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Research Article

Valuation of State-Owned Enterprises in the Process of Privatisation in Ethiopia: Procedures and Methods

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Abstract

Real property valuation is a vital component in the privatization of state-owned enterprises (SOEs). In Ethiopia, real property valuation is a difficult task as there is a lack of skilled manpower in the field, no adequate real estate market, and legal gaps in valuation. In addition literatures are scant about how real property valuation is done. Therefore, this study examines real property valuation procedures and challenges in the process of privatization of state-owned enterprises (SOEs) in Ethiopia. To achieve the objective of the study, qualitative research approach is applied. The target populations of the study were appraisers who participated in the valuation of SOEs. A purposive sampling technique was used to select respondents. Primary data were collected from appraisers using key informant interview (KII). Document review from different secondary sources was employed to triangulate the KIIs. The data were analyzed using thematic grouping and narration. The study found that for profitable enterprises Depreciated Replacement Cost (DRC) and Discounted Cash Flow (DCF) methods have been applied while for loss-making enterprises the DRC method has been used. These methods are selected based on the preceding three years of data. Moreover, these valuation methods are not applied in a proper way and the basis of selecting these methods are unjustifiable. The valuation result of SOEs, do not reported in a standard valuation reports formats. Lack of skilled manpower, inappropriate use of the valuation approaches, inappropriate base for selecting techniques of valuation, and organizational inefficiency are the key problems faced during valuation. To improve the situation market principles should be applied in the valuation of SOEs for privatization purposes in Ethiopia. These can be achieved by introducing strong institutions responsible for valuation regulations at the central level.

Keywords

Privatization, State-Owned Enterprises, Valuation, Procedure, Ethiopia

1. Introduction

The goal of valuation of State-owned Enterprises (SOEs) is to create a fair agreement between the governments and those who purchase SOEs [46]. The results of the valuation exercise are used to support negotiations with possible investors and influencing the price the state ultimately receives [27]. In valuing SOEs, it is important to balance the need to protect public property from being undersold with the need to avoid scaring away possible buyers [23]. That means if the enterprise is sold at a low price, the government will be blamed for giving away public property while if it is valued at an unreasonably high price, and cannot be sold, the government will fail to meet its policy commitment to liberalizing the economy

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indicating that both overpricing and under-pricing are undesirable [13]. Therefore, before SOEs can be sold, the market value of the enterprises should be determined by using appropriate valuation methods [25]. The international valuation standard and other regional and national valuation standards suggest the use of appropriate valuation approaches and methods [24, 36, 41]. The three typical valuation approaches are the cost approach, the income approach, and the market approach [20, 21, 45]. The choice of these approaches depends on the objective and purpose of the valuation, the standard of value, the premise of value, and the availability and reliability of data [42]. There are several valuation methods under each valuation approach [24, 36, 41].

The appraisers have the responsibility to recognize the importance of adopting a suitable approach/method of valuation to determine the market value [22]. In doing so, both internal and external appraisers can do a valuation assignment. To ensure an independent valuation result, external appraisers commonly undertake the valuation assignment [30]. Internal appraisers can also carry out the valuation by ensuring their independence with legislation [18]. However, the possibility of independence can be low in the case of internal appraisers [6]. Concerning, valuation in the case of privatization, external appraisers are commonly employed. In some cases, this is supplemented by valuations undertaken by the company itself and other sectors of the government [31].

Since 1994, the Ethiopian government has sold off several SOEs to the highest bidder or to companies that would be compatible with its goals and allow it to transfer technology and knowledge [26]. Several empirical studies have been undertaken in Ethiopia about the process of privatization and its procedures. However, the empirical evidence so far has said little about the valuation of SOEs. For instance, Regassa [35] simply states that the government sold away SOEs at an unreasonably low price and the valuation process was flawed. [40, 39, 27, 13] also described that the valuation of SOEs in Ethiopia is a complex and difficult task. Another study by [26] stated that the market value of SOEs was not appropriately known. The absence of regular or systematic accounting, absence of regular auditing, unavailability of recent balance sheets or profit and loss statements, inadequate data availability and unrecorded arrears are the reasons that make valuation difficult and complex [44]. All these empirical works did not show the actual procedure and methodology of the valuation of SOEs. Thus, this paper examined the procedures, methods and challenges of valuation of SOEs in the process of privatisation in Ethiopia.

