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Assessment of Valuation Methods and Modalities of Divestment used by Privatization and Public Enterprises Supervising Agency (PPESA)

A research project submitted in partial fulfillment for the Degree of Executive MBA

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Declaration

I, the undersigned, declare that this project is my original work, has not been presented for a degree in any other university and that all sources of materials used for the project have been duly acknowledged.

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This is to certify that the research project prepared by Saba Esseye, entitled: Assessment of Valuation Methods and Modalities of Divestment used by Privatization and Public Enterprises Supervising Agency (PPESA) submitted in partial fulfillment of the requirements of the degree of Executive Masters of Business Administration complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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Saba Esseye

Abstract

Privatization of State Owned Enterprises (SOE) has increasingly become an important phenomenon in both developed and developing countries in the last few decades. Literatures on privatizations in Ethiopia indicate that Privatization and Public Enterprises Supervising Agency (PPESA) has a closed door policy and little is known regarding valuation of the Enterprises to be privatized. The aim of this paper is therefore to fill this gap, assess and increase knowledge on how valuation is being done in Privatization and Public Enterprises Supervising Agency (PPESA). The methodology used is a case study design where the units of enquiry focus on the valuation method and the modalities of divestment. Both primary and secondary data are used; interview of relevant experts in PPESA and data of 316 privatized firms. Relevant books, publications & reports have also been examined. Moreover, the status of privatization is reviewed and trends are analyzed; attempts are also made to examine the variance of this valuation with the final acquisition value. The findings show that PPESA uses both asset valuation & business valuation methods. PPESA has shown effort to use current acceptable methods and tools like Capital Asset Pricing Model (CAPM) during business valuation, but it may be misleading to use it in the absence of a stock exchange and other standards to refer to estimate the different variables in the model. The data also shows that privatization has not attracted FDI as expected; though with limited data and only one variable was used, the valuation of the firms in estimating the market value seems very low. In almost all cases the valuation is much lower than the acquisition price. It is recommended that in order to address challenges with valuation, there is a need for stock exchange both for privatizing the remaining firms with PPESA as well as for making progress in the trade industry in Ethiopia.

Key words: Privatization, valuation methods, modalities of divestment

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List of Abbreviations

CAPM	Capital Asset Pricing Model
EPA	Ethiopian Privatization Agency
FDI	Foreign Direct Investment
GoE	Government of Ethiopia
MoPE	Ministry of Public Enterprises
NPV	Net Present Value
PE	Public Enterprise
PPESA	Privatization & Public Enterprises Supervising Agency
SAP	Structural Adjustment Program
SOE	State Owned Enterprises
WACC	Weighted Average Cost of Capital

Chapter One

Introduction

1.1 Background

Ethiopian Privatization Agency is established after EPRDF came in to power by throwing out the socialist affiliated Derg regime where private ownership was discouraged by a strict limit on the size & type of the ownership. This policy of the Derg regime & the confiscation of private property that occurred at the start of this regime made the government to own many enterprises engaged in a different type of business sectors. Due to this fact EPRDF has received many public enterprises by the time it came to power in 1991.

The Ethiopian Privatization Agency was, therefore, first established in 1994 as per proclamation No. 87/1994 with the main theme of

- Taking the government out of the manufacturing & service industries thereby instituting private ownership;
- Encouraging the expansion of the private sector & thereby promoting the economic development of the Country.

The influence from the different international monetary organizations has also fastened the establishment of this agency. As indicated by Worku (2005), many developing countries including Ethiopia have privatized public owned enterprises as a manifestation of their commitment to implement the reform packages induced by multilateral institutions through the Structural Adjustment Program.

Later in 2004, the two entities, Privatization Agency & Public Enterprise Supervising Authority were amalgamated into a single authority as “Privatization & Public Enterprise Supervising Authority (PPESA)” through proclamation # 412/2004. The reason for the amalgamation was to coordinate the implementation of the privatization program with the activities of supervising public enterprise which was engaged in the support of public enterprises to make them competitive & profitable.

In 2015, PPESA is reorganized as “Ministry of Public Enterprises (MoPE)” through proclamation no. 915/2015 to redefine the Organization, Powers & Duties of the Executive organs of the Federal Democratic Republic of Ethiopia. With this new arrangement, the privatization task is handled by the Investment Administration & Privatization Directorate under the state Minister for Corporate Finance. This research was conducted while MoPE was operating under the official name of PPESA. The name PPESA is used throughout this research report as the data obtained & the interview conducted are relevant with this context.

According to publication of PPESA (PPESA, 2013), the Privatization wing of PPESA started its task, with 234 State Owned Enterprises (SOEs) In these two decades it managed to sell the majority of the enterprises. Many concerns are, however, raised around the clarity of the sale as some of the enterprises still do not get a buyer.

One major component of the privatization process is the valuation of these firms. Before a Public Enterprise (PE) can be sold to private investors it is necessary to determine the price of each share (the value of the company). Firms can easily be valued when Capital Markets exist; Ethiopia has no capital market until now and in the absence of this capital market, valuing firms couldn't be a straight forward process. It will also make it open to bias & criticism.

Concerns about privatization typically focus on the pricing of assets, transparency, and labor impacts (Vuylsteke, 1988). A saying that shows the important role of valuation in privatization process & the impact it has on the outcome to stake holders & the public at large. Similar concerns are also raised in the Ethiopia case being unsure that the public property is transferred to private owners with a well-deserved price or not.

Hishe (2005) in his assessment of the privatization process in Ethiopia expressed that the criteria for evaluating bids, selecting buyers, and selecting enterprises for sale were not clear. He states that the valuing system was so vague and confusing that led to suspicion of the whole process.

This research therefore focuses on the valuation methods used by the Ethiopian privatization agency when valuing firms to be privatized in comparison with

acceptable methods described & accepted by the literature. In what follows, the statement of the problem is presented along with the research objectives.

1.2 Statement of the Problem

According to proclamation No. 87/1994, the Ethiopian Privatization Agency (EPA) is established to privatize enterprises under the government control so that the government can get out of the different manufacturing and service giving businesses for a better future of the industries by attracting foreign & local investment. The first objective of the Agency is to implement the Privatization Program in accordance with the privatization of Public Enterprises legislation and in a transparent and efficient manner.

One major step in the privatization process is valuing the firms to be sold and selecting the methods of divestment. However, there are arguments that the agency lacks clarity & has a closed door policy regarding valuation (Hishe, 2005). This in turn makes it unclear whether the firms are finally sold out with a reasonable price or not thereby creating a void in the process of privatization and exposing it to criticism. This gap is creating public discontent and uncertainty in the benefit the government/public is expected to obtain from the sale.

As it is documented one of the main objectives of the Ethiopian Privatization Agency is to implement the Privatization Program in accordance with the privatization of Public Enterprises legislation and in a transparent and efficient manner. Little is known, however, how firms are valued when floated for tender, thereby lacking transparency. There is, therefore, the need to assess the valuation of firms & methods of divestment used by the Agency.

Although many researches have been conducted with regard to the privatization in Ethiopia, little or no detailed work has been done with a focus on valuation. One major work regarding valuation of Public Enterprises was done by Kuma Tirfe in 1993. His work assesses the existing situations in Ethiopia & requirements of privatization when the then Transitional Government of Ethiopia endorses a policy of privatizing Public Enterprises. His study was made at the start of privatization in

order to give idea on how privatization should be treated & to indicate requirements & challenges.

Other works on privatization after the Government of Ethiopia (GOE) started privatizing Public Enterprises mostly focus on assessing the general process of privatization (not going in detail about the valuation), and dealing with the legal aspects & the privatization process. (Getachew, 2003) dealt with the process & performance of privatized manufacturing firms. He focused on analyzing the profitability; efficiency, capital expenditure, employment statuses of manufacturing privatized firms. Hishe (2005) has done broader assessments about the whole process of privatization, valuation being one component. Many others focused on assessing whether the government met its objective when privatizing the public enterprises by taking the different objectives separately.

Other researches made on privatization are focused on assessing the efficiency of privatized firms by taking a single sector or industry in comparison with other private firms in the same industry or sector. Worku (2005) assesses the efficiency of privatization in manufacturing industries. Dereje (2005) deals with the financial & operating performances of newly privatized firms in the case of Leather Industries.

Others assess the role of privatization in investment attraction & its general contribution to the Ethiopian Economy. Selvam et al (2013) made an empirical study about privatization potentialities in investment attraction. And Eshete (1996) dealt with the impact & policy implications of privatization in Ethiopia.

The intention of this paper is, therefore, to assess and increase knowledge on how valuation is being done in PPESA, examine the valuation methods used in light of acceptable valuation methods and compare the performances with other similar countries. Attempts are also made to examine the variance of this valuation with the final acquisition value as well as to review and analyze the modalities of divestment used by PPESA. Accordingly, the following research questions are addressed.

1. How does the privatization trend in Ethiopia look like?
2. Are the valuation methods the agency uses accepted in the literature?
3. Does the Agency use relevant expertise in valuing the PEs?
4. Assess how close the value determined by PPESA is with the market value?
5. What modalities of sale (methods of privatization) were used in comparison with other African Countries?

1.3 Objectives

The general objective of this study is to assess the Valuation Methods and Modalities of Divestment used by PPESA.

Specific objectives include:

- To identify, describe and examine the valuation methods used by PPESA in comparison with acceptable methods
- To measure the variance of the valuation with the acquisition price
- To review and assess the trend in privatization and modalities of divestment used by PPESA

1.4 Significance of the study

Ethiopia has privatized more than 300 firms until now through PPESA; valuation is one of the major milestones in the privatization process. This study will provide

- Some clarity regarding how valuation is done at PPESA
- Indicates the strengths and weaknesses of the method used by PPESA
- Show similarities and differences of the valuation methods with other African countries
- Indicate future research work on the privatization process

1.5 Scope and Limitations of the Study

The scope of this research is limited to one part of the privatization process: valuation at PPESA and the trends and modalities of privatization is assessed using the data obtained from PPESA of privatized firms up to September 2014.

The nature of the research report is more of descriptive because of the limited data to make detailed analysis. Even though most of the data was available regarding the privatization of firms, some were not open to the public. Thus, the researcher was not able to secure the valuation guidelines and depended only on the information given during the interview. There was also resistance to provide financial related data. In addition, there was some variability between data collected in person from PPESA in soft copy and summarized data on PPESA's publications. The analysis made, the findings and recommendations forwarded are therefore based only on the data obtained and the interviews made with the experts.

Chapter Two

Theoretical Framework and Literature Review

2.1 Historical Background of Privatization

Privatization of State Owned Enterprises (SOE) has increasingly become an important phenomenon in both developed and developing countries in the last few decades. More than 100 countries in the world have privatized some or most of their state-owned companies, (Nellis, 2000).

A privatization is a sale of a government owned company to private investors (Brealy, Myers & Allen, 2011). It refers to the transfer of public assets to private investors through such methods as stock offers, auctions, negotiated sales, voucher coupon exchanges & management employee buyouts. But it includes privatizing the management of state activities through management contracts, leasing, joint ventures and contracting out state activities through concessions.

Savas (2006) expressed privatization as ‘privatization means relying more on the private institutions of society, the market, the family and voluntary groups and less on government to satisfy people’s needs. This saying expresses the efficiency that is expected from privatizing.

