Constraints to Privatization:
The Egyptian Experience

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Abstract

Privatization is perceived as the cornerstone of Egypt's economic reform program. This paper presents an overview of the challenges that the privatization program has encountered so far and means of tackling them. It discusses the political and legal constraints to privatization, taking into consideration the role of the different actors that are involved in the process, namely the executive authorities, public opinion, press and the People's Assembly. Implementation constraints are also considered, including social constraints, the valuation process, the absorptive capacity of the stock market, and the selling of loss-making companies to strategic investors. Finally, the paper concludes by offering policy recommendations given that the ultimate objective is to increase the efficiency of public enterprises through divesting state monopoly and encouraging competition within the framework of a market economy.

ملخـــص

إن الخصخصة تمثل عنصر من العناصر الأساسية لبرنامج الإصلاح الاقتصادى فى مصر. تقوم هــذه. الورقـــة باستعراض التحديات التى نجح برنامج الخصخصة فى مواجهتها وطرق التعامل معهـــا. كمـــا تناقش، العوائق السياسية والقانونية، مع توضيح الدور الذى لعبته لجهات المختلفة عمـــلية الخصخصـــة، ومـــن أهمها السلطة التنفيذية، والرأى العام، والصحافة ومجلس الشعب. بالإضـــافة إلى ذلك يقوم البحث بفحص العوائق التى تواجهه عملية التنفيذ الفعلى للخصخصة بما فى ذلـــك الاعتبارات الاجتماعية، وعملية التقييم، والقدرة الاستيعابية لسوق المال، وبيع الشركات الخاسرة لمستثمر استراتيجى. ويخلص البحث إلى التوصيات أخذاً فى الاعتبار أن الهدف النهائى هو زيادة كفاءة القطاع العام من خلال تقليص الدور الاحتكارى للدولة، وتشجيع المنافسة ووضع آليات السوق موضع التنفيذ.

I. Introduction: The Progress of Egypt's Privatization Program to Date

The transfer of state-owned public enterprises (PEs) to the private sector—privatization—is perceived as the cornerstone of the economic reform program, which Egypt launched in 1991. The implementation of a privatization program is considered the most challenging component of the reform process. The sensitivity of the public opinion towards this issue, the constraints that the PEs' valuation process confronts, and the need for a new legislative environment to facilitate this transitional period must all be taken into consideration.

The government of Egypt has thus embarked on preparing the legislative environment as well as the public opinion for privatization. By issuing Law 203 of 1991, public sector companies were rendered as independent economic entities, and a framework for their management was established comparable to that of the private sector. This included the gradual elimination of ties between the goals of public sector companies as profit oriented businesses, and the state budget's objectives at the macro-level, as well as those of other governmental bodies. Furthermore, the Capital Market Law 95 of 1992 was in turn issued to regulate the stock market and introduce a framework for trading. This was followed by setting government guidelines for privatization which were published in 1993 and updated in 1996. Preparing the public opinion for this transition took place simultaneously through organizing seminars and workshops for leaders of public enterprises and representatives of the government to interact and exchange views with their counterparts who led successful privatization programs abroad.

During the period from 1991 to 1996, three companies—Coca Cola, Pepsi and Al Nasr Boilers—were fully privatized through direct negotiations with strategic investors. In addition, tranches ranging from 5 percent to 20 percent of the shares of 16 companies were floated on the stock market, and the majority of 10 companies were sold to their employees. Starting April 1996, the privatization program began to take off, being characterized by momentum and continuity in an improving macroeconomic environment and an encouragingly receptive public. This was coupled with the stock market's renewed absorptive capacity for the shares offered, in addition to a boost in investors' confidence in the government, leading them to take initiative towards buying PEs. The cumulative achievements of the privatization program since 1991 include (Table 1):

- Floating the majority stake of 38 companies on the stock market and placing them under Law 159 of 1981, which governs private sector corporations.
- Sale of the majority of 10 companies—also transferred to the private sector—to strategic investors. In addition, there are three more transactions which are being finalized.
- The total sale of 27 companies to their employees, some are currently being transferred to the private sector.
- The total sale of assets of 28 companies to private investors.

Thus, the total number of companies transferred from Law 203 is 91. Sixty-four companies were transferred to the private sector, since the sale of assets does not mean the transfer of the entity to the private sector. In addition, tranches representing a stake of less than 50 percent were sold in 20 PEs, of which 9 came from the flour mills and pharmaceutical sectors and are still mostly state owned. Hence, to date 111 companies have been affected by the privatization program.

In spite of these achievements, it is unrealistic to claim that the Egyptian privatization program is proceeding without constraints. Several challenges were and still are being encountered. This paper discusses these constraints and shows how Egypt has addressed them. Following the introduction, Section II deals with the political and legal constraints to privatization. The executive authorities, public opinion, the press, and the People's Assembly members are considered. Section III considers the other constraints to implementing privatization, including social concerns, the valuation process, the absorptive capacity of the stock market, and the selling of loss-making companies to strategic investors. Section IV offers policy recommendations and concludes the analysis.

Table 1. Achievement Indicators

Description	All State-Owned PEs	Privatized Companies	Percentage of Privatized Companies to All State-Owned PEs
Number of Companies	314	104	33
Book Value (£E bn)	12	4.2	35
Market Value (£E bn)	60	20	33

Source: The Public Enterprise Office.

II. Political and Legal Constraints

This section reviews the political and legal constraints that Egypt's policymakers have encountered in realizing privatization as an aspect of economic reform.

A. Political Constraints

The Role of Executive Authorities

The second half of the 1980s brought dramatic international change: the fall of the Soviet Union, the revolution in communications and information, huge advances in science and technology, and free trade initiatives such as the Uruguay Round Agreement. There was increasing international competition and a trend began forming regional economic blocks based on free trade such as NAFTA and the European Union among others. These transformations came at a time when the Egyptian economy was unable to meet its debt obligations in 1987 and 1991, and were coupled with critical imbalances and failure to cope with the global changes which required a certain level of efficiency and competitiveness in the international arena. Competing on international markets necessitates the development of policies towards trade liberalization, structural fiscal reform, the deepening of the financial sector, measures to improve private sector incentives, and privatization and public sector reform.

