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The "IPO-Plus"

A New Approach to Privatization

A proposed new form of privatization, IPO-Plus, combines the efficiency of case-by-case privatization with the equity of mass privatization.

Itzhak Goldberg
Gregory Jedrzejczak
Michael Fuchs

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Summary findings

Every approach to privatization entails tradeoffs. The chief advantage of case-by-case privatization—including sales for cash or initial public offerings (IPOs)—is *efficiency*. Case-by-case privatization generates revenues, gives shareholders control over managers, and provides access to capital and skills. But it is slow and does not promote widespread public participation.

Voucher-based mass privatization programs, by contrast, are designed to promote *equity* in the distribution of wealth, through widespread participation. But they do not ensure efficiency because they may not generate revenues, bring in new capital or skills, or give shareholders control over managers.

To promote equity and efficiency, Goldberg, Jedrzejczak, and Fuchs propose a new form of privatization—IPO-Plus—that incorporates key features of both case-by-case privatization and mass privatization.

IPO-Plus promotes equity through widespread (but not mass) participation in privatization. It promotes efficiency by making privatization transparent, by fostering capital market development, and by creating independent financial institutions that would press companies to improve their financial performance.

It relies not on vouchers but on the sale of low-priced public shares. It allows deferred payment for company shares as an incentive to purchase them as well as downwardly flexible share prices.

Because the quality of the enterprises chosen for privatization is essential to the success of the IPO-Plus program, it is important that few enterprises be offered in each auction and that the list of enterprises targeted for IPO-Plus be published before the program is launched. This will motivate potential investors to join the program by setting up management companies, establishing public investment funds, and buying shares in them.

IPO-Plus is more likely than mass privatization to create "real owners." Investors in IPO-Plus are given a subsidy, but only in proportion to what they themselves choose to pay. The individual determines (up to a ceiling) how much to invest in the program.

IPO-Plus is particularly appropriate where the objective is to encourage outside ownership rather than significant employee ownership. It encourages the emergence of market intermediaries and ensures the concentration of enterprise shares in investment funds. Outside ownership and concentration of share voting rights provide the basis for enterprise restructuring and economic growth.

This paper — a product of the Private/Financial Sector Development, Europe and Central Asia Region — is part of a larger effort in the department to understand the effect of privatization on enterprise restructuring. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Itzhak Goldberg or Michael Fuchs, telephone 202-473-6289 or 202-458-5875, internet address igoldberg@worldbank.org or mfuchs@worldbank.org. August 1997. (25 pages)

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A NEW APPROACH TO PRIVATIZATION: THE "IPO–PLUS"

By Itzhak Goldberg, Gregory Jedrzejczak and Michael Fuchs[1]

INTRODUCTION

The need for innovative privatization methods

This paper addresses policy-makers interested in privatization. As acknowledged in the World Development Report, "From Plan to Market"[2], each approach to privatization creates trade-offs among various goals.

On the one hand, case-by-case privatization, such as sales for cash or initial public offerings (IPO's) provides *efficiency*. Important advantages of case-by-case privatization are generating revenues, creating control of shareholders over managers and access to capital and skills. But this approach does not promote widespread public participation in the privatization process and is relatively slow.

On the other hand, voucher-based mass privatization programs (MPP's) are designed to promote *equity* in the distribution of wealth and widespread public participation in privatization, but MPP's do not sufficiently ensure efficiency, because they do not bring in new capital or skills, create control of shareholders over managers or generate revenues.

This paper proposes a new form of privatization, which includes central features of both case-by-case privatization and mass privatization in order to promote *both efficiency and equity.*

Selection of suitable methods for privatization is still a timely issue in many countries. Several transition economies – with Russia as the prime example – have completed MPP's, but are left with undivested state holdings in partially privatized companies and with large non-privatized sectors such as the infrastructure sector (transport, energy and telecommunications) and the financial sector (banks and insurance). In other large countries, such as China

[1] Comments from Loup Brefort, Mark St. Giles, Matthew Hogopian, Mukul Kumar, Ira Lieberman and John Nellis are appreciated.

[2] See page 3.12 of the World Development Report, 1996, published by the World Bank.

and Vietnam, there continues to be considerable state ownership, and wide distribution of property rights to the public at minimum cost – as envisaged in mass privatization programs – may be impractical or politically unacceptable. The potential role of cash sales or IPO's is also limited, because private sector purchasing power is small and the financial infrastructure for conducting public share offerings is insufficiently developed. In African countries the number of companies targeted for privatization may be small and the values to be distributed may be insufficient to support a mass privatization program.

In choosing mass privatization rather than the case-by-case approach countries of Eastern Europe and the Former Soviet Union were predominantly concerned with equity considerations: private wealth available for buying assets was low in comparison to the supply of assets to be privatized. "Of course, low wealth does not by itself pose a problem for privatization (as opposed to public revenue), since it only implies low prices of privatized assets... More important than low wealth is *the extremely uneven distribution of private wealth*, with black market businessmen and ex-communist officials holding the lion's share".[3] Case-by-case privatization in Eastern Europe and the former Soviet Union would have been politically unacceptable, as state assets would have been sold to communists, criminals and foreigners for very low prices.

However, experience has shown that, although MPP's are designed to create broad distribution of ownership, they do not necessarily achieve this goal. Rather than resulting in broad ownership, quick transfer of ownership in Russia led to the transfer of wealth to a narrow group of enterprise owners. While the MPP created a critical mass of private enterprises, it failed to establish the expected political support for the reform process. "Overall, the way privatization has been conducted is resented by many Russian citizens who feel that they have received a pittance while some managers – and their high-placed political supporters – gained a fortune"[4]. A recent empirical study[5] found that the shareholding of enterprise managers in Russia is high – at around 60% of equity capital – and is still growing. This experience has given rise to growing skepticism about mass privatization which stresses speed and pertains to achieve widespread participation in a "big bang" through the free distribution of property.

There is also growing recognition of the weakness of MPP's in promoting efficiency. As property is distributed for "free", shareholders tend to be more apathetic and take the attitude that they do not bear any real risk should their shares lose in value. Rather than resulting in shareholder control over managers, MPP's gave rise to growing insider domination. Although insider

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[3] Boycko et al, 1994, p. 254.
[4] World Development Report, 1996, Chapter 3.
[5] Blasi and Schleifer, May 1996.

entrenchment in the Russia MPP can partly be attributed to the political power of enterprise managers and the weakness of the Central Government, it is also a reflection of the design of the MPP. Insider entrenchment in Russia stems, *inter alia*, from the free distribution of privatization certificates. Free distribution encouraged citizens to re-sell their certificates for a pittance to insiders and contributed to the weakness of the investment funds, which lacked liquidity and could not establish control over enterprise directors (see **box I** on the Russian MPP).

The IPO–Plus method of privatization proposed in this paper is designed to achieve: (i) equity through widespread public, *but not mass* participation in the privatization process, and (ii) efficiency through transparent privatization and capital market development creating independent financial institutions with responsibility for putting pressure on companies to improve their financial performance. Instead of vouchers as under an MPP, the IPO–Plus relies on (i) the sale of low-priced public participation shares, (ii) incentives for the purchase of company shares by allowing deferred payment, and (iii) downward flexibility in share prices. Each of these features is discussed in more detail below.