The first organized effort to divest SOEs took place in Chile under the influence of the “Chicago boys” during the 1970s’ Pinochet era of economic reform. But the largest and best-known effort of privatization was that of Margaret Thatcher’s government in the United Kingdom during the 1980s. Thatcher succeeded in making privatization politically popular while selling off the commanding heights of the British economy: British Airways, British Airports Authority, British Petroleum, British Telecom, and several million units of public housing, to name only a few examples. Thatcher’s political strategy emphasized widespread public share offerings rather than auctions to other private firms. Over the decade, this approach tripled the number of individual shareholders in Britain, giving the policy a popular base of support. (Poole, Econlib.org)

Savas (2006) also tried to show the path privatization has gone through how it has become a world-wide phenomenon by quoting Schopenhauer as ‘all great ideas go through three stages: in the first stage, they are ridiculed, second stage they are strongly opposed, third stage, they are considered to be self-evident.’ Privatization has now reached the third stage; it is now a world-wide practice.

Privatization started to be popular in developing countries after John Williamson coined in the term “Washington Consensus” in 1989 to summarize commonly shared themes among policy advice to developing countries by Washington based institutions at the time (IMF, World Bank, U.S Treasury Department)(Wikipedia).

It refers to 10 relatively specific economic policy prescriptions “standard reform package” promoted for crisis-wracked developing countries; one of the prescriptions was “Privatization of State Enterprises”.

The motives for privatization seem to boil down to the following three points (Brealy, et al 2011):

1. **Increased efficiency.** Through privatization, the enterprise is exposed to the discipline of competition and insulated from political influence on investment and operating decisions. Managers and employees can be given stronger incentives to cut costs and add value.
2. **Share ownership.** Privatizations encourage share ownership. Many privatizations give special terms or allotments to employees or small investors.
3. **Revenue for the government:** Different arguments arise about privatization; the arguments pro privatization focus on profit maximization, efficiency, a net increase in employment & economic growth. While the arguments against privatization concern many layoffs, lack of consideration for broader social objective.

One of the reasons advocated for privatization was that the government–provided services were so inefficient and unresponsive that they gave rise to public

disenchantment. While the loss making services caused serious problems to the domestic economy (Hishe, 2005)

The efficiency gains of privatization seem warranted in many cases. Moreover, gains in productivity and output do not always imply a loss in employment. There is little doubt that when we consider privatization in a competitive environment, the change is almost certainly positive. The distributional effects, however, are uncertain and opaque. (Bourguignon & Sepulveda, 2005)

2.2 Valuation Methods

While discussing valuation methods, IVSC (2011) state the importance of distinguishing between, price, cost & value.

Price is the amount asked, offered or paid for an asset. Cost is the amount required to acquire or create the asset. When that asset has been acquired or created, its cost is a fact. Price is related to cost because the price paid for an asset becomes its cost to the buyer. But value is not a fact but an opinion of either

- a) the most probable price to be paid for an asset in an exchange, or
- b) the economic benefits of owning an asset

A value in exchange is a hypothetical price and the hypothesis on which the value is estimated is determined by the purpose of the valuation. A value to the owner is an estimate of the benefits that would accrue to a particular party from ownership.

The word “valuation” can be used to refer to the estimated value (the valuation conclusion) or to refer to the preparation of the estimated value (the act of valuing), (IVSC, 2011).

Kuma (1993) dealt about valuation just at the beginning of privatization in Ethiopia; when EPA was established. He expressed valuation as sophisticated since no particular method of valuation is considered correct and since it depends on forecast of future income and estimates of its certainty.

2.2.1 Main Approaches of Valuation

There are three main approaches of valuation. They all are based on the economic principles of price equilibrium, anticipation of benefits or substitution (IVS, 2011).

- a) **Market Approach** provides an indication of value by comparing the subject asset/business with identical or similar assets/business for which price information is available. The three most common sources of data used in the market approach are public stock markets in which ownership interests of similar businesses are traded, the acquisition market in which entire businesses are bought and sold, and prior transactions in shares or offers for the ownership of the subject business.
- b) **Income approach** provides an indication of value by converting future cash flows to a single current capital value. This approach considers the income that an asset/business will generate over its useful life and indicates value through a capitalization process. Various methods are used to indicate value under the income approach. Those methods include the capitalized cash flow or earnings method and the discounted cash flow method. The income approach requires the estimation of a capitalization rate when capitalizing income or cash flow and a discount rate when discounting cash flow. In estimating the appropriate rate, factors such as the level of interest rates, rates of return expected by market participants for similar investments and the risk inherent in the anticipated benefit stream are considered. Enterprise value is typically derived through the capitalization of profits or cash flows through the application of a capitalization rate or discount rate before debt servicing costs. The capitalization or discount rate applied is the weighted average cost of capital of an appropriate mix of debt and equity.
Small and medium-sized businesses are often transferred as an asset sale rather than by transfer of the equity interest.
- c) **Cost approach** provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction. The *cost approach* cannot normally be applied to a business except in the case of early stage or

start-up businesses where profits and/or cash flow cannot be reliably determined and adequate market information is available on the entity's assets.

The availability of valuation inputs data will also determine which approaches of valuation to use. More than one valuation approach or method may be used to arrive at an indication of value, especially where there are insufficient factual or observable inputs for a single method to produce a reliable conclusion. Where more than one approach and method is used, the resulting indications of value should be analyzed and reconciled to reach a valuation conclusion.

The value of certain types of businesses, e.g. an investment or holding business, can be derived from a summation of the assets and liabilities. This is sometimes called the "net asset approach" or "asset approach". This is not a valuation approach in its own right as the values of the individual assets and liabilities are derived using one or more of the principal valuation approaches described above before being aggregated.

2.2 Common Methods of Privatization

According to Brealey, Myers & Allen (2005) the following are the most commonly used methods of privatization:

1. Public offering of shares
2. Private Sale of Shares
3. New private investment in an SOE
4. Sale of government or SOE assets
5. Reorganization (or break-up) into component parts,
6. Management/employee buyout
7. Lease and management contract

2.2.1 Public offering of shares (IPO)

The state selling to the general public all or large blocks of stock it holds in a wholly or partly owned SOE. This method of selling requires the following to be fulfilled:

(i) the enterprise be a sizeable going concern with a reasonable earning record or potential, or that it can be readied to become so; (ii) a full body of financial, management and other information is available or can be prepared for disclosure to the investing market; (iii) there is discernible liquidity in the local market; and (iv) either the equity markets are developed or there is some structured mechanism (including a regulatory body) that can be made to function to reach, inform and attract (as well as protect) the general investing public. It meets a government's objective to encourage widespread share ownership.

The main advantages of public offerings are that they permit widespread shareholding, allow the broader resources of the general investing public to be targeted, and are normally characterized by openness and transparency. For the above reasons, they are often also politically more palatable.

Without strong equity markets, public offerings will not generate much response unless mechanisms are devised that allow the general investing public to be reached. In the case of Ethiopia, however, due to the absence of equity markets this method is not applied at all.

2.2.2 Private sale of shares

Under this transaction, the state sells all or part of its shareholding in a wholly or partly owned SOE to a pre-identified single purchaser or group of purchasers. It is assumed the SOE is a going concern set up in the form of a corporation represented by shares. The privatization can be full or partial, with the latter resulting in mixed ownership enterprises.

The sale of a government's shares in an SOE can be handled in a variety of ways. Two common ways are full competitive process, with prequalification of bidders, and

direct negotiation, with ad hoc procedures for identifying potential buyers (often involving a wide investor search).

While a sale of shares obviously implies that the enterprise would be sold as a going concern with all its assets and liabilities, activities such as balance sheet restructuring (e.g., alleviation of liabilities) may be carried out prior to offering the shares.

In some countries only one of the methods may be used. Senegal's privatization law requires a competitive process. The preamble of which specifically states the intent to avoid direct sales to predetermined buyers and the need for a transparent process (Vuylsteke, 1995).

2.2.3 New Private Investment in an SOE

This is the solicitation of new private investment by way of capital increase of the SOE. A government may wish to add more capital to an SOE (mostly for rehabilitation and for expansion) and achieve this by a capital increase opening equity ownership to the private sector. The main characteristic of such a privatization method is that the state is not disposing of any of its existing equity in the SOE. Rather, it increases the equity and causes a dilution of the government's equity position.

2.2.4 Sale of Government or SOE Assets

Here the transaction consists basically of the sale of assets, rather than shares in a going concern unlike the above three cases. The sale of separate assets may be only a means of selling the enterprise as a whole. Thus, the assets may be sold individually or be sold together as a new corporate entity.

In some cases, assets are not technically sold, but are contributed by the government to a new company formed with the private sector. The shares received by the government for this contribution may then be sold. The sale of asset can be through open competitive bidding or through direct negotiation with a pre identified party (Vuylsteke, 1995).

Scenarios observed that drives the asset selling method are:

- When it is desired to privatize part of the SOE
- When the intention is to sell the entire SOE but it is not saleable as a going concern.
- The enterprise may be saleable as a going concern but for other financial (e.g., tax) or legal reasons, a sale of assets is in the best interests of all parties.

2.2.5 Reorganization (or break-up) into component parts

This method involves the breaking up or reorganization of an SOE into several separate entities or into a holding company and several subsidiaries. This technique can be regarded simply as a form of restructuring prior to privatization.

2.2.6 Management/Employee Buyout

The term management buyout (MBO) generally refers to the acquisition of a controlling shareholding in a company by a small group of managers. It often also designates a similar transaction where employees or management and employees acquire a controlling interest.

The leveraged management/employee buy-out (LMBO) involves the use of credit to finance the acquisition, with the assets of the acquired company generally used as security.

2.2.7 Lease & Management Contracts

Both leases and management contracts are arrangements whereby private sector management, technology and/or skills are provided under contract to an SOE or in respect of state-owned assets for an agreed period and compensation. While there is normally no transfer of ownership and therefore no divestiture of state assets, these arrangements can be used to "privatize" management and operations and thereby possibly increase the efficiency and effective use of state assets.

The management contract assumes no financial responsibility for the enterprises operation while in the case of lease the private operator leases assets or facilities owned by the state and uses them to conduct business on its own account.

2.3 Privatization in Africa

Oliver C. Campbell White & Anita Bhatia put it as privatization in Africa reflects some of the problems which have beset many other development processes: lack of political commitment, poor design, insufficient resources, weak management, and corruption. But in another way it is worse because privatization is a one-off opportunity not only to reduce the fiscal & administrative burdens of a large public enterprise sector but also to spur private sector development, to instill greater government accountability, and to contribute to the fight against poverty.

Other writers have also emphasized the importance of privatization to the African region to have more dynamic private sectors, more efficient and effective infrastructure, provision and increased investment from both domestic and foreign sources. But African states have generally been slow and reluctant privatizers (Nellis, 2005). According to John Nellis, on average, African states have privatized a smaller percentage, about 40 % of their SOEs than other regions, far less than in Latin America or the transition economies. Much of the African divestiture that has taken place has been of smaller, less valuable, often moribund manufacturing, industrial and service concerns. In contrast, infrastructure privatization has lagged. Of the roughly 2300 privatizations in sub-Saharan Africa in the decade 1991-2001, only about 66 involved these generally higher values, economically more important firms.

(Kayizzi-Mugerwa, 2002) questions the commitment towards privatization in African countries as: African countries undertook privatization in an effort to assuage donor fears over domestic reform commitment than out of ideological or economic conviction.

There have been numerous strikes against proposed sell-offs of state enterprises as unions fear lost jobs or reduced benefits. Student activists, academics and others

have condemned both the theory and practice of privatization. Some indigenous business groups have criticized the prominent role of foreign companies in the privatization process. Even high-level government officials, such as Gabonese Interior Minister Louis Gaston Mayila, have denounced privatization as a form of “economic re-colonization” (Africa Recovery, 2000).