The various government authorities reacted differently to these rapid changes. The authorities responsible for the management and implementation of the privatization program were more motivated and convinced than others. In various circumstances, however, certain authorities coordinating with the privatization program were not motivated to solve emerging problems such as notarizing land and granting licenses. Some tended to exaggerate the dictates of the law to the point of hindering the program's progress rather than adopting a solution out of fear that they may be criticized by the opposition.

Confronting the Lack of Political Cooperation

Raising the level of consensus among the various authorities was carried out through enhancing the personal and institutional dialogue with the concerned authorities and inviting their top management to seminars and workshops to discuss the different aspects of privatization. In addition, many of these authorities' directors were assigned to committees responsible for setting privatization policies for sectors involving several government bodies, including the Ministries of Electricity and

Energy, Maritime Transport, Finance, and the Central Auditing Agency, and others were involved in setting the privatization strategy for the transport, maritime transport and electricity sectors. The Higher Ministerial Committee of 22 ministers headed by the prime minister, was also created to deal with obstacles, to unify the positions of different ministries concerning the major issues related to privatization and to resolve any problems hindering the program. This technique of utilizing ministerial committees is one of the most efficient techniques because each minister adopts the solution relevant to his ministry and guarantees its implementation.

The Role of Public Opinion

After decades of government intervention in nearly every aspect of economic life, Egyptian citizens had come to feel that state intervention was essential. Pro-intervention trends grew among the different categories of society including labor, students, intellectuals, academics, and the press. They supported government's role in the economy believing that it guaranteed fair distribution, protection of the poor and, hence, social stability. These sectors of society opposed return to market economy, which to them meant reverting to the pre-revolution system that existed before 1952 and which had been attacked furiously in every respect for four decades.

Therefore, it is not surprising that no one in Egypt dared speak openly about the privatization of state-owned enterprises (SOEs) or criticize their performance until the early 1990s. The prevailing wisdom maintained the public sector to be the backbone of the economy, the driving force for growth, and a safety net against poverty and starvation. These views were propagated through media, making the SOEs 'untouchables' until the late 1980s.

Confronting Negative Public Opinion

After the debt crisis of 1987, the Egyptian government realized that it was necessary to implement comprehensive economic reform, particularly after the partial reforms of the 1980s proved inefficient, and the rescheduling of foreign debt in 1987 became useless. Pioneer figures in the government became aware that a comprehensive reform entail the transformation of SOEs into market-driven units by transferring their ownership and management to private hands. They also realized the importance of an early start for preparing the public for the transformation to privatization.

It was not feasible to begin justifying privatization on the basis of the poor performance, efficiency and losses of several SOEs. It seemed best to encourage participation in discussions about the privatization experiences of other countries. Extensive dialogue on comparable experiences abroad was expected to lead gradually to a discussion of the situation of SOEs in Egypt, options for the future and perhaps the possibility of privatization. It was hoped that this would foster a new public opinion supportive of the reform, which would eventually grow into a trend and flourish with the transformation's success.

In 1990, experts and architects of successful privatization programs abroad were invited to participate in discussions and workshops attended by Egypt's pioneer government officials, public sector management, journalists, academics, and intellectuals. Over a three-year period, from 1990 to 1992, several influential workshops and seminars addressed the privatization experiences of Britain, France, Italy, Germany, Mexico, Chile, Argentina, Korea, Thailand, Russia, Turkey, and others. On several occasions, these experts met for informal discussions with the ministers involved in privatization. A new awareness eventually emerged in those sectors of society that influence public opinion. This in turn, facilitated the extension of discussions to the public through the press and the media that covered these events and analyzed the findings. A new perception of reform and privatization was born in the Egyptian society.

In less than two years, many leaders shifted from discussing the experiences of others to emphasizing the necessity of privatization in Egypt. Several seminars and workshops were organized as part of a publicity campaign. In a locally organized seminar, the initial discussions addressing and analyzing the problems of SOEs in Egypt took place, and privatization was raised as an option. Since then, discussions on SOEs and the importance of privatization have expanded. By the time privatization began, it had already attracted several advocates who were encouraging the reform and privatization of SOEs. The veritable takeoff was the first successful sale of three companies to strategic investors and the floating of tranches ranging from 5 percent to 20 percent of the shares of 16 SOEs on the stock market in 1994 and 1995.

The awareness campaign continued to attract new supporters from various sectors and neutralize the effect of critics. Creating positive public opinion for privatization is a continuous process, since there are several issues that critics could use to stall the process and polarize public opinion. Examples include the problems of excess labor, the challenges of the valuation process and the controversial sale to foreign investors.

Efforts to create, maintain and develop awareness must be ongoing to sustain privatization.

The Role of the Press

The Egyptian press is comprised of 300 daily, weekly and monthly journals and periodicals, which employ more than 4,000 journalists and reporters representing the opinions of the various dominant parties in the Egyptian political and cultural life. Freedom of speech and expression and the abolition of censorship have progressed in tandem with economic reform and the move towards a market economy. This environment has given the Egyptian press the liberty to publish the different opinions of journalists, writers and intellectuals without interference. Two developments relevant to privatization became possible.

First, the Egyptian press played a vital role in informing the public about the experiences of other countries that completed successful privatization programs. The press was the most important channel of communication conveying to the public the fruits of the government debates. In addition, it created a forum for dialogue about the problems of Egypt's public sector, as well as the related issues of privatization and reform of PEs. The press also played an effective role in steering public opinion away from opposition to serious consideration of the privatization option, acceptance and readiness, and ultimately to addressing and presenting solutions to the challenges of privatization.

The second development—due to increased press freedom—was the negative role played by a few journals and periodicals that fostered opposition in order to stall privatization. These journals mainly represent opposition parties or pro-government intervention schools of thought, which are against the free market economy. These journalists expressed doubts about the ability of a market economy to realize growth and fair distribution, the processes and measures used in implementing the program, valuing companies for privatization, how labor issues are tackled, sale techniques, 'foreignization', and so forth. The opposition press tried to seize any opportunity to point out the challenges or obstacles facing the program to discredit all efforts and mobilize the public against privatization. Some journals even sought to provoke readers just to increase their distribution.

