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PRIVATIZATION THROUGH LEASING: THE TOGO STEEL CASE

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A government wanting to divest state-owned enterprises (SOEs) can theoretically choose among several courses of action: it can liquidate them, allow them to go into some sort of hibernation, or privatize their ownership through total or partial sales. It can also privatize the management of those enterprises by entering into management contracts with private parties or by leasing the enterprises' assets to those parties.Under the latter arrangement, the private partners undertake to run all or part of the enterprises, and lease the physical installations from the government for specified lengths of time in return for paying predetermined fees. The government retains ownership of the physical assets, thus leaving it free to pursue any of the other options when the leases expire. Thus, leasing is a form of privatization that permits a government to avoid making the drastic departure from the *status quo* entailed by liquidation or outright sale of an SOE, while leaving it free to pursue a wide range of options in the future, including divestiture, which might become attractive once an SOE has been turned around.

This chapter describes an actual leasing experience in Togo; one of the first of its kind in Sub-Saharan Africa. In 1984, the Lomé steel mill, a small smelting and rolling operation producing reinforcing bars, was leased to an American entrepreneur. The mill had been operating at a loss since its commissioning in 1979. The leasing venture turned out to be a commercial success for the private investor, and operations were subsequently expanded with a major diversification project. This study

examines the Togo steel case with two questions of interest to policymakers:

1. Under what conditions is leasing to a private operator likely to be more attractive than either continued operation under state management (if this alternative is open) or outright liquidation?
2. How should the leasing agreement be structured so that it is sufficiently attractive to the private entrepreneur, while also safeguarding the country's interests?

Historical Background

Toward the mid-1970s, when Togo's economy was flourishing because of the high price of one of its major exports, phosphates, Togo became interested in establishing an iron and steel industry. Part of the rationale for doing so was the desire to exploit an iron ore deposit in northern Togo. However, due to its small size, poor yield, and distant location that deposit was never exploited. Instead, Togo accepted an offer made by a Swiss company, BBC, to construct a mini steel plant with an annual capacity of 20,000 tons of reinforcing bars. The proposed plant was to use local scrap iron as feedstock to produce ingots and rolled products. BBC's proposal was accompanied by a poorly prepared feasibility study that demonstrated the investment's economic viability. The study's shortcomings included an incorrect analysis of the scrap supply in Togo and adjoining countries, overoptimistic estimates of the local and regional market for reinforcing bars, and financial projections based on very unrealistic assumptions, such as full utilization of capacity at plant start-up. Nevertheless, the government accepted the report's conclusions and entered into an agreement with BBC.

A consortium of Austrian, Swedish, and Swiss companies was formed to supply the plant on a turnkey basis. In April 1976, the Togolese government signed a CFAF 13 billion contract with the consortium (approximately US$32.5 million).[1] A financing package of CFAF 9.5 billion was put together that same year in the form of medium-term loans from Austrian, Swedish, and Swiss banks. The Togolese government funded the balance of CFAF 3.5 billion. The government set up a national iron and steel company, Société Nationale de Sidérurgie (SNS), to operate the plant. The mill was built in an industrial estate near Lomé and commenced operations in 1979.

The company's operating results were disastrous right from the start (table 7.1). Sales in 1980 were about one-fourth the original projections, and the operating results showed a net loss of CFAF 2,184 million instead of a projected net profit of CFAF 1,780 million. Total unit costs were more than six times BBC's projections, about three times the local selling price, and about six times the c.i.f. import price (CFAF 110-120,000 per ton). Direct costs alone were estimated at CFAF 177,600 per ton, which under the prevailing production conditions ruled out any prospect of improving profitability by raising production volume. Moreover, the constraints on local availability of scrap, ignored in the BBC study, forced the company to turn to ever more distant sources of supply, so that the price of the scrap increased with increasing production: the company estimated that at full capacity (20,000 tons), the cost of scrap per ton of steel produced would average CFAF 42,000 compared to the feasibility report's estimate of CFAF 13,200.

In 1980, the disappointing sales volume led the local authorities to grant SNS a monopoly on the import, production, and sale of reinforcing bars in the local market; a monopoly previously held by another state company. However, because Togo's domestic consumption of reinforcing bars did not exceed 6,000 tons, SNS had to develop export markets to utilize even 25 percent of its capacity. It did manage to export steel to Niger and Burkina Faso in 1980, but the amounts were small and the transactions were at a loss since the world price did not even cover SNS's variable production costs. Moreover, in those two countries Togolese steel was subject to import duties 8 percent higher than those applied to products of European origin. By the end of 1980, SNS's cumulative losses, after 18 months of operation, totaled CFAF 308 million before depreciation and financial costs, and CFAF 2.9 billion after depreciation and interest.

