

**Participation of private equity and other  
financial sponsors in privatisations;  
possibilities of management buyout in the  
privatisation procedure**

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**Privatisation and  
Market Liberalisation in Belarus**

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# Contents

<b>Some privatization process lessons</b>	<b>3</b>
<b>After privatization: Sources of Capital</b>	<b>15</b>
<b>Cost of capital and value creation</b>	<b>20</b>
<b>Inside Venture Capital Business</b>	<b>23</b>
<b>Venture Capital Fund. Structure and Investment Process</b>	<b>29</b>
<b>Main dilemmas for Belarus</b>	<b>38</b>
<b>Sindicatum CI information</b>	<b>39</b>

## **Some privatization process lessons**

## Stages and elements of privatization

<b>Preparation</b>	<b>Achieving the critical mass</b>	<b>Consolidation</b>
Overlap with liberalization	Commercialization of state enterprises, splitting up large firms	Hard budget-constraint
Dissolve plan ministries	No barriers for entry private sector of new enterprises	Regulation of competition
Legislation for private property	Small privatization	Large privatization
Privatization agency	re - privatization	

## **Goals of privatization**

- Efficiency
- Competition
- Revenue
- Distribution
- Depolitisation
- Development of capital markets

## Privatisation: ideal versus reality in transition 1

- Consensus about goals and models
  - Clearly defined rights before privatization
  - Clear rules for process
  - High administrative capacity
  - Clear rules of the game
  - Clear ownership rights
  - High market- transparency
- Conflicts on distribution disputes delay process ex ante/ex post constraints
  - Uncertainty of ownership,
  - Unclear rules => lack of transparency, corruption
  - Low administrative capacity
  - conversion of power
  - High uncertainty of rights
  - High market uncertainty
  - Large windfall profit/loss
  - Valuation is like a lottery especially in early stage

## Privatization: ideal versus reality in transition 2

### Potential owners with:

capital  
know-how  
motivation  
governance skills

### Developed institutions

competition  
capital market  
banking system  
regulation supports  
market

### Not enough buyers

low savings, stock flow  
lack of experience, skills  
lack of entrepreneurship  
governance problem

=> low price

### Lacking institutions

monopolies  
thin capital markets  
very few bank-loans  
lacking legislation

# Models of privatization (1) ADVANTAGES AND DISADVANTAGES

## Wild privatization

implemented in spite of political system, support new private sector

corruption  
insiders favored  
arbitrary allocation

## Re-privatization

signal strong support for private ownership

difficult to define assets,  
problems with  
compensation & distribution

## Voucher-system mass privatization

equality, population-accept (solve political constraint)  
creates capital for demand valuation through auctions  
fast privatization

diversification of ownership  
may weaken stabilization: increased consumption, wealth effect, transfers (if legal) from persons with low savings rate to people with high savings rate, buying vouchers crowd out invest

## Institutional ownership

equality, population-accept  
develops institutions  
fast privatization

governance problem  
monitoring the monitors  
high power concentration

## Models of privatization (2) ADVANTAGES AND DISADVANTAGES

### **Direct sale** THA-model

absorb purchasing power  
core investor =>  
active governance  
often direct input of capital

lack of capital =>  
low sales price  
distribution problem  
valuation problem

### **Installment** leasing with option to buy

absorb purchasing power  
little capital necessary  
core investor =>  
active governance

valuation problem  
distributional problem

### **Employee- takeover** gift, reduced price

enterprise democracy,  
no capital problem,  
more equal distribution  
individual ownership  
=>efficiency, + employment

valuation problem,  
only for private employees  
lower capital mobility  
risk-concentration  
monitoring managers?

# Baltic countries small privatization - overview

	Estonia	Latvia	Lithuania
<b>early</b>	Small state firms, <b>new cooperatives</b> most management owned, Soviet <b>leasing</b> : 12 to employees Estonian leasing: 200 firms, most management owned	<b>New cooperatives</b> most owned by management Soviet <b>leasing</b> to employees	<b>New cooperatives</b> most owned by management Soviet <b>leasing</b> , 60 to employees 1990-91 employee-shares, around 3% of assets
<b>small</b>	1990 law: <b>insider advantages</b> 360 employee owned, 90 management owned advantages <b>cut</b> 1992-93 Most privatized 1992 1200 firms sold 2000.	1991 law, <b>insider advantages</b> 85% privatised 1994 by municipalities most to management some to other employees	Privatisation by <b>auctions</b> , Possible to use vouchers 1992 1993 1994 1995 57% 70% 76% 100% <b>no advantages</b> <b>for employees</b>

