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Harald Sondhof and Markus Stahl*

Management Buy-outs as an Instrument of Privatization in Eastern Europe

Privatizing government enterprises is one of the most difficult tasks in the transformation process taking place in the former socialist economies. What contribution do management buy-outs have to make in coping with that task?

All the countries of Eastern Europe and the CIS are currently in the process of replacing their planned economies with market economic systems. Such a transformation requires the state to make a rapid withdrawal from planning responsibility and substantially to renounce its rights of ownership over the means of production. The prime tasks involved in bringing that about are to create a new system of private law and to privatize government enterprises. Whereas it is possible, formally at least, to introduce a system of private law very swiftly, it is a much more time-consuming and difficult matter to transfer ownership of the means of production to private hands.

The difficulty arises partly out of the very scale of the privatization task. The state's share of the means of production in the former socialist countries is virtually 100%, with the exception of Hungary where experiments with private enterprise have a certain tradition (cf. Table 1). In Western Europe and the USA, on the other hand, the level of state involvement is only approximately 10% and even in the Scandinavian countries, which are often described as socialist, state ownership does not play a significant part. Thus the countries of Eastern Europe will need to transfer four-fifths of their economies to private ownership if they want to create similar conditions to those of Western Europe regarding ownership of the means of production.

Another indication of the scale of the task involved is the large number of enterprises to be privatized. There are approximately 100,000 such industrial enterprises in Eastern Europe. The relatively small number of units accounting independently in the former state-controlled economies creates a false impression here, as these mainly consisted of artificially created administrative units. In 1987, only approximately 3,400 industrial

enterprises were registered in East Germany, and these were grouped into 256 combines ("Kombinate"). On the other hand West Germany, which was roughly four times the size, had more than 44,000 industrial enterprises, 11,000 of which had between 100 and 1,000 employees.¹

Privatization Alternatives

If significant successes in privatizing state enterprises are to be achieved swiftly, a comprehensive strategy is needed which provides for all conceivable forms of privatization to be applied where and when suitable. The basic alternatives available are a stock market flotation, direct sale to outside investors, and various forms of management buy-out (MBO).

□ The flotation of former government enterprises on the stock market, like the various coupon models also under discussion, has the advantage that participating shares can be widely dispersed among the general public. In addition, the enterprise will also subsequently be subjected to the allocative and supervisory mechanisms inherent in the capital markets. However, in contrast to Western Europe, where stock market flotations of government enterprises have frequently been successfully carried out, particularly in Italy, France and the United Kingdom, there are limits to the effectiveness of this approach in Eastern Europe. For one thing, the high costs involved mean that this method can only be considered for very large enterprises, while for another the eligibility of enterprises for the capital markets, and the capital markets themselves, are not yet sufficiently developed.

□ These problems are of no consequence if government enterprises are sold off directly to private-sector companies. Furthermore, a take-over by Western investors is normally also coupled with transfers of

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¹ Cf. Statistisches Jahrbuch 1989 für die Bundesrepublik Deutschland, Stuttgart 1989, pp. 164 and 613.

management, technology and capital, which are all urgently needed by Eastern European enterprises. However, it is highly unlikely that there is sufficient demand for the greater portion of Eastern European state enterprises to be purchased, whether domestically because of a shortage of capital, or by Western interests because the political situation is not yet considered sufficiently stable.

□ The common element in all buy-outs is that they transfer the rights of ownership of industrial or commercial facilities to those who are employed in them: in the case of a management buy-out in its narrow sense, the existing management are the purchasers, while a buy-in involves new managers brought in from outside, and an employee buy-out has the ownership spread among the entire payroll of the enterprise. There are two main benefits to the MBO as a means of privatization when it is set against either stock market flotation or a direct sale to outside investors. Firstly, it is particularly well suited to small or medium-sized firms such as those formed by the break-up of the old combines and giant enterprises, and secondly, MBOs are able to draw upon a substantial pool of "privatization demand", from the very people who work in the enterprises concerned. When it comes to what are often termed "minor" privatizations, involving retail stores, cinemas, taxi services, inns or hotels, etc., some form of MBO structure is virtually the only feasible alternative, given the acceptance problems which would arise in the event of an outside purchase.

