	185	160
XIV NIF S.A Zachodni	380	374	220	211	170
XV NIF S.A Hetman	410	401	270	131	70
NIF Jupiter (II NIF and XI NIF merged)	760	746	500	414	230

Source: based on Szczepkowska, ‘Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na przykładzie Narodowych Funduszy Inwestycyjnych’, p.12-13; Ministry of State Treasury, ‘Report of NIF programme 1997-2003’, p. 17.

The loss of investment activity tends to be the major weakness of the NIFs. Despite the intensive sale of shares, the majority of capital was allocated in risk-averse bonds and debt securities which were unable to cover the losses of the portfolio companies. The loss on investment activity reached 16.42 million PLN at the end of 2001. The total profit of the NIFs in 2001 was negative as well and accounted for 51.2 million PLN,[24] which amounts to thirty-seven percent of the previous year’s loss.[25] Figure 5 presents the net profit generated by NIFs during the period 1996-2003.

[24] Hashi, ‘The Polish National Investment Fund Programme: Mass privatisation with a difference’, (para. 26 of 37).
[25] Nevertheless ca. half of the NIFs generated positive profits at the end of 2001.

Figure 5: Net profit (loss) generated in NIFs, 1996-2003, mln PLN



Source: Source: Ministry of State Treasury, 'Report of NIF programme 1997-2003', p. 21.

3.4. The pace and scope of privatisation

The mass privatisation programme definitely contributed to the acceleration and the increasing scope of the privatisation process although it covered merely 512 companies and when compared to other CEE countries this appears to be minimal. For instance the MPP covered 1,800 companies in the Czech Republic and 15,000 companies in Russia. On the other hand the long duration of the scheme implementation raises questions as to whether the pace of privatisation could have been slower or faster if alternative methods had been used.

3.5. Lower costs of ownership change

It is extremely difficult to judge if the mass privatisation programme led to the reduction of the costs of ownership transformation. During the transition period Poland relied mostly on case-by-case privatisation, while on the other hand in cases of direct sale to investors allowed the generation of revenues needed for reforms. The mass privatisation programme was not costly since it was to a large extent financed by the World Bank. The sale of stakes in only 115 companies generated over 745 million PLN (approximately $195 million) for the state which remains pretty moderate for privatisation revenues. Table 6 compares privatisation by three main methods.

Table 6: Comparison of privatisation by indirect, direct and NIF method

Element	Indirect privatisation (1990-2003)	NIF programme (1995-2003)	Direct privatisation (1990-2003)
Investment (mln PLN)	69, 655	6, 014	4, 955
Investment in environment protection (mln PLN)	4, 662	674.5	225
Employment	217, 097	63, 631	87, 747
Average salary (PLN)	2, 929	2, 270	2,130

Source: Source: Ministry of State Treasury, 'Report of NIF programme 1997-2003', 39.

3.6. Distribution of the 'national' wealth and boosting the public interest in the stock market

The mass privatisation programme played a marginal role in Polish transformation.[26] The NIF scheme did not manage to encourage interest in the stock market. Public interest in the programme peaked during the certificate distribution and conversion then dropped afterwards. The average Pole did not feel any significant impact of the distribution of the wealth accumulated during socialism as the value of the certificate was very low. The majority of citizens decided either to sell the certificates even before they were converted into the 15 NIF shares or the NIF shares in the very first weeks of their trading and therefore interest in the stock market as such, was significantly limited.

3.7. Development of corporate governance mechanisms

Avoiding a control vacuum

The NIF structure is characterised by the dominant position of one leading fund, the incentive of compensation for the fund management companies, the participation of the reputational foreign investors and the regulatory framework of the scheme, provided monitoring mechanisms and avoided a control vacuum (no dispersed ownership structure). The available data on the mass privatisation programme delivered evidence that the NIF structure did not suffer from a control vacuum which was common in the Czech Republic, Slovakia and Russia. Just the opposite: it created a complicated and multi-level structure that caused the overlapping of competence of various agents and might in effect have led to higher transaction costs.

Designing a structure of sound governance mechanisms

The NIF structure may appear to be relatively successful with respect to the active role of funds, monitoring, incentive structures and restructuring results, yet some

[26] Michał Federowicz , 'Corporate governance and industrial relations in Poland', Centre for the Study of Economic and Social Change in Europe, School of Slavonic and East European Studies, Working Paper, no. 28, 2003, [accessed on 8 May 2005] (para. 17 of 22).

researchers claim that more attention should have been given to managerial incentives and supervision.[27] An MPP scheme that from the start adds one level of intermediary institutions as in the Polish case produced a complicated, multi-level structure that is associated with the problem of 'who monitors the monitors'.[28]

Additionally the trend towards increasing the concentration NIF ownership was accompanied with the extensive buy back programmes introduced by many funds. Therefore authors claim we can observe the phenomenon of 'disappearing' NIFs. Data shows that investors involved in the NIF structures tended to merge or buy back its shares and dissemble the funds. On average the NIFs bought back more than 10% of their own shares[29]. Investors (mostly foreign, powerful financial groups) that dominated the NIF ownership tended to be involved in other Polish companies but outside the NIF structure.

