



SigmaBleyzer

Where Opportunities Emerge.

The Effect of Privatization on Social Welfare in Ukraine: Practical Experience of SigmaBleyzer

Michael Bleyzer & Edilberto Segura

February 25, 2003

SigmaBleyzer

- US company managing premier Ukrainian Investment Banking groups
- Ten years experience in Ukraine
- Investors: international financial institutions, and high net worth individuals / families
- Ukrainian Growth Funds (UGF) – over \$100 million under management, some of the best performing funds in emerging markets
- One of the largest privatization players in Ukraine
- Currently investments in over 60 Ukrainian companies
- Substantial experience in managing and restructuring companies
- Significant number of successful exits
- Leadership in International Private Capital Task Force (IPCTF)

UKRAINE: Economic Highlights

- Industrial base during Soviet times was inefficient (i.e. energy use) and oriented towards the military
- After '91, state enterprises couldn't compete and operated at 10-15% of capacity, causing production declines and financial deterioration
- Massive "real" unemployment (about 30%) even before privatization, many employed just on "paper"
- Large wage arrears in most state enterprises
- 1991 to 1995 - Preservation Strategy: subsidies to large state enterprises, with high deficits and inflation
- 1995 to 1998 - Implementation of reforms, but fiscal deficit still too high. Enterprises still underutilized
- After 1998, acceleration of reforms and good economic results: GDP increased by 5.9% in 2000, 9.1% in 2001 and 4.1% in 2002
- But growth still based on better utilization of capacity
- Investments still low due to poor business environment - deficiencies in liberalization, legal environment and governance

Ukrainian Privatization

- **First Stage (1992-1994)**
 - Leasing with redemption
 - Legislative base established
- **Second Stage (1995-1998): Mass Privatization**
 - All citizens participate
 - Process:
 - 150-200+ companies put up for sale every month
 - Individuals use vouchers to choose companies
 - Vouchers then exchanged for shares (amount determined by number of applications for each company)
- **Third Stage (1999-present)**
 - Looking for strategic investors
 - More focus on running the business
 - Significantly more transparent

Average Monthly Salaries, 2000

Sector	Average	State	Non-State
Mining	\$74.12	\$69.28	\$82.77
Food Industry and Processing of Agricultural Products	\$49.08	\$41.74	\$49.74
Light Industry	\$28.84	\$20.46	\$29.08
Coke Production and Oil Refining	\$87.06	\$41.02	\$88.70
Metallurgy and Metal-Working	\$74.92	\$62.46	\$77.09
Machine-Building	\$40.40	\$38.70	\$40.88
Electricity, Gas, and Water Production	\$69.24	\$64.83	\$71.61

Source: State Property Fund

Salary Comparison, 2001

Sector	Average	State	Non-State
Mining	100%	93%	112%
Energy Materials Production	100%	92%	126%
Non-Energy Materials Production	100%	98%	101%
Processing Industry	100%	95%	101%
Food Industry and Processing of Agricultural Products	100%	85%	101%
Light Industry	100%	71%	101%
Wood Processing, Pulp and Paper	100%	119%	97%
Coke Production and Oil Refining	100%	47%	102%
Chemicals and Plastics	100%	105%	98%
Other Non-Metal Mineral Products	100%	127%	98%
Metallurgy and Metal-Working	100%	83%	103%
Machinery	100%	96%	101%
Other Production Sectors	100%	101%	100%
Production of Electricity, Gas, and Water	100%	96%	106%

Source: State Property Fund

Average Wage Arrears by Sector, 2001

Sector	Form of Ownership	Number of Companies	Average Wage Arrears, months
Industrial Production	TOTAL	45,425	1.46
	State	3,328	2.18
	Non-State	42,097	1.17
Mining	TOTAL	990	2.47
	State	325	3.05
	Non-State	665	1.34
Energy Materials Production	TOTAL	432	3.01
	State	258	3.30
	Non-State	174	1.92
Non-Energy Materials Production	TOTAL	558	0.87
	State	67	0.96
	Non-State	491	0.84
Processing	TOTAL	42,704	1.26
	State	1,932	1.70
	Non-State	40,772	1.19
Food Industry	TOTAL	8,586	0.96
	State	278	1.05
	Non-State	8,308	0.95

Ukrainian Privatization - Bad News

- First Stage most responsible for poor distribution of privatized companies and rise of oligarchs – ownership concentrated in the hands of a few
- Second Stage attempt at “socially just” privatization failed, many companies sold to employees did not survive
- Process was too complicated and not transparent
- Very slow pace!!
- Too much focus on privatization proceeds and not enough on private sector development

Ukrainian Privatization - Good News

- Creation of a market-based economy with 60% of industrial output in private hands
- Economic growth rates in privatized companies have been higher than in industry as a whole
- Companies improve with private ownership, resulting in improved social welfare
- Social impact - privatization didn't increase employment, but it has:
 - improved salary levels
 - drastically reduced wage arrears
 - reduced debts to the government
 - increased tax receipts
 - supported the rise of small business

