

The Good, the Bad and the Ugly: Employee and Management Owned Firms

By Sam Vaknin, Ph.D.

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Margaret Thatcher started a world trend during her tenure as Prime Minister is Downing Street. It is called: Privatization. It consisted of the transfer of control of a state-owned enterprise to the Private Sector. This was done by selling the shares of the company. At times, the control itself was maintained by the state - but the economic benefits emanating from the ownership of shares was partly sold to privates. Such economic benefits are comprised of the dividend yield of the shares plus the appreciation in their value (due to the involvement of the private sector) known as capital gains.

But the privatization process was not entirely homogeneous, uniform, transparent, or, for that matter, fair.

The stock of some of the enterprises was sold to an individual, or group of individuals, by a direct, negotiated sale. A "controlling stake" (nucleus) was thus sold, ostensibly yielding to the state a premium paid by the private investors for the control of the sold firm.

This method of privatization was criticized as "crony capitalism". For some reason, a select group of businessmen, all cronies of the ruling political elite, seemed to benefit the most. They bought the controlling stakes at unrealistically low prices, said the critics. To support their thesis, they pointed to the huge disparity between the price at which the "cronies" bought the shares - and the price at which they, later, sold it to the public through the stock exchange. The "cronies" cried foul: the difference in the prices was precisely because of privatization, better management and financial control. Maybe. But the recurrence of the same names in every major privatization deal still looked suspiciously odd.

Then there was the second version: selling the shares of the privatized firms directly to the public. This was done using either of two methods:

An offering of the shares in the stock exchange (a cash method), or

The distribution of vouchers universally, to all the adult citizens of the country, so that they could all share the wealth accumulated by the state in an equitable manner. The vouchers are convertible to baskets of shares in a prescribed list of state enterprises (a nonchash method).

But a smaller group of (smaller) countries selected a whole different way of privatizing. They chose to TRANSFORM the state-owned firm instead of subjecting them to outright privatization.

Transformation - the venue adopted by Macedonia - is the transfer of the control of a firm and / or the economic benefits accruing to its shareholders to groups which were previously - or still are - connected to the firm.

In this single respect, transformation constitutes a major departure - not to say deviation - from classical privatization.

Ownership of the transformed firm can revert to either of the following groups, or to a combination thereof:

The employees of the firm, through a process called Employee BuyOut (EBO)

The management of the firm, in the form of a Management BuyOut or Buy In (MBO / MBI)

A select group from within the firm. Such a group uses the assets - current and future - of the firm as collaterals, thus enabling them to get the credits necessary to purchase the shares of the firm. This is called a Leveraged BuyOut, because the assets of the firm itself are leveraged in order to purchase it (LBO).

Finally, the creditors of the firm can team up and agree to convert the firm's debts to them into equity in the firm, in a Debt to Equity Swap (DES).

Sometimes, the state continues to maintain an interest in privatized - as well as in transformed - firms. This is especially true for natural monopolies, utilities, infrastructure and defence industries. All the above are considered to be strategic matters of national interest. Some countries - Russia and Israel, for ones - continue to own a "Golden Share". This highly specific type of security allows the state to exercise decision making powers, veto powers, or, at least, control over business matters that it considers vital to its security, financial viability, or even to its traditions. Israel's golden share in the national air carrier, El Al, allows it to prevent flights in and out during the religiously holy day of Sabbath!

Until very recently the common (economic) wisdom in the West had it that Transformation was - in the best case - a sterile, make - believe exercise. The worst case included cronyism and corruption. One thing was to privatize and another was to privateer. But there were some grounds for some solid criticisms as well:

(1) The main ideological thrust behind privatization was the revitalization of stale and degenerated state firm. Badly managed, wrongly financially controlled, applying an incoherent admixture of business and non business (political, social, geopolitical) considerations to their decision making process - state firm were considered as anachronistic as dinosaurs. Many preferred to see them as extinct as those ancient reptiles. An injection of private initiative acquired the status of ideological panacea to the corporate malaise of the public sector.

But this is precisely what was missing in the Transformation version. It offered nothing new: no new management, no new ideas (were likely to come from the same old team) and, above all and as a direct result of this preference of old over new - no new capital.

To this, the supporters of Transformation answer that the one thing which is new - personal capitalistic incentives - far outweighs all the old elements. Incentive driven initiative is likely to bring in its wake and to herald the transformation - in the most complete and realistic sense - of the state firm.

Change, renovation and innovation - say the latter - are immediate by products of personal profit motivation, the most powerful known to Mankind.

(2) The process of Transformation blurred the distinction between labour, management and ownership. Employees acted as potential managers and as co-owners in the newly transformed companies. The very concept of hierarchy, clear chains of authority (going down) and of responsibility (going up) - was violated. A ship must have one captain lest it sinks. It is not in vain that the management function was separated from the ownership function. Employees, managers and owners, all have differing views and differences of opinion concerning every possible aspect of corporate governance and the proper conduct of business.

Employees want to maximize employment and the economic benefits attached to it - managers and shareholders wish to minimize this parameter and its effects on the corporation. Managers wish to maximize their compensation - employees and owners wish to minimize or moderate it, each group for its own, disparate reasons.

