



Weekly Briefing

**Latvia economy briefing:
The status quo of Latvian state-owned enterprises and its
representative enterprises**

Nina Linde

The status quo of Latvian state-owned enterprises and its representative enterprises

Introduction

The state of the art of Latvian state-owned enterprises (here and after SOEs) in this briefing will be described and analyzed based on the report conducted by KPMG¹ Baltics “State ownership policy review in Latvia”ⁱ and latest available annual report of Cross-Sectoral Coordination Centre (CSCC) of Latviaⁱⁱ. The detailed reports and the current briefing are dedicated to understanding the development stage of SOEs in Latvia.

Description of the sector is provided to introduce the main indicators and shareholders of the SOEs in Latvia. The value of SOEs is growing twice less intensive than the value of private companies in Latvia and one of the possible solutions is initial public offering to boost financial resources and corporate governance standards.

In Latvia, there are 12 shareholding entities of SOEs from the side of the state. This number of shareholders creates several significant issues in the management system of SOEs. These issues of shareholding management in the country is raised and decentralized control problems are described in this briefing.

Description of the Latvian state-owned enterprises sector

SOEs have a huge impact on the economy of Latvia. The State has direct ownership in 96 enterprises, where 65 are 100% State-Owned Enterprises, 4 - directly and effectively controlled by the State (>50% and <100% ownership), in 27 – has no direct and effective control (the State ownership <50%). Meanwhile, State-Owned Enterprises have ownership of 52 companies. 12 shareholders control SOEs in Latvia from the side of the state.

Among 10 most valuable companies in Latvia 5 are owned by the state, and their common value equals about 4 billion EURⁱⁱⁱ, where 44% of the total turnover are made by the three largest SOEs – Latvenergo, Air Baltic Corporation and Latvijas Dzelzceļi. Besides, 5,3% (or 49 799) of total employees in Latvia are working in the SOEs. The following graph illustrates the dynamic of total turnover and profit of SOEs:

¹ <https://home.kpmg/lv/lv/home.html>

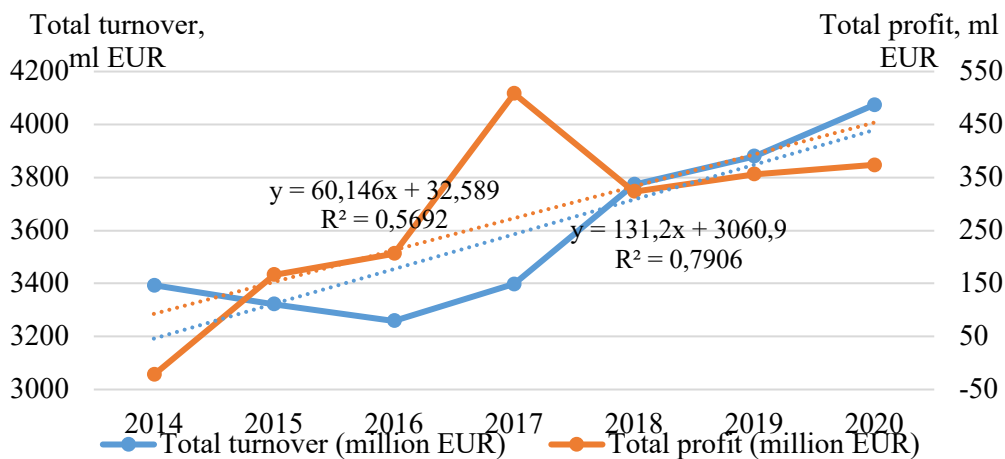


Figure 1. Total turnover and profit of SOEs in Latvia

Source: Image developed by the author using CSCC data and calculation results

The significant increase of profit in 2017 was due to the impact of the Corporate Income Tax Reform and the total effect of the mandatory procurement public service obligation (OIK) grant. The figure shows that there is a positive dynamic in the turnover and profit for SOEs in Latvia.

Total assets of SOEs equals 9.5 billion EUR. The following figure represents total assets of SOEs in Latvia by sector:

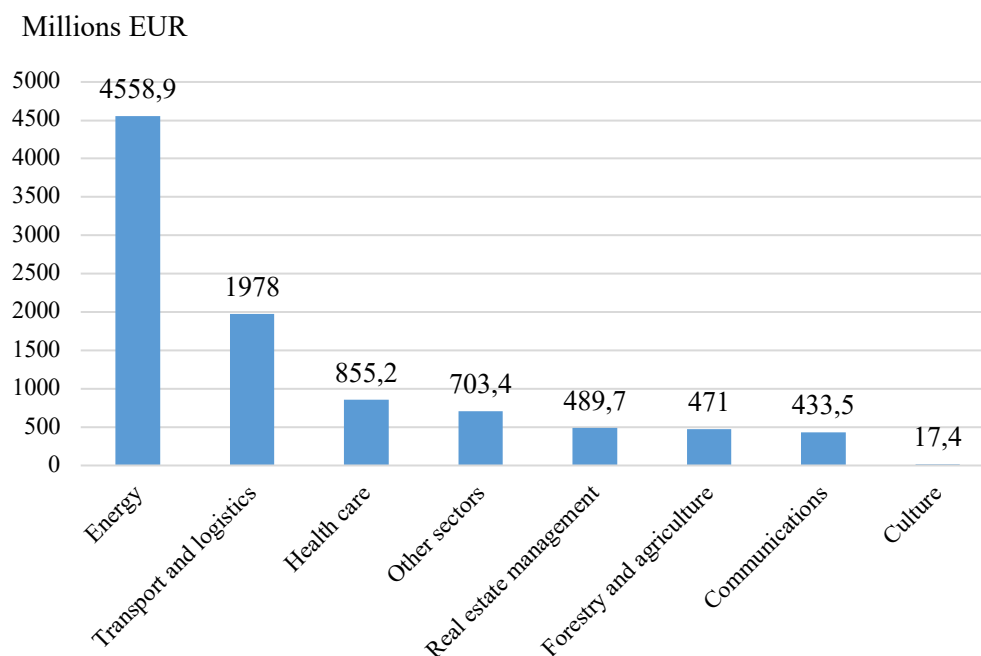


Figure 1. Total assets of SOEs by sector in Latvia

Source: Image developed by the author using CSCC data

The majority of assets of SOEs in Latvia are located in the sectors of energy and transport (68,7% of total assets), followed by health care sector (9% of total assets). The smallest number of assets is in the sector of culture – 0,2% of total assets.

Partial privatization of large SOEs

It must be stated that the total value of Latvian state-owned enterprises has increased by only 14% over the past five years, while the total value of private enterprises has increased by 28%.^{iv} The possible solution for more confident and fast growths of SOEs value is to go public as the experience of neighbour countries shows that without losing control it provide an opportunity to attract additional financial resources for faster development and motivate companies to work to the best corporate governance standards. At the national level, the most significant benefit from going public is expected from the activation of the national capital market, the inflow of foreign direct investment and the increase in the amount of taxes paid as a result of faster development of the company.

“The management policy of state and municipal capital companies, division of state capital companies and gradual centralization of state capital company management functions”^v concept report raised the issue of possible partial privatization of large SOEs as a way to increase the value and, therefore, the efficiency of SOEs. This concept envisages the obligation to requires the state to reassess at least once in five years all the shareholding to check if they are fulfilling the conditions of ownership listed in the State Administration Structure Law.^{vi}

There are 12 non-privatizable state capital companies in Latvia, which are protected as strategically important companies. The issue of listing of state-owned companies has been sharp since the 1990s, the adoption of this concept is likely to result in the listing of a 5 to 25% stake in these companies while maintaining state control over the shareholding. The problem here is to determine the share of the company that can be offered as 5-10% will not attract foreign investors, meaning that the state will earn less, because of the smaller demand. 20-25% will attract foreign investors but at the same time put state control in the threatened position.

SOEs management structure

It is important to note that there are 12 holders of SOEs shares from the side of the state and it is 64% of the whole ownership, while 36% is privatized. In the following graph the structure of shareholders is represented:

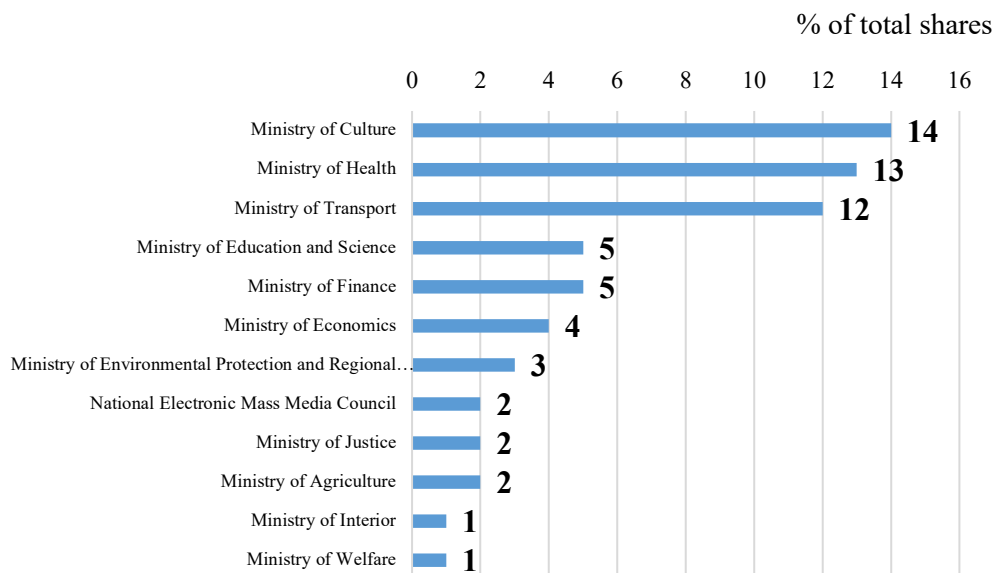


Figure 2. Shareholders of SOEs in Latvia

Source: Image developed by the author using CSCC data and calculation results

Figure 2 illustrates that Latvia has decentralized management of shareholding. The number of entities that manage SOEs shares is 12, which is a rather big number for efficient management. More centralized participation would diminish the interests of potentially conflicting line ministries, which would need to develop policies and regulations for their respective sectors, manage public funding, and at the same time control public corporations operating in their sector. In addition, a large number of small SOEs affect the quality of management and increase external administrative costs. This should be considered for the future strategy of SOEs development in the country.

In Latvia, the SOE ecosystem is diverse and shareholders' interests are questionable as they are less likely to be profit-oriented. As a result, management and standardization of the sector is a challenging issue. The solution for this issue is to centralize state shareholding management to one entity to increase efficiency, potential and control over SOEs.

Target setting procedure issues

The fact that SOEs are working not in their most efficient way is proved by the procedure of target setting for SOEs in Latvia. The targets are frequently set below the past performance level, meaning that there is no intention for development inside of these enterprises. Besides, there is a lack of evidence that a comparison with other companies in the same field is used for

target setting. Especially often can be met the situation of not challenging enough targets, when the performance bonuses for the management of the enterprise are based on the performance and target attainment. This means that there is a lack of proper management for SOEs as well as a low level of competition in the market.

All in all, the process of target setting is underdeveloped in Latvia. There is a necessity for an independent evaluation of this procedure as well as suggestions for improving the efficiency and control over targets and performance of SOEs. The more competitive environment in the market would also have a positive impact on SOEs performance and target setting.

Summary

Overall, the Latvian state has ownership in 92 companies and 52 SOEs representative enterprises. Covid-19 crisis has left a significant impact on the sector. Some of the sectors will be influenced more than others. For example, the most damaged SOEs are in the sectors of transport and logistics, health care, real estate management and culture. Meanwhile, the sector of energy, which has the biggest turnover and profit in the country will be influenced less than others.

Besides, SOEs sector has several significant issues that are not related to the current crisis and these issues need to be addressed to increase the efficiency of the country on the world stage. The first issue is the increase of SOEs value on the market. The solution here can be the initial public offering of SOEs. However, an open question is – what is the optimum share to offer to attract foreign investors and not to threaten state control? The second issue is the shareholding management. Due to a rather big number of shareholding entities, it is difficult to control and manage the efficiency and development of the sector. Therefore, a change of shareholders structure from 12 to 1 entity can be considered. Thirdly, the process of target setting is lacking transparency and causes a lot of questions regarding its efficiency. When bonuses for management depend on the performance, targets can be set lower than the current performance, meaning that they are not challenging for the company and do not lead to the development of the enterprise. More independent evaluations should be made to increase the sector's transparency and efficiency.

¹KPMG Baltics. (2019). State ownership policy review in Latvia. Available at: http://www.valstskapitals.gov.lv/images/userfiles/SOE_Review_LV_Final_report.pdf

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- ii Cross-Sectoral Coordination Centre of Latvia. (2019). Public Report of the State-Owned Enterprises and Shares in 2018. Available at: http://www.valstskapitals.gov.lv/images/userfiles/Latvia_Report-on-State-Owned-Enterprises-and-Shares-in-2018_ENG_%281%29.pdf
- iii Top101.lv (2020) Top 101 – 2020. Latvijas vērtīgākie uzņēmumi. Available at: <https://top101.lv>
- iv Top101.lv (2017) Vai Latvijā valsts uzņēmumi ir gatavi vērtības uzrāvienam tuvākajā nākotnē. Available at: <https://top101.lv/experts-opinion/26/vai-latvija-valsts-uznemumi-ir-gatavi-vertibas-uzravienam-tuvakaja-nakotne>
- v Cabinet of Ministers and CSCC (2020). Konceptuālais ziņojums “Par valsts un pašvaldību kapitālsabiedrību pārvaldības politiku, valsts kapitālsabiedrību iedalījumu un valsts kapitālsabiedrību pārvaldības funkciju pakāpenisku centralizāciju”. Available at: http://www.valstskapitals.gov.lv/images/userfiles/PKCZinoj_VKS_parvaldibas_politika.pdf
- vi The Parliament of the Republic of Latvia. (2015). Law on Governance of Capital Shares of a Public Person and Capital Companies. Available at: http://www.vvc.gov.lv/export/sites/default/docs/LRTA/Likumi/Governance_of_Capital_Shares_of_a_Public_Person_and_Capital_Companies.pdf