THE IPO–PLUS SCHEME

A brief overview of the scheme

Under the IPO–Plus scheme private interests are allowed to establish special investment funds called *Privatization Investment Funds* (PIF's) to buy the shares of enterprises being privatized. The PIF's issue their own *Public Participation Shares* (PPS's) to the public. These participation shares are issued at a uniform low price to ensure broad public participation. A *deferred payment mechanism* generates purchasing power to supplement the capital raised by the PIF's through the issue of shares (PPS's). In addition the purchasing power of the PIF's is enhanced by allowing them to buy the shares of enterprises being privatized at a low price. The structure of the scheme is summarized in the **chart**.

To initiate the program, management companies are formed by private interests. Management companies are required to provide some founders capital from private sources to enable them to establish PIF's as joint stock companies. Once they have been licensed, management companies can apply to license one or more PIF's under their management. To encourage the founding of PIF's the regulatory authority for the securities industry will need to develop transparent, rigorous, but open licensing procedures. Once PIF's are licensed and prospectuses for public offering have been registered, management companies can engage in selling PPS's to the public.

Box I **Russian privatization - lessons for IPO–Plus**

The first phase of privatization in Russia took place from 1992 through 1994 and included the MPP for medium and large companies. The design of the Russian MPP did not contain an institutional concentration of ownership through financial intermediaries such as investment funds. The designers believed that funds would emerge spontaneously by buying vouchers from employees and using them to participate in auctions to gain a sufficient stake, if not a controlling block, in enterprises. "The voucher investment funds, initially constrained from acquiring more than 10 percent of the shares in any enterprise, were left with some 30% of the public's vouchers and widely dispersed ownership, but without a clear role in enterprise governance or in capital market development. These funds remain a problem for the Government, notably the Russian SEC...".[6]

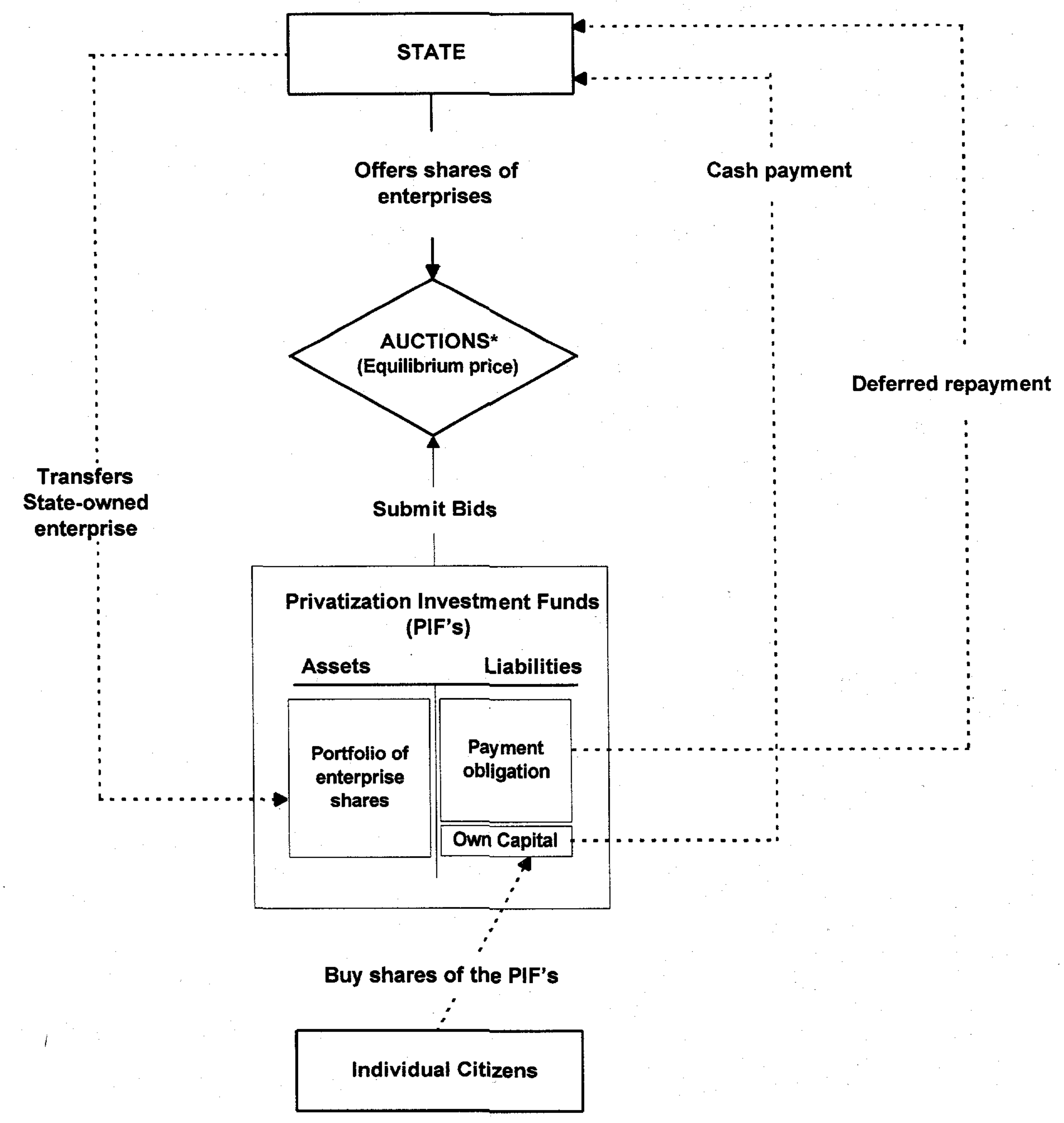
The Russian Voucher Investment Funds (VIF's) suffered from four major problems: (i) they lacked *liquidity*, (ii) they did not have access to company *registries* and were unable to establish ownership after having bought shares, (iii) there was insufficient time to revise the *legal foundation* to support them in their struggle with the incumbent directors, and (iv) the tax code discouraged them from restructuring their portfolios of enterprise shares, as heavy taxation was imposed on capital gains. As a result, of some 650 VIF's originally formed in 1992-1993, only some 300 are still in existence, and of these perhaps only 80 to 100 are viable. These viable funds account for about 75% of invested vouchers, but the quality of their performance is uncertain[7]

The second phase of Russian privatization began in 1995 and was based on *cash sales of the residual shares* in the enterprises, which had been privatized through the MPP in phase one. The second phase also included the loans-for-shares scheme. "Residual share sales were largely non-transparent,....The process led to increased control by enterprise managers and the ownership of major banks...One analyst indicates that the outcome of the MPP doomed cash privatization. That is outsiders are loath to purchase block of shares for cash in enterprises owned by insiders".[8] The proposed privatization strategy for Russia in the third phase (1996-1997) is mainly based on a case-by-case approach.

