CPSE ETF-Merits and Demerits

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It has been more than year since the launch of the CPSE ETF, an innovative product used by the Govt. of India for divesting its stake in a basket of CPSEs simultaneously. It was a first, an idea which had not been tried and tested in India or for that matter anywhere else in the world. The closest example of Government using ETF route to sell shares was in the case of the Tracker Fund of Hong Kong (HK Tracker / TraHK), but the objectives in this case were different.

The CPSE ETF has given strong returns to investors outperforming the Nifty and Sensex, especially in the case of retail investors who stayed invested in the scheme for one year, to earn the loyalty units. The corpus of fund saw some exit initially as arbitrageurs moved out but has been stable since then. It is the most actively traded ETF on the stock exchanges and has added to liquidity in the underlying counters. Before we get into understanding the merits and demerits of CPSE ETF, it is relevant to understand genesis of the product and objectives that were intended to be achieved through this product.

The Background

The disinvestment of Government equity in Central Public Sector Enterprises (CPSEs) began in 1991-1992. Till 1999-2000, it was primarily through minority stake sales in CPSEs through small lots. From 1999-2000 till 2003-2004, the emphasis of disinvestment changed in favour of strategic sales viz. majority stake sales along with the transfer of management control to a strategic partner identified through a process of competitive bidding. After 2004-2005, disinvestment realisations have been through minority equity stake sales, while ensuring that the Government of India (GoI) retains majority control in the CPSEs. The total proceeds from disinvestment between 1991-1992 and 2013-2014, amounted to Rs. 1,52,789.72 crores.

The routes for such disinvestment have primarily been through the Initial Public Offering (IPO) route in the case of unlisted CPSEs, and by way of Follow-on Public Offering (FPO) and Offer for Sale (OFS) routes in the case of listed CPSEs. Though these routes did help in meeting the disinvestment target, it was typically observed that in the case of listed CPSEs, the indication regarding an upcoming FPO / OFS led to significant negative price impact on the CPSE stocks, and resulted in causing capital depreciation for existing retail investors in the process. This undesirable price disruption was on account of market participants discounting the ensuing FPO / OFS well in advance, thereby adversely impacting the net realization for the GoI from the proposed stake sale, while leading to dissatisfaction among existing retail investors.

The challenge was to create a win-win situation, the product should improve realisation for the Government and should cater to retail investors without creating disruption for existing investors. Thus the idea to launch an Exchange Traded Fund (ETF) which would have a combination of different listed CPSE companies.

What are ETFs?

ETFs are similar to Passive Mutual funds but have an advantage of significantly lower fund management charges and real time prices. ETFs have been very successful globally. At the end of March 2015, the Global ETF industry had 4049 ETFs, with assets of US$2.78 trillion. A recent E&Y study predicts annual growth rates of 15-30% around the globe in the coming 5 years and estimates that the ETF industry could surpass the hedge fund industry in assets under management over the next 12–18 months.

Globally, ETFs are used by retail investors as well as institutional investors. For the retail investor, ETFs provide a great opportunity to invest in a basket of stocks with a lower ticket size and at much lower cost as compared to a Mutual Fund. For the institutional investors, ETFs help the fund managers focus more on strategic decisions to create alpha while the beta gets tracked with a significant exposure to an ETF based on the underlying index.

However, in India the success of ETFs had been restricted to Gold ETFs. At the end of March 2015, there were 48 ETFs with AUM of Rs. 14,371 cr. listed on the Indian exchanges. Other ETFs (Non Gold) had been at a tax disadvantage due to double impact of STT, however these points have since got resolved and with the change in investment guidelines for EPFO, NPS and IRDA, the ETF AUM in India is poised to grow significantly.

CPSE Index

As explained above it was a new idea, the closest example being the Hong Kong Tracker. The Hong Kong Government had in 1998 acquired substantial stakes in various listed companies through market stabilisation operations. Fearing that open market sales of these stocks would destabilise the equity markets, it used the stocks to set up an ETF through which it raised $4.3 billion in 1999. The markets had appreciated during this period, and hence they wanted to pass on the larger benefit of these gains to the retail investors and the residents of Hong Kong. Also, as the stakes were bought in the Hang sang Index companies and same was being divested, the Index was already existing and had ample liquidity.

However, the objective for CPSE ETF was different as the Government of India (GoI) in this case the promoter, was selling its stake in the CPSEs, and had the choice of other methods like FPO and OFS. Hence this process had to be more efficient for the GoI while being attractive and beneficial for retail investors. This had to be achieved while ensuring an improved realisation for the GoI by reducing market disruption seen in the case of other divestment methods.

The basket options available would not be tracking any existing index and hence a new index had to be created. The choice was between creating a more balanced basket and the other for a better performing basket even though it might be more concentrated on the energy sector. Views were taken from investors and intermediaries, and it emerged that a basket with better performing stocks would be preferable . Liquidity of the underlying also had to be considered as the index had to be liquid for the product to be efficient.

Based on these factors, the final basket of 10 stocks was chosen as Oil & Natural Gas Corporation, GAIL (India), Coal India, Rural Electrification Corporation, Oil India, Indian Oil, Power Finance, Container Corporation of India, Bharat Electronics and Engineers India.

CPSE ETF

Based on the CPSE Index, the CPSE ETF was launched on 18th March 2014 with an upfront discount of 5% and loyalty additions of 1 units for every 15 units for the retail investors after continuously holding the units allotted in the NFO for 12 months.

The issue was oversubscribed and it collected close Rs. 4500 cr. of which units worth Rs. 3000 cr. were allotted to the investors.

