PSU stake-sale needs a rethink

Divesting in CIL, IDBI Bank when their share prices are low makes little sense. Borrowing against govt's stake will bring more benefits

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On July 10, 2020, the Government of India announced its intention to sell its stakes in Coal India Limited (CIL) and IDBI Bank to raise ₹20,000 crore (approximately $2.67 billion). This decision of the government to sell its stakes in CIL and IDBI Bank, whose share prices are almost 70 per cent and 55 per cent lower than their five-year peak, is short-sighted (see Chart). It comes on the heels of the government's sale of its 11.47 per cent stake in ITC Limited and 4.59 per cent stake in Axis Bank in May 2020 for ₹22,000 crore.

As of June 30 this year, the aggregate value of government's stakes in CIL and IDBI Bank was an estimated ₹74,805 crore. To raise ₹20,000 crore, the government would have to sell around 27 per cent holdings in both entities.

Media reports have stated that CIL may buy back the government's stake if no other suitable buyers are found. Though CIL's outstanding cash and bank balance stood at ₹31,124 crore as of end-March 2019, it is essential for the company to maintain ample liquidity to discharge its commitments to its employees, vendors and lenders rather than to effect a share buyback.

Case against selling

While it is impossible even for the most astute stock-pickers to consistently buy at the trough and sell at the peak, the government incurs two kinds of financial losses by selling its stakes in public sector undertakings (PSUs) amidst a cyclical downturn. First, the government earns a lower quantum of capital gains. Its 66.13 per cent stake in CIL was worth ₹1,77,088 crore ie more than thrice the current value, at its five-year peak share price of ₹431.40. And, its 46.46 per cent stake in IDBI Bank was worth ₹46,154 crore, more than twice its current value, at its five-year peak share price. Second, the government loses the dividends it earns from these entities. In FY19, the government earned an estimated ₹7,058 crore in dividends from CIL and ₹614 crore from ITC; IDBI Bank and Axis Bank had paid negligible dividends.

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The government must instead borrow against its PSU stakes; a more advantageous financing option. First of all, by borrowing, the government does not sacrifice the upside potential in the value of its shareholdings. Second, it has continued access to PSU dividends. CIL was the government's highest dividend grosser in FY19. Dividends paid by the industrial constituents of Bharat-22 ETF accounted for a quarter of the government's FY19 dividend income of ₹1,13,421 crore.

Third, the valuation of PSU stakes is bound to improve as the economy recovers, thereby enabling the government to raise incremental debt using the existing pool of pledged shares. Fourth, as the debt raised is backed by PSU shares, the net sovereign debt remains unchanged.

A strong case may thus be made for defending India's sovereign credit rating, which is precariously perched at BBB-, the lowest investment grade rating. While S&P has retained the stable outlook on India's sovereign rating as on date, Moody's and Fitch downgraded their outlooks to negative in June 2020.

Debt instruments

The government must include in its debt package a variety of medium-to-long tenor debt instruments targeted at investors with varying risk appetites such as banks, institutional investors, blue-chip private sector corporates, high networth individuals and middle income retail investors. These include medium-tenor (say five-year) loans, plain vanilla bonds, deep discount bonds, callable bonds, and convertible bonds.

Notwithstanding the Covid-19 outbreak and loan moratoriums, the liquidity position of the better-managed Indian and foreign banks continues to be comfortable. Several blue-chip private sector corporates, including Reliance Industries, Wipro and Infosys, oversee investment portfolios worth lakhs of crores.

The government may reduce interest-expense related cash outgo by including deep discount bonds in its debt programme. Deep discount bonds are akin to cumulative deposits; no interest is payable during the tenor of the instrument. Interest is paid together with principal at maturity.

Issue of callable bonds enables the government to reduce its indebtedness by redeeming them ahead of maturity during years of robust economic performance and/when profitable PSU divestments occur. Convertible bond investors may choose to convert their bonds to equity if these are 'in the money' on the designated conversion dates and/or at maturity. Hence, the government will not be required to repay or refinance these bonds.

Listing plain vanilla, deep discount, callable and convertible bonds is essential to provide investors with an exit option ahead of maturity, and will enhance the attractiveness of long-tenor bonds of (say) 10-15 years' maturity.

Stake buyers

The buyers of the government's stakes in ITC and Axis Bank have not yet been disclosed. It is likely that LIC, one of the public sector non-life insurance companies or some government-linked entity may have purchased/will be purchasing the government's stakes in ITC, Axis Bank, CIL and IDBI Bank. If this were the case, divestments may be viewed as merely a transfer from one arm of the government to another. So, the government will have indirect access to the divested PSUs' capital gains and dividends vide the dividends paid by the buyer of these shares. While this is a logical viewpoint, such transactions can be sub-optimal.

Borrowing against PSU shares from a wide spectrum of investors during a downturn is more prudent than requiring government-linked entities to buy PSU shares for around ₹42,000 crore (between May and July 2020 alone). Also, the government plans to partially divest its stake in LIC through an IPO. Requiring LIC to buy the government's stakes in PSUs in an ad-hoc manner implies that LIC's strategic and operational independence is limited. This view will depress LIC's valuation and lower IPO proceeds.

The government conducted a fire sale of its ITC and Axis Bank stakes in May, close on the heels of its March 24 lockdown announcement. Fiscal prudence and financial savvy ought to now prevail over the easy way out ie, requiring government-liked entities to purchase the PSU stakes. Failure to do so will result in India continuing to face the lives versus livelihoods dilemma long after humankind has learned to counter the coronavirus.

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Government's stakes in industrial constituents of Bharat-22 ETF and select banks

₹ cr	Stake as of June 30, 2020 (%)	Value of stake (estimated)	FY19 dividend receipts (estimated)	Share price as of July 10, 2020	Discount to 5-year peak share price (%)
Coal India	66.13	53,898.12	7,058.21	131.30	69.56
IOC	51.50	41,768.03	6,094.12	86.15	62.11
NTPC	51.02	45,635.76	3,324.54	90.40	42.30
PGCIL	51.34	46,372.03	2,914.80	172.65	23.81
BPCL	52.98	43,252.78	2,612.96	376.35	31.77
NHPC	70.95	14,467.71	1,119.56	20.30	41.16
GAIL (India) Ltd	52.06	24,043.31	1,090.02	102.40	48.72
ONGC	60.41	59,734.01	962.15	78.60	63.07
NLC India Ltd	79.20	5,046.31	661.02	45.95	62.61
NALCO	51.50	3,497.29	647.46	36.40	60.69
ITC	11.47	27,394.72	613.99	194.30	47.16
SJVN Ltd	86.77	7,655.19	514.82	22.46	44.06
Bharat Electronics	51.14	12,410.90	333.06	99.60	48.50
Engineers India	51.50	2,367.54	188.17	72.75	64.75
NBCC (India) Ltd	61.75	2,878.79	98.50	25.90	82.22
Industrial Constituents of Bharat-22 ETF	–	3,90,422.48	28,233.38	–	–
Axis Bank	4.59	5,703.89	1.43	453.75	45.18
IDBI Bank	46.46	20,906.94	0.79	43.35	54.70

Source: Companies' 2019 Annual Reports, www.bseindia.com, www.moneycontrol.com & author calculations