

Government and enterprise



Maximizing value from privatizations

Interviews with governments,
management and private equity
investors across Europe

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Government and enterprise is a series of studies and initiatives that examine the dynamics of governments' relationships with enterprise. In this publication, we aim to dig deeper into government ownership of national assets to understand how states prepare for and effectively execute their privatization strategies.

The *Government and enterprise* series will continue to explore the types of organizations that governments (national and local) own, what they can deliver in partnership with the private sector, and how they regulate provision from the market.

Government and enterprise

Introduction

Today, governments around the world find themselves exploring a wide range of measures to restore economic stability. The more traditional options of increasing taxes and cutting expenditure are unlikely to be enough to dramatically reduce today's historic levels of national debt and governments are exploring all means of raising funds to reduce deficits, including privatizations.

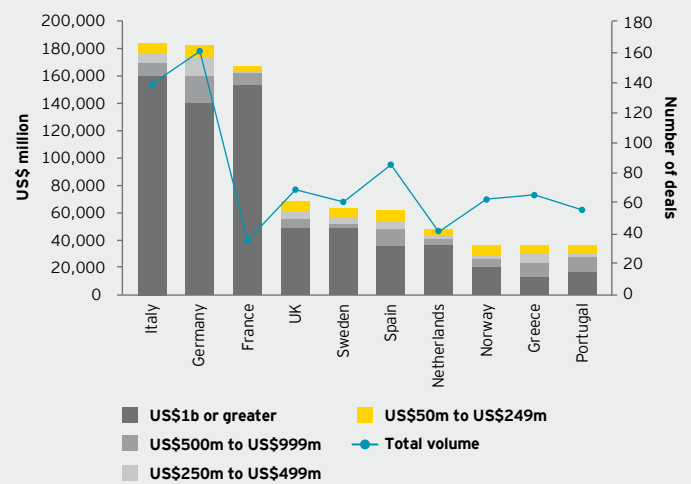
For the purpose of this study, we define privatization as the process where the ownership of national assets are transferred from the state to the private sector, through the sale of shares.

As governments seek to bridge the gap between their income and deficit levels, we expect to see an increased number of privatizations taking place concurrently, each of them competing for the same limited supply of global funds. This increased competition will put pressure on governments to optimize their approach to exiting assets under state ownership. As governments come under greater scrutiny – from local and international markets and stakeholders – maximizing the financial value of the transaction will take on a higher priority than ever before.

These challenges form the back-drop to our study, which looks into privatizations conducted in Europe over the last 15 years, to uncover leading practices and the lessons learnt. There were approximately US\$900 billion of assets privatized globally between 1995 and 2010 across Europe. Our study draws on examples from these privatizations and brings together the experience of governments, the teams that prepare the asset for sale, advisors and our own Ernst & Young professionals across 12 European countries. Their insights will help to share leading practice with those involved in future privatization processes, shining a light on how to mitigate value loss, develop a systematic approach to the transaction, plan effectively and execute with precision.

This study also explores how financial value is traded-off against other types of value and how to achieve and demonstrate effective outcomes from a privatization. 70% of respondents in our study admitted that they felt that value had been lost during privatizations. In the current environment where government strategies are under greater scrutiny, there's an increasing need for states who choose to privatize to demonstrate that they've taken the very best decisions to maximize financial value.

Privatization deals by country, 1995-2010



Source: Thomson Reuters SDC Platinum

Although privatization isn't a new concept, the characteristics of future privatizations are likely to change. Countries that have already sold off a significant proportion of assets will have difficulty finding appropriate assets to sell to raise sufficient funds. Creativity and innovation will be key to realize new opportunities, which are likely to be in different sectors and with new types of assets.

This study explores how governments can segment their portfolio of assets to identify "easy wins," "tried and tested" and "new wave" opportunities. At a time when governments are challenged by an unprecedented need to raise funds, and the market is coping with the aftermath of a global recession, this study provides practical insights to help guide those embarking on the privatization journey.

Raise, optimize and preserve

Highlights

We explore how governments are seeking to raise, optimize and preserve their capital in an attempt to reduce fiscal deficits. For governments, privatizations – the sale of state-owned assets to the private sector – are an important source of raising capital. Our findings shine a light on how governments effectively optimize the amount of capital raised and preserve the overall value of a privatization program.

1 Raising funds dominates governments' capital agendas

- ▶ 67% of respondents stated that the need to raise funds had been the main driver for privatizations in the past.

This will continue as the key driver of privatizations over the coming five years. However, governments must now take into account the nature of the global economy and the impact this has on capital availability and competition for funds.

- ▶ 70% of respondents felt that maximum value had not been achieved in past privatizations.

Understanding why value was not maximized and incorporating the lessons learned from the past into future transactions is crucial to governments seeking to raise funds and justify their privatization strategies.

2 Raising and optimizing capital requires a structured approach

- ▶ Our research suggests there's often an ad hoc approach to privatizations. Consistency across all elements of the privatization process is a challenge.
- ▶ Our respondents stated that a dedicated corporate finance team, appointed by the government to manage their asset portfolio, can help to reduce value loss during privatizations.

A dedicated corporate finance team can help to provide consistency in these transactions – an important part of creating a systematic approach. It provides governance to all aspects of the process and independence to facilitate the different stakeholder groups, enabling transparency and the sharing of leading practice across the privatization program. This will help to ensure optimal strategy development, preparation and execution of each individual transaction.

3 Optimizing financial value to ensure future capital requirements are met

- ▶ 90% of respondents reflected that they would do more to prepare for future privatizations.

Effective preparation is a critical part of any privatization. Performing an independent assessment of exit readiness gives government and management an increased level of understanding of the key issues and risks before embarking on the execution.

- ▶ Only 38% of respondents explicitly identified the value trade-offs made in a privatization transaction.

There are often competing objectives in privatizations. The way various stakeholder objectives are prioritized will have a significant impact on funds raised for the business or for the state. Governments need to identify and define the different types of value; they need to be clear of their stakeholders' objectives and the different measures of success.