As privatization took off by mid-1996, information on the program's achievements and the performance of PEs was used by some of these reporters to undermine the image of the public sector, its leaders and certain sales transactions. This led the holding companies, officials from the Ministry of Public Enterprise Sector and the Public Enterprise Office (PEO) to think twice before disclosing information, thus creating a rift of communication and understanding between decision makers and reporters. Miscommunication reached a critical stage when some reporters published untrue information about companies whose shares were being offered for public subscription in the stock market, causing the coverage rates for the shares in some companies to decline.

Confronting Negative Press

In order to bridge the gap between the government and the media at that stage, the Minister of Public Enterprise Sector held a daily meeting with representatives and correspondents of the major newspapers to provide them with the proper information and policies that the privatization program will follow. This has helped achieve accuracy of published information, though some opposition papers still choose to follow their own approach.

The Cairo Center for Economic Information, with the support of the International Monetary Fund (IMF), was established to provide journalists with information not only on the program, its progress and challenges, but also on economic and social issues. High-level seminars are held regularly for experts and government officials involved in the reform program. The aim of these events is to expound on the various aspects of reform and related issues and provide journalists with accurate, in-depth information and answers to their relevant inquiries.

The Role of the People's Assembly

The People's Assembly (PA) played an important monitoring role in the privatization process by presenting questionnaires and inquiry requests to the general assembly and various subcommittees. In two years, two questionnaires were submitted by one opposition member representing labor concerning the implementation procedures and the policy behind appointing chairmen for the boards of privatized companies. Another, 18 inquiry requests were submitted relating to public enterprise losses and management efficiency. There were also 19 questions from majority representatives addressing the valuation and privatization process, sales proceeds and their use/allocation, the situation prevailing in the textile sector, and remuneration and bonuses for top management in the private sector. Although these questionnaires and inquiry requests are considered excellent signs of democracy, they assisted opposition parties in their campaign against privatization. The frequent inquires by majority representatives caused those in charge of the privatization program to question the degree of support from the majority members.

Confronting Opposition in the Legislature

Direct contact with members of the PA was enhanced through continuous meetings with the Minister of Public Enterprise Sector, the officials from the Ministry and holding companies, as well as the members of specialized committees in the Assembly, to create a dialogue on the main issues of privatization.

Comprehensive databases were established for each company undergoing privatization to facilitate the preparation of a White Book to disclose all measures and procedures undertaken and show compliance with relevant laws. Copies of each White Book were sent to every member of the Assembly. Management information systems and decision support systems about the privatization program were created to support decision makers and help them respond to questionnaires and inquiries.

The defense bureau was given additional support in response to lawsuits filed by some opposition members of the Assembly claiming that, according to Law 203, the privatization process was against the Egyptian Constitution. The Higher Constitutional Court issued a response that Law 203 and the privatization proceedings are constitutional,[1] which had a positive impact on the legality of all the transitional measures.

B. Legal Constraints

The transformation of the Egyptian economy from one governed by the mechanisms of semi-centralized planning to an economy steered by market forces was impossible without the necessary legislative changes. These changes allowed market forces to replace the government decision-makers who rule the old economic system. Privatization, the core of the economic reform program, could not be achieved

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[1] The Higher Constitutional Court issued the following justification to its verdict:

- Abuse of the articles of the Constitution by subjugating it to a certain philosophy contradicts its adaptability to serve new horizons sought by the public.
- The Constitution must not be viewed as presenting final and everlasting solutions to the economic conditions that were surpassed by contemporary evolution. Rather, it should be understood in light of higher values aiming at liberating the nation and the citizens politically and economically. The Constitution is a progressive document, its texture being in harmony with the spirit of this era.
- The Constitution, despite guaranteeing the so-called 'Socialist Privileges' (its support and preservation perceived as a patriotic obligation through Article 59) presented no definitions for Socialism.

without the proper legal framework, which could only be brought about through implementation of appropriate legislation.

Several groups, especially intellectuals advocating government intervention, protested against the legality of privatization practices. They referred to Article No. 24 of the Constitution, which states that public ownership is the people's ownership and is asserted by the continuous support to the public sector. It adds that the public sector leads progress in all sectors and assumes primary responsibility for the country's development plan. On this basis, the opposition claimed that all measures and legislation governing the implementation of the privatization program were unconstitutional and had no legal basis. In an attempt to cripple the privatization efforts, a few members of the People's Assembly, including heads of opposition parties, lawyers and intellectuals, filed a lawsuit before the Higher Constitutional Court asking it to render Law 203 of 1991 and, in turn, the entire privatization program unconstitutional.

Although the Constitution permits reform and transformation to a market economy, the laws and regulations governing the organization and working procedures of public companies were hindering any progress in reform and privatization. Prior to 1991, public companies functioned like governmental authorities and were only companies in name. They were organized under 37 government organizations overseeing their management. Each group of organizations fell under the domain of the minister of its sector or field of activity. About 14 ministers intervened in the day-to-day management of these organizations, by virtue of their specialization and organization.

The boards of public companies did not have freedom in management. In most cases, investment decisions were dictated by the National Investment Bank. The government would also impose numerous new graduates on these companies, whether or not more employees were needed. In spite of the regulations governing work procedures in public companies, the government's intervention in management extended to setting the prices of sales and purchases. Consequently, these companies were not independent economic entities. Their economic role became mingled with the social role of the state, rendering them socioeconomic entities. This led to entangled debts and credits with other government bodies, a burden that was reflected on the operations of these companies and eventually on the state budget.

These entangling relations between PEs and the government made it difficult to evaluate public companies. A prerequisite for evaluating PEs is their existence as autonomous economic entities operating in a commercial, stable and profit-oriented manner. Under government intervention, assuming a valuation was conducted, new external decisions could impact the size of investment, or labor or other variables, before the finalization of the privatization transaction. This would render the valuation inaccurate and obsolete and would halt the privatization process.