In 1981, a World Bank mission carried out the first diagnostic study of SNS. Among the main causes of poor performance it identified were (a) the lack of experience of SNS's management staff, especially in the areas of procurement, marketing, finance, and administration; (b) the small size

1. The CFA franc (CFAF) is pegged to the value of the French franc (F1 = CFAF50). The rate of exchange of the CFA franc in terms of U.S. dollars varied appreciably over the time period covered here. In 1984, at the time the leasing agreement was concluded, the rate was approximately CFAF400 to the U.S. dollar.

Table 7.1 SNS' Performance, 1979 and 1980

Category	*Unit*	*1979 (6 months)*	*1980 Actual*	*1980 BBC projections*[a]
Sales	Tons	1,100	5,450	20,000
Operating results				
Operating profit (loss)	CFAF millions	(314)	(1,400)	n.a.
Interest on external loans	CFAF millions	392	784	n.a.
Net profit (loss)	CFAF millions	(704)	(2,184)	1,780
Cash flow	CFAF millions	(186)	(1,111)	n.a.
Unit costs				
Direct costs and overhead	CFAF/ton	n.a.	240,000	n.a.
Depreciation	CFAF/ton	n.a.	200,000	n.a.
Financial charges	CFAF/ton	n.a.	143,850	n.a.
Total		n.a.	583,850	94,100

n.a. = not available

Numbers in parentheses indicate losses.

a. Based on projections contained in the feasibility report prepared by BBC in the mid-1970s.

Source: World Bank, 1981, *Report on State-Owned Companies in Togo* (Washington, D.C.).

of the local market, coupled with severe competition from European suppliers; (c) the inordinately high production costs, resulting largely from the high cost of imported raw materials; and (d) the inadequate financing, especially for working capital.

First Privatization Attempt

In mid-1980, the Togolese government and BBC started discussions with a view to rehabilitating SNS by setting up a new organizational and management structure. The negotiations took place sporadically over several months and finally collapsed in April 1981. The main elements of BBC's proposal were to set up a new company, Aciérie du Togo, S.A. (ATSA), jointly owned by BBC and the Togolese government. BBC would lease the steel works from SNS and manage the facility, using a team of nine expatriates. BBC would make a loan of SwF 9.4 million to ATSA, while SNS would continue to be responsible for its existing liabilities. BBC proposed that the plant be leased from SNS for a yearly rent, made up of a fixed sum of CFAF 50 million and a variable part equal to 75 percent of the gross operating profit.

According to the projected operating account of the new company, the project would generate a cumulative cash flow of CFAF 3.5 billion over 10 years, which would cover about 40 percent of the external loans contracted, equivalent to about 25 percent of total debt service. However, the projection optimistically assumed that the sales volume would rise from 5,250 tons per year in 1980 to 35,000 tons per year in 1985. A simple calculation showed that if sales in 1985 and beyond were 30,000 tons per year instead of 35,000 tons, the cumulative cash flow over ten years would fall to CFAF 837 million; and if sales were only 20,000 tons per year, the cumulative cash flow would actually be negative. Thus, the proposal was financially unsound, and the government's decision to reject it was understandable. An economic analysis using border prices to value inputs and outputs also indicated that value added would be negative even if BBC's optimistic sales projections were met.

At this juncture, the World Bank recommended that the plant be closed as soon as possible. One of the major preconditions of a World Bank structural adjustment loan in 1983 was the satisfactory resolution of the SNS problem by rehabilitation or privatization, if these alternatives were

feasible, or by closure and liquidation. This pointed to the need for studies to explore the economic feasibility of rehabilitation and assess SNS's net worth in order to draw up a liquidation account in the event of closure or privatization.

In 1982, the government invited bids from specialist firms for a detailed technical and economic study of SNS. The terms of reference for this work included a technical assessment of the plant's operations and identification of possibilities for improvement, a study of scrap supply, a market study for the plant's products in Togo and the region, and an assessment of the company's organization. As one of the outputs of the study, the consultant was to recommend the most economical plan of action from among four alternatives: cease operations entirely and wind down the company, mothball the facilities until the economic situation warrants resumption of operations, close down the smelter while continuing to operate the rolling mill with imported billet, or rehabilitate the company if this could be done within a reasonable timeframe and with a decent chance of success.

