Corporate value creation, governance and privatisation
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Document Version
Publisher's PDF, also known as Version of record

Publication date:
2001

Link to publication in University of Groningen/UMCG research database

Citation for published version (APA):

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Chapter 12

Conclusions and Implications

12.1 Introduction

In the previous chapters, we reviewed the literature, designed the framework and methodology for the study and reported the case studies of food, beverage, footwear and leather and textile enterprises and compared the industries. In this chapter, we present the conclusions and implications of the study.

According to Cook, Kirkpatrick and Nixson [1998], the development of a dynamic private sector is a *sine qua non* for structural changes towards a market economy and they argue that there are three components of private sector development: privatisation, large-scale enterprise restructuring and small and medium-sized enterprise development. This research focussed on privatisation and value creation in the large manufacturing enterprises in order to gather knowledge for assisting in the building of efficient and outward looking private enterprises in Eritrea.

In section 12.2, we report the summary and the conclusions. In section 12.3, we discuss the implications of the study and finally in section 12.4, we describe the directions for further research.

12.2 Summary and Conclusions

In this section, we will summarise the findings from the literature as well as the conceptual framework and the empirical part.

*Theoretical Background and Experiences of Developed and Transition Economies*

The literature reviewed in chapters 2, 3 and 4 revealed that lessons can be learned from the experiences of privatisation and restructuring of enterprises in developed and transition economies. The first sub-question of this research was: 1. *What lessons can be learned from the experience of other countries to facilitate restructuring and privatisation of enterprises in Eritrea?* We have reviewed literature of developed economies in the West and transition economies in the Central and Eastern Europe to study their experiences. In the United Kingdom, the government restructured companies before privatisation to make companies attractive to buyers and to improve their performance [Bishop, Kay and Mayer, 1995]. In the UK, the government used the method of share floatation for privatisation and this facilitated the selling of companies. The availability of financial markets also assisted in creating broad share ownership of the general public. The reviews of corporate restructuring literature in the developed countries also showed that according to Bowman et al. [1999] financial restructuring using leveraged buyouts and management buyouts create value because they leave the management in place.

The downfall of communism in the Central and Eastern European countries in 1989 and 1990 marked a new era of transition from a command economy to a market
economy. The Central and Eastern European transition countries such as Hungary, the Czech Republic, Poland and the former GDR were studied because they are advanced in the transition process. The countries established agencies to follow up privatisation and restructuring of companies. In general, the transition was slow and politically difficult due to technical, economic, managerial, attitudinal and policy related problems. According to Filatotchev [1996], the ability of enterprises to become commercially efficient depends on a mix of factors relating to the entrepreneurial and market-oriented skills of managers, access to finance, the nature of governance and the role of the employees. The privatisation of small enterprises was also easier in comparison to the privatisation of large enterprises. The smaller state-owned enterprises, such as retail shops and restaurants, are easier to privatise, as the repercussions are likely to be minimal both in social and economic terms. They are not big enough to command what Kornai [1992] refers to as the “soft budget constraint”. In the case of larger state-owned enterprises, however, the picture is more complicated. There are serious dangers of information asymmetry, insider control and asset stripping, unless the management remains accountable and is properly monitored. The governments try to restructure enterprises to make them attractive to buyers by the refinancing of debt, the reorganising of operations, the slimming of the payroll or the introduction of new management. The experiences of the transition economies show that buyers do not like to acquire indebted companies and the governments assumed the accumulated debts in order to attract buyers during privatisation. However, the methods adopted were different (direct write-off, isolation of financially troubled companies (hospitalisation) and/or involvement of banks).

The experiences of the former East Germany (GDR), Hungary, the Czech Republic and Poland provide some lessons for privatising state-owned enterprises. The Treuhand (a privatisation agency of Germany) benefited from the availability of managers and finances from West Germany. The agency restructured large conglomerates into smaller entities and privatised companies quickly. The Treuhand assigned enterprises that were hard to sell to managers to turn them around. The managers were also entitled to a success fee if the companies were privatised [Carlin, 1993]. In Hungary, they followed gradual transformation and were looking for strategic buyers and since they started earlier than the other countries, they were able to attract more foreign investors than the other countries in the region and massive lay-offs and liquidations of companies did not take place. The experience of the Czech Republic is well known for the introduction of vouchers (free distribution of shares to its citizens). This method facilitated sales, but resulted in dispersed ownership. Moreover, the lack of concentrated ownership affected the restructuring of the companies after sale. In Poland, first banks were privatised to provide and participate in the governance of state-owned enterprises. The Polish bank-led enterprise restructuring provided alternative methods of reducing enterprise debt such as debt for debt swaps, debt-to-equity swaps (equitisation) and debt sale. The banks were also intertwined with foreign banks and the Polish hired foreign investment managers to advise companies.

Corporate governance has recently become a key discussion item for the reform of state-owned enterprises and the development of a modern enterprise system. The review of property rights theory, agency theory and incomplete contract theory highlighted the importance of ownership and owner-manager relationships in creating value. Moreover, management empowerment is essential in enhancing the enterprise
value. However, ownership control is also important to follow up whether management is creating value. Thus, we posed the second sub-question of this research: 2. How effectively are enterprises in transition governed? The review of the literature of corporate governance in transition economies revealed that state-owned enterprises were converted into corporations whose shares were held by the state until privatisation took place and privatisation agencies were established to follow up the companies and facilitate their privatisation and restructuring. The case studies of Breda, Hess and Singh [1996] evidence that managers, once they have autonomy to do so, have undertaken much the same restructuring measures that were evident in the cases of firms governed by foreigners.

In order to know how value can be created in manufacturing enterprises, we posed the third sub-question of this research: 3. What are the determinants of value creation in an enterprise? The literature reviewed in chapter 4 indicated that value is created by restructuring and managing operations, investment and financing, while the value chain model indicated that the relationships between the firm and its suppliers and customers can create value. The literature reviewed indicated that the value created in an enterprise is determined by managers’ decisions on companies’ operations, investment and financing and governance. The combination of value based management models [Rappaport, 1986; Copeland, Koller, Murrin, 1990; Crum and Goldberg, 1998; and Porter, 1985] helped us to identify a framework for this research.

