Summary

Introduction

The past decade has witnessed a dramatic change in our view of the legitimate role of the state in economic activities. 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. The boundaries of the state started to shift with the privatisation in Britain and peaked with the transition from state-socialism to a market economy in Eastern Europe.

Throughout the developing and transition countries governments are striving to reform their economies. Yet 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. These enterprises hinder growth, impede market liberalisation and thus both directly and indirectly limit efforts to reduce poverty. A key task facing the economies in transition is to transform state-owned enterprises into value maximising private firms [World Bank, 1995]. 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.

In Eritrea, the loss making state-owned enterprises became a burden to the meagre economy of the new nation. The government set an objective for Eritrea to realise knowledge-intensive and export oriented industries. 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 committed to privatising state-owned enterprises. In order to understand how the privatisation process is influencing the performance of the state-owned enterprises and in order to assess how managers are trying to create value in the manufacturing industries in Eritrea, we have conducted this research. The central theme of this study is:

*Whether and how the state-owned enterprises in Eritrea are restructuring into value creating, private enterprises and what lessons can be learned from their experiences.*

This book has four parts: Introduction, Theoretical Background and Literature Reviewed (Part I), Conceptual Framework and Methodology (Part II), Empirical Study (Part III) and Conclusions and Implications (Part IV). The introductory chapter elaborates the recent phenomenon of privatisation and the background history of the manufacturing enterprises in Eritrea, explores the basic problems encountered by state-owned enterprises and poses questions to be addressed in this research. The following sections summarise the theoretical background and literature reviewed, the conceptual framework and methodology, the empirical study and the conclusions and implications of the study.
Theoretical Background and Literature Reviewed

In order to highlight the relevant privatisation issues and the problems encountered in transforming state-owned enterprises, we studied corporate governance as well as value creation theories. Moreover, we reviewed the relevant literature on privatisation and restructuring of state-owned enterprises of the developed countries and the transition economies of Central and Eastern Europe to learn lessons from their experiences.

Corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. The primary reason for corporate governance is the separation of ownership and control, and the agency problems it engenders. Corporate governance has recently become a key discussion item for the reform of state-owned enterprises and the development of modern enterprises. The review of property rights theory, agency theory and incomplete contracts theory highlighted the importance of ownership and owner-manager relationships in creating value. To this, we may add that management empowerment is essential in enhancing the value of a company. However, ownership control remains important to follow whether management is creating value.

The value creation models reviewed highlighted important factors in creating value in enterprises. The Restructuring Pentagon of Copeland, Koller and Murrin [1990] indicates that the firm value will increase by internal and external restructuring of a business. They argue that even if a business is to be sold, internal and external restructuring of the business can increase the value of the business and the bargaining potential of the seller. The Crum and Goldberg [1998] Potential and Resilience Evaluation (PARE) Model also focuses on value creation and shows that innovation ability, implementation capability, vulnerability position and reserve capacity are the main determinants of creating value. The Porter’s [1985] Value Chain Model indicates that cost leadership and differentiation help the company to create value. Controlling the cost drivers, reconfiguring the value chain and becoming unique in some dimensions creates value. Porter argues that value is created when a firm creates competitive advantage for its buyers, lowers its buyers’ costs or raises its buyers’ performance. The Rappaport [1986] Value Creating Network Model shows that managers’ decisions on operations, investments and financing create value and it aligns the value drivers to the enterprise objective of value creation. These models were used in designing the conceptual framework of this study.

The experience of the United Kingdom (UK) revealed that the Government has prepared the state-owned enterprises to be privatised by imposing hard budget constraints, clear commercial goals, performance pay and decentralised and accountable management reforms [Bishop, Kay and Mayer, 1995]. Share issue privatisation was also the most widely used method in UK. The experience of the Central and Eastern Europe countries also revealed that the common methods were sale of state-owned enterprises’ assets in auction or public offering of shares, free distribution of vouchers and leasing and management contracts. Some governments also tried to restructure enterprises to make them attractive to buyers mainly by refinancing of debt.
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 based on the value based management models [Rappaport, 1986; Copeland, Koller and Murrin, 1990; Crum and Goldberg, 1998 and Porter, 1985] and corporate governance theories. The framework includes operations, investment and financing, governance, value creation and enterprise environment. The conceptual framework is used to identify potentially relevant factors for creating value in enterprises in transition and it was also used to focus the collection of data and to structure the analysis in the enterprises studied.

In order to take an in depth study of limited cases, we have selected a case study method [Yin, 1994]. Cases within the food, beverage, footwear and leather and textile industries in Eritrea were selected. Multiple data collection methods strengthen grounding of theory by triangulation of evidence [Eisenhardt, 1989; Scapens, 1990]. Due to this, we collected financial statement data, distributed questionnaires to managers and interviewed managers and Government officials. The financial data collected are analysed with financial techniques such as ratio analysis, 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.

Empirical Study

The Eritrean economy is largely based on agriculture and the manufacturing industries are mainly agro-based. The government of Eritrea offered 39 of the large manufacturing enterprises in Eritrea for sale at the end of 1996. The government also established a privatisation agency known as National Agency for the Supervision and Privatisation of Public Enterprises (NASPPE). At the end of June 1999, the NASPPE sold 18 companies mainly smaller enterprises while 21 mainly large enterprises were still under government ownership. Moreover, small enterprises were quickly sold because there was demand for them from local investors, while selling large enterprises was more 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 explore and explain how managers are creating value and in order to assess the influence of privatisation on company performance, we have made an empirical investigation of which the findings are discussed in chapters 7-11 of this book. In the following paragraphs, we will highlight some of these findings relating to operations, investments and financing, governance and value creation.

