PART I

INTRODUCTION, THEORY AND LITERATURE
Chapter 1

Introduction

1.1 Introduction

Privatisation has become a central feature of the economic policies of a variety of nations in the developed and developing world and in the capitalist, as well as, in the previous socialist states. Governments all over the world have begun privatising state-owned enterprises. During 1980's and early 1990's, more than 15,000 state-owned enterprises have been privatised; most of them since 1990 [Kikeri, Nellis & Shirley, 1994].

The wave of privatisation in Western developed countries began in 1979 when Mrs. Thatcher became Prime Minister of UK. Many state-owned enterprises in the UK, such as, British Gas, British Airways, Rolls Royce, and the British Airports Authority were sold to private investors. “The sales of state-owned enterprises' assets in the UK generated more than 34 billion pounds until 1992 [Moore, 1992, p.115].” Other developed nations, such as, France, Italy, The Netherlands and Japan also implemented privatisation programs. In the Western developed economies, governments privatised public enterprises in order to improve the efficiency of the state-owned enterprises, to motivate the public to become shareowners and to alleviate governments' budget deficits. The highly developed financial markets and the limited number of state-owned enterprises to be privatised in the West facilitated the privatisation process.

The fall of the Berlin wall in 1989 and the collapse of the communist political system in Eastern Europe and the former USSR in 1991 made the privatisation of state-owned enterprises the focus of discussion within and outside Eastern Europe. “In the former East-Germany (GDR), the Treuhand has sold a total of about 6,000 whole enterprises and another 6,000 parts of enterprises during mid 1990 to mid 1993 [Carlin, 1993, p.1].” Similarly, other Central and Eastern European countries such as Hungary, Czech Republic, Poland, Russia, Ukraine, Romania and others have privatised many state-owned enterprises worth billions of dollars and the privatisation process is still continuing.

In the former communist countries of Central and Eastern Europe, privatisation now plays a crucial role in transforming these countries into a market economy. There are thousands of enterprises in manufacturing, service and retailing that are to be divested immediately to private investors. However, there are no mature financial markets and the people do not have money to buy companies. In addition, strong labour unions are impeding the privatisation process. On the part of the government the deficit of the state budget constitutes the most immediate pressure to find additional resources, that is, revenues from privatising state-owned enterprises. Foreign investment is also expected to bring in foreign currency, new technology and management skills into the ailing Central and East-European industries. However, experience so far shows that foreign investment in the former communist countries is very small and is targeted on profitable companies or those companies which have a domestic market or an export potential. The large manufacturing enterprises, in particular those with financial difficulties, did not attract foreign investors and are still in the hands of the state [Wijnbergen, 1997].
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The collapse of the communist system had also its repercussions in the developing countries of Africa, which were following a Marxist ideology, such as, Ethiopia, Mozambique and Angola. At present all these countries are engaged in privatisation of state owned enterprises.

On May 24, 1991, the Eritrean Peoples Liberation Front (EPLF) liberated Eritrea from the colonisation of Ethiopia. Industries in Eritrea, which were nationalised by the Ethiopian socialist government, have then been transferred to the ownership of the State of Eritrea. The loss making state-owned enterprises are, however, becoming a burden to the meagre economy of the new nation. The Government set as an objective for the new Eritrea to realise knowledge-intensive and export oriented industries and services. In its macro-policy, the Government articulated that the ultimate objective of the government is to withdraw completely from operating public enterprises and leave them to the private sector. The policy promotes that the private sector is the lead actor in the economic activities of Eritrea. The Government is, moreover, committed to privatising state-owned enterprises in manufacturing, banking and other services, as well as the public utility companies. The Government of Eritrea established a Privatisation Agency in 1995. Privatisation of the state-owned enterprises is expected to bring efficient and competitive enterprises that contribute to the development of Eritrea. In 1997, the Government of Eritrea has started with the privatisation of thirty-nine manufacturing enterprises. However, in Eritrea the people are also poor, there are no financial markets at all and it was hoped that foreign multinationals could be interested in acquiring these companies. However, the loss making enterprises do not attract foreign buyers and the liquidation of large enterprises is not an option because of high social cost such as unemployment and deindustrialisation.