Until the late 1980s, the Egyptian Stock Market was not prepared to execute privatization transactions, which constituted a serious constraint. An indicator of the weakness of the most important capital market institutions, namely the Cairo and Alexandria Stock Exchanges, was the value of transactions on the market, totaling only £E342 million in 1990 and averaging around £E1 million daily, which is extremely low. This modest value was coupled with weak institutions confined to a limited number of brokerage and portfolio management companies that barely performed their function. How, then, could the stock market expect to absorb the shares from privatization which might reach several billion Egyptian pounds? It was essential to introduce legislation to facilitate the creation of capital market institutions capable of undertaking the various privatization functions, to regulate monitoring operations and to facilitate the implementation of the program.

Confronting Legal Constraints

The legislative constraints on the organization and management of these public companies were all finally addressed with the issuance of Law 203 in 1991, allowing their privatization. Law 203 identified 314 public companies and affiliated them with holding companies, declaring them to be public business sector companies, and thereby candidates for privatization. As the name implies, the new organization, management and control of these companies is comparable with that of business establishments. Based on Law 203, PEs were rearranged under 17 holding companies managing diversified portfolios, instead of 27 holding companies with each specialized in a specified sector or activity. All the companies came under the aegis of the Minister of Public Enterprise Sector, thereby abolishing all means of intervention by government authorities in the companies' management.

A board of directors—elected by and responsible before the general assembly of the affiliate—assumes the affiliate's management. According to Law 203, the board sets forth the policies for the affiliate and monitors their implementation under the supervision of the general assembly. The general assembly of the holding company is responsible for taking decisions related to the sale of a stake greater than 50 percent of its affiliates' shares.

Government bodies can no longer impose decisions related to investments on public companies or provide loans guaranteed by the government. Companies must rely on their own resources or obtain bank credit on regular terms. Excess labor can no longer be assigned to companies, and selling prices for products—except pharmaceuticals—and purchase prices for raw materials are no longer dictated by the government authorities. Law 203 made PEs independent economic entities operating commercially on grounds similar to those of private business. Continuing the development process of the necessary legislative framework demanded enhancing the capital market and its institutions. The Capital Markets Law No. 95 of 1992 and its executive regulations introduced new types of institutions previously unknown in the Egyptian capital market, to regulate its operations and control. This law regulated the establishment and norms of investment funds in Egypt. These investment funds represent institutions that invest their shareholders' money in portfolio shares and bonds. Law 95 also regulated the establishment, operation and monitoring of brokerage firms by the Capital Markets Authority, as well as the operation of portfolio management, share promotion companies and underwriting firms, among others, which are essential for the success of privatization programs. The law also introduced the idea of Employee Shareholder Associations (ESAs) for public and private enterprises and their establishment as independent entities. Workers could buy their companies' shares through these associations and repay through the annual dividend yield. In 1992, Egypt's legal environment began to prepare for privatization transactions. The program acquired strong momentum, and capital market institutions increased from seven firms at the end of the 1980s to 204 firms by the end of 1997 (Table 2).

Table 2. Institutions of the Egyptian Capital Markets Authority, end of 1997

Type of Institution	Number
Brokerage firms	132
Underwriters and portfolio managers	36
Investment funds	18
Investment fund management	9
Depositary institutions	4
Record management firms	3
Clearance houses	1
Securities valuation and rating companies	1
Total	204

Source: The Capital Markets Authority's internal reports, April 1993.

III. Implementation Constraints

A. Social Constraints

A major characteristic of the Egyptian economy for several decades has been the domination of social considerations over economic efficiency. This manifested itself in various practices, the most notable of which was the government's allocation of labor to government entities and public sector companies and enterprises, as already mentioned. This served to absorb the inflow of new labor, regardless of the optimal number of employees required by each organization. This overstaffing inflated the public sector, which was estimated at twice the necessary workforce and made state-owned companies, a bastion of redundant labor. Table 3 shows the size of labor in public enterprises in 1995/96, prior to labor restructuring efforts, as a representative sample of the public sector at large.

There is no data on the scope of redundant labor; however, there are estimates by the management of troubled companies. These estimates indicate that PEs currently employ around 180,000 redundant workers, most of whom work in the financial, administrative and service departments. These estimates undoubtedly represent disguised unemployment, in light of the level of technology used and the prevailing organization inside these PEs. The restructuring and modernization at the technical and managerial levels will reveal even more excess labor, especially if advanced technologies were introduced.

Table 3. Number of Workers in PEs under Law 203 of 1991

Holding Company	Number of Workers	Average Salary per Worker	Total Salaries (£E million)
Spinning and weaving	96,524	5,532	534
Textile manufacturing and trade	96,762	5,085	492
Cotton and foreign trade	49,156	5,900	290
Engineering industries	62,178	7,688	478
Metallurgical industries	72,827	9,337	680
Mining and refractories	61,826	9,042	559
Chemical industries	47,400	7,785	369
Pharmaceutical industries	29,145	7,583	221
Food industries	94,616	4,365	413
Mills and silos	56,505	3,858	218
Agricultural development	40,082	3,044	122
National construction	57,061	6,817	389
Electrical construction	90,741	5,466	496
Housing, tourism and cinema	19,918	6,326	126
Maritime transport	24,187	9,468	229
Transport	33,476	6,900	231
Total	932,404	6,271	5,847

Source: The Ministry of Public Enterprise Sector.

Table 4 indicates that excess labor in PEs represents around 33 percent of the total labor force in those companies. The social pressures of excess labor constitute a serious constraint and a real challenge for the Egyptian privatization program. The issue of how to deal with excess labor in PEs when restructuring and privatizing, is a great source of concern for labor and the public. In turn, it creates resistance to the program from some labor groups, providing critics with ammunition to undermine the privatization effort.

'Retiring' almost 300,000 workers from PEs will put pressure on the job market, with nearly 1.6 million people already unemployed. It is worth mentioning that most unemployed people are looking for jobs in fields that are already saturated in the public sector. The early retirement of this excess labor force requires paying compensation packages averaging £E25,000 per worker. Thus in order to carry out the retirement program for excess labor, companies must gather funds amounting to £E7.5 billion in three to four years, averaging around £E2.5 billion annually. This exceeds the available finances estimated at around £E4 billion, representing one-sixth of the sales proceeds forecasted for the coming three to four years of the program.