Identifying stakeholder objectives can be done in a structured way to bring transparency to the decision-making process. We have developed a model to help governments identify the needs of their stakeholders – the “value framework.”

This helps to enable informed decision-making and allows governments to take early action to minimize value erosion.

Governments must support and strengthen the management team ahead of the privatization. Ongoing communication and understanding of each others' objectives, supported by a structured communications plan and clear benefits, will help achieve stakeholder commitment to the privatization.

- ▶ 54% of respondents felt that managing the impact of government influences were a challenge; over one third felt that policy changes impacted the execution.
- ▶ 53% of management and their advisors felt that there was a lack of expertise in the management team.
- ▶ Of those respondents who achieved their objectives, only 43% tested the market before privatization.

Successful execution is predominantly driven by effective preparation. Changes to market conditions and government influences, including policy changes, have a major impact on the ability to execute in line with objectives. Effective communications across stakeholder groups will help reinforce the understanding of objectives and enable informed, transparent decision-making against changing external factors.

4 Preserving capital enables ongoing success

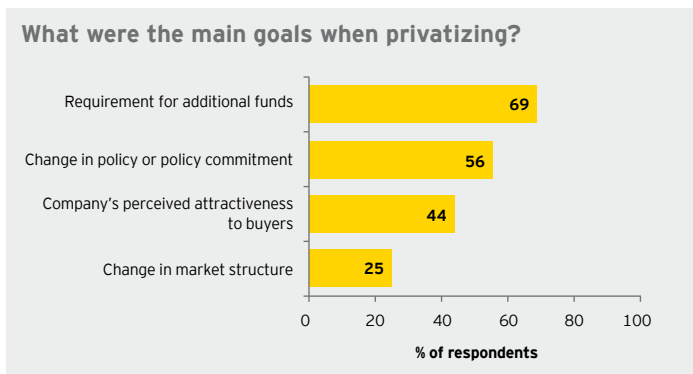
- ▶ Only 33% of respondents had a formal evaluation process in place to identify issues arising from the privatization transaction and help learn from them.

Leveraging leading practice and learning from experience is an integral part of a systematic approach. This is particularly important for privatization programs that include municipal, as well as national level programs, as is anticipated in many countries.

For governments, the first step in delivering a successful program of privatizations is to evaluate and implement the lessons learned from previous exits. The ongoing success of the program is dependent on each individual privatization being successful, and the ability to demonstrate this to the market and wider stakeholder group.

What you need to know before privatizing

The need to raise capital has led to privatization becoming an increasingly attractive option to governments. This is largely due to two reasons. First, it can reduce national debt as a result of sale proceeds from existing assets. Second, it can reduce the deficit by undertaking a radical approach to privatization, reducing the cost of delivering services and redefining the role of the state.



Our research shows that privatization is primarily driven by a need for funds. 69% of respondents said the need for additional funds has historically been the main driver of privatization. We believe a practical requirement for funds will continue to drive privatization activity over the next five years. As a consequence, our report takes an in-depth look at the need to maximize the value realized in this capital constrained environment.

“All the goals were met and exceeded. The new organization was well organized, with a government supervisory control and lots of private expertise making the needed business decisions. The government was very happy with the capital flow ... better service was provided to the citizens at a better price and the business went on growing adding further value to the shareholders. This also increased the employment opportunities.” (Government, Germany)

“Privatization in Sweden ... ideology has been more of a factor, leading to much talk of increasing efficiencies and achieving greater value for money.” (Advisor, Sweden)

The question of value

70% of respondents admitted that value was not maximized during their privatization. The definition of value in a privatization is complex. Measuring value is more complicated than a simple shareholder value, which would be considered by corporate or private equity (PE) investors when assessing the success of a transaction.

Our study illustrates the different types of value that each stakeholder group seeks from privatization transactions:

- ▶ Service users/consumers – value of service
- ▶ Citizens – social policy implications
- ▶ Government as shareholders – proceeds
- ▶ Government as policy-makers – gross economic value and value to society

These different, potentially conflicting objectives, reinforce how complicated it can be to identify whether value is maximized. For a privatization to be considered a success, governments need to be able to articulate the value created for these different stakeholders and clearly demonstrate the value trade-offs that have been made.

“It’s worth noting that it was not an objective to maximize the financial proceeds from the sale of the enterprise. Such an objective would have been inconsistent with the objective of increasing efficiency. For example, we could have raised larger proceeds by insulating an enterprise from competition and by giving monopolies little or no price regulation. This would have made them very attractive to investors, but a lightly regulated monopoly would have little incentive to improve efficiently or serve its’ customers well.” (Government, UK)

In the current economic environment the question, “Have governments optimized value throughout the privatization process?” is one that is frequently asked. We believe shareholder value will be the primary measure of success by which governments will be judged. Realizing and demonstrating value, time and time again, is a prerequisite to maintaining the commitment and goodwill of all stakeholders involved in future privatizations.



Raising capital and maximizing value

Our study identified two main enablers for governments to raise capital and maximize value:

1. Adopting a systematic and consistent approach to the privatization process, both as part of a wider privatization program and for stand-alone transactions.
2. Establishing a dedicated corporate finance team (within the government) with privatization experience to run both a program of privatizations and individual transactions. This function will enhance governance and consistency, and will allow teams to leverage and apply leading practices to all aspects of the privatization process.

“As there was no clear vision and a strong urge to meet the political objectives, this always prevented the business from attaining the right value in the market. The consumers were at the receiving end with unreliable services.” (Management, Italy)

The benefits of a systematic approach

Our research shows that in the past 15 years there has been a tendency to approach privatizations in an ad hoc way, with each transaction being treated on a stand-alone basis. This has led to inconsistency in approach and delivery and can hinder governments’ ability to leverage leading practice from one privatization to another. More fundamentally, it can lead to a lack of cohesion across objectives, processes and goals, leaving governments more open to the challenge that value has been lost from privatizations.