Even though privatisation is in process in the former socialist countries of Africa, most research on privatisation was focused on the transition economies of Central and Eastern European countries. There is not much research on the process of privatisation and restructuring of the former socialist countries of Africa so far and country specific studies are lacking [Bennell, 1997]. This research tries to fill in the gap by focussing on the privatisation of state-owned manufacturing enterprises in Eritrea. Manufacturing enterprises employ the majority of the workforce in Eritrea and they have a large impact on the economy. The enterprises, moreover, provide a good case to understand the process and problems encountered in privatisation in a developing country.

1.2 History of the Eritrean Manufacturing Industries

Historically, Eritrea has been a trading nation, given its strategic location and easy access to the markets of the Middle East, Africa and Europe. Eritrea has a long history of industry and manufacturing. By the end of 1945 there were more than 300 small, medium and large factories.

In the 1950’s and 1960’s, Eritrea had a sound economic foundation, that is, well distributed and diversified transport and communication networks, a number of small and medium-scale private enterprises, commercial farming plots and industrious entrepreneurs and workers. Almost all the factories and industries that exist today were built towards the end of the Italian colonial era, the Federation period and the Haile-Selassie era. The total number of factories was
estimated to be 160 by 1970's, of which 67 were regarded as large. Their capital investment was estimated at 25-37 million Nakfa\(^1\) [Mebrahtu, 1995, p. 13].

In 1975 the Socialist Government of Ethiopia nationalised all large-scale industries in Eritrea. The regime imposed strict price controls and introduced import restrictions, which both reduced the scope for efficient business operations. After nationalisation, the majority of the industries had been facing several problems and the state-owned enterprises were running with a government subsidy to provide employment. These industries were also managed by individuals who had only political affiliation to the ruling Workers Party of Ethiopia, but no management calibre and thus, the factories became inefficient loss makers. The dismal economic situation and the poor performance of the public enterprises was compounded by the protracted war for independence (1961-1991), which not only resulted in a large number of displaced people and other war victims, but also exacerbated the shortage of skilled manpower and the inadequacy of institutional capacity.

When Eritrea became independent from the Ethiopian colonisation and the nationalised industries were transferred to the Government of Eritrea. The Eritrean Government inherited inefficient manufacturing enterprises that accounted for over 85% of manufacturing output and 90% of industrial employment. The Government of Eritrea has already issued Proclamation No. 83/1995, in which the National Agency for the Supervision and Privatisation of Public Enterprises (NASPPE) to privatise state-owned enterprises was established.

1.3 Relevance of this Study

In many countries, particularly in the poorest countries, the inefficient, loss-making state-owned enterprises are a significant burden on government budgets and scarce resources in many countries. “These enterprises hinder growth, impede market liberalisation, and thus both directly and indirectly limit efforts to reduce poverty [World Bank, 1995, p. xi].” A key task facing the economies in transition is to transform state-owned enterprises (SOE’s) into value maximising private firms. The ultimate goal of the transformation is not merely to engineer a change in ownership, but also to increase efficiency, flexibility and competitiveness of enterprises, that is, to create organisations that use their assets efficiently and which are capable of competing effectively in an open market economy. Privatisation can be an important means to achieve competitiveness and to reduce political interference. But selling public enterprises poses formidable problems. According to Bennell [1997, p. 1798], “the actual saleability of state-owned enterprises, in particular the larger ones, has remained a key constraint in most Sub-Saharan Africa (SSA).” The number of potential buyers is often limited, and capital markets in developing countries are often inadequate or non-existent for absorbing divestitures. Selling enterprises to an underdeveloped private sector, with limited savings and borrowing

\(^1\) Prior to November 1997, the official currency in Eritrea had been the Ethiopian Birr. However, afterwards, the Eritrean government has introduced the Nakfa as an official currency of Eritrea. The Ethiopian Birr was exchanged to Nakfa on 1 to 1. Therefore, all data in this study are reported in Nakfa. The exchange rate of a Nakfa to a US$ was pegged to about 6 Nakfa during 1993-November 1997 and afterwards floating about 7.20 Nakfa [GOE, 1998].
capacity proved to be a slow and torturous process in particular situations where capital markets are non-existent and where reliable valuations of state assets up for sale are absent. The focus of this study is the Eritrean example. Therefore, the first characteristic of this study is to present a privatisation experience of one SSA country.