Selected UGF Portfolio Companies Data

Company Name	Government Debts, \$ ('000)		Wage Arrears, \$ ('000)	
	1997	2001	1997	2001
Central Ore Mining	\$8,654	\$881	\$2,152	\$755
Chimik	\$54	\$9	\$21	\$5
Conditioner	\$678	\$523	\$207	\$187
Dneporazot	\$2,020	\$1,533	\$5	\$373
Kharkiv Machine-Building Plant (Svitlo Shakhtarya)	\$1,018	\$63	\$432	\$62
Khartsyzsk Pipe Works	\$6,214	\$241	\$4,176	\$1,109
Kherson Combines	\$192	\$847	\$870	\$1,017
Kyiv Refrigerator #2	\$16	\$18	\$59	\$33
Makiivka Pipe Rolling Plant	\$408	\$80	\$179	\$337
Marganets Repair	\$1,107	\$6	\$505	\$17
Mariupol Illicha Steel	\$9,551	\$1,809	\$3,625	\$4,224
Markokhim	\$5,135	\$615	\$145	\$102
Melitopol Compressor Plant** (data for 2000)	\$910	\$468	\$583	\$69
Melitopol Tractor Hydro Units Plant	\$865	\$10	\$527	\$152
Nikopol Pipe	\$208	\$61	\$226	\$11
Northern Ore Mining	\$295,650	\$876	\$52,417	\$1,232
Ordzhonikidze Ore Mining (data for 2000)	\$5,788	\$801	\$2,654	\$408
Pershotravnevy Agricultural Machinery Plant (Berdyansk Reapers)	\$1,387	\$177	\$864	\$132
Poltava Confectionery	\$86	\$50	\$42	\$123
Poninka Paper Combine	\$408	\$258	\$179	\$235
Rosava Tires	\$17,008	\$7,903	\$1,105	\$79
Sevastopol Shipyard	\$1,952	\$375	\$3,880	\$728
Slyvansk High Voltage Insulators	\$933	\$20	\$557	\$29
Zaporizhstal	\$4,055	\$3,372	\$3,074	\$1,995
Zhydachiv Pulp and Paper Combine	\$320	\$54	\$469	\$178
Zaporizhya Meat Processing	\$43	\$15	\$51	\$35
Totals	\$366,657	\$23,066	\$81,001	\$15,628

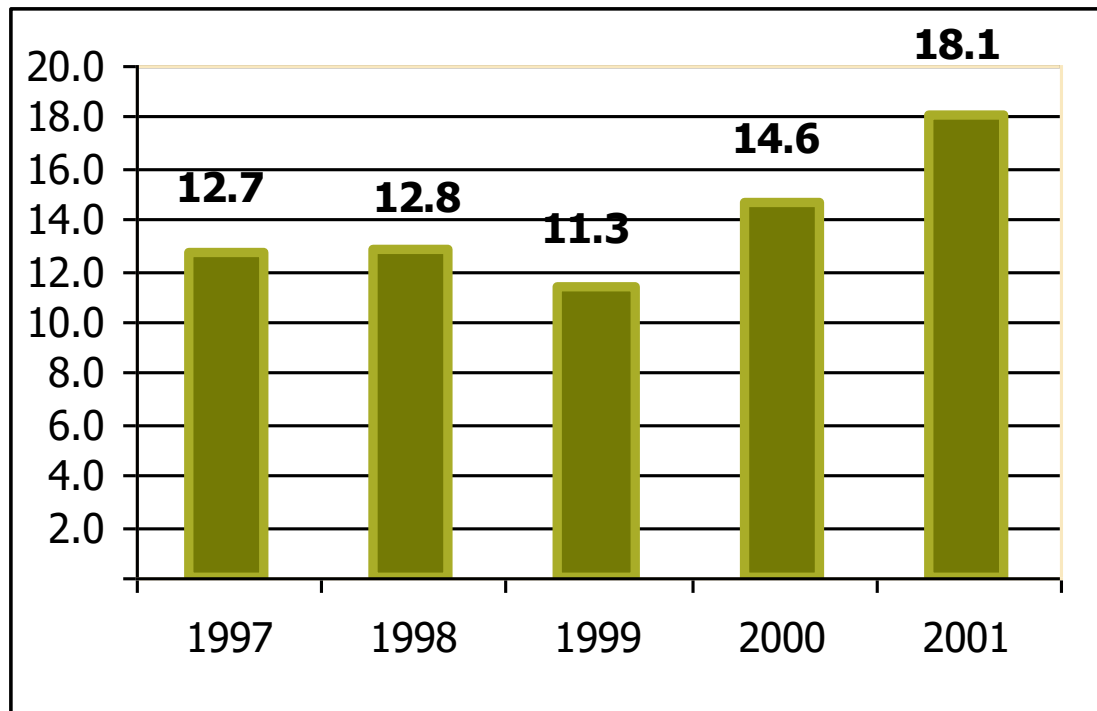
Sevastopol Shipyard (SSY)

