

## ***Latvia: State Ownership Policy Review [Part II]***



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# Glossary

Term	Definition
<b>Akciju sabiedrība, AS</b>	Joint stock company
<b>Cabinet of Ministers</b>	Cabinet of Ministers of Republic of Latvia
<b>CAGR</b>	Compound annual growth rate
<b>CapEx</b>	Capital expenditures
<b>Capital company of a public person</b>	A capital company, in which all capital shares or voting stocks belong to one public person
<b>Commercial law</b>	The Commercial Law of Republic of Latvia. Latvijas Vēstnesis, 158/160, 04.05.2000. <a href="https://likumi.lv/ta/id/5490">https://likumi.lv/ta/id/5490</a>
<b>Company</b>	State-owned enterprise
<b>Competition Council</b>	The Competition Council of Republic of Latvia
<b>COSO</b>	The Committee of Sponsoring Organizations of the Treadway Commission, which is a joint initiative of the five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence
<b>CSDD</b>	VAS Ceļu satiksmes drošības direkcija
<b>CP</b>	Commercial paper
<b>CSB</b>	Central Statistical Bureau of Latvia
<b>CSCC</b>	Cross-Sectoral Coordination Centre Republic of Latvia
<b>EBITDA</b>	Earnings before interest depreciation and amortization
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EC</b>	European Commission
<b>Enterprise Risk Management</b>	The culture, capabilities, and practices, integrated with strategy setting and its performance, that organizations rely on to manage risk in creating, preserving, and realizing value.
<b>EU</b>	European Union
<b>FCMC</b>	Financial and capital markets commission
<b>General strategic objectives</b>	Objectives of the company specified by the highest decision-making body of the public person, which the public person wants to achieve through participation in the company and which arise from legal acts and policy planning documents
<b>GDP</b>	Gross domestic product
<b>IFRS</b>	International financial reporting standards
<b>Internal Controls</b>	<p>A process, effected by an entity's Supervisory board, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objective relating to operations, reporting, and compliance (<i>Source: COSO</i>)</p> <p>The policies, processes, tasks, behaviours and other aspects of an organisation that taken together:</p> <ul style="list-style-type: none"> <li>• Facilitate effective operation by enabling it to respond in an appropriate manner to significant business, operational, financial, compliance and other risks to achieve its</li> </ul>

	<p>objectives. This includes safeguarding of assets and ensuring that liabilities are identified and managed.</p> <ul style="list-style-type: none"> <li>• Ensure the quality of internal and external reporting, which in turn requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from both internal and external sources.</li> <li>• Ensure compliance with applicable laws and regulations and also with internal policies.</li> </ul> <p>(Source: ACCA)</p> <p>Policies, procedures, practices and organizational structures designed to provide reasonable assurance that business objectives will be achieved, and undesired events will be prevented or detected and corrected.</p> <p>In that context, internal controls are structures, tools, processes or mechanisms that help ensure an outcome. (Source: ISACA)</p>
<b>IPO</b>	Initial public offering
<b>ISACA</b>	Previously known as the Information Systems Audit and Control Association®, ISACA now goes only by its acronym to reflect the broad range of IT governance professionals it serves
<b>KPI</b>	Key performance indicator
<b>LSE</b>	London Stock Exchange
<b>Medium-term operational strategy</b>	Medium-term strategy
<b>Ministry of Agriculture</b>	Ministry of Agriculture of Republic of Latvia
<b>Ministry of Culture</b>	Ministry of Culture of Republic of Latvia
<b>Ministry of Economics</b>	Ministry of Economics of Republic of Latvia
<b>MoF, Ministry of Finance</b>	Ministry of Finance of Republic of Latvia
<b>Ministry of Health</b>	Ministry of Health of Republic of Latvia
<b>Ministry of Transportation</b>	Ministry of Transport of Republic of Latvia
<b>OECD</b>	Organisation of Economic Co-operation and Development
<b>OLE</b>	Owner's letter of expectations
<b>OTC</b>	Over the counter
<b>Public policy objective</b>	Specific performance requirements and activities imposed on SOEs other than the maximisation of profits and shareholder value. More broadly defined public policy objectives include not only non-financial objectives, but also "expectations" communicated to SOEs, for example related to corporate social responsibility, sustainability, etc.
<b>PPP</b>	Public private partnership
<b>PwC</b>	PricewaterhouseCoopers SIA, Registration Number: 40003142793, Address: Krišjāņa Valdemāra iela 21 - 21, Rīga, LV-1010, Latvia
<b>Regulation no 20</b>	Cabinet of Ministers Regulation No 20 "Nomination procedure of the Executive management and Supervisory board members in the capital companies, in which shares are owned by the State or by a public body" (07.01.2020.)
<b>Regulation no 63</b>	Cabinet of Ministers Regulation No 63 "Regulations on the Number of Members of the Executive management and Supervisory board of Public Limited Companies and Public Private Companies and the Maximum Monthly Remuneration of Members of the Executive management and Supervisory board" (04.04.2020.)
<b>RAKUS</b>	SIA Rīgas Austrumu klīniskā universitātes slimnīca
<b>ROA</b>	Return on assets

<b>ROE</b>	Return on equity
<b>Sabiedrība ar ierobežotu atbildību, SIA</b>	Limited liability company
<b>SASL</b>	The State Administration Structure Law. Latvijas Vēstnesis, 94, 21.06.2002. <a href="https://likumi.lv/ta/id/63545">https://likumi.lv/ta/id/63545</a>
<b>SOE</b>	State Owned Enterprise
<b>SOEL</b>	Law “On Governance of Capital Shares of a Public Person and Capital Companies”. Latvijas Vēstnesis, 216, 31.10.2014. Available at: <a href="https://likumi.lv/ta/id/269907">https://likumi.lv/ta/id/269907</a>
<b>State</b>	Republic of Latvia
<b>Subsidies, state budget funding</b>	Funding that SOEs receive from the state budget directly or indirectly, e.g., through subsidies, appropriations, public service contracts, compensations for performing certain services, or through guaranteed income (e.g., customers are legally required to purchase services from the company or company’s revenue is generated mainly from providing services to public sector clients)
<b>Supervisory board</b>	Non-executive board
<b>VAS</b>	Valsts Akciju Sabiedrība. State owned joint stock company
<b>VSIA</b>	Valsts Sabiedrība ar ierobežotu atbildību. State owned limited liability company

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# Synthesis of the Assignment

The State-owned enterprises (SOEs) are the backbone of many economies around the world accounting for 20% of investment, and up to 40% of domestic output. According to the International Monetary Fund (IMF), SOEs' assets are worth 45 trillion US dollars, equivalent to half of global gross domestic product (GDP). In Latvia, the SOEs play a critical role as well. Over 170 SOEs (from which 70 group SOEs in which the State has a decisive control) influence the economy of Latvia and people's lives by providing goods and services ranging from sports infrastructure and culture to electricity and transportation.

The outbreak of COVID-19 has magnified the importance of well-organized and financially sound SOEs. The pandemic has left a profound negative impact on the global economy – including the Latvian economy. The fiscal deficits have widened, unemployment level has risen, and many businesses have either permanently closed or face impaired future prospects amid unexpected indebtedness and withdrawn investment projects. These unprecedented consequences call for exceptional and bold measures. This is a critical moment for the policy makers governing the SOEs to revamp and promote more resilient, profitable and sustainable SOEs for the long-term benefit of the society.

The macroeconomic dynamics mentioned above in conjunction with the “room for improvement” circumstances across the Latvian SOE landscape related to undiversified funding / financing sources and in many cases conservative financial target setting make the objective of this Assignment timely and critically important: **an assessment and gap analysis of the current capital structures and corporate governance standards of SOEs as means to draft a methodology towards forming optimal capital structures and related roadmap to implement it.**

The **key takeaways** from the conducted assessment indicate the following:

- SOE ownership and **corporate governance practices are not harmonized** increasing the risk of ambiguous expectations, inactive ownership, and heterogeneous corporate governance.
- The SOEs' financial positions exhibit signs of too high indebtedness relative to the peers as well as poor profitability that in combination may lead to **potential debt overhang<sup>1</sup> issues**.
- The financial instruments used by the SOEs are mostly **bound to traditional types of financing** such as subsidies, European Union (EU) funding, and commercial bank loans despite the available spectrum of alternative instruments providing many benefits that the former tools cannot.
- Public capital markets and especially **initial public offerings (IPOs) could resolve some of the inherent corporate governance challenges and accommodate sustainable risk taking** by financing new expansion projects without assuming excessive financial risk.
- The feedback from pan-Baltic institutional investors, recent examples of other Baltic SOEs, and the preliminary assessment of IPO readiness among selected sample of SOEs display that **certain larger, more commercially oriented SOEs are viable candidates for tapping public capital markets**.

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<sup>1</sup> Debt burden so large that an entity cannot take on additional debt to finance future projects. The burden is so large that all earnings pay off existing debt rather than fund new investment projects, making the potential for defaulting higher.

In addressing the challenges identified and to meet the objective of the Assignment, a holistic approach for developing the necessary methodology was used. Namely, the proposed changes include two separate yet interlinked processes (all of which are supported with the necessary changes in the legislation):

**Active ownership principles** – developed with an aim of creating efficient, transparent and simple process for active ownership. It is a fundamental building block for making sure that the proposed SOE financing methodology becomes successfully implemented in practice.

**SOE financing methodology** – designed specifically to stimulate efficient allocation of capital and to solve subpar financial performance by introducing a determination of objective and market based financial targets, diversified set of financing instruments, and a more active use of public capital markets as a source of capital attraction and reason for corporate governance improvement.

#### **State ownership policy document (active ownership principles)**

To bring greater clarity and consistency to ownership issues, a State ownership policy document should be developed serving as a tool for communicating expectations and good practices to shareholders, boards and executive management team. A State ownership policy document would unify the State's longer-term vision on the overall SOE governance that would ultimately allow the stakeholders to comprehend the structural direction in which the State sees its enterprises heading. This would also inform the public of the key principles guiding the State's assets and its ownership policy towards them.

#### **Owner's letter of expectation (active ownership principles)**

An OLE is a vital and necessary tool to induce an active ownership by the State and in the same time foster a more efficient and transparent communication of the relevant expectations for the SOEs. The OLE provides a framework under which the State has the option to voice its expectations for an SOE for a 5-year period.

#### **SOE financial target setting methodology (SOE financing methodology)**

A more granular methodology is needed to translate the high-level expectations set by the State (via State ownership policy document and OLE) into measurable and objective targets. Therefore, there should be a defined perimeter of objective and balanced financial target setting (neither too aggressive nor too conservative), especially, against the backdrop of undiversified funding / financing sources and the overarching notion of maximizing shareholder's returns in a sustainable manner.