The UK Government’s approach to the privatization of their transportation networks in the 1990s is a good example of an ad hoc approach. This involved several different structures and a significant amount of change. Railtrack, the group of companies that owned the British railway system, was a public limited company (PLC) and became a company limited by guarantee, as Network Rail, when it failed. National Air Traffic Control (NATS) became a public private partnership (PPP) with the UK airlines. London Underground

involved the creation of private infrastructure companies which were subsequently re-nationalized, and the Channel Tunnel Rail Link was a company financed by government guaranteed bonds. A systematic approach to these privatizations may have delivered more sustainable businesses resulting in less government intervention and changes in status, thereby reducing finance costs.

The institutional framework

When considering how to adopt a systematic methodology, it’s important to look at the structures the government has to manage its assets and privatization processes. Most countries have a dedicated corporate management team in place – a center of corporate finance – to manage and advise governments on their portfolio of assets. This offers the opportunity to share experiences and develop leading practices, which can be used consistently from one transaction to another. We found that while structures of the dedicated corporate finance team may differ, of primary importance is their remit and responsibilities for the assets they manage.

Our research provided insight into the extent of roles and responsibilities they fulfill:

- ▶ Institutionalize the separation of policy and shareholder objectives to ensure trade-offs are made in a transparent way.
- ▶ Manage the current portfolio of assets, or actually add value through performance driven portfolio management techniques (e.g., those used successfully by PE).
- ▶ Explore new types of assets to privatize, which could redefine the role of the state.

Our research shows having a dedicated corporate finance team managing the process is necessary to be able to extract the maximum value from a privatization.

“We had a dedicated privatization agency with a clear set of procedures.” (Government stakeholder, Estonia)

Strategy

When developing a systematic approach there is a need to establish a privatization strategy which defines the planning process and prepares for execution. The strategy should:

- ▶ Identify and segment the assets available.
- ▶ Clarify governments' objectives in respect to each asset sale.
- ▶ Define the trade-offs between stakeholder value objectives for each asset within the asset groups to enable robust, optimal and transparent appraisal and decision-making.

Segmenting the "privatization portfolio"

Rather than considering each asset in a privatization portfolio individually, there is real benefit in segmenting the asset base to understand the relative complexity, time frames and value of the entities which governments own. This analysis of the asset portfolio will pave the way for a systematic program of privatization, which can be aligned to a government's overall fiscal deficit or electoral policy goals.

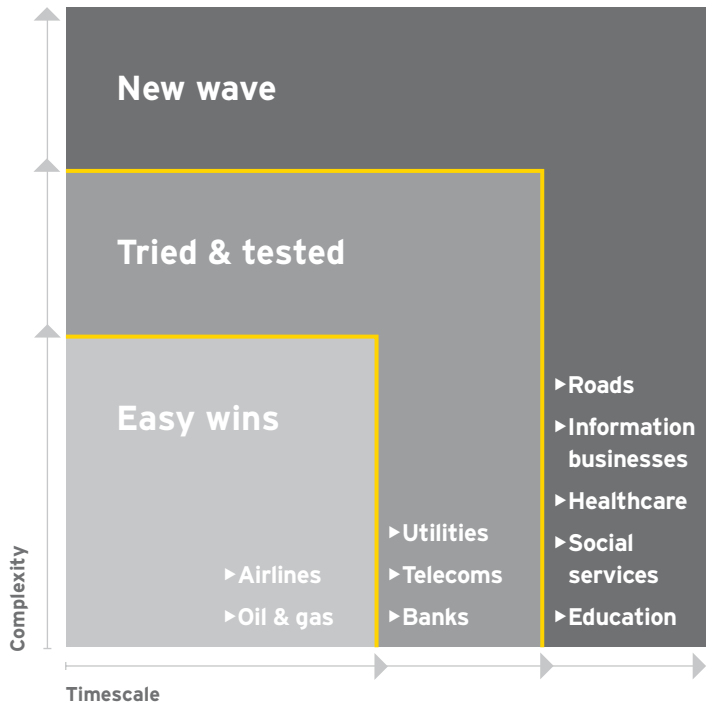
Assets can be grouped into three categories:

"Easy wins" – Assets owned in whole or in part by the state and operate in an established, competitive market. For example, the government owns a minority stake in an autonomous corporate entity competing with other private businesses, such as an airline. These assets may need a small amount of preparation but are predominantly straight-forward to package for sale. Buyers will be easy to identify and time frames are likely to be short. However, market sentiment is particularly important in determining the timing of realizing value from these assets.

"Tried and tested" – Assets operating either as a monopoly or in sectors which have a track record of privatizations, such as state-owned utilities, where established privatization precedents already exist. These assets tend to be more complex and can require structural changes, for example, the introduction of competition or regulation. Substantial preparation is often required to package these assets for sale.

"New wave" – Assets that traditionally operate as a public sector service, but where sufficient safeguards and policy influence can be exerted by less direct means. For example, taxation or sector regulation. This group of assets could include services or revenue streams that can be packaged together and put into a corporate structure, then be privatized at a later date. This represents a new wave of privatization. Innovation and creativity are required to identify the assets. Substantial structuring work and preparation will be needed prior to exit. Examples of new wave assets could include information services e.g., meteorological offices or entire national or regional road systems.

Segmenting the assets in this way enables governments to identify and address the complexity of each asset group and prioritize time frames to both prepare and execute the privatization.



Strategy



Countries entering into large-scale privatization programs can evaluate easy wins while creating the structures, market conditions and the reorganization necessary for more complex exits. This provides a base for a successful privatization program.

Some countries have already started this process. Portugal, for example, has assessed its portfolio of assets and declared it aims to raise approximately €6 billion by 2013 through privatization. These range from the sale of an 8% stake in GALP Energia, the Portuguese oil and natural gas operator, to 100% of TAP Portugal, the national airline.