Conceptual Framework and Methodology

In order to gain insight in the functioning of enterprises during the transition to a market economy, we designed a conceptual framework (figure 5-1) based on the value based management models [Rappaport, 1986; Copeland, Koller and Murrin, 1990; Crum and Goldberg, 1998 and Porter, 1985]. We used models developed in Western Europe and the USA because many lessons learned from restructuring western companies proved to be useful guides as to how to tackle the problems faced by the state-owned enterprises [UNIDO, 1994]. The models were used to identify the variables that we should look for in the empirical study. The conceptual framework for analysis is based on the concepts of enterprise environment, operations, investment and financing and governance. The framework focuses on value creation, has managerial emphasis and shows a holistic view of an entity. Moreover, the framework extends the models by including the environment of the enterprise in the framework like government policy.

According to Richard and Ericson [quoted in Nelson and Kuzes 1995, p.85], “The transition from a socialist, centrally managed system to a capitalist, market system is a unique event. There is no experience and there is no theory of successful transition from a command economy to a market economy.” Due to this, we have selected a case study method in order to make an in-depth study of limited cases. Cases within the food, beverage, footwear and leather and textile industries were selected. Quantitative (accounting and questionnaire data) and qualitative (management interviews) were collected. Multiple data collection methods strengthen grounding of theory by the triangulation of evidence [Eisenhardt, 1989; Scapens, 1990]. The financial data collected are analysed using financial analysis techniques, while the management responses to the questionnaire are described and analysed with averages and ranges. The management interviews are used to illustrate the financial and questionnaire
results. The research on privatisation until now has mainly been done at macro level. The use of multiple levels of analysis in this study (at enterprise, industry and country levels) helps in providing additional insights. In addition, to our knowledge, the use of a combination of accounting (economic value added approach), questionnaire and management interviews in the study of privatisation and restructuring of enterprises in transition is unique.

Empirical Study

Privatisation: Before conducting in-depth case studies of enterprises, we presented the economic background and privatisation in Eritrea in chapter 6. The Eritrean economy is largely based on agriculture and the manufacturing industries are mainly agro-based. It also revealed the progress of privatisation of enterprises in Eritrea. The Government offered 39 of the large manufacturing enterprises for sale at the beginning of 1997 through the National Agency for the Supervision and Privatisation of Public Enterprises. At the end of June 1999, it sold 18 companies mainly smaller enterprises, while 21 mainly large enterprises were still under government ownership.

Privatisation in Eritrea, like in Central and Eastern Europe, attracted limited foreign investors. Moreover, small enterprises were quickly sold because there was available demand from local investors, while selling large enterprises was difficult due to a weak private sector and a lack of foreign investors. The Board of NASPPE is selling companies “as they are” without restructuring and it is using the direct sales method (sales by auctions).

In order to assess whether and how enterprises in Eritrea are creating or destroying value and to understand the influence of privatisation, we posed the following empirical sub-questions:
4. Have companies been creating value during 1991-1997, to what extent and how?
5. How are managers trying to maximise enterprise values?
6. How is the process of privatisation influencing the manufacturing industries in Eritrea?

We have used the conceptual framework to structure and analyse the data. We argued that restructuring and managing operations, investments and financing and governance could create value and facilitate privatisation of enterprises. The empirical findings are reported in chapters 7-11. The following paragraphs summarise and conclude on operations, investments and financing, governance and value creation.

Operations: The availability of domestic market demand and the over thirty years experience of distributing products directly to the customers has helped the beverage enterprises to have well organised sales departments and skilled salespersons. This has helped the companies to adjust when the government liberalised trade and prices. Unlike, the beverage enterprises, the footwear and leather, and textile enterprises had been selling their products to a distributing agency (EDDC) and when this agency was liquidated in 1993 the companies faced difficulties. The liberalisation of trade and prices has opened the markets for synthetic products such as polyester and plastic bags. These substitute products made the textile companies non-competitive price-wise at domestic markets as well as their export markets. The footwear and textile enterprises have been selling their products mainly in Ethiopia. The introduction of
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tariff barriers by the Ethiopian government and the present war between Ethiopia and Eritrea has stopped the trade between the two countries.

Analysis of the cost structure of the enterprises studied revealed that the material costs are high in comparison to the labour costs and overhead costs of the companies. The availability of water at a cheap price, the contracting of a whole year supply of other materials needed when their prices are cheap and the finding of alternative suppliers at cheaper prices helped the beverage industry to become a least cost producer. The main constraints that the food processing enterprises are facing are a shortage of raw material supply and the quality and cost of the supplied material. Hides and skins are available in Eritrea and further processing of skin to the crust and finished stages instead of exporting it at a semi-finished stage as it is done now may enhance value creation and may improve the export potential of leather shoes. The material costs of the textile enterprises are high, because the managers are buying cotton at world market prices from Aligheder Cotton Plantation (the only supplier of cotton in Eritrea).

Investment and Financing: The analysis of the balance sheet data showed that except in beverage enterprises, in all other enterprises studied there was no major investment in fixed assets throughout 1991-1997. The companies had been investing mainly in working capital and the lack of fixed asset investments is making enterprises less competitive. The managers interviewed perceived new investments in equipment and machinery, and upgrading technology as highly relevant and critical in creating value. The financial performance analysis also evidences that the short-term survival strategy followed in investment policy is negatively influencing the creation of value. For instance, the Board of NASPPE stopped the investment of modernisation of the Bottling Department in the beer factory when partially completed due to privatisation and this is creating a problem. In addition, the Ministry of Defence is not authorising long-term investments, even though the companies such as Barka Canneries are not offered for sale in the near future and have money to finance the investment projects.

The analysis of the financial structure of the enterprises studied revealed that the textile enterprises are highly indebted. The managers of the textile enterprises had been borrowing from banks using government guaranteed overdraft loans. The other managers mainly used internally generated funds from retained earnings because they feel that the lending interest rates of the Commercial Bank of Eritrea are high. This, however, also implied the highly profitable companies such as Asmara Brewery have not been shielding their income through prudential use of borrowings to avoid taxes. The 80% dividend payout rate declared by the Board of NASPPE also constrained the retained earnings of the companies and due to this some are encountering problems of financing their working capital investments.

