

# Indian Journal of PUBLIC ENTERPRISE

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VOI. 8 No. 15

December 1993

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**Institute of Public Enterprise Research**  
**ALLAHABAD**

# WHY THE PUBLIC ISSUE IN DISINVESTMENT IS UNDERPRICED ?

ABHIJIT DUTTA\*

## OBJECTIVE OF THE PAPER

The present paper envisages to throw light upon the situation under which disinvestment should take place and also point out why there is a tendency of the disinvested shares to be underpriced. The second section of the paper takes up the case of SAIL — a major Indian State Owned Enterprises (SOEs) that was disinvested and try to fit the situation of the previous section to analyse the situation under which the share of SAIL were underpriced.

## INTRODUCTION

There is an alleged tendency of the public Issue in case of disinvestment to be underpriced. this is more so in the case of the developing countries where, most of the State Owned Enterprises (SOESL) run under losses. The basic reason for this loss making is often laid on the reason of social welfare and strategic position that this SOEs occupy. It would be proper in this place to say that the government should try to reduce its stake in those SOEs where its strategic requirement is less. In other words, a sale or disinvestment of such a SOE does not necessarily mean that the government has to move away from its welfare motive. Therefore it is just that the government should have a upper hand in disinvesting such SOEs and command more price

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\* ICSSR Research Scholer, Institute of Public Enterprise, Hyderabad.  
The auther registers his thanks to Prof. R.K.Mishra for the suggestion in improving the paper, however the observations in the paper are solely that of the authers. The article draws its experience upon Prof. L.P.Jones idea in mathematical analysis. However parameters have been changed as required for the study.

on the public issue. In practice however the case is not so. Most of the public issue are grossly under priced<sup>(1)</sup>. This matter induces a lot of public debate. The present paper tries to look into the situation under which a public offering is viable and also tries to answer why and under what situation the public issues in case of a disinvestment is underpriced.

Basically the disinvestment or the privatisation are broadly dependent on certain parameters. Some of the parameters necessary for the consequent development of the paper are defined below.

## PARAMETERS

Since the basic objective of the State or the government is to provide welfare, it is a pre-emptive assumption that all the SOEs are set up to provide welfare. Therefore the value of a SOE is partly given by the present value of the future stream of social benefit that will be acquired out of it. If we talk in terms of a single SOE in which the govt. plans to disinvest, let us denote the social value of the SOE by the term  $V_{dg}$ .

The government expects to disinvest but it is well understood that it expects some form of welfare from the private sector. Again the social value after disinvestment (or sale) to private sector is nothing but the present value of the future streams of social benefits that will acquire after the sale. In single SOE situation, let it be denoted by  $V_{dp}$ .

Besides the social value, each SOE has a monetary value. This value is in term of the maximum value that one unit of money can fetch in alternative use. Therefore when ever the government thinks of disinvesting in any SOE it should think of the premium of government revenue or it has to weigh between the value of the money when it is in its hand and the value of the money when it is not in its hand. Let us denote it by  $X_g$ .

Similarly the private sector also has to think of the alternative use that it can put the one unit of money before it stakes it in the public issue of the disinvestment plan of the government. Let us denote this premium of revenue on the value of one unit of money in the hand of the private sector as  $X_p$

It has been sent that the government generally sets a minimum reserve price for any disinvestment. Though it does not set a maximum price it does have an expectation, which will enable to strengthen the exchequer. Let the maximum price which the government expects out of the disinvestment be denoted by  $M_g$ .

The private sector on the other hand has a limit to pay and will try to bargain the price down. Let the maximum price acceptable to the Private sector be represented by  $M_p$ .

The equilibrium between  $M_g$  and  $M_p$  will denote the actual price paid. Let it be denoted by  $M$ .

Therefore we arrive at the following parameters which effect the disinvestment:

$V_{dg}$  = Welfare before disinvestment in the government hand.

$V_{dp}$  = Welfare after disinvestment in private hand.

$X_g$  = Premium of government revenue or the value of one unit of money in the government hand.

$X_p$  = Premium of private revenue or the value of one unit of money in the private hand.

$M_g$  = The maximum price acceptable to the government.

$M_p$  = The maximum price acceptable to the private party.

$M$  = The price at which the public issue is offered.

### **RULES THAT GUIDE THE DISINVESTMENT**

If we represent welfare by  $W$  and expect a change of welfare due to disinvestment, let such a change be denoted by  $DW$ . Thus if  $DW$  = the change in welfare by disinvestment,

then the price of the public issue should be positive only if the price of  $DW$  is greater than Zero i.e. ;  $DW > 0$ .

Therefore,

$$DW = M - V_{dg} \dots\dots\dots (1)$$

Or,  $DW = M - V_{dg} > 0$  should be the condition for the price of the public issue of the disinvestment.

Since the government is the custodian of all the natural resources and the manmade resources, it has to consider the value maximisation after the disinvestment in terms of social welfare as well as in money terms (since it wants to improve its position of the exchequer). Therefore,

$$DW = \text{Increase in social value} + \text{Increase in revenue value} \dots\dots\dots(2)$$

Now, social welfare is possible only when welfare after disinvestment ( $V_{dp}$ ) is greater than the welfare before disinvestment ( $V_{dg}$ ). Or in other words the difference between two should be positive ie :  $V_{dp} - V_{dg} = +ive$ .

The above equation (2) also includes maximisation of revenue value. To get a positive DW, it is absolutely necessary to get a positive value of the latter factor. That means that the difference between the product of the actual sale price and the maximum value acceptable price to the government and the product of the actual price and the acceptable to the private sector should be positive. That is  $MX_g - MX_p = +ive$ .