# Baltic large privatization - overview

Estonia	Latvia	Lithuania
<p>1989: 7 peoples enterprises 1991: 7 SOE experiments most employee-owned</p> <p>-----</p> <p><b>1992: Est. Priv. Agency</b> German Treuhandmodel Tenders based on price, investment-, job-guarantee End of 2000 500 firms sold 5.5 bill EEK (450 mill \$) 4.9 bill EEK inv. guarantee 56 000 job guarantees</p> <p><b>Peak privatisation 1994</b> <b>Most privatised 1995</b> <b>Nearly all by end of 1998</b> Public offering min. shares for vouchers start autumn 1994, by the end of 97: 39 holdings for 2.3 bln EEK most utilities sold end 2000</p>	<p>1991, 6 SOE sold to insiders 1992-94 ministries decentral priv. 50 firms privatised, 78 firms corporatised 234 leased to insiders</p> <p>-----</p> <p><b>1994 Lat. Priv. Agency</b> by 1998: 1009 tenders 190 mill LVL (350 mill \$) 244 mill LVL debttakeover 127 mill LVL inv.guarant. 47 735 job guarantees</p> <p><b>Peak privatisation 1997</b> <b>Most privatised 1997</b> <b>Nearly all by end of 1998</b> Aug.1994 voucher trade 95-00 88 public offerings 2000 few utilities and large enterprises left</p>	<p>1991 LIPSP priv. shares for vouchers Employee share from 10% 1991 to 50% 1993 3000 LIPSP firms sold 1992 1993 1994 1995 38% 62% 75% 99%</p> <p>46 "hard currency sale"</p> <p><b>Peak privatisation 1992</b> <b>Most privatised 1994</b> Slow priv. minority sha-res, and very large firms</p> <p>-----</p> <p><b>1996 Lith. Priv. Agency</b> Privatisation for cash ministries slow process 98 State Property Fund, =&gt; privatisation faster End 2000 some utilities and very large firms left</p>

## Status for privatization - EBRD 2004

	private % GDP	large	small	gover- nance	main method	second method	peak years
Belarus	25	1 .	2+	1 .	not priv.		
Bulgaria	75	4 -	4 -	3 .	direct sale	voucher	1997
Croatia	60	3+	4+	3 -	insider	voucher	1995
Czech R.	80	4 .	4+	3+	voucher	direct sale	1992-94
Estonia	75	4 .	4+	3+	direct sale	voucher	1994-95
Hungary	80	4 .	4+	3+	direct sale	insider	1992-96
Latvia	70	3 .	4+	3 .	direct sale	voucher	1996-97
Lithuania	75	4 -	4+	3 -	ins/vouch	direct sale	1992-94
Poland	75	3+	4+	3+	ins/vouch	direct sale	1997
Romania	70	4 -	4 -	2 .	insider	direct sale	1995
Russia	70	3+	4 .	2+	ins/vouch	direct sale	1993-94
Slovak R	80	4 .	4+	3 .	direct sale	voucher	1992-96
Slovenia	65	3 .	4+	3 .	insider	voucher	1995-96
Ukraine	65	3 .	4 .	2 .	insider	direct sale	1998-99

index 1=no privatization to 4+=full privatization

## Conclusions

- Privatization necessary for decentralized market-oriented decisions and motivation
- Small privatization easy to implement. Large privatization needs highly developed institutions => problems of implementation or later stage
- Privatization part of global liberal wave. What is current situation?
- Competition more important than ownership
- Big Bang: weak institutions may cause unfair distribution and path dependent barriers for further reform Gradualism: long period of commercialized SOEs, weak corporate governance (Poland, China - weight on new small private companies)
- Western model of privatization cannot be easily transferred to less developed countries because of lack of institutions, distributional problems, political conflict, lack of potential owners with capital, know-how, motivation, governance skills
- Important to build up state capacity and limit negative effects of corruption, inside dealings in privatization: keywords: simplification and transparency
- Lack of capital and institutions opened for new privatization models : voucher, insider-takeovers, restitution (re-privatisation)

## **Conclusions. Privatization models**

- **Models of privatization evaluated on speed corporate governance, efficiency, distribution,**
- **Strong variation in models and speed, and implications for different social groups**
- **Re-privatization: when nationalization not too long ago especially for land, housing**
- **Direct sale: East Germany, Estonia, Hungary plus most countries in later stages**
- **Voucher model: Czech, Lithuania, Russia**
- **By 2005 only few large infrastructure enterprises, and some minority state-shares left**

## **After privatization: Sources of Capital**

## Main dilemma: Debt or equity financing

### Equity Financing

It does not require collateral and offers the investor some form of ownership position in the venture. The investor shares in the profits of the venture, as well as any disposition of its assets on a pro rata basis

### Debt Financing

Financing method that involves an interest-bearing instrument, usually a loan, the payment of which is indirectly related to the sales and profits of the venture. Typically, it requires that some asset (buildings, plant, land, ...) be used as collateral

