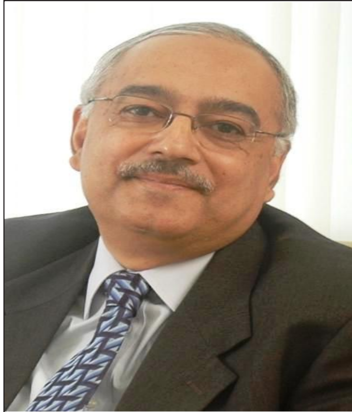
Disinvestment in India



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Disinvestment, a key component of economic liberalization, remained largely dormant for a significant portion of the post reforms period in India. Disinvestment in India got a leg up when the former Indian President Dr. A.P.J. Abdul Kalam, in his opening address to Parliament in the 2002 budget session, stated, "*It is evident that disinvestment in public sector enterprises is no longer a matter of choice but an imperative. The prolonged fiscal hemorrhage from the majority of these enterprises cannot be sustained any longer*,"

The change in the perception of holding controlling interest in public sector enterprises also played a role in the timing of reforms. Just as the external debt crisis forced India to come out of the slumber it had gone into, and sparked the initial round of economic reforms, the burgeoning fiscal deficit and the fiscal crisis of the Indian state had increased the opportunity cost of Public Sector Enterprises.

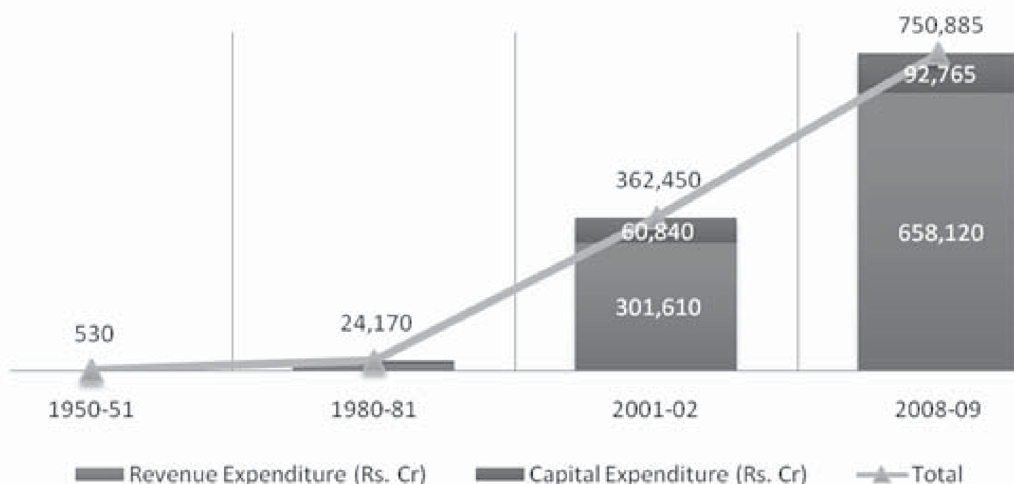
Loss of a monopoly position and the protection that was accorded to a public sector enterprise, coupled with rising competition from private sector competitors had seen many of the government-owned enterprises lose their market share. As technology moved ahead and reduced boundaries, many of the PSUs have found themselves unable to match up to the technological prowess and efficiency of private sector rivals.

The Case for Disinvestment

"Throughout the centuries there were men who took first steps, down new roads, armed with nothing but their own vision." (Ayn Rand). The government has embarked on a journey of empowering the people with better health care, infrastructure and more governance. Wagner's law, and a dash of common sense, tells us that the development of an economy will be accompanied by an increased share of fiscal expansion in the Gross National Product.

As progressive nations develop, expenses related to the State (Welfare), Administrative & Defense Budgets grows continually. Ever since the Independence of India, both the central and state governments have aimed at working towards social development and eradication of poverty. The role of public expenditure in the goals of growth, equity and stability has varied across different phases of economic development in India.

The graph summarizes the quantum leap that fiscal expansion has taken over the years. Non availability of funds for critical areas like education, health and social infrastructure because of fiscal burden in the flow of government funds into PSUs have often been cited as a strong argument for the disinvestment. And as the graph illustrates, the expenditure is unlikely to go down.