Evolvement of active institutional investors

The current NIF involvement in new Polish companies is marginal and in the non-MPP companies appears to be relatively modest. Funds are *de facto* in legal and organisational terms diversified conglomerates acting as closed investment funds[30].

3.8. NIF scheme versus other privatisation methods applied in Poland

Privatisation is an indisputable positive for the companies.[31] There is however no agreement about the scheme and the pace of the process.[32] Comparative studies of privatisation schemes in Poland show that the identity of the owner matters significantly. Outsider-owned privatised firms noted significantly higher annual revenue growth than either state or insider-owned firms. Firms privatised to outsiders, particularly to foreigners, tended to perform better in terms of labour productivity and investment.[33] Privatisation to investment funds is five times more productive as

[27] Grosfeld, Tressel, 'Competition and corporate governance: Substitutes or complements? Evidence from the Warsaw Stock Exchange' (para. 15 of 41).
[28] Estrin, 'Competition and corporate governance in transition', (para. 12 of 42).
[29] Hetman NIF bought 50% of its shares, Kwiatowski NIF bought 25% of its share, NIF Progress – 20%, NIF Octavia – 19%, Drugi NIF and NIF Jupiter 9-13%. Apparently, the tendency toward increasing ownership concentration results also from the ending time of the programme and associated payoff from the State Treasury and thus the ownership block enjoys higher premia. Some observers claim that the new, more concentrated structures evolving currently show higher efficiency since they eliminate one layer of agents in the corporate governance structure as noted by Maciej Samcik 'Wokół parkietu: NFI Hetman może zniknąć',2002, *Gazeta Wyborcza* – on line resources, http://www2.gazeta.info/elemnty/druk.jsp?xx=1121702&plik=/htm/1121/a1121702.html; Maciej Samcik 'Czy Prokom zainwestuje w fundusze NFI należące do PZU?' 2002; *Gazeta Wyborcza* – online resources, http://www2.gazeta.info/elemnty/druk.jsp?xx=1131064&plik=/htm/1131/a1131064.html
[30] Szczepkowska, 'Funkcjonowanie przedsiębiorstw w ramach grup kapitałowych na przykładzie Narodowych Funduszy Inwestycyjnych', 11-2.
[31] Estrin, 'Competition and corporate governance in transition', (para. 24 of 42)
[32] Svejnar, 'Transition economies: Performance and Challenges' (para. 8 of 45); Gerald Mc-Dermott, 'Network restructuring and firm creation in East-Central Europe: A public-private venture', William Davidson InstituteWorking Paper, no. 361, 2000, http://wdi.umich.edu/files/Publications/WorkingPapers/wd361.pdf [accessed on 10 April 2002] (para. 7-8 of 56).
[33] Commander, Dutz, Stern, 'Restructuring in transition economies: Ownership, competition and regulation' (para. 15-16 of 43); Roman Frydman, Cheryl W., Gray, Marek Hessel, Andrzej Rapaczynski, 'The limits of discipline', *Economics of Transition*, 8, 2000: 579.

privatisation to insiders, whereas privatisation to foreigners and blockholders is three times more productive as privatisation to insiders. Concentrated ownership is beneficial[34] but as shown by Grosfeld and Tressel[35] the controlling shareholder in Poland has a negative effect, when a CEO, bank or NIF controls the company.[36] Relative to MEBOs, mass privatisation and direct sales more than double the productivity change recorded over the subsequent two years, with the effect slightly stronger for direct sales. Insider privatisation has been mostly associated with low investment, limited managerial change and product innovation.[37] Table 7 presents performance of companies privatised by the NIF scheme as compared companies privatised by other methods.

<u>Table 7: Performance of privatised companies in 2003</u>

Method	No	Loss making (net)	Cost ratio	Operating ration	Net operating ratio	Liquidity ratio
Total	2,434	34.7	93.5	5.9	4.4	24.4
Sole State Treasury companies	337	39.5	87.3	10.9	9.8	28.8
NIF	367	43.3	98.4	1.9	0.6	13.2
Indirect privatisation	275	32.4	94.0	6.0	3.9	30.3
Controlled by the state	174	35.6	102.7	-2.7	-4.0	14.7
Debt swaps	12	58.3	106	-5.7	-5.8	16.9
EBO	1092	25.7	96.9	3.1	1.9	32.6
In process of direct privatisation	18	83.3	90.2	9.6	17.0	1.0

Source: Source: Ministry of State Treasury, 'Report of NIF programme 1997-2003', 35.