## Alternative sources of financing

- Personal funds
- Family and friends
- Commercial banks
- Suppliers and trade credit
- Government loan programs
- Grants and subsidies
- Industrial partners
- Business Angels and informal investors
- Venture capital
- Risk capital; private equity

# Stages of Business Development Funding

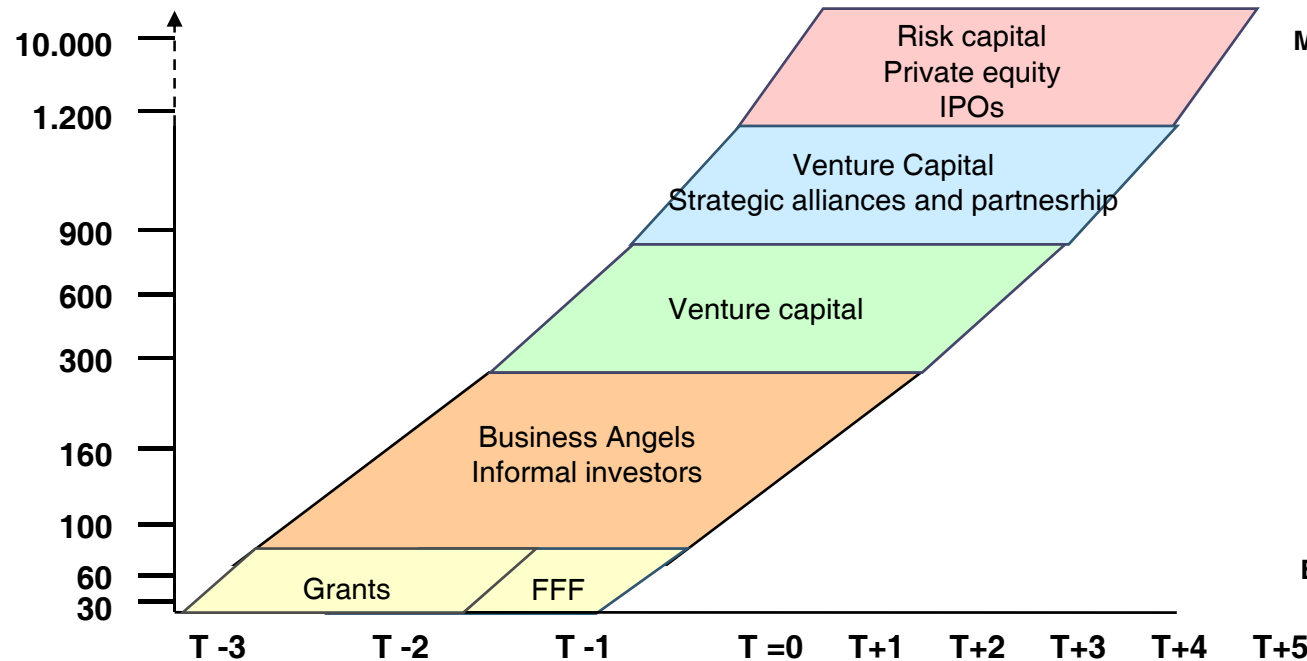
<b>Early Stage Financing</b>	
Seed capital	Relatively small amounts to prove concepts and finance feasibility studies
Start-up	Product development and initial marketing, but with no commercial sales yet; funding to actually get company operations started
<b>Expansion or Development Financing</b>	
Second stage	Working capital for initial growth phase, but no clear profitability or cash flow yet
Third stage	Major expansion for company with rapid sales growth, at breakeven or positive levels but still private company
Fourth stage	Bridge financing to prepare company for public offering
<b>Acquisitions and LBO Financing</b>	
Traditional acquisitions	Assuming ownership and control of another company
Leveraged buyouts (LBOs)	Management of a company acquiring company control by buying out the present owners
Going private	Some of the owners/mangers of a company buying all the outstanding stock, making the company privately held again

# Financial Life Cycles

## Outside Equity and Risk capital

FFF: Personal savings and friendly sources

Amount invested (000 €)