The move of Russian privatization from mass to case-by-case privatization provides an important lesson for IPO–Plus privatization. The design of IPO–Plus is based on a combination of features from both approaches. By making PIF's an in-built feature of the design the IPO–Plus attempts to avoid the problems encountered by the Russian VIF's. Incorporating PIF's as a design feature reduces the power of directors and thwarts them in their attempts to prevent outside owners from acquiring controlling blocks of shares. The cash payment for the shares in the PIF's (the PPS's) provides the PIF managers with some initial liquidity and enables them to establish a power base vis-à-vis the enterprise directors. In addition, an important pre-condition for launching IPO–Plus is establishing a sound legal foundation for the PIF's.

[6] Lieberman et al, 1996.
[7] St. Giles, March, 1997.
[8] Lieberman et al, 1996.

How the IPO–Plus scheme works



* Enterprise shares are offered in the first auction at "nominal book value". If there is over-subscription, shares are allocated pro-rata among the bidding PIF's at "nominal book value". If there is under-subscription, a second auction is organized where the shares are sold, irrespective of the book value, to the highest bidder.

The PPS's are regular shares in mutual funds incorporated as joint stock companies and constitute the *only class* of shares in a PIF. The price of the PPS's in each subscription is pre-set by the Government as a design parameter of the program. A low subscription price will encourage widespread public participation, as will limiting the number of PPS's, which can be purchased by any one person in the primary issue. Such a limitation is similar to the provision in MPP schemes, whereby each citizen is entitled to only a certain number of vouchers. However, in the IPO–Plus there is likely to be more variation in the number of PPS's purchased. Setting a higher limit for each person's purchase of PPS's provides greater choice for those individuals, who can afford to buy PPS's, but distributes the benefits of participating in the privatization program *less equitably.* This important trade-off between equity and feasibility –ensuring that the volume of PPS's sold is sufficient to support the program – must be addressed by policy-makers in the design of the program.

PIF's sell PPS's at a given price during the subscription period. A lengthy subscription period is desirable, because it allows the PIF's to market their PPS's to the public, but it also raises issues regarding equity among PPS owners[9]. Once the subscription period is over, PPS's will trade on the secondary market at prices reflecting the market value of the enterprise assets held by the PIF's. By purchasing PPS's on the secondary market investors will be in a position to accumulate larger blocks of PPS's, thereby enhancing corporate governance in the PIF's.

THE PROCESS OF ENTERPRISE PRIVATIZATION

The role of investment funds and the bidding process

The public can participate in IPO–Plus privatization only through privatization investment funds. There is no direct sale of enterprise shares to individuals at preferential terms as in other mass privatization schemes. This in no way precludes citizens from buying shares in privatized companies directly, but such purchases will be at market prices and without the deferred payment mechanism made available to the PIF's (described in the next section).

Enterprise shares are offered to the PIF's at a low starting price. Determining this offer price may be difficult, but a typical, less arbitrary choice would be the "nominal book value". This is usually a politically "safe" choice, because book value is believed by politicians to reflect the original investment by the state in the enterprise and therefore pre-empts accusations of selling state property "too cheaply".

[9] In Former Soviet Union countries the maximum subscription period allowed under joint stock company laws is usually 6 months.

In the event of *over-subscription* for shares of an enterprise being offered at auction, shares are allocated on a *pro-rata* basis. This prevents share prices from being bid up. Pro-rata allocation of the shares of the more attractive companies among widely held funds is an equitable solution. Although a traditional auction would allow upward price flexibility to determine the allocation of shares, under IPO–Plus bidding up the prices of enterprise shares would be self-defeating, because PIF's would compete by using the enhanced purchasing power provided by the deferred payment mechanism. In effect they would undermine the role of this mechanism. It is worth underlining that the main objectives of IPO-Plus are widespread and transparent privatization, and it will not be possible to achieve these objectives without compromising on the objective of maximizing privatization proceeds.

In the event of *under-subscription* for enterprise shares, prices of enterprise shares at the auction should be allowed to drop below the initial offering price -- i.e., remaining enterprise shares will be sold to the highest bidder. Thus, when demand proves to be insufficient despite the low initial offer price, downward price flexibility for any unsold shares will encourage PIF's to make bids. PIF's are, however, in no way be obliged to purchase enterprise shares, even at prices below the initial offer price and after taking into account the deferred payment mechanism. Enterprises may remain financially unattractive at a low (or zero) equity price. Any obligation to buy such enterprises will force the PIF's to purchase assets with negative value and undermine the commercial objectives of the PIF's.

DEFERRED PAYMENT FOR ENTERPRISE SHARES

Generating sufficient purchasing power

The purchasing power of the PIF's in buying shares offered for privatization is enhanced by the deferred payment mechanism made available by the Government. By using deferred payment PIF's can increase their purchasing power in proportion to the number of PPS's, which they sell to the public. The aim should be to generate sufficient purchasing power for the sale of the assets being privatized.

Prior to launching the program the size of the deferred payment is set in relation to the number of participation shares which the PIF's are estimated to be able to sell, the "cash-credit ratio", CCR. The intention is to give the PIF's access to sufficient purchasing power to purchase the shares targeted for privatization under the program[10]. The CCR is a uniform ratio applied to all PIF's, determined by the Government.

[10] Note that there is no obligation on the part of the PIF's to bid for shares at any auction. PIF's use their own assessment of enterprise future earning capacity in determining whether to bid for

$$\text{CCR} = \frac{\text{Value of assets for IPO–Plus privatization}}{\text{Own Capital (No. of PPS's sold X Price of PPS)}} - 1$$

Establishing an *ex ante* value for the CCR can be approached from two angles: (a) by estimating the number of PPS's, which the PIF's can reasonably be expected to sell, and (b) by assessing how many PPS's the PIF's will need to sell in order to be viable. Although it will be difficult to make any precise assessment of the demand for PPS's, an estimate should be possible taking into consideration such factors as eligible population, propensity to save, and willingness to take risks. It should also be possible to make a pro forma assessment of the viability of the PIF's. PIF's will have to sell a minimum number of PPS's so as to generate sufficient fees to cover the costs of managing their assets. Approaching the issue from both these angles should provide reasonably reliable guidance in setting the CCR.

There is a risk that, after launching the program, the sale of the PPS's turns out to have been overestimated, and the CCR will *ex post* have been set too low to provide sufficient purchasing power for the program. If it takes longer to develop interest in the program than initially envisaged, sales of PPS's may initially be disappointing despite the low price. In pre-empting such a situation the Government and the PIF's should be encouraged to undertake an intensive initial publicity program.

If PPS sales turn out to be lower than estimated, two possibilities exist. First, it is likely that a larger proportion of enterprise shares will be sold at the second round auctions, i.e. at below their nominal value. Second, the authorities can consider the option of increasing the CCR. There may be dangers in changing this parameter too frequently both as regards the credibility of the program as a whole and as regards equity among PPS investors. But at certain intervals, maybe annually, and after the closure of subscription in an open series currently being offered by the PIF's, an effective means of attracting more momentum to an IPO–Plus program would be to increase the size of the CCR.