The SOE financial target setting methodology takes into account three key aspects that should be quantified based on corresponding guidelines and benchmarks: **balance sheet metric (optimal capital structure), rate of return target and dividend policy**. The proposed SOE financial target setting methodology, linked with OLE period, offers guidelines for the SOEs to define objective financial targets that stem from comparable benchmarks, sectors / industries, and companies – i.e. *market based benchmarking*.

#### **Preferred financing instruments (SOE financing methodology)**

A list of financing instruments tailored specifically for each SOE segment by taking into account the current gaps in financing (possible and recommended use of financing instruments vs actual use) serves the purpose for making the overall use of financing instruments more diversified. This is necessary to reduce

concentration risks observed among SOEs by relying predominately on traditional forms of financing that in many cases do not offer the same benefits as alternative sources of financing. In addition, a more diverse set of actively used financing instruments should warrant more flexible balance sheets and provide a boost for corporate governance processes.

### **IPO readiness assessment (SOE financing methodology)**

Finally, given the identified signs of high indebtedness and dismal profitability levels among the SOEs, IPOs should be increasingly considered as a possible option in attracting fresh capital to cover future investment plans, make capital structures optimal, and improve overall governance practices. Similarly, some data points indicated overcapitalized balance sheets that hints for conservative business activities and inefficient use of capital. The preparation for an IPO encompasses building attractive equity story considering optimal use of capital structure, ambitious growth targets and enticing dividend yields – all of which resolves the issue of overcapitalization.

For this to happen, it is recommended to introduce an IPO readiness assessment that would allow the State to determine the level of maturity or readiness for making a successful debut on stock exchange. Exchanging ownership rights for private capital must be done correctly and with a high confidence of favourable acceptance by the FMPs. In this regard, an IPO readiness assessment is based on a market-based criteria (quantitative and qualitative) that have to be assessed and fulfilled in order to warrant a successful IPO.

# Executive summary

## Corporate governance review

### **1. The sheer number of SOEs and the limited institutional capacity by SOE governance institutions (i.e. line ministries, shareholders and Coordination Institution) hinder harmonized corporate governance practices.**

In order to ensure similar governance of SOE performance, the Latvian SOE ownership model has been restructured, moving from a decentralized model to a decentralized with a coordinating institution. The ownership and governance structure of Latvian SOEs is set up according to a hybrid model – SOE operational and strategic governance is implemented through the Coordination Institution, shareholder and line ministries.

To safeguard the separation of the State's ownership functions and other State functions, the existing governance framework establishes clear separation of the roles and tasks for all involved governmental bodies in the SOE governance. Therefore, each of the SOE governance institutions should exercise its governance rights with high degree of professionalism and effectiveness and have the capacity and competences to effectively carry out its duties. In practice, the ownership holdings are largely in line with the sectoral breakdown of responsibilities among the line ministries.

However, considering the significant number of the SOEs in Latvia and limited capacity of shareholders and Coordination Institution, the overall SOE corporate governance practices exhibit a relatively high degree of unevenness. Within the scope of the Assignment a heterogeneous corporate governance has been observed in the following areas - assessments for State's participation in SOEs, monitoring of SOE performance, disclosure and transparency as well as internal controls.

### **2. The Coordination Institution in its current advisory role lacks tools to enforce harmonized SOE governance practices.**

The Coordination Institution has been established with the aim to oversee and harmonize SOE corporate governance practices. The Coordination Institution attempts to maximise the performance, and economic and social contributions of SOEs. The duties of Coordination Institution have been entrusted to CSCC. The CSCC, in broad terms, is the only public institution that supervises and offers guidance to SOEs; therefore, it is one of the institutions that must be informed about the SOE dividend pay-outs, medium term strategy and annual reviews. However, as Coordination Institution is neither a shareholder or a Supervisory board member of the SOEs, stakeholders perceive its policies as recommendations rather than mandatory norms that need to be followed.

Although the Coordination Institution was established to unify corporate governance practices, it was provided only an advisory role in the SOE corporate governance and has not been provided with tools to enforce the implementation of corporate governance practices. The recent changes

of the Law on Governance of Capital Shares of a Public Person and Capital Companies (SOEL)<sup>2</sup> increases Coordination Institution's role in the control of good governance practices by imposing a duty to monitor SOE compliance with disclosure of information; yet again with no tools for the Coordination Institution to enforce the compliance. Even though the disclosure and transparency practices by shareholders and SOEs still vary, significant changes in the SOE and ministry practices have been observed leading to more transparent disclosure.

**3. The existing SOE target setting and monitoring practices revolve around a yearly assessment of financial targets that have been set at the inception of medium-term strategy and after a period of time might not always correspond to SOEs development due to being overly operational, thus discouraging the Executive management to push for bold long-term targets.**

The current corporate governance framework requires that SOEs undergo a yearly performance review. The evaluation of SOE performance regarding the fulfilment of the company's financial and non-financial objectives is carried out in accordance with the practices set in the CSCC Guidelines<sup>3</sup> and corresponding Rulings of the Cabinet of Ministries<sup>4</sup>. The medium-term strategies are created as a base planning document via the cooperation of all SOE's ownership levels – representative of shareholder, Supervisory board or shareholder meeting, and the Executive management. The aim of a medium-term strategy is to determine SOE strategic objectives, and business development plans forecasting SOE potential development scenarios.

However, in practice, SOE financial operating reports are compared with the planned financial results in the medium-term strategies. Hence, the existing SOE performance evaluation process does not lead to an effective assessment of SOE operations due to a mismatch of underlying economic conditions in the time when the goals are established, and the time when they are reviewed. In other words, it is an undue exercise to define operational financial metrics (that correspond to achieving long-term goals) as tools of SOE performance review in a so far future as theoretically 7 years. State Ownership Policy Review [Part I] has recommended SOE target setting model providing that SOEs should limit a number of financial and non-financial targets that should be reported to shareholders. State Ownership Policy Review [Part I] suggests that a set of 6-8 financial and non-financial are optimal to ensure a focused approach in the SOE governance. Hence, according to best practice, the number of targets should not be excessive reminiscing operational rather than long-term plans, and the targets themselves should generally be based on overall convergence and performance that are similar to closest peers rather than overly detailed projections (e.g., gross-margin in certain segment, specific renovation project etc.).

Best practice tells that the existing operations and developments within the companies should be considered and evaluated both on an operational level and in long-term perspective. Furthermore,

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<sup>2</sup> Law "On Governance of Capital Shares of a Public Person and Capital Companies". Latvijas Vēstnesis, 216, 31.10.2014.

<sup>3</sup> Cross-Sectoral Coordination Centre Republic of Latvia. Guidelines for Performance Evaluation in SOEs In Which State Exercises Decisive Influence.

<sup>4</sup> Cabinet of Ministers Regulation No 95 "Rules on the Performance Evaluation in SOEs in Which State Exercises Decisive Influence", 09.02.2016.

the focus should be directed towards identifying the strengths and weaknesses of SOEs' management.

The existing target setting process discourages SOEs from setting ambitious goals in their medium-term strategies as the failure to achieve the set goals could possibly result in negative SOE's performance review. Additionally, the current SOE evaluation process leads to an unintentional lack of interest to set ambitious goals as the Executive management remuneration in terms of the yearly bonus is dependent on the evaluation of the SOEs operational performance and fulfilment of yearly financial and non-financial target set in medium-term strategy. Although, it is necessary to indicate that the international best practices support Executive management's variable remunerations, i.e., bonus dependency on the achievement of the long-term strategic objectives.

**4. The legislative framework provides detailed procedure for appointment of the Supervisory board and Executive management, while the revocation of the Supervisory board and Executive management lacks a clear procedure, thus increasing the chances of political influence on the SOE Supervisory board and Executive management.**

Existing legal framework regarding the Supervisory board and Executive management in SOEs follows the same commercial corporate practices as those of private market participants. In addition to the general corporate practices, the SOEL and CSCC guidelines provide policies and procedures regarding the composition of the SOE Supervisory board and Executive management members and nomination of Supervisory board and Executive management members, following OECD guidelines with the aim to allow SOE Supervisory boards to make objective, experienced and independent judgements.

For a Supervisory board to effectively operate in an independent manner, the SOEL dictates that at least half of the members of the Supervisory board members must be independent. The SOEL provides clear criteria based on which the Supervisory board member is considered independent.

While most of the Supervisory and Executive management's tasks are described in SOEL or Commercial law, the existing regulations regarding the Supervisory board's and Executive management's liabilities (both Supervisory board and Executive management) are vague and thus open to wide interpretation by the shareholder. There have been some cases in which the manner of the changes in the Supervisory board composition (i.e. sudden revocations and short-term tenures) clearly indicated that the decisions were made based on other factors than economic considerations from the line ministries. While there should not be any changes in the existing regulations, in order to safeguard the independent judgment and encourage focused and ambitious SOE development, SOE Supervisory board and Executive management members should continue to follow the private market practices and revocation of Supervisory board or Executive board members should be publicly communicated clearly indicating the reasoning for the revocation thus limiting any potential influence on the SOE Supervisory board and Executive management.

**5. The internal control and risk management system of SOEs is designed to fit into the context of public sector control measures and maintain the integrity of the company, rather than focusing on business objectives and promoting its growth.**

External legal requirements, for example, the law On Prevention of Squandering of the Financial Resources and Property of a Public Person, Law on Annual Financial Statements and Consolidated Financial Statements, Law on Accountancy and the Commercial Law, and control mechanisms define basis of internal controls and establish compliance framework for SOEs in Latvia.<sup>5</sup> The framework distinguishes different compliance levels for companies receiving State funding. The regulatory framework for SOEs receiving State funding is as stringent as for public administration institutions. Its priority is to ensure compliance of operations with the outside regulatory framework. Meanwhile, SOEs operating without State funding can operate with relatively broad discretion, allowing to link risk management with strategy and improvement of business performance, and therefore can be more commercially oriented. Despite of the attempts to improve SOEs' transparency by requiring these to report on the operating principles of the risks management policy, most of the SOEs deviate from the legal framework and do not publicly disclose the operating principles of their risk management policy. Consequently, public cannot have an assurance if the internal control procedures are adequately implemented in SOEs.

## The proposed SOE segmentation



### The proposed segmentation for SOEs in the context of new methodology

The importance of having a segmentation in place for the planned methodology is explained by the sheer number of Latvian SOEs, and the aspects of “one size does not fit all”. As of the Assignment date, there are over 70 majority-owned SOEs with heterogeneous business profiles, different sizes and State dependency, etc. Therefore, it is important to introduce a specific form of an SOE segmentation that would render the methodology applicable for all SOEs addressing various aspects of different financial characteristics.

