Transforming State-Owned Enterprises: Utilizing Insolvency/Restructuring Approaches to Achieve the Aims of Privatization

Special Colloquium on Privatization and Restructuring/Insolvency:
New Directions for Transforming State-Owned Enterprises

Athens, February 5-6, 2011

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Insolvency/Restructuring: A Neglected Tool for Addressing Plight of SOEs

- Privatization and restructuring/insolvency are generally treated as two completely separate disciplines
- In privatizations, limited attention, if any, may be devoted to how insolvency/restructuring approaches and processes can be harnessed to facilitate or otherwise support the privatization process
- However, many of the tools and techniques applied in restructuring/insolvency can be directly relevant and applicable to the privatization of state-owned enterprises (SOEs)

Insolvency/Restructuring: A Neglected Tool for Addressing Plight of SOEs (cont'd)

- Domestic insolvency laws for commercial enterprises may be drafted in such a way that they not only address private enterprises, but possibly also the situation of financially distressed SOEs
- Some domestic insolvency laws, in fact, do this by putting SOEs on the same plane as private enterprises for purposes of identifying those debtors that are subject to the ambit of a nation's insolvency law (i.e., who are "eligible" debtors)
- For example, this approach is reflected in the insolvency law treatment of SOEs set forth in the *UNCITRAL Legislative Guide on Insolvency Law* which has helped establish a standard for international insolvency law

Insolvency: A Neglected Tool for Addressing Plight of SOEs (cont'd)

- UNCITRAL Legislative Guide notes
  - "An insolvency law can apply to all types of debtor engaged in economic activities, both private and state-owned, especially *those state-owned enterprises which compete in the market place as distinct economic or business operations and otherwise have the same commercial and economic interests as privately-owned businesses*." p. 40 (emphasis added)
    - Note: UNCITRAL does provide a caveat for "large-scale privatization programmes or where [SOEs] are involved in sensitive sectors of the economy…"
- Some States have set up their insolvency statutes in a way that basically considers SOEs in a similar manner as private enterprises for purposes of insolvency law
  - See, e.g., China in its new Enterprise Bankruptcy Law

Insolvency: A Neglected Tool for Addressing Plight of SOEs (cont'd)

- Yet actual practice in this area may diverge substantially from what is set forth in the relevant insolvency statute
  - In practice, few SOEs may be subjected to the discipline or rigors of the insolvency process even in those States which purport to treat SOEs similarly to private enterprises
    - e.g., China's carve-out of over 2000 of its largest and most significant SOEs from the application of its new Enterprise Bankruptcy Law

Basic Value Proposition: How Value is Central to Both Privatization and Restructuring/Insolvency

- Privatization
  - A core objective: Unlock ***value*** of State-Owned Enterprises (SOEs) by putting assets and/or operation of SOE in private hands
    - "The disinvestment process [is designed] to facilitate ***unlocking the true value*** of the Central Public Sector Enterprises for all stakeholders – Investors, Employees, Company and the Government" (Indian Min. of Finance, Dept. of Disinvestment)
- Restructuring/Insolvency
  - Micro level: maximize ***value*** of estate and distribute value among stakeholders in accordance with established priority scheme
  - Macro level: recycle ***value*** in economy from less productive uses to more productive uses

Basic Value Proposition (cont'd)

- Valuation Process: central to both insolvency/restructuring and privatization
- In both privatization and insolvency/restructuring scenarios, analysis starts with understanding the value of the troubled enterprise—i.e., valuation process as a threshold and indispensable step in the process
  - Restructuring/Insolvency: What is the value of the enterprise, and is the enterprise worth more as a going concern or in liquidation
  - Privatization: What is the (maximum) value of the enterprise that can be achieved in the privatization process (whether through private sale, auction, IPO, etc.)
- Of course, in certain privatizations, States may temper pure value-based considerations with other social, political, and/or economic considerations
  - i.e., emphasis on receiving highest bid or price may not be sole or even decisive consideration in a particular privatization
  - governments may also focus, for example, on which bidder will be committed to making investment in plant and equipment, preserving most jobs, etc.

Issue of Hard Budget Constraints

- **SOEs**: generally considered not to be subject to hard budget constraints
  - this means that a serious fiscal burden can be placed on the State to prop up unprofitable and inefficient SOEs
    - also need to take into account the role guarantees that may be extended by the State in support of SOE obligations (as this may only way for SOEs to get third-party financing)
  - indeed, lack of hard budget constraints for SOEs may be one of the central policy concerns with SOEs and also may be one of the principal drivers for the desire on the part of governments to privatize SOEs
- **Privatization**: attempt to subject former SOEs/now privatized enterprises to hard budget constraints inherent in a market economy and competitive environment
  - newly privatized enterprises can no longer count on financial support from the State—must stand on their own
- **Insolvency**: insolvency process provides ultimate tool for enforcing hard budget constraints

Privatization Needs/Restructuring-Insolvency Answers

Privatization Needs

- Make SOE more efficient
- Generate maximum value for SOE
- Dispose of SOE's non-core assets

Restructuring/Insolvency Answers

- Reorganize and restructure entity on an economically viable basis
- Ability to conduct auction to achieve highest value for reorganized enterprise
- Sale of assets free and clear of liens

Specific Thorny Issues Arising in Privatizations

- Paring down massive debt overhang of SOEs
- Reducing redundant labor employed by SOEs
  - Yet doing so while ensuring that employment and other social needs of displaced employees are taken into account and properly addressed
- Running SOE on a commercial basis—need to introduce an entrepreneurial ethic
- How to achieve consensus among diverse stakeholders when privatizing an SOE, esp. with all of the divergent interests involved