The study was awarded to a reputable French firm, Hexatec, which estimated the Togolese demand for SNS's products at about 4,500 tons per year without plant modifications, and 6,000 tons if a rolling facility to produce small bars were added. Hexatec saw the potential export market as consisting of Burkina Faso, Niger, and Benin, which together could absorb 5,500 to 9,000 tons per year depending on whether or not plant modifications were made. Other countries of the region were found to offer little potential: Mali because of strong competition from European suppliers; Ghana and Nigeria in view of their own production capacity; and Cameroon, Côte d'Ivoire, Gabon, and Zaire because of the very low selling prices that would be required to match the competition. Even for the most promising countries, ex-works prices would have to be much lower than for the local market, where SNS enjoyed a high nominal rate of protection (projected by Hexatec to be on the order of 60 percent).

According to the consultant's study, scrap could be obtained from three sources, successively more distant and more expensive. Togo itself could provide some 3,000-4,000 tons per year at an average millgate price of CFAF 12,000 per ton; adjacent countries, from which the material could be trucked in, could supply 3,500-5,000 tons at CFAF 20,000 per ton; and other West African countries, from which sea transport had to be used,

could supply scrap at CFAF 43,000 per ton. In comparison, the average delivered price of scrap in Europe was CFAF 25,000 per ton in 1983.

The most negative finding of the Hexatec study concerned unit manufacturing costs. Under conditions prevailing at the plant in 1983, Hexatec estimated the unit manufacturing cost at CFAF 183,000 per ton of finished product. By implementing a program of management and technical improvements, Hexatec calculated that the unit manufacturing cost could be decreased to CFAF 135,000-145,000 per ton depending upon the extent of rehabilitation. In comparison, unit manufacturing costs at similar plants in Europe, according to Hexatec, would not exceed CFAF 74,000. Thus, even with the reduction in unit costs that could be achieved by tightening operations—approximately 20 percent under the best scenario—the company would make no profit on export sales and only modest profits on local sales. Thus, Hexatec did not see any way SNS could fully absorb depreciation charges and debt servicing costs.

In view of the discouraging outlook presented by the Hexatec report, the government asked the consultant to study in greater depth the scenario of closing down the mill's smelter and operating the rolling mill alone with imported rather than locally made billets. Hexatec concluded that this option could work only if SNS's entire production were sold in the domestic market. Furthermore, Hexatec considered this scenario as involving a substantial long-term risk. If the world economy picked up, steel mills would be more interested in selling finished products than billets, and the company could find itself paying more for billets than for the finished bars.

Thus, the conclusion implied by the Hexatec study was that the government should close the SNS plant. The next logical step seemed to be the recruitment of another consultant to audit the company's books, ascertain the company's net worth, determine the plant's market value, and recommend the best liquidation procedure. At this juncture, as the Togolese government was pondering the Hexatec report, an American businessman with previous involvement in a mini steel mill similar to SNS in Central America, visited Togo and expressed an interest in taking over part of the plant's operation. By this time, as the audit report showed, SNS's cumulative losses since start-up totaled nearly CFAF 12 billion, the net book value of assets was negative CFAF 6.3 billion, and the market

value of the company's physical assets was estimated at less than CFAF 1 billion. Thus, liquidation was an unsavory prospect, especially because of the mint condition of the plant, the quality of its equipment, and the CFAF 13 billion that the Togolese government had spent to build it.

The Ibcon Lease Proposal

In December 1983, the American entrepreneur's company, Ibcon S.A., submitted a proposal to the Togolese authorities to form a joint venture with the government that would lease the SNS mill and produce large diameter bars using imported billet and small bars using imported coils. The ingot casting operation was to be discontinued.

The proposal contained financial projections based on a production program of 6,000 tons per year, which matched Togo's domestic demand in 1982. On this basis, once stable operations were reached, net income was projected at 15 percent of sales after a modest lease payment to the government. The proposal also contemplated selling steel to a few large construction projects then in the planning stage, and projected the gradual development of about 4,000 tons per year of exports to Benin, Burkina Faso, and Niger. The plant would employ 65 people.

According to the Ibcon proposal, resumption of operations on this basis would require about CFAF 335 million of new investment, of which 35 percent would be financed through equity and the balance by a long term loan. Ibcon would own 40 percent of the equity, while the Togolese government and the International Finance Corporation (IFC) would each own 30 percent. IFC had expressed an interest in investing in the venture and in providing some long-term loans. The government's contribution would be in lieu of the lease payment for the first year of operation. The financial return on the operation, projected at 55 percent in the proposal, assumed that domestic sale prices would be approximately equal to import prices plus customs duty of 41 percent.

The unit manufacturing cost projected by Ibcon for the large reinforcing bars (rolled in the plant) was comparable to those in the Hexatec study. The concentration of sales in the local market, at protected prices, permitted an appreciable operating profit, whereas the Hexatec scenario also envisaged unprofitable foreign sales. Furthermore, the profit margin on small reinforcing bars (made from imported bar stock) was projected to be

very high owing to the low processing expenses and the advantage conferred by tariff protection.