As shown in the table performance of companies privatised by the NIF scheme remains disappointing.

[34] Estrin, 'Competition and corporate governance in transition', (para. 25 of 42).
[35] Grosfeld, Tressel, 'Competition and corporate governance: Substitutes or complements? Evidence from the Warsaw Stock Exchange' (para. 20-1 of 41).
[36] In the Czech Republic ownership concentration is associated with better performance as long as strategic investor other than investment fund is the author of this concentration as noted by Andrew Weiss, Georgiy Nikitin, 'Performance of Czech companies by ownership structure', William Davidson Institute Working Paper, no. 186, 1998, http://wdi.umich.edu/files/Publications/WorkingPapers/wd186.pdf [accessed on 3 April 2002], (para. 3 of 45).
[37] Commander, Dutz, Stern, 'Restructuring in transition economies: Ownership, competition and regulation' (para. 15-6 of 43).

3.9. Polish NIFs versus the MPP in other Central and East European countries

Research shows that 19 out of 25 transition countries used some form of mass privatisation as either a primary or secondary method,[38] although the applied schemes varied significantly in terms of structure, pace and governance mechanisms that eventually evolved. In most of the Central and East European countries mass privatisation programmes were implemented earlier and faster than in Poland. A total of 512 Polish companies privatised via 15 investment funds amounts to a marginal share of all companies as opposed to many of Central and East European countries: some 600 funds were created for 2,352 privatised companies in the Czech scheme[39] whereas the Russian MPP covered 14,000 medium and large enterprises accounting for two thirds of the industrial labour in terms of employment.

Russia and Ukraine implemented rapid mass privatisation and relied mostly on management-employee buyouts, whereas the Czech Republic, Lithuania and to a lesser extent Slovakia based their programmes upon equal-access voucher distributing the shares among the society[40] and privatising the companies via investment funds.[41] The rapid mass privatisation was crucial from the perspective that it used the window of opportunity and eliminated the threat of reform regression. On the other hand, the equal-access voucher privatisation allowed for speedy and relatively fair distribution of the nation's wealth. However, neither method contributed to the emergence of new investment funds nor generated resources for government. Moreover, both led to a poor corporate governance structure.[42] Rapid mass privatisation failed to provide the existing management with incentives or the tools for improving efficiency. The equal-access voucher privatisation resulted in dispersed ownership since the programme usually involved the whole population of a country. Researchers argue that the failure of the voucher mass privatisation to provide effective governance structure is rooted in the structure of long agency chains since a citizen who receives a privatisation voucher cannot provide appropriate incentives for corporate control.[43] From this perspective the voucher investment funds provided a 'vehicle for high abuse'[44]. The dispersed ownership resulted in a control vacuum which in turn led to tunnelling carried out by managers or majority shareholders at the expense of minority shareholders[45]. Moreover, the Czech case shows that the investment privatisation funds acted more like agents than owners since they were receiving a management fee but did not benefit from any increase in the equity value. Additionally since the stock

[38] Estrin, 'Competition and corporate governance in transition', (para. 12 of 42).

[39] Coffee, 'Privatisation and corporate governance: The lessons from securities market failure', (para. 22 of 71).

[40] Svejnar, 'Transition economies: Performance and Challenges' (para. 31 of 45).

[41] Coffee, 'Inventing a corporate monitor for transitional economics: The uncertain lessons from the Czech and Polish experiences', 122.

[42] Estrin, 'Competition and corporate governance in transition',(para 12-4 of 42); Coffee, 'Privatisation and corporate governance: The lessons from securities market failure', (para 24 of 71).

[43] Joseph Stiglitz , 'Whiter reform?', ABCDE Conference Washington D.C., World Bank 1999; Joseph Stiglitz, 'Quis custodiet ipsos custodes? Corporate governance failures in the transition', ABCDE Conference, Paris, World Bank, 1999 as quoted in Estrin, 'Competition and corporate governance in transition', (para. 14 of 42).

[44] Joseph Stiglitz, 'The role of government in economic development', in Michael Bruno, Borin Pleskovic (eds.) Annual World Bank Conference on Development Economics, Washington D.C., World Bank, pp. 11-23 as quoted in Estrin, 'Competition and corporate governance in transition', (para. 14 of 42).

