The Rigged Market in PSU Stocks

Back in 1993 and 1994, millions of Indian speculators made, and then lost, a lot of money in the primary market. There were two related reasons for this boom-and-episode in Indian stockmarket history: (1) speculators' greed; and (2) the rigged nature of the new-issue market.

I will first explain the reasons of the rigged market in new issues in 1993 and 1994. Then, I will use the similar arguments to explain why, today, the market for PSU stocks is also rigged.

The Rigged Market in New Issues

Making a quick buck in the stockmarket was never as easy as in 1993 and 1994. (That the wealth made was not kept, is another fact.) All one had to do was to buy into hot new issues brought to the market by hundreds of merchant bankers. Typically, these issues were made at par. But, the initial listing took place at well above that number, sometimes at Rs 30 or even Rs 40 per share. So, trebling or even quadrupling one's money in three months time was easy. The problem was how to get as many shares allotted to oneself as possible. The demand for these new issues was so huge that speculators who applied for 50,000 shares got only 100 allotted to them. So, many of them found ingenious ways of getting around that problem by making multiple applications in different names. (When the government announced it plans to introduce proportionate allotment, there were cries of protest from small Indian speculators.)

Most such speculators were not interested in even knowing anything about the companies they were buying into. They would happily pay twenty times the latest twelve-months' earnings (which were artificially inflated) for new, non-descript businesses, than to look at large, well-established businesses selling at much lower PE multiples.

The demand being there, the supply had to come. And come it did. More money was raised by the primary market in 1993 and 1994 than in any two-year period, (past, as well as subsequent) in the history of India's stockmarket. Reputed firms of merchant bankers brought many new issues of increasingly poor investment quality to the market to satisfy the demand. I am reminded of a quote from an article on merchant bankers published in 1894: *"Firms of old standing vied each other in foisting unremarkable rubbish on the guileless investor."*

We all know the result of the speculative excesses of the IPO boom of 1993 and 1994. Most of the companies who raised money during the period cannot even be found on today's stockmarket pages.

Why did this happen? As I mentioned in the beginning, the primary reason was the greed of the small Indian speculators. But, I also mentioned another, important reason: the rigged nature of the primary market.

Consider how prices are set in a well-functioning secondary market, as compared to the primary market. In a well-functioning secondary market, there are thousands of buyers and thousands of sellers trying to buy and sell on any day. Their opinion, or rather, *changes* in their opinions determine daily market prices. For example at any given point of time there are buyers of thousands of shares of Reliance Industries at, say 120.10,120.05, 120.00, 119.95, 119.90, 119.85, and so on. Similarly there are sellers of thousands of shares at 120.15, 120.20, 120.25, 120.30, 120.35, 120.40, and so on. The most optimistic non-owner of the stock is willing to convert his cash into shares at Rs 120.10 and the most pessimistic owner is willing to convert his shares into cash at Rs 120.15. Until someone changes his opinion about the value of the stock there will be no quotation. Assume that one of the non-owners of the stock who had earlier bid Rs 120.00 changes his opinion and revises his bid to Rs 120.15. Assuming no other change, at this price, there now exists a willing buyer as well as a willing seller, and therefore a deal is done and a quote appears on the screen. All this happens in a flash of a second while thousands of buyers and sellers are changing their opinions.

The presence of thousands of buyers and sellers does not mean that stock prices cannot diverge too far away from their intrinsic values. Markets can be irrational, even for prolonged periods of time, in-spite of the presence of numerous buyers and sellers. The presence of numerous players on either side of the trade does imply one thing, however. And that is, that as a group, neither the buyers, nor the sellers, hold the *balance of power*.

Now compare the price-setting mechanism described above with that of the price-setting mechanism of a primary market which is experiencing a boom. There are three main differences between the two.

First, in a primary market experiencing a boom, there are millions of speculators who are competing with each other to buy a limited amount of stock being offered by a handful of sellers.

Second, in a primary market, the sellers *always* know more about the fundamentals of the business being offered for sale than the buyers.

Third, in a primary market experiencing a boom, the sellers can choose the *timing* of the sale of shares. Not surprisingly, they will sell the shares only when the public is willing to overpay for them.

The above three advantages enjoyed by the sellers in a primary market, shifts the *balance of power* in their favour. The effect is that the primary market game in boom time, is rigged against the buyers.