The Russian Government has a federal level privatization program for 2011 to 2013, consisting of “easy wins” and “tried and tested” assets. However, they have taken a considered approach to selecting and prioritizing assets.

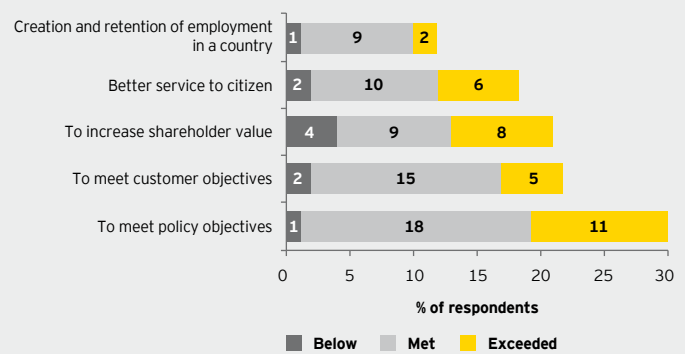
“For our budget policy, there is no need to sell assets immediately at all costs ... we will sell assets either when we find the investor that we are extremely interested in, or when we want to sell at a target price.” (Government, Russia)

Alignment of objectives

There are two levels to government objectives: the overall program level and the transaction level. The program level objective is to achieve some form of debt repayment, deficit reduction or reduce the level of ownership and role of the state. At a transaction level, the objectives are more complex than those of a corporate or PE investor, who generally seeks to achieve maximum shareholder value.

Governments have a broader, more complex group of stakeholders to satisfy, often with conflicting objectives. If the stakeholders’ objectives aren’t clearly defined at the outset, it could be difficult to measure value created for stakeholders at the end of the transaction. Governments could run the risk of stakeholders perceiving that their needs have not been met. To avoid this situation, governments must ensure that all stakeholders understand the objectives of the privatization. The measures of success need to be agreed to by all in advance and there needs to be clarity around the value trade-offs that may be required to deliver overall success.

**What were the main goals when privatizing?
How were these met?**



In the past, the variation between stakeholder objectives and the degree to which they have been achieved, has highlighted the challenge governments face when defining goals and measures of success. Achieving a financial policy objective is typically more important than achieving a value objective and, by definition, a policy objective is broader than a value-based one. Our research shows that financial value is often considered not as important as other stakeholder objectives, but this is not always communicated clearly.

A greater understanding of all stakeholders’ objectives will help to ease the perception that their objectives have not been met. 25% of respondents commented that they would do more to align management incentives with the privatization goals in future transactions. Once the stakeholders’ needs are aligned, the appropriate incentives can be put into place. This will help to drive the right behaviors and actions throughout the privatization process from the outset.

“You need a management team that is really focused and has a mandate to privatize. The top five or six executives must be on board.” (Advisor, Greece)

Strategy

Transparency around trade-offs

Our research revealed that every privatization needs to clearly identify and articulate the value drivers and trade-offs associated with a transaction. This approach will help to satisfy public and market scrutiny.

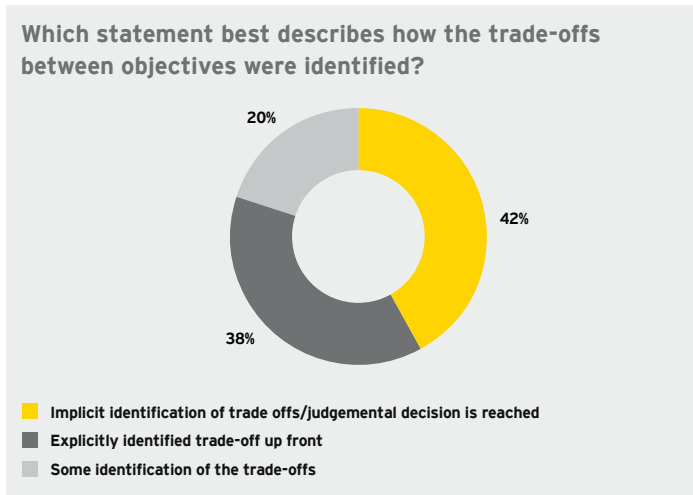
“A clear vision, proper management and the transparency of the process were all important factors that contributed to the success of the transaction.”
(Advisory, Nordics)

Only 38% of respondents explicitly identified trade-offs early in the preparation phase; the rest used judgment to reach a decision. This indicates that there was no measurable identification of either the trade-offs at the beginning of the transaction, the impact on (financial) value, the impact on the customer or alignment with policy.

As governments seek to reduce historic levels of national debt, they need to be able to demonstrate that they have maximized value from all privatization activities. If there's any loss of value in a particular area, it needs to be made clear that this is a conscious decision, taken in order to protect value elsewhere. A common challenge is measuring both the financial and the non-financial aspects of value. Taking a structured approach to identify and value these measures will enable governments to better understand the trade-offs and the implications that these may have on stakeholders when making decisions.

Our value framework

A structured and objective approach is needed in order to maximize value and make informed, strategic decisions about the privatization process. Based on the experience of our clients and our own transaction professionals, we have developed a fact-based framework to help executives make complex decisions to develop and execute a successful privatization process. This framework has been created based on our deep understanding of the risks, key assumptions and financial returns that are required to improve decision-making and help enhance value. This knowledge has been gained through our experience of working with governments, large multinationals and PE.



Only 38% of respondents explicitly identified trade-offs early in the preparation phase.