Privatisation is generally one aspect of a transformation process that includes macro-economic and micro-economic reforms. Macro-economic reforms include, price and trade liberalisation, monetary, fiscal currency exchange policies and stabilisation measures. These reforms have been introduced in many transition countries. However, the hoped-for overall regeneration of industry and the achievement of industrial competitiveness in the former socialist countries have not yet taken place. It is now clear that the success of transformation in the former socialist countries will depend on more than macro-economic reforms. In particular transformation also has to focus on micro-economic measures in order to induce appropriate supply responses. Experience shows that restructuring at the firm level will not take place automatically in response to macroeconomic policy changes or rapid shifts in global conditions. The transformation should also concentrate on removing the micro-level bottlenecks (obsolete technology, lack of marketing and management skills, lack of committed owners and overstaffing) which are impediments to a country's development [UNIDO, 1994]. A second characteristic of this study, therefore, is a micro level approach to the privatisation of enterprises.

In order to create enterprises which are saleable to investors, the firm's management, as well as, the government may need to engage in enterprise restructuring, like organisational, technological, labour, market, financial, product and management restructuring [Carlin et al., 1995]. A major dilemma in the transition countries is whether restructuring should precede or follow privatisation. There has been a great deal of argument over the appropriate sequence of restructuring and privatisation [Kikeri, Nellis, and Shirley, 1992; Pinto et al., 1993; Boycko, Shleifer, and Vishny, 1996a]. There is, however, often a need to restructure companies, at least partly, to make them viable to attract buyers, while later further restructuring by the new buyers may be required to make companies internationally competitive. According to Pinto et al. [1993, p.222], “state-owned enterprises' managers believe that prior restructuring is necessary for privatisation.” In line with this argument, the Government of Eritrea has taken some restructuring measures in 1995 to prepare enterprises for sale such as labour shedding, organisational restructuring and financial restructuring through the introduction of hard budget constraints to make enterprises self financing. A third characteristics of this study will thus be assessing the adequacy of restructuring measures before privatisation. In order to assess the adequacy of these measures, it is necessary to evaluate the impact of these changes on company value and management behaviour. How far profitability and competitiveness have been restored in the manufacturing sector during the transition period will be assessed. This means that the determinants of company value have to be identified. Enterprises need to be managed to enhance value to compete in the new market environment. A fourth characteristic of this study then is that it tries to evaluate how the manufacturing enterprises in Eritrea create value. However, how value has been created is only one part of creating viable enterprises. The other part is the question whether more value could be created. Sources of
value creation potential in enterprises needs to be assessed. Viable enterprises contribute to the economic growth of a country by providing employment and generating wealth. In order to study this, we interviewed managers. The final characteristic of this study is, therefore, that we use management opinions in evaluating whether value is adequately created and whether it can also be created further.

From these five characteristics, we hope, in a nutshell, that this study will improve our understanding of micro and managerial approaches to how enterprise value is (and can be) affected by privatisation and restructuring using the case study of enterprises in Eritrea, a country in the SSA. The combination of the five characteristics is new. This research provides a managerial perspective of privatisation and restructuring of enterprises in transition and links privatisation and value creation. It shows how enterprises are prepared for privatisation and how companies are managed differently due to privatisation. Since the privatisation process also takes a lot of time, this book also provides new insights in the functioning of enterprises in transition and it provides evidence on the consequences of a long privatisation period. Moreover, Parker [1999, p. 33] argued that “There is a need of assessing the impact of privatisation in terms of power and control.” Hart [1995] also advocated that power and control can be used to explain the recent transition of industries to a market economy and indicated that research is lacking. Our study sheds new light on the influence of privatisation on management power and ownership control in a business. In addition, it provides a multi-level and a multi-period data analysis of manufacturing enterprises in Eritrea and uses a unique data set of Eritrea.

