PSU Disinvestment: from piecemeal to holistic approach to spur efficiency

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Government public sector undertakings (PSUs) form a significant part of the Indian economy. They operate in a wide range of diverse sectors such as telecom, steel, power, fertilisers, oil & gas, petrochemical, mining, shipping, logistics and defence, among others. These PSUs contribute over 19% to the GDP and comprise ~17% of the total stock market capitalisation of the BSE. There were five public sector enterprises in 1951 with a total investment of Rs 29 crore, which has increased to 277 enterprises with a total investment of Rs 8,50,599 crore (equity plus long term loans) by the end of FY13. For decades, these companies have played a significant role in growing the Indian economy and have been used as anchors for industrial & infrastructure development, job creation, providing basic services such as water, electricity, communication, healthcare, education, transportation, etc. to the masses. However, the cost of delivering these obligations outlived the benefits over a period of time. Accordingly, many of these companies, after serving their economic utility, have become a drain on fiscal resources.

Employment generation by PSUs is already on a receding trend with the number of PSU employees (excluding contractual workers) steadily declining from 16.1 lakh in FY07 to 14.0 lakh in FY13. Moreover, many of the PSUs continue to report losses at the PAT level, signifying depletion in the nation's wealth. PSUs in the services sector continued to report losses for the fourth consecutive year while those in the manufacturing sector witnessed a decline in profit in FY13.

Therefore, it is imperative that once the PSUs outlive their economic or social purpose, the government should reduce its role in the functioning of such companies by way of disinvestment. The core objectives of any disinvestment or privatisation programme are two-fold, a) to increase the efficiency of these enterprises and of the overall economy and b) to reduce the drain of public resources by way of subsidies and capital infusion and simultaneously raise funds for meeting other socio-economic objectives in order to keep fiscal deficits under control.

The United Kingdom (UK) was among the first countries to successfully adopt and implement the disinvestment programme globally. In the UK, the privatisation programme happened in various stages. In initial stages, the government sold companies such as Britoil and British Airways, which were operating in a competitive environment and were self sustaining. During the second stage, it sold companies in the telecom and power generation space, which were monopolies such as British Telecom, British Gas, etc. However, these companies were restructured into smaller entities and allowed to compete among themselves before divestment. In addition, the government worked on creating a regulatory system and a regulatory body for better price and service regulation to protect the interest of end consumers. In the final phase, companies that depended on government subsidy and were performing social duties on behalf of the government, like Railtrack, etc. were sold. In these cases, public private partnerships, allowing private operators to manage services while still receiving subsidies, were established.

Disinvestment as an efficiency lever

Public sector enterprises have been set up to serve the broad macroeconomic objectives of higher economic growth, self-sufficiency in production of goods and services, long term equilibrium in balance of payments and low & stable prices. However, once a sector has been opened up for private operators, the government's role should steadily decline. In contrast to this, in India, the bulk of investments in PSUs have happened in sectors that have been opened up to the private sector with economic liberalisation post 1991. Consequently, these tantamount to inefficient use of public money as the performance of such PSUs deteriorated in the face of stiff competition from private operators (as highlighted by declining return ratios in the table below).

The overall growth in investment in CPSEs, in terms of 'gross block' (inclusive of capital work in progress), stood at Rs 15,48,053 crore, growth of 10.33% in 2012-13 over the previous year. In terms of broader segments, PSUs in the manufacturing side had the highest share in aggregate investment (of all CPSEs) at Rs 4,30,840 crore (27.83%). This was followed by electricity at 4,03,561 crore (26.07%), mining at Rs 3,88,125 crore (25.07%) and services at Rs 3,05,704 crore (19.75%) as on March 2013. Also, in terms of companies, the share of top 10 PSU (ONGC, BSNL, NTPC, IOC, Power Grid, SAIL, ONGC Videsh, NHPC, Nuclear Power Corp, HPCL) amounted to Rs 10,68,390 crore, 69% of the total gross block of all CPSEs.