**Risk**

Moderate

Extreme

**Cost**

Under 30%

30%

50%

50-100%



Stages

# **Cost of capital and Value creation**

# Value Creation: Economic Value Added

$$\text{EVA} = (\text{ROCE} - \text{WACC}) * \text{CE}$$

Venture Capital costs

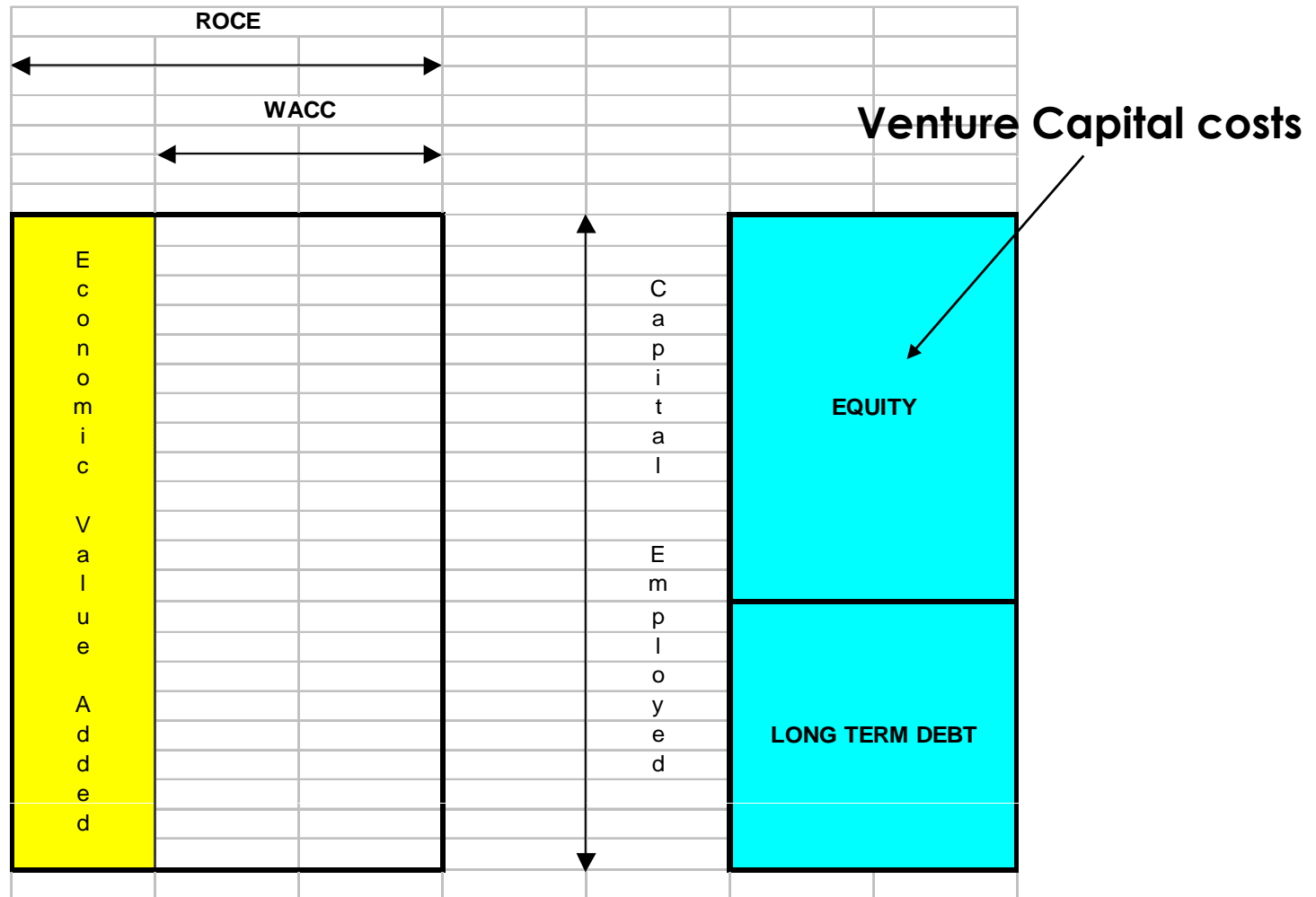


Spread



Capital Employed

# Value Creation



Sindicatum

# **Inside Venture Capital Business**

## What is Venture Capital?

The venture capital industry supplies capital, knowledge and other resources to entrepreneurs in business with **high growth potential** in hopes of achieving a **high rate** of return on invested funds

## **The key features of Venture Capital Funds industry**

- ***Ten year time frame.*** Venture Capital funds are, in most cases, set up with a 10 –year horizon. The portfolio is build up over first few years, and good exits generally take about 5 to 7 years or more to come to fruition
- ***Limited Partnership.*** In common partnerships are tax – efficient vehicles; the capital gains are taxed when they are received by the partner rather than within fund
- **Mutually binding commitments.** A Fund brings together coalition of investors. Each of investors wants to ensure that all partners (GP and LP) are tied in closely for the duration of the Fund and that there are no conflicts of interest

## Types of investors in Venture Capital Funds

- *Pension funds.* A pension fund with relatively high ratio of current employees to retirees is an ideal investor in a VC fund
- *Endowments.* Endowments for universities and charitable institutions often have very long- term liabilities and make particularly ideal investors in VC fund
- *Balanced fund managers.* Investment managers who managing a mix of equities, bonds, cash and alternative assets
- *Funds – of – funds.* Possibility of diversification across a lot of Venture Capital funds by investing in an intermediate vehicle
- *Corporations.* Here investment might be intended as a way of keeping an eye on technology developments within the sectoral focus of Venture Capital Fund
- *High net worth individuals.* Wealthy individuals with certain professional experience as a rule trough family office vehicle, make commitments to Venture Capital funds