Most privatisation research focuses at macro level issues (country level). After several years of transition experience in the Central and Eastern European countries, the theory is still poorly developed particularly in the creation and development of market value [Dewatripont and Roland, 1996]. The empirical evidence generally used to measure and understand restructuring is also inadequate [Carlin, Reenen & Wolfe, 1995]. According to Estrin, Gelb & Singh [1995, p.132], “there is little information on how the reforms have impacted on the economic behaviour and choices of firms and on their responses to the new environment.” Megginson and Netter [1999] indicated that there is only limited empirical evidence on the impact of economic reforms on firm performance during pre-privatisation. According to Djankov and Pohl [1997], the restructuring of large enterprises has received much attention and the need to transform these enterprises into viable firms is widely acknowledged, but the extent of such restructuring and the determinants that underlie a successful transformation are less studied. Moreover, research on privatisation from a firm level perspective is clearly lacking a theoretical and an empirical basis [De Castro & Uhlenbruck, 1997, p. 139]. Therefore, this study will contribute empirical evidence to the studies of transition economies.

We argue that firm-level analysis within the state-owned sector is useful for generating pragmatic policy guidelines. We also hope that with this approach we will be able to assist the Eritrean Government and investors in finding an adequate solution for privatising and restructuring the enterprises.

1.4 Research Questions
The central theme of this study is: \textit{whether and how the state-owned enterprises in Eritrea are restructuring into value creating, private companies and what lessons can be learned from their experiences.}

According to Stark \citeyear{stark1996}, “as in all versions of modernisation theory, transitology begins with a future that is not only desired but already known. The destination has been designated: Western Europe and North America hold the image of the East European future.” The experience of privatisation and restructuring of enterprises in Central and Eastern Europe and in the developed economies of the West can provide helpful lessons for Eritrea. Therefore, the first question that will be addressed in this study is: \textbf{1. What lessons can be learned from the experiences of other countries to facilitate restructuring and privatisation of enterprises in Eritrea?} The experiences of the developed economies of the West and the Central and Eastern European countries are reviewed and analysed to learn lessons for Eritrea.

According to Corbett and Mayer \citeyear{corbett1991} governance is an important issue that has not received adequate attention in the debate on transition. Therefore, the second question that will be addressed in this study is: \textbf{2. How effectively are the enterprises in transition governed?} The theories of property rights, agency and incomplete contracts are reviewed to find implications for the enterprises in transition. The corporate governance experience of the transition economies is analysed to learn lessons for enterprises in Eritrea.