The most publicly persistent and organized opposition to privatization in Africa has come from the labor movement. In 1999, there were strikes or threatened strikes against privatization in several countries including Benin, Cape Verde, Gabon and Niger. Sometimes workers succeeded in blocking or slowing down the privatization of specific enterprises or influencing negotiations for a privatization agreement. At other times, responding to external pressures, governments have simply brushed labor opposition aside, leaving a legacy of anger and political tension.

Usually, workers are reacting against threatened jobs or the possibility that benefits might be jeopardized under new management. Fears are heightened by the fact that some of the early privatizations did result in job losses. These either came with the arrival of new management, or earlier, as governments restructured financially troubled enterprises to make them more attractive to potential buyers. In São Tomé and Príncipe, agricultural laborers not only lost their jobs when state farms were privatized, they also were evicted from the plantation housing where they and their families lived.

But now governments and privatization commissions are more attentive to job concerns. Frequently, when a state enterprise is offered to private bidders, retention of existing staff is either an explicit criterion or a major consideration when the government assesses offers. In Ethiopia too it has become part of the agreement.

While acknowledging some of these shortcomings, Mr. Oliver Campbell White, a senior public enterprise specialist at the World Bank, argues that “by and large, privatization has been really a great success. Unfortunately, people don’t know enough about it.” Overall, he told Africa Recovery, privatization has strengthened public finances by reducing the huge subsidies that governments often had to sink into loss-making enterprises.

2.3.1 Commitment and transparency

Privatization “is both an economic and political exercise but more the latter,” privatization requires “the commitment of the highest political authority.” Mr. Bernard Verr, director-general of Nigeria’s Bureau of Public Enterprises and a member of its National Council on Privatization as cited in Africa Recovery, April 2000.

Most African countries have shown their effort by creating a separate institution as commission, agency, etc which handles privatization. Nigeria has placed its privatization programmers directly under the offices of the president or vice-president, or at the cabinet level. In Botswana, the Chamber of Commerce and the trade unions were involved in the creation of the Public Enterprise Monitoring and Privatization Agency in 1999. Ethiopia has also established Ethiopian Privatization Agency in 1994.

One of the key tasks facing such agencies and commissions is ensuring greater transparency and accountability in the privatization process. Different allegations of corruption are voiced around the privatization process. The frequent secrecy or lack of public information about how buyers are selected lends credence to press reports that some privatization programs are riddled with corruption or tend to favor political insiders.

How the profits of privatization are used is another area in which greater transparency is needed. Often, governments give very little indication of how such income is spent, further fueling speculation about high level corruption or the diversion of funds for pre-election spending or to plug budgetary deficits.

2.4 Privatization in Ethiopia

Like other African countries privatization in Ethiopia started as part of the Structural Reform Program (SAP) which was induced as the economic order of multilateral financial institutions.

Ethiopia's change of government in 1991 from the communist command economy towards a liberalized market economy has made privatization & SAP in general a more important issue.

The Transitional Government of Ethiopia has taken different measures to liberalize the economy:

- A national Economic Reform Program was designed
- Public Enterprises proclamation #25/1992 was issued
- Public Enterprises were newly instituted with market competitiveness
- A supervising authority was established in charge of these enterprises
- Major policy changes were made;
 - Bank interest adjustment
 - Bank currency exchange adjustment &
 - Set up of auction for currency exchange rate
 - Investment proclamation to encourage investment
 - Lifting the government control in price of goods & services
 - Transport tariff changes

Following this adjustments, in 1994, Ethiopian Privatization Agency (EPA) was established through proclamation # 87/1994, later amended by 146/1998.

The objectives of EPA as stated in the proclamation are the following:

1. To Implement the Privatization Program in accordance with the privatization of public enterprises legislation and in a transparent and efficient manner;
2. To support public enterprises in attaining higher level or capacity utilization and the employment of better management systems & technology and thereby to improve their performance and to maximize their achievements:
3. To cause the establishment of new enterprises in sectors where private investors could not participate for various reasons and which will be bottlenecks for the overall economic development:

4. To supervise the management of public enterprises:
5. To protect the ownership rights of the state in public enterprises and share companies.

Regarding autonomy of the privatizing agencies in Africa, (Kayizzi-Mugerwa, 2002) took Ethiopia as an example & indicated that the objective of the newly created agencies was 'to carry out the process of privatizing public enterprises in an orderly and efficient manner' (Government of Ethiopia 1994). However, few countries gave the agencies complete autonomy, while the composition of their boards was steered to a large extent by the governments themselves. For example, although the Ethiopian Privatization Agency was to be an autonomous agency with its 'own legal personality', its five permanent board members were designated by the government and it was accountable to the Prime Minister in all matters. Moreover, the government would designate five permanent members to its board.

Due to the fact that the previous communist government has been nationalizing private companies, the number of public enterprises were comprising company's established by the government itself & companies nationalized & later instituted as public enterprises.

The number of public enterprises when EPA started its task in 1994 E.C were 234 containing 210, 949 employees; the enterprises were worth of 593 Million Birr (PPESA Bulletin, 2006 E.C)

Out of these 25 PEs were restituted to the previous owners & 291 PEs and units are privatized with a value of 20.4 Billion ETB until end 2007 E.C as per the data collected from PPESA.

There were 41 yet to be privatized by EPA, while 17 are excluded from privatization since the government believes that their strategic benefit outweighs the benefit believed to be achieved from privatization.

(Nellis, 2005) stated that Sub-Saharan African states urgently need expanded and more dynamic private sectors, more efficient and effective infrastructure/utility provision, and increased investment from both domestic and foreign sources.

Privatization is one way to address these problems. But African states have generally been slow and reluctant privatizers; a good percentage of industrial/manufacturing and most infrastructures still remains in state hands. Of the roughly 2300 privatizations in sub-Saharan Africa in the decade 1991-2001, only about 66 involved in generally higher value, economically more important firms.

The US Embassy in Ethiopia in the economic data page of its website depicts the Ethiopian market challenges as follows: The Ethiopian economy is going through a slow process of economic reform and liberalization; however, the Government of Ethiopia (GOE) remains heavily involved in most economic sectors. The government retains control over the utilities sector, as well as telecoms, and prohibits foreign ownership of banking, insurance, and financial services companies. State-owned enterprises and political ruling-party owned entities dominate the economic landscape, reducing room for the private sector to flourish, although many of the subsidiaries of these entities themselves seek joint venture and equity partners.

But on the other hand the IMF Country report of 1999 states the Ethiopian Economic reform program as a positive outcome. Under a World Bank Structural adjustment credit (SAC) & an Enhanced Structural Adjustment Facility (ESAF) arrangement, difficult steps were taken to liberalize the economy that has suffered from many years of civil war, food security crises & heavy central planning. Liberalizations like lifting of domestic price controls, introducing a system of foreign exchange auctions, reducing import tariffs, opening private Banks for domestic investors & the start of a privatization program with small & medium public enterprises were mentioned as a positive move.

Hishe (2005) criticizes the privatization process in Ethiopia as a whole as there has been lack of transparency in the privatization process also regarding the valuation as vague and confusing. Hishe's criticism was very strong; the effort exerted by Hishe to obtain how the valuation is done at PPESA has not been indicated. It did not also indicate the degree of transparency expected from PPESA by making comparison with other countries of a similar economic status.

Chapter Three

Methodology

3.1 Research Design

This study followed a case study design with two major units of enquiry within the process of privatization in Ethiopia. The units of enquiry are valuation methods used to value firms segregated for privatization and the modalities of divestment applied during privatization in Ethiopia. The sub-units are the state owned enterprises that were privatized.

A case study entails studying a phenomenon within its real-life setting. Rather than studying a phenomenon in general, a specific example within time and space is chosen for study. This allows a particular issue to be studied in depth and from a variety of perspectives Kitchin & Nicholas as cited by Waigama (2008). The purpose of this study together with the nature of data collected influenced choice of this research design. The key question addressed by this study is how the two major components of the privatization process worked out in Ethiopia. The case study design fits well with this question.

3.2 Data and Variables

The data used for this study is both primary and secondary data. The secondary data is a quantitative data regarding privatized firms, interview with relevant staff of the agency and document review.

The quantitative data of privatized firms contains the firms privatized, the buyer, the buyer's nationality, the date of acquisition and acquisition value.

The quantitative data is used to analyze the following relations:

- The number of privatized firms in relation to time
- The proceeds to the government in relation to time

- The type of firms privatized in relation to the modalities used
- The modalities used vs. the value of the firms
- The relation of indicative price with acquisition price using three years data

It involves analyzing changes through time, review of ratios, percentages and variance analysis.

The primary data is interview with the relevant staff; the interview though focuses on valuation, it was open ended questions that enabled more information to be obtained. This interview intention is to document the valuation experiences in Ethiopia and asses in relation to acceptable methods in the literature.

3.3 Data Sources and Method of Data Collection

The data sources for this study are secondary data & some primary data. The methods used to obtain data are the following:

(i) Quantitative data

- Current privatized firms' data was collected in person through visit to the PPESA office; the data obtained covers privatized firms data since the start of privatization in Ethiopia, 1994(1987 E.C)
- The data received was in soft copy
- Clarification on the data has been requested through a revisit to the office

(ii) Interview with relevant staff in PPESA

- Interviews were conducted with the relevant staffs in the public relations section and experts who perform the valuation of the firms.
 - The interviews with the staff in the valuation section were made through the interview guideline prepared to address mainly valuation issues. (see Annex 1 for interview guideline)
 - Same questions were raised to all the team in the valuation section to confirm consistency. Also the questions were open ended questions to help address broader issues through the dialogue.

- The interview with the public relation officer was general; mainly raising questions that come across through document review

(iii) Document review

- Reviews were also made from PPESA's accomplishment reports and publications;
- The publications were also used to verify a larger portion of the soft copy data. The publications printed at different instances contained yearly privatized firms' data.
- Data collection was limited to the relevant documents to help assess the objective & build discussion. Efforts have been made not to include non-relevant data.
- Reviews of Experiences elsewhere
 - Researches on other comparable African countries and relevant books were reviewed.

3.4 Sampling Procedure and Sampling Size

As the intention of this paper is to assess the valuation method & modalities of divestment used by PPESA, the targeted population for which this assessment is made is the privatized firms since the establishment of PPESA to the date of data collection. The data collected shows 316 firms were privatized till September 2014. This research considers the 316 firms as the population data even if in some publications a higher number is indicated. In this research the whole population data is used to analyze trend in privatization, proceeds obtained, and modalities selected.

Assessment on the valuation method used was made only by examining the processes followed which were obtained through the interview process in relation to valuation methods in the literature.

The attempt to analyze the variation of the indicative price with the acquisition price is made using only 18 privatized firms since the indicative price of the whole population was not available and in some cases was not consistent. Therefore, only 18 firms data which was available to the researcher and consistent were used to do this analysis.

3.5 Method of Data Analysis

The first research question to review the acceptability of the valuation methods the agency uses in relation to the literature was addressed through review of relevant literatures in comparison with the data obtained from the organization through document review & interview.

The data with privatized firms were analyzed quantitatively for the entire targeted population to address the trend in privatization and modalities of divestment. Relevant statistical methods like, percentages, ratios, averages, etc are used in addition to the pictorial presentation through graphs to analyze trend.

The expertise used in valuation is reviewed through the interview and relevant guidelines of PPESA. The relevance of the indicative value with the acquisition price was assessed quantitatively using a three year data. The variations were analyzed both graphically & in a percentage comparison.