The proposed segmentation approach is based on a SOE categorization that is subject to the main source of generated income. As a result, there are two broad categories of SOEs – **State dependent SOEs**, and **commercial SOEs**. The notion of using source of income as the key differentiator for the SOEs segmentation is attributable to the key objectives of the Assignment, namely, to propose a methodology, which would address the formation of optimal capital structures, and the choice of relevant financing instruments given unbiased and well-formed financial targets. As these objectives entail a high degree of financial focus, the corresponding metrics used for segmenting the SOEs should also take into account financial aspects. The source of income differentiator has the following advantages: (1) Easy to gather and interpret when making the actual segmentation; (2) Reflects well the dependency on State's support and the level of commercial activities; (3) The source of income plays also an important part in several financing instruments and broad financial targets. The segmentation also is made on a **consolidated basis**, meaning that all subsidiaries should be classified in the same segment as the holding (concern) company. The rationale for this lies in the fact that in the process of capital allocation, attraction of larger financing and investors, a company is usually analysed in conjunction with the subsidiaries. This approach also coincides with IFRS reporting, and dividend

<sup>5</sup> For specific regulations of SOE internal control systems and SOE conformity with them please see Annex 9.

expectations from an SOE. Lastly, it mitigates the risk of moving capital among the group’s companies to influence the direction of results for a particular subsidiary or mother company.

## Financial review

### 1. The SOEs have delivered a subpar growth over the period 2015-2019.

The sales compound annual growth rate (CAGR) of 70 SOEs – all that are majority-owned by the State and include subsidiaries – has significantly lagged behind the EU average and to a lesser degree other European SOEs (selected sample size of 90 SOEs, see **Annex 1**) during the period 2015-2019. There is a notable divergence between commercial SOEs (i.e. SOEs that are not included in the State budget, and receive less than 10% of the 3-year average sales as State support) and State dependent SOEs (i.e. SOEs that are included in the State budget and/or receive more than 10% of their 3-year average sales as State support). The commercial SOEs have grown their sales at a faster pace, namely, delivering a sales CAGR of 6.7% compared to 5.1% generated by the State dependent SOEs. Compared to an average Latvian company, the Latvian SOEs have achieved a similar performance with commercial SOEs slightly outperforming and State dependent SOEs falling short by 0.8%. Baltic publicly traded SOEs have clearly lagged behind the other comparable, yet, the conclusions should be viewed with caution since the sample size represent only a handful of companies most of which are in mature and regulated industries.

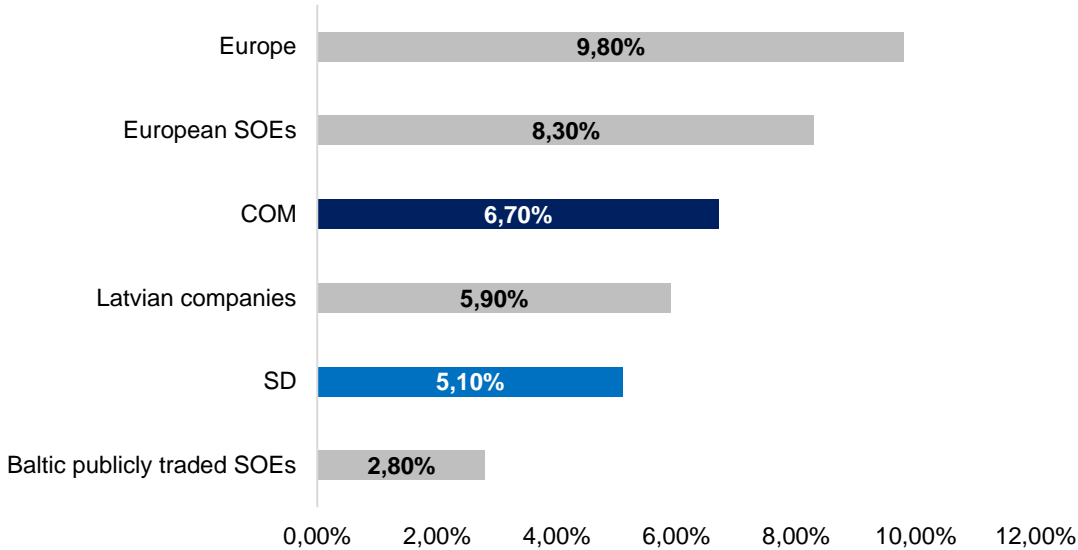


Figure 1. Sales CAGR, 2015-2019, [COM= Commercial SOEs; SD = State dependent SOEs]

The reason for the subpar performance of SOEs, and, in particular, of the State dependent SOEs is twofold:

On one hand, the level of State financing received for delivering goods and services with the objective to fill the market gap or fulfil the State’s objectives is oftentimes (during the SOE interviews) cited to be insufficient. The consequences of an insufficient State financing for its mandated objectives can lead to depressed profitability, inefficient cross subsidisation, and,

ultimately, render an SOE incapable to compete with private competitors. In some cases, SOEs cross subsidise the non-commercial goals (i.e. fulfilment of State objectives) with the monies generated by the commercial activities. This, in turn, implies a certain degree of opportunity cost within the commercial segment.

On the other hand, the commercial activities could be driven inefficiently, thus disabling the SOEs from delivering similar growth as private peers. During the SOE interviews, this was not explicitly mentioned as a key reason behind the aforementioned underperformance. In addition, certain SOEs (mostly commercial SOEs) are exposed to a country-specific regulatory environment, which sets a pricing cap as to how far the sales can be increased, making the benchmarking process subjective. However, according to the conducted analysis, commercial SOEs have fallen short the EU average benchmark values, and given the fact of the limited scope of non-commercial goals that such SOEs embody, the commercial activities remain as an obvious area of concern.

**2. The SOEs have become more indebted over the period 2015-2019, exceeding the average level of indebtedness among EU companies and other EU SOEs.**

The SOE indebtedness as measured by debt-to-equity ratio has spiked higher during 2015-2019. The increase of debt levels has happened for both commercial and State dependent SOEs. Comparing the median debt-to-equity ratio in 2019 to that of 2015, an uptick of 61% and 3% can be observed for commercial and State dependent SOEs, respectively. While the indebtedness levels of State dependent SOEs have remained flat over the period 2015-2019, the debt-to-equity ratio of 1.21 as of 2019 is more than threefold higher (in absolute terms) than that of the EU average. Conversely, commercial SOEs have experienced a higher uptick in the debt-to-equity ratio during 2015-2019, i.e. an increase of 61%. Yet, in absolute terms, the debt-to-equity of 0.58 recorded in 2019 can be broadly considered a relatively sound level – also falling in the mid-range of other Baltic publicly traded SOEs.

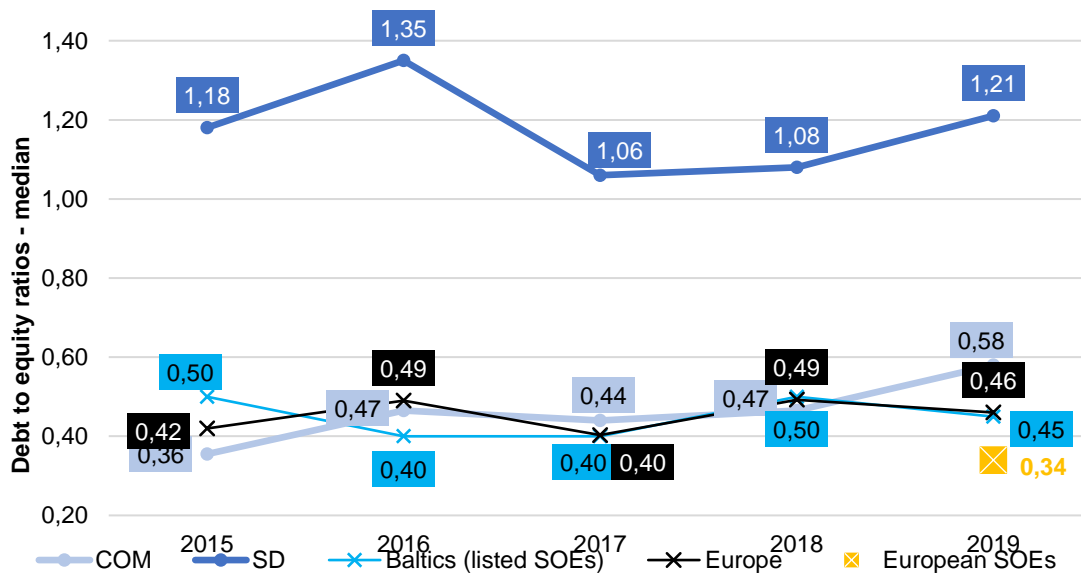
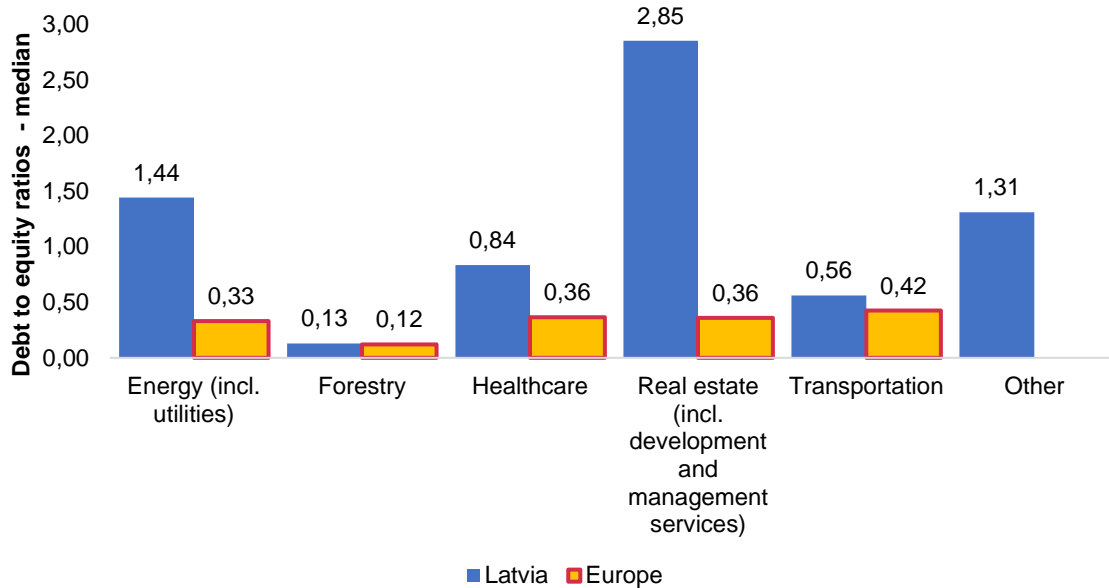


Figure 2. Historical development of SOE debt to equity ratios (2015-2019), [COM= Commercial SOEs; SD = State dependent SOEs]

The sectoral breakdown of Latvian SOE debt to equity comparison to that of the selected sample size of 90 European SOEs strengthens the overall argument of Latvian SOEs carrying excessive amount of debt on their balance sheets. The analysis in **Figure 3** reveals that Latvian SOEs are too indebted across major sectors relative to a yardstick derived from European peers.