Providing incentives by setting the terms of the deferred payment

The terms of the deferred payment are important in giving the PIF's the opportunity to participate constructively in the process of enterprise restructuring. In the period immediately following privatization – i.e. before there has been opportunity for enterprise restructuring – it is unlikely that the PIF's will be able to fund repayments of principal and interest on the deferred payment. The PIFs' only source of liquidity will be through the sale of enterprise shares at their

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shares. When making bids they are given access to the deferred payment scheme according to the size of their bids.

market prices.[11] Although it is to be expected that the market value of enterprise shares will exceed the purchasing price paid by the PIF's (book value with deferred payment), the PIF's will need any liquidity they can raise through the sale of shares for enterprise restructuring. Tight repayment terms on the deferred payment for shares may result in "forced sales" of shares, depressing the value of shares in privatized companies and eventually threatening the solvency of the PIF's.

To give the PIF's a sufficient time-frame for conducting enterprise restructuring it will be advisable to structure the deferred payment with a grace period, during which no principal is repaid and no interest accrues. Following the grace period concessional terms should be offered on the repayment of the deferred payment. Alternatively, rescheduling and/or partial write-off of the deferred payment could be a component of the program design. However, so as to avoid giving the PIF's perverse incentives, i.e. giving PIF's the incentive to show poor performance so that their debt will be rescheduled or forgiven[12], any rescheduling or write-off should be independent of performance, and uniformly applied.

Under IPO–Plus privatization, PPS holders are exposed to the economic benefits and risks associated with enterprise restructuring irrespective of the terms of the deferred payment.[13] PPS investors are able to choose whether they wish to participate or not. They are able to select freely among the PIF's, and it is up to each PIF to convince potential PPS purchasers of the PIF's future performance potential. The PIF's will need to demonstrate their professionalism by bidding for the most promising enterprises and by actively engaging in enterprise restructuring. Over time those management companies which are successful in enhancing the value of the assets under their management will have greater ease in attracting the public to purchase PPS's.

SELECTION OF ENTERPRISES FOR PRIVATIZATION

Selecting suitable enterprises will provide the momentum behind the program

Unlike case-by-case privatization, mass privatization requires the selection of a critical core of enterprises, which form the "supply side" of the program. The distinguishing feature of an MPP is the large number of

[11] Initially PIF's will have access to some liquidity arising from the sale of PPS's. This may be useful in funding some establishment costs. However, as PPS's give access to deferred payment, when they are used for purchasing enterprise shares, PIF's will have a strong incentive to use funds from the sale of PPS's at the enterprise auctions.

[12] Similar perverse incentives, known as *moral hazard*, arise in other insurance schemes, such as deposit insurance.

[13] PPS holders' downside risk is limited to the value of the PPS. Their upside risk is enhanced by the low initial offer price and the deferred payment mechanism.

enterprises to be privatized and the speed of the process. As speed is a major objective, evaluation of individual enterprises and selection on the basis of quality is impractical. Moreover, as vouchers are free, it is considered "fair" and politically acceptable to include enterprises of unknown, possibly negative, value. In Eastern Europe and the Former Soviet Union large numbers of enterprises were included in MPP's to ensure popular support and to justify the distribution of vouchers to the whole population.[14]

Under IPO–Plus the number of enterprises selected for privatization will be smaller. Enterprises will need to be made available successively in order to balance the supply of enterprises with the demand ("purchasing power"), which increases only gradually as the PIF's sell their shares to the population. Building supply and demand will be a *simultaneous and continuous* process. The process can be described in a number of steps. First, the process of licensing management companies and PIF's can start as soon as the relevant legislation and regulations are in place. The licensing process can be set in motion irrespective of the start date for the auction of enterprise shares. Second, the pre-selected list of enterprises to be privatised through the scheme should be announced at an early stage so as to encourage participation and allow the enterprises to prepare prospectus material and the management companies to assess the enterprises. Management companies should have the opportunity to evaluate the enterprises and undertake due diligence studies in as far as this is possible. Third, so as stimulate the sale of shares in the PIF's (the PPS's), these shares should be made available at a fixed offer price throughout the prospectus period (e.g. for six months). Fourth, so as to establish momentum for the sale of PPS's it is important that the auction process commences early during the subscription period, preferably by conducting regular auctions of a number of enterprises.

The number of enterprises to be sold at any one auction will need to reflect the PIF's success in selling PPS's in the preceding period. Public participation in the privatisation process through the purchase of PPS's will depend on building up a sense of excitement about the whole process. Were PIF's required to sell sufficient PPS's to purchase a larger number of enterprises *prior to* the initiation of the auction process, the danger is that the PIF's marketing campaign to sell their PPS's would run out of momentum. Thus PIF's should be encouraged to buy at auctions while simultaneously marketing subscription in their shares. The auction of good enterprises will result in positive publicity, as will the active participation of the PIF's in the auction process. As more companies are auctioned, publicity will stimulate the sale of more PPS's and gradually it will be possible to auction more enterprises.[15] Should the sale of PPS's be smaller than anticipated or delayed, the sale of enterprise shares will have to be reduced reflecting the limited funds at the

[14] Lieberman et al, 1995; Boycko et al, 1994.
[15] St. Giles, 1995.

PIFs' disposal. Thus the scale and speed of privatization will depend on building demand for PPS's

It is here – with regard to the scale and speed of privatization – that IPO–Plus presents a compromise between case-by-case privatization and mass privatization. As the sale of enterprises is a continuous process under IPO–Plus, the targeting of companies for privatization needs to be more selective than in MPP's. As in case-by-case privatization the selection of good companies for the IPO-Plus is important so as to stimulate demand for PPS's, but the demands on enterprise quality are less under IPO–Plus due to the deferred payment and the fact that the (low) initial offer price cannot rise in the bidding for enterprise shares.

As mentioned above, it is important to hold regular auctions of enterprises to preserve the momentum behind the program. Auctions can be conducted for larger or smaller batches of enterprises. If the number of enterprises offered at individual auctions is relatively small, PIF managers will have a better opportunity to assess the viability of the individual enterprises. However, if the number of enterprises committed to the IPO–Plus *program as a whole* is too small, it will be difficult to justify building the required financial market infrastructure, hamper possibilities for the PIF's to undertake risk diversification and reduce public interest in buying PPS's. Prior to the launching of the program the Government needs to commit to privatizing *a significant pre-selected number of enterprises* which meet the quality criteria of IPO–Plus. Exactly which enterprises among those selected for privatization are scheduled for sale at the individual auctions can be decided subsequently to reflect progress with the sale of PPS's.

Although it is desirable that the subscription period for any series of PPS's be as long as possible, a long subscription period with a fixed offer price does raise certain equity issues. Investors who buy PPS's in the latter part of the subscription period possess more information about the portfolios of enterprise shares owned by the PIF's than those who buy earlier. They will most probably also pay less in real terms for their shares. Inflation during the subscription period will contribute to raising the real value of enterprise assets and reducing the real burden of purchasing PPS's. Nonetheless, practical considerations argue for keeping the subscription price unchanged during the subscription period. It will also be advisable to disallow dividends and trade in enterprise shares during the subscription period to prevent dilution of the PIF's. This will allow the PIF's to assemble their portfolios and give shareholders the opportunity to observe the final portfolio of the PIF's. At the close of the subscription period each shareholder will own an interest in the pool of all assets of the PIF, including accumulated interest and any realized gains, proportionate to the amount of shares bought.