Table 4. Estimate of Excess Labor in Egypt's Public Enterprises

Category of Companies	Size of Excess Labor (workers)
More than 20 losing companies	60,000
More than 60 other losing companies	100,000
140 companies realizing modest profit	140,000
Total excess labor	300,000

Source: The Ministry of Public Enterprise Sector.

It is, therefore, apparent that workers' concerns, the increase in unemployment and the lack of resources needed to pay compensations for the retirement scheme represent valid and critical constraints to the progress of Egypt's privatization program.

Confronting Social Constraints

Dialogue with Labor Unions and Committees

Confronting these social constraints and accommodating labor's concerns were essential to the privatization process. The authorities developed a system of shared decision-making in order to make the process transparent and participatory. The Ministry of Public Enterprise Sector and holding companies have not taken any decisions prior to negotiations with unions, the Ministry of Manpower and the General Union for Egyptian Workers to attain a consensus. Labor committees in the concerned companies attended the earliest stages of the diagnostic study of losing companies and participated in the discussion of the management's proposals for dealing with excess labor. Such meetings revealed a high level of awareness on the part of union representatives and an appreciation of the need for reform. This approach to decision making limits opposition to those sectors with political ideologies that reject the process of transformation to a free market economy. It neutralizes the majority of workers and wins their necessary support for reform efforts.

Offering Workers Special Privileges through the Privatization Program

Through ESAs, workers in public enterprise can buy 10 percent of the shares in their companies that are sold to strategic investors or the stock market. Their share is taken before prorating the offered shares with a discount of 20 percent on the selling price. ESAs are also granted credit facilities for the term of repayment of the purchased stake ranging from eight to ten years on annual installments, thus enabling employee shareholders to repay from their dividend yield. Such privileges enhance workers' support and involve them in the privatization efforts. They can observe the positive impact of privatization and retain a feeling of loyalty to their company even after it shifts to the private sector.

Selling the Majority Stake of Companies to ESAs

One way through which Egypt's economic reform program—particularly its privatization effort—was able to appease workers' concerns was the complete sale of companies to ESAs representing the workers. The program, in fact, witnessed the full sale of 28 companies to ESAs before 31 January 1999, of which 10 companies came from the public works and land reclamation sectors, six from the rice milling, animal feed and pasta production sector, and five from the maritime transport sector, this in addition to five inland transport companies. These companies were sold at reasonable prices—normally the book value with repayment over eight to ten years. The holding company also provides technical and financial support in the form of soft loans at only 5 percent simple interest to enable companies to improve, grow and preserve their operations and employees.

Implementing the Early Retirement System

The optional early retirement system has been implemented in PEs suffering from excess labor. It was designed in conjunction with union committees, the Ministry of Manpower and the General Union for Egyptian Workers, and was approved by the Higher Ministerial Committee for Privatization attended by the Minister of Manpower. This system allows workers to request early retirement in return for a termination bonus of at least £E15,000 and a maximum of £E35,000. The request should be made by the worker. The worker's age must range from 50 to 58 years for males, and 45 to 58 for females. Applicants must have a minimum of 20 years of service and must subscribe to social insurance to be eligible for the monthly pension from the company after retirement.

In its first stage, the system is applied to losing companies subject to liquidation or sold as assets or separate units, and to the losing companies under restructuring prior to sale. Until December 1998, this system was applied to 71,000 workers. Only companies that are not viable, cannot be restructured, and that must be liquidated are allowed to apply this system. This is done through a joint decision with the union committees, especially for workers who do not meet the above conditions, and particularly those who fall below the required age and who are not entitled to a monthly pension. A few holding companies assume responsibility for the rehabilitation of workers through the Social Fund for Development, which provides transfer training for younger workers to equip them for the requirements of the labor market. In spite of the fact that this technique should be the primary method to deal with the excess labor problem, it was applied in Egypt only on a limited scale.

To finance the early retirement plan of excess labor in PEs, Egypt adopted a special system that allows holding companies to retain one-third of the sale proceeds and assets, while two-thirds goes to the Ministry of Finance. The holding company's portion is normally used to pay retirement compensation for those who choose early retirement, along with the settlement of affiliates' debts. The Ministry of Finance's share is used to settle public debts.

Holding companies have already used the one-third allocated to them in the payment of £E1.5 billion in compensation to 60,000 workers who retired early. Thus, there has been a good match between resource inflows from privatization proceeds and outflows in compensation for excess labor. This is because the sale of profitable companies occurred simultaneously with and parallel to the restructuring of companies with financial and labor difficulties to turn them into viable and profitable units ready for sale in successive stages. As long as there are profitable companies that can be sold, and which are not burdened with excess labor, the labor restructuring of losing companies will be possible with the available resources from the privatization proceeds. The issue of financing early retirements becomes urgent with the decline of the remaining profitable companies and with the preparation of losing companies and modestly profitable ones, which suffer from varying degrees of excess labor, for being sold.

The holding companies today have 80,000 requests for early retirement, requiring £E2 billion in funds. The Ministry of Public Enterprise Sector is currently considering different means of financing present and future retirements. Solutions include: raising a syndicated loan with banks in foreign or local currency using either unutilized land or shares owned by holding companies as collateral; selling valuable excess real estate and placing the proceeds in a finance pool from which other holding companies can draw to settle dues related to early retirements; and issuing bonds on the government, with bank collaterals (privatization bonds), for medium-term maturity of three to five years to finance early retirement, thereby amortizing the balance from the holding company's share in privatization proceeds. The Egyptian experience with privatization can thus be characterized by a smooth gradualism, labor support and consideration of the social parameters. The major threat to the program however, seems to be the social parameter, particularly the problem of excess labor.

The crisis situation may occur due to the retiring of a huge number of workers especially younger ones, who may stay jobless with the assumption that it is the role of the government to compensate them. There is concern that 'retired' workers will quickly spend their compensation money and then return to the government and public sector to find jobs. If this happens, resentment will build up and may catalyze great opposition to privatization, particularly among workers. It is, therefore, essential to expand the establishment of institutions to finance and facilitate the development of small and medium industries to absorb the excess labor under the age of 50. It is also necessary to develop new incentives, other than cash compensation, for early retirement of younger workers.