Specific Thorny Issues Arising in Privatizations--Insolvency/Restructuring Responses

- **Debt**: Insolvency/restructuring process provides a classic tool for reconfiguring the debt profile of a troubled enterprise—i.e., a balance sheet restructuring
- **Labor**: Insolvency/restructuring process often results in reduced workforce or renegotiated labor agreements
  - Obviously, there has to be some transition plan for employees displaced in any SOE rationalization process
  - Note the important parallel between privatization and insolvency
    - Insolvency is essentially predicated on there being a social safety net in place to cushion the blow to any workers displaced in the insolvency/restructuring process—in fact some countries have put in place employee guarantee funds to address just this need
    - For privatization to be successful, there needs to be some type of social safety net as well to smooth the transition for displaced workers

Specific Thorny Issues Raised by Privatization--Insolvency/Restructuring Responses (cont'd)

- **Commercial Basis**:
  - Idea is to come up with a business plan that will be sustainable or viable over a period of time (e.g., notion of "feasibility")
  - Insolvency process can lead to the installation of new management (including so-called Chief Restructuring Officers during the pendency of a restructuring) to put the troubled enterprise back on a more sound footing
- **Consensus**: Insolvency law provides a mechanism for achieving consensus among key stakeholders, particularly through the use of "cramdown" mechanism as a way to bind dissenting classes of creditors

Need to Attract New Capital to Troubled SOEs

- One of the recurrent issues with SOEs is that they have been woefully underinvested
  - capital expenditures and maintenance may have been neglected, possibly for an extended period of time
- In other words, there may be a need for a massive infusion of new capital in order to modernize the enterprise so that it can operate in an efficient and profitable manner and be competitive
- Yet no one except State may be willing to put new money into an insolvent SOE
  - Unfortunately, this can represent a continuing drain on the national treasury—i.e., 'throwing good money after bad'

Need to Attract New Capital to Troubled SOEs (cont'd)

- Insolvency/restructuring provides the tools for putting new capital into troubled enterprises by providing a clear and predictable framework for new money coming in (i.e., assigning priority to new money)
  - Debtor-in-possession (DIP) or interim financing
  - Exit financing
  - New equity investors

Importance of New Strategic Investors to Privatization and Restructuring/Insolvency

- Privatizations have often been helped where there are strategic investors who invest in the SOEs
  - Such investors may be domestic or foreign
    - many privatizations—including many successful ones--have relied upon foreign capital
- Restructuring/insolvency provides a well-defined process for strategic investors to come into the picture in an orderly way that maximizes value for the existing stakeholders
  - E.g., role of ‘stalking horse bidder’ in stimulating interest by other potential bidders

Sequencing Privatization and Restructuring/Insolvency—Which Should Come First

- Not necessarily one standard formula for proper sequencing
  - approach will likely depend on the specific facts and circumstances of the particular SOE being privatized as well as the overall objectives of the State in the privatization process
- One possible scenario
  - Step I: Insolvency/Restructuring
    - Put the SOE in a position where it is restructured so that it is an attractive candidate for privatization
  - Step II: Privatization
    - With the SOE having previously been restructured, it is now in a position where it can be privatized—moved from Government hands to private hands—using the approach that best accomplishes the specific goals of the State for that particular privatization

Sequencing Privatization and Restructuring (cont'd)

- How to sequence privatization and restructuring/insolvency may be affected by various factors
  - what type of restructuring of SOE is required—i.e., financial restructuring versus operational restructuring
  - who is better positioned to effect the necessary restructuring—government (while enterprise is still controlled by the State) or private owners (following privatization)
- May be considerations of effect on purchase price if restructuring is—or is not—completed prior to the time of sale or other form of privatization
- Also considerations of impact on timing of whether necessary restructuring is done pre- or post-privatization
  - Will undertaking the necessary restructuring pre-privatization unduly delay the privatization process?
  - Might the Government do some of required restructuring pre-privatization and private owner/operator the rest post-privatization

Applying Insolvency/Restructuring Approaches to SOEs that are Potential Candidates for Privatization

- Conduct thorough and comprehensive due diligence
- Undertake meaningful, hard-headed valuation of enterprise
- Make decision as to whether to reorganize or liquidate troubled enterprise
- Develop sensible and realistic business plan for reorganized enterprise going forward
- If decide on reorganization, should it be an out-of-court restructuring versus in-court restructuring?
  - Need to consider issues and desirability of speed, formality (or lack thereof), ability to bind dissenting creditors, etc.
- Also, should reorganization be on an expedited basis (i.e., "prepack") or on normal timetable?
  - Prepacks can be invaluable where speed is of the essence to a successful reorganization

Applying Insolvency/Restructuring Approaches (cont'd)

- Arrange appropriate and necessary financing for entire span of restructuring process
  - whether or not this financing is available can be decisive in determining whether reorganization or restructuring succeeds or fails
- Consider appropriate ways to reduce and/or otherwise reconfigure debt burden of enterprise
  - e.g., debt exchanges, debt-for-equity swaps, Dutch auctions, etc.
- In context of an SOE restructuring/privatization, labor and other social issues can truly be paramount and must be addressed directly and comprehensively
  - Need to address full range of issues related to severance, pensions, unpaid wages, job placement in privatized enterprises and elsewhere, job retraining, as well as ways in which employees can participate in upside of privatization process (e.g., preferential access to stock offerings, etc.)

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