Successes in Eastern Germany

The wave of "minor" privatization in the wholesaling, retailing and services sector in eastern Germany is now almost complete, and the vast majority of the 30,000 businesses involved have been sold to existing management or employees. In manufacturing, which

comprised approximately 10,000 different businesses after the first phase of deglomeration, 5,000 privatizations had been carried out by March 1992, of which approximately 20 % were MBOs. Roughly half of the MBO companies now operating in eastern Germany employ less than 50 people; however, for businesses in the manufacturing sector the average number of employees is 180. MBO privatization has predominantly occurred in industries where a rapid return on investment can be expected or, in other words, in the service sector and in wholesaling and retailing. Nevertheless, the by no means inconsiderable number of management buy-outs in core industrial sectors such as the machine tools and appliances industries, vehicle manufacturing, steel, optical instruments and precision mechanics does show that more investment-intensive areas can also be privatized by this method. Managers tend especially to buy up businesses if local competition is relatively low.²

As regards the 3,500 small or medium-sized businesses remaining to be privatized (as of March 1992), the Treuhandanstalt, which is responsible for coordinating privatization, intends to give preference to the management buy-in approach. It has developed its own concept to promote initiatives of this kind, which includes giving priority to MBI bids if they match the value of other offers received. The Treuhandanstalt is also helping to find suitable buy-in managers, and giving support in the disposal of non-core assets in order to keep down the purchase prices of the businesses concerned. Other measures included in the concept are payment holidays for the purchaser and the provision of loan guarantees for funding related to the transaction.³

In all, a total of approx. 3-4,000 MBO transactions can be expected in eastern Germany's manufacturing industry. If one assumes an average of 100-150 employees per enterprise bought out, that would mean that something over one quarter of a million jobs can be secured by means of MBOs. To that figure can be added a further 150,000 or so employed by service businesses which have been, or will be, part of the "minor" privatization movement. Thus at least 5% of the 8.5 million jobs in former East Germany will be associated with MBO privatizations.

Management Buy-Outs in Eastern Europe

If one assumes that there are approximately 100,000 industrial enterprises in Eastern Europe and the CIS,⁴ which need to be deglomerated so as to give a total of at least 200,000 to 300,000, that would mean 70,000 to

Table 1
Size of the Government Sector
in Selected Countries,
in terms of production and employment (%)

Country	Production	Employment
France (1982)	16.5	14.6
Sweden (1990)	—	10.6
United Kingdom (1978)	11.1	8.2
West Germany (1982)	10.7	7.8
USA (1983)	1.3	1.8
Czechoslovakia (1986)	97.0	—
East Germany (1982)	96.5	94.2
USSR (1985)	96.0	—
Poland (1985)	81.7	71.5
Hungary (1984)	65.2	69.9

Source: David Lipton and Jeffrey Sachs: Privatization in Eastern Europe: The Case of Poland, Brookings Papers on Economic Activity, No. 2, 1990, p. 300.

² Cf. iwd-Dokumentation, No. 7, 13th Feb. 1992.

³ Cf. Federal Ministry of Economics: Management Buy-Out in den neuen Bundesländern als Weg der Privatisierung, Bonn 1991.

⁴ As estimated by the Institut für Weltwirtschaft in Kiel.

100,000 potential MBO transactions even if only one third of the privatizations carried out took that route. An estimate of the potential MBO volume in "minor" privatizations in Eastern Europe based on eastern German figures is one million operating units. However, the present position in these countries as regards MBO privatization is a difficult one to assess:

□ In Poland, approximately 100,000 retailing businesses have been privatized since the privatization law was passed in July 1990, most of these via MBOs. In the industrial sector, approximately 1,000 government enterprises have been "liquidated", which generally means that they have been taken over by their managements.⁵

□ In the course of "minor" privatization in Czechoslovakia, 16,500 small firms have passed to private owners since January 1991, and another 30,000 small and medium-sized businesses are candidates for MBOs.⁶