B. The Challenge of Enterprise Valuation

Valuation is the first step in the process of preparing public enterprises for sale. Valuation affects all successive steps, so much so that the main after-sale criticisms are often about the valuation. The valuation process is a mix of both science and art, since it requires the application of various well-known techniques and principles, coupled with special skills and methodologies which relate to each unique case or company. The maximization of the sale value could be achieved by selling a few unutilized or unprofitable assets separately prior to the sale of the company as a going concern—such case would best illustrate the 'artistic' part of valuation.

Obstacles in the Valuation Process

The first obstacle to the valuation process emerges from the numerous approaches to valuation and the high probability of obtaining different results from each technique. The major techniques are:

- The Net Book Value of the Company

This method reflects the historical worth of the company and is represented by the book value of net equity—paid up capital, reserves, retentions, and provisions that do not cover real risks. This also equals the total asset value after deducting liabilities and provisions made against possible risks.

- The Adjusted Book Value Method

This method is applied to obtain a better idea of the market value of the company. It relies on the inflation applicable to each asset type for the relevant period beginning from the acquisition of the asset, in addition to accounting for the change in exchange rates of the country of origin from which the asset was procured.

- The Replacement Value

This is an asset-based valuation technique that yields a net asset value which should reflect the cost of acquiring or building up a similar project or plant. There are three approaches to this technique:

a. Replacement as is, meaning the value of the asset based on its current condition and potential longevity. This is appropriate for privatization purposes.
b. Replacement anew, meaning the value of a similar asset but new, not accounting for its current condition.
c. Replacement with state-of-the-art technology, this implies a similar asset but upgraded with the latest technology.

- The Discounted Cash Flow Model

A model that describes the value of a company as an on-going concern based on its ability to generate future cash. It accounts for the time value of money and the various levels of risk associated with this activity.

- Price to Earnings Multiplier

This method is like a benchmark against which investors compare various securities, using the reciprocal rate-of-return by measuring the price as a multiple of the earnings per share. In privatization, it is considered prior to sale, since it reflects the forecasted market reception for the share.

A narrow gap is expected between values only if the size of the company is optimal and if it possesses technological, administrative and marketing abilities that reflect on its capacity to generate revenue and, hence, profitability. In this case, all the company's assets are utilized. The current and future revenue-generation ability reaches its peak. The value according to the price/earnings multiplier, therefore, will not vary much from the replacement value of assets or the value calculated using the discounted cash flow model. Nevertheless, this case rarely occurs, especially among public enterprises that are characterized by inefficiencies.

The valuation of Qaha Company for Preserved Food, sold in 1998, illustrates the obstacles of valuation and represents one of several similar cases encountered during the Egyptian privatization experience (Table 5).

Table 5. Valuation of Qaha Company (£E million)

Market value of net assets (using market value of land)	218.6
Market value of net assets (using new cities prices for land)	179.2
Adjusted book value (using new cities prices for land)	62.4
Book value of the company	37.8
Valuation according to DCF model:	
Discount rate 13 percent	19.8
Discount rate 12 percent	22.6
Discount rate 10 percent	29.9
Valuation according to 10 multiple of EPs	zero

Source: The Public Enterprise Office.

The next obstacle in the valuation process is the cost attached to the process which ranges from £E100,000 to £E300,000 with an average of £E200,000 per company. This implies that valuation of all public enterprises reaches £E62 million. It is worth mentioning that any valuation done more than six months prior to the date of sale needs to be updated, consequently raising costs and compounding the problems of privatization, especially that they are only part of the total costs related to privatization.

Egyptian expertise was limited in the beginning of the privatization program and was not sufficient to undertake the valuation of candidate companies for privatization. The success of the valuation process still relies on local and foreign consulting firms and individual consultants to evaluate each company to assure a fair value prior to sale. These foreign and international consultants do, however, keep diverse funds supporting the program. It is only logical to direct part of these funds, allocated for valuation, to consultants from donor countries. This issue received extensive criticism from the public who assumed that foreign experts would be directed by their countries to undervalue companies to enable their investors, and both the foreign and local private sector, to buy them at lower rates.

Confronting Valuation Obstacles

The Egyptian experience dealt with the obstacle of having a wide variance in the valuations of any company by adopting a special approach to handle privatization-related decisions, based on two principles. First, individual officials should not make decisions alone, but rather through one of seven committees or institutions: the affiliate's board of directors, the affiliate's general assembly, the holding company's board of directors, its general assembly, the quadripartite committee, the central auditing agency, or the Higher Ministerial Committee for Privatization chaired by the prime minister. Second, decisions within these institutions should be made by consensus. This method of decision-making alleviates undue pressure on individuals in charge of privatization.

The Egyptian privatization program overcame scarcity of funds by accepting grants from countries offering to contribute to that effort. The Egyptian government accepted grants from the World Bank ($600,000 unused), USAID ($35 million), and the European Union (Ecu43 million), in addition to a UNDP grant ($3 million). This approach leveraged the financial strain on the government, so that its contribution has been minimal since the beginning of the program and did not exceed $2.5 million.

The problem of assigning valuation to foreign entities was solved by having another valuation conducted by an internal joint-committee of the holding company and the affiliates' expertise. Particular companies, which are critical to the program or present unique challenges, are valuated by several foreign consultants in addition to local committees. This process showed critics and the public at large that the aim of the program is to reach a fair valuation to avoid underselling. Overvaluation of companies was also avoided which would have undermined the Egyptian government's credibility and deprived investors of the chance to make a purchase at a reasonable price.

The procedures also included a review of the valuation studies by the Central Auditing Agency (CAA) along with a verification of the methodology used and its applicability to the particular company. This leads to either a modification of the valuation, or to its complete rejection by the CAA. The quadripartite committee—comprised of representatives of sellers, mainly the holding company, the affiliate, the Ministry of Public Enterprise Sector, and representatives from the Capital Markets Authority, the Stock Market and the CAA—reviews all valuations prepared for the company, choosing whichever it deems most indicative of the true value of the company and in-line with the prevailing stock market conditions. This decision-making process guarantees that valuations by foreign consultants are used only as a guideline for the domestic decision makers and institutions, which ultimately reach a consensus thereby preventing unilateral and subjective decisions.