*Figure 3. Debt to equity of Latvian SOEs vs European SOEs<sup>6</sup>, 2019*

Overall, it can be concluded that an average Latvian SOE has become more leveraged in the recent past, and for the State dependent SOEs, the debt carried on balance sheets can at some point imply an elevated risk of requiring the State to contribute with direct equity injections. The combination of poor growth and persistently elevated debt levels send a clear signal that either the undertaken investment programs offer insufficient return prospects (the likely scenario<sup>7</sup>) or that the SOEs have been forced to assume a large portion of debt to fund short-term, operational activities.

The risks associated with overly leveraged SOEs can lead to system-wide negative consequences, especially in the case of unprecedented external shocks. Under conditions of decreased demand (i.e. tightening cash flows), SOEs may have to cut on necessary investment programs, furlough employees and/or request notable equity injections from the State.

### **3. The sources of financing used by the SOEs are undiversified and concentrated on State subsidies, retained earnings, and loans from commercial banks.**

In analysing the financial source (i.e. what and the extent of its use), a selected sample of 14 SOEs was scrutinized. From the 14 SOEs (see **Annex 2**) 8 are commercial and 6 State dependent SOEs (Sadales tīkls and LDz cargo consolidates within the respective mother companies). The analysis revealed six different financing instruments on which the SOEs have relied upon during 2019, including the amortization effects of the present instruments, e.g., commercial bank loans and

<sup>6</sup> SOEs indicator poll is compiled from the financial data of 90 various European SOEs

<sup>7</sup> The asset base of the SOEs in which the State has a decisive influence has persistently grown over the 2015 – 2019 period, yet the profitability levels have not picked up with the EU peers (see figure 1.).

bonds. The six financing instruments consisted of the following: subsidies (State financing), retained earnings, EU financing, State Treasury loans, bonds, and commercial bank loans. The bond financing was observed only among three SOEs.

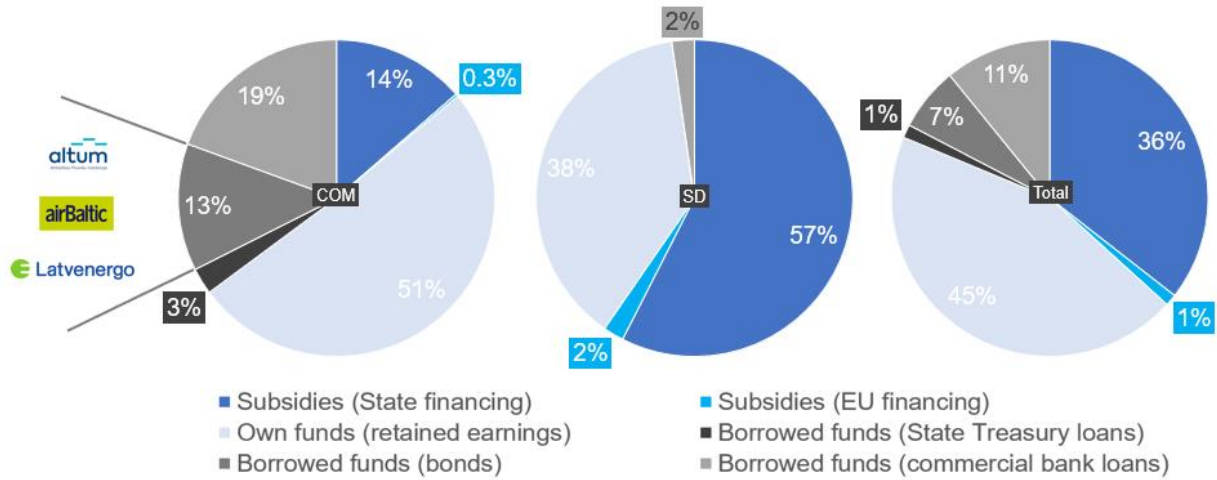


Figure 4. SOE financing sources used in 2019, split between Commercial SOEs (COM) and State dependent SOEs (SD)

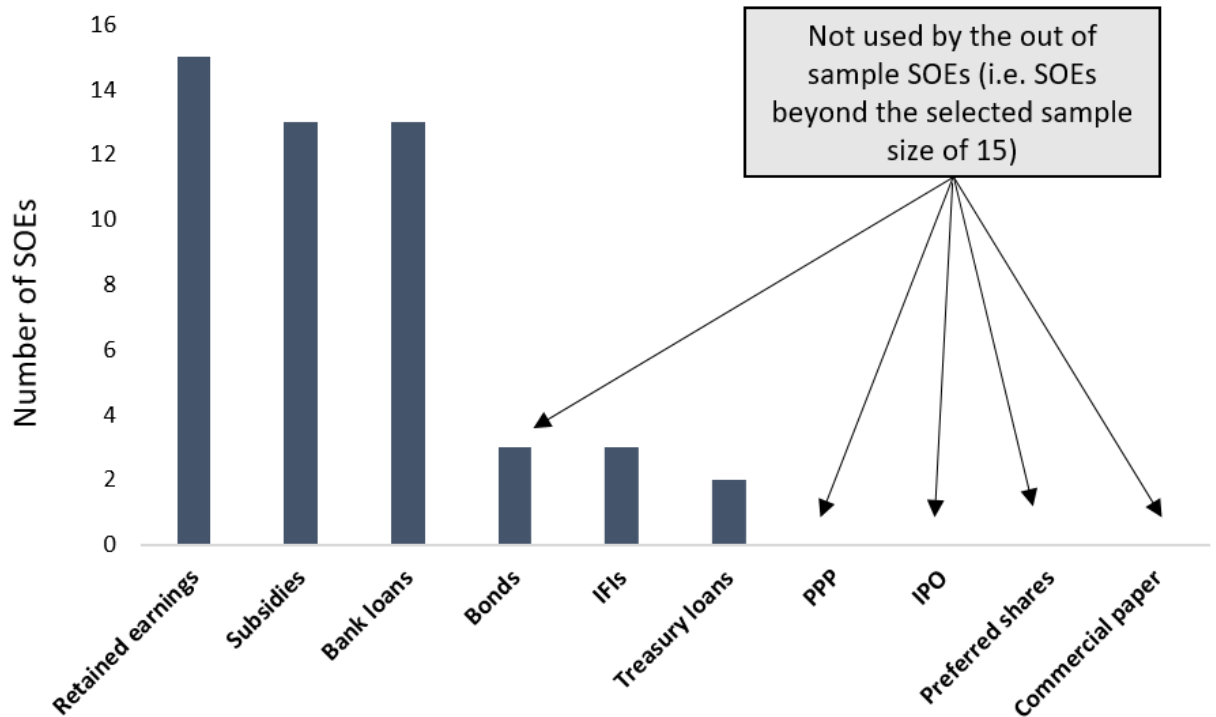


Figure 5. Selected SOEs and their use of financing instruments in 2019

The aforementioned analysis and breakdown of the various financing sources indicates a high degree of homogeneity and concentration in a limited subset of possible alternatives. There is a significant reliance on commercial bank loans (in terms of the possible borrowing instruments)

among both commercial and State dependent SOEs. While this is somewhat offset by the presence of bonds, it has to be noted that the actual picture presents a much lower use of bonds. This is due to the sample size bias, which currently includes all SOEs, which have tapped public fixed income markets, and leaves other SOEs out from which no one has issued bonds.

Finally, the gap analysis on financial instruments reveals that there is a wide range of different alternatives that currently are not put into use by Latvian SOEs. These alternative financing instruments embody attracting financing from both public capital markets and other sources such as public private partnerships (PPP) and commercial paper issues that offer many benefits that traditional forms do not. Hence, a more active use of different financing instruments beyond just traditional alternatives allows one to not only mitigate concentration risks, but also capture various financing instrument specific benefits such as fresh financing without increased leverage profile, more flexible debt maturity profiles as well as lower cost of debt.

#### **4. The domestic public capital markets are well-functioning and able to channel successfully private investment, despite the illiquid patterns of the secondary market, and historic unpopularity among Latvian SOEs and private companies.**

Statistically, the domestic (and pan-Baltic) capital markets have been on a structural decline since the great financial crisis. The number of Latvian publicly traded companies has plunged from 35 in 2008, to 21 in 2019. Similarly, the market-cap-to-GDP measure indicates a significant divergence from the world's average. In 2019, the Latvian market-cap-to-GDP ratio stood at 2.7%, while the corresponding average for the world was ca. 90% and for Europe around 70%. The structural decline has led to shallow liquidity in secondary markets and caused a pessimistic perception of the underlying feasibility of domestic public capital markets.

However, the past examples and the recent activity in the primary market have proven that the market is well-functioning, namely, it can successfully channel private investment provided that certain pre-requisites are met. For instance, both of Latvian SOEs (i.e. Latvenergo and Altum) have issued bonds, which have been oversubscribed by the investors, confirming the appetite from institutional investor for transparent and well-structured issues. The presence of strong demand, in turn, allows the SOEs to consider longer maturities, larger issues and/or lower yields. Both SOEs have communicated a willingness to proceed with bond issuances (e.g., refinance the maturing ones) that sends a clear signal of the benefits offered by the public capital markets.

The most recent IPO by Ignitis grupe (Lithuanian SOE) was the largest IPO in the Baltic capital markets' history, where private investment amounted to EUR 450 million. The firm was dual-listed on Nasdaq Vilnius and London Stock Exchange and benefitted from previously tapping the debt capital market via issuing green bonds. This allowed Ignitis grupe to get comfort with the level of disclosures required by the public markets and ensure there is a smooth transition to raising new equity capital via the IPO.

Another relatively recent IPO by Estonian SOE Tallinna Sadam succeeded to attract EUR 147.7 million of private investment, and over 14 thousand retail investors, thereby boosting domestic savings culture. The feedback from the management teams has been unanimously positive citing many benefits offered by the public capital markets – e.g., enhanced corporate governance and well-needed funds for future growth opportunities.

There are also ongoing pan-Baltic efforts to develop short term tradeable instruments such as Commercial Paper (CP). This can be another tool for local SOEs to tap the money or debt capital markets. CP's development is backed by the memorandum of understanding signed by all Baltic Central Banks together with EBRD and Nordic Investment Bank with the aim to promote and develop a regional CP market – which will contribute to diversifying sources of short term finance for local firms and improving the regional debt capital market while mobilising funds from institutional investors.

**5. Institutional investors expect from SOEs (in the case of SOE IPOs, bond or CP placements) stability, transparency, visibility on the future growth path and the dividend policy, as well as a seasoned management team with a focus on active value creation.**

After the discussions with pan-Baltic institutional investors, and the conducted analysis on all of the SOEs that have used capital markets to fund growth, several important elements crystalized. These elements represent the common expectations from the private investors' side when it comes to capital allocation decisions.