Governance: The Government as an owner neglected the companies and except in the beverage enterprises, there was no major new investment injected to revive the companies during 1991-1997. Moreover, the Government has been constraining management decisions. Due to these constraints, the managers perceived that the management team is less empowered to influence the critical restructuring activities needed to create value.
Managers also perceived a change of incentive system (of management and of employees) as relevant in creating value because the salary scale of the companies in particular that of the textiles was low in comparison to the salary scale of the private sector and civil servants in Eritrea. Due to this, the managers of textile companies were not able to retain or hire skilled professionals and this is hurting the companies’ potential for creating value.

The beverage enterprises in particular the Red Sea Bottlers tried to attract customers by making their products available, affordable and acceptable (the 3 A’s of Coca-Cola company) to the customer. The other enterprises were less focussed to the customer.

The Government’s food subsidy and restrictions on the sales prices and profit margins of flourmills and bakeries are decreasing the value created in these companies. The Government’s restriction on exports of skins without further processing helped the tanneries to create value, while allowing exports of cotton directly and asking textile companies to buy it at the world market prices is hurting the textile companies in Eritrea.

Value Creation: The food processing enterprises on average destroyed a value of two million Nakfa each year during 1991/92-1997. They on average lost value prior to 1995, but afterwards created value due to the increase in value created in Barka Canneries. The beverage enterprises have been creating value throughout the study period. The largest value created was in 1995, but in 1997, the value created decreased to a less than one third of that in 1995. The footwear and leather industry on average created a value of one million Nakfa each year during 1991/92-1997. The shoe manufacturing enterprises on average lost value, while the tanneries created value. The tanneries created value starting 1995, because prior to that date the Government used to fix prices. The textile enterprises studied destroyed value during 1991/92-1997, due to absence of orders, obsolete machinery and a lack of financing due to continued operating losses of the companies each year.

The empirical research also revealed that the Government has made regulatory reforms in 1991, 1995 and 1997. In 1991, the Government liberalised trade and prices and in 1995 granted autonomy to enterprise managers, which increased their power. The financial performance measures improved in 1995 and this indicates that increasing the autonomy of the managers and making them accountable to their actions enhances value creation. Monitoring management and putting in place transparent incentive schemes that are likely to induce managers to create value is essential. This research suggests that managers’ have ideas on how to create value, but management’s decision empowerment on operations, investment, financing and governance is hindered. Due to the implementation of privatisation process, the NASPPE is restricting managers in policies and practices followed in operations, investment and financing and governance and we called these restrictions the ‘privatisation trap’. The ‘privatisation trap’ created uncertainty on managers and employees and restricted managers’ decision power on short-term investments such as inventory purchases, credit extension and long-term investments. The financial performance of enterprises in 1997 declined partly due to the ‘privatisation trap’. The privatisation of large enterprises in Eritrea is taking more time than planned in 1997 and simply waiting to find a buyer creates uncertainty, destroys the value creation
potential of the enterprises and drains the government budget during the interim-period. This research evidences that the longer the time the implementation of privatisation process takes, the higher the amount of value that can be destroyed. Therefore, it is important to devise policies that nurture the value creation potential of the enterprises.

12.3 Implications of the Study

In order to assess the theoretical and policy implications of the study, finally, we posed the last sub-question of this research: 7. What implications does the study have and how can privatisation and restructuring programs be designed and implemented most effectively?

Theoretical Implications

On speed of privatisation: Once governments have decided to privatise, the next policy debate is centred on the speed of privatisation. Some researchers advocated for rapid privatisation known as a ‘Big Bang’ approach and others favoured the slow privatisation known as the ‘Gradualist’ approach as discussed in chapter 2.

The advocates of rapid transformation suggested that governments are much better served if they simply divest as rapidly as possible [Boyko, Shleifer and Vishny, 1996; Murphy et al. 1992]. They argue that the gradual approach to privatisation would allow managers greater latitude to sabotage reform than will be possible with a faster divestment strategy. On the other hand advocates of gradual transformation suggested that gains from hasty privatisation must be weighed against the social costs of speed like high unemployment [Aghion and Tirole, 1993; Katz and Owen, 1993].

The empirical cases studied reveal that the performance and value created in 1995 improved. The government of Eritrea liberalised trade and prices in 1991 and reformed the state-owned enterprises by granting operational autonomy to enterprise managers in 1995. These reforms done prior to privatisation announcements have helped the companies to create value in the food processing, beverage and footwear and leather enterprises. The value lost in the textile enterprises was also minimised. However, the financial performances and the value created in the enterprises decreased in 1997, when the Government offered the enterprises for sale. This suggests that reforms implemented prior to the announcement of sale improve the value created (supports the view of gradualists), while once companies are offered for sale quick divestiture is best (supports the view of rapid privatisation).

On sequencing of privatisation and restructuring: According to Megginson and Netter [1999], one of the most commonly asked practical questions about privatisation is whether governments should restructure state-owned enterprises prior to sale or leave any such restructuring to private buyers. The early advice from the World Bank [Nellis and Kikeri, 1989] was that governments should restructure state-owned enterprises prior to divestment, both because they are better able than private owners to cushion the financial blow to displaced workers (through unemployment and pension payments) and in order to provide a private buyer of the state-owned enterprises with a ‘clean slate’. For instance, preparing companies for privatisation
was the standard practice in the U.K. Portes [1994, p. 1187] argues: “Privatisation of large state-owned enterprises is not a disastrous one, given the constraints and the alternatives. There is still time to do some of the restructuring necessary to make privatisation successful.”

However, the World Bank and its affiliate IFC later on advocated for selling company ‘as is’ in particular small and medium sized state-owned enterprises [Kikeri, Nellis and Shirley, 1992; Donaldson and Wagle, 1995]. Donaldson and Wagle [1995, p. 34] stated:

“Governments are often tempted to make enterprises more attractive to purchasers before sale, reasoning like house-sellers,..... However, while making a house more superficially attractive might, indeed spark greater interest among buyers and increase the chances of a good bid, buyers of most companies other than the smallest retail shops are interested primarily in company and market fundamentals, and are unlikely to be swayed by appearances.”