According to the terms set forth in the Ibcon proposal, a ten-year renewable lease for the plant would be concluded between the government and the new company, with both cancellation and renewal options. The proposed lease amount was set at the higher of either 20 percent of annual gross profit or CFAF 40 million (US$100,000). Ibcon proposed that the new company would sell all the unnecessary plant and inventory on behalf of the government at the best possible terms for an unspecified commission. A five-year, renewable management contract would be established between the new company and Ibcon S.A., whereby the latter would take full responsibility for managing the plant through an expatriate plant manager and senior company staff. In negotiating the final proposal, the government's goal was presumably to maximize the project's social benefits, while Ibcon's goal was presumably to maximize the return on its investment and minimize the risk involved.

As a foreign investor setting foot for the first time in Africa, Ibcon was believed to be quite concerned about the political, financial, and economic risks of doing business in Togo. Based on the projected operating account included in the investor's proposal, the government was able to determine how changes in various assumptions were likely to affect the project's economic and financial characteristics. For this purpose, the government's technical staff set up a spreadsheet model of the project. Four quantitative measures were of primary interest to policymakers: the economic rate of return to Togo, the impact of the agreement on the government's cash flow, the impact on the country's foreign exchange resources, and the financial rate of return earned by the foreign investor. Table 7.2 presents the results obtained along the four performance measures under various scenarios.

The net economic benefit was calculated as the difference between discounted sales proceeds and discounted input and factor costs over a ten-year period, with both inputs and outputs valued at border prices. The opportunity cost of using the assets, measured by the estimated liquidation value of the plant, was treated as a cost in year 0, revenues from the planned export of surplus scrap steel by Ibcon were accounted for in year 1, while the plant's salvage value was recognized as an inflow in year 10. Dividends, net of taxes, accruing to foreign shareholders were treated as

Table 7.2 Results of Evaluating Ibcon's Proposal Under Various Scenarios

Scenarios	*Economic rate of return (%)*	*Impact on government cash flow (CFAF millions)*[a]	*Net foreign exchange outflow (CFAF millions)*[b]	*Financial rate of return to shareholders (%)*
1. Base case, 6,000 tons/year, no exports[c]	Negative	–48.2	142.0	37.7
2. Base case, 10,000 tons/year, 2,500 tons exports	0.6	–26.6	107.6	45.8
3. Scenario 2, plus rent increased to 40% of gross margin	5.4	–9.0	89.5	34.0
4. Scenario 2, plus government share of equity increased to 49%	6.4	–11.2	92.0	34.4
5. Scenario 2, plus 10% import duty on coils	4.0	–12.9	94.7	38.7
6. Combination of 4 and 5	8.4	–0.8	82.6	28.9
7. Combination of 3, 4, and 5	10.7	9.7	72.0	21.4

a. Average annual cash flow to the government with the lease agreement minus the average annual cash flow to the government without the agreement. Thus, a negative sign indicates that the government's cash flow was worsened by the lease agreement.

b. Average annual net foreign exchange outflow with the lease agreement minus the average annual net foreign exchange outflow without the agreement. Thus, a positive sign indicates that the government's foreign exchange reserves would be worsened by the lease agreement.

c. Description of base case

Rent as percentage of gross margin	20.0
Government share of equity (%)	30.0
Tax on turnover (%)	10.0
Corporate tax on profits (%)	49.0
Tax on dividends (%)	25.0
Tax on salaries (%)	2.0
Import duties (%)	2.1

Source: Ministry of Planning and Administrative Reform, Togo.

Table 7.3 Ibcon's Proposal: Estimated Net Annual Economic Benefit After Stabilization of Operations

Category	*Quantity (tons)*	*Price[a] (CFAF/ton)*	*Total revenues (CFAF millions)*
Revenues:			
Large bars — domestic	5,600	147,800	827.7
Small bars — domestic	1,900	181,600	345.0
— export	2,500	181,600	454.0
Total	10, 000	-	1,626.7
	Foreign exchange (CFAF millions)	*Local currency (CFAF millions)*	*Total (CFAF millions)*
Costs:			
Large bars[b]			
Billets	512.1	56.9	569.0
Electricity, fuel, oxygen	48.6	20.8	69.4
Consumables	22.0	9.4	31.4
Spare parts	13.0	5.6	18.6
Management contract	39.2	16.8	56.0
Insurance	0	12.3	12.3
Direct labor/administrative salaries	0	32.5	32.5
Selling/General and administrative expenses	0	9.0	9.0
Audit expenses	0	1.1	1.1
Shrinkage	79.9	8.9	88.8
Subtotal	714.8	173.3	888.1
Small bars			
Coils	535.4	59.5	594.9
Transformation costs	5.3	21.1	26.4
Subtotal	540.7	80.6	621 3
Total costs	1,255.5	253.9	1,509.4
Revenues minus costs	371.2	(253.9)	117.3
Debt servicing	40.1	0	40.1
Dividend outflow net of tax	21.4	0	21.4
Net economic benefit	309.7	(253.9)	56.0