In order to assess the improvement of value of the manufacturing enterprises in Eritrea during the study period, we will need to know the determinants of value, that is, the sources of value in business enterprises. Moreover, company valuation is a prerequisite for successful privatisation. The determinants of the value of the firm during privatisation are essential for fixing the price and for avoiding overvaluation or undervaluation. Hemming \citeyear{hemming1995} states that if an enterprise is sold at its fair market value, everybody can benefit from efficiency improvements not achievable under state ownership. If there is free disposal or heavy discounted selling of companies, it is inconsistent with equitable sharing of national wealth. However, determining the value of an enterprise for sale is not easy in a transition economy because there are no mature market mechanisms that one can rely on. The issue of how to evaluate companies and which method to use is essential for successful and transparent privatisation of enterprises. “The saleability of companies to be privatised depends upon the profitability or potential for profit, productivity, strategic buyer and specific characteristics of the individual company [Shafik, 1995, p. 1146].” The ultimate goal of transition to a market economy, according to Djankov and Pohl \citeyear{djankov1997}, is to transform from a highly distorted economy with many loss-making firms to a “normal” market economy in which the overwhelming majority of firms are profitable. Therefore, the third question that will be addressed in this study is: \textbf{3. What are the determinants of value creation in an enterprise?} The determinants of restructuring and value creation in a business are identified from the literature in finance of the Western market economies because the ultimate goal of transition is creating a market-oriented company in a market driven economy.
The key task of the economies in transition is to transform state-owned enterprises (SOE's) into value maximising private firms. Therefore, transformation is not simply changing ownership, but also increasing efficiency, flexibility, and competitiveness of enterprises. Profitable enterprises attract plenty of interest from investors; therefore, the critical issue of transformation is how to improve the performance of the enterprises to make them profitable. “Selling an enterprise as a competitive going concern is, moreover, easier and quicker to accomplish [UNIDO, 1994, p. 58].” Selling enterprises as on-going concerns is more valuable than liquidation in Eritrea because the machinery is old which thus cannot be of any use except as a scrap value. Therefore, the question of asset stripping by foreigners or domestic investors is not an issue in Eritrea. The government privatisation policy also clearly indicates that buyers are expected to continue operation of the companies and new investors are prohibited from dismantling machinery for asset stripping purposes. Privatised enterprises are expected to continue operation and new buyers will be engaged in further restructuring the enterprises to improve efficiency, and the value of the companies. Therefore, improving the on-going value of enterprise will help in attracting buyers during the transition and in increasing the private sector contribution to economic development of Eritrea. The fourth research question, therefore, is aiming at assessing whether and how the manufacturing enterprises in Eritrea are improving their performance. For this reason, we will need to study the past performance of the enterprises and management's future plans to improve company value. Therefore, the following group of questions is addressed in this study: **4. Have companies been creating value during 1991-1997, to what extent and how?** The past value performance of the manufacturing enterprises in Eritrea will be collected from financial and other documents of the companies. The management interviews also provide explanations of how enterprises are creating or destroying value.

The changes that are introduced in restructuring enterprises during the privatisation process have an impact on value of the manufacturing enterprises. The effectiveness of the restructuring techniques used and the privatisation methods strived for are essential in judging whether the objective set is achieved or not and in assessing if there is a need for further improvement. Management plays a key role in restructuring enterprises and empowerment of management helps in creating value in a business. The managers’ decisions, policies and practices influence firm value. The challenges that managers face during transition to market economy also influence their attempt to enhance firm value. Due to this, it is essential to study how management behaves during transition to a market economy. Therefore, the following qualitative question is studied: **5. How are managers trying to maximise enterprise values?**

To answer this question, an in-depth interview with the company managers was conducted to reveal management strategy in restructuring their companies. The different types of restructuring that relate to company operations, investment, financing and governance are discussed in the theoretical and empirical parts of this study.

Understanding of how the privatisation of the economy and the privatisation process is influencing firm behaviour at the time of transition to a market economy and how firms are adjusting to the new market environment is essential. It is also important for policy makers to assess how different industries respond to privatisation of the economy and privatisation
process. Therefore, the following question is asked: **6. How is the process of privatisation influencing the manufacturing industries in Eritrea?** Comparative study of the industries in Eritrea is conducted to investigate the variation and commonalities of the industries and to learn lessons from their experiences.

The lessons from the experience of restructuring and privatisation processes in the manufacturing enterprises in Eritrea are relevant for the company management, the government of Eritrea, and others. Therefore, the following questions are posed: **7. What implications does the study have and how can privatisation and restructuring programs be designed and implemented most effectively?** The findings of the study and their implications contribute to designing effective privatisation and restructuring programs to transform enterprises into value creating private companies.