For the two recent (Tallinna Sadam and Ignitis grupe) SOE IPOs, the following pre-requisites for a successful IPO were held in common:

- Sufficient level of free-float – offering ca. 33% to private investors;
- Resilient cash flows with a momentum of growth and a visibility on the future development;
- Seasoned management team, and corporate governance practice up to the par;
- Macroeconomic tailwinds supporting the future development;
- Transparent and predictable dividend policy;
- Obtained credit rating from a reliable agency.

Similarly, the following pre-requisites were held in common for the two recent SOE bond issuances (Latvenergo and Altum):

- Transparency and visibility on how the company envisions putting the capital at work;
- Sufficient issue size for private investors to cover the administrative costs;
- Long enough maturity profile creating a higher term premium;
- Obtained credit rating from a reliable agency.

**6. SOEs should be forerunners in joining stock exchange, which is supported by pan-Baltic FMPs and deemed necessary by many policy makers.**

Many policy makers are increasingly appreciating the benefits of a robust capital market and are viewing it as a mechanism in order to facilitate growth, strengthen corporate governance practice and provide knock-on benefits for a wider society.

Initiatives such as EU capital markets union (CMU) aiming to create a single capital market in the whole territory of EU, Financial and Capital Market Commission (FCMC) developing a 10-step program to enliven domestic capital market, and Finance Latvia Association citing the importance of well-functioning capital markets. Additionally, many of the analysed countries have formed dedicated policies and made notable steps towards improving active ownership by opening the

SOEs for non-State capital via public capital markets. For example, Norway has developed a new policy aiming to gradually reduce ownership in more commercially oriented SOEs, Sweden has purposely divested many SOEs to improve corporate governance and attract financing for growth, and other Baltic countries have been active in this field as well (as described above).

Just as important, pan-Baltic institutional investors have indicated their willingness to participate by subscribing to SOE share and bond issuances.

Finally, an IPO readiness assessment was developed during the Assignment in order to determine commercial SOE readiness to successfully enter stock exchange. The assessment covers many criteria, the fulfilment of which is deemed vital by FMPs to increase the likelihood of a successful debut.

From the five analysed commercial SOEs, it can be concluded that Latvenergo and Latvijas valsts meži are ready candidates for a strong and favourable IPO process. Among the many fulfilled criteria, both companies have robust financials, operate in stable and growing industries and are well-governed (especially, Latvenergo considering the transparency stemming from active bond issuances that to a large extent would provide a major tailwind for Latvenergo in structuring the IPO).

# Recommendations

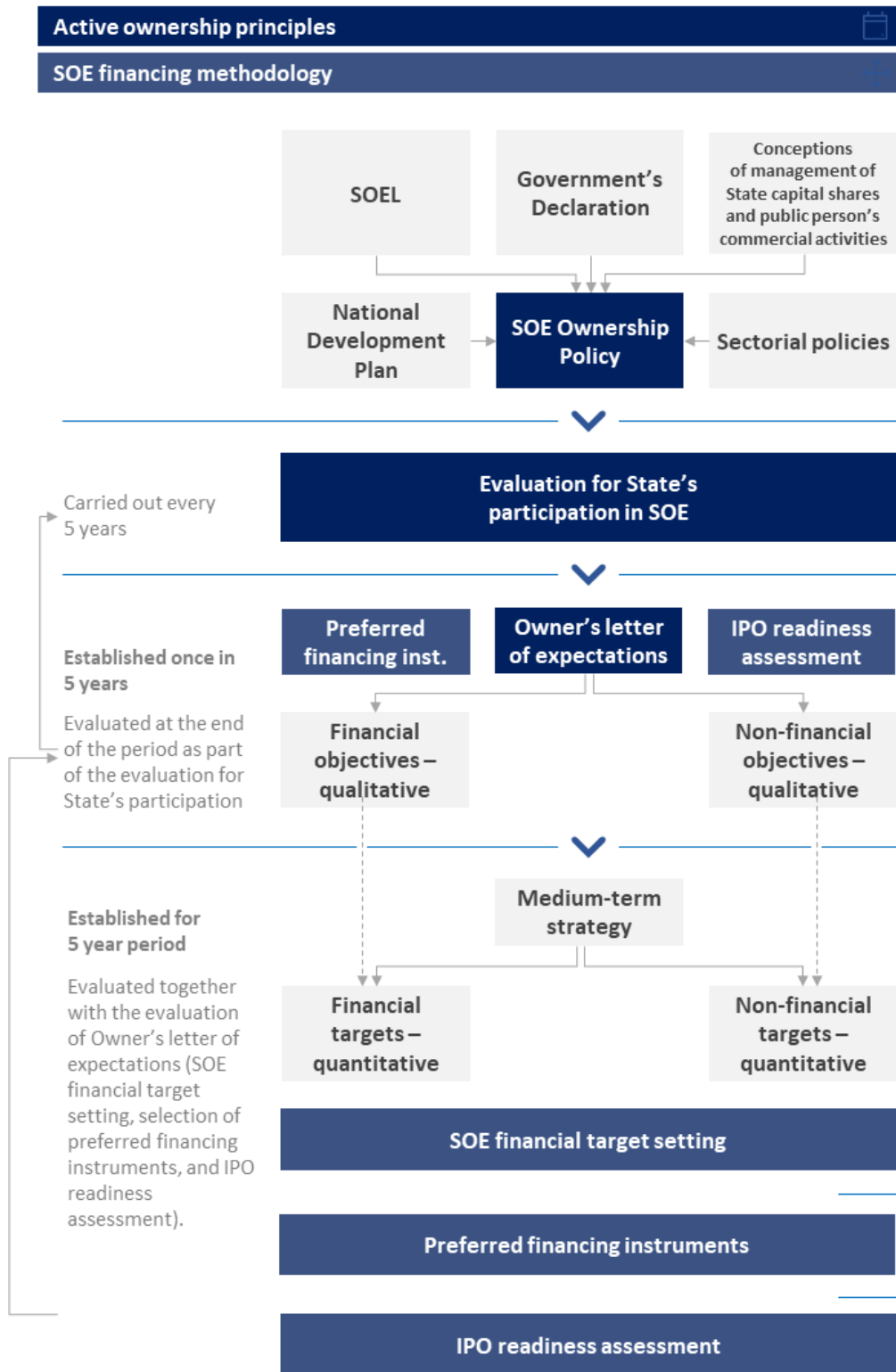


Figure 6. Overview of proposed active ownership principles and SOE financing methodology

## Induce active ownership principles by ratifying a comprehensive SOE State Ownership policy document, creating owner's letter of expectations and adjusting the existing medium-term strategy guidelines.

### Context

- Latvian SOE ownership model has been strengthened by creating a Coordination Institution with an aim to harmonize SOE corporate governance. However, the existing corporate governance practices show that despite the attempts to unify shareholder and SOE practices, significant discrepancies remain. This is mostly attributable to the sheer number of SOEs and lack of a comprehensively established single State ownership policy document.
- During the interviews with pan-Baltic institutional investors, SOEs and other financial market participants (FMPs) active ownership was cited as the most vital issue to be solved. Several examples were brought up illustrating the detrimental consequences of shareholder's inactivity – e.g., foregone investment opportunities that would have resulted in favourable returns, structurally lagging financial results relative to the closest peers, lower flexibility and predictability due to unexpected dividend extractions etc. The most imminent homework for solving the perceived inactivity, according to the feedback from the market, includes a mechanism that transparently outlines the long-term expectations by the State, clear-cut methodology how to measure and set specific targets, and a more active dialogue involving shareholders, SOEs, line ministries as well as key FMPs.

The State ownership policy on the SOE governance has to take **a long-term approach allowing SOEs to become efficient**, profitable and given an opportunity to develop. Considering the Latvian SOE ownership model, it is crucial to have clearly defined SOE objectives, target setting and monitoring procedures all of which ensure harmonized and efficient SOE governance. For the State to allow SOEs full operation autonomy in achieving their defined general strategic objectives, it is necessary to first establish concrete expectations regarding the SOE performance evaluation as well as determine clear SOE performance monitoring procedures.

### State ownership policy document

The SOE ownership policy in Latvia is expressed in several policy documents such as Latvia's sustainable development strategy, Latvia's National Development Plan and the Government's Declaration of the intended activities of the Cabinet of Ministers, SOEL and Conception of management of State capital shares, Conception of public person's commercial activities and the subsequent sectoral policies. Based on the SOE ownership model the ownership policy is implemented by 11 ministries and the National Electronic Mass Media Council and Public Asset Manager "Possessor" having various understandings and interpretations on the SOE ownership policy and its objectives.

**To harmonize SOE corporate governance practices the State should develop unified SOE ownership policy document** complying and clearly defining State's overall SOE ownership policy strategy and objectives towards SOEs. The SOE ownership policy should be developed as medium-term policy planning document **aligned with the political cycle and government's period of operations and aimed at achieving**

**specific objectives of national importance and covering a wide range of issues.** The SOE Ownership Policy and State's objectives toward SOE should be subject to public disclosure.

Firstly, the SOE ownership policy **should determine specific criteria and strategic rationale for State's participation in SOEs.** The policy should encourage establishing or maintaining a participation in an SOE only if the strategic objective for establishing or maintaining participation in SOE cannot be achieved by exercising its public power directly through the State administration or by encouraging private market participants to ensure delivery of the necessary goods or services. It would decrease the number of SOEs in Latvia, and simultaneously increase the institutional SOE governance capacity allowing the State to act as an informed and active owner. The SOE ownership policy should serve as a foundation to review State's ownership objectives and legal framework establishing SOE corporate governance.

Many OECD countries have opted to limit their SOE portfolio to companies delivering strategically important goods or services (e.g., mining, energy, transport sectors) or having a commercial purpose. To fulfil non-commercial public policy objectives, governments have established public administrations or non-profit foundations. For example, the relatively small amount of the SOEs in Estonia and Lithuania - 29 and 51, respectively - allows governments to more actively engage in SOE governance and to monitor their performance on a more granular basis. In Lithuania and Estonia entities providing healthcare or culture services (i.e. State-dependent non-commercial SOEs) have been established as either public administrations or foundations.

Based on the State's rationale towards participation in an SOE, the SOE ownership policy should establish **SOE segmentation process.** The segmentation should constitute from the same principles and implementation as outlined in the proposed segmentation approach. The segmentation should inform State's strategy towards commercial and State-dependent SOE development by determining the level of State's participation in SOE, financial targets and financing instruments. The SOE Ownership policy should establish State's objectives towards each of the segments, for example, asserting that commercial SOEs should work in the similar market conditions as private market participants, including but not limited to increasing their profitability and ensuring effective State capital management. To render a coherent segmentation process, where the SOEs could be assessed by applying one common language understood by a broad base of FMPs, it is recommended to adopt International Financial Reporting Standards (IFRS) for primarily commercial SOEs and more mature State dependent commercial SOEs. Additionally, based on the State's objectives towards each of the segments, State should require commercial SOEs to have an IPO readiness assessment, evaluating SOE potential to join the capital market. Depending on the readiness assessment's results, State should re-evaluate it's the level of participation in SOE.