In preparing the selection of enterprises and the proportion of the shares in these enterprises to be privatized under an IPO–Plus program it should be underlined that IPO–Plus is *not* envisaged to be an exclusive method of privatization. On the contrary, shares in the same enterprises, which are sold on concessional IPO–Plus terms, may also be offered to employees on concessional terms or offered to the general public (including PIF's) at non-concessional prices. It is envisaged that shares sold to the PIF's on preferential terms and shares offered for free sale to the public will together constitute *at least 51%* of the shares in the individual enterprises. Whichever method of privatization is chosen, all shares will be freely tradable on the secondary market allowing institutional investors, including PIF's, to accumulate significant holdings.

BIDDING AND PRICING ENTERPRISE SHARES

Promoting sales of enterprise shares in an uncertain economic environment

According to the auction pricing mechanism described above, enterprise shares are initially offered to the PIF's at a fixed-price. Over-subscription results in pro-rata allocation of shares. By allocating shares pro rata, some measure of the interest of each PIF in the shares of any given enterprise is reflected in the final distribution of shares. A PIF which has been successful in selling PPS's will also be "rewarded" by being able to bid for a larger quantity of shares at the auction of attractive enterprises.

Nonetheless, the fundamental question remains as to why the valuation of individual enterprises, as reflected in the bids made by the PIF's, should not be allowed to influence share prices in an upward direction at the time of the initial public offering. First, keeping the offer price unchanged rather than allowing prices to be bid up at the auction preserves the value of the "give-away" element in the privatization process. Second, the availability of information on the current status and future prospects of enterprises in transition economies is very poor. If PIF's are encouraged to bid up the share prices, the risk is that shares will be priced above their intrinsic value, thereby exposing the PIF's to potential financial losses. Empirically, the difficulty of evaluating enterprises is borne out by experiences in Russia, where investors were allowed to make "sophisticated bids" with a maximum price, but only 2% chose to do so: "Usually, large investors just brought in suitcases of vouchers, and tendered them to get whatever shares they could get in the auction. Evidently, even large investors had no idea what the companies were worth, and felt that shares were cheap enough not to bother with complicated bids."[16]

[16] Boycko et al, 1994.

In cases, where the initial offer price is "too high" and enterprises remain unsold, it will be necessary to stimulate the sale of unsold shares by allowing downward price flexibility in a second auction.[17] Establishing a sufficient number of PIF's will be important so as to prevent collusion in the bidding process. Preventing collusion among bidding parties is essential – both with the fixed offer price and in the flexible-price second round. Collusion by "bidding rings" can best be avoided by promoting the emergence of a sufficiently large number of PIF's, at least 20, who compete vigorously to buy shares of the best companies, and who are unlikely to be able to maintain a cartel, even if one is formed. Low costs of entry in establishing PIF's and in participating at the auctions will promote efficient price formation at the auctions.

Setting the initial offering price may be difficult, both economically and politically. Information on enterprise fundamentals is unreliable due to poor accounting systems. The intrinsic value of enterprise assets is difficult to determine due to uncertainty regarding corporate governance after privatization (sale of controlling or non-controlling stakes), uncertain demand for the products produced by the enterprise, and uncertainty with regard to broader factors such as country risk and macroeconomic stability. As mentioned above, many countries have opted for using "nominal book" value as a starting price because of political convenience.

The bias in favor of under-pricing in IPO–Plus privatization has some similarity with price-setting behavior in traditional IPO's. On the IPO market, once the issuer and underwriter have agreed on an offer price, any excess demand leads to quantity rationing rather than adjustment of the offer price. Underwriters are remunerated for accepting uncertainty about the value of the shares offered by systematic under-pricing of primary offers. Neither in the traditional IPO, nor in the IPO–Plus does this detract from the incentive for underwriters or PIF managers to arrive at a realistic valuation of enterprises. The risk is that underwriters in the traditional IPO will underwrite shares at a higher price than they can fetch on the secondary market or "cheat" an issuer by setting the price too low.[18] Similarly, PIF managers in IPO–Plus privatization risk entering bids which are too large at the given offer price or entering a bid which is too small and does not reflect the potential earning capacity of the enterprise being offered. This also applies in cases of over-subscription of the shares on offer, as the size of the bids determines the pro-rata allocation of shares.

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[17] It may not be possible to sell certain enterprises at a positive value prior to enterprise restructuring or relief from debt/arrears.

[18] On the IPO market such price-setting would rapidly undermine the business interests of the underwriter.

Underwriters in traditional IPO's and PIF managers in IPO–Plus privatization both run the risk of the "winners curse" – they may be allocated shares in the primary offer which fall in value in secondary trading. They also risk losing credibility as underwriters (in the traditional IPO) or with investors in PPS's (in IPO–Plus), if they do not bid aggressively enough for attractive enterprises. However, by initially allocating shares at a fixed offer price the IPO–Plus recognizes the difficulty of making reliable assessments of future earnings in transition economies and puts much less emphasis on valuing enterprise earning prospects than the traditional IPO.

In allocating shares at the time of privatization MPP's have generally relied on auctions in one form or another[19]. The purest method of auction allocates shares according to Walsarian general equilibrium pricing. This method was closely approximated in the "Czech model", which was based on the *simultaneous centralized* auction (exchange of vouchers for enterprise shares) of all enterprises to be privatized. Shares were offered simultaneously for fixed prices, which were loosely related to their relative book values. In case of under-subscription, demand and supply were matched by reducing share values in terms of vouchers. In case of small over-subscription demand was satisfied on a pro-rata basis and in case of large over-subscription shares were withdrawn and included in the subsequent round at a higher price. The iterative nature of this process led to improved price formation. Allocation of shares was achieved by determining relative values with voucher points, rather than absolute money values, being the numeraire.[20]

In the "Russian model" bidders at the auctions could make two types of offers. They could tender vouchers for whatever number of shares were available for allocation (type A offers) or specify the quantity of shares desired at a certain "cut-off" price (type B offers). The number of shares allocated to each bidder was calculated by adding up all the bids of both types and arriving at an equilibrium price. The Russian model was simple to implement and succeeded in giving unsophisticated investors access to share ownership, preventing them from being out-bid by professional investors. But, when it came to actually implementing the program, almost no offers were of type B and the iterative process remained virtually unused. As a result auction prices did not reflect economic values and shares were generally regarded as so cheap that more complicated bidding techniques could be dispensed with. The decentralized auction process adopted by the Russians reflected the political power of

[19] There are obvious advantages associated with the auction model in its "pure" form. Auctions allocate shares according to the principle of willingness to pay rather than rationing, they define market-based enterprise valuations and facilitate subsequent secondary market trading, they reduce reliance on bureaucratic intervention to a minimum, and they allow investors full freedom of choice. But, as described in the text, auctions in MPP's do not always live up to all these characteristics.

[20] Shafik (1993 and 1994).

directors and local governments and resulted in privatization characterized by fragmentation and lack of iteration. This fragmentation proved to be the single most important source of insider power, giving insiders the opportunity to manipulate auctions and buy majority stakes.

The sales mechanism adopted in IPO–Plus privatization builds on experience with traditional IPO's and with MPP's conducted in recent years. In the first round all shares in any specific enterprise targeted for IPO–Plus privatization are sold at a single auction conducted by a centralized national exchange. This ensures transparency in the bidding process. Bids are made by investment funds acting on behalf of small shareholders, thus ensuring relatively "well-informed" price formation.