According to the World Bank [1995] report, although governments sometimes had to cut the size of a firm’s labour force and to absorb some debt in order to make a firm attractive to potential buyers, more extensive investments in restructuring have usually not paid off in terms of higher privatisation proceeds.

The empirical case studies of large manufacturing enterprises showed that judgement has to be exercised. For instance, the case of Asmara Brewery revealed that the Board of NASPPE stopped the rehabilitation project when partially completed. A firm must continue to adapt dynamically to its environment, grasping opportunities and avoiding hazards in order to maintain its value. Completion of the partially finished project of modernisation in Asmara Brewery would have helped the company to increase its productivity, sales and value. Moreover, even if the government does not get its money back as sales proceeds, it will come in the form of profit taxes from the future company profits. The risk of delaying investments makes companies less competitive in particular when the process of privatisation takes a long time. The cases studied show that the enterprise in transition require restructuring that creates value by influencing the fundamentals of the business rather than a restructuring that makes companies superficially attractive as stated by Donaldson and Wagle [1995]. The case studies also reveal that restructuring is not only a matter of getting higher proceeds at the time of sale, but also a matter of nurturing the value creating potential of the company in the future for enhancing the viability of the enterprises.

On adjustment to the market: According to Brada and Kutan [1994], the key issue in the process of transition from socialism to capitalism is whether the large state-owned firms can adjust in a flexible and effective way to newly-emerging market forces. Many analysts argue that state-owned manufacturing firms would not respond to the new economic environment, would decapitalize companies by paying out surpluses as wages and would then use their bargaining power to negotiate a bailout with the government [Kornai, 1990; Murrel and Wang 1993]. Kornai [1990, p. 58] argues: “It is futile to expect that the state unit will behave as if it were a market-oriented agent.... State ownership permanently recreates bureaucracy.”
On the other hand, Portes [1994, p. 1186] explained the experiences of large state-owned enterprises in Central and Eastern Europe as follows:

“The role and prospects of state-owned enterprises were underestimated—often with colourful images of producing obsolete goods…. There was no coherent policy towards them, except to privatise as rapidly as possible or simply to make them fold by cutting off finance, so little thought went into trying consciously to modify their behaviour before privatisation.”

Case studies of state-owned enterprises [Pinto et al., 1993; Brada and Kutan, 1994] evidence that the state-owned enterprises have been much more responsive than feared, but show a mixed picture. Some state-owned enterprises are seen as responding rapidly to the new market environment while others appear to be “drifting”, dissipating their assets while making little or no effort to respond to the market.

The experiences of the case studies in Eritrea also provided a mixed evidence that some enterprises in the food processing, beverage and footwear and leather industries adjusted to the market environment, while the textile enterprises had the problems of adaptation and were losing their local as well as export markets to synthetic and substitute products.

**On selectively nurturing value creation potential:** The economic aim of privatisation is improving the efficiency of the existing enterprise assets while protecting their value. The announcement of privatisation and the selling process, which started in 1997 in Eritrea, decreased the value created in the enterprises. Moreover, as the implementation of the privatisation process takes a long time the potential for value creation in the future of the companies is diminishing. The cases studied evidence that there is uncertainty regarding the time that the companies will be sold. In Eritrea, the government announced that the sales process will be completed in one year that is, the end of 1997. However, the implementation of privatisation required a longer time than planned. Over four years have passed and the large manufacturing enterprises are still owned by the state. The process of privatisation is affecting the drivers of value of the companies. When the uncertainty of the time of sale increases the government puts restrictive control measures and this is reducing the empowerment of the managers to create value and results in a ‘privatisation trap’.

The ‘privatisation trap’ affects the value drivers of the enterprises and the value performance of the enterprises deteriorates during the implementation of the privatisation process and it also affects the future value creation potential of these enterprises. For instance, the value created in Asmara Brewery decreased to a third of that of 1996 level mainly due to the ‘privatisation trap’. Moreover, the enterprise managers are restricted on hiring personnel and professional employees such as technicians are leaving for other lucrative jobs in the private sector. The exodus of the skilled employees creates difficulty in operating the machinery during the transition period and reduces the attractiveness of the companies to buyers. Human skill is an asset and contributes to the value creation potential of the companies. The managers are unable to retain skilled professionals due to a low salary in the companies to be privatised or hire new ones due to the limited availability of skilled labour in the market.
Rappaport [1986] identified that value is created by influencing the operations, investments and financing of companies and identified the drivers of value in a business. However, the case studies revealed that the ‘privatisation trap’ is affecting the drivers of value due to uncertainty of the time of sale. The cases studied evidence that the duration of the implementation of the privatisation process matters. The government need to estimate the time required to privatise companies and if the time needed is long then selective restructuring and balancing of management empowerment and control are essential for avoiding the ‘privatisation trap’ and nurturing the value creation potential of the companies. In the case of Eritrea, for instance, the beverage enterprises have been value creating and investing in modernising their machinery can improve their productivity and value. Restructuring companies at the time of sale, according to Copeland, Koller and Murrin [1990], enhances the bargaining power of the seller. Restricting investment in these companies for over four years reduces their value creating potential and their future competitiveness. The case studies show that ownership change is relevant but also other factors such as management reform and empowerment, change in management behaviour, fixed asset investments and cost controls are essential in enhancing the enterprise value and facilitating their privatisation. Moreover, enterprise structure and management of operations, investments, financing and governance influence the viability and the saleability of enterprises. Due to this, selectivity and balancing of management policy measures and government policy measures are essential for protecting the enterprises’ value and their potential for creating value in the future at the time of privatisation.