This article is organized into five sections. Section two is devoted to the review of the related literature. The research method is presented in section three. Section four presents the findings and discussion of the study. The last section is dedicated to the conclusion and policy suggestions.

2. Literature Review

Valuation is widely used in financial and other markets to assist private or public institutions' decision-making in the process of financial reporting, taxation, compulsory acquisition, purchasing and selling, loan security, privatization, or other statutory purposes [2, 24, 41]. To arrive at specific values appraisers should employ appropriate valuation approaches, methods and techniques [24, 36, 41]. There are three valuation approaches recognized in the valuation profession namely, the cost approach, the income approach, and the market approach [28, 21].

Value using the income approach is determined based on the cash flows of the enterprise that will be able to generate in the future [28, 43]. It is appropriate in cases where more evidence of rental transactions exists [41]. Direct capitalization and DCF are the methods under the income approach [24, 33, 36, 41]. Direct capitalization uses the relationship of the first year’s net income to a required rate of return to determine market value while the DCF method uses an appropriate discount rate to translate a series of cash flows [42].

The cost approach assumes the value of the property is inherent in the cost to create the property based on land acquisition and building costs less wear and tear and depreciation [28]. It is not appropriate for income-generating properties [29]. It is used in estimating the value of a non-operating business or a business that continues to generate losses. There are three methods under the cost approach namely replacement cost, reproduction cost and summation methods. Replacement cost is a method that indicates value by calculating the cost of a similar asset offering equivalent utility while the reproduction cost method indicates value by calculating the cost of recreating a replica of an asset and the summation method calculates the value of an asset by the addition of the separate values of its parts [24].

The market approach is based on comparing the company with other similar enterprises for which price information is available [34]. In cases where there are substantial volumes of transactions, it is the preferred approach [11]. However, its reliability declines when market conditions are volatile [19]. This approach is applied to assets that are actively publicly traded or properties that have frequent and recent observable transactions [24]. Under the market approach, comparable transactions and guideline publicly traded comparable methods are typical. The former utilizes information on transactions involving assets that are the same or similar to the subject property. The latter utilizes information on publicly traded comparables that are the same or similar to the subject [24].

The three approaches should arrive at relatively similar and theoretically consistent value indications. But, valuations are not mutually exclusive and one can use more than one approach for cross - verification [34]. In cases where the appraiser has a high degree of confidence in the accuracy and reliability of a single approach, it is not required to use more than one approach [11]. However, utilizing more than one approach is recommended [37]. A study in Tanzania by [46] found that market-based approaches are appropriate for loss-making companies that have market evidence while cost approaches are appropriate for loss-making companies that do not have market evidence. On the other hand, for profit-making companies, the income-based approaches are appropriate. A study by [12] revealed that the DCF methods are suitable for profitable companies. Another study by [31] repealed that DCF method has been used to value SOEs in many OECD countries. However, in the case of non-listed companies, asset-based approaches like accounting for net assets, replacement cost, and liquidation methods are widely used.

The valuation methods do not support a credible valuation if the appraiser does not have a thorough understanding of the market sector within which the subject entity exists and operates [42]. In the privatization process, it is common that valuation demands quality staff more than any of the other aspects of privatization [16]. In many organizations for Economic Co-operation and Development countries (OECD) including the Czech Republic, Estonia, Italy, Latvia, Israel, Lithuania, and the Netherlands external appraisers have undertaken the valuation assignment. Conversely, a few countries like the UK and Kazakhstan employed internal appraisers. Others including Denmark, France, Australia, Korea, Turkey, and Mexico followed a mixed approach i. e. in some valuation assignments they employed specialist consultants and in others, internal appraisers undertook the valuation assignment [31].

