Nandini Gupta: Are PSUs the govt's cash reserve?

The government's attempt to use PSU cash to fix its fiscal deficit has worrying implications for future disinvestment

Nandini Gupta / January 8, 2012, 0:48 IST

The recent move to make public sector units (PSUs) and financial institutions buy back public sector enterprise shares suggests a focus on the short term, plugging the hole in the budget deficit in this fiscal year — rather than on setting up a long-term disinvestment programme that increases the efficiency of public sector enterprises. Long-run privatisation plans continue to be difficult to implement — it is one of the most politically contested economic reforms, opposed at one time or another by most of the major political parties.

The government has met only 2.8 per cent of its Rs 40,000-crore disinvestment target for the current fiscal year (by selling a 4.35 per cent stake in the Power Finance Corporation in October 2011). Now, scrambling to meet its revenue target, and faced with a mounting deficit and high borrowing costs due to the financial crisis, the government has started eyeing the tens of thousands of crores of cash reserves held by profitable PSUs.

For example, Coal India stated — in response to a government query — that it will have Rs 60,000 crore in cash reserves by March 2012, while the National Mineral Development Corporation and Oil India had cash reserves of Rs 20,725 crore and Rs 13,589 crore, respectively, as of September 30, 2011. A share buyback by PSUs, or purchases of shares in other firms, would allow some of this cash to revert to their largest shareholder — the government. However, while the share buyback scheme clearly serves the government’s short-run purpose, it has long-run implications that need to be considered.

Will the buyback plan benefit public sector firms and minority investors? The first issue is whether reducing cash reserves may affect the long-run value of these PSUs. In the current uncertain financial environment, where the euro crisis has increased borrowing costs — particularly for emerging-market firms — it may not be prudent to deplete internal cash reserves. Companies may be waiting for the economy to improve, or for asset prices to fall further, before committing funds for long-term investments. In this case, positive cash reserves do not necessarily imply an absence of investment opportunities; they may actually provide a buffer for financially constrained companies. Another potential effect is that it may discourage PSUs from accumulating cash reserves in the future, leading to less efficient investment decisions as firms seek to tie up funds to forestall such moves by the government.

A second issue is whether the share buyback scheme provides any benefits other than letting the government cash out its ownership stake. Research suggests that disinvestment through minority equity sales has led to a significant improvement in the average sales and profitability of Indian PSUs. Comparing disinvested firms to enterprises that have been selected for privatisation but have not yet sold any equity, a 10 percentage point increase in the level of private equity is shown to increase average annual sales by 3.3 per cent and returns to sales by 3.8 per cent, without lowering employment or reducing wage compensation.

The improvements in financial performance following the sale of minority stakes is related to the market discipline imposed by improved monitoring by
investors in disinvested firms. One potential advantage of the share buyback scheme is that it will lower the government’s stake, thereby reducing the potential for future interference, and increasing the relative ownership stakes of minority investors.

However, considering the long-term consequences, the relaxation of rules by the securities regulator and the pressure on firms and financial institutions to undertake this buyback just underscore the lack of autonomy of PSUs from government interference. It suggests that the government as a majority investor may exert an undue amount of influence to benefit itself, potentially at the expense of minority investors. Minority investors undervalue companies controlled by a majority investor whose objectives are not consistent with shareholder value maximisation.

This may not bode well for the future. If and when the government resumes its disinvestment programme through public offerings on the stock market, minority investors will be wary of investing in companies when the government is likely to intervene whenever it is in need of cash. The returns reaped from minority equity sales will be less than the true value of the shares. Given that disinvestment has stalled because of low valuations in the current economic climate, the government should be acting to reassure investors, not to scare them away.

Recent evidence suggests that the positive effects of privatisation on firm performance are even larger when privatisation involves the sale of majority equity stakes and the transfer of management control to private investors. Moreover, employment increases significantly following majority privatisation, perhaps in response to the increase in profitability and expansion of output. Thus, the government should focus on selling majority stakes in companies like Air India, which is bleeding cash (to the tune of Rs 7,000 crore in the last fiscal year alone).

Privatisation, however, remains a game of political ping-pong. Recent research suggests that since 1991, successive governments have delayed the privatisation of firms located in politically competitive districts and in the home state of Cabinet ministers, suggesting that all political parties when in opposition use privatisation as a cudgel to beat the party in power at election time. For example, although it was the Congress government that initiated the privatisation programme in 1991, sensing a public backlash against the NDA’s reform programme, the UPA coalition ran on a platform of limited privatisation in 2004. Given the stalemate in Parliament and political opposition to privatisation, perhaps the only way the government can undertake disinvestment is by asserting that it needs the cash? In which case, something may be better than nothing.

The writer is a visiting scholar at the Indian School of Business, Hyderabad, and Associate Professor of finance at the Kelley School of Business, Indiana University