The companies in Eritrea are also highly linked with each other (see figure, A11-6). The empirical part of this study reveals that in Eritrea material costs are high and there are inter-linkages and interdependencies among the factories studied. These evidence that in Eritrea, the Value Chain Model of Porter [1985] is relevant for creating value. The value chain analysis can reveal where value can be created within the enterprise, within the value chains of the suppliers or within the value chain of the customers. The NASPPE should also consider the interdependencies and linkages of companies at the time of privatisation. Privatisation of a supplier, for instance, may cause a chain reaction on the dependent firms by cutting the already established relationship and destroy value. Moreover, for instance the Keih Bahri Tannery is the supplier of finished leather to the private and public shoe manufacturing companies in Eritrea. However, the government is not renovating the old machinery in the tannery due to privatisation and thus, the whole footwear industry is becoming less competitive quality wise in shoe exports.

The lack of institutions such as legal and financial institutions also hinders the progress of privatisation. Privatisation of large manufacturing enterprises where there is a weak private sector like that of Eritrea is difficult and takes a long time. Simply waiting to find a buyer for over four years not only decreases the value of the companies during the implementation of privatisation, but also affects the value creation potential of the companies in the future as well due to the ‘privatisation trap’. Therefore, selective nurturing of value creation potential is needed to maintain value and enhance enterprise value and develop restructured value adding private manufacturing enterprises that contribute to the economic development of Eritrea.
Policy Implications

How can the state-owned enterprises in Eritrea be transformed into value creating private companies?

Facilitate privatisation: The Board of NASPPE in Eritrea is mainly using the direct sales method with auctions. Adopting a variety of sales methods can help in facilitating privatisation of large state-owned enterprises in Eritrea. The privatisation of large enterprises in Eritrea can be facilitated by learning lessons from the experience of other countries such as the developed economies in the West and transition economies in Central and Eastern Europe. The experience of developed countries reveals that share issue privatisation is generally preferred over asset sales for large state-owned enterprises [Megginson and Netter, 1999]. The experience of the Central and Eastern Europe transition economies also evidences that share issue privatisation was used with the assistance of IFC in countries where there were no previous capital markets [Donaldson and Wagle, 1995]. This helped the countries to facilitate privatisation and to introduce and develop capital markets. Capital markets facilitate a transfer of shares, help to raise funds and can improve corporate governance by supplying relevant economic information to stakeholders [Reza, 1999]. However, capital markets cannot be effective in the absence of a well-functioning banking system. For some large enterprises in Eritrea also a partial sales such as joint venture with a strategic partner (preferably foreigner) instead of directly divesting 100% may facilitate privatisation because it can help in acquiring new technology to upgrade products and processes and it can bring in new capital to cover cash flow problems.

The experience of privatisation in the Central and Eastern Europe as well as Eritrea shows that buyers are looking for viable enterprises with the potential to thrive in the market. Preparing enterprises for sale by reducing redundant labour, imposing hard budget constraints, setting clear commercial goals, introducing performance pay and decentralising and introducing accountable management prior to privatisation helped the U.K. state-owned enterprises to attract buyers and improve their performance after privatisation [Bishop, Kay and Mayer, 1995]. In the Central and Eastern Europe also the countries are preparing enterprises for sale by financial restructuring, corporatisation and management reform. The Polish experience of privatising banks first and making banks play a role in the restructuring of enterprises indicated that privatised banks could provide enterprises with effective governance. The intertwining of Polish banks with foreign banks also helped the Polish banks to acquire skills and modern management.

The empirical cases studied in this research revealed that there is neglect of the owner once enterprises are offered for sale and the companies’ value is deteriorating as time goes on. Good management during the interim period is essential for improving the viability of the enterprises and its future competitiveness. Creating value in state-owned enterprises due to improved management systems facilitates the eventual transfer of these enterprises to the private sector [Reza, 1999]. Privatising banks and other financial institutions, starting pension programs and intertwining large enterprises with foreign similar companies may facilitate privatisation and restructuring of large state-owned enterprises in Eritrea.
Finding new markets: The Eritrean government has indicated that the footwear and textile industries will play an important role in the economy by generating exports [GOE, 1999]. However, the cases studied revealed that there is a lack of market for these companies’ products. These companies have been selling mainly in Ethiopian markets due to its proximity and the previous colonial relationship. However, the Ethiopian government put a trade barrier at the beginning of 1997 and then afterwards in 1998 also the problem of the border war started. Due to this, trade was halted and these two industries lost their Ethiopian markets.

Sharer [1999] argued that sub-Saharan African countries could encourage trade through regional trading arrangements and through more active participation in the multilateral trading system. Eritrea is a member of IGAD (Inter Government Agency for Development), which is an association of the Horn of African countries, the COMESA (Common Market for Eastern and Southern African countries) and recently joined the COMSSA (Common Market for Sahelian-Saharan countries). These trade arrangements provide larger market opportunities for Eritrean products. Access to industrial countries markets can provide a market opportunity where the enterprises can charge higher profit margins. The European Union (EU) provides trade preferences for developing countries. The Lome IV convention, signed in 1975 and extended in 1980 and 1985, gives certain products (such as textiles, leather products and others) originating in developing countries (such as Eritrea) duty-free access to the EU market. The easy access to the sea and the proximity of Eritrea to the Middle-East countries also can provide a market opportunity to manufacturing enterprises in Eritrea, because the labour costs in Eritrea are cheaper in comparison to that of the Middle-East and this can give the Eritrean companies a competitive advantage. However, there is a lack of selling experience in some enterprises, in particular the textile companies. For instance, the textile companies encountered difficulty in selling their products and resorted to bartering their finished products for cotton with two Ethiopian traders. This evidences that there is a need for organising distribution channels through effective agents who can help companies in marketing products and in providing up to date market intelligence to keep pace with changing market conditions.

Reducing material costs: The cost structure of the companies studied indicated that material costs form a large part of the manufacturing costs. The managers interviewed thus rated production efficiency and effective use of resources of high relevance in creating value. The responses of the managers of food companies also indicated that disturbances in materials supply generated critical problems.

Porter [1985] argues that when a firm sets out to become a low-cost producer in its industry, it attains superior performance. He further suggested that a firm can gain a cost advantage by (1) control of cost drivers and by (2) reconfiguring the value chain (adopt a different and more efficient way to design, produce or market the product).

