Disinvestments through Public Offers : Opportunities and Challenges

S.Vishvanathan
Managing Director & CEO
SBI Capital Markets Ltd.

Background to Disinvestment

Over Rs. 45,000 crore has been raised through the Disinvestment program since 1991, until the end of March 2010. The program gathered momentum during the years 2000 to 2003, when a good number of Disinvestments took place. The golden era for the Indian stock markets from 2003-04 to 2008 was the most opportune time for large-scale Disinvestment. However, during this period, due to the political environment, PSU Disinvestment remained a contentious issue. As a result, in the 5 years from 2004 to 2009, only Rs.6,700 crore could be raised from Disinvestment.

With the incumbent Government continuing at the helm of affairs in 2009 and backed by a move progressive coalition, the market sentiment picked up post-elections, and it was imminent that Disinvestment program would be given a clear impetus.

NMDC was the biggest issue of the Government in 2009-10, where Rs.9,930 crore was mobilised. During this financial year, the Government also mopped up sizeable amounts in few other issues - Rs.8,480 crore from NTPC, Rs.2,247 crore from OIL, Rs.2,012 crore from NHPC and Rs.882 crore from REC. With this, the Disinvestment in 2009-10 fell short of the target of Rs.25,000 crore by only Rs.1,448 crore.

Returns to investors from earlier Disinvestment issues

In the past, a majority of the PSU stocks have delivered substantial returns to the investors. From the time of its IPO in 2003, Maruti Udyog delivered annualized returns of 40%. NTPC had also delivered attractive returns to its IPO investors. Power Grid Corporation and Rural Electrification Corporation have also been outperforming the market. A few issues - such as GAIL and ONGC – have, however, underperformed the market, but have still delivered close to 15% annual returns to the investors. In the recent times also, the BSE PSU index has witnessed a rise of about 39% after the elections last year, outperforming the BSE-500, which posted a relatively modest 24% growth.

Thus, if we consider the average returns over a seven year period, regardless of the global economic scenario post melt-down, the earlier divested PSU stocks (prior to 2009) have rewarded the investors well. The returns were mainly attributable to the fact that these issues were reasonably priced, as compared to other private sector companies, which had tapped the market during that time. With good discounts offered to the investors, which resulted in attractive returns, a consistently strong retail interest was observed in most Disinvestment issues, launched prior to 2009.

Response to the recent Disinvestment issues

One of the prime objectives of Disinvestment exercise would be to cover a larger section of individual investors, and ideally, Disinvestment issues should attract large and nation-wide retail participation. However, the recent issues have elicited a poor retail investor response.

In the last financial year, NTPC's follow-on public offer (FPO), undertaken in February 2010, managed to get an overall subscription of only 1.2 times - with retail participation of barely 16% of the total 42.8 million shares reserved for them. Only around 80,000 applications were received from retail investors all over the country. Even in the FPOs of REC and NMDC in February / March 2010, the retail portion was under-subscribed.

The Government is aiming to raise Rs.40,000 crore from Disinvestment issues during FY 2010-11. It is expected that Public Sector Undertakings like Steel Authority of India, Hindustan Petroleum, Bharat Petroleum, Coal India, National Aluminum, Power Grid Corporation, MMTC, IOC and many other large PSUs would hit the market[1] .

The public expectation is that Disinvestment issues should provide return for investors in excess of 25-30%. This has actually been the case in most of the early Disinvestment issues in the 1990s as also those launched prior to the melt-down in 2008-09. It appears that a suitable up-front discount in Disinvestment issues is a strong motivating factor for achieving an overwhelming retail response. This can also help in creating a nation-wide equity investor base for future issues.

Pricing of Disinvestment issues

From the perspective of the Government, as an issuer, it would naturally like to receive the best price from a large set of investors, and at the same time, motivate retail investors with attractive discounts during the price discovery process.

