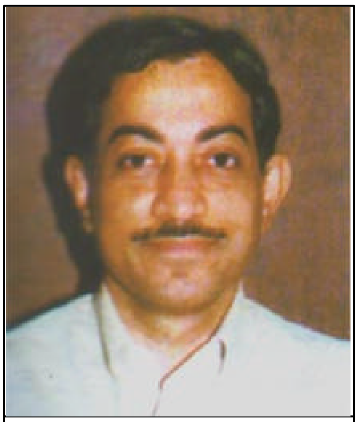
PSU Disinvestment - Capital Market Route - Issues and Challenges



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Summary
The article seeks to briefly trace the evolution of the Indian Capital Markets as an effective and efficient route for Disinvestment. It brings into perspective the recent experience of the public offers, under the Disinvestment Programme of FY2003-04, in terms of the timing, regulatory, pricing, selling and positioning challenges. Finally, some issues on the way forward are raised from a Capital Markets' and the Disinvestment perspective.

1. Brief Introduction and Background

Privatisation or what is commonly referred to as 'Disinvestment' has greatly evolved since the initial policy statements issued by the Government of India in the early 1990s. Post-independence, when most Public Sector companies (PSUs) were formed, the Indian capital markets already had a long history of organized trading. With liberalization, both the PSUs and the capital markets faced challenges on a global scale. The Indian capital markets have matured in terms of the regulatory framework, investor access, size, technological interface, settlement systems and other infrastructure. The evolution of disinvestments over the last decade and the role of the capital markets as the 'means' to the end of successful disinvestments is briefly delineated below:-

- **First Phase (from early 90s till 1999)**
  - o Decade of debate (over companies to be disinvested and the disinvestment levels);
  - o ***1991-92* - Early success** in Disinvestments through the capital markets of **upto 20% in select PSUs in favor of Mutual Funds, Financial Institutions, Investment Institutions.**
  - o ***Late 90s*** witnessed an approach shift from public offerings to strategic / trade sales.

- **Second Phase (From 1999 till FY2003-04)**
  - o ***1999-02*** - Increasing emphasis on strategic sales continues. Completion of strategic sales in various public sector companies.
  - o ***2002-03* –Asset Management Company proposed** to hold, manage and dispose residual holding in companies where disinvestments have happened in favor of strategic partner.
  - o ***2003-04*** –Approval of disposal of Government Of India's residual equity through '**Offer for sale**' route. Wide spectrum of industries was chosen so as to present diverse investment options – viable option for global funds. **Recent Offers** of CMC, DCI, IPCL, IBP, ONGC, GAIL, Maruti collected over **Rs. 14500 crores (over $3 billion)**.

As we write, the future of disinvestments has been one of the prime debates among the various political parties. Broadly, while Disinvestments are accepted, the nature and direction of the disinvestments is anticipated to change. Irrespective, of the direction of the Disinvestment Programme, the Indian capital markets have emerged as an effective means for PSU disinvestments.

2. Challenges and issues faced in the recent disinvestments through the capital market route

The success of the recent offerings has debunked the perception that the Indian capital market are not well developed, thereby inhibiting large scale fund raising or preventing disinvestment at full valuation. Apart from the demand-side challenges, the recent offerings tested the resilience of the entire capital market ecosystem. – the regulatory framework, settlement systems, the banking systems etc.

At this juncture, it would be appropriate to chronicle the issues and challenges that the Disinvestment Programme FY2003-04, through the ' Offer for Sale' route, faced.

2.1 The Regulatory Process

SEBI Guidelines and practices for Initial Public Offerings (IPOs) are geared towards IPOs for unlisted companies. In most of the recent cases, **100% of the equity share capital** issued by the aforesaid companies was **already listed** on the stock exchanges. These listed companies were also **complying with the ongoing requirements** outlined in the listing agreements of the various stock exchanges. These guidelines did not envisage an offer for sale by a listed company by one of its shareholders.