Chapter Four

Findings and Discussion

4.1 Status of Privatization in Ethiopia

4.1.1 General Overview

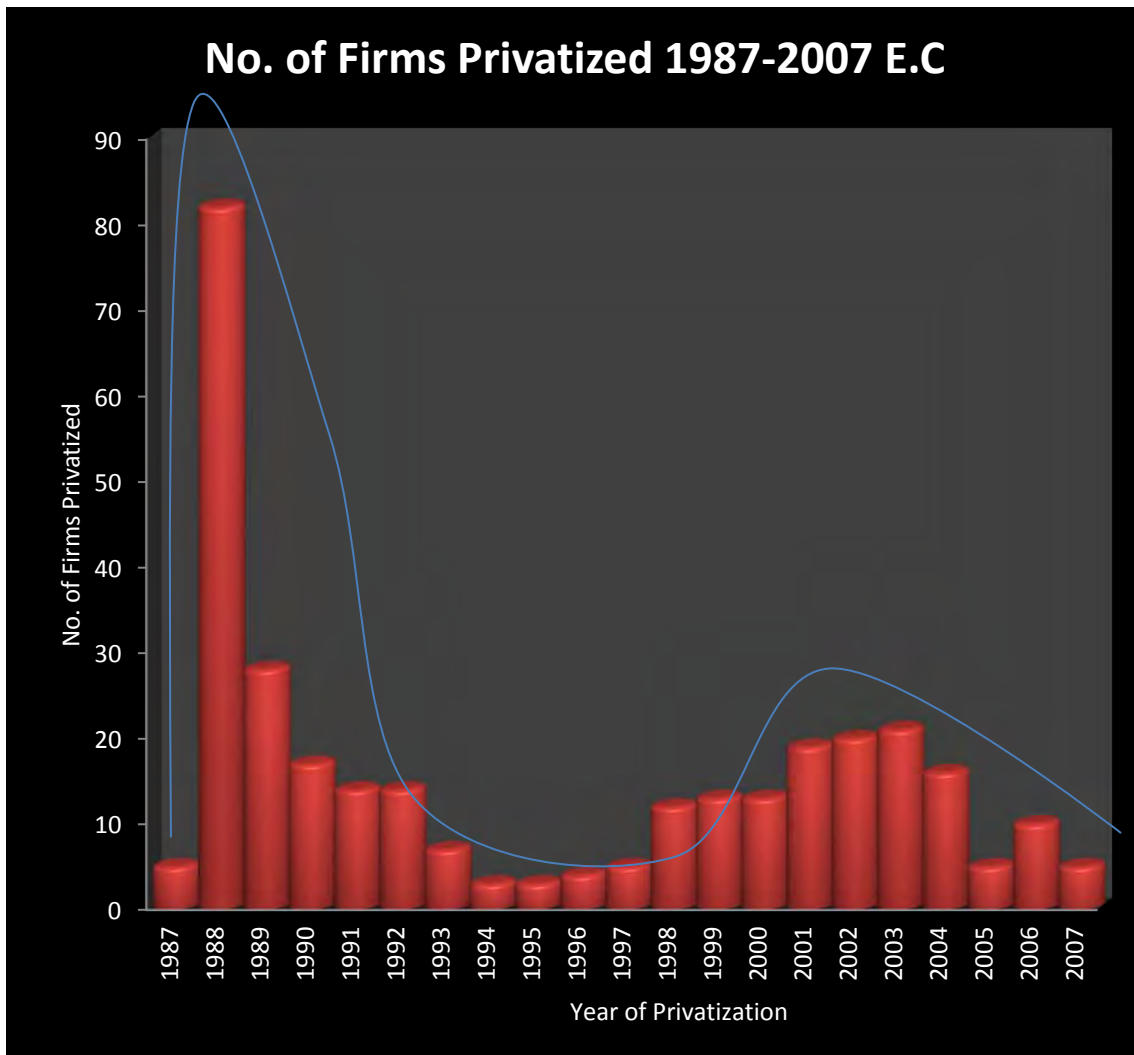
In this chapter, privatization data obtained from PPESA will be analyzed in different aspects of the components of privatization. And it is mainly analyzed in terms of the objectives of this paper.

According to the data obtained from the Ethiopian Privatization Agency, 316 public enterprises & units are sold starting from 1987 E.C until end of 2007 E.C. The sales proceeds from these enterprises is 20.4 Billion Birr. In some of the publications of PPESA the number of firms privatized is referred to be above 370 but this paper's analysis and discussion is on the 316 firms data collected from PPESA in 2015.

The graph below shows that the highest number of firms privatized was in 1988 E.C, second year after Ethiopian Privatization Agency was instituted and we observe a sharp decline up to 1993E.C. The five year period from 1993 to 1997E.C seems to be the trough of the privatization period where low numbers of firms were privatized, 1997 E.C being the lowest. In 1998E.C it picks up momentum, increasing trend is observed until 2002 E.C and declining again.

The decline in the last five years is to be expected logically as the number of firms segregated for privatization dwindles or sold out; PPESA will remain with few firms to privatize. But the period from 1993E.C to 1997E.C was significantly low.

Figure 1: Number of privatized firms by year of privatization



Source: Row data from PPESA (2007 E.C)

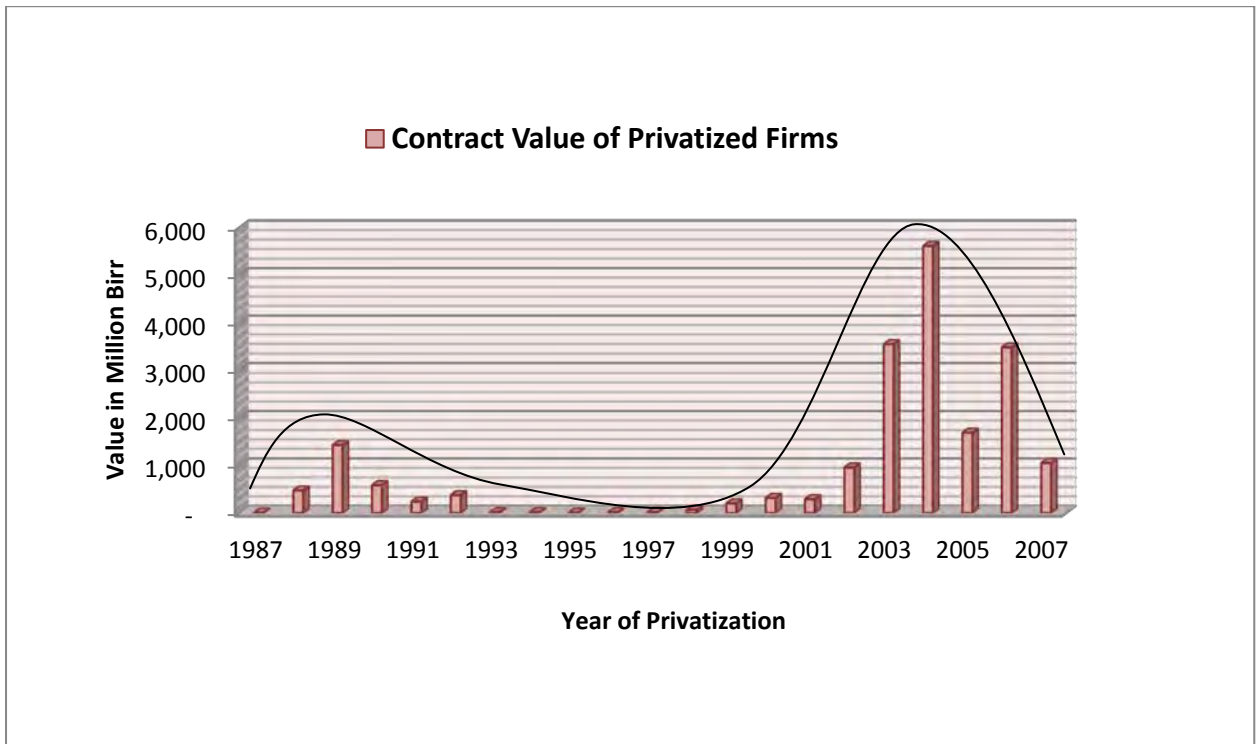
This paper gathered from PPESA's accomplishment report of 1987 to 2000 E.C, the agency noting the slow process, made an assessment of the problem behind this slow process. It is stated that the following improvements were made:

- a) Amalgamated EPA with PE supervising agency to help the time required to handle privatization.
- b) New regulation for valuation method was implemented
- c) Allowing installment payment for local investors (up to 35% down payment & 65% installment). Foreigners with other investments in Ethiopia were also allowed 50% installment payment.

d) In addition to sales, joint venture, lease & management contract methods were also put in place.

Let us compare the privatization trend we depicted above in terms of the value of the firms.

Figure 2: Value of privatized firms by year of privatization



Source: Row data from PPESA (2007 E.C)

Generally, the trend we observed above in the number of firms privatized matches the trend with the value of firms. In both cases making two bell shaped like curves where the trough in between is the period 1993E.C to 1997E.C.

But the difference is in the case of the number of firms privatized, the bigger bell curve is at the beginning of the privatization period 1987 to 1992 E.C; 1988 E.C being the pick and the smaller bell curve is at the end. In the case of the value of firms privatized, the smaller bell curve is at the beginning 1987-1992 E.C whereas the bigger bell is at the last 6 years 2002 to 2007 E.C; 2004 E.C being the pick.

What we can observe from this analysis is even if large number of firms were privatized during the beginning 5 years of the privatization period, they were relatively small in value. Firms which were economically significant in value were privatized during the last six years (2002 to 2007 E.C).

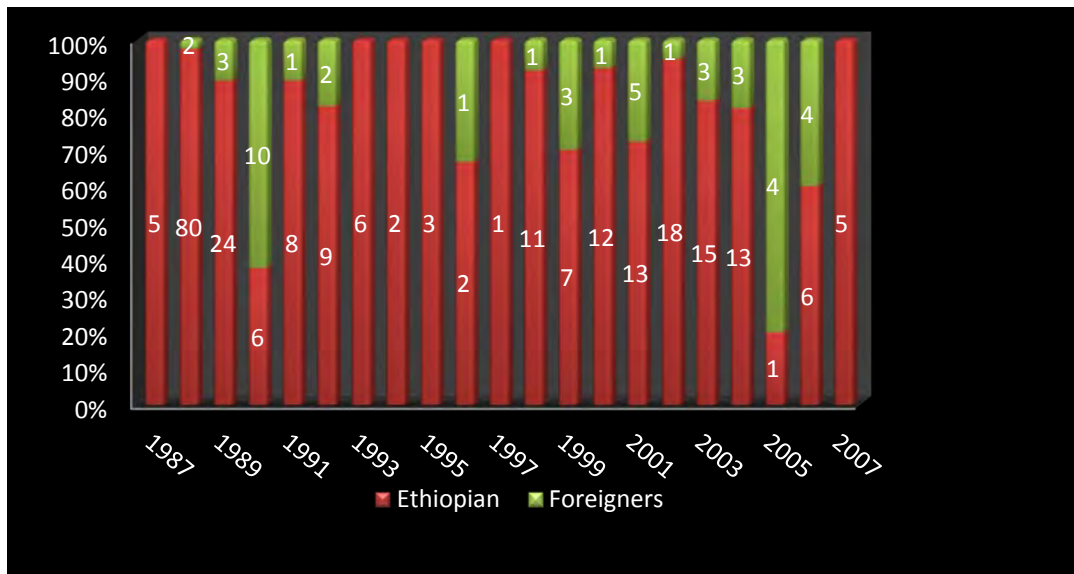
We see similarity in the case of Zambia, as indicated by (Fundanga & Mwaba, 1997) Zambia started with the small parastatal companies in tranche 1, and hoped to work up into the larger ones in later trenches.

