# The Mixed Ownership Model – did it work?

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Greek mathematician and founder of modern-day geometry, Euclid, once said that without assumptions there is no proof. The corollary of that statement is that in any argument we should examine the assumptions underlying the argument carefully.

In his article "SOEs selldown rewarded investors, not taxpayers" published in the NBR on 16 August, Brent Sheather reviews the partial selldown by the government of the three electricity companies, Meridian, Genesis and Mercury (the Mixed Ownership or MoM companies).[1]

Sheather notes the huge increase in the value of the three SOEs that has occurred since their public listing and the large increases in dividends paid by the SOEs. Yet he is quite critical of the public floats of the companies and he argues that the taxpayer lost out from the sales.

The critical assumption that Sheather makes that allows him to reach this conclusion is the assumption that the increases in value and dividends that have occurred in all three of the MoM companies since their sharemarket listings would have occurred if the companies had remained 100% government owned. Sheather makes this assumption and doesn't ask the obvious question of whether the listings were in fact a reason why the companies' performance have improved.

Last year, TDB Advisory published a comprehensive report reviewing the experience of the Mixed-Ownership Model, focusing on the financial performance of the three firms.[2] We met and interviewed senior management and directors of the three companies, and we examined the financial performance of the companies before and after their listing. Our research was independent and undertaken on a pro bono basis and can be found on our website, www.tdb.co.nz .

Our report found major changes in the behaviour in all three of the Mixed Ownership companies once they knew they were to be publicly listed. We found the companies' business strategies changed, with the companies increasing their focus on their core business. Poorly performing or non-core investments were sold, and unnecessary investment proposals were shelved or abandoned entirely. Meridian, for example, sold its stakes in subsidiaries Right House, Whisper Tech and its USA solar business in the lead up to the float and Mighty River (now Mercury) withdrew from its offshore geothermal

[1] The Sheather article can be found at https://www.cpam.co.nz/Articles-Of-Interest/

[2] https://www.tdb.co.nz/wp-content/uploads/2018/10/TDBs-Mixed-Ownership-Review-Jul-18.pdf .

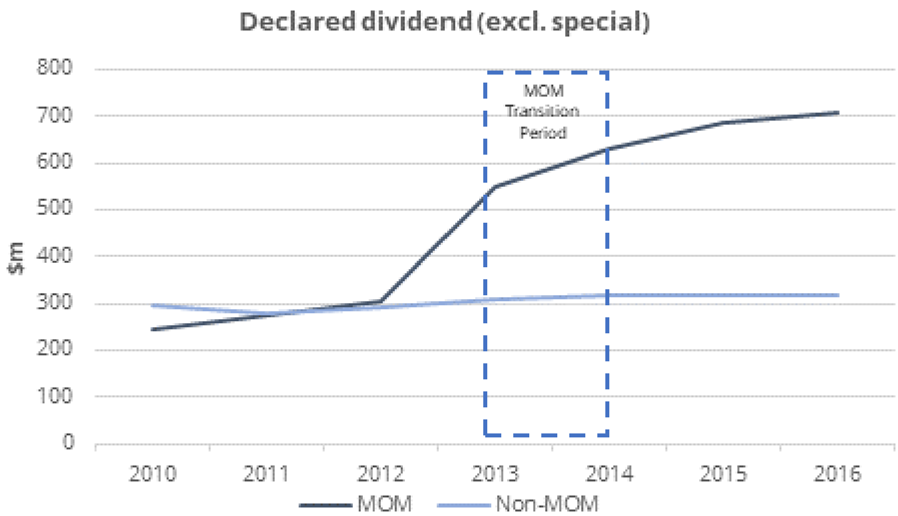
investments in Germany and Chile. This focus back on core business freed up capital and allowed the companies to improve their returns to shareholders.