The management interviews indicated that the Ministry of Agriculture could help in informing farmers on the type of agriculture products needed in the manufacturing industries. The lowlands of Eritrea have been inaccessible during 1973-1991 due to the war of liberation, but now there is an opportunity for development of commercial farms in this area, which could produce cotton, sorghum, and livestock for hides and skins for industrial inputs. The cases studied in this research also revealed that the
availability of materials at cheaper prices and importing materials at low prices during the harvest seasons helped managers to reduce costs. In addition, vertical integration with suppliers or the use of some form of alliance can ensure continuity of the supply of materials. Moreover, improved materials management, researching for sources of raw materials in those countries that are competitive and training on materials management and logistics can assist the improvement of cost efficiency in the enterprises.

**Investment in fixed assets and the upgrading of technology:** Obsolete technology is one of the main constraints that the companies are encountering in competing. At the time of establishment many companies started operations with second hand machinery and except in the beverage enterprises, there was no major investment done after the independence of Eritrea.

The interviews with the managers of the footwear and leather and textile industries also indicated that obsolete machinery is a problem and step-by-step renovation of critical areas would have increased the sales of the companies. For instance, Keih Bahri Tannery is the sole supplier of tanned leather to public and private enterprises in Eritrea. However, since the machinery in this tannery is old, the tanned leather produced is of a lower grade. The shoe manufacturing companies are becoming less competitive at the export markets due to the relatively low quality of the shoes produced with this lower grade leather. Renovating the machinery of Keih Bahri Tannery can benefit the domestic shoe processing factories growth in Eritrea. The textile industry managers also complained that the spinning department machinery is old and is producing lower quality threads. Due to this, the exports of knitwear articles are affected. Investments in critical parts can improve the viability of the textile industries. The case study of Eritrea Textile Factory also revealed that the knitwear articles of the company are not exported because they are not combed. Introducing combing machines at the Spinning Department of the factory can open new export markets for the factory to Europe, the USA and the Middle East. The privatisation process of large enterprises has already taken over three years and thus, completing partially finished projects like that of Asmara Brewery and investing in the machinery in critical areas such as those of tannery and spinning departments in textiles can create value.

**Access to finance:** The food processing, beverage and footwear and leather enterprises are financing their operations with internally generated funds retained in the business, while textile enterprises are facing financial problems due to continued operating losses. The textile companies are financing their operations with government guaranteed overdraft loans and are paying high interest costs. The managers interviewed stated that the interest rates of the Commercial Bank of Eritrea are very high and they indicated that there is a need for long-term financing using low interest rates from the World Bank or other financial institutions to finance capital expenditures. The World Bank and its affiliate IFC provide financial assistance to countries reforming their economies for companies (being privatised and in post-privatisation) selectively to enhance the credibility of reforms with the investors and potential supporters [World Bank, 1995; Donaldson and Wagle, 1995]. The government of Eritrea has also recently established the Agricultural and Industrial Development Bank (AIDB), which aims at financing investment projects. The experience of the developed and transition economies revealed that banks play a role
not only in providing loans, but also in providing governance by participating in the board meetings to control organisations. Since there is no capital market in Eritrea, the banks can play a role in providing the governance needed. Introduction of pension funds and the development of capital markets also helped the transition economies as a source of funds for enterprise restructuring and privatisation. There is no pension or capital market in Eritrea. Development of private financial institutions and designing pension policies and starting capital markets also may contribute as a source of finance and governance for the enterprises in Eritrea.

Empowering and controlling managers: The cases studied indicated that prior to 1995, the Ministry of Trade and Industry strictly controlled managers, but in 1995 the Government allowed operational autonomy. This contributed to the performance improvements during 1995 and 1996. However, in 1997, the Board of NASPPE put restrictions on inventory purchases, credit extensions and fixed asset investments. Due to these restrictions managers were constrained from creating value and the performance of the companies declined in 1997. The managers also perceived that the management team was hardly empowered to create value on the most critical activities.

Giving managers the autonomy to respond to competition and holding them accountable for results can enhance value creation. According to Scott [1998, p.182], “The more decision-making power managers are given, within reasonable limits, the more commitment they will feel to delivering outstanding results.” According to him empowerment works when increased responsibility is matched with increased autonomy of decision making, with enhanced performance-based rewards and with concerted investment in management training.

Good management of the companies during the interim period is essential; otherwise, companies destroy value. A rationalisation program for public enterprise management could be formulated which could include (1) a further strengthening of policies to encourage the enterprise managers to operate with full managerial, administrative, financial and operational autonomy; (2) technical, organisational and financial rehabilitation to allow the enterprise to operate efficiently and to reach at minimum the financial “break even point” and (3) a training program for managers and selected staff to improve practices and quality of operations, and in parallel, an infusion of technical assistance would be appropriate [World Bank, 1994].

The empirical part showed that there was neglect on the side of the owner. Companies were not nurtured to compete effectively at the market because the owner did not inject new capital. The owner was also placing strict control on enterprise managers and there was no management incentive system provided.

Training needs: The case studies reveal that there is a need for training in technology-related fields and marketing. The managers identified training in technological fields such as leather technology, textile technology, milling and others. Asmara Brewery and Red Sea Bottlers Share Company introduced new technology, but encountered problems of operating programmed logic computer systems (PLC). The Eritrean manufacturing firms have been getting polytechnic graduates from the Institute of Polytechnic in Bahrdar, Ethiopia. Since Eritrea is a separate country now, the managers indicated that there is a need for a polytechnic institute in Eritrea or the
Faculty of Engineering at the University of Asmara may accommodate these needs. Eritrea, a small nation with a small market, needs also to embark on trading. Marketing skills can thus help Eritrea to compete in the region. The managers identified a training need in export marketing, purchasing and logistics management. Increasing and upgrading the marketing courses (only two courses at present) that the University of Asmara is offering and elevating marketing to a department level can accommodate these needs.

Focussing on value based management Focussing on value can help managers on identifying the value drivers and on influencing them to generate higher values. Value management is a new way of thinking that aims at raising the value of a company by exploiting all its internal and external potential. Value-based management has been applied in the developed countries of the West. It can also be implemented to manage manufacturing industries in Eritrea and to some extent it may be applied to public enterprises' management as well.