INTERMEDIATION

The role of privatization investment funds in capital market development

It is a central feature of IPO–Plus privatization that investment funds act as intermediaries and individuals do not participate directly as owners of enterprise shares. In most mass privatization schemes, investment funds have emerged spontaneously to assemble and manage the holdings of individual shareholders. In Poland and Kazakstan a mandated, limited number of funds are core institutions of the privatization programs. IPO–Plus combines features of both approaches: investment funds are an integral part of the privatization mechanism, but they are not mandated by the authorities.

There are several reasons for adopting indirect ownership through funds as the basis for IPO–Plus privatization. First, PPS's are offered to small investors at a low denomination to encourage widespread participation in the Government-backed program. Diversification of risks through funds is a desirable safe-guard for investor savings. Second, were individuals to participate in the ownership of enterprise shares directly, it would be much more complex to administer the deferred payment for enterprise shares, the size of which is related to the number of PPS's sold and to manage the bidding process for enterprise shares. Since they are separately capitalized incorporated entities with limited liability, PIF's are able to assume liability (and provide some security) for the deferred payment on enterprise shares. Individual share- holders in the funds would not be able to provide similar security, nor would they be willing to take on such liabilities. Third, the requirement that enterprise shares are bought by PIF's on behalf of PPS holders – rather than by individuals – will encourage the accumulation of block holdings of enterprise shares. This enhances the incentive for management companies administering the PIF's to engage in enterprise restructuring. The aim is to engineer a form of change of ownership which ensures that incentives are in place for subsequent enterprise restructuring.

Finding real owners, able to discipline managers of privatized enterprises and carry out restructuring, has been a central issue in discussions on enterprise privatization since the very beginning of the transition. Privatization investment funds were to provide a "short-cut" to enforcing corporate governance. It is still too early to judge whether the funds prove to fulfill these expectations. This is true of spontaneous funds as in Russia and the Czech republic and state-engineered funds as in Poland and Kazakstan.[21]

As investment funds are an integral part of IPO–Plus privatization, care has to be taken in designing the structure of privatization investment funds (PIF's) *prior* to launching IPO–Plus privatization. This requires the authorities to specify up-front a coherent legal and regulatory framework for investment funds and to establish the institutional infrastructure for registering and trading enterprise shares, thus reducing considerably the dangers of fraud and misrepresentation which have been a feature of investment funds in some emerging markets.

Investment funds will also play an important role in promoting capital market development by advertising and marketing their shares to the public, by assembling and assessing information on enterprise prospects and by providing opportunities for risk diversification for small private investors.

Investment funds and other types of collectively-owned investment institutions do not normally play as large a part in the early stages of capital market development as they do in developed markets. In the early stages of the transition to a market economy individuals, whether managers or mafiosi, tend to acquire the attractive assets. It is only later in the development process that individuals who have grown wealthy through risky entrepreneurial activities (or their heirs, the next generation) become risk averse, and more interested in capital protection than capital accumulation. Thus, in order to stimulate investment in PPS's in the IPO–Plus scheme, it is important that PPS purchasers come to regard themselves as part of the entrepreneurial process of wealth accumulation.

Under IPO–Plus privatization investment funds (PIF's) are closed-ended funds. They are not obliged to redeem their shares on a regular basis and shareholders may buy shares in the funds only during the pre-defined

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[21] Evidence to date suggests that state control of the Polish National Investment Funds initially weakened the funds' mandate to undertake enterprise restructuring. Subsequently, however, the Polish funds have been more inclined to take a pro-active, long-term position in restructuring enterprises than their Russian counterparts.

subscription period[22]. Once the subscription to a PIF is closed, attracting more funds would require opening a separate PIF. PIF's could *in principle* be organized as corporate entities, mutual funds or as unincorporated entities, but in economies in transition, where company law is well defined and contract law is only emerging, the preferred form of establishment will most probably be the corporate form.

Unlike typical corporations, it is a requirement that privatization investment funds be founded and managed by outside fund managers, which are established as separate legal entities. The business risks of the management companies are separate from the risks associated with the return on the funds under their management. This separation of responsibility has several advantages. First, the remuneration of the fund managers is transparent as is the return on the funds under their management. Second, management companies are able to build expertise by managing multiple funds. Third, the shareholders of a fund can elect to change the fund managers, should they not be satisfied with the performance of the management company.[23]

As a result of the close link between capital market development and IPO–Plus privatization, the authorities assume more responsibility for the soundness of the nascent capital market than under other methods of privatization. The authorities will need to focus on three fundamental factors, which will support the sound management of PIF's: the terms of the contract between the PIF's and the management companies, the corporate governance exercised by the shareholders of the PIF's and the oversight exercised by the supervisory authorities themselves:

- Fund managers may be encouraged to act in the long-term interests of PIF shareholders by linking their remuneration to performance indicators. As in other emerging markets it may, however, be difficult to use such indicators as the growth in net asset value of funds under management while the secondary market for enterprise shares is not well developed.[24]

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[22] As discussed later in the text, the fact that PIF's are closed-end funds makes it essential to establish a liquid secondary market so as to allow investors to redeem their shares.

[23] In transition economies enabling fund managers and PIF's to fulfill these roles may require amendments to the company law. Without such amendments the company law in transition economies may well require managers of a company to be the original shareholders. This contrasts with the role of fund managers envisaged in the text, which is purely administrative. The company law may also limit flexibility of a corporation in opening subscription to a new series of its shares. PIF's will need to be able to open new share subscriptions.

[24] It may also be difficult to define indicators, which are free from manipulation and are linked to the long-term performance of enterprise shares rather than short-term price fluctuations. One way of focusing the attention of fund managers on the long-term growth in share value would be to give fund mangers an equity option, the size of which is linked to the achievement of pre-defined target indicators.

- As investors in PPS's pay in cash for their participation in the privatization process, rather than acquiring shares for "free", they have incentives to take a more active role in governance of the PIF's. On the whole, investment management is built on more solid foundation in those countries where investors have had to pay for their shareholdings than getting them for nothing.[25] Direct corporate governance exercised by PIF shareholders depends on participation at annual meetings. To exercise their influence at these meetings it is important that shareholders are given equal voting rights and the right of approval in selecting shareholder representatives on the supervisory board and changes in fund investment and management policies. By insisting on the establishment of supervisory boards the regulatory authorities can assist in protecting shareholder interests. These boards can perform control functions such as supervising management costs and investment policies, ensuring that reliable information is provided to shareholders, and assessing the fees paid to PIF managers. It would, however, be mistaken to place too much reliance on the role of supervisory boards. Board members will be less well-informed and less motivated to manage fund dispositions than the fund managers under their surveillance.[26]

- The function of the securities regulatory authority is to establish regulatory practices for PIF's and their management companies. These will include requirements as to adequate reserves for PIF's and management companies, disclosure requirements as regards investments and investment policies, procedures for protecting current shareholders and issuing new shares, accounting practices for PIF's and management companies etc.