-- = not applicable

Note: Figures pertain to 1988, by which time the operations of the new company were expected to have stabilized. Figures in parentheses indicate losses.

a. Estimated border prices calculated on the basis of c.i.f. Lomé prices plus 20 percent handling and transport from port to plant, plus a 15 percent premium to reflect the advantages of local availability and quick delivery.

b. Estimated international prices used for all tradables; local taxes are excluded from input and factor costs; no shadow prices used for salaries and wages.

Source: Derived from: Ibcon S.A., Proposal to the Togo Government, (December 1983).

costs to the country. Debt servicing on foreign loans was handled the same way. The resulting costs and benefits for 1988, by which time operations were projected to have stabilized, are shown in table 7.3 for the base case, that is, the project as put forth in Ibcon's proposal. The project is seen to result in a small net economic surplus of CFAF 56 million in 1988. The numbers in table 7.3 provide some idea of the magnitude of individual revenue and cost categories that, in turn, yielded the economic rates of return presented in table 7.2.

The second performance indicator—impact on government cash flow—was defined as the incremental revenue obtained by the government with the project compared to without the project. In the latter case, government revenues would consist mainly of customs duties on imported reinforcing bars, while in the former case it would consist of rent, dividends, and tax receipts.

The third performance indicator—net foreign exchange impact of the project—was defined as the difference between the foreign exchange outflow with the project (capital goods and raw materials imports, interest on external loans, and after-tax dividends paid to foreign shareholders) and those without the project (finished product imports). Thus, a positive result on this measure would mean the project lowered Togo's foreign exchange reserves.

Table 7.2 shows that the project would generate a reasonable economic rate of return only if exports were realized, rents and import taxes were higher than assumed in Ibcon's proposal, and the government's equity stake was raised. Note that the economic return would not exceed 11 percent even in the most favorable scenario (no. 7). Government cash flow, as compared to the liquidation alternative, would at best be neutral (scenario 6) or slightly positive (scenario 7). In every scenario, the project's net impact on the balance of payments was likely to be negative: the manufacture of reinforcing bars from imported billet used more foreign exchange than direct importation of the finished product. However, the project's financial return after taxes was likely to be high in all the cases, ranging from a low of 21.4 percent to a high of 45.8 percent.

Thus, the government's first analysis seemed to suggest that the economic value of Ibcon's proposal, while not negligible, was likely to be small even if certain conditions were added to the original Ibcon proposal. However, Ibcon's proposal would save the government from the

unpleasant task of closing a new, expensive industrial plant and laying off a few hundred employees. Among the government's other concerns was Ibcon's proposal to abandon smelting without a serious study of its profitability, especially since another mini mill expert had recently suggested to the government that smelting could be profitable. In addition, the government wanted to ensure that Ibcon did not sacrifice SNS's long-term interests in its pursuit of short-term profits. Specifically, the government was concerned that Ibcon might not bother to develop export markets, pursue diversification opportunities, and/or maintain the steel plant properly. These issues arose during the negotiations that followed Ibcon's proposal.

Negotiations with Ibcon

Negotiations between the Togolese government and Ibcon took place sporadically during a two-week period. On the matter of equity, the Togolese government said it preferred not to participate in the new company's capital, although it would welcome part of the capital being made available to private Togolese investors. Ibcon agreed to take care of the company's initial capital, with or without a contribution by the International Finance Corporation (with which no agreement was finally to materialize), and to make part of the capital available to Togolese investors after a few years. A second change to the original proposal was Ibcon's offer to include the collection, preparation, and export of steel scrap in the activities of the new company. The government accepted this after the computer model confirmed that it would improve the project's economic rate of return. Ibcon also agreed to explore diversification opportunities for the mill, including the possibility of recommissioning the arc furnace and resuming smelting if and when it appeared to be financially feasible. With that possibility in mind, the furnace and its ancillary equipment would be mothballed rather than dismantled and sold.

