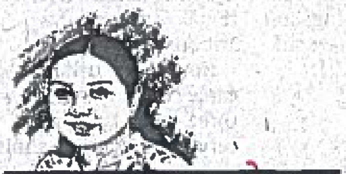
Does the strategic sale of PSUs work?

History says it does, but also suggests that the Centre needs to up its game on extracting a better price from private acquirers



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CIRCUIT BREAKER

The Centre's decision to give its disinvestment programme a steroid shot by selling off controlling stakes in healthy PSUs to private firms has drawn extreme reactions. The stock market appears thrilled with the idea, and has bid up stock prices of the said PSUs by 18-50 per cent. But PSU insiders are likening the idea to pawning off family silver to pay off a gambling debt.

So, is strategic disinvestment in profit-making PSUs a good idea? Well, hindsight is always 20/20. Therefore, to gauge this, it is useful to take stock of the rash of strategic sales effected by the previous NDA regime between 2000 and 2004. Taking the view that the government had no business being in business, the Vajpayee regime had identified nine PSUs in non-strategic sectors (outside of defence, atomic energy and railways) where it ceded both majority equity stakes and management control in favour of private buyers, through open auctions.

Of the nine PSUs, one (IBP) was snapped up by another public sector giant (IOC). But in the eight others (Modern Food Industries, Balco, Hindustan Zinc, Paradeep Phosphates, VSNL, IPCL, CMC, Hindustan Teleprinters), the Centre's equity stakes of 26-74 per cent were sold to private sector buyers such as Sterlite, the Tatas, Zuari, Hindustan Lever, TCS, Reliance Industries and Himachal Futuristic.

Scan & Share

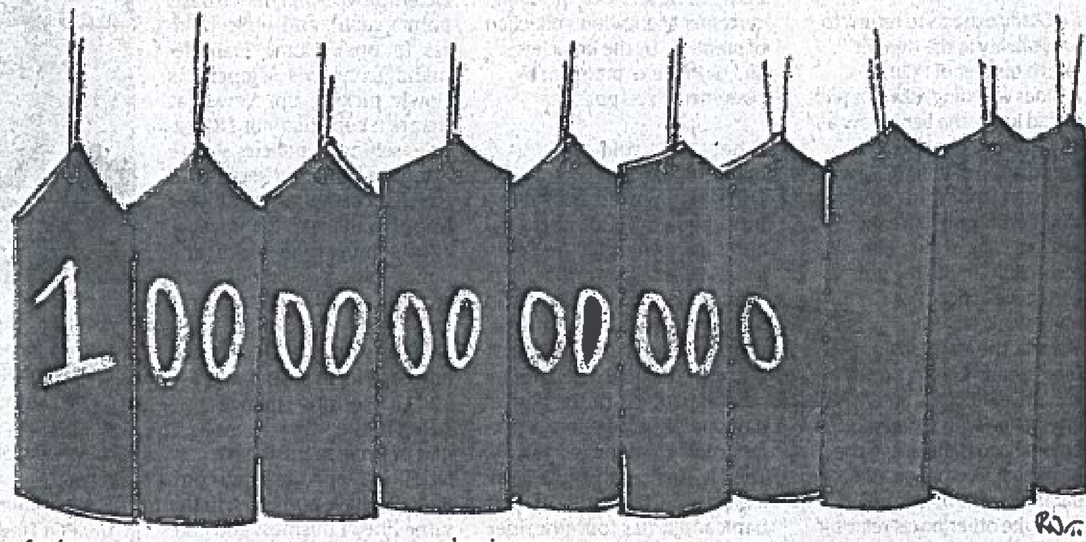
Fillip to finances

The performance of these eight PSUs pre- and post-disinvestment allow little room for doubt that privatisation was indeed a turning point in their financial fortunes. Hindustan Zinc, for instance, has seen its net profits shoot up from ₹67 crore at the time of its sale in FY03 to ₹9,698 crore in FY19, on the back of a 47-fold increase in sales. Balco managed a 14-fold profit expansion from ₹40 crore in FY01 to ₹573 crore now. Under government ownership, these metal majors were hamstrung by a high cost structure and a perpetual lack of funds for capex, shortcomings the Sterlite-Vedanta group overcame.