The case studies reveal that management policies and practices followed in enhancing the value created in a business influence the performance and the sale of the enterprises to be privatised. Companies that create value like the beverage enterprises are easy to sell while companies that destroy value like the textiles are hard to sell. Thus the saleability of enterprises is influenced by the value creation potential of the enterprise. Management actions in restructuring and managing operations, investments, financing and governance affects the value created in a business and its future viability and saleability. Moreover, focussing on the creation of value can enhance the competitive position of the enterprise. Government policies, in particular the privatisation policy also influences the value creation process. The case studies reveal that the process of privatisation hampers the value creation process and the longer the time it takes to privatise companies more value can be lost. Thus establishing sound management with the value creation focus can help in facilitating the privatisation of the enterprises and in thriving in the market environment.

Government Regulatory Intervention The Government as an industrial policy maker has been intervening in various ways in the cases studied. The Eritrean government has liberalised trade and prices in 1991, but it restricts the prices of foods (wheat flour and bread) while it also subsidises food. Fostering competition is fundamental to improving the performance of state-owned enterprises in competitive markets. However, competition can only be effective if government transfers and subsidies are eliminated. The interference in sales prices and profit margins of the flourmills and bakeries is limiting the creation of value because the factories are becoming less sensitive to customers needs.

The Government, based on its free market policy, used to allow exports of hides and skins directly, but the traders in search of quick profits exported the skins and the tanneries faced a problem of skin. Later on in 1995, the Government prohibited exports of skins without further processing and this increased the supply of skin to the tanneries and it helped them to create value and it provided employment in the footwear and leather industry. Unlike the hides and skins, the Government allows exports of cotton directly and the managers of Aligheder Cotton Plantation have been asking textile companies to buy the local cotton at world market prices. Prior to 1997, the textile companies used to import cheaper cotton from Ethiopia. Now they are
using cotton from Aligheder Cotton Plantation in Eritrea and this is hurting the textile companies. In principle, the Government should not interfere in prices; it should be left to the market. However, according to Cook, Kirkpatrick and Nixson [1998, p.14]:

“Governments have a responsibility for economic co-ordination and initiatives to strengthen particular activities and to moderate the sector costs of enterprise restructuring and sectors level economic change. Whilst in most countries markets have assumed the dominant role in allocation decisions, there remains a role for policy interventions that focus selectively on areas where the private-market development solution is inadequate…. Success is achieved through a pragmatic and judicious balance of policy measures, rather than by adopting an ideologically ‘correct’ but incomplete policy stance.”

Since this is a transition period and since the market mechanism is not fully developed, selective interventions such as in the case of prohibiting the export of raw hides may increase the overall value generated in the economy.

12.4 Future Research Direction

In this research, we have focussed on privatisation and creation of value in order to understand the functioning of enterprises in transition from state to a market economy. The findings highlight that selective nurturing of value creation potential is essential for transforming the enterprises in Eritrea. Further research on developing and designing tools to selectively nurture value creation potential of enterprises in transition is essential.

The empirical research was executed in four manufacturing industries and fourteen state-owned enterprises in Eritrea. However, the findings to some extent can provide some lessons to learn for the other state-owned enterprises in the manufacturing and service sectors and to private owned manufacturing enterprises in the same industries. For instance, the Government offered state-owned hotels for sale in 1993, but the large hotels are still in government hands and they are facing similar management problems as the cases studied. The privately owned food, footwear and leather, and textile enterprises are also encountering similar challenges such as a lack of export markets and high costs of materials. Future research can focus on these enterprises.

The cases included in this study were a few. A large-scale quantitative study would increase the statistical generalisation, validity and reliability of the results. Moreover, we have studied the management perception of relevance, influence and criticality of restructuring activities using 48 filled in questionnaires. The perception of the managers can further be studied by extending the number of respondents and analysed using multivariate analysis techniques such as multidimensional scaling and conjoint analysis to provide statistically generalizable results. Finally, the outcome of a change of ownership on company performance in Eritrea can be studied by comparing pre and post privatisation performances.
12.3 The Research Questions Revisited

1. What are the determinants of restructuring and value creation in an enterprise?

In chapters 3 and 4, we have reviewed the literature to identify the determinants of restructuring and value creation in an enterprise. The literature reviewed in chapter 3 indicated that good governance is one of the factors that affect creation of value. The relationships between managers and owners and also the relationship between the company and its stakeholders such as suppliers, creditors, customers, employees and the community influences the value created in an enterprise.

The corporate finance models of value creation [Rappaport, 1986; Copeland, Koller and Murrin, 1990] also indicated that value is created by management decisions on operations, investments and finances. The Porter’s (1985) model of industry competitiveness also indicated the industry’s attractiveness and a company’s position within the industry determine the profitability of an enterprise. Moreover, the Porter’s value chain model (1985) also indicated that value could be created by firms value chain with the suppliers and customers. The Crum and Goldberg Potential and Resilience Evaluation (PARE) model (1998) also indicated that the value created in a business depends on the company’s potential (innovation ability and implementation capacity) and its resilience (the vulnerability position of the company and reserve capacity). By combining these corporate finance and industrial theories, we have designed a framework for the study (fig 5..). This framework shows that the determinants of restructuring and value creation in a business are operations (sales, cost, productivity and profit margin), investment and financing (fixed asset investment and working capital investments, debt to total assets and capital) and governance (relationship among managers, owners, employees, suppliers, customers creditors and the community).

2. What lessons can be learned from the experience of other countries to facilitate restructuring and privatisation of enterprises in Eritrea?

In chapter 2 to 4, in order to learn lessons from other countries, we have reviewed the literature of developed economies and transition countries. Although each country is
special in some ways, some lessons can be learned from the experiences of developed and transition countries.