Each step in the framework articulates the core elements in a decision-making process:

► **Frame the decision**

- Understand the views of key stakeholders
- Articulate to stakeholders the policies behind the historical ownership and structure of the asset
- Understand constraints, policies and motivations from the seller's perspective
- Share understanding of objectives and the approach toward sale and transfer
- Gain clarity of decisions and challenge the motivation for change

► **Identify creative and achievable alternatives**

- Investigate a range of alternative assets and exit routes
- Consider the potential stages that the seller will have to go through to transfer ownership
- Develop a "do nothing" option comparison

► **Establish clear value criteria and trade-offs**

- Develop measures to assess the effectiveness of each alternative
- Establish a set of decision criteria that is objective and aligned with the overall strategic objective, and consider the importance of each criteria
- Understand the non-financial benefits of the privatization, as well as the indirect financial benefits and costs

► **Acquire meaningful and reliable information**

- Identify the critical information the buyer will need in order to aid their decision-making
- Assess data for relevance and reliability

► **Build quality business modelling**

- Construct robust business models, using the information already obtained, in order to assess effectiveness of options and uncertainty
- Use quantitative tools and techniques (e.g., simulation modelling, cost driver analysis and benefits assessment) to help identify risks and opportunities and develop a strategic approach
- Incorporate risk and uncertainty assessments

► **Commit to action**

- Develop a business case to present to stakeholders
- Gain full stakeholder buy-in

With this value-focused, structured approach, governments can make effective decisions about which assets to privatize and their relevant priority. By the end of this process, governments should have achieved improved stakeholder commitment, management and key staff commitment and put in place mechanisms to enable an audit trail of decision-making, robust implementation and tracking of benefits.

The analysis and stakeholder engagement throughout this process will also enable more effective preparation and execution of the strategy, contributing to a more successful privatization. Benefits can be tracked throughout the privatization process and, if a change in market conditions or information occurs, governments can quickly reassess the situation and identify whether there's a need to revisit alternative options of ownership for the asset.

"Process performance metrics were not defined and there were no strict parameters used to measure operational performance. Fortunately, the end result was positive but the lack of communication was definitely felt." (Government, Germany)

Preparation

Our research findings clearly demonstrate that preparation is crucial to a successful execution of an asset sale. Robust preparation will go a long way to achieving objectives and minimizing value loss. Over 90% of respondents said that, based on previous experience, they would do more to prepare for future transactions.

“Preparation for the privatization is very important. Unexpected situations arise, leading to difficulties; therefore, the team should be well equipped to manage these situations.” (Government, France)

6 key steps to effective preparation

- Step 1: Seek independent advice
- Step 2: Perform a readiness assessment
- Step 3: Prepare information
- Step 4: Evaluate and strengthen management
- Step 5: Review operational improvements
- Step 6: Test the market

Which activities did you undertake before you started the privatization process?



The specific situations for each and every transaction may be unique but the six key steps, which were identified across all sectors of ownership, are very similar.

Step 1 – Seek independent advice

Our research showed that value leakage was minimized when governments had appointed independent advisors to support them early on in any privatization process. Engaging advisors early to assist with a structured and independent assessment of readiness not only gave greater understanding of the potential issues but also provided help to resolve them prior to execution.

Advisors were able to leverage their experience to help sellers:

- ▶ Identify and provide advice on the implementation of operational improvements and restructuring requirements.
- ▶ Assist with the preparation of critical information for the buyer.
- ▶ Provide strategic and operational advice on a range of other aspects of the privatization, enabling management to focus on running the business and maintaining performance throughout the process.

“We took an active role in the exit. We spent €3 million on financial due diligence, did commercial due diligence and operational due diligence as well. We are professional buyers and so we know what we would want to see.” (PE Investment Director, Norway)

Over 90% of respondents said that, based on previous experience, they would do more to prepare for future transactions.



Step 2 – Perform a readiness assessment

Nearly half of the respondents who felt they had successfully delivered value had completed an assessment of exit readiness before embarking on any process. When asked how they would enhance preparation in the future, 38% of respondents said they would increase due diligence of the entity's risks.

Performing an early, independent and structured assessment of readiness for sale identifies the potential issues and risks and creates opportunities for governments to address these before the privatization process starts. These factors can be incorporated into the plan, helping to inform the decision-making process throughout preparation and execution of the sale. This should include evaluating the quality and depth of information, management skills, operational improvements, market opportunities and a consideration of exit routes.

Our research looked at privatizations with a range of exit routes, correlating the size and complexity of the asset with the most appropriate exit opportunities. Over the last 15 years, trade sales have accounted for the majority of privatizations, with an IPO exit more common for larger transactions. PE accounted for a lower percentage of exits overall. However, as PE models have moved away from leverage as a value creator to operational improvement, we expect to see this increase in the future.

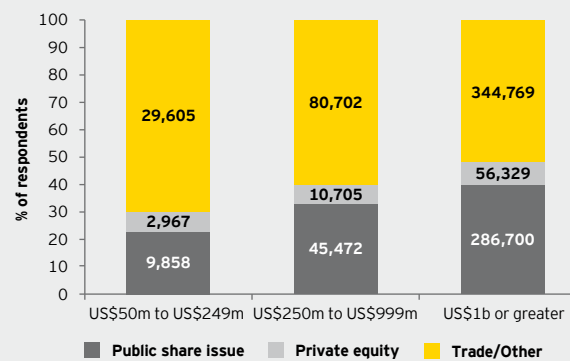
Pursuing multiple exit options is something we've often seen in previous divestments. In the current environment, testing the market and pursuing a tailored option will be increasingly important to give the best chance of success.

Step 3 – Prepare information

35% of management felt that a lack of available information was an issue in preparing for their privatization.

Respondents suggested that thorough, detailed information is often lacking in state-owned enterprises. Therefore, basic financial information needs to be prepared to enable informed decision-making and to support the future value proposition. It also needs to stand up to the scrutiny of the different buyer groups. Management need to recognize that the information and key performance indicators required to run a business are distinctly different from the information that is needed to sell that business.

Privatization deals by exit route and size, 1995-2010



Management need to recognize that the information and key performance indicators required to run a business are distinctly different from the information that is needed to sell that business.