In any public issue, the price discovery happens through placements with QIBs, HNIs and retail investors. In the recent Disinvestment issuances, although retail investors were offered a discount over the price offered to QIBs, the response from the retail investors has been muted. Hence, it is essential that the pricing should be perceived to be attractive and the stock should appeal to the retail investors as a convincing investment proposition.

Increasing retail participation continues to remain a challenge

The Swarup Committee Report on "Investor Awareness and Protection" (2009) mentions that out of 188 million investors holding financial assets, only 8 million participate in debt and equity - including mutual funds and unit-linked insurance plans. In 2003, SEBI and National Council of Applied Economic Research (NCAER) had estimated that 21 million individuals had invested in equity or debentures, while 19 million had invested in mutual funds. The reference period for this study was 2000-01. The SEBI-NCAER Survey further observed that the number of equity investor households in India had halved from 12.1 million in 1998-99 to 6.1 million in 2000-01. Now, the Swarup Committee Report indicates that the number of individual retail investors too has shrunk to around 8 million.

Thus, compared to the potential investor base in India, the actual retail investor base for marketing of equity issues is quite low.

<u>Retail imperatives for Disinvestment</u>

- Distribution of wealth to the general public
- Reach out to the *aam aadmi*
- Creating a huge and diversified investor base for future Issues
- Adding new investor base for the existing market
- Banks' (especially PSU banks) Retail distribution network needs to be activated for marketing of Disinvestment issues

Analysis of retail investor base in India

Holding a Demat account is compulsory for direct participation in the equity market. Even in IPOs / FPOs, retail and HNI clientele can apply only through the Demat route. Thus, the total potential eetail customer base in India, with regard to marketing of equity issues, would be equal to the number of unique Demat accounts in the country. The two depositories in India, NSDL and CDSL, together have around 17 million accounts. Taking into account multiple / combined Demat accounts, *the number of unique Demat accounts would be only about 10 million.*

Retail and HNI coverage for equity issues is undertaken by stock brokers, independent financial advisors (IFA) and other intermediaries, who market the issues to their clientele. However, unlike in the case of mutual funds and life / general Insurance products, the vast banking network is as yet not being leveraged for marketing of primary equity offerings.

Thus, it is evident that equity issues reach only a small portion of the domestic investor base in the country, and for the Disinvestment exercise to achieve its full objectives, it is necessary to ensure constant addition to the existing investor base and to consistently reach out to the retail investor fraternity nation-wide in all offerings.

Probable solutions

I.Two-stage process in IPOs / FPOs with small public float

In order to achieve these objectives, a multi-layered process can be conceptualized to attempt to address these objectives. The process could flow as under:

1. In both IPOs and FPOs with nominal public float (i.e. akin to an IPO), issuance of a small portion of stock, for enabling a broad price discovery, would need to be undertaken. This could be on a French Auction basis, with a wide price band and offered to Domestic Institutional Investors like Banks, Mutual Funds, Insurance Companies, Pension Funds, etc. as also to Foreign Institutional Investors. The French Auction issue would have to be through the secret price discovery process, the results of which could be announced within 1-2 days.
2. Based on the price discovery, the main public issue for a larger amount could be undertaken, which would be open to QIBs, HNIs and Retail Investors through the book-building route - with a narrower price band around the discovered price and with appropriate discount for retail investors.
3. *It is a matter for consideration whether, for eetail investors, a deep discount of 40-50% could be offered, with a proviso that this would be for an individual allotment of upto, say Rs. 50,000, with a lock-in of 1 year.*
4. Over and above the higher discount portion, the retail investors could also be permitted to subscribe to the issue at the normal price for the usual amounts. This type of arrangement, while pulling the retail investors to the discount portion, would also create appetite for the normally priced retail portion.

<u>Rationale for success of lock-in shares</u>

- An up-front discount or immediate gain entices the retail investor.
- With a sufficiently high discount, the lock-in may not be a deterrent to retail investors.
- By limiting the allotment of such shares (deep-discount) to an individual, the Government could achieve the objective of bringing in a larger number of investors into the PSU fold. Also, the "restricted" supply could build up appetite for future issues and create a positive sentiment for PSU IPOs and FPOs.
- Lock-in will also help in dis-incentivising speculation, upon listing.