Although they agree this approach has merits in accumulating experience which would be valuable in handling bigger & more complex privatization exercises, they also argue that it will imply starting the process of privatization on a low note and have the disadvantage not to create the necessary confidence in the international business community that the country concerned is ready to do business. A big sale such as that of a telecommunication company--one of the most popular in most programs or a profitable mining operation, such as Ashanti Goldfields in Ghana builds such a confidence in the international business community.

4.1.2 Extent of Foreign Participation

Foreign participation is often used as a measure of the success of privatization programs. It is a yardstick for measuring the degree of confidence that the international investor community has in the business environment of the country concerned.

Figure 3: Extent of foreign participation by year of privatization



Source: Row data from PPESA

In the Ethiopia case foreign involvement started during the second year of privatization, in 1988 E.C by Sheikh Mohammed Ali Alamudi. We observe more foreign involvement in 1990 E.C, but all foreign involvements until this period was only from the same investor, MIDROC Ethiopia & affiliate companies.

The data obtained from PPESA show us out of the total firms privatized during 1987 to 2007 E.C, 44 firms are bought/leased by foreigners. 55% of the foreign investments are owned by the Ethiopian born Mohammed Hussein Ali Al Amoudi. He has been heard saying in many public speeches that “I am investing in Ethiopia with my heart”. This can be interpreted as he is investing out of love/sympathy not considering the viability of the investment. In this comparison privatization through restitution is excluded since it applies for Ethiopians only. And also firms bought with a joint investment of foreigners with Ethiopians are counted under foreigners since the attempt here is to measure the degree of foreign involvement.

In general, the figure above will tell us that the foreign attraction is still minimal and Ethiopia still needs to address different issues to increase confidence in foreign investors to do business with Ethiopia.

According to Doing Business 2016, ranking countries by the ease of doing business, Ethiopia stood 146th out of 189 countries. The low rating was in the areas of starting up a business, getting electricity, registering property, protection of investors, trading across borders, getting credit etc. which implies Ethiopia has a lot to improve in these areas to attract investors.

4.2 Valuation Methods used by PPESA

The Ethiopian Privatization & Public Enterprise Supervising Agency (PPESA) as the name indicates contains two wings. One engaged in the Privatization task & the other engaged in supervising the Public Enterprises Operation. Each of the wings is headed by Deputy Directors.

Before finalizing this paper, it is gathered that PPESA is reorganized as Ministry of Public Enterprises (MoPE) through proclamation no. 916/2015 with a duty to oversee & assist PEs and also conduct the privatization program. The Ministry now oversees all PEs including those accountable to other governmental bodies. See Annex 2 and 3 for the new and old organizational structure respectively.

Under the privatization wing there is a directorate for valuation & project development which handles the valuation of the PEs to be privatized. The decision on which PEs to privatize & how many to privatize at a time rests on the Board of Directors. Per the organizational structure, the directorate for valuation starts its task after receiving this decision from the board of directors.

Generally the GOE has segregated PEs as strategic & non-strategic. Those under strategic are the ones government decided to continue control over them, these enterprises are 17 in number and are in the category of telecommunication, Banks, Electric, Sugar, Road and huge investments like EAL, Ethiopian Shipping Lines etc.

The PEs which are considered for privatization are those under non-strategic category. By the time the data for this paper was gathered, there were 41 PEs yet to be privatized more than 300 PEs were already privatized.

The valuation directorate has 4 groups engaged in valuation. Each group contains a team of 5 professionals from different disciplines. It is composed of two Engineers,

one Accountant, one Economist & one management person. One of the 5 will be assigned by the directorate to be the coordinator.

It is gathered that the directorate used to have 5 groups with the different professional discipline but staff leave the organization for better opportunities & the directorate is now functioning with 4 groups.

This arrangement of the groups is to help the directorate to handle valuation of 4 firms at the same time; each group handling one each.

The directorate for valuation after receiving the decision from BOD will assign the Enterprises to be valued to these groups of professionals.

PPESA has a valuation regulation; and these groups will use the regulation to undertake the valuation. The attempt to obtain the regulation from the agency was not possible and the discussion below relies on the interview result.

The steps followed by the group are the following:

1. Request for audited financial statement of the organization for the last 5 years with all the notes. If five years audited statement is not available the team will use the available audited statements plus the financial statements prepared by the organization.
2. Review the statements & prepare for discussion with the PEs management. Discussion with management will be made including all relevant department heads, legal attorney & key staffs. The team will request for further information and any special issue in the organization that will affect the valuation directly or indirectly. This includes visit of the organization & gathering information regarding machines that are no more functional, any bottle neck for the operation of the company, law suits that may not be stated explicitly in the audited statement and any existing & expected opportunities of the company.

This step is iterative; the teams need to make a thorough review, get back to the management & key staff for interview, clarifying issues observed that will help in the valuation process.

3. The third step is working on the valuation of the Enterprise with the available information.
4. Peer review; each group's valuation will be circulated to the other 3 groups for peer review & comments. Amendments can be made as per the comment.
5. Submission for the review of the directorate of valuation & project analysis. This person is a certified person in valuation. As per the comment provided a rework might be required.
6. Once approved by the directorate for valuation & project analysis, it is submitted for the head of the privatization wing; the Deputy Director.
7. It will then be submitted for the Agency head, the Director of PPESA's approval.
8. The final approvers are the BOD.

PPESA uses two types of valuation methods: asset valuation and business Valuation.

According to Samuel (2006E.C), whether an Enterprise is profitable or not, asset valuation indicates the total value of the Enterprises assets. But business valuation is the market value of a profitable or a potentially profitable Enterprise.

As per the article above the decision on which methods to use lies on the response to the following questions:

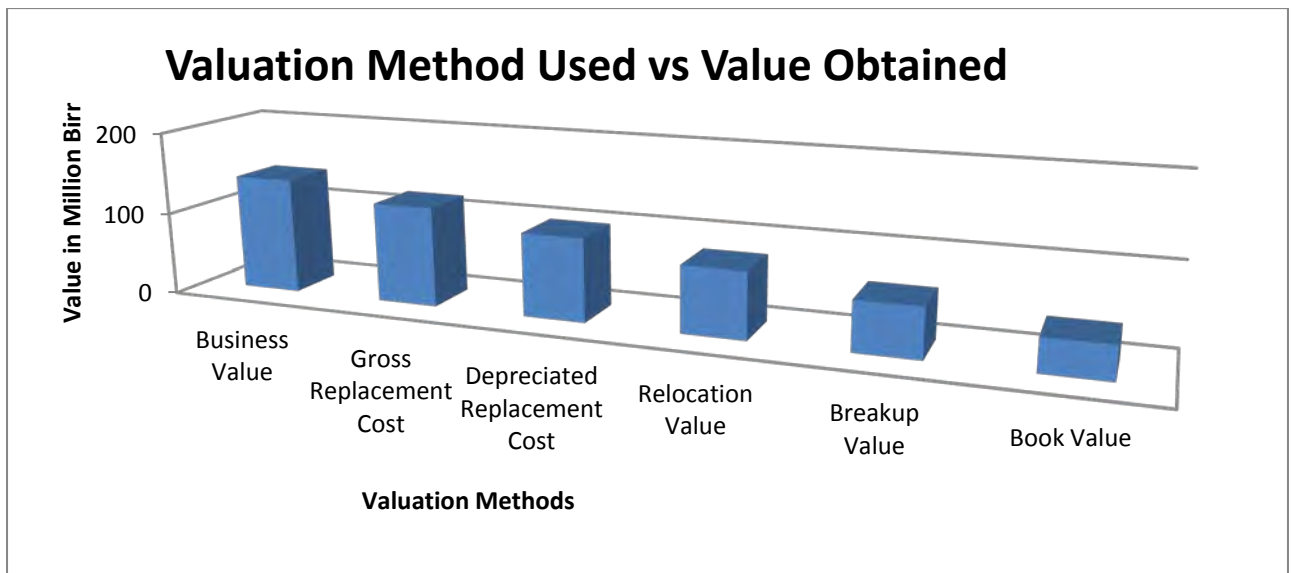
- Is the Enterprise profitable or potentially profitable? If yes, it is better to build the indicative value on future earnings of the Enterprise.
- If the Enterprise is not profitable but it is of a going concern, then a valuation that depends on its assets will be appropriate to use.
- On the other hand, if the Enterprise couldn't continue as a going concern and couldn't be sold as a going concern, then asset valuation will be done.

There are two options in this case,

1. A valuation with the assumption of putting the Enterprises assets to work as a whole or partly in a similar Enterprise (Relocation Value) and
 2. The valuation with the assumption of selling the Enterprise's assets separately to close the business as a whole (Liquidation Value).
- When there is a special purpose property, an asset valuation will be undertaken separately.
 - When an asset is non-core for an Enterprise or is an excess, an asset valuation will be made for this asset. It can be either in a market value or scrap value.

Which valuation method gives the right valuation of assets/businesses? Samuel (2006E.C) in his article on Valuation Fundamentals & Methods of Valuation explains the different valuation methods using the graph below. He explained that for a similar asset, we can arrive at a different value depending on the purpose of valuing the asset, the nature of the asset and the valuation assumptions made.

Figure 4: Valuation Methods Comparison



Source: Article by Samuel W/Yohannes on PPESA News Bulletin, Vol. 1, No8, 2006 E.C

He explained that for a similar asset, we can arrive at a different value depending on the purpose of valuing the asset, the nature of the asset and the valuation assumptions made.

He depicted in the above graph that the highest value will be obtained with the assumption that the asset will be employed to gain income in the future-using the income approach. This method will be appropriate in the case of valuing a business for sale, merger or acquisition as a profitable business.

It is gathered that Enterprises which are not profitable for the last 3 years will not be considered for Business Valuation; such Enterprises will be valued using Asset Valuation. To this paper, this criterion is a very narrow criterion; other inputs about the nature of the business, existing market situation of its products or services using data from relevant industries would help to supplement the decision. Also 3 years data is not sufficient to make decision on the going concern of a business.

4.2.1 Asset Valuation in PPESA

The first task in Asset Valuation is to request the Enterprise for a comprehensive physical count of all fixed assets. The inventory should include date of purchase, cost, year of installation/purchase, book value, make, model, existing condition (working, non-working, requiring maintenance etc). The team also needs to verify the conditions of the assets.

4.2.1.1 Building, Infrastructure & Plant Valuation

For buildings, the bill of quantities is prepared by specialists starting from sub structure to all parts of the building. For the plant also, related machines, AC, ventilation, pneumatic systems including electric installation are all considered as a plant & detail bill of quantities will be prepared by the specialists.

The year of make & the material types in which the building or plant are made of are also documented. Gross Replacement Cost will be calculated using the bill of quantity obtained above. The unit price used as a replacement cost will be searched

from the Ethiopian Customs Pricing CD & if a specific item is not available on the CD, the price will be searched from the internet.

Once the Gross Replacement Cost is known, straight line depreciation will be used to arrive at the existing estimated value. If the building is in a business area, the income approach will also be used to assess what income it will bring if the building can be put to a different business; if used as a multi-purpose building. This actually means if it can be rented as a building.

The team expressed that getting information regarding rent prices is difficult; and the team need to assess rent prices of similar buildings around the same area indirectly by approaching as a user.