Pattern of investment in gross block (Rs crore)

Sector	Investment in Gross Block (FY13)	Investment in Gross Block (FY12)	% of Gross Block
Agriculture	921	869	0.1
Mining	388125	353499	25.1
Manufacturing	430840	388893	27.8
Electricity	403561	351939	26.1
Services	305704	295007	19.8
CPSEs	18902	12867	1.2
	1548053	1403074	100.0

Source: Department of public enterprises, ICICI Securities

Top ten PSU's investment in gross block (Rs crore)

Company	Investment in Gross Block (FY13)	% of Gross Block
ONGC	236568	15.3
BSNL	175815	11.4
NTPC	140355	9.1
IOCL	123113	8.0
Power Grid	115424	7.5
SAIL	78593	5.1
ONGC Videsh	67967	6.4
NHPC	45429	4.4
Nuclear Power Corporation	42947	2.8
HPCL	42179	2.7
Top 10 companies	1068390	69.0
Total Gross Block	1548053	100.0

Source: Department of public enterprises, ICICI Securities

Financial ratios for PSU companies

Important Ratios	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
ROCE (%)	21.0	21.5	19.5	21.0	21.1	18.0	17.6	14.1	13.5	12.6
ROE (%)	18.2	19.0	17.5	17.9	15.6	14.3	14.1	13.0	12.7	13.5

Source: Department of public enterprises, ICICI Securities

Ownership of these enterprises is significant as nations across the globe have struggled to improve and sustain the performance of such enterprises over a period of time. There are primarily two major approaches to improving the effectiveness of state owned enterprises through ownership dimension i.e. privatisation, where ownership is transferred to buyers and divestment where minority ownership gets transferred to buyers. Hence, privatisation or disinvestment has been pursued by many governments to isolate the ownership and economic utility of these companies.

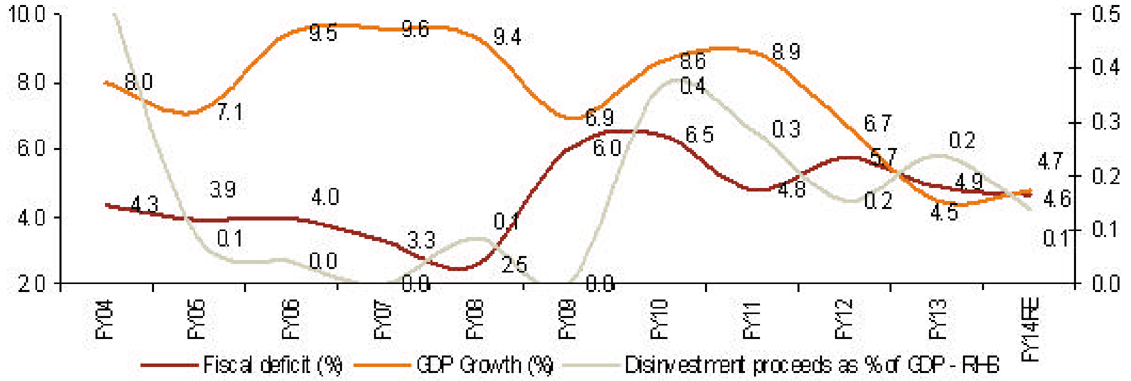
Post disinvestment, enterprises enjoy better commercial freedom, lower political interference and are able to take decisions on staffing, raising funds, etc. Hence, the disinvestment process improves the overall economic efficiency by facilitating unlocking of the true value of enterprises for all stakeholders i.e. investors, employees, company and the government along with better transparency and accountability through market discipline. Ownership, competition and regulation play an important role in sustainable growth of any enterprise. The primary role of the government is to act as moderator for creating an ecosystem for competition and regulation while ownership holds the key for credible and timely decision making process.

Disinvestment for managing fiscal deficit

Though initial privatisation efforts across the world were aimed at increasing efficiency, gradually as the world entered into economic turmoil, governments have increasingly tilted towards disinvestment as a route to finance fiscal deficits. This holds true in the Indian context as well.

Disinvestment offers only a brief respite for a government that is prone to overspending and is financially cramped. The Indian disinvestment programme has been fairly successful in raising ~Rs 1.5 lakh crore since 1992 and has helped the government in curtailing its fiscal deficit by around 0.2-0.4% over the past few years. Over 65% of the disinvestment receipts came in during the last five years with each year contributing about Rs 20,000 crore on an average suggesting an ad hoc approach towards disinvestment. Moreover, merely Rs 12,700 crore has been raised through a strategic sale (where the government has ceded management control) since 1992. Also, the disinvestment process is largely dominated by a partial stake sale without transfer of management control (contributing ~90% of the total receipt).