During discussions, the government expressed its concern about several issues, including the continued operation of the arc furnace, proper maintenance of the leased facilities, and a commitment by Ibcon to actively explore export possibilities. For its part, Ibcon expressed a strong preference that the government should participate in the venture's equity, and tried to obtain a lease, tax, and pricing package that would allow a financial return compatible with the venture's perceived risk. Tax

provisions, in particular, were debated at length, with the Togolese government insisting that its cash flow with the lease arrangement should at least equal the import duties that it would have collected on finished products if the project were not implemented. The negotiations finally led to an agreement in principle between Ibcon and the Togolese government providing for the creation of a new company under Togolese law, the Société Togolaise de Sidérurgie (STS), whose capital would be subscribed entirely by Ibcon. STS was established in July 1984 and the final agreement was signed in October 1984.

The final agreement between STS and the Togolese government stated that the company would start operations by manufacturing reinforcing bars of 6-8 mm diameter from imported coil (that is, by simple straightening and cutting), while bars of 10 mm diameter and above would be made from imported billet or from other raw materials. The purchase, preparation, and export of the steel scrap held in inventory by SNS would also be STS's responsibility. STS would resume the use of the arc furnace and casting facilities when economic conditions warranted it. Ibcon would provide all new investments necessary to implement STS's manufacturing program, including working capital, without government guarantees. Furthermore, STS committed itself to explore promising diversification opportunities and new manufacturing operations that appeared financially viable.

For its part, the government offered STS several assurances. The legal guarantees included freedom for STS to exercise all the provisions of its statutes, including those relating to choice of shareholders and associates, with the understanding that STS would endeavor to sell up to 30 percent of its shares to Togolese private interests as soon as possible. The government's economic and financial guarantees dealt with import duties and taxes on competing finished products, which were to be kept at the levels prevailing at the time of signature for five years. At the end of this period the import tax and duty were to be reviewed by mutual agreement. Domestic selling prices were to be determined by a government-approved schedule, reviewed on a semi-annual basis, and indexed for automatic adjustment for direct operating costs outside the company's control (essentially, imported raw materials). Also, the government promised to make foreign exchange available for imported equipment, operating expenses, and the repatriation of profits and dividends. Finally, the government guaranteed that for the duration of the agreement STS would be exempt from import duties on equipment, spare parts, raw materials, and other inputs not available in Togo, including semifinished products such as coils. It also agreed to waive all export duties on the company's products.

The formula to be used for calculating the lease amount was as follows. The lease fee would be a fixed amount of CFAF 70 million for the first two years of operation; thereafter, and until year 6, the fee would be the higher of an increasing percentage of gross margin or a fixed amount, the latter also increasing annually. Starting in year 6 and to the end of the lease, it would be set at the higher of CFAF 80 million or 40 percent of gross operating income. The lease was to be valid for ten years, renewable by mutual agreement. Upon expiration of the lease agreement, all investments made by STS and inventories in excess of the initial level would be repurchased at book value by the government, which would retain a right to inspect all important investments made by STS after year 6.

Thus, the final agreement differed from Ibcon's original offer in three respects. First, the production program was altered so that 8 mm bars were no longer to be rolled from imported billet, but manufactured by straightening and cutting imported coils, and the collection, preparation, and export of steel scrap was added to the company's activities. Second, Ibcon was to be a majority shareholder of STS, with an initial holding of 100 percent that would be reduced to 70 percent following the issue of shares to Togolese investors. No longer was there any question of technical assistance fees or annual commission on gross profits payable to Ibcon. However, since Ibcon controlled STS, there was nothing to prevent transactions of this kind from taking place between the two companies. Finally, the amount of rent was increased significantly from 20 percent of gross operating profit (minimum CFAF 40 million) to 40 percent of gross operating profit (minimum CFAF 80 million) after five years of operation.

A Preliminary *Ex-Post* Evaluation

The draft agreement of March 1984, including the export of 6,000 tons of scrap a year, was projected to yield an economic rate of return of 6.3 percent (table 7.4). Compared to the alternative of liquidating the steel plant, it promised to yield a small net foreign exchange saving of CFAF 9.6 million and a worsening of the government's cash flow deficit by

Table 7.4 Evaluation of the Draft Agreement of March 1984 with Ibcon S. A.

Scenario	*Economic rate of return (%)*	*Impact on government cash flow (CFAF million)[a]*	*Net foreign exchange outflow (CFAF million)[a]*	*Financial rate of return to shareholders (%)*
Conditions as reflected in draft agreement of March 1984 (details in text)	6.3	–7.1	–9.6	21.8

a. Same definition as in table 7.2. Note that the final agreement, compared to Ibcon's original proposal (see table 7.2, base case) promised to improve both the government's cash flow position and the country's foreign exchange position. As this table shows, the final agreement was projected to *reduce* the country's foreign exchange outflows relative to the option of liquidating the steel plant.

