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STOCK MARKET

FOREIGN INSTITUTIONAL INVESTORS (FIIs): INCREASING TREND IN INDIA

RAJESH KUMAR A. SAINI

Foreign institutional investors have gained a significant role in Indian capital markets. Availability of foreign capital depends on many firm specific factors other than economic development of the country. This write-up examines the contribution of foreign institutional investment particularly among companies included in sensitivity index (Sensex) of Bombay Stock Exchange and an effort has been made here to develop an understanding of the investment decisions, trading strategies and behaviour of the FIIs in Indian equity markets. The author opines that foreign investors invested more in companies with a higher volume of shares owned by the general public and choose the companies where family shareholding of promoters is not substantial. Among the financial performance variables the share returns and earnings per share are significant factors influencing their investment decision.

Introduction

1. Entities covered by the term 'FII' include Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or investments on behalf of a broad-based fund.

Foreign portfolio inflows through FIIs, in India, are important from the policy perspective, especially when the country has emerged as one of the most attractive investment destinations in Asia.

With the emerging market crisis of the late 1990s, the role of Foreign Portfolio Investment (FPI) and the major players therein, *i.e.*, the Foreign Institutional Investors (FIIs) has come under intense scrutiny by academics as well as policymakers. A general perception about the FIIs is that they are speculators and their investment is motivated by short-term gains. The FIIs in pursuit of short-term gains adopt short-term trading strategies such as positive feedback trading and herding (*i.e.*, buy or sell stocks together as a group). Such behavioural biases of FIIs, it is believed, may lead to price overreaction and contribute to the creation or exacerbation of a financial crisis.

What is FII ? How it is permitted ?

2. An investor or investment fund that is from or registered in a country outside the one in which it is currently investing. Institutional investors include hedge funds, insurance companies, pension funds and mutual funds.

The term is used most commonly in India to refer to outside companies investing in the financial markets of India. International institutional investors must register with the Securities and Exchange Board of India to participate in the market. One of the major market regulations pertaining to FIIs involves placing limits on FII ownership in Indian companies.

Foreign Direct Investment in India is permitted under the following forms of investments :

- Through financial collaborations.
- Through joint ventures and technical collaborations.
- Through capital markets *via* Euro issues.
- Through private placements or preferential allotments.

FDI is not permitted in the following industrial sectors :

- Arms and ammunition.
- Atomic Energy.
- Railway Transport.
- Coal and lignite.
- Mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper, zinc.

Foreign direct investments in India are approved through two routes :

(*a*) *Automatic approval by RBI* - The Reserve Bank of India accords automatic approval within a period of two weeks (provided certain parameters are met) to all proposals involving :

- Foreign equity up to 50 per cent in 3 categories relating to mining activities.
- Foreign equity up to 51 per cent in 48 specified industries.

- Foreign equity up to 74 per cent in 9 categories.
- FDI up to 26 per cent in the Insurance sector is allowed on the automatic route subject to obtaining licence from Insurance Regulatory & Development Authority (IRDA).

Investments in high-priority industries or for trading companies primarily engaged in export are given almost automatic approval by the RBI.

(*i*) *FDI in India on automatic route is not allowed in the following sectors :*

- Proposals that require an industrial licence and cases where foreign investment is more than 24 per cent in the equity capital of units manufacturing items reserved for the small-scale industries.
- Proposals in which the foreign collaborator has a previous venture/tie-up in India.
- Proposals relating to acquisition of shares in an existing Indian company in favour of a Foreign/Non-Resident Indian (NRI)/ Overseas Corporate Body (OCB); and
- Proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted and/or whenever any investor chooses to make an application to the Foreign Investment Promotion Board and not to avail of the automatic route.

(*b*) *FIPB Route* - Foreign Investment Promotion Board (FIPB) is a competent body to consider and recommend foreign direct investments, which do not come under the automatic route. Normal processing time of an FDI proposal in FIPB is 4 to 6 weeks. FIPB is located in the Department of Economic Affairs, Ministry of Finance. Its constitution is as follows :

- Secretary, Department of Economic Affairs (Chairman)
- Secretary, Department of Industrial Policy & Promotion (Member)
- Secretary, Department of Commerce (Member)
- Secretary, (Economic Relations), Ministry of External Affairs (Member)

FIPB can co-opt Secretaries to the Government of India and other top officials of financial institutions, banks and professional experts of industry and commerce, as and when necessary.

Foreign Investment Implementation Authority (FIIA)

The Government has set up Foreign Investment Implementation Authority (FIIA) to facilitate quick translation of FDI approvals into implementation by providing a pro-active one stop after-care service to foreign investors, help them obtain necessary approvals and by sorting their operational problems. FIIA is assisted by Fast Track Committee (FTC), which has been established in 30 Ministries/Departments of Government

of India for monitoring and resolution of difficulties for sector specific projects.