This break in the "chain of command", this diffusive, fog like property of the newly transformed entity lead to dysfunction, financial mismanagement, lack of clarity of vision and of day to day operations, labour unrest (when the unrealistic expectations of the workforce are not met).

So, at the beginning, during the 1980s, the West preferred to privatize state owned firms - rather than to transform them. A fast accumulating body of economic research demonstrated unambiguously that privatization did miracles to the privatized firms. In certain cases, productivity shot up 6 times. Between 60 to 80 percent of GNPs in the West are private now and a vigorous trend to privatize what remains of the public sector still persists.

But the same studies revealed a less pleasant phenomenon: only a select group of businessmen benefited from privatization. The paranoid allusions of the critics of this process were completely substantiated. Something was very corrupted in implementation of the seemingly wholesome idea of privatization. The public - as a whole - economically suffered.

This led to the emergence of a new social consciousness. It was provoked by the unacceptable social costs of capitalism: more people under the poverty line, homelessness, a radicalization in the inequity of the distribution of income among different strata of society. But this trend was enhanced by the apparent corruption of the privatization process.

This new social consciousness converged with yet another all important and all pervasive trend: the formation of small businesses by small time entrepreneurs. The latter functioned both as owners and as employees in their firms. There were 16 million such owners-workers in the USA alone (1995 figures). About 99% of the 22 million registered businesses in the USA were small businesses. No economic planner or politician could ignore these figures. Employee owned firms became the majority in the service and advanced technology sectors of the economy - the fastest growing, most lucrative sectors.

In its own way, as a result of these two trends, the West was moving back to transformation and away from privatization, away from separation of ownership and labour, away from differentiation between capital and workforce. This is a major revolution.

The OECD (the organization of the richer countries in the world) established an institute which follows trends in the poorer parts of the world, politely called "Economies in Transition". This is the CCET.

According to the CCET's latest report, privatization continues in an uneven pace throughout the former Eastern Bloc. Some countries nearly completed it. Others have claimed to have completed it - but haven't even started it in reality. Some countries - Macedonia amongst them - have sold the shares of state owned firms (=businesses with social capital) to managers and workers - but the managers and workers have largely not paid for these shares yet. It is by no means certain that they will. If the managers and workers default on their obligations to pay the state - the ownership of the company will revert back to the state. This is paper privatization, a transformation of expectations. No one can seriously claim that the transformation is completed before the new owners of the firms respect their financial obligations to the state.

In all, privatization the world over, proceeded more rapidly with small firms. Selling the bigger firms was much more difficult. Most of these behemoths were composed of numerous profit centres and loss making business activities. A solidarity of accounts and guarantees existed between the various operations. The more profitable parts of a company supported and subsidized the less competent, the losing parts. This was not very attractive to investors.

The official figures are heart warming. In parentheses - the percentage of firms privatized:

Albania , Czech Republic , Estonia , Hungary , Lithuania, Poland and Slovakia all privatized 90% of their small firms. In Russia and Latvia, the figure is 70%.

The picture is more clouded with the larger firms:

Czech Republic (81%), Hungary, Estonia (75%), Lithuania (57%), Russia (55%), Latvia and Slovakia (46%), Mongolia (41%), Poland (32%), Moldavia (27%), Romania (13%), Belarus and Bulgaria (11%), Georgia (2%).

But what hides behind the figures?

The Czech Republic is infamous for its cronyism and for the massive transfer of wealth to the hands of a few people close to government circles.

On the face of it, the situation in Poland looks a bit better: a universal voucher system was instituted. People were allowed to deposit their shares with 14 management funds. These funds also bought some of the shares, making them part owners. They control now 500 enterprises, which make up 5% of the country's GNP.

Some of these funds are 50% foreign owned, so their management and moral standards are Western. But, even there, rumours abound and not only rumours.

So, what is better - privatization or transformation?

Maybe the lesson is that we are all human. There is no method immune to human fallacies and desires, to corruption or to allegations of it. Transformation tends to benefit more people - so, maybe it looks more just. But long term it is inefficient and leads to the ruining of the firms involved and to permanent damage both to the economy and to the workers-owners. Is it better to be the owner of a bankrupt firm - or to work in a functioning firm, where you have no ownership stake? This is not an ideological or a philosophical question. Ask the employees of the Pelagonija Construction Group.

Privatization, on the other hand, is much more open to manipulation - but at least it secures the continued existence of the firms and the continuous employment of the workers.

Sometimes, in economic reality, we have to give up justice (or the appearance of it) - in order to secure the very survival of the workers involved.

I, personally, prefer privatization over transformation.

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Outsourcing NOT Just for Big Business

By Paul Rich

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Outsourcing has become a controversial issue and a hot topic among presidential candidates this year. But have you stopped to think how your business can benefit from the efficiency, functionality and cost savings of outsourcing? If you have, you might find that, like many others, you are already outsourcing-and enjoying its benefits.

What is Outsourcing?