IPCL and CMC, in good financial shape under the Centre, made further headway on scale and profitability after their strategic sales before being merged into their acquirers. IPCL's net profits of ₹249 crore in FY03 shot up to ₹1,600 crore in 2006 when it was merged with Reliance Industries. CMC expanded its profits from ₹25 crore in FY02 to ₹280 crore in FY14, when it was merged with TCS. Paradeep Phosphates, which had seldom turned a profit under government ownership, has remained consistently profitable under the Zuari group since the sale. In fact, VSNL appears to be the only one from the 2000-2004 batch of privatised entities to have gone downhill since disinvestment, thanks to bruising competition in international telephony. Even Modern Food industries, referred to the BIFR under its first acquirer, seems to have later found its feet under a new owner.

The above evidence suggests that strategic sales do unlock significant value for both PSU stakeholders and their private acquirers by helping hobbled firms perform to their full potential. But what about taxpayers who effectively gave up those stakes? Given that these PSUs had potential, did strategic sales extract good value for taxpayers by rightly pricing their assets? Evaluated on this score, the track record is checkered.

A CAG audit of the nine PSU strategic sales published in 2006 has flagged specific shortcomings in the sale process last time around. Addressing them in the current tranche of sales could ensure that taxpayers have as much reason to be as happy with strategic sales of PSUs in the long run as investors.



Disinvestment prep

PSUs often have substantial undervalued assets sitting on their balance sheets in the form of surplus land, mothballed facilities and intangibles. This makes it imperative for the Centre to factor in the market value of such assets while setting reserve prices for strategic sales. But the CAG audit on the 2000-04 sales noted that the valuation exercise had fallen short on this score. Though each PSU was supposed to be valued under three methods — discounted cash flow (DCF), asset value and recent transaction multiples — the reserve price for 7 of the 9 sales was based on DCF alone. Faced with impractical deadlines, valuers often skipped important assets such as real estate and half-complete projects. In the Balco case, the valuer was given only 19 days for this exercise. The PSUs actively contributed to undervaluation with poor record-keeping.

These suggest that the Centre, in this round of strategic sales, must provide sufficient time to the valuers for a complete exercise, while cracking the whip on PSUs to clean up their records.

Healthy competition among bidders is essential to good price discovery in an auction. The CAG noted that, in the 2000-2004 auctions, though 70 bidders had thrown their hats into the ring initially, 48 withdrew at various stages. In the end, Modern Foods and Paradeep Phosphates were sold to their only bidders, while Balco, Hindustan Zinc, VSNL, Hindustan Teleprinters and CMC had only two bidders each to choose from. The sales were still concluded above reserve price.

But going by the details, prospective investors in PSUs seem to have been put off by shifting goalposts, non-disclosure of full financials and the government attaching one too many conditions to the sale.

In the VSNL sale, for instance, after deciding that 'surplus land' would not be part of the sale, the Centre took over four years to demerge it. Apart from addressing the transparency aspect, the Centre must peg the deal advisor's fee to the bidding interest generated.

Post-sale claims

Given that many strategic sales were concluded in February/March, when the financial statements of the PSUs were not published, sale agreements included clauses for the buyer and seller to settle post-deal claims based on differences between PSUs' disclosed assets versus actuals. This led to private acquirers lodging fat post facto claims with the government, which the latter refused to pay. In Modern Foods, Hindustan Lever claimed ₹17.5 crore after finding that the company hadn't provided for legacy receivables. In Paradeep Phosphates, massive net-worth erosion led to the Zuari group demanding ₹151.5 crore, almost the entire sum it paid for the acquisition. Post-sale claims leave a bad taste in the mouth for both the acquirer and the seller. So, it is best that the Centre presents a complete and clean set of books to potential buyers before the bidding process begins.

In addition to all this, one overarching requirement for the government to maximise its takings from strategic sales, is not to rush through them to raise quick money for the fisc. Taking stock of hidden PSU assets, setting a fair reserve price, ensuring wide bidding interest and hammering out the modalities of each deal require the government to devote considerable bandwidth to each PSU strategic sale. To maximise value from this route, it is also essential that the Centre is able to walk away from deals that don't do justice to the assets on the block. In short, the PSU strategic sale process must be freed from the tyranny of over-ambitious disinvestment targets and fiscal year deadlines.