In Ethiopia, there is no real property valuation policy or governing body. Additionally, there are no certified appraisers to carry out the valuation assignment [8]. As a result, different purposes of valuation, it is carried out according to the interest of the institutions [9]. For instance, for expropriation purposes, it is undertaken using the expropriation laws Proc. No. 1161/2019 and regulation No. 472/2020. According to these laws, the cost approach has been predominantly applied. For the case of judgment execution, federal courts use the income and cost approach while other courts use only the cost approach [7]. In addition, financial institutions perform the appraisal for mortgage purposes using the cost replacement method [8].

3. Materials and Methods

This research employed a qualitative research approach. The researcher believes that the information about how SOEs have been valued is obtained from appraisers who participated in the process of valuation and officials of the Ministry of Public Enterprise (MoPE) - now Public Enterprises Holding and Administration (PEHAA). To this argument, KIIs were conducted with four internal and one external appraiser. At the time of data collection, four appraisers were working in the ministry and the external appraiser was a former staff of the ministry few years and now he is a private consultant. KIIs were also undertaken with two officials of the MoPE. In addition to the primary data, secondary data were gathered from reports of the MoPE, books, journals, legal documents, etc. Data from the documentary review were used to ensure the accuracy of information obtained from KIIs and as additional information to those collected from primary sources. The qualitative data obtained from KIIs was transcribed in field notes. The recorded data were coded manually using a qualitative codebook. Emerging codes, predetermined codes and a combination of emerging and predetermined are the commonly used ways of preparing qualitative codes using a qualitative codebook [15]. The current study employed a combination of emerging and predetermined codes because of its flexibility during the data analysis [15]. The coding process was used to generate themes/categories for the analysis. Using the thematic classification, the data were clustered and narrated according to major thematic area.

4. Findings and Discussion

4.1. Background of the Appraisers

In the MoPE, at the time of data collection, there were four appraisers. One appraiser has a BA Degree in Economics and worked for about 11 years of which five years on valuation. Three appraisers are engineers of which two are mechanical engineers with no professional experience and one industrial engineer with five years of work experience in valuation. This indicates that appraisers lack the professional skills to value enterprises. According to key informants, external appraisers have been employed in valuing unique properties, which can be encouraged and is consistent with other countries' experience [32]. The valuation profession requires high-skill and competent manpower that should be updated with training. However, in the context of the Ethiopian practice provision of training for the appraisers was low.

4.2. Valuation Procedure

The valuation procedure used in the MoPE is described as follows

1. *Inspection and market research:-* Under this category appraisers examine the overall building characteristics which include the age of the building, the construction material of the building, types of machinery, and other office materials. It also comprises the collection of data about similar enterprises including neighborhood data, sales and rental prices, planning permits, and other related data.
2. *Communicating with officials of the privatized enterprises:-* Once the inspection and market research are conducted, the appraiser team communicates with the officials of the enterprises about other information that is not obtained by inspection and market research.
3. *Collection of financial report:-* the financial history of

the enterprise is collected.

4. *Data verification:*- the appropriateness of the collected data is verified.
5. *Valuation and reconciliation;* the mechanics of valuation are done.
6. *Reporting*- Communication of the result to the concerned body.

The study revealed that valuation does not follow the standard procedure in the valuation literature. This may be due to the absence of a valuation standard in Ethiopia [9]. Using non-standardized valuation leads to valuation inaccuracy [1, 3, 5, 7 10, 17]. An inaccurate valuation can make the enterprise too cheap or too expensive, which may have an impact on the government and the potential purchaser.

4.3. Valuation Approaches and Methods

4.3.1. General Overview

The study found that either the discounted cash flow (DCF) method or the depreciated replacement cost (DRC) method or both methods have been used. The DRC method was the only technique used until 2013. However, in 2013 some appraisers took training in the UK and these appraisers influenced the officials of the ministry about the need for using alternative valuation methods. Currently, depending on the profitability of enterprises, either or both methods have been used. Profitability is determined based on the latest three years' balance sheet. Enterprises that have had positive cash flow at least one fiscal year from the past three are considered profitable while others that have negative cash flow in all three years are considered loss-making. Profitable SOEs are valued by both methods and the maximum value is taken as a final value. On the other hand, loss-making enterprises are valued using the DRC method.

