Investment appeal of privatisations

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Privatisations are known to do well on their initial public listing, but are they good investments in the long run? Is it possible to predict their performance?

A PRIVATISATION takes place when a government sells part or all of its equity holdings in a company to the public. This is usually done through an initial public offering, also known as a privatised initial public offering, or PIPO.

The sheer size of privatisations in recent years has caught the attention of the investment community. According to the World Bank, privatisations raised a total of US$450 billion ($554 billion) for companies from 2000 to 2008. Much of this increase occurred in China. Between January 2000 and August last year, the Chinese government alone raised US$175 billion – the largest privatisation proceeds from a single country.

Institutional investors such as investment companies, mutual funds, brokerages, pension funds and insurance companies have been eager investors in privatisation issues. These investors are widely known to be sophisticated and better informed than individual investors.

To see if institutional interest in privatisation correlates with the future performance of companies that underwent privatisations, we conducted a study to measure the predictive power of institutional ownership on the stock-price performance of privatised companies in the long run (up to three years after listing). We also measured their operating performance using standard financial ratios. The institutional ownership was measured three months after the listing of the PIPO. The data for this study came from annual reports and financial databases such as Bloomberg, FactSet and Thomson Reuters.

We examined a total of 333 PIPOs worldwide from January 2000 to August last year. As a whole, PIPOs show significant positive long-run stock returns. The average three-year buy-and-hold abnormal return (that is, returns in excess of how the market performed) is 28 per cent.

Of more interest to the study, PIPOs with institutional ownership show significant positive long-run stock returns, while those without institutional ownership perform no better than the overall market. This suggests institutional investors are able to pick winners, and investors can profit from this knowledge.

We also examined company profitability, operating efficiency and capital expenditure in the three years before and after privatisation. As before, we compared the operating performance of PIPOs with and without institutional ownership. We found that operating performance exhibits the same pattern as stock-return performance.

Despite the hype, the overall performance of Chinese PIPOs was disappointing.

The three-year buy-and-hold excess return for the average Chinese PIPO is minus 12.5 per cent, compared with 63.3 per cent for the average non-Chinese PIPO. Chinese PIPOs after privatisation also show a significant fall in profitability.

On further analysis, we found that institutional ownership again makes a difference to performance. For example, Chinese PIPOs with institutional ownership (which accounts for one third of the Chinese PIPO sample) show significant positive long-run excess returns, in contrast to those without institutional ownership, which actually experience significantly negative excess returns averaging minus 42 per cent three years after listing.

In sum, our findings indicate that institutional ownership plays a big part in the success of PIPOs, particularly in the long run. This is true of all PIPOs globally, and especially so for Chinese PIPOs, which otherwise show mediocre performance.

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