The two values obtained for the building will be compared; i.e. the value with the Gross Replacement Cost approach & the value if the building is put to a different use (rent). Then the higher of the two will be used.

Here, the informal way of collecting rent estimates do not seem appropriate, the agency should provide the team other tool to estimate the rent fee. The issue associated with land ownership will also distort the estimation. Though officially land is owned by the government, it is practically known that buildings are bought with the land in consideration. The soaring real estate market shows the high attachment of the cost with the land rather than the building itself.

4.2.1.2 Machinery & Workshop Equipment

In here also Gross Replacement Cost is used to obtain the replacement value as discussed above, the Ethiopian Customs Price CD or the internet will be used to get the current price. (Commissioning, installation, ---- will also be included).

Then Depreciated Replacement cost (DRC) will be calculated using the age factor (date the machines are bought/started to be used) and obsolescence factor (as per the inspection result through physical, technical, structural & functional).

Obsolescence factor is not straight forward as the year factor and depends on the evaluator whether to consider the machine as a scrap or as a machine.

4.2.1.3 Vehicles

For valuing vehicles the agency uses Ministry of Finance & Economic Development factors policy which puts into account, year of make, model, Country of made, down time, maintenance schedule etc.

4.2.1.4 Office Equipment & Tools

Here also Gross Replacement Cost is used but will not be depreciated like the other assets, rather the equipment will be assessed for existing condition, and a % out of 100 will be assigned in comparison to new, similar equipment. If the condition % is below 25%, the item is considered as a scrap & will be valued zero; unless it is made of iron. In the case of iron made equipment & tools, it will be weighed & be multiplied by per kilogram price of iron bits to get the scrap value.

For conditions above 25%, the new equipment value (GRC) will be multiplied by the office equipment condition % to arrive at the existing value.

4.2.2 Business Valuation in PPESA

As discussed above, to undertake valuation using the Business Valuation method, an Enterprise's financial statement should show that the company have been profitable for the last 3 years.

For an Enterprise that fulfils this criterion, the team will work on collecting relevant data that help them estimate the future cash flow of the Enterprise.

The following are the major data that the team will collect:

- Five years audited report-review of the financial statements & notes, analyze trend
- Obtain relevant data for making sales growth assumptions like growth in GDP, increase in consumptions (relevant to the Enterprise)
- Evaluate the requirement of replacement of capital items or utilization of idle capacity

- Consideration of cost minimization with replacement of old machines, west management, decrease in down time.
- Always use of existing staff is assumed

Once the team exhausted the available relevant data the team will estimate 10 years cash flow for the company plus terminal value.

Then NPV will be used to estimate the present value of the future cash flows.

(Brealey et al, 2011) indicated that NPV is a good tool to estimate valuation of ongoing businesses. NPV is calculated by discounting the cash flow at an adjusted discount rate, usually at the after tax weighted average cost of capital (WACC).

WACC is calculated as follows:

$$\text{WACC} = [E / (E+D)] R_E + [D/E+D] R_D (1-T)$$

Where: E=Equity, D= Debt, R_E =Return on Equity, R_D =Return on Debt

In PPESA, R_D is estimated using the existing bank loan rate. Also the researcher gathered that CAPM (Capital Asset Pricing Model) is used to estimate R_E .

The CAPM R_E is calculated as $R_E = R_i + \beta (R_M + R_i)$, where

R_i = Interest rate /Treasury bill rate (in the case of PPESA a bond rate is used)

R_M = Market return

β = A stock's sensitivity to changes in the value of the market portfolio

In PPESA, the market return is estimated as an average rate between a minimum 10% to a maximum 25% depending on the industry the company belongs to.

As gathered by the researcher, in PPESA the estimation of β do not have a specific guidance to follow. But as per the interview result for a stable businesses i.e. stability in production & operation, etc. $\beta=0.9$ to 1 is used.

Then finally the team will prepare the draft valuation of the company.

The effort of PPESA to follow modern acceptable methods to value a business is a big step forward, but estimating the variables in the models used in the context where there is no stock exchange is not an easy task & may lead to error. Therefore, PPESA need to draw a clear guidance on how to estimate the return on equity with less ambiguity.

If the value obtained by this business valuation is lower than the firms' liability, then the liability will be taken as the indicative value (PPESA Bulletin, Meskerem 2004 E.C)

The above situation shows how the team will be required to make many assumptions in the absence of standards. This entails the requirement of high integrity of the staff handling the valuation; requiring due diligence at every step of the valuation process.

4.2.3 Accuracy of Valuation

As discussed earlier, valuation depends on the situation. To evaluate the accuracy of a firm's valuation will not be an easy task since the nature & condition of the firm to be valued & the intent of valuing it matter. A buyer & seller may have a different perspective & may arrive at different values. But it will be possible to analyze if widely acceptable & relevant methods are applied, required expertise is used and also whether it undergoes different levels of review.

In the case of PPESA the interview result shows that a huge effort is being made to apply acceptable valuation methods. In the absence of capital markets, valuing a company is difficult. Especially, the business valuation requires lots of assumptions to be made. All these assumptions are made by the valuation team (with endorsement of the valuation directorate).

It shows us the degree of judgment required from the team which implies it is a task that high competence is required; achieved through both having the necessary training & experience.

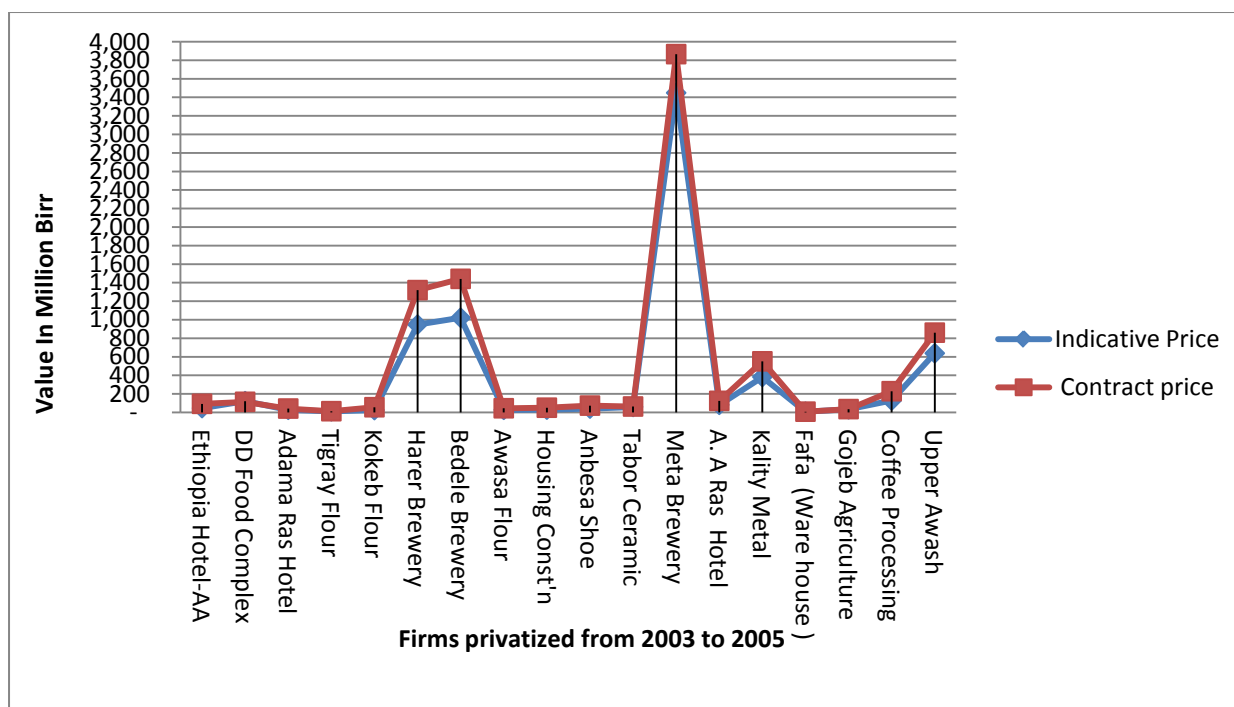
Though the teams are young & energetic, all are first degree holders from the different disciplines. The directorate for the valuation department is a certified person in valuation and the researcher has gathered that he has made an effort to train the staff engaged in this task. But they still need to undergo through more training to be able to make acceptable decisions in the absence of many standards.

This paper tried to analyze how close the valuation of privatized companies is with the acquisition price. If there were instances the companies were valued by a third party, comparing the two valuations would have been more meaningful. But in the absence of such data, the acquisition price is used. The acquisition price at least tells the buyer's value of the company.

The data for the valuation of the firms i.e. the indicative price when the firms were floated for tender were obtained only for those sold from 2003 to 2005 E.C. These are 21 firms, out of which 3 of them are transferred to another government institutions without a competitive bid at the valued price/indicative price.

Therefore, the data for the 18 firms were analyzed as follows:

Figure 5: Comparison of indicative value with acquisition value (2003 to 2005 E.C)



Source: Row data from PPESA (2007 E.C)

Table 1: Percent change of Contract price (Acquisition Value) with Indicative price

% Change of Contract Value from Indicative Value	No. of Firms Sold
(0-20)%	1
0-20%	5
20-40%	2
40-60%	4
60-80%	4
80-100%	1
100-120%	0
120-140%	1
Total	18

Source: Row data from PPESA

The data indicates that out of the 18 firms only one was sold below the indicative price, while the rest 17 were sold above the indicative price. Some are sold with a price double the value indicated.

Ethiopia Hotel was sold with a double price of the indicative value, Adama Ras Hotel & Addis Ababa Ras Hotel were also sold with a 49 & 53% change above the indicative price respectively. Beer Factories have also gained around 40% change from the indicative price.

As per the above data all the values except one are below the value the buyer agrees to buy. But this shouldn't mean that the firms were undervalued when floated for tender; but it may give a heads up that if buyers are willing to buy with such a price, is there an area in the valuation that needs a revisit?

This paper would suggest further analysis to be made regarding how the land component is treated during the valuation; due to the existing gap in the value attached to land.

The graph helps us to have a general or summarized look of the relation between the two values. We do not see an exaggerated gap between the two considering the different levels of assumptions & estimations required to arrive at the indicative price in the absence of a capital market.

Hshe (2005), has gathered opinion about the appropriateness of the valuation of privatized Enterprises both from the investors & the employees working in the privatized firms.

The result of his research shows that the investors believe that the firms were overvalued; while the employees believe that the firms were undervalued to provide incentive to investors to buy. This shows that the investors' perspective & the employees perspective are different, both looking at it from different angles. There is no ground to conclude there is over/under valuation.

4.3 Modalities of Privatization in Ethiopia

The most commonly used methods of privatization as indicated in the theoretical background are

1. Public Offering of Shares
2. Private Sale of Shares
3. New private investment in an SOE
4. Sale of government or SOE assets
5. Reorganization (or break-up) into component parts,
6. Management/employee buyout
7. Lease and management contract

4.3.1 Public Offering of Shares

The most appropriate & transparent way of privatization is Public Offering of shares; which means floating shares of the SOE to the public through a share market. This method of privatization eases the burden of valuation, shortens the process of privatization & above all it is more transparent to the public. But unfortunately, until now Ethiopia do not have a capital market and didn't apply this method.

According to Fundanga and Mwaba (1997) in the case of Zambia, the privatization program initiated Zambia to establish a Stock Exchange. To facilitate wider disposal of SOEs, the Zambian Privatization Act provided for the sale of a percentage of the shares of some companies, especially the large ones, to the public through the Stock Exchange. Since no Stock Exchange existed by 1992, one of the most important things that had to be done, was to pass the Zambia Securities Act. The Securities and Exchange Commission was established in December, 1993 and the Lusaka Stock Exchange in 1994.