Notwithstanding the above, in the interest of greater market orientation, consistency of disclosure practices and to enable larger investor participation - Government of India (acting on behalf of the President of India) as the selling shareholder, the Companies, Intermediaries and all concerned **voluntarily accepted adherence** to the existing regulations. The final document soliciting subscription was called a 'Sale

Document' and did not constitute an offer document or prospectus in terms of the SEBI guidelines. Additionally, SEBI, in public interest, extended guidance / support through relevant guidance notes to align disclosures with various practices and legalities of the entire regulatory framework including Securities Contract Regulations Act, Company Law, Takeover Code and various relevant provisions. Thus, the voluntary acceptance of the SEBI guidelines, achieved consistency with the prevalent disclosure standards for IPOs, adherence to research and listing norms and to the book-building procedures normally followed. This familiarity with accepted practices, processes ensured Investor participation in large numbers.

2.2 Timing of the Offerings

The timing of the offerings and the aggressive timetable (Completion of all six offerings, from Offer opening to receipt of trading permissions in about 45 days) posed tremendous challenges – in terms of **optimal sequencing** of each offer for the success of the entire programme and the resilience of the capital market infrastructure.

An unprecedented amount of nearly Rs. 13,800 crores (approximately $ 3 billion) was disinvested. Oil & gas was the dominant sector with the other sectors being Information Technology, Dredging and Petrochemicals.

The sequencing of the offers ensured an optimal buildup for the entire programme. Companies with strategic sales were at the forefront followed by the larger offerings. This enabled fair demand generation for all the offerings.

The scale and simultaneous nature of the disinvestments required width, depth, breadth of retail and institutional investors. Targeting maximum wallet share from all investor classes was done through a well-coordinated, consistent marketing plan. This plan aimed at optimal demand generation and hedged the negative cascading impact of the secondary market or of the simultaneous offers.

The past years had seen selective fund raising and few public offers. Resultantly, the entire IPO infrastructure chain and intermediaries had witnessed capacity shakeup with many players exiting. To achieve the aggressive timelines, the entire IPO engine was cranked up. From bid to delivery, from the banking and distribution channel to the stationery logistics, to the regulatory interface, issues were dealt with keeping aggressive timelines.

2.3 Pricing

Most IPOs are priced in a static environment; with their fundamentals being compared and benchmarked with listed peers. Book building has become an accepted mechanism for price discovery of unlisted companies. But, these **PSUs were already listed and therefore had fluctuating 'benchmark valuations'**. Pricing each of the cases had its challenges – cases like IPCL had a long price history, ONGC had a recent history of strong volumes while Dredging Corporation had a price history with only about 1.5% of its capital listed. Therefore, market prices had to be adjusted for price-volume elasticity, peer group valuations and benchmarked over a period of time rather than at a point of time.

Book building proved to be an effective mechanism to maintain price-demand tension. Indicative prices were communicated to potential bidders through a '**floor price**' **or a** '**price band**'. The floor price, used for the first time in the capital markets, set a base price, with the upside being discovered. The price band directed price bids within the declared band with most of the companies discovered prices being at the top end of the
band.

'Price is what you pay and Value is what you get' has been an important valuation principle. Whilst pricing such listed companies the key challenge was the co-existence of different prices for the same 'value' i.e. 'company'. This led to the challenge of **balancing multiple stakeholders' objectives**. The risk reward tradeoff of incumbent and prospective shareholders had to be balanced. Additionally, to ensure widespread retail participation a pre-determined 5% discount was given on the discovered price.

2.4 The Selling Challenge

Any public offering presents the challenge of attracting the required **width, depth, and breadth of investors**. The principal objective of the disinvestments was to enable the retail investors to participate in the PSUs. IPOs through the capital market route present the best platform to build a diversified shareholder base.

The offers saw participation by retail investors in large numbers, across the country. Selling to the Foreign Institutional Investors (FIIs) involved positioning the India story as well as the company. Simultaneously, most emerging markets were attractive destinations and these companies had to fight for relative market share.

