PRIVATIZATION AND VALUATION OF PUBLIC ENTERPRISES

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1 INTRODUCTION

Ethiopia is currently in the process of change from the socialist economic structure to the market system. In 1974, almost all of the major means of production were nationalized and put under public control. After almost seventeen years, the past socialist-oriented Government was replaced and the present Transitional Government has issued a new economic policy. This policy, among other things, outlines that the role of the state as an economic operator will be limited. It further states that except in strategic activities, public enterprises (PEs) will be privatized. As the privatization move requires determining the price at which PEs change hands from public to private ownership, how to value PEs is one of the debates which is underway in Ethiopia.

The purpose of this study is to contribute ideas on how the issue of valuation should be treated in the attempt to privatize PEs. The methodology chosen to analyze the issue of valuation is (1) review of government privatization policy, (2) review of academic literature on valuation and privatization, and (3) analyze the most recent five-years audited financial statements of 224 Public Enterprises (PEs). The five-year period used varied by company, as some have yet to update their books. This constraint (varying time periods) was determined by the author to be not significant for the purposes of the present study.

The study is divided into five parts. Section 1 is this introduction. Section 2 deals with the conceptual framework which attempts to address such questions as why the need for valuation arises, the link between valuation and policy, and the modalities of valuation in the context of privatization, and the methods of valuation. Section 3 deals with the difficulties of valuation, and adjustments required on current PE financial reports. Section 4 deals with the organizational aspects of valuation. Section 5 presents conclusions and recommended actions.

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2 THE CONCEPTUAL FRAMEWORK

2.1 What is Valuation and What are the Difficulties?

Valuation is fixing or determining of how much a property is worth. It is "sophisticated guess-work"(Dewing, 1953, p.287). A number of factors interact to make it sophisticated and guess-work. First, there is no one particular method of valuation that can be considered correct. The methods of valuation are many, and all lead to different results. Second, valuation is difficult because it is necessarily based upon forecasts of future income and estimates of the certainty of receiving that income(Johnson, 1967, p.621). Here what makes it difficult is that the forecasted income may not be realized and the future is often uncertain. The size and reliability of the stream of income produced by the assets valued are by no means certain. Third, there are at times no market quotations readily available for the companies intended to be sold. The accountant's book value is available, but it fails to provide a satisfactory measure of value. Fourth, the valuation of an ongoing business concern involves looking into the interests of various groups, namely the workers, creditors and customers. The relationships between these interest groups should be fairly taken into account in the valuation process. Fifth, in estimating the value of a company's individual assets, both buyers and sellers come up with "values" favourable to their interests and these values are often at variance.

2.2 Why Valuation ?

In a competitive system, the issue of valuation comes into the picture.

i) The first is when a company is in financial distress and is unable to meet its maturing debts. Under such circumstances, the company is placed in the hands of the Court. The Court temporarily freezes payments to creditors and preserves the then status. This is mainly to prevent benefiting a particular group of creditors or avoid unfair distribution of claims on the income or the assets. Normally, time is granted to study the situation and determine whether the company can be preserved as a going concern or whether it should be liquidated. Upon receipt of a petition from a company or its creditors, the Court can make one of the following arrangements. It can appoint a receiver to manage the company or leave it in the hands of the existing management. The principal duties of this receiver (trustee) are to prepare a compilation of the assets and liabilities of the company and draw up a plan of reorganization with the advice of creditors and shareholders. If the trustee sees no hope for continuation, he may suggest liquidation. The Court hears the trustee's plan and if it finds it to be fair, equitable, and feasible it will refer it to the creditors and shareholders for approval. If this plan is accepted by two-thirds of the creditors and by the majority of the shareholders, it will be effected. If the company's liabilities exceed its assets, it is considered insolvent and the shareholders have no vote. In this case, the creditors and the shareholders (in that order) receive the liquidation value.

ii) During its life cycle, a company which is a going concern may combine with another under a different arrangement (merge or consolidation).[1] Combinations occur for different reasons. A company with a weak cash position may wish to combine with another with a stronger liquidity position. A company with weak marketing capacity may wish to combine with a strong marketing department. Normally, combinations of companies involve complementarity at the strategic or functional level, and often they are in the same line of business. Generally, the intention is to benefit from economies of scale. The economies of scale lie in the future spreading of fixed overhead management costs over a wider volume of sales. Here the role of valuation to establish the value of the undertakings to be combined. The value to be determined will serve as a floor price for the company intended to be sold. The owners will use the floor price and negotiate to receive a price higher than the benchmark. It is ultimately the shareholders or their designated board members who decide whether a privately-owned business should be combined or sold at a valued price or not. The owners cannot blame their representatives for their own failure to make their positions known.