Preparation

Step 4 – Evaluate and strengthen management

53% of management and advisors felt there was a lack of expertise in the management team, compared with only 31% of government respondents. There was also a marked difference in the perception of capacity: 29% of the private sector management and advisors we interviewed felt that the management team was under-resourced, compared with only 13% from government. It's apparent that governments tend not to recognize (or are overly optimistic in recognizing) the quality and depth of management experience.

This presents a risk when taking steps to strengthen the management team. Maximizing value is clearly linked to a strong management team. It's important to assess whether management have the capacity and the capability to deliver the required results from the privatization. Any concerns need to be addressed early on in the process. If governments are too optimistic, their steps to rectify weaknesses may not go far enough.

“Restructuring of the business and creating an efficient management team was very important.”
(Government, Norway)

“The performance under state ownership was very poor ... the company needed an effective management change which could make the business more efficient, provide development and growth in the increasingly competitive market. Privatization prompted the necessary reforms.”
(Management, France)

29% of the private sector management and advisors we interviewed felt that the management team was under-resourced, compared with only 13% from government.

Step 5 – Review operational improvements

34% of respondents who reviewed operational improvements during preparation felt they had maximized potential value.

Our research showed that identification and documentation of improvements was important to the privatization process, but implementing these improvements was not always necessary. Often, buyers prefer to implement their own improvements, rather than the seller's recommendations. We have learnt from our global divestment study *Divesting in turbulent times* that implementing improvements made no significant difference to meeting value expectations. Understanding the strategic value that these changes can make to private sector investors will help sellers articulate the benefits, increasing the likelihood of governments maximizing the financial value of transactions.

“What we see as typical value eroders on exit includes: little support for the upside, poorly addressed key business issues, drawn-out process and minimal access to management.” (Government, Italy)



Step 6 – Test the market

43% of those who had achieved their value objectives had undertaken market testing in advance of the privatization.

When defining the strategy for a privatization, governments should consider which of the likely exit routes would best achieve their objectives. Governments must determine where each buyer group attributes value, along with their respective priorities and critical success factors. Only then can they develop a strategy to position the business appropriately to align with the buyers' requirements. Based on our experience within PE transactions, we understand that the more experienced buyers are better at anticipating the required level of preparation needed to make the transaction a success.

Governments should ask themselves: is there a demand for this asset right now? Supply and demand and market fluctuations all pose a risk to exit. The ability to respond to these variables in a flexible way will help avoid value erosion, or worse, a failed privatization, which could affect the broader program.

“The credit should go to the government for understanding the need to bring the company to market at the right time.” (Government, Germany)

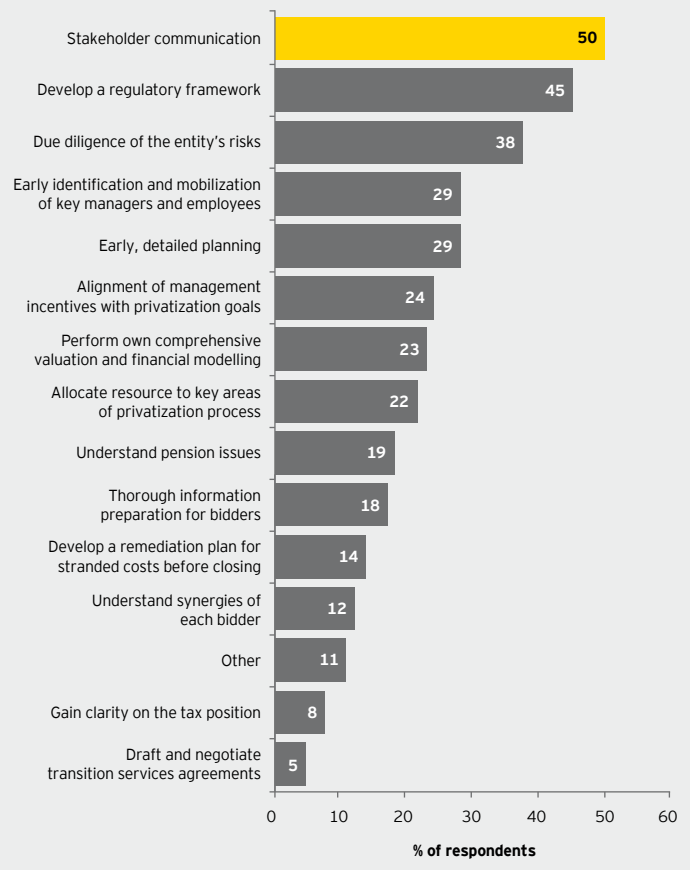
The future

We've established that early preparation in the overall privatization process is hugely important. We have identified five major areas that respondents plan to focus on to enhance their preparation in future transactions:

- ▶ Improve communications with stakeholders
- ▶ Develop the regulatory framework
- ▶ Conduct more due diligence of the entity's risks early on in the preparation process
- ▶ Identify and mobilize key managers
- ▶ Undertake detailed planning at an early stage

These five elements should form part of the readiness assessment.

What would you do more or less of to achieve the same goals?



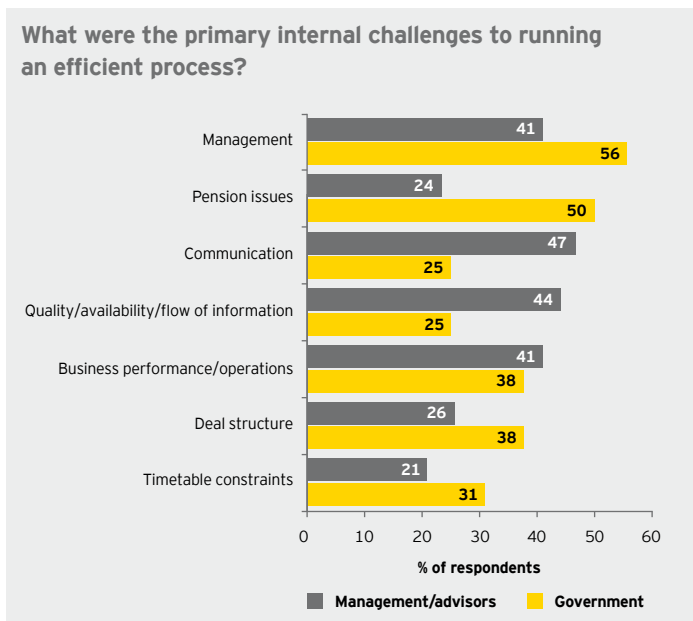
Preparation

Execution

The challenges

The success of the execution phase is driven to a large extent by the quality of the preparation. The main challenges arising during the execution stage of the privatization process are: capability and capacity of management to deliver on objectives, ensuring effective and timely communication with stakeholder groups and their overall ability to be flexible and adapt to issues as they arise.

