CRITERIA FOR ESTIMATING VALUE OF GOVERNMENT OWNED COMPANIES

YORAM DAHAN
ECONOMIST

At what price is a company owned by the Israel Government to be sold? There are those who claim that until now the prices have been much too low. In her last report, the State Comptroller found some serious discrepancies concerning the recent sale of "Paz" and " The Jerusalem Economic Corp.". According to the Comptroller's findings the price set in the tender was lower than the realistic value. What is the realistic value? Are the accepted criteria in the business world (capital value, value of capitalizing of profits and market value) sufficient in estimating realistic value?

The purpose of this article is to take into consideration the factors which are taken into account when determining the realistic value of a government company. As a rule, estimating the value of a government company is done in the same way as one would estimate the value of a non-governmental company, however, additional factors have to be taken into consideration which are unique to Israeli Governmental Companies and which influence the nature of the company and the value of it's stocks: A guaranteed market for it's products, production incentives which are not based solely on profit motive, agreements between the company and the government, wages and more. The main purpose of this article is to take a look at these unique factors but first we will take a closer look at the party that is interested in selling these companies i.e. the state which is represented by the government. We shall see what the government is interested in receiving in return for the companies and how the government differs from other stock holders. To this end we shall present a review and a background and the conception that led to the decision to sell these companies.

From the narrow perspective of the government (budget, external and internal debt, balance of payments) the answer to the question: "At what price?" is naturally "The highest possible." However, from our limited experience and from the experience of other countries dealing in liquidation of assets we see that it is not so simple, as the companies that are not profitable investors are naturally not interested in buying, while it is difficult for the government to let go of the profitable ones because they bring in income for the country. It is even difficult for the government to detach itself from a company that does not make a profit because any government owned company gives political power to the Ministers in charge.

From a wider perspective, the price that the government perceives as stockholders and as sellers is not necessarily in line with that of private stockholders or prospective buyers. The government considers the cost to the economy of the country, the best interests of the public as well as other considerations such as: the type of investor i.e. foreign or local, the currency that will be used in the transaction, the continuation of supply of the product at a reasonable quality after the sale, the continued employment (especially in development areas), the type of sale (a sale through the stock market will be more beneficial to a larger number of people in the country), etc. Part of the price has to do with a concept that has changed over the years: With the establishment of the State of Israel there was a need for speedy economic development which demanded establishing industry which required large investments in amounts that were not available in Israel. It must be remembered that the capability of the private sector in Israel at the time to invest such sums was limited. Speedy growth was especially important in certain branches of the economy such as building and security and generally speaking industry in development areas. Today these considerations are no longer relevant to the same degree especially since the basic attitude towards government involvement in the economy has changed. The change is stated in the decision of the Committee of Ministers dealing with economic affairs of March 1978 which states: "The policy of the government pertaining to government owned companies is to minimize involvement as much as possible while encouraging the involvement of the private sector. Within this policy the government is interested in selling portions of, or whole companies that it owns. Sale of these companies will occur only if the price is reasonable and the buyers have the knowledge and experience to further advance the company in question." In reality the number of companies sold is much smaller than expected especially in view of the governments statements. The political dynamics and the inertia of the managements is in opposition to change. Even when there is a desire for change the preference is for gradual changes. Eight years after this decision Itzhak Moda'i was appointed Minister of Finance. Moda'i, known for his liberal thinking pushed this concept of privatisation forward by appointing one of his men, to the post of Director of the Office of Government Companies and also brought into the picture as consultants the First Boston Bank who specialize in sales of government companies. All of this gave a great forward push to the government policy but to date it is still not enough to be deemed satisfactory.

At this point it would be appropriate to note that occasionally the government does not favorably represent the public interest as it does not accurately estimate the value of a company (as the State Comptroller pointed out) and this is due to the fact that a Minister might want to demonstrate a political success by showing that the government policy of diminishing interests in governmental companies is being accomplished and therefore sets a low price.

Now we will survey the factors which influence the price set for the sale of a government company in Israel with special attention to those factors which will be influenced differently when the majority of the stocks of the company are being sold. In this case the factors to be taken into account are:

A. A government company might have a guaranteed market for it's products due to a tendency of the Government to buy products and services from companies that it owns or at least to give these companies preferential treatment in it's sales to the public. These arrangements diminish the risk factor for these companies as the demand for their products is ensured.