The Disinvestment program should aim at developing a huge nation-wide investor base, which would start investing in equities, and this alone would ensure a steady subscription from retail investors for future Disinvestment issues.

The deep discount route would motivate small investors, and also not expose the Government to large discount outflows to a concentrated group of investors. This would, therefore, be acceptable as an argument to the people at large as also to the political class.

II.Sub-demat account:

In addition to incentivisation as above, there are some process related issues, which if smoothened out, may help make IPO investments easier to execute - and hence attractive.

It has been observed that 95% retail contribution for public Equity offerings comes from 15 top centres - mainly the four big metros and Gujarat. Many life insurance companies collect large premia from Tier III and I towns in India, which do not figure in the list of significant IPO collection centres. Around 80% of the first-year premium on life insurance products was contributed by ULIP (Equity Market linked) until recently.

While the tax-break for the insurance product is an immediate incentive, it is also true that there is a 'hidden' retail appetite for equity products, which if incentivized / facilitated suitably, can be developed into a strong nation-wide retail investor base for all public offerings – including Disinvestment issues.

In this context, let us look at the process involved in IPO subscription, which requires opening of a Demat account in order to buy and sell shares, with the pre-requisite of a PAN registration.

The PAN penetration in India is far lower than bank accounts or mobile connections. The Government is making intensive efforts to expand the direct tax net by making PAN compulsory and by providing appropriate incentives to PAN holders - and more importantly by dis-incentivising the resistance to obtaining PAN. But these measures are taking considerable time for implementation / success.

While it is not our case to dilute the regulatory requirements for opening a Demat account for transacting in equity, it is a matter for consideration whether the purpose of regulatory compliance could be achieved by an equally secure but simple process of what is described hereunder as 'Sub-demat' account.

The attributes / features of a Sub-demat account would be on the following lines:

– All banks offering DP services be allowed to open the Sub-demat accounts.
– The Sub-demat account to be opened with the same level of KYC compliance as currently required for opening of bank account.
– At the level of opening of a Sub-demat account, the requirement of having a PAN would not be insisted upon.
– The Account would be maintained under the style "ABC Bank A/c XYZ Customer", i.e. the Customer's Demat Account would be subordinated under the Bank's Demat Account.
– Credits in the form of share purchases in the name XYZ can be afforded into such account, like in any other Demat account.
– However, no sales would be permitted from the Sub-demat account. In other words, the beneficiary would be allowed to only acquire shares in the Sub-demat account. When the beneficiary proposes to sell such shares, the Sub-demat account would have to be converted into a proper Demat account, with submission of PAN details, etc.
– The Sub Demat account can be converted into a normal individual Demat account any time - upon submission of PAN Card details / proof.
– Necessary granular controls to prevent any possible money laundering (multiple applications) can be worked out.
– Regulatory clearance for Sub-demat account would need to be obtained and operational details / systems worked out in co-ordination with NSDL and CDSL.

The above 'incentive' may catch the fancy of debutant retail investors, who would join the equity cult. The Sub-demat account would simplify the investment process, and the conversion from a Sub-demat account to a normal Demat account would have the collateral benefit of increasing the PAN penetration.

In conclusion

The Government has charted a comprehensive road map for Disinvestment, the success of which would depend primarily on repeated demonstration of investor confidence. The key is to ensure that this confidence is reflected in every issue. For this, creating a larger nation-wide retail investor base is essential.

The objectives of Disinvestment exercise would be fully met once larger and larger proportion of the investible population begins to participate in the process. For this, successive offerings would need to be priced attractively and marketed effectively to induce the retail investor to put his hard earned savings into the public sector issues. The idea is to enthuse the retail investor and compel him to invest.

[1] Source: www.bsepsu.com/dis_pipeline.asp