- Good example of a company transformed by privatization
- Shift in focus from military repair to commercial repair
- Before selling controlling stake, government split SSY into 39 individual companies - no concept of client needs, no marketing
- SSY was in decline by 1998, when we purchased controlling stake
- We divided SSY into 5 Profit Centers (SBUs):
 - Ship Repair (Commercial and Naval)
 - Ship Building (Sevmorverf)
 - Machine Building (Sevmormash)
 - Port (Avlita)
 - Resort/Recreation (Yugmorservice)
- New systems and controls were put into place
- Workforce reduced (in theory) from 7,352 in 1997 to just over 3,600 at present, but most in 1997 were not receiving any salary
- The number of “real” wage-earning employees actually grew from 2,880 in 1997 to 3,600 at present

SSY Results

	1996	1997	1998	1999	2000	2001
Net Sales (millions)	\$ 9.40	\$ 12.70	\$ 12.81	\$ 11.28	\$ 14.62	\$ 18.06
Net Income (millions)	-\$ 1.50	-\$ 0.80	\$ 0.80	\$ 0.76	\$ 0.52	\$ 1.70
Port - Cargo Loaded	N/A	176	146	263	705	790
Ships Repaired	N/A	7	8	25	44	47

Net Sales



SSY Results, Social Impact

Company	Average Monthly Salary		Net Revenue per Employee		Number of Employees		VAT Payments, ('000)		Profit Tax, ('000)	
	1997	2001	1997	2001	1997	2001	1997	2001	1997	2001
SSY	\$48	\$96	\$1,728	\$5,424	7,352	3,330	\$1,592	\$1,319	\$497	\$861

- All areas improving, even local government attitude
- 2001 salary more than double the average Ukrainian salary
- Number of employees grew from 2,880 (1998) to 3,330 (2001)
- 350 SMEs created connected to SSY
- \$6.5M debt reduction (wage arrears, government, etc.)
- English summer camp brings 800 kids and 1200 adults to Crimea every summer
- Increased consumer spending in Sevastopol

Conclusions

- Privatization is good!
- But privatization alone is not sufficient
- The **privatization process** is very important:
 - Transparency
 - Simplicity
 - Predictability
- The **speed** of privatization is critical
- Focus **must be** on restructuring the economy, realigning private and public sector responsibilities, creating healthy and profitable private enterprises, reducing government's role in business
- Focus **should not be** on raising money through the sale of state assets to finance budget deficits
- Privatization is only one element of a more comprehensive task - **building market economy**

Building Market Economy

- The success of future privatizations will depend on creation of the capital-friendly business environment
- The Bleyzer Initiative (TBI) Economic Policy Framework aims to improve the business environment as the basis for transforming a developing country into a country with:
 - high rates of economic growth
 - better per-capita income
 - less income inequality
 - fair protection of the poor
- Countries with these improved conditions are less susceptible to terrorism and political instability
- TBI Economic Policy Framework has two components:
 - macroeconomic stabilization policies
 - policies for sustainable investments, or investment drivers

TBI Economic Policy Framework

- Macroeconomic Stabilization
 - Fiscal policies
 - Monetary policies
- Investment Drivers (Initially 70 investment drivers were identified, analyzed and grouped into the following key government policy action groups, which stimulated foreign direct investments in successful transition economies)
 - 1. Liberalization and deregulation of business activities**
 - 2. Stability and predictability of legal environment**
 - 3. Corporate and Public Governance**
 - 4. Liberalization of Foreign Trade and International Capital movements**
 - 5. Financial Sector Development**
 - 6. Corruption Level**
 - 7. Political Risk**
 - 8. Country Promotion and Image**
 - 9. Targeted Investment Incentives**

TBI Framework – A Tool for Action

- A generic prescription for government policies based on benchmarking, best practices definition and statistical analysis of 128 countries
- $FDI = \sum_{n=1-9} a_n d_n + K$
d=investment driver; a=coefficient; k="natural resources" constant
- “Not Actionable” correlation between FDI flows and “natural characteristics” (e.g., location, size, natural resources, GDP, population, etc.)
- High “Actionable” correlation between government policies and FDI flows
- *Measuring economic impact of government policies based on the gap between a given country and the best in class in each of the nine government policy areas*
- Econometric model of a transition economy predicting FDI flows based on government policies
- Priorities for 9 points may be different in different countries but all will need to be addressed to attract stable flows of FDI
- TBI Framework provides a **comprehensive tool** for building consensus and developing an **Action Plan** for any economy in transition

THE BLEYZER INITIATIVE

- Replicate the developed countries wealth creation capacity in other countries
- **Refocus** multilateral and bilateral assistance to non-market economy countries on building market economy and private sector development
- Use TBI framework to create capital-friendly environment and attract private equity capital
- Focus most financial assistance on creating private businesses – SMEs and conditions for large multinationals' operations
- Leverage private capital with donor's money
- Implement comprehensive coordinated assistance program for countries in transition: **use donor capital to create the environment, which attracts private capital**
- **Consider privatizing foreign assistance programs beginning with private capital-funded pilot offering a hybrid investment approach to countries in transition**