iii) When a small business (a going concern) has plans for expansion, which necessitate additional equity capital, it often will desire to convert from a private limited held company to a share company. The procedure used, and "Initial Public Offering", requires the services of an investment bank to determine the price at which the shares will be offered; in essence to value the company.

iv) Finally, with the dissolution of the socialist system, there arises the question of valuation i.e., when publicly owned enterprises are transferred to private economic participants. In this situation, valuation comes into the picture to determine a fair price at which assets and liabilities are to be transferred to private owners. Here valuation is used to give a realistic indication of the price at which the concern should be sold, to protect the stake of the public and ensure market acceptance. It is a public policy decision as to whether the company to be privatized should be sold above, at or below the price indicated by the valuation. In this study, we are concerned with this type of valuation problem.

2.3 The Need for Valuation of PEs to be Privatized

Once the decision to privatize has been made, the procedures adopted for privatization by the government and the ultimate price at which the concern will be transferred to the new owners are of great interest to the public, the potential buyers, the employees and other actors in the product, service and financial markets. As the level of concern is high, the procedures for determining the price become very important.

The objective of PE valuation is to provide a technical financial analysis to help to ensure that a reasonable price is obtained from the sale of public property. If the PE is sold at a low price, the government will be blamed for giving away public property. If the PE is valued at an unreasonably high price, and cannot be sold, the government will fail to meet its policy commitment of liberalizing the economy. Both overpricing and underpricing are undesirable. What makes the valuation process complex is its inability to determine a price which is judged to be correct by all interested parties. It should be noted that in PE valuation, it is the public that makes the determination of whether or not reasonable care has been exerted in determining a price. A valuation that fails to meet the expectations of the public will fail to be credible.

2.4 The Linkages Between Valuation for Privatization, Government Economic Policy and the Modalities of Privatization

One easily discernible link is that privatization of PEs is only possible when it is supported in government policy, and the need for valuation of PEs for privatization purposes arises when PEs are to be privatized. Whenever government policy does not allow privatization, the option could be to look for other modalities which do not lead to ownership transfer

From the policy perspective, two issues need to be examined. One is the TGE's economic policy issued in November, 1991, which reserves some strategic activities ranging from public utilities to banking and "core" activities (which are fairly spread across all sectors). There is no need for the time being to value these PEs for privatization purposes. The second policy issue related to the valuation of land. The economic policy supports the view that ownership of rural and urban land remains with the government. At the same time, it allows some PEs to be privatized. As the idea of privatization of PEs and retaining ownership of land are somewhat incompatible, it is necessary to examine how to privatize PEs without valuing and selling the land with the organization.

Keeping in mind the policy constraints in valuation, to know the nature of PEs which require valuation and which do not, one approach is to dissect the PEs according to their capital size. The reason for doing this is that the investment requirement of strategic industries is high and the PE with high capital will be readily identified and excluded from the list of PEs to be valued.

If PEs with large capital were to be retained and the rest were to be privatized, the share of PEs which would require valuation is about 78%, as the last grouping, i.e., 22%, has been reserved for public ownership.

The next issue is these 78% of PEs were to be valued for privatization, how to separate out the value of land in the overall value of the organizations to be privatized.

Table 1
Classification of PEs by Net Worth

Category	Net Worth Size in Birr (millions)	No. of PEs	Percentage Share	Cumulative Percentage Frequency
Negative	Net Worth < 0	57	25%	25%
Small	0 < Net Worth < 5.0	96	43%	69%
Medium	5.0 < Net Worth < 10	22	10%	78%
Large	10 > Net Worth	49	22%	100%
Total		224	100%	

Source: Computed from MOPED data.

2.5 Determination of Land Value in the Privatization of PEs

In privatization, transfer of ownership requires that title to the property be conveyed to the buyer. However, at the time of this writing, land is public property and there would be no way of establishing private ownership. However, possession of land through different arrangements - mainly rural land use for private commercial purposes - is allowed after the mixed economic policy was issued in 1990. More recently there has been a debate on the extension of leasehold arrangements to urban land.