## How does a venture capital fund work?

- Venture Capitalist execute different tasks during the life of a fund:
  1. Fundraising
  2. Deal Flow
  3. Selection of a business plan and negotiations
  4. Follow-up of investment
  5. Sale of portfolio company, IPO
- ... And back to fundraising once around 75% of the committed funds have been invested

## Venture Capital and other sources compared

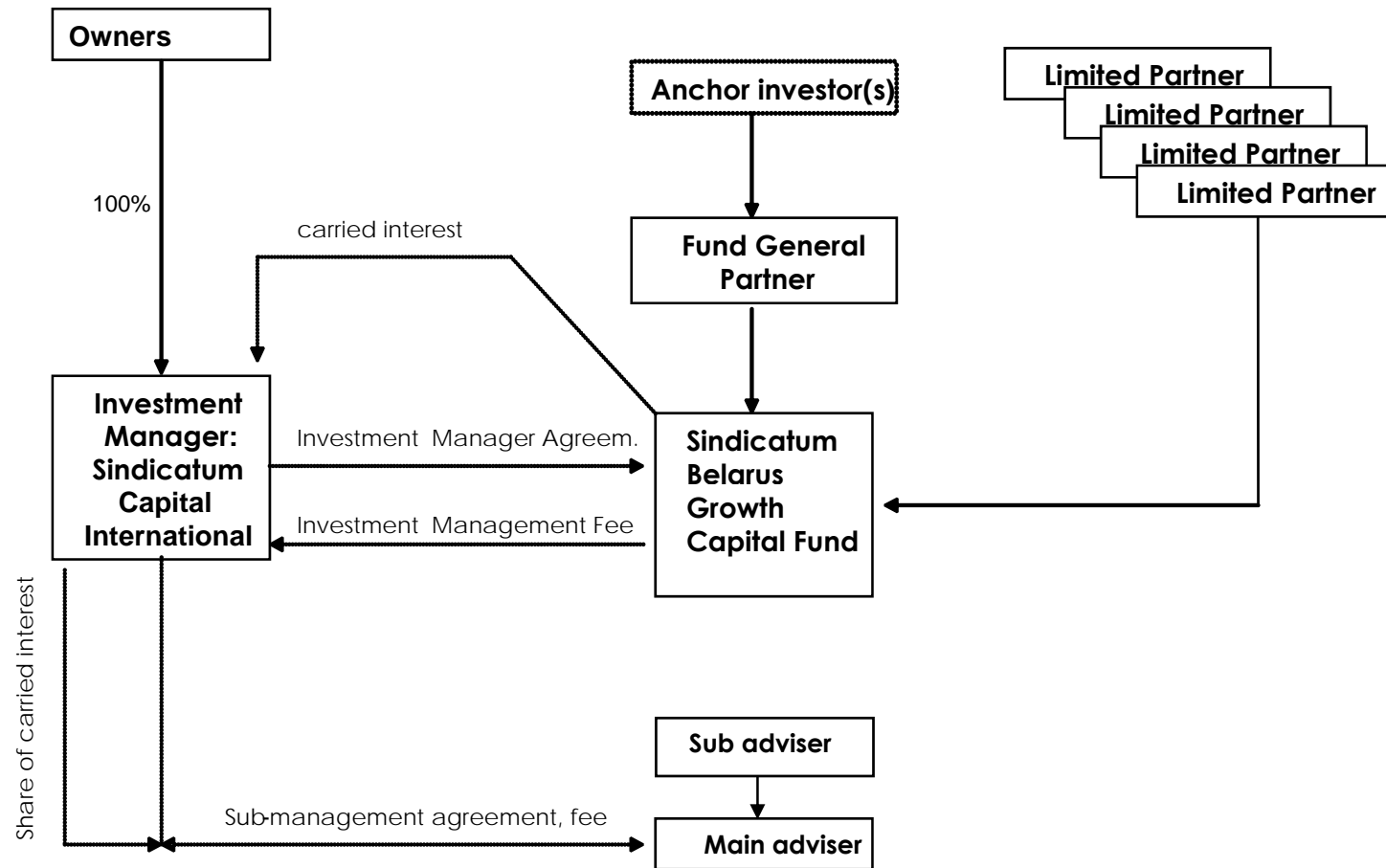
	Advantages	Disadvantages	Decision on
F&F&F	Quick; not demanding	They only bring money	Trust, friendship
Industrial partner	Quick, know-how and contacts; they can bring customers	Exit unclear; sometimes conflicts of interest	The nature of the business and the strategic interest for the partner
Business Angel	Quick; they facilitate contacts	Exit unclear and costly	Profitability and personal preferences
Venture Capital	Professional, oriented to value creation, clear exit	Slow, they can control certain decisions	Profitability
Banks	Quick	Guarantees	Risk assessment
Grants	Cheap and easy to get	Slow; not always available	Economic and political impact