Establishing the institutional and regulatory framework for the PIF's is essential to the soundness of the privatization process. While the government will need to guide the process of establishing and maintaining this framework, the danger under IPO–Plus privatization may well be *too little involvement in enforcing the "rules of the game" and too much involvement in the game itself.* In addition to taking an active role in designing and regulating the PIF's, the government is the source of supply of shares (in enterprises being privatized) and determines the terms of the deferred payment for enterprise shares. It follows that the success of IPO–Plus privatization will *depend crucially on the government giving its full support to the program.* This support will entail showing restraint from interfering unnecessarily in the operation of the PIF's and their

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[25] An example of the cash subscription effect is Hungary, where shareholders are demanding good results and better service. Shareholders in "free share" countries believe they do not stand to lose anything and are more apathetic.

[26] If boards are to police conflicts of interest between fund managers and investors in the funds, it is essential that board members are independent of the management companies. In the USA it is a requirement of the Investment Companies Act that at least 40 percent of the members of the board of investment funds are independent of the fund's management company. In transition economies this degree of independence may be more difficult to enforce.

relations to their shareholders. Confidence in the program will depend on the government exercising responsible oversight, while fully respecting the role of PIF's as independent financial institutions.

Experience regarding the supervision of funds participating in mass privatization schemes has been mixed. On the one hand there are few cases of outright fraud committed by PIF's. On the other hand many funds could be accused of neglecting investor interests, misrepresentation, passivity, erosion of accumulated assets etc. – i.e. behavior that would be prosecuted in mature markets. It is important to build institutional capacity in the supervision of security markets from the very beginning of the privatization process. Parallel to the development of government supervision PIF's should be encouraged to establish self-regulatory organizations to assist in supervision of market participants and introduce operational standards.

As PIF's collect some cash from the sale of PPS's, they may not be as liquidity constrained as privatization funds in an MPP environment. Nonetheless, due to high start-up costs and low enterprise profitability the return on PIF assets may be low subsequent to enterprise privatization. In the first period of their operation, the terms of the deferred payment for enterprise shares may determine the viability of the PIF's. As mentioned above, these terms should be such that they allow the PIF's to partake constructively in enterprise restructuring (by exercising corporate governance as outside owners) and to consolidate their own capitalization. Following the grace period of the deferred payment, the situation could arise where a PIF is unable to honor its obligations. This could result in the PIF having to finance repayments of the deferred payment by the sale of enterprise shares in its portfolio. *Under no circumstances should the government undertake to re-capitalize PIF's by buying shares in PIF's*, as this would amount to re-nationalization of enterprise assets.

SECONDARY MARKET DEVELOPMENT

IPO–Plus promotes capital market development

Capital market development is an integral part of IPO–Plus privatization. Already prior to initiating IPO–Plus privatization it will be necessary to establish an auction mechanism for the sale of enterprise shares, a reliable share registry, mechanisms for selling PPS's and the regulatory and supervisory infrastructure for privatization investment funds. Once the process for the initial transfer of ownership has begun and investment funds have accumulated portfolios of enterprise shares, it will be essential to facilitate secondary market trading.

The success of IPO–Plus privatization depends on the ability of the privatization investment funds to trade their enterprise shares and on the ability of shareholders in the funds to trade their PPS's. Secondary market trading will be fundamental to the corporate governance exercised by the PIF's with regard to the enterprises and by the shareholders of the PIF's with regard to the PIF's themselves. PIF's need to be able to buy and sell enterprise shares so as to accumulate larger holdings of shares in some enterprises and divest other enterprises. Unless they are able to adjust their portfolios, PIF's will be unable to exercise efficient corporate governance. Similarly, PPS holders need to be able to trade their holdings of PIF shares, reflecting changed perceptions of the returns being achieved by the PIF's.[27]

Shares in the enterprises sold to the PIF's are originally bought on favorable terms. Only in trading on the secondary market will the price of enterprise shares begin to reflect perceptions of market participants regarding potential future enterprise earning capacity.

Similarly, the shares in investment funds, PPS's, are initially sold at an identical pre-set price. Again, establishing a market value for the PPS's depends on secondary trading in the PPS's, where prices reflect the efficiency of the management companies in selecting and trading enterprise shares and in exercising corporate governance. Secondary market pricing of shares in closed-ended funds will also exercise a valuable commercial discipline on fund managers. If a fund manager's performs poorly, then the preponderance of sellers over buyers will cause the share price to trade at a discount to net asset value. As a result a secondary or tertiary issue of shares will be made harder, as will launching a new fund. PPS's in a new fund will not be sold if buyers expect the secondary market to impose a discount to net asset value. By contrast, managers who perform well will find that PPS's in the PIF's under their management trade at a premium to net asset value. These managers will be able to increase funds under their management relatively easily.

As IPO–Plus privatization puts considerable emphasis on capital market development as part of the privatization process itself, it should be possible to build the institutional structure for secondary market trading (registration and settlement systems) onto the mechanisms already established for the primary transfer of enterprise shares and sale of PPS's.

The management companies of the larger PIF's will manage more funds than other investors, and will most likely dominate secondary market trading. The tendency will be for these management companies to engage in off-market block trading and, unless they are obliged to adhere to strict reporting rules, there is a danger that they will undermine market transparency. To stimulate secondary market trading and prevent fraud and insider dealing *transparency* is

[27] Since the PIF's are closed-ended funds formed as companies, they will be unable to redeem the PPS's bought by citizens, as would be the case with open-ended mutual funds.

essential. Immediately following all trades market, participants should be obliged to provide information on trading volumes and prices to a widely accessible, centralized information dissemination system.

Similar concerns are common to capital market development in all emerging markets. The advantage of IPO–Plus privatization is that it lays the foundation for transparent, well-functioning share trading and registration systems, and rather than letting the market determine the need for capital market institutions and their nature – as has often been the case under MPP's – IPO–Plus integrates privatization with the process of establishing well-functioning and sound capital market institutions. IPO–Plus recognizes the "public good" nature of financial markets and the important role of the state in establishing such markets. This is similar to the Polish multi-track approach to privatization, which is presented in **Box II**. In Poland both the MPP and IPO's rely heavily on capital market development.

Box II **IPO–Plus has learnt from Polish experience**

Poland chose not to implement an "across the board" radical MPP. Privatization was conducted through a multi-track approach based on a mix of "classic" privatization methods and the MPP model. In effect, this multi-track approach contained many of the features of IPO–Plus, although they were scattered among three main privatization tracks: initial public offerings (IPO's), management/employees buy-outs (MEBO's) and the MPP.

IPO's

The first privatization cases were patterned after the British privatization experience of the 1980's. For logistical reasons five enterprises were offered to the public in one batch rather than a case-by-case basis. As capital market infrastructure was underdeveloped, there were economies of scale in offering all five companies together. Although these IPO's were not underwritten, offers were solicited at a fixed price. Demand was also enhanced by allowing investors to pay with a treasury bond with 20 percent discount. However, following the "Bank Slaski debacle", where fixed subscription prices were undervalued by a factor of 10 in secondary trading, fixed-price subscription was later replaced by an auction mechanism. Eventually, the practice of simplified IPO's was abandoned and the process slowed-down considerably.