The implication is that if one assumes that the value invested in land and land development will be significant proportion of total investment, new investors may prefer to enter into leasing arrangements or management contracts rather than outright purchases. PEs which may attract leasing could be the ones in agriculture, housing and the hotel sectors. Even in these sectors investors may consider themselves tenants and fear the risk of being evicted by the land owner, or the rent increasing to exorbitant levels, especially when the government is the land owner (lessor) on the one hand and low maker on the other.

It may take some time to decide on a change in the land tenure regime in Ethiopia, because the policy provides that the issue related to the ownership of land will be decided by a referendum after the transition period is over. In the meantime, the valuation of land for the purposes of determining sales prices does not arise. However, valuing the rent will be relevant.

In valuing PEs as going concerns, the value of land cannot be excluded because of this policy. Instead, a basis needs to be provided to determine the rent. The basis should take into account the size, location and duration of leases. When the whole organization is leased out to be managed by the private participants, the rent of the land will be one component of the total rent. However, when the going concern is intended to be valued for privatization, the land rent needs to be separately determined.

2.6 Methods of Valuation

The modalities of privatization could be divided into two for the proposes of valuation:

i) privatization of ownership, and
ii) privatization of management

Under privatization of ownership, the going concern will be valued assuming that land will be held by lease contract and the ownership of the rest of the property is conveyed to the new private owner. Land is not valued as an asset of the organization; it is assumed that the investor will conclude a separate contract for the land.

Under privatization of management, it is assumed that ownership of the organization including land will remain with the state, and that the private participant will have access to the possession under lease or management contract. Here the need for valuing the whole organization does not arise. However, rent of the organization needs to be determined. Land rent will be an integral part of the property rent.

2.6.1 PE Valuation Methods for the Purposes of Transfer of Ownership

The principal valuation approaches found in the financial literature are:

- the liquidation value method
- the original cost, less depreciation method
- the replacement cost, less depreciation method
- the market value method
- the capitalization of income (net present value) method

A discussion of when each of the above could be used follows.

The Liquidation Value Method: This approach is useful when the owner is forced to sell individual assets at a liquidating price. The assumption here is that every asset has some value for a prospective buyer and that there is a market for bringing the seller and the buyer together. It is further assumed that the seller is forced to accept the liquidating price. The valuation, in this case, may be done *ex ante*, but in practice it is the *ex post* value assigned by the market that prevails. The assets are valued individually and generally only tangible assets are included. First, the assets are identified, second, the potential buyers are identified, and finally formally or informally, potential buyers are surveyed to determine the market value of the assets. For assets with a less-easily defined market, experts in the field are consulted. From the total liquidating value of the assets are subtracted the liabilities to arrive at the net realizable value. This method is often used to determine the floor price for a going concern

The Original Cost Less Depreciation Method: This approach could be used when the owner decides to sell the fixed assets at their net book value (original cost less depreciation.) From the realizable value of the fixed assets are subtracted any liabilities. If the owner decides to sell the going concern *in toto*, the current assets are added to the book value of the fixed assets, and the liabilities are subtracted, to determine the net worth. This is used as a starting point in the valuation.

The Replacement Cost Less Depreciation Method: This method is used when the seller thinks that a prospective buyer will pay either the replacement cost (as a maximum) or the replacement cost less depreciation (as a minimum). The underlying assumption of the seller is that the buyer is interested to acquire not only the used assets but the accompanying whole organization.

The Market Value Method: This method is used when the securities of an existing concern are traded. It is possible to estimate the value of the going concern on the basis of the per share market value. The value of the company is the product of the per-share quoted price and the number of outstanding shares. The market price of the share reflects the market's expectation of future earnings of the company.

The Capitalization of Income Method: The conceptual approach of this method is the present value approach. To calculate the capitalization of income of the company, the enterprise to be sold must be expected to produce net income after tax in future. It is assumed that the earnings per year are constant. The yearly after-tax income is divided by the offering price. If the resulting ratio (the return on investment) is lower than that of similar companies in the industry, the price to be offered is reduced, or, failing to negotiate a reduction, the buyer will desist.