Valuing profitable SOEs using the two methods is consistent with empirical works including [46] and [32]. However, reconciliation was not considered, contrary to the valuation practice elsewhere [37]. For loss-making SOEs, it is only the improvements that have been considered, which may result in no value. Within the scope of valuation, the DRC method is mostly seen as a solution of last resort, when no other option is available [14]. Moreover, the value of a business using the DRC method is likely to be lower than its true value unless an estimate is made for the value of goodwill and other intangible assets, such as brands.

4.3.2. Depreciated Replacement Cost (DRC) Method

Based on the discussion with key informant appraisers and other experts, the mechanics of SOEs using the DRC method are described as follows

1. *Replacement cost of the improvement* – Appraisers have been calculating the direct cost using the square foot method i. e., unit cost per area is calculated from the market. Indirect cost is estimated by considering some percentage of direct cost i. e., 2% for building & building supervision, 2% for design & soil laboratory, 12% for life and fire insurance, and service charges.
2. *Depreciation*- The straight-line depreciation method has been used by assuming buildings have lost value at a steady rate over their economic life. The economic life of enterprises is considered by taking the type of construction materials. It is 30 years, 40-50 years, and 75 years for those which are built in mud, concrete, and bricks respectively.
3. *Site value* - site value is not included in the valuation of SOEs.
4. *Final Value* - it is the sum of the replacement cost of the improvements, direct cost, and indirect cost.

Discussion

First, the use of percentages in calculating indirect cost is baseless and there is no convincing reason by KIIs of how these proportions were taken rather they are following what is written in the valuation directive. *Second*, in estimating depreciation the use of the straight-line method only is not reliable and accurate since the depreciation amount changes from year to year, from location to location, and from property to property. In addition functional and external obsolesces are not considered. Without considering the appropriate depreciation, it is difficult to reach an accurate market value. This also links back to the lack of formal training of the appraisers who may lack the necessary skills and insight to make interpretations about properties or real estate markets that go beyond merely calculating values. *Third*, the effective age has been considered by simply taking the buildings' actual age, the actual age and effective age may be different since the latter is the actual condition and utility on the valuation date rather than its chronological age [38]. *Fourth*, the economic life of enterprises is considered by taking the type of construction materials only. However, this type of argument may result from incorrect value opinions as the life of the building is not only determined by building materials but also by weather conditions, the use by the client, design, and others [47]. *Fifth*, land value had not been added to the value of SOEs. The reason for the exclusion is that the constitution of the Federal Democratic Republic of Ethiopia under Article 40 (3) denies the economic value of the land. However, the same article states that land is the common property of the government and the people of Ethiopia, which is contradictory. Moreover, practically when real property is sold in the open market the value of land is taken into account in the price of the property [9] Key informant appraisers also argue that estimating the value of vacant land is difficult in Ethiopia because of the absence of a land market. However, the local government in different cities has sold land every year. So, the appraisers of the ministry may take the actual lease price of the neighborhood as a benchmark price of the land as vacant in estimating the value of the enterprise. *Finally*, entrepreneurial profit is not part of the calculation. This indicates that the government has been selling SOEs to individuals and institutions for cheap prices as the value of enterprises is simply the DRC value of the improvements.

4.3.3. Discounted Cash Flow (DCF) Method

DCF method uses an appropriate discount rate to translate a series of cash flows over time, together with any reversion value or resale proceeds, into an indication of present value [29]. Based on the discussion with key informant appraisers and officials, the determination of the value of SOEs using the DCF method is examined as follows.