Operations: The availability of domestic market demand and the over thirty years of experience of distributing products directly to the customers has helped the beverage enterprises to have well organised sales departments and skilled sales persons. This has helped the companies to adjust when the government liberalised trade and prices. Unlike the beverage enterprises, the footwear and leather and the textile enterprises had been selling their products to a distribution agency (EDDC). 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 with respect to their prices. Material costs are fairly high in comparison to the labour and overhead costs of all the companies studied. The shortage of raw material supply and the low quality and high cost of the supplied material are the main constraints in the food processing and footwear factories in Eritrea.

**Investment and Financing:** Except in the beverage enterprises, there was no major investment in fixed assets in the enterprises studied throughout 1991-1997. A lack of investment in new machinery and upgrading of technology made the enterprises less competitive in the market. The Board of NASPPE does not allow new investments due to privatisation. In Asmara Brewery, for instance, the Board stopped the modernisation of the Bottling Department, when the project was partially completed. The Ministry of Defence also is not authorising long-term investments, not even when the companies, such as Barka Canneries, are not offered for sale. The financial structure analysis revealed that the textile enterprises are highly indebted. The managers of food processing, beverage producing and footwear and leather enterprises are therefore preferably using retained earnings to finance their operations and investments. The Board of NASPPE, however, declared a dividend payout of 80% of profits on the assumption that since the companies are going to be privatised, there is no need of retention of large amounts of profit in the company. However, some companies such as Dahlack Shoe Factory and Asmara Pickling Tannery were not able to finance their working capital requirements to meet their operations.

**Governance:** The Government as an owner neglected the companies to be privatised. 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. The salary of the workers of the state-owned enterprises was low in comparison to the salary of the private sector and civil servants in Eritrea. Due to this, skilled professionals such as engineers, technicians and accountants are leaving their jobs in state-owned enterprises for better paying jobs in the private sector. The exodus of skilled employees from state-owned enterprises is reducing the potential for value creation in these companies.

**Value Creation:** The food processing enterprises on average destroyed a value of two million Nakfa each year during 1991-1997. These enterprises 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 a third of that of 1995 due to the privatisation process. The footwear and leather enterprises on average created a value of one million Nakfa each year during 1991-1997. The shoe manufacturing enterprises on average lost value, while the tanneries created value. The tanneries created value since 1995 because the government stopped fixing tanned leather prices. The textile manufacturing enterprises studied destroyed value during 1991-1997, due to an absence of orders, obsolete machinery and technology and a lack of long-term financing. The operating losses of the companies also hampered the restructuring of the enterprises.
Due to the implementation of the privatisation process, the NASPPE is restricting managers in policies and practices followed in operations, investments and financing and governance of enterprises. In addition, the enterprise environment in poor developing countries constrains the saleability of state-owned enterprises. We summarise these restrictions with the term ‘privatisation trap’. The ‘privatisation trap’ created uncertainty with managers and employees and restricted managers’ decision power to create value in enterprises.

Conclusions and Implications

One of the economic aims of privatisation is improving the efficiency of existing state-owned enterprises while protecting their value. This research evidenced that the longer the time of implementation of the privatisation process, the higher the value that can be destroyed in state-owned enterprises to be privatised. During the privatisation process agency problems between management and the state as an owner increases. The managers are uncertain about their future and the state also increases its control mechanisms on companies to be privatised. The state restricts the authority of managers in operations, investment and financing and governance. These restrictions reduce the management’s decision-making empowerment and destroy the value creation potential of the enterprises. Moreover, the saleability of the large state-owned enterprises in poor developing countries is constrained by a lack of potential buyers and capital markets. Therefore, privatising state-owned enterprises in poor developing countries is more difficult in comparison to the privatisation of state-owned enterprises in the developed countries. The increase in agency problems during privatisation and the constraints encountered in selling state-owned enterprises in poor developing countries result in a ‘privatisation trap’.

This study documents theoretical and policy implication of the study and the implications of the research to the conceptual framework (model). The debate on the speed of privatisation is centred on the ‘Big Bang’ approach that is divesting state-owned enterprises as rapidly as possible and the ‘Gradualist’ approach, that is slow privatisation. This study evidences that reforms prior to the announcement of sale improve the value created in enterprises, while once companies are offered for sale quick divestiture is best. Moreover, the debate on the sequencing of privatisation and restructuring is focussed on whether governments should restructure state-owned enterprises prior to sale. This study shows that judgement has to be exercised. The cases studied revealed that selective restructuring and nurturing the value creation potential is essential. In addition another debate on privatisation is whether state-owned enterprises adjust to the market environment. The case study of Eritrea provides mixed evidence that some enterprises in the food processing, beverage and footwear and leather industries adjust to the market environment, while all the textile enterprises are encountering difficulties in adjusting to the market environment.

In order to transform the state-owned enterprises in Eritrea into value creating private entities there is a need of changing ownership, finding new markets, reducing material costs, investing in new machinery and upgrading of technology, access to finance, empowering and controlling managers and training management and employees.