The ETF listing completed 1 year at the end of March 2015 and the loyalty units for the retail investors got credited to their Demat Accounts by Mid-April. The CPSE ETF has positive recall amongst the investors, and there are talks for further divestment using the Tap process or by launching further tranches.

Merits of the CPSE ETF.

Let us understand the merits of CPSE for different stake holders, The Government of India and the Investors – Institutional and Retail.

Advantages of the CPSE ETF for the GOI

As mentioned above, the objective for the Government of India, which in this case is the promoter of the CPSEs, was to have a vehicle which improves realisation to the GoI, reduces market disruption and is able to reach out to retail investors.

The CPSE ETF was launched with a 5% upfront discount and additional loyalty additions for retail investors staying invested for 12 months. Though the discount of 5% upfront is similar to discounts announced at the time of FPOs and OFS, the actual realisation in these cases used to be much lower. As the divestment was done in single stocks through these methods, the market would discount these scripts heavily in anticipation of the event. Various examples of earlier divestment have shown that this reduction in the listed price ranged between 10-25%. Hence the realisation through FPO and OFS was lower for the government.

In case of the CPSE ETF as the stocks were divested as a basket there was minimal impact on the underlying, and also the allotment period involved reduced the chances of short selling of the index.

The CPSE ETF was also able to reach out to retail investors garnering approx. 40,000 unique applications.

Further if the government decides to use the Tap process for continuous divestment, this could well become a vehicle to get a smooth flow of funds at regular intervals with minimal discounting.

Advantages for the Institutional investors.

The launch of the CPSE ETF saw good response from the Institutional investors as well. The reason was simple, these were stocks which in any case formed a part of their portfolio and now getting the basket at a discount from the GoI was a no brainer.

There were objections about the AMC charges and being a new instrument whether there would be ample liquidity. The AMC charges were much smaller as compared to the benefit from the discount and the experience with liquidity has been good.

Globally ETFs are used by institutional investors even without a discount. This is primarily as the charges have become very competitive and many institutions use ETFs to manage beta, or to invest in the index till they deploy the funds into their researched stocks at the next opportunity.

Advantages to the Retail investors

The advantages for the retail investors are many

a. Ability to invest in multiple stocks with small amount as the unit created gives them economic benefit of the underlying stocks in the index.
b. Diversification, since it also makes the investment less volatile for them as the underlying is a basket of stocks. It also makes is easier for the retail investors to take a thematic call instead of stock specific call.
c. Upfront discount and loyalty additions: The CPSE ETF came with a 5% upfront discount and loyalty additions to the tune of 1 unit for every 15 units held. This gave them a discount of 5%+6.67% = 11.67%.
d. High dividend yield, since the CPSE Index consists of stocks which have a track record of high dividends, in the range of 2-3% per annum.
e. Ample Liquidity, since the units of the CPSE ETF are listed on the stock exchanges and the AMC was obliged to provide ample liquidity through authorised participants. This gives the retail investors a facility to exit in the smallest of the quantities through the stock market.

Hence the CPSE ETF has enough advantages for all stake holders, no wonder it saw great success, and the GoI could now use the same ETF for more divestments as well.

There has been some criticism of the product as well. Though in most of the cases, the merits far outstripped the demerits, it is important to understand the de merits as well.

Demerits of the CPSE ETF

To get into more details let us also look at the demerits on CPSE ETF with respect of each stake holder.

For the Government of India the demerit has been mostly around the time to market. As the product was new and involved number of stocks and multiple parties like the AMC etc., the time to market was higher, due to which little time was available at the NFO stage to appropriately advertise and market the Issue, so as to attract retail investors. However, once the ETF route has been used and the product has become stable, the Tap structure which has been enabled in the ETF can make the further divestment process very smooth for the government and significantly reduce the time to market, as well as provide sufficient time for positioning the Issue suitably to retail investors.

For the institutional investor the demerit is in terms of additional expenses i.e. the AMC charges. The institution has to buy the basket of stocks in the weightage as per the index, and they do not get the flexibility to only buy some of the stocks or to purchase the stocks in different weightages as compared to the index. Institutional investors can address this by purchasing the base minimum quantity through the CPSE ETF, and going overweight on certain individual stocks, thereby modifying the weightage of individual stocks in their portfolio appropriately, as per their investment objectives, fund mandate and outlook. There were concerns around the liquidity of the product, but experience has proven that ETFs only add to the liquidity of the underlying scripts, and there is also the option of reaching out to the AMC and redeeming their units to the underlying stocks. However, there is an additional effort of reaching out to the AMC for the same and today many institutions may not be attuned to this process.

For the retail investors the merits have been many and the demerit is limited to the fact that basket is heavy on the energy sector and for an evolved investors, he might not like or want all the stocks in the basket. The liquidity in the exchange for CPSE ETF has been good; however in case of some other ETFs, sometimes the liquidity is not good, eating into their returns through a higher bid offer spread.

Conclusion

The CPSE ETF has been an innovation and first in the world in many ways. The initial experience has also been good and encourages the government to continue looking at the CPSE ETF for further divestment. Usage of tap structure and divestment through further tranches will only add to the success of this method. It can be replicated and used by the government for many other CPSE/PSU or even by large business groups having multiple listed companies.

The merits for all the stake holders far exceed the demerits, and further divestment and usage of this route will only reduce the demerits.

It is not surprising that ETFs have become very large globally with close to $3 trillion in assets and growing at the rate of 10-15% per annum. It is a category to watch out in India as well, and may soon be a large asset class in itself. With regulations now permitting large institutions like the EPFO, Pension Fund managers and the Insurance companies, this might happen sooner then we think.