Under all the five methods of valuation, the interest of those who have claims against the company will be taken into consideration. Either the owner should initially settle and transfer the ownership of property or the new buyer who takes over the property will also take over the obligations. At times creditors may oppose the transfer of ownership on the grounds that their claims should be settled prior to ownership transfer.

The new buyer will also investigate and ensure whether or not current assets could be converted into liquid cash. If there are doubts that claims shown in the books are collectible, he will make his own adjustments

2.6.2 Valuation Where Ownership Transfer is not Involved

As one of the objectives of privatization is to bring about efficiency, divestiture of management is also considered as privatization. Here conceptually the government maintains the ownership to the property and lets private participants manage the concern. Giving out PEs to private participants on the basis of lease or management contracts could be cited as examples

Under a lease arrangement, valuation involves fixing a reasonable rent for the term of lease period. If the property is conveyed to the user on the basis of a management contract, the issue of valuation involves determining that reasonable share of profit which the managing private participant should take. Candidates for lease or management arrangements are the state farms, particularly until such time the ownership of land issue is resolved.

Joint venture arrangements in which the government holds a minority interest and allows majority private stakeholders to run an economic unit could be considered as another mechanism of privatization. Under joint venture arrangements, the property to be contributed will be valued. Also, the profit sharing arrangement needs to be fixed. As the party which has the majority shares in the company will eventually have the controlling interest, a clear arrangement needs to be carefully reached from the start.

3. DIFFICULTIES IN VALUATING PES IN ETHIOPIA, AND THE NEED FOR ADJUSTMENT

There are a number of problems which make valuation of PEs difficult. Some of the main problems are discussed below.

3.1 Results of Financial Analysis of the Most Recent Five Years

3.1.1 PEs Have No Shares Quoted

In an economy where a stock market exists and functions, the price of shares is a useful guide for valuation of the economic unit intended to be sold. In Ethiopia, the stock exchange closed after 1974. As a result, investors' attitudes as to how much they are interested to buy (and at what price) is unknown

3.1.2 Historical Earnings of Most PEs may not Attract Investors

Whenever shares are unquoted, interested parties who wish to buy the economic unit compare the earning record of the economic unit to be sold with the opportunity cost of their capital and decide to buy if the earning record is greater. The most recent five years average profit performance of 224 PEs paints the following picture.

Table 2
Classification of PEs by Profit Performance

Classification of PEs	No.	Percentage
Profitable PEs	115	51
Loss Making PEs	71	32
Information Incomplete[2]	38	
Total	224	100

Source: Computed from data at MOPED.

Of the 224 PEs surveyed, 51 percent are profit making. The remaining 49 percent are either loss making or their probability position is unknown.

3.1.3 The Accounting Records are not Updated

As of October, 1993, i.e., at the time of this study, the books of many PEs are not updated to provide financial reports which learned investors require for analysis.

Table 3
Status of PE Books of Account Preparation[3]

Period	No. of PEs	Percent
Updated through 1992	40	18%
Updated through 1991	70	31%
Updated prior to 1991	114	51%
Total	224	100%

As can be seen from the above table, over 50 percent of the PEs are only now closing the books for periods prior to 1991. The lack of up-to-date financial information could inhibit the valuation and privatization effort if not corrected.

3.1.4 Some of the PEs have negative Capital

It should be noted that for PEs in the first category on Table 1, claims against the assets are greater than their value. Before this group of PEs is offered for sale how the claims are to be resolved must be answered. One alternative would be that their debts should be taken over and met by the government. If this is not feasible, it may be advisable to sell at the liquidating value, distributing the proceeds to the creditors (banks).

From the grouping with negative capital, about 42 percent are in industry, 28 percent in agriculture, and 16 percent in construction. The rest are found in the housing, hotel, mining and transport sectors.

Those which have medium net worth size are found in industry and agriculture. PEs which have large net worth are found mainly in industry, mining, energy, transport, finance and construction. Most of the PEs in the large size are core industries and are not for sale according to the economic policy and may not be of concern for valuation.

On the whole if it is assumed that PEs with large net worth will be in the public ownership, about 78 percent are up for valuation leading to privatization. If the medium sized firms are grouped with the large ones, about 68 percent will be candidates for valuation.