Internal challenges



Management capability and capacity

A key theme that runs through the process from preparation into execution is management. Our research found that the management team's depth of knowledge and experience makes a significant difference to the outcome of what is an intense process.

The ability of management teams to contribute effectively to the execution process is seen as a significant constraint by both government and management. Management needs an appropriate level of experience and an appropriate amount of time to devote to the transaction.

"Use of [interim] management to supplement experience meant this turned from a challenge to a key strength."
(Government, Netherlands)

Quality and availability of information

Nearly half of management and advisors felt that the quality of information provided was an issue, compared with only 25% of government. Governments would be prudent to rely on management to understand the significance of good-quality, readily available information. They should build this into their expectations of activities and time frames for preparation to prevent this being an issue in the execution phase.

"We underestimated the scope for early improvement in efficiency. The reason was the asset managers had much more information than we did. They did not want demanding targets and, usually by withholding information, persuaded us they would only be able to make slow progress. The result was that the shares were priced too cheaply and the initial capital structure had too little gearing and that, where there was a price cap, it allowed too much increase in prices."
(Government, UK)

Communication

There's a significant difference of opinion between government and management regarding the adequacy of communication. Only 25% of respondents from government felt that communication between the parties during the transaction had been a concern, compared with 47% of management and advisors.

Stakeholders should not underestimate the importance of regular, open communication. Effective communication between key stakeholders drives the progress of the transaction. Understanding and communicating their respective goals and challenges is essential for success.

"Governments need to communicate more with the companies being privatized rather than letting their own agenda influence the way the process is run."
(Management, Spain)



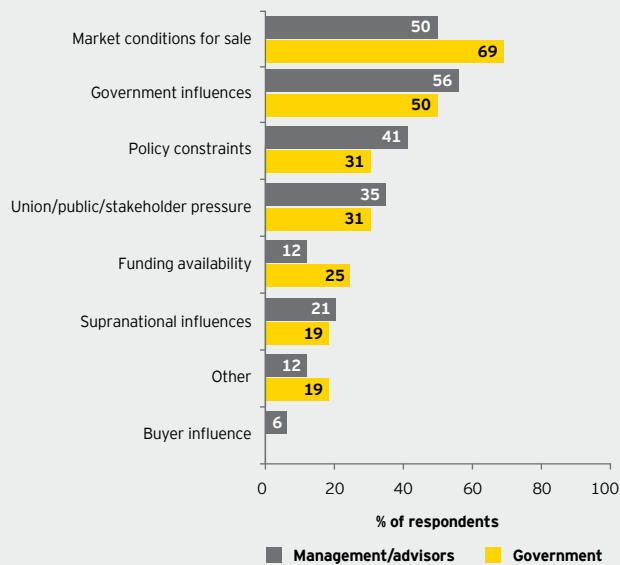
Pensions

Half of government respondents saw pensions as a challenge during the execution phase, compared with only one-quarter of management. Pensions are a primary responsibility of governments and even with effective preparation they can often be complex to deal with. Often the complexity itself can impact the bidders' perception of value.

Pensions highlight the different responsibilities each stakeholder can have throughout the whole transaction. Constant communication across all stakeholders can help to create a smoother process.

External challenges

What were the primary external challenges to running an efficient process?



Market conditions

The most common external challenge faced by governments embarking on privatizing national assets were market conditions. The volatility experienced in the financial markets over the last two years has introduced an additional layer of complexity to privatizing assets.

“The critical success factor is the stability of the markets over the preparation and execution periods.”
(Management, Portugal)

While market conditions can't be changed, experienced advisors and government bodies can proactively advise on the best course of action for opportunities and challenges, as well as how both parties can remain flexible and communicate effectively with all stakeholders.

“There were many instances when the time lines needed to be extended and every time an extension was required a lengthy formal procedure had to be followed. Communication with the advisors and their understanding of the bidders is very important and a high level of cooperation is needed at every stage of the process.” (Government, Nordics)

Impact of government influence and policy

There are a number of government bodies and regulatory authorities with potentially conflicting interests in a privatization. Our research highlighted examples of these conflicts arising between municipal level governments and national government departments.

In addition, changes to central government policies and legislation during the privatization process need to be managed carefully across the stakeholder groups to minimize any negative impact on the privatization.

“Unclear decisions of central government caused one potential buyer to withdraw.” (Government, Netherlands)

A dedicated corporate finance team is often able to mitigate some of the competing interests between government departments by making policy and shareholder conflicts more transparent, defining overall priorities for the privatization and remaining in constant dialogue with all the stakeholders throughout the process.

Post privatization

Following any privatization, governments have good reason to continue to monitor assets' performance under the management of their new owners as performance could prompt further investment and divestment considerations. Governments may also have a continued interest in the privatized asset to ensure they have protected the public interest. In the UK, the recent re-nationalization and re-privatization of British Energy, the national energy supplier, highlights how government involvement can vary.

"Businesses being privatized need to survive and thrive. Nothing tarnishes a privatization program more than business failure of a privatized company."
(Government, UK)

Evaluation

It's during the period immediately after the transaction when the details are still fresh, and the individuals responsible for undertaking the privatization are still involved, that the leading practices and lessons learned can be uncovered and shared.