# **Venture Capital Fund. Structure and Investment Process**

## Structure of Venture Capital Funds

- **Venture Capital funds are partnerships ( or investment vehicles) not companies**
- **The Venture Capital Fund is a vehicle for parties interested in investing in high – growth companies. These parties are gathered together in a fund, bound by a set of commitments for the fund duration**
- **As a rule, Venture Capital funds are granted a finite 10 – year life by investors in the fund**
- **Venture capital funds managers in the first three to five years guide invested companies as they grow, and ultimately exit them in years 5 to 10 by selling them to larger companies or by undertaking an initial public offering**
- **The Fund managers team lives or dies based on its performance (amount of capital returned to investors and speed). If team delivers a good performance to the investors, every three to five years it will normally be able to rise another Fund**

# Typical Venture Capital Fund Structure



## How Venture Capital funds are compensated?

**The Fund partners and staff are rewarded in two ways – through a management fee and through carried interest**

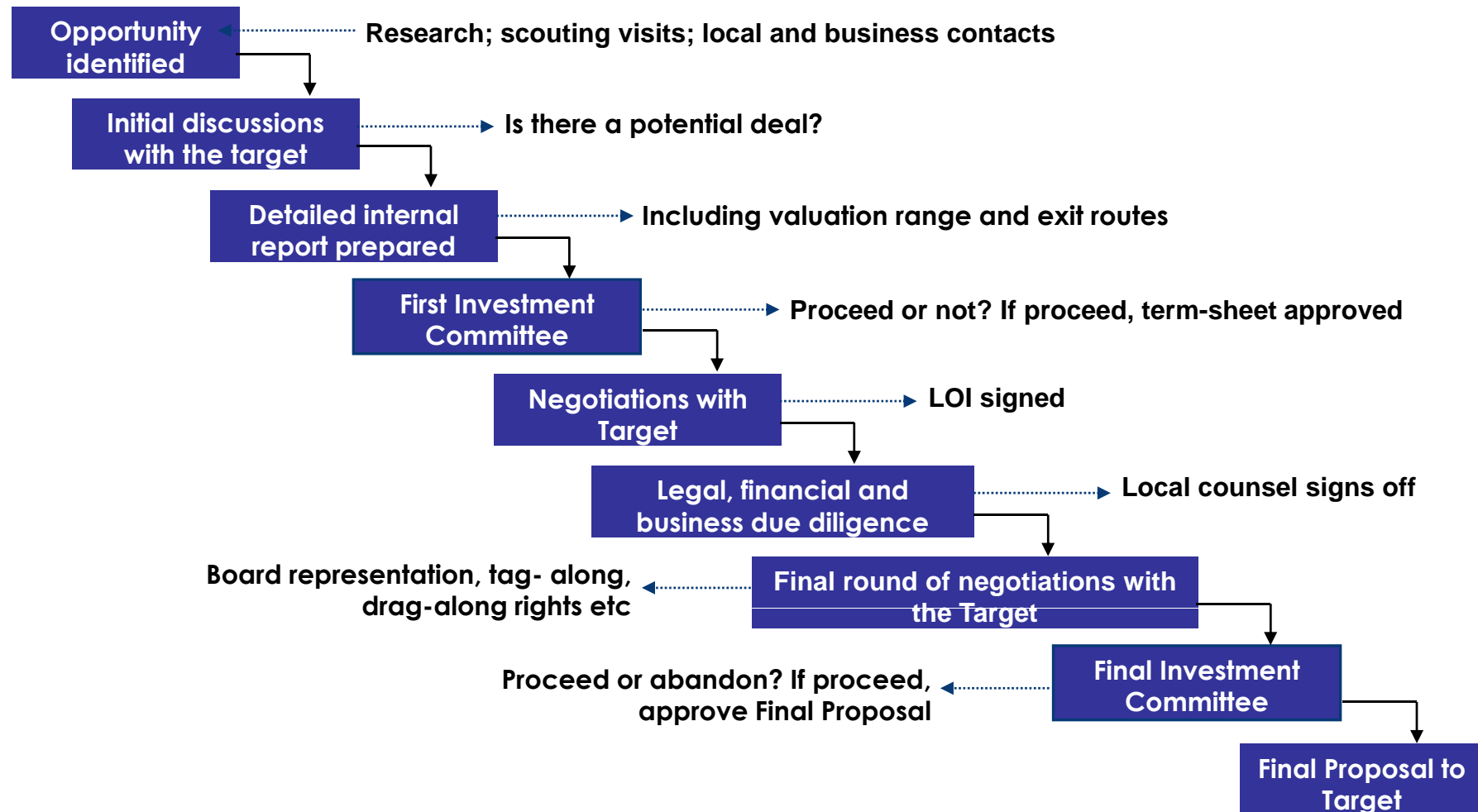
**Partners and staff of a Venture Capital funds receive an *annual fee* – roughly 1,5 – 3 % of the total amount of the Fund they manage each year**