B. Article 4 of the Law of Government Businesses states as follows: "A Government company shall operate in the same manner as a non-governmental business with an exception in the event that the Government sets other standards (by the Financial Committee of the Knesset)." According to this policy the company may be prohibited from buying according to strategies which would have normally be followed by private companies. Thus government companies cannot always diversify their products due to government restrictions which are imposed upon them. In other words profit is not the sole factor taken into consideration. Even though it would be profitable for a company to operate in a certain area, the opportunity to function in this area is closed to it because it has not been stated as one of it's objectives. A good example of a company that has not taken advantage of it's potential due to Government restrictions is EL AL Israel Airlines which was restricted from expanding it's interests into the hotel field either on it's own or through subsidiaries because it's stated purpose as outlined in it's charter is to supply air transport. Other examples are companies that produce military products and in this case the restriction manifests itself in limitations as to whom they can sell their products. It must stated however, that the state to negotiation and change at the time of sale and it would be feasible that the Government might ask for an additional sum of money if it were asked to revoke any limiting factors. (As an example El Al could possibly become a leader in the Hotel sector due to it's resources and would therefor diminish the competition in this sector in Israel).

C. Sometimes the profitability of a

government company is relatively low and this is due to agreements between the Government and the Government owned companies which are made to serve national interests such as a desire not to allow price increases in the company's products thereby restraining the inflation rate. The prospective buyer must take this into consideration because these agreements could prove to be detrimental to potential earnings in the future. In addition there is uncertainty about the duration and conditions of these agreements and therefore the prospective buyer might pay less for the company. An example of this was the proposal to sell "Paz" when the agreement as to how to set the price of gas (from which the company draws it's profits) was not finalized at the time of the negotiations with the potential buyers. This created uncertainty which prompted the investors to offer a lower price as a compensation for the insecurity. Sometimes the Government does not have an agreement with the company but in the case of sale it would want some kind of guarantee from the buyer that they will serve it's interests such as selling only to friendly countries, supplying a product on a certain standard, etc. This guarantee can be given in the form of "gold stocks" such as were issued in the case of the Israel Chemicals Ltd. or in any other contractual form. We should be aware that in this situation the government transfers ownership to the investors in every sense but still retains that right to determine policy in a specific sector in which the Government has a vested interest.

D. The salaries of workers, especially on the managerial level are relatively lower than in the private sector. The government owned companies that are being sold are the first to feel the new Government policy and it is therefore problematic if workers have to be laid off or the working conditions impaired. It seems that government companies are less efficient than private ones due to public and social considerations. As an example there are government companies that need to fire employees but are restricted in the number of workers that they can lay off in order to avoid unemployment especially in development areas. The potential investors should therefore take into consideration the fact that they will be asked to raise salaries which will naturally result in less profit. This factor could be greatly eased if the new owner was allowed to lay off non productive workers.

E. Sometimes the potential for reacting to prevalent conditions is greatly reduced due to public control and the need to obtain Government approval. This is set out in Article II (A) (8) of the Governmental Companies Law which states: "Reorganization, voluntary liquidation, compromise, arrangement or merger with another company requires Government approval." The private company could therefore react to changes much faster because it is not subjected to government constraints and approvals.

F. Two thirds of the Directors of the government companies are appointed by the Ministers responsible for the companies and the consideration which guides these appointments is not always beneficial to the companies as they are political appointments. In practice it turns out that the Directors are not always the best professionals that the company could secure and so the decision making process is hampered. It would follow that private companies could find Directors who are able to devote more of their time and have specialization fitting their roles. Another point is that according to the Government Companies Law Directors are not allowed to receive pay whereas in the private sector the pay is an additional incentive.

In summary we can say that the sale of the stocks of a government company to a private company does not influence the value of the company whereas past experience has shown that the sale of stocks to a private company has usually increased the profitability and productivity resulting in better use of the assets of a given company. In general in the past government companies have been sold at less than their real value.

RESEARCH & DEVELOPMENT OF CARAVANS SUITABLE FOR ISRAEL HAS BEEN COMPLETED

EYTAN BLUMENTHAL
MANAGING DIRECTOR BEN-TAL ECONOMIC CONSULTATION & INITIATION OF INVESTMENTS LTD.