One-third of respondents had a formalized review processes in place. However, 64% of these admitted that the review process was not always followed or consistently applied. This is an area in which PE, as a serial transactor, excels. They embrace a meticulous evaluation approach to enhance return on investment. By capturing the lessons learnt on exit, they are able to apply the very latest in leading practices.

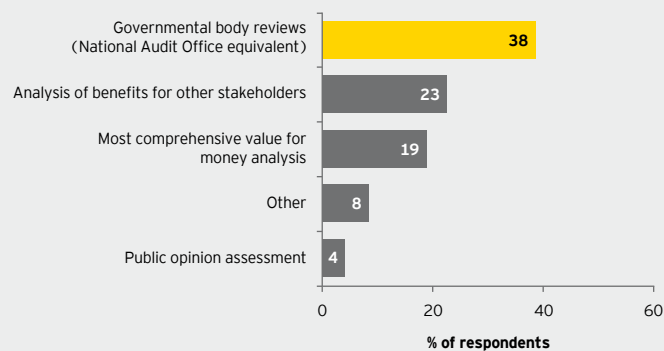
With many countries considering privatizations as part of an ongoing program, identification of leading practices early on and their application to subsequent engagements can help prevent value loss on future deals.

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Government and e

Our research suggests that governments should ensure they have an appropriate framework for collecting and sharing leading practice across all the relevant state entities.

What tools were used to measure the achievement of objectives?



Our research suggests that governments should ensure they have an appropriate framework for collecting and sharing leading practice across all the relevant state entities in order to utilize learnings from previous transactions. This reinforces the need for a dedicated corporate finance team.

“It is clear that the high-profile nature of these transactions will prompt very close scrutiny from domestic and international press as well as from opposition parties in the home nation. What is fundamental is that the method for capturing and sharing the lessons from privatizations are enshrined into the process from the initial strategy and planning stage of the transaction.” (Government, Italy)

nterprise



Stakeholders in privatizations

Conclusion

In the aftermath of the global economic crisis we expect an increase in privatization activity across many European countries over the next 3 to 5 years.

In particular, we will see a shift for some countries from the less traditional asset groups, such as transport and education, to more innovative, less familiar asset groups which may not have been privatized before. This will heighten the need for governments to deliver maximum value from privatizations as they compete for the limited supply of global investment funds.

This increased competition for funds is evident at both a state level and at a municipal level, as local authorities seek to close funding gaps and reduce their own spending requirements. A consistent, systematic approach to privatizations within a country is fundamental to instill leading practices across different bodies and levels of government. Communication is critical to keep all stakeholders aligned and supportive of the privatization and fully aware of the benefits and challenges it can bring.

Governments must intrinsically understand the value of national assets. A systematic approach should be adopted to drive value and increase the probability of realizing a successful privatization. We believe achieving optimum value will be at the heart of any privatization objective for governments and entities alike.



These are the key questions that stakeholders in privatizations should consider:

Systematic process

- ▶ Has the overall effectiveness of the privatization approach been considered?
- ▶ What are the objectives of the privatization program or the transaction?
- ▶ What's the best way of organizing the process?
- ▶ Is there a dedicated corporate finance team with the right expertise and responsibilities, to manage and realize asset privatizations in an optimal manner?

Strategy

- ▶ What types of assets do you have? Can they be segmented?
- ▶ Are all the stakeholders clear on the objectives?
- ▶ Have the value trade-offs been identified?

Preparation

- ▶ Has an assessment of readiness been performed, covering:
 - ▶ Management strength and depth?
 - ▶ Information suitability and availability?
 - ▶ Operational improvements?
 - ▶ Market appetite?

Preparation (continued)

- ▶ Are the right advisors being used in the right way?
- ▶ Look at the business through the eyes of the buyer. What are their assumptions on the value drivers and the priorities?
- ▶ Are the incentives aligned and understood?

Execution

- ▶ Have the issues identified in the readiness assessment been fully addressed?
- ▶ Who is ensuring all the stakeholders are clear on objectives and communicating during the process?
- ▶ Are there any potential government policy changes that needs monitoring? If so, by whom?

Post privatization

- ▶ Have the previous privatization experiences been reviewed and are the lessons learnt being applied to the new privatization program?
- ▶ Is there an effective evaluation structure in place to ensure ongoing review of the privatization program?

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Further reading

Beyond the Bears: How do private equity investors create value? A study of 2009 exits

An annual study of 300 of the largest European businesses owned and exited by PE revealing insight into how the industry can build on its successes and overcome the challenges it now faces.

Government and enterprise survey; Government as best class shareholder

An in-depth study which looks at governance models of state ownership globally. The paper explores the perspective of government as a shareholder and how state owned enterprises compare to the performance of private companies

Divesting in Turbulent Times

A global divestment survey of senior executives of large companies. The survey identifies trends and challenges faced by companies divesting in today's economic climate.

Capital Confidence Barometer

A regular survey of senior executives from large companies around the world. Our findings gauge corporate confidence in the economic outlook and identifies boardroom priorities and emerging practices in the way companies manage their capital agenda.

About this study

For this study Ernst & Young and mergermarket surveyed senior members in government, management teams and PE who have been involved in privatization transactions over the last 15 years; from 1995-2010. The research consisted of qualitative interviews and quantitative analysis of privatization transactions across industry sectors. Interviewees came from 12 countries; Estonia, France, Germany, Greece, Italy, Netherlands, Norway, Portugal, Russia, Spain, Sweden and UK. This research was carried out between March and August 2010.

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How organizations manage their capital agenda today will define their competitive position tomorrow. We work with our clients to help them make better and more informed decisions about how they strategically manage capital and transactions in a changing world. Whether you're preserving, optimizing, raising or investing capital, Ernst & Young's Transaction Advisory Services bring together a unique combination of skills, insight and experience to deliver tailored advice attuned to your needs – helping you drive competitive advantage and increased shareholder returns through improved decision making across all aspects of your capital agenda.

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