3. Factors contributed significantly to the FII flows to India

- *Regulation and Trading Efficiencies* - Indian stock markets have been well-regulated by the stock exchanges, the SEBI and RBI leading to high levels of efficiency in trading, settlements and transparent dealings enhancing the confidence level of FIIs in increasing allocations to India.
- *New Issuance* - We have witnessed extremely high quality issuance during the year from companies such as NTPC, ONGC and TCS leading to strong FII participation with successful new issuance of over $ nine billion, yet another record for the year.
- *Attractive Markets* - Indian equity markets continue to be attractive to foreign investors with expected earnings growth of over 13 per cent compared with negative growth expected among competing countries in the region such as Taiwan and Korea. Indian blue chips are seen to have high quality of balance sheets with net debt to equity of the top 30 companies being negative, with net cash on the balance sheets. However, earnings growth is expected to be lower than last year and upside in stock prices will be subject to sentiments in the global markets and foreign flows to emerging markets. However, high quality new issuance from PSUs and other large corporates will continue to see good demand from FIIs. However, domestic mutual funds have been net sellers of equities during 2004 with risk aversion still prevalent among local investors after seeing several short periods of high volatility. With the booming stock markets presently catching the headlines in local press, this trend will hopefully reverse during 2005.
- *Outsourcing* - The rhetoric over outsourcing of jobs to India has died down after the US elections and demand will soar for Indian BPO and software service companies. However, Indian software companies will need to enhance margins by going up the value chain to high level consulting and scaling up the project sizes. Significant outsourcing opportunities will also open up in textiles and drugs with dismantling of quotas for textiles and introduction of product patent regime for pharmaceuticals.
- *Infrastructure* - Woefully inadequate infrastructure is the biggest bottleneck for the growth and profitability of Indian corporations. The administration needs to move much faster in privatisation of Projects in the areas of power, transportation, ports, airports and other urban infrastructure to enhance competitiveness. This is particularly relevant due to the fact that competing countries in Asia Pacific and China have moved at a much faster pace during the last five years and have in place a first world infrastructure.
- *Capex Cycle* - With strong balance sheets, high liquidity in the banking system, supportive capital markets and growing demand for goods

and services we expect to see a strong wave of capital expenditure cycle during the year leading to tremendous opportunities for Indian equities.

- *Dollar Weakness* - Analysts continue to look for a weak US Dollar with the US twin deficits (Budget and trade deficits) unlikely to be resolved anytime soon. Studies have shown that flows into emerging markets rise significantly during times of Dollar weakness and India will continue to be a beneficiary of this trend. Indian Rupee is expected to strengthen further during 2005 which will be particularly favourable for domestic demand oriented businesses such as banks and automobiles.
- *Rising Commodity Prices* - Demand supply dynamics in both crude and metals call for higher prices during 2005 with increasing Chinese demand and economic recovery in Japan. This has inflationary implications for India going forward, though it will be a boon for commodity counters.
- *Consolidation* - FII activity has been focused on large cap companies due to liquidity reasons, and, hence, several high quality mid cap companies trade at a valuation discount due to lack of investor demand. We expect to see significant merger activity among mid caps which will enable them to gain better valuations under the institutional radar screen, in addition to consolidation efficiencies. While China attracts significantly higher FDI, India with its highly developed capital markets will be a beneficiary of FII flows at increasing pace each year. To summarise, Indian markets have successfully absorbed the gains seen during 2003 and consolidated well during 2004 with a modest gain and look set to outperform the global financial markets during 2005.

4. Trends of FII investment in India

- *Past years' FII investment in India*

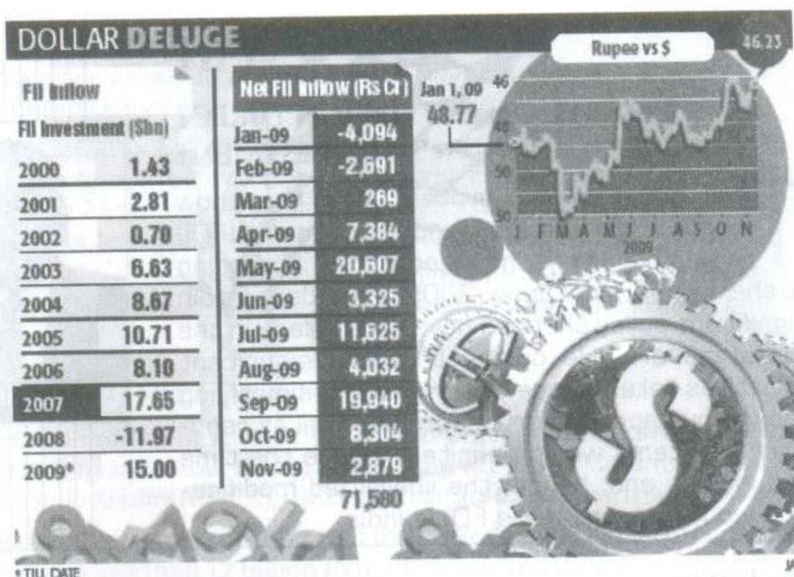
Year	*Gross Purchases (Rs. crore)*	*Gross Sales (Rs. crore)*	*Net Inv. (Rs. cr.)*
1993	2,661.90	66.8	2,595.10
1994	9,267.20	2,476.10	6,791.20
1995	6,665.90	2,812.20	3,853.80
1996	15,739.20	4,935.60	10,803.60
1997	18,926.50	12,719.20	6,207.30
1998	13,899.80	15,379.70	-1,479.90
1999	37,211.50	30,514.70	6,696.80
2000	77,666.60	71,155.40	6,511.20
2001	56,799.20	43,506.50	13,292.70