Secondly, the SOE ownership policy should include the **State's objectives on a sectoral level** in order to provide a clear guidance for the SOEs. This is vital to allow both the overall SOE management and general public to grasp the potential impact to SOEs of the envisaged sectorial changes. Furthermore, the disclosures per each sector in which the SOEs operate would facilitate higher visibility on the future investments and allow to make necessary adjustments in the overall capital allocation tactics. Lastly, the SOEs are often perceived as flagship organizations that are expected to pave the way for other organizations in absorbing the imminent structural changes. To do so, defined sectorial objectives in the SOE Ownership Policy document would allow the SOEs themselves to prepare and take bold steps that are necessary to achieve the envisaged sectorial plans.

Thirdly, SOE Ownership Policy should establish overall SOE broader public policy objectives, for example, implementation of **ESG standards**. As an owner, the State should have high ambitions for sustainable business that would follow **objectives set in global Sustainable Development Goals (SDG)**. SOEs have to act in an exemplary way, which includes working strategically and transparently with a focus on cooperation to promote sustainable business practices. Other examples include a stipulated policy for gender balance in SOEs' management, capped compensations difference from the top decile and the bottom decile, carbon neutral investment projects, etc.

Fourthly, to clearly establish State's ownership objectives on the individual SOE level, the SOE ownership policy should clearly establish the requirement for shareholder to create an **owner's letter of expectation that encompasses and aligns SOE ownership policy objectives and SOE development ambitions**.

Lastly, to strengthen SOE corporate governance practices State should **enhance Coordination Institution's role in the SOE governance**. The Coordination Institution should act as an advisory institution for SOE Supervisory boards and shareholders respecting their autonomy and giving the necessary guidance. However, to harmonize corporate governance the Coordination Institution should have an authority to monitor shareholder practices towards implementation of SOE Ownership Policy. The State ownership policy should provide an opportunity for the Coordination Institution to act as a temporary Supervisory member for a period up to one year, if (1) the SOE's Supervisory board has been established for its first term or there are significant changes in the SOE Supervisory board, i.e., at least half of Supervisory board members have changed or (2) shareholder has requested a Coordination Institution's assistance in SOE governance. To allow Coordination Institution to ensure necessary guidance, Coordination Institution would need to strengthen their institutional capacity by attracting more professionals involved in the SOE governance.

### **Evaluation of State's participation in SOE**

Having a significant SOE pool and various reasons for State's participation in the company, it is necessary to **harmonize procedures associated with the State's participation in an SOE**. The existing framework creates an obligation for State to carry out a competitive neutrality and economic assessment to either establish or maintain its participation in SOEs. To strengthen corporate governance practices related to shareholders' rationale for State's participation in SOE it is necessary to define a **precise scope and criteria for the evaluation of the State's participation in an SOE**. The assessments should be subjected to an independent and binding review by the responsible authorities, such as, Competition Council and CSCC.

The process of evaluation of the State's participation needs to (1) follow the State's objectives towards participation in SOE set in SOE Ownership policy and (2) focus on the scrutinization of the State's participation in a capital company and active evaluation of alternative solutions how to ensure the necessary goods or services. The process of evaluations or re-evaluation of State participation in SOEs should be strengthened by:

- stipulating that a public person has a duty every 5 years to re-evaluate its participation in all SOEs without an exception;
- providing precise criteria that must be included in the competitive neutrality and economic assessment. The assessments should be subject to independent binding evaluation by the competent authorities;

- the economic assessment and competitive neutrality assessment should be subject to public disclosure. To protect the commercial secret of the capital company, assessment on continuing participation in the company shall be made public by obscuring information containing commercial secrets.

As a result of the evaluation for State's participation in SOE the State should determine its interest for participation in the SOE and the general strategic objectives of the SOE. The State's interest for further participation in SOE should be defined in owner's letter of expectations.

### Owner's letter of expectations

Given the State's diverse interests in participation in SOEs, size and variety of SOE portfolio in Latvia, the "one size fits all" solution for the SOE objective setting does not lead to an effective SOE governance. To clearly establish State's ownership objectives on the SOE level the shareholder should create an **owner's letter of expectation that encompasses and aligns SOE ownership policy objectives and SOE development ambitions.**

The owner's letter of expectations would strengthen SOE corporate governance practices by **encouraging State to take more active participation in the SOE governance and would help track the fulfilment of the SOE ownership policy objectives.** The aim of owner's letter of expectations is to communicate State's expectations towards further development of SOEs.

For example, if the owner has decided to reduce the level of its participation in the SOE, the owner's letter of expectations would serve as a transparent and accountable tool for outlining such path with the corresponding high-level steps that the shareholder would expect from SOE to achieve or consider as to deliver on the newly defined objective (i.e. opening of capital structure via IPO or increase firm-wide transparency by tapping the bond market). Similarly, the shareholder might perceive the environmental targets of paramount importance, and thus draft such targets in owner's letter of expectation by assigning a high level of priority for the objective to be achieved.

The owner's letter of expectation should be a natural result of the evaluation for State's participation in SOE and thus **should be tailored to each specific SOE** considering the SOE ownership policy objectives, sectoral objectives, specific objectives and potential developments of SOE.

The owner's letter of expectations should outline the general strategic objective and high-level long-term financial and non-financial objectives that the SOE should strive to achieve over the owner's letter of expectation's term. It would be at the shareholder's and Supervisory board's discretion to set additional commercial objectives for the SOEs. The owner's letter of expectation should include at least:

- The **reasoning for States participation** in the SOE;
- **Non-financial objectives** - strategic SOE ownership and sectorial policy objectives that the State as an owner expects from the SOE,
- **Financial objectives** regarding rate of return, dividend policy and capital structure based on the proposed SOE financial target setting (see in the following sections).

The owner's letter of expectation should be renewed during the re-evaluation of State's participation in SOE or adjusted in cases when there are structural changes in the market or company's commercial and non-commercial activities.

## Strengthen and diversify SOE financial standings by implementing a SOE financing methodology.

### Context

- Latvian SOEs have been delivering subpar performance relative to comparable private businesses – both similar SOE and EU. In the same time, the SOEs carry higher debt burden, mainly due to low-yielding CapEx, than what is on average observed for the publicly traded Baltic SOEs and an average EU private business. The combination of mediocre returns and high indebtedness implies a significant risk for sustainable growth prospects, in the worst case, leading to debt overhang issues (inability to borrow even when the new borrowing is actually a good investment that would more than pay for itself).
- The financing sources used by the SOEs are undiversified and split predominately among three sources: bank loans, state financing (incl. grants) and retained earnings. The concentrated portfolio of financing sources has direct negative implication on the companies' potential to withstand economic shocks in a way that protects shareholder's capital. It also implies lower flexibility and forgone advantages associate with other more innovative financing sources as well as leaves implications on an adequate profitability.
- According to the OECD guidelines and best practice, the key building block of SOE governance is to warrant a level playing field and to facilitate a competitive neutrality. To achieve these elements, the following must be accounted for in a well-defined SOE financing methodology: transparency and disclosure around cost allocation, transparent and adequate compensation for non-financial objectives, and methods in place to calculate a market-consistent rate of return on business activity.

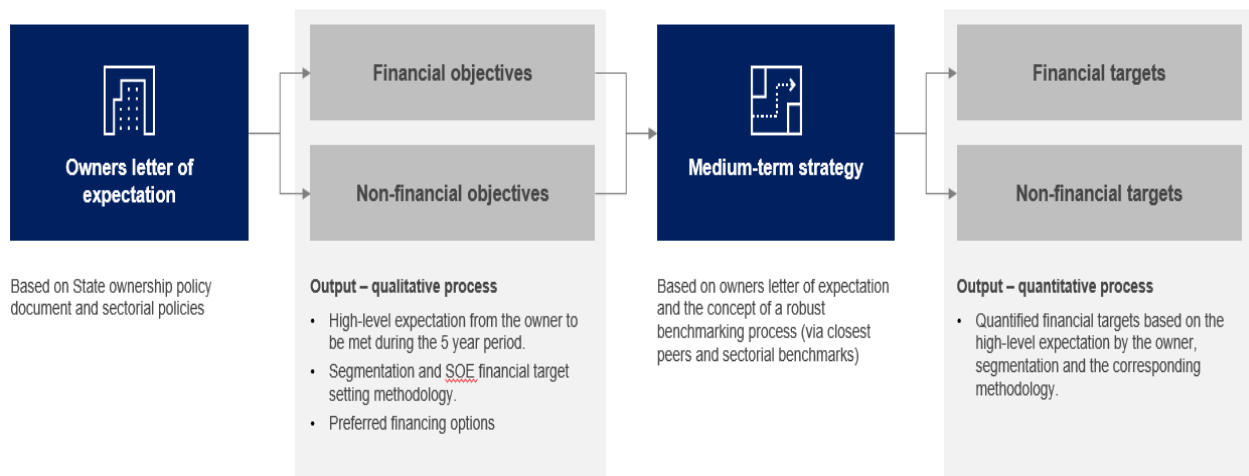
### SOE financial target setting

	Commercial SOEs	State dependent SOEs	
		Commercial	Non-commercial
Optimal capital structure	<ul style="list-style-type: none"> <li>Based on <b>leverage and coverage factors stemming from relevant investment grade credit rating</b> (methodology) defined by one of the top-tier credit rating agencies.</li> </ul>	<ul style="list-style-type: none"> <li>Debt-to-equity (or any other sector specific metric) based on <b>sector or close peer benchmarking</b>.</li> </ul>	<ul style="list-style-type: none"> <li>Return and capital structure expectations set as to fulfil non-commercial goals in an efficient and sustainable manner, <b>not making losses</b>.</li> </ul>
Rate of return	<ul style="list-style-type: none"> <li>Return on equity (or any other sector specific metric) based on <b>sector or close peer benchmarking</b>.</li> <li>Regulated business segment should be subject to benchmarking based on the maximum allowed level of return by the relevant legislation (e.g., nominal WACC).</li> <li>State subsidised business segment should be subject to sector or close peer benchmarking.</li> </ul>		
Dividend policy	<ul style="list-style-type: none"> <li>Dividend pay-out ratio (or any other sector specific metric) based on <b>sector or close peer benchmarking</b>.</li> <li>Dividend pay-out ratio should consider the leverage and coverage factor levels / ranges necessary to achieve or maintain an investment grade credit rating.</li> </ul>	<ul style="list-style-type: none"> <li>Dividend pay-out ratio (or any other sector specific metric) based on <b>sector or close peer benchmarking</b>.</li> </ul>	<ul style="list-style-type: none"> <li>Dividends should be determined for each company separately, <b>allowing to make no dividends</b>.</li> </ul>

Figure 7. An overview of SOE financial target setting methodology

The aim of medium-term strategy is to clearly cascade the objectives set in the owner’s letter of expectations by establishing more concrete steps of action to deliver on the set expectations. The medium-term strategy is structured on a similar basis as the OLE covering both operational financial and non-financial targets. In the process of defining and quantifying the communicated targets by the shareholder, the SOEs should take into account two aspects: **(1) achieving similar performance to that of comparable businesses in commercial lines of business and (2) fulfilling the non-commercial goals outlined in the OLE with high-quality and cost efficiency.** Namely, the more concrete targets set in the medium-term strategy should unambiguously reflect the planned trajectory of defined targets moving into a direction of successful fulfilment of OLE expectations.