3.1.5 The Debts of Some PEs are in Excess of Owners Equity

Under normal business practice, owners of business are expected to maintain a reasonable debt/equity ration. The lenders generally see to it that this reasonable level is maintained, through loan covenants. However, analysis of the capital structure of Ethiopian PEs indicates that (a) in many cases the debt load is too high, and (2) in certain cases debt exceeds the book value of assets (i.e., the company has negative net worth.). This has forced the author to compute the equity to debt ratio instead of calculating the debt equity ratio.

Table 4
Classification of PEs by Equity-Debt Ratio

Equity-Debt Ratio	No. of PEs	Percent
0.00 and less than 0.50	7	2%
0.50 and less than 1.00	49	22%
1.00 and less than 1.50	106	47%
1.50 and less than 2.00	35	16%
greater than 2.00	29	13%
Total	224	100%

Source: Computed from data at MOPED

Theoretically, to not exceed a reasonable risk level, every Birr in borrowings should be secured by 2 Birr in assets. However, only the last group of PEs meets this requirement. The rest, i.e., 87 per cent, are heavily depended on credit. Much of the credit int he PEs must have come from the financial institutions - the state commercial and development banks. Therefore, prior to privatization, how the debt of the banks should be paid or to be written off must be resolved.

As both the banks and the PEs are currently owned by the government, one may think that the debt payment issue is irrelevant. However, details must be worked out to determine how much of the bank lending is depositors money. If the bulk of claims by the banks are depositors money, the write off option may not be feasible since banks may be seriously affected and be unable to meet their obligations to depositors.

3.2 Adjustments Required on the Current Financial Reports of PEs

3.2.1 Principal Reasons for Adjusting Financial Reports

Audited financial statements are often used by prospective buyers of PEs to form opinions as tc whether or not it is worth buying and at what price. Although the buyer knows that the seller to the PE would not sell the PE at depreciated historical cost, there are reasons to base the decision of to buy or not to buy on the audited financial statements. First, the financial statements are the main source of information to determine profitability over time and to verify the existence and value of the assets. Secondly, the prospective buyer will be able to predict the future profits from past performance trends, taking into account the need to normalize past results.

After going through each item of the financial statement, the buyer may accept the statements as an accurate reflection of the assets, liabilities or earnings, or make some adjustments - upward or downwards. Downwards adjustments may be made when the buyer thinks abnormal sales have occurred, or when abnormal fluctuations appear in sales, investment and expense items. Any figure which is believed to have resulted in an unusual profit will be adjusted downwards.

As the seller of the PE, the owner could also adjust financial information to the level of income which could be earned had the business operated under normal conditions. Both the buyer and seller work out what they consider to be a realistic valuation based on normalized performance before they meet for negotiation.

If we assume that the objective of the investor is to maximize the present value of future profits (or cash flow,) prospective buyers will choose to buy PEs which reward investment with reasonable profit. At a minimum, the new owners want to ensure themselves that the profit reward will be at least equivalent to the cost of capital.

As indicated in the analysis of PEs profit performance in Appendix III, of 224 PEs, over fifty percent are profitable. As prospective buyers are not only interested in any profit but are interested in reasonable profit, an attempt has been made to further classify profitable PEs by magnitude of profit. The results are summarized in the following table.

Table 5
Classification of PEs by Profit Percentage to Net Worth

Profit Percentage to Net Worth	No. of PEs	Percent
0 and less than 10	39	34%
10 and less than 20	23	20%
20 and less than 30	12	10%
30 and less than 40	7	06%
40 and less than 50	7	06%
50 and above	27	24%
		100

Source: Computed from MOPED data

Per the above analysis, five-years' average profit earned as a percentage of net worth (return on equity) varies considerably. Although 115 PEs appear profitable, considering the present cost of capital (14 percent), investors may not be attracted to invest in PEs in the first and probably in the second grouping.

PEs in the last grouping appear to be the most attractive. However, investors may wish to investigate the financial details to satisfy themselves whether this level of earnings will continue. If they think there are facts which indicate that these earnings may not continue, they will likely adjust the exaggerated returns to a level that more accurately reflects future expectations.

From the seller's point of view there are also considerations which require adjustment when valuing PEs. The impact of past price controls and de-facto or de jure monopoly status should be investigated and quantified. This normalization process will lead to sales and earnings adjustments. The need for these adjustments is dealt with in more detail below.