Outsourcing simply means "contracting out" various functions of your business. It doesn't necessarily mean that you will be contracting out work to foreign countries because there are many American companies that provide outsourcing services i.e.. commercial printing services and cleaning services, among others.) The vendors who supply outsourced services may be self-employed contractors, consulting firms, temporary employee services or professional service firms. One common example of outsourcing is payroll processing. Other commonly outsourced functions that can be provided by professional services firms include: Succession planning Accounting and tax preparation Information technology (IT) Consulting (i.e. due diligence, business planning) Distribution services Pension management Manufacturing Assembly Staffing Grounds Maintenance Estate and income tax planning

Why Outsourcing Can Work for Your Business

Fortune 500 corporations are under the microscope for outsourcing thousands of jobs overseas to low wage workers, potentially leaving American workers out of work. But according to Forrester Research Inc., of the 2.7 million jobs lost over the past three years, only 300,000 have been from outsourcing. With that in mind, outsourcing means something different for family and privately owned businesses. With fierce competition affecting the margins of many businesses, companies are finding that they cannot afford layers of administrative overhead dedicated to operating their core business. They are realizing that outsourcing provides alternatives to doing everything for themselves. For example, if your business is distribution, there may not be a need to employ a large administrative overhead dedicated to support functions like those listed above. Companies that provide outsourcing services are able to invest more time and resources into the specific functions that generate revenue. Because of this, they can operate more efficiently and economically, which can help you compete more effectively than companies that do it themselves.

Information technology is a good example of this. The cost in personnel, benefits and training to keep pace in the rapidly changing world of information technology is prohibitive for most privately owned businesses. By outsourcing this function, management is free to focus its energies on the core aspects of the business-those that provide revenue-generating products and services-and leave the other areas to vendors

who specialize in performing those functions.

Benefits of Outsourcing

Proponents of outsourcing cite a variety of reasons for "letting others do it." Here are some of the most important:

Cost savings - By outsourcing functions that were previously performed in house, companies are often able to reduce their employee levels and related costs, such as recruitment, supervision, salary and benefits. By outsourcing a capital intensive function, you can also reduce the costs of equipment obsolescence and depreciation. A portion of your cost savings will go to the outsourcer, but outsourcing vendors have a tighter control of fringe benefits and run leaner overhead structures. They also know how to deal with vendors serving the function they are providing and therefore, are able to pass on to your company the benefits derived from bulk purchasing and effective leasing.

Quality of service - Because your company is the outsourcer's customer, you will likely experience a "can-do attitude," which may not always be exhibited by an in-house staff.

More capital funds - Outsourcing reduces the need to invest capital in non-core business functions, thereby freeing capital to invest in profit-making aspects of the business.

State-of-the-art technology - Outsourcers have to spend time and money on the most current equipment and on employee training to remain competitive. By outsourcing certain areas, you are assured of receiving the most efficient services and the latest technological advances within that particular function.

Price stability - By signing a contract to outsource, you will likely be able to obtain stable pricing, eliminating the future need to shop around. Stable pricing allows the company to budget operating expenses and capital purchases more accurately, while potentially preventing the likelihood of surprise expenses.

New business partners - Outsourcers clearly wish to be viewed as your business partner. And as a business partner, they share in the desire to keep your company operating at its maximum potential. Through this business partner arrangement, outsourcers are eager to introduce you to other outsourcers to assist in that goal.

More time to focus on core business activities - You cannot overlook this intangible benefit of outsourcing. If a company is to be successful and profitable, management is needed to spend time planning and directing the company's business strategies and not wasting time worrying about managing certain administrative or ancillary functions.

Potential Drawbacks

As with every new system and procedure, you have to take the good with the bad. Critics argue that outsourcing creates too much loss of control, less flexibility, questionable savings and the risk of over dependence on too few vendors. Owners of family and privately owned businesses should understand that initiating an outsourcing

arrangement takes considerable management time. Finding and selecting the right outsourcing company can take many months. And outsourcing companies need to be given overall directives and guidelines for what the company wants done, and therefore, some level of supervision by management will ultimately be needed. Also, if an outsourcer is replacing a function that has been historically done within the company, layoffs could very possibly affect employee morale and may cause talented staff in other core areas to leave for fear of job security. In addition, be cautious not to completely eliminate the internal ability to provide the basic product or service you offer. For example, if you are a manufacturer and you have outsourced the assembly of your product, be sure you can still provide a sample of a specialty order in-house if asked to by a customer. A delay of a product sample could cost you the customer's business.

One of the biggest complaints by companies that have outsourced is that there has been a mismatch between expectations and reality. When an outsourcer is marketing its services there is usually much enthusiasm and talent dedicated to solving the problems that were defined at the outset. However, once the contract is signed, the outsourcer brings in its implementation team, which often lacks the same level of enthusiasm that the sales and marketing team had. Due diligence is necessary when beginning any new business relationships. It is best to get recommendations from current customers of the outsourcer or other reliable sources in your industry.

Careful Selection Is Key

By being aware of these drawbacks at the start of the outsourcing process, you can mitigate many of these and build outsourcing relationships that benefit your business. The key to successful outsourcing is careful selection of both the functions you outsource and the vendors you choose to supply them.

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