The increase in expenditure should be viewed in perspective. The GDP has grown at a healthy 7-10% over the last two decades primarily helped by the increasing fiscal expansion. The need to promote industrial growth and maintain sanctity of disposable incomes has led to a rationalization of taxes which directly impacts the ability of the government to fund the expenditure.

Traditionally, the fiscal expansion has been financed with high cost debt. But the rationality of that is questionable. It is akin to taking a high cost loan when you have investments in shares of companies that are highly valued.

The routes to Disinvestment

- ***The Equity Route***: Much talked about and the most favored

- ***The Strategic Sale Route***

  The rationale for Strategic sale is that government should close down sick state-owned enterprises which have no potential for revival or it should sell its stake to a strategic partner, if it can find an interested party to invest in the company. However, that would be a more political than economic decision. In democracy, politics cannot be ignored and it is an incorrect to argue that economic considerations should always override political considerations. However strategic sales are often important, especially in those cases where the sale would free up considerable bureaucratic bandwidth.

Snapshot of Disinvestments in India

Offer for Sale to Public through Book Building

Particulars	Domestic Offer For Sale To Public Through Book Building
Pricing	Optimized, since price is discovered through a bidding process
Target Investor Set	Essentially Institutional Investors but retail investors also
Time Involved	3 - 4 months
Regulation	SEBI guidelines, Stock Exchange requirements

Suitability:

- Companies in which Interest by Institutions is expected to be substantial.
- Profit making companies with good intrinsic value, high future earnings and good operational efficiencies that can be scaled up
- Companies not in need of significant technical, managerial, marketing inputs or capital infusion

International Offering (ADR and GDR)

Particulars	International Offering
Pricing	Valuation by QIBs
Target Investor Set	FII (Retail investors for ADRs and GDRs)
Transaction Costs	High, in the range of 2-5% depending on issue size
Time Involved	3 - 5 months
Regulation	Disclosure requirements by Securities Exchange Commission (SEC) and accounting in accordance with US GAAP (for ADRs), NASDAQ / NYSE/ LSE listing requirements

Suitability

- Companies which have stocks listed in the international markets or companies with actively traded stock in domestic markets
- Companies with good intrinsic value, good future prospects and of international repute

Advantages

- Access to deeper international markets and capital, sometimes at better price.
- Creates price tension between the overseas and home market
- Enhances visibility

Disadvantages

- Time consuming process
- Stringent regulatory requirements
- Accounting norms and disclosures and regular reporting to SEC in case of ADRs
- High cost about 4-5% for ADRs and about 3% for GDRs

Benefits of Disinvestment

Having sufficiently laid the ground disinvestments as a source of government funding, the process for disinvestment has always been keenly debated at various forums.

Efficient manner of fiscal funding

Disinvestment is considered desirable for a plethora of reasons, but they primarily belong to two schools of thoughts. The first propagates the inflow of money that into the government's coffers augmenting the government's non-debt receipts and, thereby, reducing the fiscal deficit.

The second school of thought is latent efficiency of tapping the equity markets to fund fiscal deficits. In the year substantial offloading of equity takes place, the funds available to the private sector equity would be greatly reduced. On the flip side, heavy government borrowing does exactly the same. On the one hand, disinvestment in PSEs results in institutions and the public at large holding shares, whereas in case of a debt issuance, it would end up with bonds. In either case, the public's savings stand transferred to the government, rather than to the private sector looking for funds to invest.

From a budgetary prudence point of view however, the cost of servicing debt comes at a much higher price than that of servicing equity.

The Domino Effect

The FPO of NMDC Limited garnered about Rs. 110 Bio, which was, for the purpose of discussion used to build around 2,300 kilometers of roads. The apparent benefits apart, the company's shares being listed induces increased transparency, the stock market brings pressure on senior managers by doing performance evaluation, corporate governance improves, and to the extent that employees are given some shares, they become more aligned towards the growth and success of the organization.

For an 8.38 percent divesture, the benefits reaped are significant. The roads that are built will further add to the productivity of the economy. In plain terms, the cost of holding the 8.38% shares in NMDC, which is a robust organization, comes at the cost of not having those 2,300 kilometers of road. The opportunity loss of holding shares is too large for a responsible government to ignore.