1. *Holding Period* - 10 years were considered for all SOEs
2. *Estimation of Income & Expense* – net operating income (NOI) is forecasted using the past three consecutive years' balance sheet. Vacancy and collection losses (V&CL) and bad debts were not considered. In addition, the expenses for property tax, utilities, tenant improvement, and the reserve fund were not incorporated
3. *Terminal Value* – terminal value is calculated using the following formula

$$TV = \left(\frac{(NOI_n) * (1 + r)}{r - g}\right)\frac{1}{(1 + r)^n}$$

Where NOI = net operating income
r = bank interest rate taken from the national bank
g = growth rate
n = cash flow period

4. *Final Value* - the sum of terminal value and the sum of discounted NOI of the ten years

Discussion

Using a 10-year holding period for all privatized enterprises is not convincing. This is because the holding period can be varied based on the year of building, the actual physical appearance of the building, building materials, weather conditions, etc. In addition, appraisers forecast the income of SOEs by assuming enterprises will be fully occupied and all income is realized throughout the holding period of the enterprises. Moreover, the formula for estimating terminal value uses the 10^{th-}year NOI. Since the terminal value is the remaining value after the project has ceased its function, the cash flow from the operation period should not be used in determining the terminal value. In addition, expenses for property tax, utilities, tenant improvement, and the reserve fund should be considered to make the valuation more accurate.

4.4. Valuation Reporting

The most widely used valuation reports that can fill any valuation need are categorized into three groups namely summary valuation report, narrative valuation report, and restricted use valuation report [4]. According to the key informants and observation of the valuation report by the researcher, the valuation report in the ministry has many issues in common with the summary valuation report and is based on the ministry's guidelines, but there is a long procedure to approve the report for decision-making. The valuation prepared by the appraisers' team should be first approved by the team leader and then by the investment administration and privatization director and then by the state minister and by the minister. Finally, the minister will accept or reject the report. This practice improves the valuation result to some extent. However, the process is a bit longer and makes the valuation bureaucratic. Since the final report is approved by politicians the possibility of improving valuation error is minimal. In such cases, the estimated value of SOEs may not indicate the actual worth as there may be the political motivation of the report by leaders and this leads to the resource of the country being understated or overstated which will affect the strategy of privatization.

5. Conclusion and Policy Implication

The Ethiopian government has been transferring SOEs since 1994. Profitable SOEs are valued by the DCF method and DRC method simultaneously and the maximum value from the two methods is taken as the final value. On the other hand, loss-making enterprises are valued by using the DRC method. The mechanics under each method of valuation are appropriate. The valuation report approval process is bureaucratic and can be politically motivated as the final decision is by leaders who are not professionals and this suppresses the appraiser's freedom of expression in giving their opinions. This paper also revealed that the ministry lacks adequate organizational capacity. Appraisers do not have the right skills to meet the challenges of a more complex assignment given that the valuation assignment requires specialized skills. The lack of historical and comparable data worsens the situation. This has meaningfully affected the strategy of the privatization process. To improve the valuation of SOEs, the scope and methodology of real property valuation for privatization should be standardized based on accepted principles and standards and undertaken by certified and skilled experts. This can be achieved by introducing strong institutions responsible for valuation regulations at the central level. The institution should also ensure appraisers use the appropriate valuation approach/ method. In doing so, the DRC method should be applicable for certain enterprises that require separate estimates of value for the land and improvements appropriately. In addition, in applying the DCF technique appropriate variables (holding period, vacancy, and collection losses) should be estimated logically and scientifically.

Abbreviations

DCF	Discounted Cash Flow
DRC	Depreciated Replacement Cost
KII	Key Informant Interview
MoPE	Ministry of Public Enterprise
NOI	Net Operating Income
OECD	Organization for Economic Co-operation and Development
PEHAA	Public Enterprises Holding and Administration
SOEs	State Owned Enterprises
V&CL	Vacancy and Collection Losses

Author Contributions

Habtamu Bishaw Asres is the sole author. The author read and approved the final manuscript.

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Biography

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Research Fields

Habtamu Bishaw Asres: Real Estate Economics, Land Governance, Land Administration and Management, Real Property Valuation, Housing Finance, Property Taxation