3.2.2 The Impact of Price Controls

PEs whose outputs were under price control had relatively lower earnings compared with those PEs whose outputs were not under price control. In the sugar industry, the output of two PEs has been under price control while a third PE was not. While the latter had an average profit of over fifty percent, the former two made profits of 20-30 percent. If the owner of the "uncontrolled" PE is of the opinion that earnings of the first two were depressed because of the price controls, the owner should adjust future projections to the level which could be earned if price controls on his competitors were lifted.

3.2.3 The Impact of Monopoly

Some of the PEs which enjoyed monopoly power had over fifty percent profit on net worth. If there had been fair competition, it is unlikely that earnings would have been this high. Therefore, the earnings of monopoly PEs may require downward adjustment. This is to base future expected earnings on an adjusted (normalized) past trends.

3.2.4 The Impact of Government Mandated Employment Policy on PEs

PEs are thought to have been relatively overstuffed in the past, due to past government employment policy and the need to absorb a significant portion of the workforce. Thus, profits (narrowly defined) were likely lower than would otherwise have been the case. To correct for the impact of this on the bottom line, the past wage and salary expenses of PEs need to be adjusted downwards to a level congruent with a right-sized workforce. The implications of right-sizing on future earnings likewise need to be considered. These include the possibility of severance payments contingent liabilities etc. - basically the costs of any retrenchment policy.

4 THE NEED FOR AN ORGANIZATION

The involvement of three different organizations is needed to implement the privatization policy of the Transitional Government. The first is the governmental apparatus to issue the law enabling the valuation. The second is an organization which carries out the task of valuation. The third is an independent organization which ensures that the interest of the third parties are well protected.

4.1 The Organization in Government which Issues the Law Enabling Valuation

To enable PE valuation, legislation should be issued by the government. The law to be issued should provide broad guidelines on how valuation should be carried out, how the interest of various parties shall be protected (in the event that valuation leads to sale), land what arrangements are to be made to protect such interests. The appropriate organization to issue such legislation in Ethiopia is the Council of Peoples Representatives.

4.2 The Organization to Carry Out the Valuation

The committee empowered to undertake the valuation should consist of persons from different disciplines. An accountant should be included in the committee to investigate the financial statements and revalue assets and liabilities. A lawyer should also be included to deal with legal and contingent liability questions. I A technical person with experience in the industry concerned should also be involved. Other disciplines may also need to be included depending on the nature of the business.

4.3 The Organization to be Empowered to Protect Third Parties' Interests

Once the legal framework is issued, valuation and sale could be carried out under the supervision of courts. The role of the courts would be to appoint experts who have the appropriate qualifications, and manage the divestiture/privatization process (including the valuation). The courts would ensure that the interest of third parties - that is, banks, other creditors, and workers - are respected. Courts normally work closely with the committee of third parties and shareholders' representatives, to facilitate the process. In the Ethiopian case, as shareholders do not exist, the Ministry of Finance should represent the public interests.

The involvement of court is desired to ensure fairness. As PEs are owned by the public, it may be considered biased if valuations are done by the government machinery.

4.4 Defects of the Existing Law and the Need to Enact an Enabling Law on Valuation

The Commercial Code of Ethiopia of 1960 provides legal guidance on what business organizations are, how they are established, carry on their activities and how they are liquidated in times of difficulty. It has provisions on at what value the assets are shown on the balance sheet. It specifies that fixed assets, merchandise, wastes and inventory, are to appear in the balance sheet at historical cost. The articles of the Commercial Code do not provide for how a going concern as an organization or its individual assets are valued during privatization and leasing. Neither does it lay down the duties and responsibilities of those involved and the degree of care to be exercised to protect the interests of third parties. This is mainly because the Commercial Code does not entertain the economic policy changes that are underway. Therefore, an enabling law should be enacted reflecting the views contained in the economic policy.

4.5 Considerations in Valuation and Pricing

Once an enterprise is valued and reviewed, the procedure of sale should be worked out. The procedures for valuation and sale should take the following points into account:

i) The procedure should be sufficiently transparent
ii, It should protect the interests of the public
iii The price determined should be fair to the buyer
iv' It should be easy to effect the sale

Some of the above points appear to conflict. The price which is fair to the buyer may be considered to be giving away public property to individuals at a cheap price. On the other hand, excessively high valuation is likely to discourage investors in PEs. Because of this, the issue as to whether the valuation undertaken is fair or not and the issue of at which price the PE should be sold becomes at times a political decision.