□ In Hungary, the number of MBOs in retailing and services is much smaller simply because many of the businesses were already operating as private enterprises. Since 1989, there have been a number of MBOs, including large-scale ones, in manufacturing industry.⁷

□ In Russia, numerous *de facto* privatizations via MBOs have been carried out in the last three years, some of which have involved relatively large enterprises (cf. Table 2). Because the lines of demarcation between different forms of ownership have become more and more blurred by the many legislative changes, the status of private enterprise in Russia is especially difficult to ascertain.⁸ The only approach which would so far appear to be guaranteed in law is the special buy-out variant in which the entire workforce of an enterprise takes over its ownership to form a "cooperative". The first of these workforce buy-outs was that of the relatively small Khlyupin Building Materials Plant. The business was first leased by the workforce for one year before it was allowed to be transferred to private ownership.⁹ In view of the firmly anchored role played by workforce democracy, this form of privatization is similar to the Yugoslavian model of workers' self-administration.

MBOs might be expected to play a relatively more

significant part in the privatization process in Eastern Europe than they have done in former East Germany. Because of the special difficulties associated with any moves to stimulate these economies by founding new private enterprises, and because foreign investors have been very hesitant to become involved there, a takeover by the management is virtually the only practicable form of privatization which remains. The problem is added to in the CIS by the unavailability of any infrastructure of existing companies with which to do business, and this evidently minimizes the prospects of success for private firms.¹⁰

Incentive and Control Structures

On the level of the individual firm, the most important benefit produced by an MBO transaction is that it firmly ties in the incentive and control structures which are vital to raising efficiency. An obvious incentive, but no less effective for that, to produce thoroughgoing improvements comes directly from the management's participation in the capital value of the enterprise. Because this creates a direct link between the participating income to which the managers are entitled and the profits earned by the company as a whole, it can be assumed that they will redouble their efforts to make it a commercial success. The same also applies if second and third-level management or the workforce as a whole are granted ownership participation. However, the more widely dispersed these ownership shares are, the more the increased effort of any employee will again become a public good, thus diluting the incentive to perform originally flowing from financial involvement. The cooperatives which have been permitted in the former Soviet Union since 1989 tend to suffer from this flaw.

The combination of management and proprietor roles inherent in an MBO also tends to defuse the classic problem of supervision and control arising in the relationship between principal and agent.¹¹ For stock-exchange-quoted companies, it is possible for this

⁵ Cf. Andreas Polkowski: Polen, in: K. Bolz (ed.): *Ordnungs-politische Standortbedingungen für Direktinvestitionen in Mittel- und Osteuropa*, Hamburg 1992.

⁶ Cf. World Bank News, Vol. XI, No. 2, 16th Jan. 1992, p. 3.

⁷ Cf. Keith Crane: Property Rights Reform: Hungarian Country Study, in: *Transformation of Planned Economies. Property Rights Reform and Macroeconomic Stability*, OECD, Paris 1991, p. 82.

⁸ Cf. Simon Johnson and Heidi Kroll: Managerial Strategies for Spontaneous Privatization, in: *Soviet Economy*, Vol. 7, Oct.-Dec. 1991, pp. 281-316.

⁹ Cf. David Ellermann: Perestroika with Worker Ownership, in: *Annals of Public and Cooperative Economics*, Vol. 61 (1990), No. 4, pp. 519-535.

¹⁰ Cf. Simon Johnson and Heidi Kroll, op. cit., p. 303.

¹¹ Cf. Michael Jensen and William Meckling: Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, in: *Journal of Financial Economics*, Vol. 3 (1976), No. 4, pp. 305-360.