**The carried interest refers to situation where the Fund managers team is entitled to particular percentage (on average from 15 to 20) of all the gains, once the partners (investors) received 100% of the capital of the fund. There also are a few factors to note regarding carried interest:**

- Hurdle rate
- Claw backs
- Division of the carried interest

**Key Stages in the Investment Process –  
Acquiring, Monitoring, Exiting**

# Investment Process – Acquisition Stage



## Target Profile: A Checklist

- Defendable local niche
- Good brand (locally)
- Capable management team with good track record
- Sound reputation

**MUST HAVE**

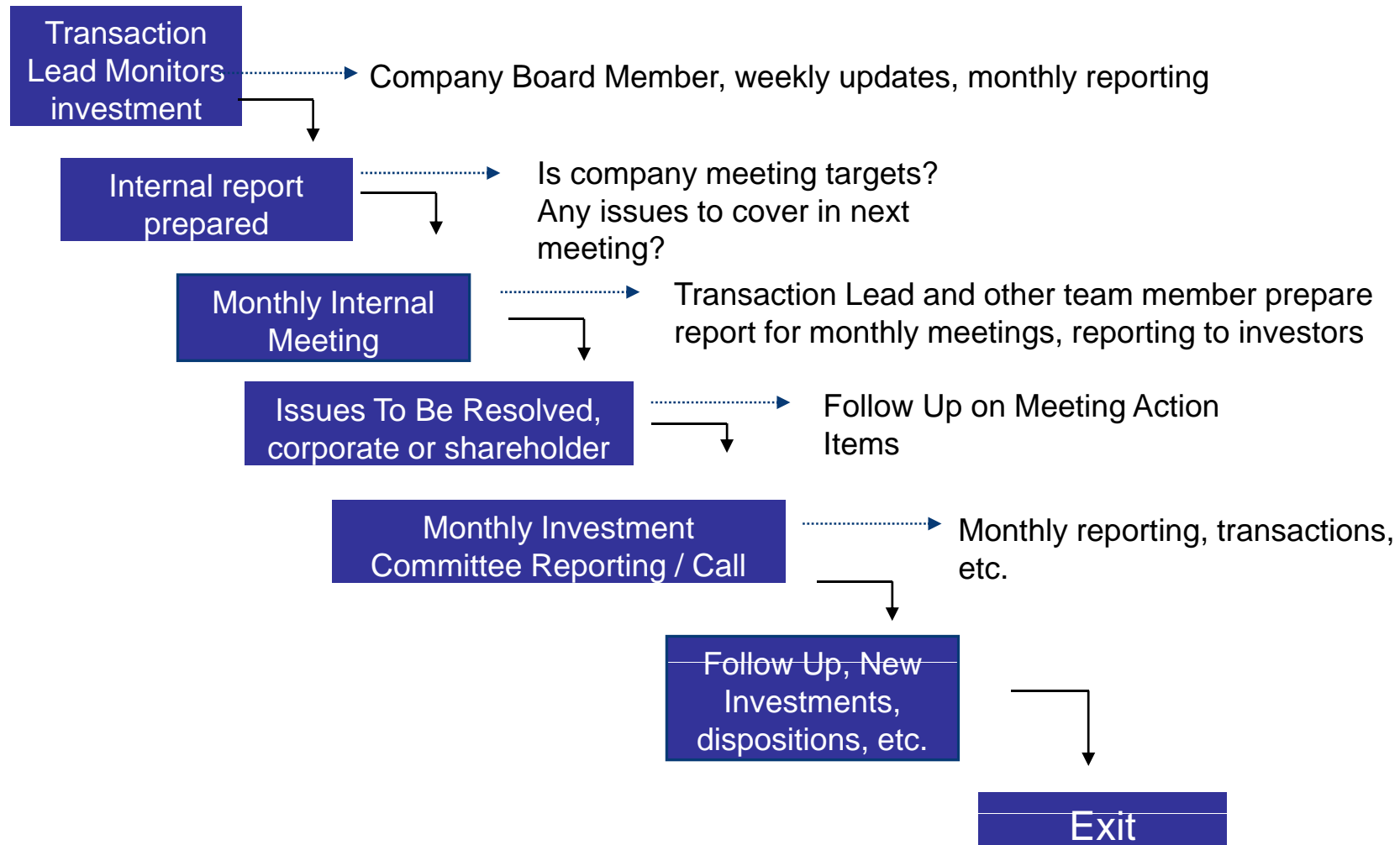
- Substantially owned by management
- Evidence of profitability over cyclical peaks and troughs
- Lean cost structure
- Record of survival in crisis