The procedure of valuation, the decision to sell and the process of sale should be transparent. If the public is well informed on how and why it is done, the valuation, sale and ultimately the privatization goal will be achieved. After a decision is reached on how the sale is to be effected, how the title of ownership of the property is to be transferred should be easy. If the procedure is frustrating, it is likely to inhibit the privatization effort.

5. CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

- Valuation complex guesswork undertaken to determine value and thus prices. The need for valuation arises when companies are in financial distress and apply to the court to handle the valuation of their assets and fairly distribute these to creditors. The need may also arise when a company wishes to combine with other going concerns or expand. In the Ethiopian situation, valuation is presently required for the purposes of privatization.

- Valuation for privatization purposes should take into account the policy of the government. In the Ethiopian situation, the economic policy intentions on core activities and land ownership need to be taken into consideration. If capital size classification is used, PEs found in the medium category are 10 percent and in the large capital category, about 22 percent. If PEs classified in the medium and large capital category are to remain publicly owned, the share of PEs to be privatized (and requiring valuation) is sixty-eight percent.

- Until such time as the present policy on land ownership changes, land is not valued on the books of companies. Instead, if the present land leasing policy is approved by the Council of Peoples Representatives, land rent will be determined. In the valuation process, if the PEs are valued for privatization leading to transfer of ownership, the overall organization is valued and land should be treated as leasehold. On the other hand, if only the management of PEs is privatized, the need for valuation does not arise. However, rent should be determined at how much PEs should be leased or contracted out. Under privatization of management, land rent will be determined together with the treat for other property.

- Wherever PEs can be sold as going concerns, methods of valuation that could be considered are: original cost less depreciation, replacement cost less depreciation, market value and the capitalization of income (present value). The last method is considered superior because it takes the time value of money into consideration. It should be noted that all methods yield different results. Whenever PEs cannot be sold as going concerns, the liquidating value method should be considered as an option.

- A number of difficulties should be expected in valuing PEs. Some of the major difficulties are: PEs have no shares quoted on the market, earnings of most PEs may not attract investors, accounting records are not up to date, and the debts of some PEs are in excess of owners equity.

- Analysis of the profit performance of 224 PEs reveals that only 51 percent have been profitable in recent years. The position of the rest are either unfavourable or unknown. From the 51 percent profitable PEs, 62 PEs had small profits, 26 had reasonable profits and 27 had excessively high profits.

- Price controls on the products of some PEs have suppressed profits. On the other hand PEs whose products were not under price control and which enjoyed monopoly privileges made excessive profits. In valuing PEs, abnormal situations should be recognized, and returns adjusted. Under Ethiopia's situation, the earning adjustments should normalize the price control, monopoly and employment policy effects.

To produce appropriate valuations, the need for a normative organization is inescapable. The organization will set guidelines, ensure reasonableness and follow-up on proper implementation.

The valuation methods and process need to take many factors into account. It must be transparent if it is to get the support of the public. The value to be determined should be fair. At the same time, the mechanism should protect the interest of the people. The procedures should also be easy to implement.

2 Recommendations

- Financial analysis of the recent five period reveals that 25 percent of PEs have negative equity (net worth). This means that claims from creditors on the assets are collectively greater than those assets. Had these PEs been operating in the free market, creditors would have forced them to liquidate. To rectify this situation, a decision should be taken on how to safeguard the interests of creditors involving courts, creditors and the Ministry of Finance in the process would make the valuation and privatization effective.

- From the analysis carried out, 73 percent of PEs do not have enough assets to guarantee their borrowings. Theoretically, PEs are required to provide guarantees for money they borrow. For every one Birr in borrowings, there should have been Birr 2 or more in the form of assets. This shows that the overly relaxed credit policy of financial institutions needs to be reviewed and modified. It may be worth examining debt for equity swaps in some cases. The conversion of debt to equity added with the lifting of price control will definitely improve the financial performance of some PEs

- PEs should update their accounts. Presently only eighteen percent of the PEs have closed previous years' books of account and obtained formal audit Reports. The remaining 82 percent appear to be working on the back log. Of the total of 224 PEs, the status of 38 percent is unknown. Investors require current financial information upon which to base a valuation, in turn leading to a decision to invest or not to invest. Without current financial information, there is no basis for investors to consider investing in PEs.