It is indicated that UNDP provided the financing for technical work required to effect most of these legislative changes under a Privatization and Industrial Reform Program covering institutional reform and capacity building in the major reform areas and sectors of the economy, including: privatization, law reform, capital markets development and public sector reform.

Then onwards the privatization process started moving quickly; according to World Bank, Findings, October 1996, Zambia privatized 122 company units between December 1994 & June 1996.

4.3.2 Private Sale of Shares

Private Sale of Shares is when the state sells all or part of its shareholdings in a wholly or partly owned SOE to a ~~identified~~ identified single purchaser or group of purchasers. It is assumed that the SOE is a going concern set up in the form of a corporation represented by shares. As can be gathered from the data below, PPESA has used Private Sale of Shares either through a competitive bid or negotiation. And out of the total 316 privatized firms 51 of them or 16.1% is sold through this method. When comparing the share of this method in terms of the value of privatization, it takes the biggest share of 59.5%.

It is known that PEs in Ethiopia are not organized as a share company, but PPESA has reorganized those PEs that need to be privatized with this form as a share company before proceeding to a sale.

4.3.3 Sale of SOE Assets

The other method of privatization used by PPESA is Sale of the SOE Assets.

Here the transaction consists basically of the sale of assets, rather than shares in a going concern. The sale of separate assets may be only a means of selling the enterprise as a whole. Thus, the assets may be sold individually or be sold together as a new corporate entity.

In the case of PPESA, the decision to sale the SOE as a going concern or through sale of assets is determined initially at the stage of valuation. But during the initial stages of privatization most companies were valued using the asset sale method until the reform made to speed up privatization in 2008. This reform includes using Business valuation for profitable companies. Therefore, this mode of sale will be used for firms that are initially valued as an asset sale. The firms in this category are sold as pieces of assets with no going concern motive. Firms sold with this method are only 8 in number or 2.5% out of the total privatized firms up to 2007E.C.

Comparing value wise; its percent share is very minimal, only 0.1% of the total value of the 316 privatized firms.

4.3.4 Management/Employee Buyout (MEBO)

The term generally refers to the acquisition of a controlling shareholding in a company by a group of managers and Employees.

PPESA has used this method for a large number of retail shops & some hotels. These are 45 in number and it is 14.2% out of the total 316 PEs & units. All are transferred to the workers through a safety-net program. The government has organized these shops under one share company, named Addis Fana S.C.

MEBO has advantage in addressing one of the privatization objectives of broadening ownership base & also minimizes the social cost associated with layoffs & liquidation of enterprises. But on the other hand giving preferences to insiders inhibits and may even eliminate competition in the privatization process.

When considering the privatized value of these 45 shops/sales outlets it is only 0.2% of the total privatized value of the 316 firms. Though the numbers are large their contribution to the privatization in terms of value is low.

4.3.5 Total Sales/Direct Sales

PPESA used this method to privatize the majority; 54.1% of the total privatized firms & units. In this case to the valuation method used is asset valuation but though valued through asset valuation, the firms are sold as a whole unit. Their contribution to the value of firms privatized is 30%, next to the total share sales.

4.3.6 Joint Venture

PPESA has used the joint venture method of privatization to some of the SOEs. The privatized share ranges from 22% to 83%. In this category we have National Tobacco, Ambo Mineral Water, Abyata Soda Ash, Adey Abeba Yarn Factory#2, and some in state farms. And unlike the sale of other hotels, Sodere resort hotel is sold through a joint venture 55%, government retaining 45%. Most joint ventures are

made with foreign companies with the intention of drawing the technical expertise to the country.

In addition to these Enterprises there were others which were sold under a joint venture agreement initially but later on sold 100% to the same buyer. Repi Soap & Detergent Factory and Bebekka Coffee Plantation. In this paper only the data for the sales are considered since the data for the joint venture was not complete and how the changes are made is not clear.

4.3.7 Concession

PPESA has sold the Legedembi Gold Mine to National Mining Corporation, a MIDROC affiliated company through a concession. Concession is a license agreement to explore, develop, sell and export oil or minerals extracted from a specified area for a fixed period of time. The bidding price paid for the concession is paid regardless of whether oil/mineral is found and commercial production takes place. If commercial production occurs, the host government also earns royalties based on gross revenue and/or a profit tax based on net income, both of which are based on the quantity of production and the price at which the production is sold. All financial risks of development, including the costs of exploration, are absorbed by the successful bidder (openoil.net).

In the case of Legedembi Gold Mine the price of this concession is indicated in the data below (ETB 1.3 Billion) but this paper do not have information regarding the form of sharing commercial production of the gold.

4.3.8 Business Sale

PPESA has sold 3 hotels through a business sale; selling only the business of the hotels. It is not clear why it is sold in this form & how the terms are stated.

4.3.9 Lease

This method of privatization is applied by PPESA for agricultural firms only. There are 5 state farms which are privatized using the lease term. The lease period varies from 5 to 70 years.

Like in the case of the joint venture 2 firms, Dire Dawa Textile and Ethio-Japan Textile were leased in the earlier years (1998 & 1999 E.C) & later sold to the same buyer in 2002 E.C through total sales & 100% share sales. In the data below only the sale is included; the information on the lease value was not available.

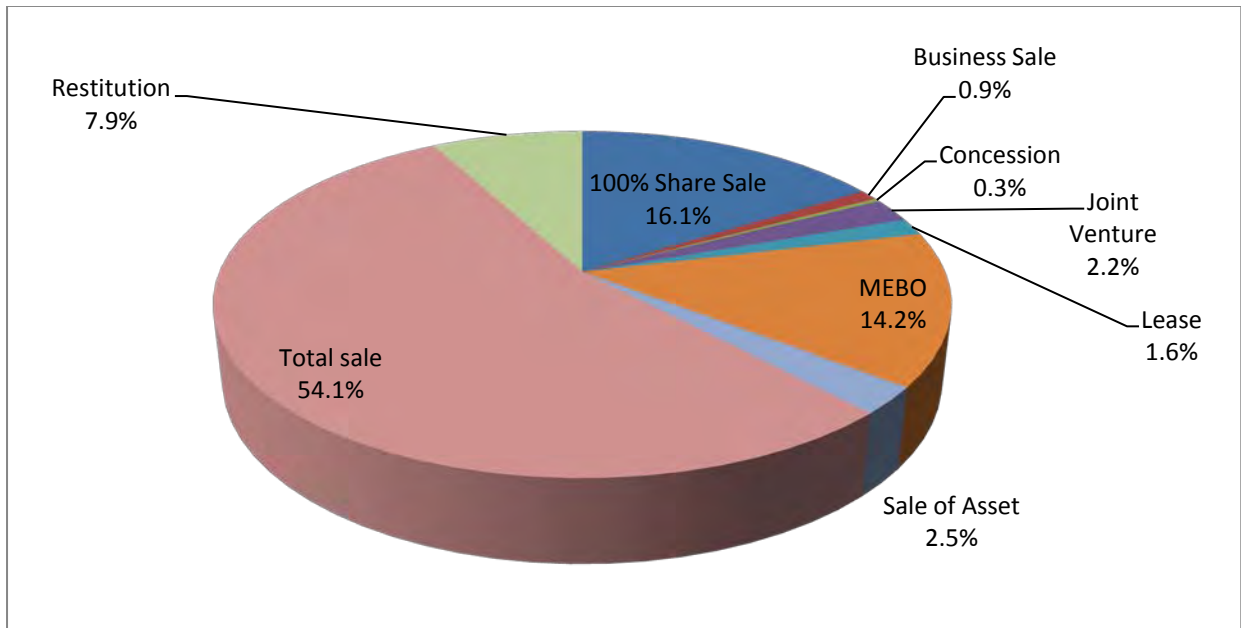
Table 2: Number & Value of Privatized firms by Mode of privatization

Mode of Privatization	Number of Privatized Firms	Contract Value	% Share in terms of quantity	% Share in terms of value
100% Share Sale	51	12,134,212,080.00	16.1%	59.5%
Business Sale	3	2,640,167.00	0.9%	0.0%
Concession	1	1,290,429,153.00	0.3%	6.3%
Joint Venture	7	675,445,506.00	2.2%	3.3%
Lease	5	26,119,299.00	1.6%	0.1%
MEBO	45	46,867,960.00	14.2%	0.2%
Sale of Asset	8	29,380,124.00	2.5%	0.1%
Total sale	171	6,082,487,403	54.1%	29.9%
Restitution	25	88,933,012	7.9%	0.4%
Grand Total	316	20,376,514,704	100%	100%

Source: Row data from PPESA (2007 E.C)

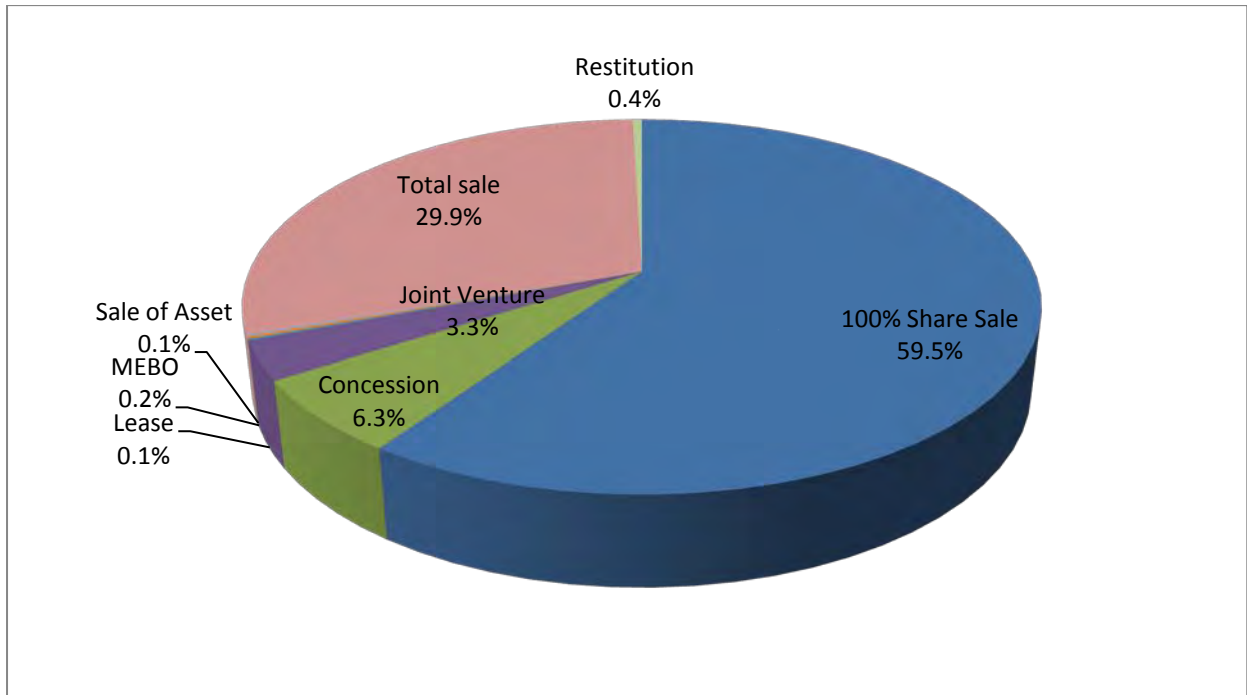
The following is pictorial representation of the above data in order to illustrate the proportion of divestment modalities.

