Foreign Institutional Investment Flows (FIIs) in Indian Companies

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1. INTRODUCTION

In the context of the balance of payments crisis of 1991, a comprehensive structured and financial sector reform process was initiated in India as recommended by committee on the financial system (Chairman M. Narasimham, 1991) which became the starting point for gradual deregulation of financial sector and development and integration of various segments of financial markets. As a result of this, the Indian stock market has witnessed metamorphic changes and a transition-from a "dull" to a highly "buoyant" stock market. Improved market surveillance system, trading mechanism and introduction of new financial instruments have made it a center of attraction for the international investors.

Foreign investment - both portfolio and direct varieties - can supplement domestic savings and augment domestic investment without increasing the foreign debt of the country. Such investment constitutes non-debt, creating financing instruments for the current account deficits in the external balance of payments. Capital inflows into the equity market give higher stock prices, lower cost of equity capital, and encourage investment by firms. Foreign investors often help spur domestic reforms aimed at improving the market design of the securities markets, and help strengthen corporate governance.

The Indian stock market is getting increasingly integrated with the rest of the world. Indian companies have been permitted to raise resources from abroad through issue of ADR's, FCCB and CCB's. Further, foreign companies are allowed to tap the domestic stock markets. NRI's and OCB's are allowed to invest in Indian companies. FIIs have been permitted to invest in all types of securities including govt. securities. The investments by FIIs enjoy full capital account convertibility. They can invest in a company under portfolio investment route up to 24% of the paid up capital of the company. This can be increased up to the sectoral cap/ statutory ceiling, as applicable. The Indian stock market has witnessed unprecedented buoyancy in recent years. Strong macro-economic fundamental, positive investment climate, sound business outlook and continued foreign institutional investment supplemented by the active participation of domestic financial institutions have driven the bullish trend. Benign inflation rate, record level of foreign exchange reserves and fiscal consolidation by the Government made the Indian securities market more attractive for the overseas investors. Moreover, the recent initiatives by the Government for developing the corporate debt market, increasing the ceiling on investment by FIIs in the domestic debt market and moving towards convertibility of rupee in the capital account are the positive factors, which emboldened the market sentiment. Indian stock market has experienced a steady growth both in terms of registered FIIs (1110 as on October 5, 2007) and their volume of investment (US$35.93 billion at the end march 2005 -06). With 23 organized stock exchanges, 1758865 Cr. annual market capitalization (at the end march 2006) and 443175 US $ million annual turnover (at the end march 2006) and more than 2 crore household investors, Indian stock market is believed to be dominated by Foreign institutional investors.

The Indian financial market was opened to the foreign institutional investors in 1992 to widen and broaden the Indian capital market. Since then, the net investment by FIIs in India has been positive every year except in 1998-99 (Table-1). During the last three years, there has been a phenomenal increase in the portfolio investment by FIIs in the Indian market. The gross purchases of debt and equity together by FIIs increased by 59.9 per cent to Rs.3,46,978 crore in 2005-06 from Rs.2,16,953 crore in 2004-05. The gross sales by FIIs also rose by 78.6 per cent to Rs.3, 05,512 crore from Rs. 1, 71,072 crore during the same period. However, the net investment by FIIs in 2005-06 declined by 9.6 per cent to Rs.41,467 crore in 2005-06 from Rs.45,881 crore in 2004-05 mainly due to large net outflows from the debt segment. The cumulative net investment by FIIs at acquisition cost, which was US$15.8 billion at the end of March 2003, rose to US$ 45.3 billion at the end of March 2006. Several factors are responsible for increasing confidence of FIIs on the Indian stock market which include, inter alia, strong macro-economic fundamentals of the economy, transparent regulatory system, abolition of long-term capital gains tax and encouraging corporate results. Reflecting the congenial investment climate, the total number of FIIs registered with SEBI increased to 993 during 2005-06 compared to 685 a year ago, an increase of 308 over the year. A distinctive feature of the profile of the newly registered FIIs relates to increase in registration from the unconventional countries such as Malaysia, Australia, Saudi Arabia,Trinidad and Tobago, Denmark, Italy, Belgium, Canada, Sweden, and Ireland etc.

The FII investment in equity increased significantly since 2003-04. During 2005-06, FIIs increased their net investment in equities. The net FII investment in equity during 2005-06 was Rs.48,801 crore, the highest ever in a single year. Buoyancy in the markets was sustained in 2005-06 on account of surge in net investment by the institutional investors with FIIs playing a major role. Month-wise, FII investment was negative in the months of April, May and October 2005.

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However, during the remaining months of the financial year, there was large net equity investment by FIIs, particularly in the second half of 2005-06, which drove the benchmark indices to surpass the earlier record highs on several occasions. The net FII investment in December 2005 was the highest for 2005-06, followed by July 2005 and February 2000.

Table-1 : FII Investment in India

Year	Gross purchase (Rs.Crore)	Gross sale (Rs. Crore)	Net investment (Rs. Crore)	Net investment (US $ mn.)	Cumulative net investment (US $ mn.)
1992-93	17	4	13	4	4
1993-94	5593	466	5126	1634	1638
1994-95	7631	2835	4796	1528	3167
1995-96	9694	2752	6942	2036	5202
1996-97	15554	6979	8574	2432	7634
1997-98	18695	12737	5957	1650	9284
1998-99	16115	17699	-1584	-386	8898
1999-2000	56856	46734	10122	2339	11237
2000-01	74051	64116	9934	2159	13396
2001-02	49920	41165	8755	1846	15242
2002-03	47061	44373	2689	562	15805
2003-04	144858	99094	45765	9950	25755
2004-05	216953	171072	45881	10172	35927
2005-06	346978	305512	41467	9332	45259

Source; Sebi

India has emerged as an important destination for global investment. This is reflected in the no. of Foreign Institutional Investors (FIIs) registered with Sebi All FIIs registered with market watchdog Sebi have increased from 10 in Jan.1993 to 1110 on October 5, 2007 (Table-2)

Table-2 : Registration of FIIs.