- There is need for the establishment of professional accounting associations which work for the advancement of the accounting profession and at the same time give guidance on Ethiopian accounting problems.

- The Commercial Code does not provide an adequate basis for valuation of business organizations and their assets. It also fails to provide guidance on how PEs are intended to be transferred to private ownership or how their assets are to be valued. Therefore an enabling law should be enacted dealing with the recent developments in Ethiopia.

- There is need to train and develop local expertise on valuation and stock markets to reduce dependence on foreign technical advisors.

- A stock market should be established so that market share values could be used as a basis for future company valuation.

NOTES

1. Merger is a combination of two businesses in which one survives and the merged company goes out of existence, and leaves its assets and liabilities to be combined with the surviving company. nsolidation involves the fusion of two or more companies into a third entity, a new one, which sorbs the assets and liabilities of all companies so combined.

2. Data classified incomplete if data of one or more of the five years are not available, e.g. when a PE is new and when audit report is not available. Most PEs in this classification are found in construction and agricultural sectors.

3. Updating account includes getting the books of account closed, and audited by an external auditor.

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Appendix I

Distribution of Public Enterprises bv Sub-Sector

Sector	No. of PEs	Percentage Share
Industry	113	50%
Agriculture	37	17%
Mining and Energy	5	2%
Transport and Communications	13	6%
Construction	18	8%
Housing	5	2%
Trade	14	6%
Hotels and Tourism	8	4%
Health	3	1%
Finance	5	2%
Others	3	1%
Total	224	100%

Source: MOPED data.

Note that this list is note exhaustive, although it is believed to cover the majority of Public Enterprises.

APPENDIX II

Classification of Public Enterprises by Size of Net Worth

Sector	Negative Net worth	Small Net Worth	Medium Net Worth	Large Net Worth
Industry	25	61	11	16
Agriculture	16	11	7	3
Mining and Energy	1	0	0	4
Transport and Communications	1	5	0	7
Construction	10	3	0	5
Housing	2	1	1	1
Trade	0	11	1	2
Hotels and Tourism	2	2	1	3
Health	2	2	1	3
Finance	0	0	0	3
Others	0	2	1	0
Total	57	96	22	49
Percentage share	25%	43%	10%	22%

Source: Computed from MOPED data.

Appendix III

Classification of Public Enterprises by Profit Performance

Sector	Profit making	Loss making	Information Incomplete
Industry	63	40	10
Agriculture	8	20	9
Mining and Energy	2	2	1
Transport and Communications	10	2	1
Construction	6	5	7
Housing	1	0	4
Trade	10	1	3
Hotels and Tourism	5	2	1
Health	3	0	0
Finance	4	1	0
Others	2	0	1
Total	114	73	37
Percentage share	51%	33%	17%

Source: Computed from MOPED data.

Appendix IV

Classification of Public Enterprises by Accounting Updating

Sector	Accounts	Updated	Through
	1992	1991	prior to 1991
Industry	31	46	36
Agriculture	0	5	32
Mining and Energy	0	2	3
Transport and Communications	1	1	11
Construction	2	2	14
Housing	0	0	5
Trade	3	5	6
Hotels and Tourism	0	5	3
Health	1	1	1
Finance	2	2	1
Others	0	1	2
Total	40	70	114
Percentage share	18%	31%	51%

Source: Computed from MOPED data.

Appendix V

Classification of Public Enterprises by Accounting Updating

Sector	Equity-Debt Ratios Between				
	0.0 & <0.5	0.5& <1.0	1.0& <1.5	1.5& <2.0	2.0&>
Industry	1	22	62	14	14
Agriculture	1	15	15	3	3
Mining and Energy	0	1	1	2	1
Transport and Communications	0	1	8	0	4
Construction	3	7	5	1	2
Housing	0	0	0	3	2
Trade	0	1	9	4	0
Hotels and Tourism	0	2	1	5	0
Health	0	0	1	2	0
Finance	0	0	3	0	2
Others	0	0	1	1	1
Total	5	49	106	35	29
Percentage share	2%	22%	47%	16%	13%

Source: Computed from MOPED data.