3. Have companies been creating value during 1991-1997, to what extent and how?


4. How are managers trying to maximise enterprise values?

The success in transition to market economy depends on the ability of managers to create value. The manager’s decision, policies and practices influence the value created in a business. The Government gave autonomy to enterprise managers’ autonomy over operational matters, but they are restricted on long-term investment. Due to this the managers had been focussing on short-term rather than long-term. The managers perception on relevance, empowerment and criticality of operation investment and financing, governance and problems showed that managers know the importance and criticality of the restructuring activities, but managers are less empowered on the most critical activities, such as acquiring new machinery and technology upgrading. The empirical study also showed that the efforts of managers from profitable companies tried to invest in machinery such as Asmara Brewery and Dahlack Shoe Factory while others did not such as the textile companies.

5. How do enterprises react to the transition to a market economy?

The liberalisation of trade and prices affected both input prices of materials and the sales price of outputs of the factories. The textile enterprises increased sales but increase in the price of materials was higher and thus resulted in losses. Due to transition to market economy the textile companies became less competitive in domestic as well as export markets. The beverage enterprises are mainly domestic oriented and by maintaining high quality and charging reasonable price, the managers were able to fend off competitors from other countries or substitute products. In food industry also the price of imported materials increased but since there is government intervention in terms of food subsidy, it did not create much problem. The Government is selling food at a subsidised price and limiting the profit margin of flourmills and bakeries. There was not much room for competition. In footwear and leather also the government protects export of raw hides and skins and this gave an opportunity to the tanneries. The footwear industry has been exporting to Ethiopia and due to the reputation of the Eritrean shoes there was less problem of competition in
the Ethiopian markets. However, in other European markets the companies were less competitive due to a lack of quality shoes.

6. What implications does the study have and how privatisation and restructuring programs can be designed and implemented most effectively? Can the conclusions be generalised?

12.2 Synthesis

The past decade has witnessed rapid economic change and structural transformations throughout the world. The worldwide change towards increased trade liberalisation and a market economy gives a decisive importance to issues of privatisation and restructuring. A reduction in government’s involvement in the direct ownership of enterprises and an increase of the private sector were frequently advocated. The western developed economies are privatising companies to improve efficiency and to enhance competitiveness of state-owned enterprises. The transition economies of Central and Eastern Europe are also adopting to a market economy and managers are restructuring their enterprises to thrive in the market. The Sub-Saharan african countries also based on the advice of the World Bank and the International Monetary Fund (IMF) are engaged in structural adjustment programs to restructure their economies. The Government of Eritrea also emphasised on the establishment of efficient, outward-looking private enterprises in Eritrea on its macro-policy.

Developing and transition economies are privatising and restructuring their enterprises to emulate the capitalist system. One of the basic pillars of the capitalist
system is value creation. The enterprises that thrive over the next decade will be those
that focus their resources most aggressively to activities which drive value creation
[Scott, 1998]. In this study, we are focussing on creation of value in order to
contribute to the macro-policy objective of the government of Eritrea. The central
theme of this study is as follows:

“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.”

Value creating enterprises and value oriented managers can contribute to the
economic development of Eritrea. The aim of this research is to study the
transformation of the state-owned enterprises. According to Donaldson and Wagle
[1995, p. ii], “the goals of privatisation are improved efficiency, high sales price,
effective corporate governance and economic investment.” In this dissertation, we
have focussed on privatisation and value creation in order to know how privatisation
influences the creation of value in enterprises in transition. Rappaport [1986] advocates
for value based management. He argues that value should be managed not only in
phase I restructuring one time restructuring like divestiture, spin-off, acquisition,
stock repurchases and debt swaps, but also in phase II restructuring (day-to-day
management of the business in planning and performance monitoring of all business
strategies on an on-going basis). Stern and Stewart and Co. [1991] also introduced
value based financial management system known as economic value added (EVA™)
to analyse and measure the value created in a business. The experiences of the
developed and the transition economies were investigated to learn lessons from
privatising and restructuring of enterprises. Moreover, the experiences of the Central
and Eastern Europe case studies of enterprise restructuring revealed the challenges
that the managers are facing in adjusting to market environment.

In the empirical part of this study, we assessed the influence of privatisation of the
economy and privatisation processes on the creation of value. In addition, we studied
management policies, practices followed in particular in financial management and
their influence on creation of value. We have studied fourteen manufacturing
enterprises in the food processing, beverage, footwear and leather and textile
industries. We have used the conceptual framework of value creation for analysing
how a firm creates value, for identifying and measuring which activities drive value
and which destroy it and for identifying actions for initiating change to enhance value
creation. The following section presents the summary and conclusions of this study.

The conclusions of this study can be summarised as follows: Even though each
country is specific in its own way, the experiences of privatisation and restructuring of
enterprises in developed and transition economies provides useful lessons on the
method of sales, impact of restructuring and management behaviour during the
transition. Small enterprises are easier to sell while selling large enterprises is difficult
in countries with weak private sector due to a lack of capital of local investors and a
lack of interest from foreign investors. Buyers do not like to acquire indebted company and though its degree varies, most governments are restructuring enterprises for sale.

**Implications to the Model**

The case studies evidence that the conceptual framework can further be improved (see fig. 12-1). Managers must have the power to lay-off workers, seek lower-cost suppliers, end unprofitable activities and pursue new markets to create value [World Bank, 1995]. Moreover, the cases show that the decision empowerment of managers is constrained by the control of the owners and the situation of the company such as lack of financing. In addition, the backward and forward linkages with suppliers and customers respectively can help in value creation. Not only internal improvements but also external alliances with suppliers and customers can help in creating value. The case studies also revealed that not only corporate finance and industrial theories but also politics influence the creation of value.

Fig. 12-1. Conceptual Framework of this Study Revisited
According to Reza [1999], “*Even hard budget constraints and enterprise downsizing, -let alone liquidation of irretrievable, loss-making state-owned enterprises, -may not always be easy options. Consideration of unemployment and social stability often make these decisions politically unpalatable.*” In Eritrea also, the textile companies have been losing money, but despite losses the government is letting them to continue to provide employment for its citizens. The conceptual framework also extends the Rappaport Value Network model by including additional value drivers materials as percent of sales, value added per employee, new fixed assets as percent of sales, short-term assets as a percent of total assets and debt to total assets.