**Table 1.1. shows the Sub-questions Related to the Structure of this Thesis**

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<tr>
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<th>Sub-questions</th>
<th>Part I</th>
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<td>1.</td>
<td>What lessons can be learned from the experience of other countries to facilitate privatisation and restructuring of enterprises in Eritrea?</td>
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<td>2.</td>
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<td>3.</td>
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<td>5.</td>
<td>How are managers trying to maximise enterprise values?</td>
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**1.5 Organisation of the Book**

This book is organised in 4 parts and 13 chapters. Part I deals with introduction and literature review (chapters 1, 2, 3 and 4) and Part II deals with the conceptual framework for the study and the research design (chapter 5). Part III deals with the empirical study of enterprises in Eritrea (chapters 6-12) and finally, Part IV summarises and concludes the study (chapter 13). An overview of the four parts and their interrelations, as well as the level of analysis, is given in figure 1.1.

This chapter has introduced the recent phenomenon of privatisation, restructuring and the background history of the manufacturing enterprises in Eritrea. It also explored the basic problems encountered by state-owned enterprises in the former socialist countries and posed questions to be addressed in this research.

In chapter 2, the literature on privatisation is reviewed. How companies are privatised in the
developed countries in the West and in the former socialist countries and Sub-Saharan Africa is studied to learn from their experiences. The problems that the countries face in privatisation and the tools they are using to solve these problems are studied.

In chapter 3, literature on corporate governance in the developed economies of the west and in the transition economies is reviewed to highlight the governance issues and problems encountered in transition in order to learn lessons for Eritrea. The theories of property rights, agency and incomplete contracts are analysed to find implications for enterprises in transition. The issue of management empowerment and ownership control is discussed to assess its influence on creation of value in a business.

In chapter 4, the literature on corporate restructuring and value creation of both the developed and transition economies is reviewed. The restructuring and value creation theories of Copeland, Koller and Murrin Model [1990], Porter’s Value Chain Model [1985], Crum and Goldberg [1998] and Rappaport’s Value Network Model [1986] are analysed to highlight the restructuring and value creation issues and to design a conceptual framework for analysis for this study. The experience of the transition economies was also reviewed to learn lessons from the success and failures of those countries in restructuring enterprises.

In chapter 5, the conceptual framework (model) for this study is designed and the methodology of this research is presented. The research design used for this study is a case study approach in which also secondary data like financial statements and other documents are used to gather relevant information. In addition, extensive in depth interviews with company managers revealed relevant aspects related to value creating strategies of the enterprises.

In chapter 6, the economic background and economic outlook of Eritrea is presented and the economic reforms such as trade and price liberalisation, tax reforms, investment policies are explored. The privatisation and private sector development in Eritrea is assessed and its progress is evaluated.

In chapters 7-10, we present the empirical results of case studies of food processing, beverage, footwear and leather and textile industries in Eritrea respectively. The operations, investments, financing, governance, value creation and constraints in value creation of the companies are investigated. The cases reveal the underlying and contributing causes for success and failure in different circumstances. Through these studies, variances and commonalities could emerge that will enable us to answer the questions posed. In chapter 11, the case studies of food processing, beverage, footwear and leather and textile industries are compared to identify similarities and differences in structure and in the impact of privatisation. In chapter 12, we analyse the ‘privatisation trap’ and we document the influence of privatisation on enterprise operations, investment and financing, and governance. Moreover, we try to assess ways of avoiding the ‘privatisation trap’.

Finally in chapter 13, a synthesis of the results of the study is presented. The findings of the study are elaborated, implications of the study are assessed and some policy recommendations
are derived from the findings. Finally areas for further researches are identified.
Figure 1.1 Outline of the Chapters of the Book

Chapter 1
Problem identification
Research objective and Research questions

Chapter 2
Privatisation

Chapter 3
Corporate governance

Chapter 4
Corporate restructuring and value creation

Chapter 5
Conceptual framework for the study (model) and research design

Chapter 6
Economic outlook and privatisation in

Chapter 7
Case study of food processing enterprises

Chapter 8
Case study of beverage producing

Chapter 9
Case study of footwear and leather

Chapter 10
Case study of textile enterprises

Chapter 11
Cross case anlaysis of industries

Chapter 12
The ‘privatisation trap’

Chapter 13
Conclusions
Theoretical implications
Policy implications