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## **CONTENTS**

- A) OUTSOURCING CORE COMPETENCE AREAS - page 1  
- Suresh S., Director, DMS Financial Services P.Ltd.
- B) NAKED SHORT SELLING – ROLE IN EXACERBATING THE FINANCIAL CRISIS - page 3  
- Padmalatha S.
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## **OUTSOURCING CORE COMPETENCY AREAS**

**by Suresh S.  
Director, DMS Financial Services Co. (P) Ltd.**

Does a company outsource its core competence areas? That would be very risky and expensive. Going by the pattern of American companies we would find that they always manage themselves areas of core competency and outsource the rest. In fact Western companies were known for outsourcing to China and India. Yet we have an outstanding example of how Bharti Airtel (Bharti) did exactly the opposite. It outsourced core competencies and not only that, it demonstrated how an Indian company could outsource to an American company.

- ❑ In 2004 Bharti considered outsourcing the management of its telecom and IT networks to its vendors.
  - ❑ Telecom industry was characterized by the need for ‘technological superiority’. This determined the essence of competitive success. Bharti it seemed was willing to outsource an important component of its technological strength.
  - ❑ Values were not small – Bharti had Capital expenditure of US \$ 400 mn/year in network equipment, and another in IT of \$ 100 mn/year.
  - ❑ Core competencies for Bharti: 1.Network management 2. IT- this provided a meaningful differentiation through innovation, 3. Customer relationship management.
  - ❑ Bharti entered into agreements with (a) Ericsson, (b) Nokia, (c) Siemens and (d) IBM.
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- ❑ The revenues of Bharti were around \$ 1 billion, the subscriber base 4 millions and growing at 400, 000 per month. Bharti had the potential to reach a size enough to rival the largest mobile company in the world. This made it attractive as a customer for outsourcing.
- ❑ The arrangement with IBM was for a 10-year period and payment was a predetermined rate of Bharati's revenues. This raised a furore in the US and was carried on the front page of Wall Street Journal titled: Reverse outsourcing –the story of an Indian company outsourcing its telecom and IT network to the West.
- ❑ Yet another innovation in relation to Ericsson, Nokia and Siemens was to link payment not to installed capacity but to capacity provided (utilized) (erlangs in case of 'network management'). It required that capacity be up and running and that customers had used the capacity.
- ❑ With the kind of growth rates in the industry, Bharti was having a tough time doing its budgeting for capex. Outsourcing was a good solution provided it led to reducing costs. By converting to 'pay-for-use' model, Bharti achieved the elusive task – it had a predictable cost model.
- ❑ IBM used Bharti's strategy as an illustration in public forums.
- ❑ Since the risk of investment in planning and building networks got transferred substantially to the vendors, Bharti agreed to handle itself the investments for passive infrastructure such as towers, air conditioners and generating sets needed in conjunction with the telecom equipment.
- ❑ The copy-cat practice has already caught on:
  - BSNL chose Ericsson for laying out its 3G network
  - Tata Teleservices chose Nokia Siemens Networks for its GSM rollout across the country and managing it for five years.
  - BPL Mobile chose Huawei Technologies for GSM base stations (\$ 20 mns).
  - Orchestrated by Bharti, all Telecom operators have changed the structure for operating Towers. Except Aircel, all hived off towers into a separate entity or sold the towers and leased it back.
  - Now even Aircel is in talks with American Towers (ATC) to sell its 12000 towers.
  - In Dec.'08, Tata Teleservices hived off its tower arm Wireless Tata Telecom Infrastructure and merged it with SREI group company Quippo Telecom Infrastructure.

- Ahead of Quippo in size are Indus Towers, Reliance Telecom Infrastructure, Ortus Infratel, and Bharti Infratel.
- Hiving off Tower business into a separate entity enables the Telecom operator to derive better valuation for his business. Sale of Towers enables them to expand existing operations using the sale proceeds. Now the upcoming 3G spectrum auctions are the motivation to hold additional resources.

Thus it can be seen that Bharti has re-written lessons in strategy by adventuring to outsource core competence areas. It is now looked upon as a 'leader' in the Indian telecom industry for practices and has made the West sit up and acclaim its model.

## **NAKED SHORT SELLING – ROLE IN EXACERBATING THE FINANCIAL CRISIS**

***by Padmalatha S.***

The present crisis is of [still] unimaginable global dimensions. It is therefore natural that the 'blame game' will look at all possible causes – proximate and remote. What began as the consequence of dilution of lending practices based on the strength of opaque credit risk transfer mechanisms has unravelled several other undesirable goings on as well. One of these is 'naked short selling' – which some prefer to call 'abusive naked short selling'. Though several legislations were brought about in the US earlier to this debacle to curb naked short selling, they have not been effectively implemented with decisively deterrent punitive measures. Hence, when short sellers found an opportunity in the illiquidity of financial institutions reeling under the sub prime crisis, they exacerbated the situation by indulging in the abusive short selling practice, to artificially depress the stock prices of the ailing institutions.