Recently, Article 26 of Law 203 regulations was amended to allow the general assembly of the holding company to accept bids from buyers that fall below the initial valuation (i.e., the reserve price), or to order a valuation of the affiliate under sale.

C. Weak Stock Market Absorptive Capacity

The risk of Stock Market downfalls was unexpected, especially during the take-off stage of the privatization program, which witnessed a remarkable success in public offerings and Initial Public Offerings (IPOs) that took place through the Stock Market.

From May 1996 to the end of 1997, not a single offering on the Stock Market failed; in fact, shares of privatized companies were oversubscribed tens of times. The problem facing the Ministry of Public Enterprise Sector, the Private Enterprise Office and the holding companies was mainly to prepare more companies for further offerings, implying that the pace of the program was tied to the supply side and not the demand side, which seemed almost guaranteed.

By the end of 1997, however, difficulties arose in reaching the required rates of subscription for some companies, which, in turn, threatened the progress of the privatization program to meet the preset plans. It, therefore, became necessary to study and analyze this phenomenon and to take the appropriate actions. It is worth mentioning that the sale technique for each privatization candidate is determined based on profitability, size and the need for technological improvements in products and equipment, besides the development of managerial and marketing capabilities. The decision was made to sell companies either to a strategic investor or group of investors; to the company's employees through their association; through the stock market—the most rapid and optimal technique to face public concern; or through the sale of a company's assets and units separately. The privatization program gained huge momentum and a sound reputation when it began to depend mainly on sale through the stock market. Table 6 shows the number of privatization transactions completed between May 1996 and December 1997.

The boom in the privatization program encouraged several local and foreign investors—individuals and institutions—to invest in portfolios. The increase in demand led to an inflow of portfolio investment privatization shares, thereby facilitating the sale of any company without significant promotion. The prices of traded privatization shares appreciated due to the huge demand and relative scarcity of shares on a wider scale, in addition to those of Law 203 companies that were being privatized. The price/earning multiplier of these traded companies increased, thereby affecting the initial valuation of new offerings based on higher P/E ratios to reflect market conditions. Table 7 shows the P/E ratio of four shares sold during June/July 1996 compared to four others sold during June/July 1997.

Table 6. Privatization Transactions, May 1996 to December 1997

No. of companies sold (minority/majority) through stock market	42
No. of companies sold to employees associations	5
No. of companies sold as assets	20
No. of companies sold to strategic investor	5
Total number of companies	*72*

Source: The Public Enterprise Office.

Table 7. P/E Ratio for the Period June to July 1996 versus June to July 1997

Company	Date Offered	P/E	Company	Date Offered	P/E
Starch and Glucose	96/6	8.3	Simo for Paper	97/6	10.6
Kafr El Zayat Pesticides	96/7	6.9	Alexandria Flour Mills	97/7	9.3
Nile Matches	96/7	7.9	Al Saiid Contracting	97/7	11.0
Misr Oil and Soap	96/7	8.0	Giza Contracting	97/7	9.8
Average		*7.775*	*Average*		*10.175*

Source: The Public Enterprise Office.

By mid 1997, investors' attraction to the Egyptian Stock Market began to wane. Prices appeared too high with only modest yields. This coincided with two other major events. The first was the beginning of the economic crisis in East Asia, starting in Thailand in July 1997, and spreading later to the economies of Indonesia and Korea, then to Japan's stock market, and to several other parts of the world during the second half of 1997. The second destabilizing event was the terrorist attack in Luxor in November 1997. Both factors had negative effects on investment and capital inflows to Egypt. The net demand abroad for Egyptian shares declined. Table 8 demonstrates the trend of foreign net demand on the Egyptian stock market from March to October 1997 compared to the period from November to June of 1998.

New forms of supply on the stock market emerged with the offering of the Mobile Phone Co. shares in March 1998. Joint ventures and private sector, family-based companies also started to offer shares on the market. These offerings absorbed part of the liquidity available in the market and negatively affected the demand for shares of privatized companies. Nevertheless, the problem of undersubscribed companies arose for the first time in September 1997, recurring in March, April, May, and June of 1998. The inability of the stock market to absorb new offerings became a critical constraint to the progress of the privatization program. It was essential to introduce new policies and measures to remedy the situation and to restore the pace of the privatization in order for the government to meet its commitments.

Table 8. Net Foreign Demand (£E million)

March – October 1997		October 1997 – June 1998	
Month	***Net Demand***	***Month***	***Net Demand***
March	148	November 1997	-8
April	-2	December 1997	45
May	39	January 1998	-19
June	512	February 1998	-110
July	131	March 1998	-80
August	162	April 1998	-16
September	271	May 1998	11
October	444	June 1998	15
Total (cumulative)	*1,705*	*Total (cumulative)*	*-162*

Source: The Public Enterprise Office.

Confronting the Challenge of the Market's Weak Absorptive Capacity

The first set of urgent measures undertaken to address weak stock market absorption was introduced in December 1997 and included varying sale techniques and selling more companies, not only through IPOs. Sale to employee shareholder associations was applied on a case by case basis. During the first quarter of 1998, five inland transport companies were sold to ESAs. The procedures to sell three more companies to ESAs—namely Maritime Works Company (Martrans), General Marine Supplies and Sharkeya Rice Mills—were taken in the second quarter.

The sale-of-assets technique was extended for troubled companies in the form of separate assets or units. From the last quarter of 1997 through the first half of 1998, seven companies were sold using this technique. Sale to strategic investors was emphasized whether through the stock market or direct negotiations. Between December 1997 and the end of June 1998, the following companies were offered: Alexandria Spinning and Weaving, Delta Industrial-IDEAL, Qaha Preserved Food, Al Nasr Civil Works, San Stefano Hotel, Al Wady Agricultural Exports, Gianclis Beverages, the distillation factory of Al Koroum Company, Nile Hotel, Nobaseed for Seed Products, Steelco, Metalco, Al Nasr Glass and Crystal, Beni Suef Cement, and Abou Zaabal Fertilizers.