Figure 6: Number of Privatized Firms by Mode of Privatization



Privatized Firms by Mode of privatization

Figure 7: Contract Value of Firms by Mode of privatization



4.3.10 Restitution

Restitution is returning the SOEs to their former owners by collecting the additional investment the government put towards these SOEs.

PPESA has restituted 25 SOE's to their former owners with a total contract price of ETB 88.9 M. Restitution takes two forms : if the owners are interested & capable to own the firms, the firms will be transferred to them by collecting from them the investment the government made during its ownership. If the owners are not interested or not capable to own the firms, the firms will be sold like other public enterprises & owners will take their share from the proceeds.

The number of firms returned to their former owners is not only 25, according to PPESA's accomplishment report 1987 to 2000 E.C, more than 600 firms were returned to their owners. But the data obtained containing proceed to the government is only 25. It is not clear if the rest involve collection of reimbursements or not.

4.3.11 Management Contract

The data obtained from PPESA shows that management contract has been made with a British company for Ethiopian Tannery in 1997 E.C but later in 2002 E.C it is sold to the same company. The practice of providing management contract before the transfer through sale is good for both sides since the investor would guide the firm to the desired direction of profitability before the actual sale occurs. This will help government to obtain a better proceed in the sale in addition to the expertise obtained. The interested investor also will have time to evaluate the firm very well before reaching to the decision to buy.

Chapter Five

Conclusion and Recommendation

5.1 Conclusion

Privatization in Ethiopia, like other developing countries, was started in response to the structural adjustment program induced by multilateral institutions rather than own policy initiative. The onset of privatization enforced different policy changes in Ethiopia to bring about a conducive environment for private property to grow.

The data obtained from PPESA shows that 316 PEs & units have been privatized until 2007E.C. Many concerns are raised in the process of privatization including the valuation process & the selection of modalities for divestment.

This study examined the valuation methods and the modalities of divestment used by PPESA in relation to what is accepted in the literature. Also comparisons with other country experiences were made. The status of privatization is reviewed and trends are analyzed.

PPESA uses Asset Valuation & Business Valuation methods. The decision on which ones to use is made only using the criteria set as “businesses which were profitable for the last three years or more will be valued using business valuation approach; all others will be valued using asset valuation.” But as per the findings of this paper, this criterion only may be misleading since pre privatization financial data of most firms do not show consecutive profitability for the last three years even if the firms have been consistently profitable in previous years. Additional criteria should also be used regarding capacity of the firm, the relevant industry and market situation. But the main issue in the use of business valuation is estimating the variables required to do the valuation, estimation of future cash flow and what rate of return to use.

Although this paper would like to admire the efforts made by PPESA to use current acceptable methods and tools like CAPM during business valuation, it may also be misleading to use it in the absence of a stock exchange market & other standards to refer to estimate the different variables.

This paper made an effort to analyze the variance the indicative price (obtained through the valuation exercise) has with the acquisition price for a portion of the data where it is possible to get data of the indicative price. In almost all instances the indicative price is below the acquisition price, some half as low (i.e. the acquisition price more than doubles the indicative price). Though it will be wrong to draw conclusion in the absence of other third party valuation other than the acquisition price, and with a data not selected through a sampling technique, this gives a heads up to analyze further if the valuation misses any component of the Enterprise.

PPESA has used different modalities of divestment as per the size & nature of the PE. The applications of the methods agree with the literature & experiences from other countries. It has used private sale of shares, total sale of assets, MEBO, lease, joint ventures & management contract. But PPESA has not used the most important form of divestment, public share offering, which also helps to increase the ownership base of the society and eliminates the doubt attached with transparency in the valuation & divestment methods.

It is clear that public share offering requires a stock exchange market, which Ethiopia has not established until now. But, it would have been a good opportunity for Ethiopia to try to establish this market for the purpose of privatization at that time. International multilateral organizations may have been willing to provide support for the establishment like in the case of Zambia.

It is observed that from the privatized data obtained from PPESA, 10 firms with a value of 1.45 Billion Birr are sold or transferred to another government institute. These transfers do not fulfill the definition of privatization; government is just changing hands and contradicts with the objective of privatization. If it is found advisable for a government to own these enterprises, these firms have to be excluded from the privatization data. This paper believes that it would be misleading to include them in the data for privatization.

The other finding of this paper is privatization does not contribute as expected in attracting foreign direct investment. The data shows that only 15% of the firms are bought by foreigners, including the joint investment of Ethiopians with foreigners.

The majority, 55% of the foreign participation is from is MIDROC's and affiliates contribution.

5.2 Recommendations

The new Ministry of Public Enterprises (MoPE) should work with other relevant ministries to develop a share market in Ethiopia. It is well known that share markets have a significant effect in facilitating trade. In addition to helping the ministry to divest the remaining Enterprises segregated for privatization, it will also help already privatized firms to have the opportunity of raising capital & ease of changing hands.

The criteria of selecting valuation methods depending only on the last three consecutive year's profitability scenario has to be revisited. Analyzing profitability should depend on longer term financial data & considering average profitability. Also it has to be supported with additional criteria like the nature of the industry, the existing capacity of the firm, the market share, etc. But the main issue in the use of business valuation is estimating the variables required to do the valuation. Estimation of future cash flow and what rate of return to use in a country where there is no stock exchange is very difficult & may lead to error. Its use should be limited to industries where such data is available and PPESA should put more effort to have further guideline in estimating the variables like β and R_M in the CAPM model.

One of the main objectives of privatization is the expansion of private sector by taking the government out of manufacturing & service industries. Therefore, using the privatization process to transfer/sell Enterprises to another government institute is contradictory to this objective. Therefore, the new ministry should be aware of not to repeat the same in the remaining Enterprises to be divested.

Privatization is also one means of attracting foreign investment. But foreign contribution in the Ethiopia case is minimal. Therefore, the ministry should work with other relevant government institutions to improve policy & infrastructure issues that are raised by multilateral institutions as a draw back to doing business in Ethiopia.

5.3 Directions for future work

It was observed during this research that one of the main objectives of taking the government out of the manufacturing & service industries seem to be jeopardized at this point in time since we are now observing the government investing heavily in the manufacturing industry through METEC. PPESA also was not responsible to oversee METEC like other PEs even if it is hugely engaged in profit making activities, adding ambiguity to the arrangement.

This paper found out that the recent reorganization has addressed the ambiguity who oversees the performance of METEC. The new structure of MoPE has four sectors led by State Ministers (Annex 2). The Manufacturing industries & agriculture sector will oversee METEC though METEC is accountable to other authority. It becomes, therefore, important to study the overall structure for the sake of efficiency and effectiveness.

As described in the limitation, it was not possible to find detailed and consistent data on the privatized firms. This may call for further research project to study existing data and come up with an efficient data handling instrument for use both by the firms and other relevant stakeholders.

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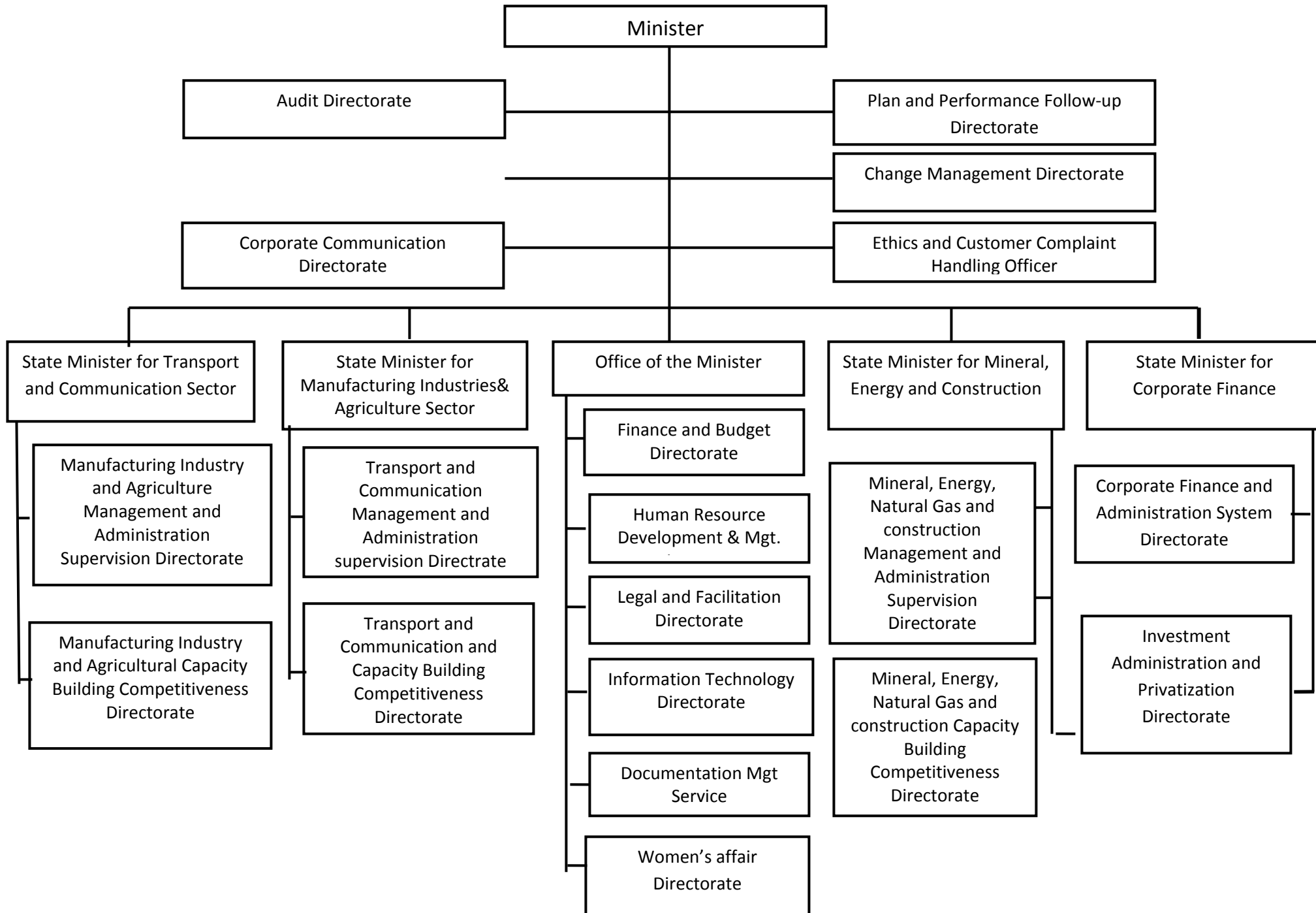
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Annex 1: Interview guideline

1. How are public enterprises segregated for sale?
2. Is there any threshold for the value and type of business?
3. What steps are followed when a public enterprise is approved to be privatized?
4. How are the PEs valued?
5. What expertise do you use for the valuation?
6. What reference do you use to value the PEs? Any guidelines?
7. What are the data you request for to work on the valuation?
8. Do you follow different valuation methods for different sectors?
9. What is the involvement of the employees in the privatized organizations during the valuation?
10. Who makes the decision on the type of valuation to be used?
11. What level of review does the valuation undergo?
12. Who makes the final endorsement of the valuation?
13. How are assumptions made during valuation? Who makes the assumption?
14. How the modalities of privatization does selected?
15. In the case of restitution, if the previous owner cannot afford to reimburse the government for investments made, what action will be taken?

Annex 2: New Organizational Structure



Annex 3: Old Organizational Structure