CFAF 7.1 million. Even though these results appeared only marginally favorable to Togo, the project was deemed attractive for the intangible benefits it promised to yield. The World Bank officially concurred with this point of view. Subsequently, the final agreement was also appraised to measure the impact of altering the manufacturing program to produce 8 mm reinforcing bars from coil instead of billet. Due to the increase in exports projected as a result, the large contract subsequently obtained from a local construction project, and the diversification that had already begun (rolling of small shapes for the local market), the economic rate of return was of the same order of magnitude as for the draft agreement of March 1984, while government cash flow was better than projected earlier.

STS itself quickly turned a profit on its operations. For its first complete financial year (1985), the company realized a net profit, after lease payment and taxes, of CFAF 112 million on a turnover of CFAF 1.5 billion. That year, STS sold about 8,000 tons of reinforcing bars and exported 6,000 tons of prepared scrap. In 1986, it sold 11,000 tons of bars, of which about 3,000 tons were exported. By comparison, the projected sales in the Ibcon proposal were 6,900 tons for 1985 and 7,800 tons for 1986.

Several factors accounted for STS's financial success. In the first place, an energetic management team was able to develop markets rapidly through aggressive selling and good service, particularly with regard to delivery times. Another factor was effective control of production costs. A significant achievement in this regard was the decision to use second-hand railroad track steel rather than billets to produce bars. Railroad track steel was 30 percent cheaper than billets and was available in large quantities in many parts of the world, including Africa, and yielded a final product that was equivalent or superior in quality to bars produced from billets. STS's procurement of raw materials was also very effective, relying on flexibility, diversification of sources, and an aggressive search for opportunities. Finally, the government's pricing policy, based on a tariff protection rate of 41 percent, resulted in high profit margins in the domestic market. An analysis carried out in 1987 by the International Finance Corporation showed that the net margin (after depreciation) in the local market was 34 percent of sales for products made from rail stock and 21 percent of sales for products made from billet. In contrast, the net

margins on exports were 9 percent of sales for products made from rail stock and -9 percent for products made from billets.

Ibcon also moved as promised to sell equity to local investors. In 1986, 35 percent of the company's equity was sold to private investors in the form of preferred stock, with 14 percent being subscribed by Togolese investors and the rest by other African investors. The shares had to be distributed through banks, since Togo had no stock exchange, and they were guaranteed to yield a minimum return of 10 percent.

From Togo's point of view, a surprising positive development was STS's early move into a new product line, pylon manufacturing. The project, undertaken in 1987, consisted of additional facilities to make pylons and structural beams from formed and welded reinforcing steel. The technology was obtained from a Danish firm, Ramboll & Hannemann (R&H), which was a world leader in the field with more than 35 years experience with the process. R&H prepared the feasibility report for the project and contributed toward the venture's incremental investment. R&H was also entitled to a royalty of 1 percent of sales. The capital cost of the project (CFAF 600 million or US$1.97 million) was financed through a combination of equity (31 percent of total cost) and long-term loans from the International Finance Corporation (CFAF 260 million) and the Danish Industrialization Fund for Developing Countries (CFAF 152 million).

The new product fit in nicely with STS's operations by allowing existing manufacturing assets to be more fully utilized. It gave Togo access to a superior technology while also advancing the country's technological expertise. While delivering roughly the same performance as traditional concrete and welded angle-iron structures, pylons made of reinforced steel were cheaper to manufacture (10 to 20 percent less) and transport (25 percent less) and are also more durable. Moreover, the new product could use STS's existing marketing, distribution, and transportation systems, both within Togo and in neighboring countries. Over a period of four years, annual sales were expected to grow to about 1,500 tons of pylons and 350 tons of structures, with roughly half the volume coming from export markets.

The pylons project probably raised the economic returns to Togo from the lease arrangement with Ibcon. Pylons manufacturing added more value than the making of reinforcing bars because it used facilities and labor more intensively. It added to STS's employment and to the taxes the firm

paid. One study conducted in 1987 estimated the marginal economic return to Togo from the lease arrangement with Ibcon, including the pylons manufacturing project, at between 11.0 to 14.5 percent depending on the exact assumptions made. This range is significantly higher than the range of returns projected when the original agreement with Ibcon was signed.

