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The Rise of the Private Sector

As FinanceAsia was going to press, the Congress Party looked as if it had finally bowed to pressure from its left wing coalition partners' demand to abandon its privatization programme in favour of only selling companies that are ìsickî. The one-year old government had previously set a divestment target of $2.3 billion for 2005, with divestments schedules for BHEL, Nalco, GAIL, the shipping Corporation of India and Maruti Udyog.

The news will come as a severe, though not wholly unexpected blow, to investment bankers in the country. Some still retain a sense of optimism and believe the government will make divestments as long as they fall within the common minimum programme — an agreement between the coalition partners whereby the government will not reduce its stake in any one company below 51%.

Top of the divestment list is Nalco. The government had said it hoped to raise roughly $400 million from the sale of a 20% stake via the equity markets. ABN AMRO and Enam are lead managers. ABN country head, Frank Hancock says the capital markets transaction is still alive and that it is the sale of 27% stake to a strategic investor that has been cancelled.

Others are not so sure. Some had hoped that promises to use privatization proceeds for social welfare programmes would appease the government's critics. But as Enam Chairman, Vallabh Bhanshali puts it, ìIt really doesn't matter who the government promised to give the money to. Privatization is a taboo word for the left wing parties in this country. They will only accept divestments of sick companies, but who's going to buy a sick company unless the price I so low that they won't accept that either.î

Still Bhanshali has not given up all hope. "Most coalitions start off being very cautious, then towards the end of their term they really get to work. The same ting happened with the NDA government. It wanted to leave a good legacy and we saw a huge amount of privatization activity in the 12 months before national elections."

Nevertheless, all Indian commentators agree the public sector is not keeping pace with the private sector and that at some point this may end up capping the growth prospects of both. JM Morgan Stanley MD Mickey Doshi says, "If the government were to seriously undertake a divestment programme of PSUs in this country, India would have a very different growth profile to the one it has today."

Where the private sector is concerned, some bankers argue that corporate governance standards are on a par with developed markets. "The top 20 Indian companies have far better corporate governance than their Chinese counterparts," notes one international investment banker who wished to remain anonymous. "It's because there's been a longer history of capitalism in India. The management of most Indian blue chips are seriously committed to decent standards of corporate governance and investors find their financials far more transparent and easier to understand than Chinese companies."

Local investment bankers are more cautious and generally prefer to highlight the huge strides corporate India has made since the government began to liberalize the economy in the early 1990s.

"The reforms started in 1991, but for the first few years no-one really took them seriously," Bhanshali relates. "The around 1994 interest rates went up and suddenly corporate India found that money was not so easy to come by anymore. CEOs slowly began to learn the meaning of the word working capital and after a period of retrenchment, they discovered what they were really capable of. As interest rates started coming down in 2001, confidence began to build up again and now we are at a stage where things have structurally changed forever in this country. There has been a major economic shift."

These comments are echoed by Kotak Mahindra executive director, Sughosh Moharikar. He says Indian companies learnt the hard way what happens when an economy is liberalized and companies overexpand. "In the mid-1990's there was a massive capacity expansion followed by a collapse in margins after interest rates went up," he says. "It took a number of years for the down cycle to work its way through the system. We're only seeing the beginning of a new investment cycle now"

India Capital fund manager Jon Thorn believes corporate India now has a lot of slack in the system, citing figures, which show that Indian corporates are the least leveraged in the whole of Asia. He says Indian companies average a net gearing ratio of just 7.7%, the lowest in Asia after Taiwan's 11.5%. At the other end of the scale is Thailand on 51.4%.

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Build it and they will come

Bemoaning India's appalling physical infrastructure is a favorite dinner party topic of India's chattering classes. Yet those who slate successive government's inability to build proper roads, commend the NDA government for its efforts to improve the country's capital markets infrastructure.

Jon Thorn, who has managed the $170 million India Capital Fund for 10 years, says the stock markets have been transformed since liquidity and confidence disintegrated in 2001.

"Because the stock market suffered total collapse, the regulators were able to rebuild from scratch and India now has one of the most sophisticated and efficient trading environments in the world,: he says. ìEverything is automated, companies have to make quarterly filings and there is T+2 settlement."

He is a particular fan of the National Stock Exchange and the impact it has had on the Bombay Stock Exchange. "It's good having two exchanges because it promotes competition," he argues. "The BSE would still have floor traders running around unless the NSE has come along and forced them to automate. Brokers are the most Luddite community on the planet. The NYSE, for example, is still operating in the stone age."

Many Indian players highlight the fact that the two Indian stock exchanges now rank as the third most active markets in the world by the number of trades after the NYSE and NASDAQ.

Local investment bankers also hope to attract new companies after re-floating the idea of IDR's (Indian Depositary Receipts) with SEBI. JM Morgan Stanley chairman Nimesh Kampani is a keen advocate of the product, since he believes it would make India a true capital raising base for the subcontinent. It might also appeal to US incorporated Indian companies that would then be able to raise money from their home market.

They also say SEBI now needs to turn its attention to the primary markets. "If I could have one wish it would be to remove paper-based applications from IPO and secondary market deals," says JM Morgan Stanley MD Mickey Doshi.

In many respects India equity deals follow international best practice. Citigroup's head of Indian ECM, Ravi Kapoor says there has been a quantum shift over the past five years as a result of a huge consolidation between merchant bankers. "There's now just a few IPO underwriters compared to maybe 40 or 50 fie years ago," he says. "Bankers are very focused on documentation, due diligence and quality of disclosure. We take 10b5 opinions from international law firms. During marketing, we have pre-deal research and global roadshows. Price discovery is done through a bookbuilding process."

The main difference between India and the rest of the world only become apparent during the bookbuilding process. Principally, the country has two main quirks. The first is that order books are built live on the NSE and BSE so that even the smallest retail investor can see how demand is building. The second concerns allocations

Like many Asian countries there are minimum allocations to retail. In India's case the band is 25-35% to retail, 15% to high net worth individuals and 50% to 60% to institutions. Most bankers wish they were removed.

Says DSPML ECM head Sanjay Sharma, "I really wish the government would get rid of these artificial buckets. Retail should be encouraged to invest through mutual funds, or at the very least there should be more of a graded structure like there is in Hong Kong, where the retail portion gets increased if it is heavily oversubscribed."

Bankers would also like to see the whole time period for secondary market offerings shortened. This is not always an issue – blocks of secondary shares can be simply crossed to their new buyers on exchange. The problem arises when a company decides to raise new equity through a fully marketed offering. ìThe time between the announcement and closure of the secondary offering used to be three to four weeks,î says JPMorgan's Indian ECM head Jatin Sanghvi. ìNot only this, but companies had to decide what the price range for a secondary market deal would be at the beginning of the process even though their shares would continue to trade for a month.

This timescale has now been halved and companies do not have to announce the price range until a day before they launch a week-long offer. However, it still takes about 3 to 3 weeks before a deal is settled because the process is no automated.

As DSPML's Sharma explains, "We still have a system whereby hundreds of thousands of retail applicants will lodge cheques, which have to clear through the banking system. Bookrunners end up having to deal with local bank branches in up to 60 or 70 cities."

And Sanghvi adds, "Indian issuers would benefit from an automated settlement process as it would enable them to undertake simultaneous offering in the domestic and international market. This would lead to added demand and pricing tension in their offerings."

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