**PREFERABLE**

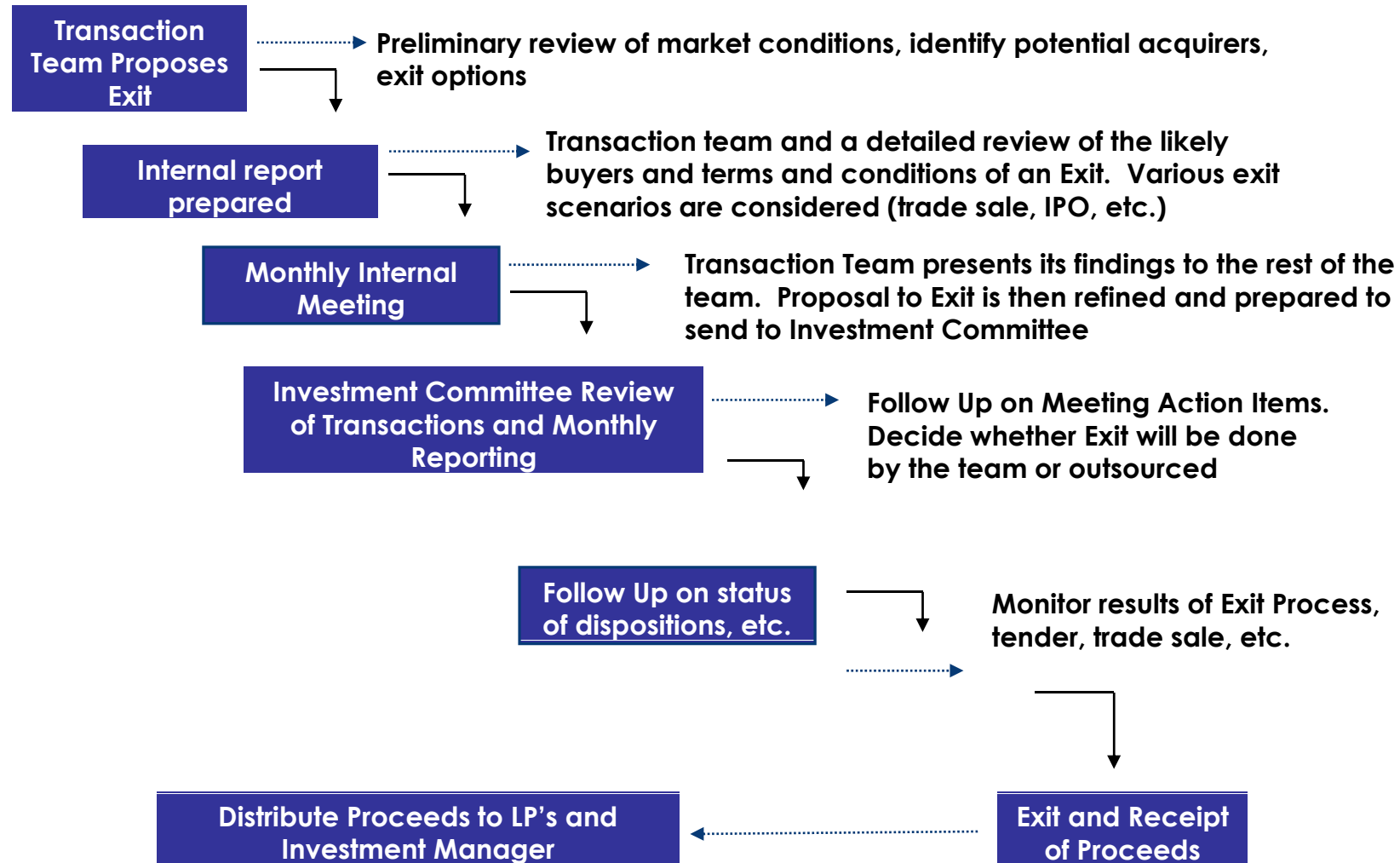
- Depth of middle management
- Immediate ability to deploy new capital profitably

**DESIRABLE**

# Investment Process - Monitoring



# Investment Process - EXIT



## **Main dilemmas for Belarus**

- **Knowledge of capital markets basics and professional experience of new owners**
- **Local financial services market infrastructure**
- **Legal practices**
- **Authorities commitment towards existing international practices**
- **Behavioral traditions of society**

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