The domino effect that this has on the economy is the benefit that most critics of the disinvestment process choose to ignore. A larger investment by the government not only improves the infrastructure; it also paves the way for foreign investment in Indian ventures that now operate in a more suitable environment. That fiscal expansion causes GDP growth and fosters further industrial development is an empirically proven fact.

Challenges in Disinvestment

An Ambitious Plan for Disinvestment

The Government has chalked out an ambitious plan for disinvestment and a large number of PSUs have shortlisted. The finance ministry has also recently come with guidelines for a phased movement towards 25% public float in all listed companies. Most of the PSUs will be affected by this guideline. There are a number of implications.

The capacity of Market to Absorb Large Offerings

The market should have the capacity to absorb the large volume of equity offerings by the PSUs. There will be an urgent need to identify new classes of investors, both locally and internationally, for supporting such issues. This will also require deepening of retail investor base in India. One of the suggestions the government can consider is to make reservations for existing shareholders of other PSU undertakings as they have the same promoter group, viz., Government of India. This will greatly enthuse the retail participation in PSU issues as there will be an added attraction of reservation in issues of other PSUs.

The Logistics to manage Large number of Offerings

The logistics for taking such companies to the market can put a strain on the system. This requires an efficient network of intermediaries – Merchant Bankers, Bankers, Registrars, Printers etc. Trained and experienced manpower, especially with Merchant Bankers is sine non qua *for success of such issues. This also offers opportunities for new players in the system. Currently the fee level being quoted are abysmally low but the expectation is that with large pipeline of offerings and high costs, the fee levels will inch up to profitable levels.*

Distribution Channels

Efficient distribution channels for such offerings will play an important role in success of such issues. Distribution process for IPOs / FPOs is very different from, say, Mutual Fund or Insurance distribution in so far as that it has to be done a very short period of time, making it a highly 'push' product. ASBA is a recent product for IPO / FPO distribution, which has a great potential for deepening this market as the Banks have a very large network. However, to make this a success, there is a need to adapt the ASBA process to the current IPO/ FPO distribution model.

The elusive retail investor

Perhaps the biggest and most daunting challenge is that retail investors continue to shun public issues. The pride of the nation, National Thermal Power Corp (NTPC), a company with strong fundamentals, and clearly a good issue, managed to get an overall subscription of 1.2 times for its follow-on offer (FPO) with a retail participation of just 16% of the total 42.8 million shares reserved for the retail investors' category. For its total shares on offer, NTPC received a dismal 80,000 applications from retail investors all over the country. One reason that is commonly attributed is the fact that the focus on retail investors is generally lesser, given the institutional interest in the public issues. Perhaps easier regulation for Mutual Funds and other collective investment avenues should help in reviving interest of this class. Even though direct investment by retail investors would still remain elusive, at least the holding of the shares by these investors through IPO specific schemes would be beneficial.

The pricing dilemma

Most countries have struggled with the Disinvestment dilemma on two levels viz. should a Government try to get higher realizations through strategic sales or should it try to sell shares a bit cheaper through a public issue so that there is widespread ownership. The participation of retail investors has been low and that of private sector institutional investors has been varying from issue to issue. Their reluctance to bid for shares can only mean that the issues have been overpriced. The result has been that neither did the public offering result in widespread ownership, nor was the Government able to get a value that it intended.

The lure of the secondary market

The primary market aids capital formation. The secondary market supplements it by giving the securities liquidity. But our culture has been ingrained with a constant fixation on the market levels. The deeper malaise lies in the fact that a country with one of the highest savings rate does not channelize it to equities as a means of investment. The lure of the returns made on the secondary market are diverting the attention of the investor from investing in companies that are extremely good long term investments. There is a need to consider a transparent, system driven auction method for sale of equity through secondary market. This can be an efficient and lower cost method and can be completed in a shorter period.

Conclusion

Disinvestment is an important component for national growth. Larger shareholder population brings efficiencies to the PSU, thereby increasing their productivity and profitability. It enables Government to garner resources for its developmental schemes. There are a number of challenges for a large disinvestment programme but none of these are such as they cannot be overcome. The disinvestment programme has always played a key role in activating the markets and this time around also, the markets will benefit greatly for the Disinvestment programme of Government of India.