The Rigged Market for PSU Stocks

Using the above analysis, is it easy to see why the current market for PSU stocks is also rigged. The spiralling fiscal deficit problem faced by the Indian government is known to the market. The government has announced a public-sector dis-investment programme to bridge the gap between its expenses and revenues. Indeed, the government has gone so far as to announce that amount of money it plans to raise each financial year by selling its holdings in PSUs. The plan for 1998-99 was Rs 5,000 crores and the plan for 1999-2000 is Rs 10,000 crores. The fiscal deficit problem accompanied by the compulsion to sell PSU shares makes the Indian government, a distressed seller. And sellers *never* get a fair price in a distressed sale from the buyers. The reason is simple. The sellers are desperate for cash. The buyers will not give them cash unless they get a bargain in return because the buyers can afford to wait, but the sellers cannot.

Now, consider three more facts. *First,* in the PSU dis-investment programme, there will be one distressed seller attempting to sell its wares to a handful of cash-rich institutional buyers. *Second,* there already exists a market quotation for the shares of many PSUs. These shares are concentrated in the hands of a few institutional investors. *Third,* the price at which the government sells its current holdings in PSUs has to be somewhat less than the market quotation prevailing at the time of pricing.

Under these circumstances, it is clear that *balance of power* lies not with the distressed seller i.e. the government, but with the cash-rich buyers, i.e. institutional investors. The buyers who, as a group, can control the quoted price have much to gain, and little to lose, by ensuring that PSU stocks quote at a bargain level because they know that before 31 March 2000, the Indian government will have to raise Rs 10,000 crores by selling the PSU shares it holds. They also know that pricing for these shares will be below the quoted price prevailing at the time of the offering. For proof just witness what happens to the quoted price and volume of PSU stocks a few weeks before the government decides to sell its holdings to institutional investors You will notice a decline in the stock price and an increase in the volume.

How is this achieved? Institutional investor A sells 10 lakh shares at Rs 150.00 to institutional investor B. Then institutional investor B sells 10 lakh shares to institutional investor C at Rs 145.00. Then institutional investor C sells 10 lakh shares to institutional investor A at Rs 140.00. And on and on it goes until the price falls to a bargain level. The profits and losses on these trades can be adjusted in New York, or in London. The institutional investors who made profits will refund them to institutional investors who made losses. The effect of all of this is that just before the dis-investment exercise, and at no loss to any single participant in the cartel, the cartel succeeds in hammering down the listed price of the PSU's shares. And all this can easily be achieved by institutional investors simply by shuffling the between them at ever lower prices that have no relation to underlying business values. (A few weeks ago, SEBI banned the use of "All or None" method of order execution on electronic exchanges. This was done precisely because it was suspected that institutional investors were misusing this facility to hammer down stock prices.)

The point I want to make here is that it pays institutional investors to form a cartel against the Indian government who is the distressed seller in the PSU dis-investment exercise. It pays the members of this cartel to keep PSU stocks down, forcing the government to sell its holdings in them to the cartel at bargain basement prices. For them, the potential profits to be made later, when stocks bought at bargain prices are sold, justify the expense incurred today.

Combine all of the above with the actions of another distressed seller sitting on a very large chunk of PSUs shares, and you will see why many PSU stocks have been hammered down mercilessly in the last few months. This distressed seller is UTI, which, for reasons I don't want go into, has decided to reduce its holdings in PSU stocks, regardless of price.

What does all of this mean to the rest of us? It means that for reasons that have nothing to do with the fundamentals of the underlying PSU businesses, the recent hammering down of their stock prices has resulted in a situation where we are being offered some of India's best performing PSUs, on a platter. I am referring to companies such HPCL and BPCL, both of which have been recommended to you by my friend and colleague, Hormuz Maloo, as well as companies such as MTNL and VSNL.

These companies are in possession of extremely valuable franchises that are churning out cash even during current times when most private sector companies are faltering. The presence of these franchises will enable these companies to continue to grow their earnings at a more than the rate of inflation. The shares of the average large Indian company today sell for a PE of 11. The businesses of these PSUs are far superior than the business of the average large Indian company. And yet the shares of these PSUs are selling at PE multiples of less than 8. Indeed, the shares of BPCL and HPCL are selling at PE multiples of less than 6. At their current valuations, these stocks offer incredible value to long-term investors who have to courage to bet against the institutional crowd and take advantage of the rigged market in PSU stocks.

Note

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