Business Standard

The best trade of the last decade

No need for fancy stock-picking. Investors have made a fortune simply by betting against government ownership

Akash Prakash **April 08, 2019** Last Updated at 23:13 IST

As one of my good friends keeps reminding me, the simplest and most profitable trade over the last decade would have been to avoid or go short on any company connected to the government in any form or fashion and go long quality stocks in the rest of the market. If one had had this simple insight a decade ago, one would have massively outperformed any benchmark. No need for fancy stock-picking or deep fundamental analysis, just one macro insight and you could have built an impressive track record, reputation and following. The value migration has been so intense that it has overpowered every other factor.

When he says connected to the government, he means either where the government is the majority owner, or where the government is the principal supplier of inputs for the business or where the government is the main buyer of the product or service and situations where the government is the principal counterparty. This broad definition covers PSUs (public sector undertakings), as well as sectors like real estate, infrastructure, telecom, power etc. Wherever the government has been involved, these stocks and sectors have underperformed. Just look at the data.

Over the last 10 years, the BSE 500 has delivered a return of 310 per cent. Compared to this, the BSE PSU index has delivered a return of 36 per cent. The BSE realty index has delivered a return of 19 per cent and the BSE power index has delivered a return of 4.6 per cent. The Nifty PSU banks index has delivered a return of 98 per cent. These broad indices hide the real damage. If one takes out the oil companies, almost every other large PSU has declined in absolute terms. Just look at BHEL and MTNL. If one were to take out SBI, there has been a bloodbath in almost every other PSU bank. The huge NPA cycle, which destroyed the balance sheet of most corporate banks in India (NPAs surged to between 12 and 15 per cent for most banks) is also linked more to this dynamic of the government being a poor counterparty then most realise. All NPAs are not promoter fraud.

What are the broader implications of this data? How will this impact our pattern of growth and its funding going forward? First of all, the government is a poor owner of commercial businesses. Investors understand this and have made a fortune betting against government ownership. In sector after sector, the playbook has been, bet against the incumbent PSU as soon as a private sector player enters. We have seen this play out in financial services, telecom and aviation— to name just a few sectors. Given our incentive and governance structures, this value migration is inevitable. The government must take heed of this dynamic and realise value from its assets. Once private players are allowed entry into a sector, the longer the government holds on to its assets the more value they lose. Witness what has happened to BHEL and MTNL—there was at one point serious strategic interest in both assets from private players at high valuations. Had the government sold a strategic stake then, it would have realised a much higher value than the market cap of both today. Similar is the case with Air India. It is far better to realise strategic value for these assets and recycle that money into the economy then to just let them wither away. Even worse than withering away, is the example of Air India and the PSU banks where the government has had to pump in thousands of crores just to keep them afloat. Rather than realising value, they become a drain on the exchequer.

Illustration: Ajay Mohanty

The second implication is on funding for infrastructure. No government in India has the resources to fund all the infrastructure needs of the country. We need private sector involvement. We had at one point the most ambitious PPP (public private partnership) programme in the world. This whole initiative is now in shambles. There is absolutely no public equity available for infrastructure. All the players in this space are in retreat and trying to sell operational assets to de-leverage their balance sheets. Given how much money has been lost, it is unlikely that public equity markets will fund infrastructure any time soon. You will need a generational change in money managers to erase the memories of these losses. Our best bet is to sell operational assets to sovereign wealth funds and global pension funds, who are attracted by the yield, and recycle these funds back into infrastructure. Exactly what is happening in the roads sector. Another similar option is to use REIT like structures for both infrastructure and real estate assets to attract domestic yield-based buyers. This model will, however, require the government to take all the pre-operating, construction and regulatory risk. We will need to build up the balance sheet and execution capacity of select public sector organisations in the infrastructure space to enable this build, sell and recycle model. Will our institutional constraints allow this? Hopefully we will manage, as these public infrastructure developers will face no private sector competition.

The government has also to become a better counterparty. There are numerous reports of various government entities routinely delaying payments to suppliers and project developers. The working capital intensity of government business is insane in many cases. We also had the courts driven cancellation of various government licences due to governance failures. Coal mines, telecom licences and various other regulatory approvals were cancelled, in many cases with projects dependent on these approvals midway through their construction cycle. We need to rebuild the credibility of sovereign risk. A government contract or licence should on paper be the safest contract you can sign. It has been far from that in India over the last decade.

Most investors are very bullish on domestic equity flows over the coming years. Morgan Stanley just put out a report forecasting equity inflows of $550 billion over the coming decade into mutual funds, insurance plans and retirement funds. This is a huge number. We have to find a way to channel some of these flows into infrastructure and other government-linked sectors. Currently, this channel is clogged. Declogging this should be one of the top priorities of whoever wins the 2019 election.

The writer is with Amansa Capital