Table 2

Russia's Largest MBOs up to mid-1991

Region	Industry	No. of employees
Kaliningrad	?	1,736
Tver	Retail and wholesale trade	929
Moscow	Chemicals	555
Ulianowsk	?	548
Rybinsk	Garments	538
Moscow	Chemicals	521

Source: Igor Filatochev, Centre for Management Buy-Out Research, University of Nottingham.

problem to lead management to abandon the goal of profit maximization and to pursue their own objectives for success, for the greater the dispersal of shares the more the costs of supervising the management begin to exceed the benefits which can be gained. Similarly, an enterprise operated under fiduciary or state administration also provides discretionary leeway for management, as the government proprietors lack both the know-how and sufficient resources to exercise effective control over the enterprise. The problem applies all the more in Eastern Europe now that the old bureaucratic structures are in the process of breaking up. A transition to self-supervision by proprietor-managers promises to be the most suitable approach in the Eastern European reform process when it comes to adjusting to market conditions.

The supervisory and control structures are further intensified by the fact that MBO companies tend to carry a large amount of debt. Interest and loan service costs impose a hard budget constraint on management, from which it has no escape. In order to meet its payment obligations, it is compelled to pay out all the cash-flow generated, without having the option of retaining it for future use. Consequently, any investment necessary for the profitability of the business can only be made with the agreement of the external lenders, who will naturally critically examine all decisions involving increased expenditure.

As a result, though this may appear paradoxical at first sight, the risk of insolvency may actually be lower despite the high leverage, for the increased financial exposure may be compensated for by a reduction in the efficiency risk due to the effective incentive and control mechanisms in place. A crucial element in the overall positive effect is that there is a marked increase in the probability of reorganization which will preserve economic value. If the increased liabilities do then ultimately give rise to "premature" insolvency, at least there is the consolation that the accumulated losses of the enterprise will not continue to be passed on indefinitely to the general public.

Macroeconomic Effects

In macroeconomic terms, MBOs should be viewed very positively in that they encourage the establishment of decentralized industry structures in accordance with the guiding policy principles of the market economy. Privatizing government enterprises does not, in and of itself, promise an improvement in economic conditions, and it is only when competitive structures are in place that satisfactory results can be expected. Oriented as they are to small and medium-sized entities, management buy-outs can be expected to be supportive of the desire to establish a middle stratum of private enterprise.

A particularly advantageous aspect of MBOs from Eastern Europe's point of view is their flexibility when privatizing break-away parts of larger enterprises. Because the large combines originally built up to make them more directly controllable by planning authorities rarely have the optimum firm size and their product mix was largely determined by a desire to attain autarky rather than any economic considerations, privatization brings with it a major problem of deglomeration. If the value chains in the former planned economies are to be tightened up, it is essential that the old combines and conglomerates should be broken down into smaller units and that auxiliary functions should be contracted out. MBOs which are so conceived that they draw upon the operating know-how of the former management are the most likely to be able to identify what shape of unit will be able to survive or prosper.

Another important feature of MBOs for Eastern Europe is that they do in principle constitute a suitable approach to restructuring firms to restore their viability. Hardly any of the enterprises operated under the planned economy system are in a position to survive in a competitive environment. Experience in Western countries has shown that the spur to increase competitiveness provided by an MBO has often been effective, apart from some of the spectacular leveraged buy-outs in which perfectly sound companies were plunged into difficulties by takeovers financed by means of "junk bonds".¹²

Problems in Eastern Europe

Because the legal framework which ought to govern the legitimate sale of government property to interested managers is largely still lacking in Eastern Europe, quite a considerable number of the MBO transactions during the first privatization phase which is still continuing have been so-called "spontaneous privatizations". These are carried out by the former *nomenclatura*, who obtain ownership of parts of the organizations they used to direct without making an adequate payment in return. They take advantage of the collapse of the old bureaucratic structures, which means they have virtually unlimited freedoms during the current transitional phase. One method often used to take hold of a new firm, for example, is to begin by hiving off a number of facilities from the enterprise and then to purchase them on favourable terms. Although these self-made agreements create the same outcome as legal MBOs in economic terms, they are in fact tantamount to the theft of government property.

¹² Cf. Frank Lichtenberg and Donald Siegel: The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior, in: National Bureau of Economic Research Working Paper No. 3022, June 1989, pp. 1-53.