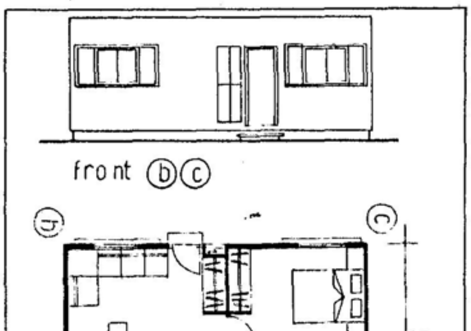
The Ben-Tal Co. in cooperation with outside investors has recently completed the development of three models of caravans which are especially suitable for conditions in Israel. The "Alon" model which is a caravan consisting of one room with a net area of 23 sq. meters, the "Yuval" model consisting of 2 rooms with a net area of 28 sq. meters net and the "Rachel" model which consists of 3 rooms with a net area of 42 sq. meters net. The caravans are constructed of fiberglass exterior walls with insulation and sheet rock interior walls. They come unassembled to the site and can be constructed in 8 hours by a professional crew consisting of 6 men.

The original Israeli development of these caravans was determined taking into consideration the following five points:

1. The price: Most of the caravans and prefabricated house which are imported and those manufactured in Israel are relatively expensive and are not suitable for meeting the massive demand that will be created by the arrival of thousands of immigrants in the coming months that will require housing. The price of the "Alon" model is $14,000, the "Yuval" model $16,000 and the "Rachel" model $19.500. As far as I know these are the cheapest caravans of this type in Israel today.

2. Supply: These caravans are to be manufactured in large quantities at a large plant in the industrial area of Ramla. After the initial running in period of two months, it will be possible to produce 200 caravans a month, including construction on site. Supply time will be only 30 days from the date of the order. In other words every order placed today (in the framework of the factory's manufacturing capacity) will be carried out within one month.

3. Adaptation to the land limitations: Experts foresee a need for 150,000 residential units during the next three years. The present pace of construction is slow and there is no doubt that temporary neighborhoods of caravans will have to be set up in all of the large cities. There is not a lot of land available and therefore it is important to take maximum advantage of every square meter of land. It would be absurd to import three room caravans of 70 sq. meters size with windows on all sides. The caravans



A THREE ROOM CARAVAN, "RACHEL" TYPE, 42 SQ. METERS

developed by the Ben Tal Co. are 23 - 42 sq. meters and one wall of each is designed so it can be connected to another caravan - a sort of two family cottage, thereby saving land.

4. Suitability to Israeli climate: Some of the caravans which are to be imported are not suitable to our weather conditions and they deteriorate very quickly. The Israeli designed caravans are insulated thereby promising that during the summer they won't be too hot and in the winter not too cold. The Israel Standards Institute recently published a new specification in which they recommend that caravans and prefabricated house have a prepared space for the installation of an air conditioner. We feel this is absurd as we are speaking about temporary housing which will be used only until permanent apartments are ready. In temporary housing such as this people would not invest in air conditioning.

5. Sophistication in planning and execution: The architect who designed the caravans gave a lot of thought and attention to details with the objective of ensuring speedy production, inexpensive on the one hand but providing maximum comfort for the future occupants on the other. Various elements that can be seen in the smaller caravans are repeated in the larger "Rachel" model. The simplicity of planning allows for quick assembly of the caravan. It is also possible to supply suitable furniture and electrical appliances (for an additional charge) and then the family would enter a furnished apartment ready to live in.

In order to reach an output of 1200 caravans in 6 months (200 a month) an investment of $6 million is required: for production lines, machinery, raw materials and running capital. The promoters are therefore seeking one or more investors that will enter into a partnership with them on this project. The managers of the Ramla plant want to emphasize that they are not looking for a partner for their plant which deals with construction of industrial buildings on a large scale throughout Israel. They are interested in partners for this specific project for which a separate limited shares company will be created of which the stockholders will be foreign investors, the engineers at the Ramla plant (who will supply the site and professional know how) and Ben-Tal Economic Consultation & Initiation of Investments Ltd. who will provide the marketing aspect and management of the project. This will make possible receipt of the contract from the government ministries and local councils for the supply of the caravans.