Increase in minimum public shareholding- long-term benefits outweigh near-term headwinds

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Expanding the capital base of the economy to fund growth has been one of the key areas that this Union Budget has focused on. The proposal to increase the minimum public shareholding or free float from the current 25% to 35% is a step towards that, and rightly so, particularly in the wake of limited retail participation in the Indian capital markets. While the modalities, particularly with respect to timeline and permitted stake sale methods, are unknown at this stage, history suggests that companies are likely to get sufficient time to comply with this rule. The last time it was done was in June 2010, when the minimum required free float was increased from 10% to 25%, and companies were given three years to abide by which was later extended.

In the medium to long-term, this is positive for the economy and equity markets. Even with 5000+ listed companies in India, promoter holding in listed companies remains fairly high. An increase in free-float stock would go a long way in improving market depth and enhancing liquidity, resulting in better price discovery and lower volatility. It has been well researched and documented that lower free float often results in higher volatility and distorted price discovery which doesn't bode well for minority shareholders. Moreover, this move would lead to adoption of better corporate governance standards, which go hand in hand with wider institutional ownership. This is particularly positive for public sector enterprises, nearly 55% of which have government shareholding of more than 65%. Increased free float may bring some of these companies eligible for inclusion in benchmark indices, thereby resulting in higher institutional interest.

In the private listed space as well, there are a lot of high-quality companies with sound financials and strong corporate governance but with low free float. Increase in supply of stock will provide an excellent opportunity to investors to further invest in such companies.

With a meaningful improvement seen in the participation by retail investors over last couple of years, their role in developing Indian financial markets has increased manifold. Having said that, current retail participation at single digits in India, via direct as well as through mutual funds, still remains significantly low when compared with developed as well as several emerging economies. As per the latest RBI data, shares and debentures still account for less than 1% of the gross national disposable income despite a sharp increase in SIP inflows over last few years. Most of the household financial savings are skewed towards bank deposits. Higher free float stock in the economy would provide a conducive environment for the much-needed retail participation in Indian capital markets, further supported by a simplified Aadhaar-based KYC, and would support the broader cause of facilitating financialisation of household savings.

The expanded free float, coupled with the other positive announcement in the budget related to increase in foreign shareholding limit to the maximum permissible sector-wise caps, bodes well for India's weightage in the global benchmark indices such as MSCI Emerging Market Index. Along with simplified KYC norms, this would go a long way in attracting more foreign inflows into India. A quick comparison of the top 10 global markets in terms of market capitalization suggests that India has the lowest free float market capitalization share after China.

The long-term benefits of higher free float are clearly significant for minority shareholders, giving them greater voice, and ultimately bodes well for market development. Our analysis based on June-end data indicates that nearly 30% of the listed universe has free float less than 35% which would effectively translate into fresh equity supply of nearly Rs3.5trn. This is particularly negative for companies with lower-than-required current free float which may underperform the broader market until the supply overhang remains. However, it is important to note that this additional supply amounts to a mere 4-5% of the overall outstanding free float market cap, and is most likely to come in a staggered manner as seen in the past.

Market also seems to be concerned about potential delisting of companies having lower free float where promoters may not be willing to dilute their shareholding. However, this remains more of a speculation at this point and is unlikely to emerge as a major concern given the opportunity that India offers as an economy.

The long-term positive implications of higher free float in terms of wider ownership, greater market depth and better governance standards significantly outweigh the near-term headwinds. This would go a long way in developing Indian equity markets, which is crucial given the role markets play in providing the much-needed capital to fund growth and investments. The staggered implementation of the same, along with the flexibility to choose from different stake sale methods as done in the past, would facilitate smoother compliance.