At the operating level the companies' performance improved too. Following listing, the companies reduced their operating costs and adopted more innovative retail strategies in the face of an increasingly competitive generation and retail market and static electricity demand. Average operating earnings for the three firms increased by $57m p.a. (or 4%) in total. The three companies' average return on assets increased from 7.8% to 8.3% p.a.

Importantly, the increase in earnings by the three companies was achieved without charging higher prices to customers.

Before the sales, the MoM companies average return on assets (RoA) was below that of the two 100% privately owned and listed gentailers, Contact Energy and Trustpower. Following their listing, the three mixed-ownership companies closed the gap, but still remained behind in terms of their RoA.

Sheather claims that the taxpayer has missed out on $3.4 billion in gross dividends because the government sold down its holdings in the firms. The dividend rises though are a direct result of the decisions of the companies to avoid non-core or poor investments and the steps they took to improve their operating performance. As the graph below shows, the increase in dividends for the three MoM companies occurred only once the sales were happening. Further, the dividend increases occurred over a time when the dividends of the two publicly listed energy companies (Contact and Transpower) stayed stable. It's possible perhaps that the large increases in dividends of the three MoM companies might have occurred anyway if the companies had stayed 100% government owned, but it seems highly unlikely. The three MoM companies had low dividend payout ratios when they were 100% government owned while their dividend payout ratios now are in line with the private sector norms.



Sheather claims also that the companies were sold too cheaply because their share prices have risen since their listing. However, what matters when judging whether a company's shares are fairly priced when being floated is the premium (or loss) that occurs on the day the shares are first listed. Whether the share price goes up or down subsequently depends on a multitude of factors that are largely outside the seller's control. Any investor is free to buy or sell shares in the company after they are listed and accept the risk accordingly.

As shown in the table below, the average listing-day premiums when the three MoM companies were floated was 9.9%. That premium is in line with the normal expectations for listing-day premiums in New Zealand capital markets for IPOs of around 10% and below the average actual long-run listing-day premium for New Zealand IPOs of 15.9%. On this basis, there is no reason to claim the MoM companies were under-priced.

| | Listing date | Listing price | First day closing price | Day 1 return |
|---|---|---|---|---|
| Mercury Energy | 10-May-13 | $2.50 | $2.62 | 4.8% |
| Meridian Energy | 29-Oct-13 | $1.50 | $1.62 | 8.0% |
| Genesis Energy | 17-Apr-14 | $1.55 | $1.81 | 16.8% |
| Average | | | | 9.9% |

Sheather argues further that because the government bond rate is below the dividend yield of the three MoM companies, taxpayers have lost out. However, if that was a sound basis for government decision-making, the government should logically borrow and buy every company on the stock market with a yield above the current 1.5% long term rate for government bonds.

Overall what can we conclude from the MoM experience? It is clear that the performance of the three MoM companies has improved markedly since the government sold down its shares. The taxpayer has done very well financially from the sales. The government has repaid debt, is receiving more by way of dividends per share on the shares it retains and has kept 51% control of the companies.

However, we shouldn't, on the basis of the experience with just these three companies, conclude whether the government selling down its holdings of commercial business in general is likely to be good for the taxpayer or the economy. A much larger sample is required.

Fortunately, we can look also to international experience with privatisations over the last forty years. Few issues have been more extensively examined in the empirical economics literature than the effects of privatisation. A recent overview study[3] by Professor Bill Megginson of the University of Oklahoma reviewed the empirical studies published over the last twenty years. Megginson looked at seventeen separate studies published in peer reviewed economic journals. Each of the seventeen studies reviewed hundreds of different privatisation experiences around the world. Megginson found that all seventeen of the studies documented significant performance improvements after companies were divested by the government. Sometimes the improvements were massive.

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[3] William L. Megginson (2017), "Privatization, State Capitalism, and State Ownership of Business in the 21st Century", Foundations and Trends in Finance: Vol. 11, No. 1–2, pp 1–153. DOI: 10.1561/0500000053.