[45] Coffee, 'Privatisation and corporate governance: The lessons from securities market failure', (para 23 of 71); Svejnar, 'Transition economies: Performance and Challenges', (para. 12 of 42).

market was small, institutional investors were locked in without a choice of either exit or voice.[46] However, in principle it was possible for financial intermediaries to concentrate their voucher holdings and carry out the effective monitoring as happened in Poland, Slovenia and Slovakia and to some extent in the Czech Republic, although the ‘who monitors whom’ structure was not always clear[47].

Further research indicates the crucial role of the regulatory and institutional regime that created the framework for privatisation[48]. In the Czech case regulations allowed for trading the shares for companies subject to privatisation outside the stock exchange and trading on the Prague Stock Exchange (PSE) did not require contemporaneous price reporting which contributed to the systematic looting of Czech companies by their controlling shareholders (IPFs) and the expropriation of the remaining minority shareholders.[49] As result of these problems between 1995 and 1999 the number of companies listed on the PSE fell by more than 80% (from 1,716 to 301). Therefore, the quality of the regulation appears to be a crucial element in the privatisation programme and the efficiency of new ownership structures.

Conclusions

The results of the Polish MPP are highly controversial and relatively blurred. Despite a lot of criticism one can conclude the main goals were achieved. Restructuring was carried out in most of the portfolio companies. Many of the NIF companies were sold outside, mostly to strategic and industrial-related, investors. The financial results, although still highly disappointing, improved. Comparative analysis shows that the Polish MPP as opposed to the Czech, Slovak or Russian schemes provided a relatively adequate control structure. It is however, harder to say to what extent looting was reduced. The structure which introduced one additional level of agents turned out to be complicated and costly. The investors involved in the NIF scheme were present in the Polish market but outside of the NIF structure. The NIF structure was not as efficient as one tailored by market institutions. It is however highly disputable whether the MPP contributed to the development of governance mechanisms in Poland. The NIFs were hardly involved in the ownership of Polish companies, they evolved towards purely investment activity and ownership concentration appeared to be the most significant control mechanisms used by the funds. The NIFs’ stake accounted for between 10 to 16% ranging from an average of 21% of some privatised, to 6% of new set companies.[50] Besides foreign and domestic companies, and to a lesser extent banks, it is questionable whether other institutional investors would be willing to engage in the active governance of Polish companies. On the other hand, the change in the ownership and governance structures of both portfolio companies and the NIFs indicates that ownership concentration is very important in transition economies. Additionally, these changes show how the development and importance of capital networks and shareholdings tended to play a crucial role in the Polish governance system.

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[46] Coffee, ‘Inventing a corporate monitor for transitional economics: The uncertain lessons from the Czech and Polish experiences’, 125

[47] Estrin, ‘Competition and corporate governance in transition’, (para 12 of 42).

[48] Edward Glaesser, Simon Johnson, Andrei Shleifer, ‘Coase versus Coasians’, *Quarterly Journal of Economics*, 116, 2001, 3, 894.

[49] Coffee, ‘Privatisation and corporate governance: The lessons from securities market failure’, (para. 31-2 of 71).

[50] Grosfeld, Tressel, ‘Competition and corporate governance: Substitutes or complements? Evidence from the Warsaw Stock Exchange’ (para. 18-9 of 41).

Comparatively the Polish scheme is 'the least mass' of the MPPs in the transition economies. Poland was the only country so far that administratively structured its investment funds. Many experts indicate the deficiencies and negative aspects of mass privatisation programmes across the CEE which may lead to the conclusion that the scheme is wrong from the outset.[51] From this perspective the Polish model, although it did not lead to efficient restructuring or emergence of corporate governance, was able to minimise, but not fully eliminate, the most problematic aspects of mass privatisation.

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[51] For instance, the evaluation of Russian privatisation programme shifted from optimistic to concerned and doubtful in 1995 as the second 'cash' phase of privatisation was not proceeding in a rapid or honest manner, then to alarm, in late 1995-early 1996, over the 'loans-for-shares' programme in which some very high potential, natural resources-based funds were transferred in a matter neither competitive not transparent nor lucrative to the selling state, to a group of financial 'oligarchs' connected to the presidency. And there were few signs of substantial restructuring, much less production growth, in the firms privatised by vouchers' as noted by John Nellis, 'Privatization in transition economies: What happened? What comes next?' 2000, World Bank, http://pppue.undp.org/indexAction.cfm?module=Library&action=GetFile&DocumentAttachmentID=31 [accessed on 10 February 2007] (para. 4-5 of 15). Addressing the poor performance of the Russian economy during the period 1995-1998 and the inequitable distribution of wealth, the Nobel laureate Kenneth Arrow described Russian privatisation as "a predicable economic disaster' and former advocate of rapid privatisation and adviser to CEE governments, Jeffrey Sachs, called for re-nationalisation of the mis-privatised companies in order to re-privatise them a second time correctly.

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