MEBO's

Small and medium size enterprises, mainly in trade, services and light industries, were offered to managers and employees using a special deferred payment scheme with below market interest rates. This proved to be a successful privatization path for small and medium sized enterprises, and failures to repay the debt were few. MEBO's may not be as successful in turning around management in larger companies.

MPP's

Many features of the Polish MPP program are similar to those of the IPO–Plus. Despite its name, and in contrast to the Russian MPP, the Polish MPP is limited to a relatively small number of companies – less than 600. The companies were selected more carefully than in the Russian MPP. National Investment Funds (NIF's) were designed and introduced as mandatory intermediaries. Their objectives have been to improve corporate governance of privatized firms by allocating large packages of shares (1/3) to one NIF, and to protect unsophisticated investors by providing professional management and diversified portfolios in the NIF's. Management companies are operated by consortia of foreign and local investment banks. These companies operate under management contracts and are selected according to transparent rules. Privatization certificates are dematerialized and traded at the Warsaw Stock Exchange (WSE). NIFs' shares are also dematerialized and will be traded at the WSE. These shares will follow the same listing requirements as those of any publicly-owned joint-stock company. NIF managers may decide to float some companies from their portfolios on the WSE or sell them to strategic investors.

CONCLUSION

Milestones in preparing IPO–Plus

The first milestone in establishing the foundation for IPO–Plus is preparing the legal framework. The legal framework includes generic investment funds legislation, a special law (or decree) governing the establishment and operation of the PIF's and often necessary adjustments in the joint stock company law. Implementation of the program will require establishing procedures for registration of PIF's and management companies, public subscription for PPS's, auction sales and access to the deferred payment. Also needed are models for such documents as: enterprise prospectuses, management agreements between the management companies and the PIF's, PIF charters, share sale and deferred payment agreements.

The legal framework must be very specific in requiring a "second round" of the auctions where prices are allowed to decrease and shares are sold at whatever price, they will fetch. In transition economies, selling companies at below their "nominal book value" may be politically difficult, because the book value is deemed to reflect the value of state property invested in the enterprise over the years. It is also important that the legal framework confirms that enterprise shares owned by the PIF's are fully transferable, even where they are used as collateral under the deferred payment mechanism.

An important element in the success of IPO–Plus is the quality of the enterprises chosen for privatization through the program. Although the program may be spread over time and only few enterprises are offered in each auction, it is important that the list of enterprises targeted for the IPO–Plus is approved and published in advance of the launch of the program. This is necessary to motivate potential investors to join the program by setting up management companies, founding PIF's and buying shares in the PIF's. The publication of the enterprises selected for the program is a necessary milestone in preparing IPO–Plus privatization.

Another milestone is the establishing a Government body to implement the privatization process, a centralized exchange to conduct the auctions on a transparent basis, a centralized share registrary to manage the registration of the PPS's and enterprise shares and a distribution network for selling PPS's to the public. It will be expedient to install computer-based systems for the sale of enterprise shares to the PIF's, thereby ensuring that correct access is given to deferred payment, and facilitating the collection of information on the sale of PPS's to the public. The sale of PPS's will need to be undertaken on a fee-paying basis through local institutions, such as through a bank with a suitably diversified branch network.

A recent example of the design and implementation of the IPO–Plus scheme in Uzbekistan is presented in **Box III**.

Box III **<u>The PIF Scheme in Uzbekistan: design and implementation</u>**

Uzbek decision-makers were close observers of the Russian MPP, and determined to follow an alternative approach. The following quotation from President Karimov's book "Along the Road to Deepening Economic Reform" illustrates the Uzbek position: "We have arrived at a definite conclusion that state property may be transformed into another form of ownership only through its sale to a new owner...The essence of the approach is rather simple: to abandon a faceless voucherized proprietor and turn over property to a real owner capable of using the property and ensuring its efficient utilization."

Program Design The Uzbek PIF scheme follows the IPO–Plus model.

Public participation shares. The price of each share is 100 sums equivalent to about 5 to 10 percent of the average monthly wage, or about 20 percent of the minimum wage. This is about the same as the fee paid for a voucher in the Czech program. Each citizen can buy no more than 100 shares in a single investment fund.

Sale of enterprise shares to investment funds. Investment funds are being offered shares in 600 pre-selected medium and large enterprises. The government is committed to privatize 74 percent of enterprise shares in these enterprises. At least 30 percent of the shares are to be sold to the funds at preferential terms (low offer price and deferred payment), 21 percent will be sold through the stock exchange, and no more than 23 percent to employees. Funds will also have access to buying shares on the secondary market and from employees. Thus funds will be able to acquire up to 74 percent of the shares in an enterprise.

Corporate governance. The influence of any single fund on the management of an enterprise depends on its share of the ownership of the enterprise. As in other countries, the shares of an enterprise owned by a single fund is limited (to 35 percent), but is higher than imposed in the Czech Republic (20 percent), Russia (25 percent) and Poland (33 percent). There is no limit on the total share held by all funds, and PIF's may cooperate to establish a working majority on the boards of enterprises.

Deferred payment. For each PPS invested in enterprise shares PIF's are given access to buy five more with deferred payment. The coefficient of five was selected on the basis of the nominal book value of the enterprises targeted for privatization and estimated sales of PPS's to the population. To ensure the long-term viability of the funds, they are given seven years to repay the credit with a four-year grace period during which no interest will accrue.

Program Implementation

A Presidential decree on the establishing and operating PIF's was signed on June 18th, 1996. Subsequently model documents for PIF charters, management agreements, prospectuses etc. were adopted. After intensive study of potential candidates for privatization, a decree was issued on September 26th announcing the selection of the first 300 enterprises. The list of enterprises was published in the press. A second list is to be published in mid-1997. The inclusion of relatively good companies in the list was seen by PIF managers as a signal of the Government's commitment to the program and provided momentum for launching the program.

Implementation began in October 1996 and the first pilot auction was held in December 1996. The pilot stage focused on Tashkent and the sale of shares was primarily conducted through *mahalas* (extended families) and the PIFs' own selling points. The program is in the process of being rolled out to the regions, where sales of PPS's will be conducted through the branches of Narodybank (the former savings bank). Sales will be promoted by a nation-wide publicity campaign. With 38 licensed PIF's the program has passed its infancy and is gaining momentum.

Thirty enterprises were sold at the first three auctions. The majority of these enterprises were large: only 4 had less than 200 employees and 3 had about 1500 employees. Interviews show that, rather than being sold predominantly to "yuppies", there are many pensioners and "middle class" citizens among the initial investors in the scheme.

Advantages of IPO–Plus – a summary

The main advantage of the IPO–Plus in comparison to MPP's based on the free transfer of ownership rights is that the IPO–Plus has a better chance to create "real owners". This can be attributed to the commercial features of IPO–Plus. Investors are given a subsidy, but only in proportion to what they themselves choose to pay. The individual is able to choose – up to a certain ceiling – how much to invest in the program.

IPO–Plus is particularly appropriate where the objective is to encourage *outside* ownership in contrast to significant employee ownership. IPO–Plus privatization encourages the emergence of market intermediaries and ensures concentration of enterprise shares in investment funds. Outside ownership and concentration of share voting rights provide the foundation for enterprise restructuring and economic growth.

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