Why are financial institutions more vulnerable to such undesirable practices? For firms outside the financial services industry, a sharp and sustained fall in share prices may reflect the market's negative perception of the firm's future value, but does not threaten the viability of the firm itself. However, for highly leveraged financial institutions that typically depend on short term funding for their business, a massive share price fall would reflect declining market confidence in the institution, and could ultimately result in a run on the bank, threatening its very existence.

Hence, naked short selling did play a part in the downfall of Bear Sterns and Lehman, but the practice per se was not the primary cause. However, as in the case of banks rushing to dole out subprime loans, the 'greed' and 'opportunistic' factor behind naked short sellers' motives in the downfall of these two institutions cannot be disputed.

### ***Blame the instrument?***

Short selling has been encouraged in most markets, including in India, since it provides liquidity and allows for hedging of long positions. They are not illegal. However, there are two important

***preconditions to a short sale – that the borrowed shares are ‘located’, and the actual delivery of shares takes place within the stipulated time period.***

In a naked short sale, however, both these conditions could be violated. This could result in the short shares exceeding the number of outstanding shares, thus creating an impression that there is active trading in the shares. Combining this with false or partly true rumours about the company’s health would drive down the company’s share prices and fuel a sell off. On delivery date, there are no shares to deliver, since probably these shares never existed. Hence, naked short sales not supported by actual delivery appear designed to deceive.

### ***The operational Hazards***

Some operational hazards of permitting naked short selling would be

Short sellers have to merely ‘locate’ the stock before they sell it. There should be some foolproof mechanism to ensure that the real stock is actually located and the short sale does not happen on phantom stock or on the basis of an agreement with the broker.

Under the present rules, the SEC gives hedge funds 3 days to deliver the stocks they short sell. Since the hedge funds do not possess the real stock before selling, there is a possibility that the hedge fund offloads a lot of phantom stock into the market for 3 days, which defeats the very purpose

The hedge funds can also settle the short sale with another block of phantom stock.

Worse still, there are still no serious deterrent penalties proposed for failing to deliver the stock

### ***Naked Shorting – advantage liquidity***

The practice of naked shorting does have the benefit of enhancing liquidity in difficult to borrow shares. However, the practice should be subjected to rigorous regulation, as had been done in the renewed ban in October 2008 in the US in which the requirements had been made more stringent – short sellers must now either borrow the security or enter into bona fide arrangement to borrow the security, and must deliver the securities within the stipulated period, with severe deterrent penalties imposed for failure to deliver.

Banning shorting or non abusive naked shorting may have a temporary or even artificial effect by increasing stock prices due to the elimination of downward short pressure. However, market volatility may also increase since a source of liquidity no longer exists. For example, hedge funds may be unable to short sell certain stocks while buying certain other stocks. Or option markets could be handicapped since offsetting short hedges cannot happen. However, when bans are lifted or relaxed, the flood of shorts could give rise to a wave of crisis sales or price falls.

### ***Challenges before the SEC in reining naked short selling***

Regulation SHO was enacted in 2005 to curb naked short selling. The regulation required that broker dealers have sufficient reason to believe that shares will be available for a given transaction, and that delivery would take place within a limited time period. The regulation has

been made more stringent in October 2008, but as expressed earlier, it remains to be seen whether the new ban is effective in curbing market malpractices.

This is with regard to the capital markets over which SEC exercises control. But who will regulate the CDS markets, which have been as responsible for the current situation? Naked bets on credit default can still happen – buyers would profit from declining debt values - very similar to short sales. On the other hand, sellers can default since they lack sufficient capital to support their obligations, leading to further credit crunches and financial institutions' defaults on CDS obligations. CDS obligations are not securities that the SEC typically controls, since CDS is an OTC contract.

Another issue in this regard is – how effectively can SEC control hedge fund activities? Hence merely imposing a ban on naked short selling may not solve the problem for SEC.

### ***India – naked short sales banned***

Though SEBI has allowed all market participants – institutions and retail investors alike – to short sell stocks, naked short selling [where the seller does not deliver shares within the settlement period] is explicitly banned. In a circular, SEBI says: “The stock exchanges shall frame necessary uniform deterrent provisions and take appropriate action against the brokers for failure to deliver securities at the time of settlement, which shall act as sufficient deterrent against failure to deliver.”

It does appear that this cautious approach of the Indian regulators has been one of the major reasons for insulating the Indian financial system from the global crisis.

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### **Services offered by DMS Financial Services Co. (P) Ltd.**

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**For details, please contact Mr.Karthi on 044-24995672.**