## 5 years for owners letter of expectation and medium-term strategy



*Figure 8. OLE’s interplay with medium-term strategy*

When the OLE expectations are received and the appropriate segment is assigned, it is the responsibility of Supervisory board to initiate a process of quantified target setting based on the proposed SOE financial target. As depicted in the **Figure 8** above, the SOE financial target setting, which facilitates the mechanism of setting objective and comparable targets, should be implemented jointly with other OLE expectations.

The SOE financial target setting offers the following:

- A **unified guide** that helps Supervisory boards and Executive management teams setting 5-year financial targets that are similar to those of comparable businesses. This is driven by applying credit rating methodology, industry/sector averages and a targeted sample size of comparable peers;
- A set of critical **financial aspects that have to be factored in to converge to comparable businesses and deliver sufficient returns without excessive risk taking.** These financial aspects tackle company’s balance sheet (optimal capital structure), income statement (rate of return targets), and shareholder’s compensation level (dividendness). This set of financial aspects tackles the most common financial targets set for SOEs as well as assesses a company from a similar perspective as OECD in defining well-defined optimal capital structures.
- A **guide on concrete financial metrics** to be used for defining appropriate target values for each of the previously mentioned financial aspect.

The SOE financial target setting methodology does not address the following:

- The necessary projections and year-by-year values to achieve the 5-year financial targets. The decisions and tactical capital allocation processes related to how the 5-year financial targets should be better achieved are left at the discretion of Supervisory board and Executive management team.
- The process and structure around budgets.
- The fulfilment of other goals and expectations laid out in the OLE except for the financial targets.

### Preferred financing instruments

Given the highly homogenous portfolio of financing instruments used by the SOEs, the State should **encourage a more active use and exploration of alternative solutions** to reduce the negative consequences of limited and concentrated financing sources. It is recommended that the State communicates a list of preferred financing instruments on a segment basis taking into account the existing gaps of financing instruments and the viability aspects. Namely, the list should be tailored for each SOE segment separately focusing on the viable and highly advantageous financing instruments that in present are rarely used (or even not at all).

The underlying premise of outlining a preferred list of financing instruments for each SOE segment is to evoke an active and high-level dialogue between the owner and the management with the intent to **facilitate assessment of other financing instruments in the context of larger investment projects, re-financing activities or other capital allocation decisions**. The financing instruments included in the preferred list should not be obligatory per se, however, the management should devote a reasonable effort to justify the selection of a specific financing instrument and provide a clear argumentation for why the preferred financing instruments were or were not selected.

	Commercial SOEs		State dependent SOEs																			
	Equity	Debt	Commercial		Non-commercial																	
Preferred financing instruments	<ul style="list-style-type: none"> <li>• IPO and secondary offerings</li> <li>• Preferred shares</li> </ul>	<ul style="list-style-type: none"> <li>• Bonds (including green bonds)</li> <li>• Commercial paper</li> <li>• Borrowings from IFIs</li> </ul>	<ul style="list-style-type: none"> <li>• State subsidies and grants</li> <li>• Retained earnings</li> </ul>	<ul style="list-style-type: none"> <li>• Bonds (including green bonds)</li> <li>• PPP</li> <li>• Borrowings from IFIs</li> </ul>	<ul style="list-style-type: none"> <li>• State subsidies and grants</li> <li>• Retained earnings</li> </ul>	<ul style="list-style-type: none"> <li>• PPP</li> <li>• Borrowings from IFIs</li> </ul>																
Aspects to consider when deciding which financing instrument to choose	<table border="1"> <tr> <td>Financial parameters →</td> <td> Maturity</td> <td> Financial capacity</td> <td> Administrative costs</td> <td> Cost of capital</td> <td> Bureaucracy</td> <td> Info disclosures</td> </tr> <tr> <td>Specific parameters →</td> <td> Innovation</td> <td> Flexibility</td> <td> Knowledge</td> <td> Ticket size</td> <td> Marketing / brand</td> <td> Reduction of financial risk</td> <td> Control effects</td> <td> Improved corporate govern.</td> </tr> </table>						Financial parameters →	Maturity	Financial capacity	Administrative costs	Cost of capital	Bureaucracy	Info disclosures	Specific parameters →	Innovation	Flexibility	Knowledge	Ticket size	Marketing / brand	Reduction of financial risk	Control effects	Improved corporate govern.
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Figure 9. The list of preferred financing instruments

The list of preferred financing instruments is developed **based on the prevailing gaps in the overall SOE portfolio** of most often-used financing instruments, as well as on the notion of how viable each instrument is for a specific SOE segment. For example, the bond financing is rarely used among the commercial and State-dependent commercial SOEs despite the fact of potentially tighter yields (especially, in the case of green bonds) relative to what the traditional banking could offer, more flexible maturity and repayment profile, improved corporate governance elements, and strong overall demand from the institutional investors.

### IPO readiness assessment

An IPO readiness assessment in relation to how viable an SOE is for an IPO is crucial before deciding to explicitly require a particular SOE to tap the capital market and issue new shares. This step will help **scope the potential IPO candidates, highlight the currently lacking areas that have to be improved, and initiate a fact-based discussion around the IPO**. Therefore, it is recommended that the vision on gradual reduction of ownership in commercial SOEs is outlined in the State ownership policy document in conjunction with the obligation to perform an IPO readiness assessment.

	Quantitative measures	Qualitative measures
Higher priority	<ul style="list-style-type: none"> <li>Positive historical and future cash flows sufficient to cover the expenses and generate positive returns.</li> <li>Stable, predictable and high yielding dividend policy.</li> <li>Company's indicative valuation over EUR 100 million.</li> </ul>	<ul style="list-style-type: none"> <li>Good corporate governance standards implemented across the entire organization – in compliance with OECD and best practices.</li> <li>ESG considerations present in the company's current as well as future operations.</li> <li>Clear reasoning behind IPO (“investment driven” or “ownership driven”).</li> <li>Seasoned executive board team and highly experienced and independent supervisory board with no scandals or controversies in the past.</li> </ul>
Lower priority	<ul style="list-style-type: none"> <li>Positive growth prospects for the company and industry / sector in which it operates.</li> <li>The market provides healthy valuation levels across the board, and is not in the bear market territory.</li> <li>Meaningful sales exposure in foreign markets.</li> <li>Minimal level of free float at 25% (yet depending on size – the larger the company, the lower the free float could be and vice-versa).</li> </ul>	<ul style="list-style-type: none"> <li>Financial risk is properly managed and not elevated in relation to the peers or sector / industry benchmarks.</li> <li>Credit rating from top-tier agency on an issuer level.</li> <li>Transparent public reporting with additional (albeit not mandatory) levers of reporting.</li> </ul>

*Figure 10. Criteria for IPO readiness assessment*

IPO readiness assessment includes both quantitative and qualitative measures, and each of the two groups include two tiers of criteria, namely, higher priority and lower priority criteria, that need to be evaluated to determine whether a company is viable for potential IPO. These criteria stem from the interviews with institutional investors, the analysis of all of the Baltic SOE IPOs and bond issuances as well as capital market expert opinions on the potential Latvian SOE IPOs. The direct benefits of the IPO readiness assessment are the following:

- Formal criteria that **allow decision makers to judge how close an SOE is to making a debut in stock exchange**.
- Criteria that **help identify gaps and set additional targets** to improve financial and corporate governance profile.
- Increased odds of a **more successful and better priced IPO**.

Most of the proposed approaches how to tackle and assess each criteria exhibit a degree of subjectivity and can differ from case to case (especially, for quantitative measures). Therefore, it is also recommended to approach the criteria by giving them an appropriate context (industry, company, shareholder). For instance, for the “meaningful sales exposure in foreign markets” it is recommended to have at least 10% of sales outside domestic market to fully meet the criterion. However, for a certain industry or company such level could be structurally impossible to reach for clear reasons that are also understood by the market, and thus the approach in fulfilling the criterion should be relaxed.

**Consider periodically bringing larger and more mature SOEs to public capital markets. To do so, stipulate capital market policy – including both debt and equity – in a State ownership policy document, impose it through owner’s letter of expectation, and amend the existent IPO-restrictive law(s).**

### Context

- Several largest and commercially oriented SOEs have cited the current legislation (that prohibits several SOEs from diluting the ownership base) as a factor for why an IPO - opening of capital structure for attracting new equity funds - is not assessed as a potential financing source. In addition, a lack of more tangible vision from the shareholder’s side in terms of recommended financing sources for covering future investments was brought up as a potential impediment in increasing the diversity of financing sources.
- In the recent past, both of neighboring Baltic countries have carried out large and successful SOE IPOs by attracting ca. EUR 140 (Tallinna Sadam) and EUR 450 million (Ignitis grupe) of capital, while keeping majority ownership at the hands of government. The key stakeholders (e.g., management and shareholders) have clearly communicated the notable benefits the IPOs have brought for the SOEs and the general public.
- Institutional investors have expressed readiness to invest in Latvian SOEs as long as the whole IPO or bond placement process is transparent, well structured, and the pricing is in line with the consensus estimates.

An IPO has to stem from an active ownership and has to be appropriately justified by providing the rationale why it is necessary, what benefits it will bring and what risks it could introduce. To facilitate new and successful SOE IPOs (also relevant for bond issues) that would set a benchmark for the subsequent issues, we recommend taking the following actions:

**Provide a precise vision on the State’s ownership for a certain group of SOEs in which a gradual reduction of ownership is expected; and incorporate it in the newly established State ownership policy document.**

To stimulate active ownership and establish transparent expectations for the SOEs, it is recommended to include a clear vision about the aims of State’s ownership in State ownership policy document. It should include guidance that **commercial SOEs are subject to a potential IPO process by which the State’s ownership level is expected to decrease allowing the exchange between the capital and shares to take**

**place.** Such vision should be backed with reasons describing what benefits it will add: e.g., to fund future growth opportunities, bring contributions to State budget, improve corporate governance and / or stimulate domestic savings culture and development of domestic capital markets.