Substituting the above two values in equation (2) we get :

$$DW = V_{dp} - V_{dg} + M (X_g - X_p) > 0 \quad \dots\dots(3)$$

Rearranging we get,

$$V_{dp} + M (X_g - X_p) > V_{dg} \quad \dots\dots(4)$$

The above inequation indicates that a disinvestment is possible only when the welfare is more in private hand rather than in the government hand and there is a positive flow of revenue earning for the state.

But what if the  $X_g > X_p$ .

Then the inequation (4) will be written as follows :

$$M > \frac{V_{dg} - V_{dp}}{X_g - X_p} \quad \dots\dots(5)$$

The R.H.S. is nothing but the government supply price, or the maximum price acceptable to the government ie ;  $M_g$ .

So, the rule of disinvestment stands thus,

Disinvest only when

$$M > M_g \quad \dots\dots(6)$$

That is, the price of the public issue should be greater then the maximum price accpetable to the government.

If we look at equation (3) and visualise a situation where by

$V_{dg} > V_{dp}$  and  $X_g > X_p$ , then the result of the

equation (3) will be "negative". The situation may be well explained, when the S.O.E. has been perennially loss making and it is well

established that a turnaround is only possible through change in ownership, from public to private hand. Under such a situation the government might establish a lower limit price than what the SOE should earn per share in course of disinvestment. Since the private sector is better placed at this moment, it will not accept the price set by the government or otherwise accept a discounted price which is far below the price that any share of the competing unit of the SOE under consideration could fetch if it goes to the market. This neatly explains why the public issue in case of a disinvestment decision by government are often "Under Priced".

## Part II

### THE CASE OF SAIL

SAIL which was established in January 1973 as a holding company for the steel and associate industry has a share capital of Rs. 3985.89 cr, as on 31.3.1993 fully held by the Government of India.

SAIL was selected as one of the 30 SOEs to be disinvested in the first two rounds of disinvestment by the Government of India. The Ministry of Steel suggested that SAIL be dropped from the list of disinvestment because it envisages that the price of the share will go up by 1994-95 and the realisation can be better. In other words the Ministry thought that till that point of time the value of SAIL was high in the Government hand. Therefore it can be safely concluded that the  $V_{dg}$  was quite high as noted by the ministry of steel.

The Ministry of Steel also suggested that the Govt. Of India will stand to loose the stake of disinvestment in SAIL because the valuation method adopted was improper thereby indicating that the value of share that was reached was improper. This on the other hand meant that the premium on the Government revenue was much higher at that point of time than as it was estimated. Thus it can be said at the point of time the  $X_g$  was also high at least higher than  $X_p$ . Invariable we also have seen that at that point of time the  $V_{dg}$  was also higher than that of  $V_{dp}$ .

On the other hand we see that the market price of SAIL as per E.T. as on 31.10.92 is on an average of Rs. 60.62 per share. This should have been the maximum acceptable price to any prudential government as it reflects the market sway for the share to be disinvested. Thus it can be represented by  $M_g$ .

It was seen that the share of SAIL was off-loaded at Rs. 13.24 per share which means that was the acceptable price to the private investors. We put it as  $M_p$ .

Initially the  $M$  was stuck (as the govt. thought it to be) at the minimum reserve price of Rs. 35 per share.

We observe that for disinvestment of SAIL, under price was preconditioned. It can be further observed that  $M$  was far less than  $M_g$ . That is  $Rs\ 35 < Rs.\ 60$ .

Hence, The above section stand in close conformation to the situations developed in the previous section.

Some eye opener in this section can be

1. The Government should always wait till the  $V_{dp}$  is higher than  $V_{dg}$ . This can be done through induction of competition.
2. The Govt. should try to maximise  $X_p$  to go up.
3. It is advisable to accept the average market price of the share of the SOE to be disinvested at a point of time as conducive to the government if the SOE is listed in the stock exchange or else the Government should try to list the SOE in the Stock Market before disinvestment.
4. Care should be taken to see that  $M$  is not below  $M_g$ . This may be done through adjusting the minimum reserve Price to that of the average market price.

## CONCLUSION

The decision whether to disinvest or not depend upon certain parameter like the social value of the SOE and the contribution to the exchequer that can be achieved through such a disinvestment. When all these parameters give a positive value, the disinvestment is possible. In case the value after disinvestment is more than the value before disinvestment, then the government has to offer the SOE at a lesser price in order to increase the value of the SOE. Thus, the price of the share disinvested always tend to be "underpriced".

In the second half of the article we observed a case in Point of low realisation in disinvestment in relation to India. We observe that the basic reason for the underprice is that the value of the SOE under

consideration had a higher value both in terms of the money value as well as the social value. Hence, the maximum price acceptable to the government went low and the price at which the public issue was offered fell.

#### END NOTE

1. This was brought out in most of the disinvestment issues in India.
2. See CAG report No. 14 of 1993 Pg 35.
3. See CAG Report No. 14 of 1993 Pg 35.
4. See CAG Report No. 14 of 1993, Anx III col. 10, Pg. 47.
5. See CAG Report o. 14 of 1993, Anx IV col. 6, Pg 34.
6. See CAG Report No. 14 of 1993, Anx IV col. 5, Pg. 48.

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1. Jones, Lerry. P. Et All <1991> *Selling State Owned Enterprises : A Cost Benefit Approach* In Rammurthi Ravi and Vernon Raymond <Ed> *Privatisation and Control of State Owned Enterprise* EDI.
2. *The Great PSU Disinvestment Row. Business World*, 28th July to 10th Aug. 1983.
3. *Report of the Comptroller and Auditor General of India*, No. 14 of 1993. ;