The method of promoting candidate companies was revised and the decision made to rely on professional promoters by involving underwriters. This entailed modifying the valuation and price-determination mechanism. In response to the prevailing price levels in the stock market, the P/E ratio for new offerings was lowered. This was applied in the case of Misr Food Company (Bisco Misr). It was decided that a P/E ratio of 7.2 would be used in pricing shares according to the price discovery mechanism, allowing for a 10 percent price fluctuation instead of the 5 percent used previously. These measures made it possible to overcome critical obstacles and bottlenecks stemming from the weak absorptive capacity of the Egyptian stock market. This enabled the government to meet its commitments and to privatize 10 companies each quarter.

D. Selling Heavy Loss-Making Companies to Strategic Investors

According to the financial results of PEs for the fiscal year 1997/98, 67 companies realized losses. Most of those companies, however, are restructurable, since they suffer imbalances in their financial structure as well as their labor force. Some of them have minor bottlenecks that might be remedied by investments financed under current circumstance and could become profitable units ready for sale and under better terms. There are, however, 20 other companies in serious trouble, realizing losses from operations before deducting interest expense or taxes. They are subject to financial and labor restructuring prior to sale. The major problems in these companies, nevertheless, lie in their need for sizable investments in equipment and machinery, improvement of their organizational and managerial structures, training for technicians and workers, and increasing their marketing capacities.

With the continued reliance on the sale of profitable units from PEs, the aggregate results of the entire sector will eventually decline to a net loss, which will certainly affect public opinion. Borrowing funds from banks, that could have been made available to the more efficient private sector entities, will be a burden on society; however, keeping these companies state-owned is a further drain of funds and represents more losses. It is undesirable, both economically and socially, to liquidate many of these companies, especially if there is a way to privatize them, by making them profitable entities realizing growth. It is best to deal with companies incurring heavy losses by selling 51 percent to 61 percent of the company to private, local industrial groups for no immediate price, with the state retaining 39 percent to 49 percent stake of their equity. The company is offered as public tender to investors who present their bids after a period of due diligence, presenting their business plans with defined investments with the range of the allowable percentage of ownership—51 percent to 61 percent. Proposals should be ranked according to the volume of investment, adequacy of the plan for improving the business and the minimal percentage of ownership claimed, in that order. Local investors are then allowed to sell up to 49 percent of their share in the company to foreign partners, with the aim of bringing technical know-how and transfer of technology.

A condition of sale to foreign entities is that proceeds will be reinvested in the company, since local investors did not pay anything for it. With the future progress of a company in sight, the state can then sell the retained shares on the stock market to the public or investors at a higher value. This appreciation in value is actually the amount the state collects from the sale of the company. Sale to foreigners is limited to company shares which on aggregate, are calculated as follows: a maximum of 49 percent of the 51 percent to 61 percent initially held by local investors, plus a maximum of 25 percent of the 49 percent initially retained by the state, equaling a maximum of 37.24 percent to 39.64 percent in total.[2] To effect this proposal, it must go through a chain of approvals starting with the Ministerial Committee for Privatization, the cabinet, and the president, until it is passed as a law by the People's Assembly.

IV. Concluding Remarks

The success of privatization is not determined solely by the number of companies sold. Rather the goal is to divest the state monopoly, encourage competition and put market mechanisms in place to increase the efficiency of public enterprises. In light of this ultimate objective—efficiency—a survey has been conducted of 28 privatized companies in 10 sectors, including textiles, cotton, flour mills, cement, chemicals, electrical devices, contracting, and food industries. This survey showed the following: sales increased in 20 companies, or 71 percent of the sample; earnings before interest and taxes (EBIT) increased in 19 companies, or 68 percent of the sample; the average salary per worker increased in 27 companies, or 96 percent of the sample; and the balance of loans to banks, including short- and long-term loans, declined in 23 cases, or 82 percent of the sample.

These achievements show that the Egyptian privatization program has successfully confronted the challenges thus far. This, however, does not mean that the program will not face obstacles in the future. The main threat to privatization is loss of public support. Privatization means a radical change in the role of government, a change that has political, ideological, economic, and social parameters. Egypt has had

[2] Calculation as follows: 49 percent * (51 percent to 61 percent) + 25 percent * (39 percent to 49 percent) = (24.99 percent to 29.89 percent) + (9.75 percent to 12.25 percent) = 37.24 percent to 39.64 percent.

remarkable success in creating a favorable public opinion, which has enabled the sale of stakes in 123 companies. This public support could deteriorate due to setbacks in the program implementation, such as renewed criticism from the media, which could lead to public backlash against privatization.

This criticism could emerge as a reaction to failures to abide by the main objective of the program, which is to enable enterprises to work under market mechanism by promoting competition and profitability. This requires furthering the transfer of ownership to private entities, abolishing the influence of holding companies which retain a minority share in sold companies, and giving preference to investors who present sound business plans although they may not offer the highest bid. Criticism could intensify if labor problems are not resolved, if workers' rights are not preserved and if their fears are not mitigated. The issue of excess labor, therefore, must be addressed prior to sale and should not be left to the private sector. Any early retirement of workers in the private sector could be misunderstood and could provoke criticism. At the early stages the number of workers forced into retirement is relatively modest, but numbers will increase when the sale of loss-making companies suffering from excess labor begins. A substantial number of these workers would be young. Concerned organizations should finance small-enterprises and retrain youth who are retired from loss-making companies, since early retirement schemes are not enough and are best suited for older workers.

Criticism may also stem from the sale of profitable companies; the delay and hesitancy in selling losing companies due to debt, excess labor problems and valuation; and relying on professional institutions in the sale process. Criticism might also emerge if companies do not abide by principles of transparency and adequate disclosure in all privatization procedures. Experience has proven that the public opinion and institutions in the capital market as well as investors require transparency concerning the progress of the program. The public must be informed about the facts related to companies sold and the use of proceeds from privatization transactions.

The skills and institutional culture of the government agencies responsible for the privatization program, especially those in the executive branch, must be enhanced. During the previous successful period of the program, some investors were exposed to workings of the government. Many investors developed a negative impression of government authorities which were slow to address their concerns in a few unsuccessful transactions, in addition to the problem of the overvaluation of assets and shares. This could make investors reluctant to bid on company offerings in the future, thereby slowing down the pace of the program and ultimately compromising the credibility of the government and the potential of privatization as a means to greater efficiency and economic growth in Egypt.