Year	Gross Purchases (Rs. crore)	Gross Sales (Rs. crore)	Net Inv. (Rs. cr.)
2002	5,446.00	4,746.70	699.30
Total	**2,44,283.80**	**1,88,313.00**	**55,970.00**

- *2009 : FII Investment is increasing in India* - Nearly half of the Rs. 70,000 crore offshore investments that have come into Indian bourses this fiscal, till October 2009, is from alleged tax havens such as Mauritius, Hong Kong and Luxembourg—the three together contributing almost Rs. 25,000 crore of the net inflow from FIIs. Significant omissions from this list are FIIs of Singapore and Switzerland, the two countries that had figured among the top five with the highest investments in Indian equities during the economic slowdown of 2008. FIIs from the two countries had put in over Rs. 15,000 crore last year. The Government has said that there is no cause of concern on the strong FII flow into stock markets with Finance Minister, Pranab Mukherjee stating that regulators were keeping a close watch on the money flow and would act if it was alarming.

  Till October 2009, FII held equities totalling to more than $160 billion. According to a Finance Ministry statement, the highest investments have come from US-based FIIs, to the tune of Rs. 21,344 crore till November 10. Second on the list is Luxembourg with Rs. 12,275 crore. France, Mauritius, the UK, UAE, Hong Kong, Australia, Norway and Canada are the other countries in the top 10, in that order. Investments from Mauritian FIIs have been Rs. 9,400 crore, ahead of the UK (Rs. 4,900 crore), UAE (Rs. 4,800 crore) and Hong Kong (Rs. 3,438 crore).

  What can be of concern for the Government is the rising share of Participatory Notes (PNs) in the total FII flow into stock markets. Since the identity of PN investors is not known, the Government had put a tight leash last year on such investments after it feared that some dirty money may have entered the market riding on P-notes. The story was similar in 2006 when Luxembourg topped all other countries with maximum investment of Rs. 12,600 crore. The top four that year included Singapore, Hong Kong and UAE—the US was a distant fifth with Rs. 3,300 crore FII investments.



FII Inflow

FII Investment ($bn)	
2000	1.43
2001	2.81
2002	0.70
2003	6.63
2004	8.67
2005	10.71
2006	8.10
2007	17.65
2008	-11.97
2009*	15.00

Net FII Inflow (Rs Cr)	
Jan-09	-4,094
Feb-09	-2,691
Mar-09	269
Apr-09	7,384
May-09	20,607
Jun-09	3,325
Jul-09	11,625
Aug-09	4,032
Sep-09	19,940
Oct-09	8,304
Nov-09	2,879
	71,580

* TILL DATE

- *One-third of investments made* via *PNs* - Poor market conditions towards the end of 2008 had forced the Government to remove restrictions on Participatory Notes (PNs), but it had asked FIIs to register in India rather than investing through PNs. It is estimated that of net FII inflows of Rs. 44,000 crore during September-October 2009, nearly a third, or Rs. 14,000 crore investment was on account of PNs.

Conclusion

5. Domestic sources of outside finance are limited in many countries, particularly those with emerging markets. Through capital market liberalization, foreign capital has become increasingly significant source of finance.

India is a labour intensive country. Therefore, in developing countries like India foreign capital helps in increasing the productivity of labour and to build up foreign exchange reserves to meet the current account deficit. Foreign Investment provides a channel through which a country can have access to foreign capital.

It is required to understand when they withdraw their funds and when they pump in more money. Higher Sensex indices and high price earnings ratio are the country level factors attracting more foreign investment in India.

Market performance is the strong basis for attracting more foreign investment for the individual companies in India. The foreign institutional investors withdraw their money when the stock market performance starts sliding down.