One such case of spontaneous privatization was the attempted takeover of the monopoly supplier of office equipment in Hungary, APISZ, in 1989. With the help of a leveraged buy-out financed by the Budapest branch of Citibank, the former management sought to obtain ownership of the firm. However, the public became aware of the criminal circumstances in which the deal had been arranged, and the plan collapsed as a result of public protest. Since then, managements wishing to take over the firms which have employed them have become considerably more reticent in Hungary.¹³

The involvement of the former socialist élites in buy-out arrangements is a fundamental moral problem to which it is virtually impossible to find any universally applicable solution. Looking at the matter pragmatically one might say that it ought not to be a question of whether or not the old elite can be permitted to participate in the privatization process, but rather one of how to make that participation, which is in any case unavoidable, as constructive as possible. To have the former cadres working actively according to the laws of the market can indeed be a contribution in the right direction.

There are also two different points of view on the problem of the state being taken advantage of when an enterprise is privatized, via a management buy-out or indeed by any other means. The public in the reforming countries has been right to criticize the unjust gains made by purchasers; as events in Hungary have shown, spectacular frauds may even have a negative influence on the entire privatization process. However, one has to ask whether it can really be allowed to be the foremost priority of privatization policy to obtain a "fair" sale price, as high as possible, for the assets concerned. There may in fact be circumstances in which the objective of maximizing sale proceeds ought to take second place to the more important goal of creating an enterprise structure in which small and medium-sized businesses feature strongly. There are macroeconomic gains to be had from a rapid deglomeration and privatization of state-owned concerns which will compensate for the initial shortfall on sales proceeds. There have already been some cases in Western countries in which privatization policy has sought to promote competition. The British government, for example, passed over a possible chance to obtain higher sales revenues from the privatization of the National Bus Company in order to ensure that the business was split up into smaller units. Priority was given to management buy-

outs in this instance by offering a 5% discount on the sale price for those wishing to use the procedure.¹⁴

Hence even the high profits earned by the first rush of managers making buy-outs do have a positive side to them, for the signals they have given to others who might want to follow in their footsteps will, regardless of other critical aspects concerning the distribution of income and wealth, accelerate the whole process of the development of competition. The sale of real estate sites, often the only valuable assets possessed by Eastern European industrial enterprises, at substantially below their real values may indeed have brought certain people quickly to riches, but at least these sites will be put to some meaningful use by their new purchasers before very long.

The problem of insufficient competence on the part of the managers making buy-outs in Eastern Europe ought not to be exaggerated. Even though the turbulent environment in which these changes of ownership are made will make considerable entrepreneurial demands on the management teams taking over the businesses, their capacity to learn from experience should not be underestimated: the average age of the managers concerned, if east German experience is any indication, is between 35 and 40 years, and these people have all needed a good deal of improvising talent in the past to survive under the planned economy. Furthermore, they may if they wish decide to court the support of Western managers by offering them the special incentive of a buy-in.

The general financial stability of MBO firms, on the other hand, is indeed a more critical factor. Although the relatively low capitalization of these firms does in individual cases mobilize the last reserves their managers have available to behave efficiently in the market, many of the companies founded by MBOs are in fact built on rather shaky financial foundations. Thus the advantage of the superior control structure provided by a small group of ownership participants is counteracted from a financial point of view by the disadvantage of a narrow funding base. In this situation, the funds necessary to carry out investment to secure the firms's future can often not be obtained. This assessment is confirmed by surveys carried out in eastern Germany. At an average of DM 11,000 per employee, MBO firms have a far lower volume of investment than other privatized firms, which have been investing in the order of DM 80,000 per employee.¹⁵

No matter what problems may be associated with MBO activities in Eastern Europe, one ought not to overlook the fact that there are frequently no alternatives available in practice to a takeover of former government enterprises by their managements. In Eastern Europe apart from former East Germany, privatization has so far almost inevitably been synonymous with management buy-outs.

¹³ Cf. Keith Crane, *op. cit.*, p. 76.

¹⁴ Cf. Corinne Mulley and Mike Wright: Buy-Outs and the Privatisation of National Bus, in: *Fiscal Studies*, Vol. 7, No. 3, pp. 1-24.

¹⁵ Cf. *iwd-Dokumentation*, *op. cit.*