The sheer scale and timing of the offerings presented a unique selling challenge both from the success of an offering and for signaling points of view. The impact of the success of the offerings was going to inevitably have a cascading effect on the confidence of the secondary market. **Pre-marketing** became an important means and end of the selling exercise. In the event, with all the challenges, most of the offers were subscribed on the first day and some of them within minutes of the book opening for subscription.

Each of the companies presented their own **positioning challenges** – relatively lesser understood business like dredging (Dredging Corporation of India Ltd.), unique business models like CMC Ltd. and the larger offerings; all had to be simultaneously positioned to retail and institutional investors, across various countries and investing temperaments. Apart from the above challenges, the continuing competitive advantage of divested companies, the future disinvestment strategy for the company, level of operational freedom, had to be tackled in finally positioning the issues.

2.5 The 'Control' Conundrum

Transfer of ownership has been the crux of any disinvestment debate. In the past, strategic sales had emerged as the preferred disinvestment route primarily due to their achieving maximum valuations. Offerings through capital markets were not perceived as a viable alternative in terms of their ability to absorb the scale or value of the offerings. The recent offerings have evidenced different situations of change in 'control':

- Government Of India **exiting in favour of the public over strategic investors through the capital markets** i.e. CMC, IBP, IPCL (partially), Maruti. Most of these offerings were the second round of disinvestments, after the first round of strategic sales.
- **Substitutions of strategic sale/sale of cross holdings with a public offering** i.e. Dredging Corporation of India Ltd., ONGC, GAIL.

Thus, capital market offerings will continue to be ideal in cases of companies of strategic importance and thereby a widespread, diversified shareholder base is required, or companies with strong, professional management thereby obliterating the need of a strategic sale and disinvesting in favor of the public.

Whilst the capital markets will continue to be a viable alternative to the capital market, most PSUs were formed at a time when the Indian capital markets were virtually nonexistent or were not recognized for their depth. Therefore, most companies have limited capital markets interface. **Transfer of ownership** to the private sector or disinvestments through the capital market places a significant onus of **transfer of best practices**; in terms of continuous investor relations, imbibing best practices, achieving high standards of disclosure, corporate governance.

The system of quarterly earnings reporting also places a significant challenge in maintaining predictability of earnings especially in seasonal businesses or when the company is in 'investment mode'.

3. Way Forward

3.1 Capital Markets' Perspective

Disinvestment does have a beneficial effect on the capital markets; the increase in floating stock gives the market more depth and liquidity, gives investors easier exit options, helps in establishing more accurate benchmarks for valuation and facilitates fund raising for future projects.

Success of the recent offerings has debunked the perception that Indian markets are not well developed, thereby preventing large scale fund raising or preventing full value for sale or disinvestment. The widespread participation by FIIs in the recent offers was a major show of confidence in the Indian capital markets and its infrastructure. The recent offerings also raised issues that need to be addressed, in terms of :

- Robust post-allotment infrastructure,
- Shorter post-offer timelines especially for retail investors,
- An electronic IPO mechanism that integrates the bidding, allotment and settlement process,
- Whilst in the past, the capital markets have been used for disinvestments through trade sales, the future could witness disinvestment through other alternatives like auctions, open offers or even buybacks in the case of professionally run, cash rich PSUs!!

3.2 Disinvestment Perspective

The disinvestment or privatization process has been looked at more dominantly as a revenue increasing process, and an integral part of the budgetary process. Indian PSUs having come of age, with many of them being globally competitive, disinvestments objective should not be merely mobilizing resources but unlocking the productive potential of the PSUs.

Additionally, rather than viewing disinvestments as an, one-time exercise, it needs to have coherent, broad based strategy – 'India' needs to be positioned continuously to global investors. Opening of the public sector to appropriate private investment would increase economic activity and have an overall beneficial effect on the economy, employment and tax revenues. This would also aid in making the PSUs become more competitive from a business and financial perspective.