For that to happen, the State **should adopt the proposed SOE segmentation**, which separates commercial SOEs that exhibit a high degree of discretion on influencing the trajectory of long-term growth and returns from the State dependent SOEs that are focused more on efficient and sustainable fulfilment of non-financial objectives. Private investors seek long-term capital appreciation that commercial SOEs are able to deliver without being overly constrained by the fulfilment of non-financial objectives.

### **Use Owner’s letter of expectations as a tool to communicate decisions surrounding IPO**

The mechanics of **OLE provide a solid ground for laying out shareholder’s expectations associated with an IPO.** It can serve the purpose for communicating that an SOE should prepare for IPO by working on lagging aspects identified in the IPO readiness assessment phase. Similarly, it can also be used to express a requirement to conduct an IPO under the actual OLE period.

In the scenario in which the shareholder wishes to realize an IPO under the actual OLE period since the IPO readiness criteria are met sufficiently, the following criteria should be disclosed:

- The motivation behind the IPO why it is chosen (preferably, with the disclosure of either being driven by ownership/corporate governance and/or investment needs).
- The range of ownership percentage that should be provided to the private investors.
- The date or timeframe in which the IPO should be concluded.

It also should be noted that the range of ownership percentage and, especially, the timeframe **should be viewed from the lens of prevailing market conditions** in order to minimize the risk of forcing an IPO when the offered valuation levels are depressed.

### **Amend “The Law on the Privatization of State and Local Government Property and the Use of Privatization Certificates” and relevant sectorial laws**

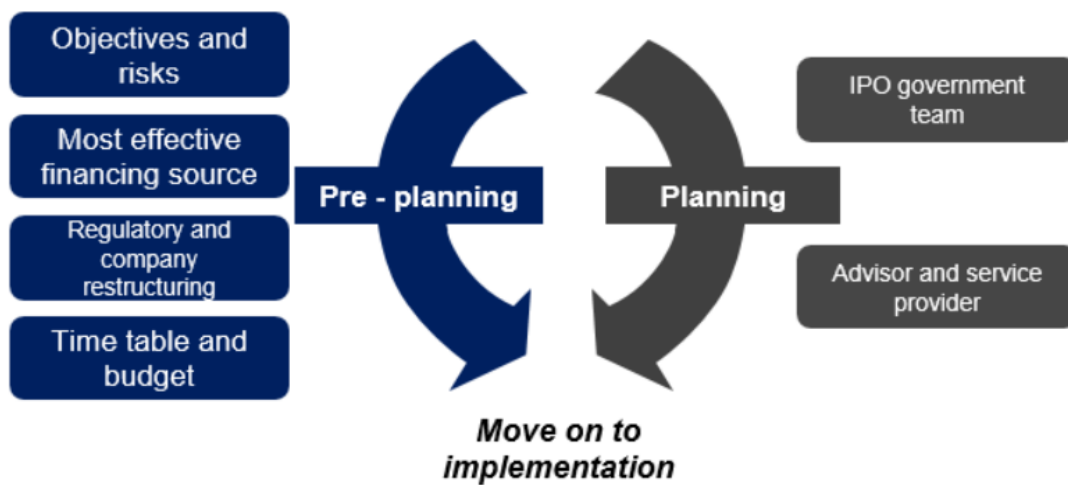
The Law on the Privatization of State and Local Government Property and the Use of Privatization Certificates and certain sectorial laws, for example, Energy law, Law on Forests, exempt several largest SOEs from considering tapping equity markets. This, in turn, **limits the available instruments of financing to fund growth, and disables SOEs from achieving an optimal capital structure** (either excessively leveraged or overcapitalized balance sheets), if an additional amount of equity would be deemed to maximize shareholder’s value.

The policy makers should amend the Privatization of State and Local Government Property and the Use of Privatization Certificates and subsequent sectorial laws lifting prohibition to expropriate SOE shares and allowing all SOEs going public. The best practice does not discourage SOEs from certain financing instruments, but, instead, provides a full spectrum of financing instruments, which can be applied for according to the SOEs’ prevailing needs. The two most recent IPOs by Baltic SOEs (i.e., Ignitis grupe and Tallinna Sadam) revealed a pattern how the State can remain as a majority holder, and still structure IPOs in a manner that is attractive for the markets, resulting in healthy demand levels. Hence, if the key policy makers circumspect the notion of potentially allowing private participation in some of the largest SOEs, the laws should be amended by determining that the State should hold a majority in the SOEs. The Law

on Governance of Capital Shares of a Public Person and Capital Companies could be amended by drawing a borderline as to how far the voting rights could be diluted in case of private participation in the SOE. For State to hold a majority, ca. 33% of the total shares (one third of ownership rights) would be the limit for private participations (also the case in Lithuania and Estonia).

***Additional recommendation for a successful IPO***

The very first SOE IPO will play a key role in the attempts to enliven the domestic capital markets. It will set the tone for the future IPOs, which will help improve SOE financing diversity and domestic savings culture. In Latvia, there have not been any IPOs by SOEs since 1999. The reasons lie in high levels of scepticism among policy makers and general public that stem mostly from ill-fated privatization cases in nineties. Given the backdrop of bad experience and stagnating Latvian capital market, it is of utmost importance to execute perfectly the forthcoming SOE IPO.



*Figure 11. Pre-planning & planning phase for a successful IPO*

Pre-planning

- Shareholder and MoF should cooperate closely to define objectives and risks associated with the potential IPO. The most common objectives by conducting SOE IPOs are ownership diversification, introduction of new competition, raising revenue prospects, performance efficiency improvements, capital market development and changing market conditions/no longer market failure. The risks are mostly linked to the IPO processes itself, where a mismanaged process could lead to an unfavourable sale of State ownership rights (e.g., timing of IPO, selection of advisors and stock exchange, unclear or inefficient use of proceeds etc.).
- Decision on the most effective capital raising alternative should be made taking into account the planned objectives and identified risks. Most governments and SOEs choose IPO as a tool for raising capital through the use of ownership rights. However, the government should evaluate and determine which alternative is the most efficient from the available scope of financing alternatives – e.g., private sale, trade sale auction, IPO, etc.
- Regulatory, industry and/or company restructuring should take place before the IPO implementation process begins. The degree of restructuring is shaped by factors such as the planned method of sale; the structure of the market in which it operates, government objectives

with respect to the envisaged market structure post-IPO and environmental aspects. It is advised to assess the potential need for restructuring in the following areas:

- Strategic restructuring focusing on the corporate performance and business strategy with the aim of maximizing sustainable and long-term returns;
- Operational restructuring pertaining to management and employment (e.g., pension liabilities, remuneration policies);
- Financial restructuring (introducing dividend policy, re-evaluating rate of return targets imposed by the State, “cleaning up” the balance sheet);
- Legal and regulatory (also changes in applicable laws, if needed) restructuring to adapt to the regulatory requirements in the marketplace. For example, the separation of monopoly activities might be necessary for SOEs operating in public utilities sector. Similarly, certain subsidiaries might be needed to divest or separate from the IPO entity. This could relate to subsidiaries that are incongruent with the presented corporate strategy, held jointly with other owners other than IPO entity or when the combined market share of the subsidiaries and the potential buyers could introduce antitrust issues.
- The government should agree on a timetable and budget, and the range of share issues in a quantitative and clear-cut manner so that the parties responsible for IPO planning and implementation would have a sound framework to apply in the following steps.

### Planning

- IPO government team consisting of steering committee and project team (e.g., shareholders, line ministries, Supervisory board, Executive management, and potentially representatives of sell-side firm). The IPO government team should be made of high-level representatives from shareholder, regulatory party, and independent experts that would form a body responsible for ensuring the integrity of transaction. Its role is to ensure that the Government benefits from best approach of opening the capital structure of the SOE. The skill set and experience embedded in the IPO government team should cover economic, financial and legal skills.
- Appoint advisor and service provider through a competitive process. The selection of advisor should be based on a competitive process involving not only domestic, but also foreign experts. The advisor selection process should also be based on the planned size of IPO and stock exchange platform. In case the size of IPO and stock exchange are relatively small, and the new shares are planned to be issued on NasdaqBaltic, respectively, the regional pan-Baltic advisors could bring more value for money.

## Further reinforce the principle of market consistency among the SOEs.

### Context

- The feedback from SOEs indicate that in some instances in which the State provides a periodic financing for the fulfilment of non-financial objectives, the underlying compensation levels are inadequate. The provided financing by the State has been observed to be too low in order for the SOEs, especially State-dependent commercial and non-commercial, to deliver similar returns to the comparable private sector peers.
- Even more so, several SOEs have mentioned the need and reliance on cross-subsidies (i.e., directing funds generated by the commercial activities towards the fulfilment of non-commercial goals). The lack of adequate level of State financing is limited to situations in which the State finances periodic or recurring delivery of non-commercial goods or services. Direct equity injections and debt financing from the State Treasury have not been cited as issue in terms of market consistent financing that can be explained by the rigorous private sector benchmarking procedures (i.e., involvement of EC) that are attached to the respective financing assessment and approval processes.

The conditions of under-financed SOEs hinders achieving competitive neutrality or “level playing field” between SOEs and privately owned businesses, which is of utmost importance to enable competition to work properly. All companies should compete on the merits and should not receive an undue advantage due to the underlying ownership structure. The “level playing field” maintains economy efficient and allows an efficient capital allocation to take place.

This problem has to be addressed from two sides since the root cause of underperformance can be attributable to either insufficient State financing or inefficient business operations by the SOEs.

**1. Separation of accounts** is the key building block for transparency and disclosure around cost allocation. The OECD has outlined that identifying the costs of any given function of commercial government activity and separating such costs from non-commercial activity is essential if competitive neutrality is to be credibly enforced. The current framework stipulates that SOEs should provide separation of accounts disclosures, however, in practice, most SOEs do not follow the requirements, and almost none of them provides this information to the broader public. The State should find effective means (e.g., sanction mechanisms) to facilitate transparency and disclosure regarding the separation of accounts for all SOEs. Otherwise, without such a disclosure in place, it is unfeasible to conduct a thorough review of the adequacy of State financing and/or the effectiveness of SOE business operations.

**2. A robust process for determining adequate levels of State financing** should be assigned for each round of State financing directed towards SOEs for the fulfilment of non-commercial goals. The State in conjunction with Supervisory board (or Executive management’s team if the Supervisory board is non-existent) should closely cooperate to determine adequate levels of State financing. The process should be driven by otherwise private business equivalent benchmarks so that the SOE does not become over-financed or under-financed relative to an average private business operating in the same industry with similar risk exposures.