India - GDP Growth, fiscal deficit and disinvestment proceeds as percentage of GDP



Source: Bloomberg, RBI, ICICI Securities

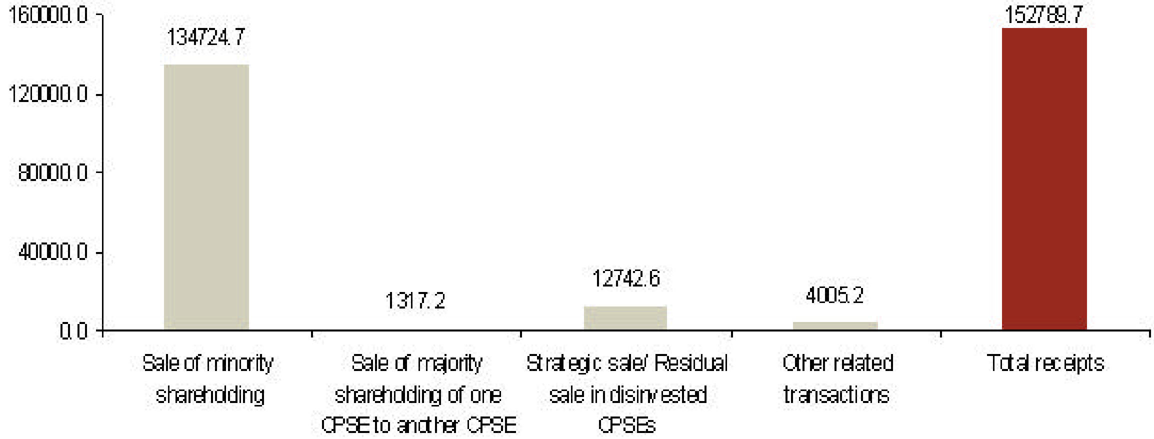
Mode of disinvestments

Globally, the transfer of ownership in part or full has happened largely through trade sales and offer for shares to institutional and retail investors through listing or strategic sale. A trade sale has been used for companies, which are smaller in size and face challenges in the near term and do not have a track record to meet listing requirements. Trade sale to a strategic investor is considered more efficient in bringing new management and expertise into the company. The government, in select cases, also provides tax and other financial incentives to prospective investors.

Besides trade sales, offering shares of existing enterprises, either to a single strategic investor, or to institutional or retail investors via public listing has been the preferred disinvestment mechanism. Public listing is adopted for companies where it is difficult to find a suitable buyer and to ensure greater accountability for various stakeholders. This mode not only gives access to a much broader range of investors but also helps in overall development of the capital markets. However, this mode of disinvestment is more complex, costly and time consuming. It involves engagements with various advisors on pricing, distribution, legal and other coordinators besides incentivising new investors to participate in the listing process.

In India, majority of the disinvestments proceeds are garnered through sales of minority stakes in state-owned enterprises (contributing ~90% of the total receipt). Merely, ~Rs 12700 crore during this period has been raised through a strategic sale (where the government ceded management control). Since majority of the disinvestments in India have happened without transfer of management control, the benefits arising due to the improvement in efficiency have been limited. Considering the effectiveness of disinvestment in improving overall efficiency of the state owned enterprises and misalignment of return and time horizon expectation of an asset between the government and private sector, disinvestment programmes have failed to produce the much desired efficiency benefits for all stakeholders. Empirically, private entities have outperformed their government held counterparts as the latter often get burdened with social responsibilities imposed by the government. Hence, disinvestment needs to be a much thought about reform with due deliberation on various aspects.

Government receipts from disinvestments



Source: Department of disinvestment, ICICI Securities

Situation specific, tailor made approach to disinvestment

Divestment of a majority stake should happen in state owned enterprises, which are operating in mature, developed, competitive and capital efficient sectors whereas partial and gradual stake sales should happen in enterprises that operate in ecosystems, which are still evolving. The role of the government is to operate in strategic and evolving sectors that serve the broad macroeconomic objectives of higher economic growth, self-sufficiency in production of goods and services, long term equilibrium in balance of payments and low and stable prices. State-owned enterprises operating in mature and competitive sectors do not add value to stakeholders and act as a drain on government finances as witnessed in the past few years in sectors like telecommunications, aviation, etc. These should be considered for majority stake sales. Disinvestments in near monopoly sectors like mining, defence, agriculture, etc. through minor stake sales or new joint ventures with private players (transfer of part of the existing business to subsidiary) would reduce corruption, bring in efficiencies and would be a win-win situation for various stakeholders.

Redefining disinvestment objective

Disinvestment is a good financial reform, which helps in establishing equilibrium between the collective interests of various stakeholders and is expected to be prominent in central policy decision making. The role of the government also needs to change from provider of product and services to facilitators of these products and services. It also helps the government in reviewing its level of engagements with various stakeholders including the industry as disinvestment produces good results if these enterprises operate in a competitive environment with market friendly policies. In addition, it acts as an effective tool in curbing corruption. However, the government needs to shift its focus from using disinvestment as a tool for fiscal management to using it as a lever for improving efficiency of government owned enterprises.