GREY AREA

PSU buybacks help achieve disinvestment target. But then target is just a number.

Buybacks are an instrument for the government to achieve its disinvestment targets.

Juggling government stakes between PSUs doesn't bring in fresh funds.

The government should take a longer-term view and focus on value creation in PSUs by restructuring their business models.

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From left, former chief economic advisor, Arvind Subramanian, finance minister Arun Jaitley , former finance secretary Ashok Lavasa with finance secretary Hasmukh Adhia (second from right) and Neeraj Kumar Gupta, secretary, Department of Investment and Public Asset Management during a press conference at National Media centre on October 24, 2017 in New Delhi

By Ahindra Chakrabarti and Chanchal Chatterjee

The government has exceeded its disinvestment target for the second year in a row. It has mopped up INR85,000 crore in fiscal 2018-19 as against a target of INR80,000 crore, largely helped by a sharp jump in the share of funds raised from buybacks in public sector undertakings (PSUs). Share buybacks, which contributed 5.33% of the amount raised last year from disinvestment, stood at 10.99% this year.

In India, the government mobilises resources from PSUs mainly through initial public offerings (IPOs), follow-on public offerings (FPOs), offer for sale (OFS), and share buybacks. Of these, the contribution to total proceeds from share buybacks has fluctuated over the last three years.

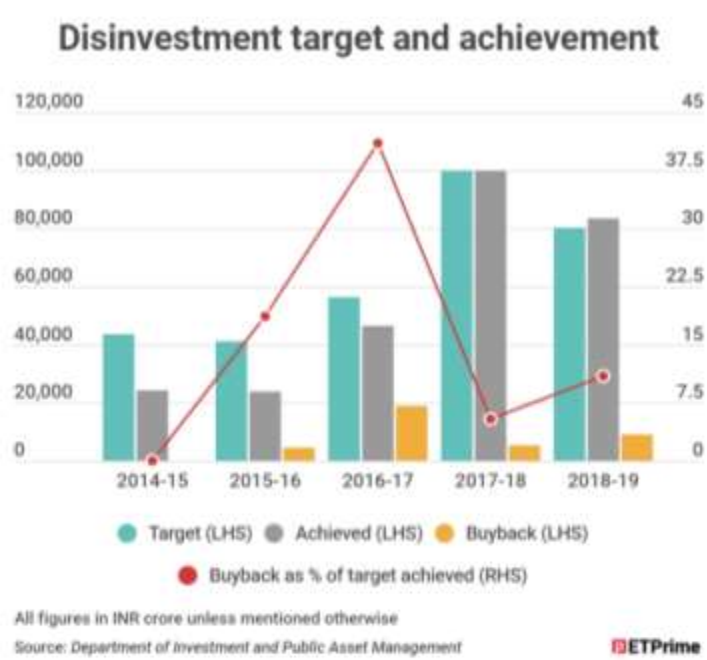
Buybacks generally create higher value for investors as they reduce the number of shares traded in the market. They also increase the earnings per share (EPS), a key metric in valuing companies. A higher EPS usually means a better market value for the company's traded shares. Moreover, share repurchases reduce equity and in turn improve the return on equity.

Companies reward shareholders mainly through dividends, the route most preferred by investors. Another option is to buy back shares at a price remunerative to shareholders. Finance theory suggests that paying high dividends increases shareholder expectation in the subsequent years. When companies fail to meet it, a negative reaction ensues. In this context, buybacks can be a preferred route for rewarding shareholders.

One road, many destinations

For the government of India, the sole objective behind share buybacks may not be rewarding the shareholders. Instead, it is an instrument to achieve the government's disinvestment targets, especially in cash-rich PSUs which do not have any ambitious capital-expenditure plans. Further, buybacks offer low transaction costs and can be implemented in comparatively shorter time periods.

Let us take a look at the government's performance in disinvestment over the last five years.



As the above graphic depicts, the government failed to meet its target for the first three years. In the fourth year, however, it scraped through. In 2018-19, the government exceeded its target by INR5,000 crore as the contribution from buybacks more than doubled in percentage terms of the total amount raised. This was largely due to Power Finance Corporation's acquisition of REC Ltd that added INR14,500 crore to the disinvestment fund.

Looking beyond the numbers, it becomes clear that one PSU buying the government's stake from another means nothing more than juggling of equity and it doesn't bring in any fresh money into government coffers. So, why is the government facing difficulties in finding investors for the PSUs?

The importance of value creation

First of all, investors don't consider PSUs as value-creating companies. Many PSUs are engaged in extracting mineral resources whose prices are dependent on the demand-supply equation, and there is limited scope for creating higher value in such businesses.

Meanwhile, the fortunes of oil and gas companies hinge on global crude prices, currency fluctuations, and so on. Further, though they are supposedly given a free hand, when it comes to taking important decisions, the ministry has the final word. If things go well, the ministry gets all the credit, but if they don't, the company is to take the blame. Hence, these companies have limited options to create higher value through strategic initiatives.

The fallout of this approach is value migration — an exodus of shareholder value from obsolete business models to new, more efficient ones. Value migration occurs when there is a disconnect between customer priorities and existing business designs.

A universal concept, value migration helps explain big successes and failures in various markets. Customer priorities keep changing, and only those businesses that promptly identify it and take timely or pre-emptive action end up on the right side of the equation. Those that fail to do so will have to helplessly watch the outmigration.

Is buyback the only way out?

But does the government have to necessarily depend on buybacks to meet its disinvestment targets, especially when it is not getting the right value?

There are two factors that favour buybacks. First, as per the Securities and Exchange Board of India guidelines, PSUs are required to achieve a minimum 25% non-promoter public shareholding by October 2020. Therefore, the government has to loosen its control. Second, some public-sector companies are in expansion or growth mode, and ensuring better returns to investors through buybacks may be the apt thing to do during such times.

Therefore, in the short run, buybacks make absolute sense. But the sustainability of buybacks as a value-enhancing exercise is questionable, especially when companies are a going concern with theoretically infinite lifespans.

Many PSUs need to look at their business design aspects *de novo*, according to the disinvestment department. A business design comprises four strategic elements:

- **Customer selection:** Who are the core customers of the company, and what are their preferences?
- **Value capture:** Expanding the value spectrum of offerings by including financing, ancillaries, solution, and so on. The ones who deliver value in innovative ways are the ones that are rewarded the most.
- **Strategic control:** Why a customer should buy from a particular company, the differentiating factor.
- **Scope:** Detailing the ways to remain relevant to the customer while generating bigger profits and obtaining strategic control.

The department of disinvestment's objective is efficient management of public investment in PSUs for accelerating economic development and augmenting the government's resources for higher expenditure while promoting people's ownership in PSUs.

For that to become a reality, the government should take a longer-term view and focus on value creation in PSUs by strengthening capacity building and restructuring their business models.

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