Apart from the benefits reflected in the economic return calculations, policy makers in Togo were pleased with the intangible gains from the Ibcon agreement. For one thing, jobs were preserved by the agreement: although the workforce was reduced from over 200 to 120, all jobs might have been lost without the agreement. Most of the workers employed by STS were former employees of SNS, and they received higher salaries than before, better training, and more responsibility. Second, by continuing to operate the plant, the government avoided the political embarrassment of shutting down a brand new facility erected at considerable cost. Third, the sale of stock in STS in 1986 broadened share ownership by Togolese people; a development viewed with satisfaction by government policymakers as well as international agencies. Finally, the agreement with Ibcon had a positive impact on international donors, who hailed the agreement, and on the international investment community in general. The manner and speed with which Togo had negotiated an agreement with a foreign company was believed to have signaled to others that Togo was an attractive country in which to do business. Not only did the government allow Ibcon to reap attractive returns, it also freely allowed the repatriation of profits as per the agreement. Soon after the Ibcon agreement was signed, Togo concluded other lease agreements with foreigners. Thus, the STS venture was believed to have paved the way for privatization on a bigger scale in Togo.

Conclusions

This chapter began with two policy questions: (a) Under what conditions is leasing a troubled SOE to the private sector likely to be preferable to the alternatives of continued state operation, outright privatization, or liquidation? (b) How should the leasing agreement be structured so that it is simultaneously attractive to the private party as well as to the country? The Togo case sheds light on both questions.

On the first question, the Togo case shows that leasing can bring new skills to the organization—technical and managerial—that allow the

available assets to be utilized more fully. Leasing may also be the means for providing an SOE with greater managerial autonomy, although as the Togo case shows, leasing may not be an inexpensive method for achieving that objective. At the same time, leasing may be preferable to outright privatization—that is, selling 100 percent of the SOE's equity to the private sector—because it keeps several options open for the government down the road. If the SOE's performance improves under private management, the SOE can be sold later for a more attractive price than when it is in deep waters. Alternatively, the government might decide to keep the firm under state ownership after it has been turned around. Finally, leasing may be preferable to liquidation for several reasons. Among the principal advantages is that some, if not all, jobs can be preserved, and the government can also avoid the political costs associated with closure and layoffs. Another advantage is that the government can postpone the embarassingly big write-off that will accompany liquidation of the company. Such a write-off is also likely to be required under outright privatization because the troubled SOE could probably be sold for only a fraction of its book value.

The Togo case further shows that international agencies such as the World Bank may look favorably upon a lease agreement, which is likely to be seen as a form of privatization, even if it is less dramatic than outright sale to the private sector. In many developing countries, governments are torn between keeping SOEs alive and satisfying external or internal demands for improving their financial performance. Under these conditions, leasing may be an option that satisfies several groups, including politicians, employees, private entrepreneurs, and international agencies. Finally, in the SNS case, the government saw the lease arrangement as generating other advantages, especially the creation of a climate in Togo that made other, larger privatization moves possible. The successful deal with Ibcon was also believed to have earned Togo the reputation of being one of the more progressive Sub-Saharan countries when it came to reforming the SOE sector.

On the second policy question, the Togo case highlights the difficulty of framing an agreement that is sufficiently attractive to the private party, and yet does not give away the store from the country's standpoint. Given the political and economic uncertainties entailed in lease arrangements with SOEs in developing countries, private entrepreneurs are likely to seek high

and quick returns on their investment. They are likely to demand attractive prices, protection from imports, and special privileges with regard to taxes and duties or government regulations; to offer very low fees or rents for the use of an SOE's expensive assets; and to ask that these matters be guaranteed to some extent via formal agreements. At the same time, they are likely to tolerate little interference from the government in the running of the business. For its part, the government is likely to seek assurances that the private entrepreneur will not run down the firm's assets during the lease period or neglect noncommercial objectives important to the country.

The process of negotiation can therefore be complex and difficult. The challenge before governments is to give away enough to the private entrepreneur to keep the entrepreneur's interest in the agreement, but not so much that the alternatives of liquidation or continued state management become more attractive from the country's point of view. In the SNS case, the odds appear high in hindsight that Ibcon might have accepted a less generous package of tariffs, pricing, import duty on coils, or lease payments than it did in March 1984. Also, the government might have put in place stronger incentives for Ibcon to promote exports or diversification. As things turned out, the last two objectives seem to have been fairly well achieved with no other incentive than the prospect of increased profits. Yet the Togo case points to need for governments to be extremely careful in handing out protection or monopoly rents to private investors.

One possible way to avoid conceding too many benefits to the private party is to structure lease agreements so that they contain a mechanism to review the agreement within a reasonable period of time. In the Togo case, the pricing policy was to be reviewed after five years, although the lease itself had a ten-year duration. At that time, the government could use the venture's actual experience (and profitability) in the previous five years to renegotiate the pricing formula so that the extent of protection might be lowered and a greater part of the benefits passed to Togolese consumers. Another interesting element of the SNS lease agreement was the requirement that about a third of the company's equity be sold to local shareholders over a specified period of time. This, too, ensured that if the venture turned out to be a financial success, at least some part of the surplus would go to people in Togo rather than all of it go to the foreign investor.