Financial year	Total registered at the end of the year
1992-93	0
1993-94	3
1994-95	156
1995-96	353
1996-97	439
1997-98	496
1998-99	450
1999-2000	506
2000-01	528
2001-02	490
2002-03	502
2003-04	540
2004-05	685
2005-06	993
As on October 5, 2007	1110

Table-3 : Country- wise FII Registered with SEBI as on March 31, 2006

Country	FIIs
USA	342
United Kingdom	148
Luxembourg	84
Singapore	47
Hong Kong	30
Canada	26
Australia	23
Ireland	23
Netherlands	23
Mauritius	22
Switzerland	19
France	17
Denmark	11
Others	87

Source; SEBI

About 90% FIIs come from the top 13 countries, there has also been an increase in the no. of FIIs registration from non-traditional countries like Malaysia, Australia, Saudi Arabia, Denmark, Italy, Belgium etc.(Table-3)

Since FIIs investing heavily in Indian stock markets, there is a need to understand the impact of FIIs investment on the Indian companies by analyzing the change in their shareholding pattern. The paper is organized as follows: in section 2, brief review of literature is presented, section 3 sets out the objectives of the study, Section 4 describes the data, sources and methodology, Empirical results are explained in Section 5 and Section 6 concludes the paper.

2. REVIEW OF LITERATURE

Bhanumurthy and Rai (2003) by using monthly data from January 1994- November 2002, examine the determinants of FIIs in Indian context by analyzing the effect of return, risk and inflation in domestic and foreign economy. Domestic and foreign returns are calculated using Bse sensex for Indian stock prices and S$P 500 for US stock prices. To capture risk, monthly standard deviations are computed from daily returns on Bse sensex and S$P 500. He uses ex-ante risk rather than realized risk, because realized risk represents a combination of ex-ante risk and unexpected risk. Whole sale price index is used to calculate year on year inflation in India and Producer Price Index is used to calculate inflation in US. He finds that FII inflows depend on stock market returns, inflation rate (both domestic and foreign) and Ex-ente risk. Brennan and Cao (1997) move from stocks to flows, accepting this foreign local asymmetry. They construct a model in which purchases of foreign equities are an increasing function of the return on the foreign equity market index. A public signal moves investors to revise their priors and hence change their portfolios; the less well informed foreign investors revise the means of their distributions more than do the better informed locals, so price moves simultaneously in the same direction as foreign purchases. The story is appealing, but their empirical support for it is weak: 'our model is able to explain only a small proportion of the variance of international equity

portfolio flows'. Using a monthly data-set for the period May 1993 to December 1999, Chakrabarti (2001) finds that the FII net inflows were not only correlated with the return in Indian equity market but was more likely the effect than the cause of the Indian equity market return. FIIs do not appear to be at an informational disadvantage compared to domestic investors in the Indian markets. Furthermore, the Asian crisis marked a regime shift. In the post-Asian crisis period, the return in the Indian equity market turned out to be the sole driver of the FII inflow, while for the pre-Asian crisis period; other covariates reflecting return in other competing markets were also correlated with FII net inflow. Batra (2003) uses daily data on FII equity purchases and sales and equity returns between January 2000- December 2002 on the BSE sensex and monthly data between January1994 to December 2002.He examines three issues, firstly if trading by FIIs reveals any trends of positive feedback trading secondly, if there is evidence of herding by the FIIs and lastly the destabilizing impact, if any, of the FII trading strategies on stock prices in India. To test positive feed back strategy, he predicts a relation between the past performance of the market (as indicated by value of market index) and the current FII investment. Herding is calculated by following the measure proposed by Lakonishok, Shleifer and Vishny (LSV, 1992) and Wermers (1998). He finds strong evidence of positive feedback strategy followed by FIIs at the aggregate level on a daily basis. However, there is no evidence of positive feedback trading on a monthly basis. There are almost no dynamics between long horizon returns and net equity purchases. He indicates that foreign investors have a tendency to herd on the Indian equity market even though they all may not do it on the same day. In times of pressure in the stock market on account of a financial crisis in the region, there is excessive selling side herding even through the extent of herding on the average and on either size of the market during a crisis may be lower than that in the immediate preceding period. Bonser-Neal et al (2002) analyzes the foreign trading behavior on the Jakarta stock exchange (Indonesia) between 1995 and 2000.They detect herding and positive feedback trading by foreign investors, but find no evidence to indicate that such trading behavior by foreign investors destabilized the market prices during the Asian crisis. Griffin et al (2002) uses a theoretical model and empirical analysis to show that global stock return performance is an important factor in understanding equity flows.
Dornbusch and Park (1995) argue that foreign investors pursue positive feedback trading strategies that make stocks overreact to changes in fundamentals.

3. OBJECTIVES

Following are the main objectives of the present study:
(i) To analyze the impact of FII investment on the shareholding pattern of Bse sensex companies.
(ii) To study the magnitude of change in the share of various shareholders for the entire study period.

4. DATA AND METHODOLOGY

In order to analyze the impact of FII investment on Indian companies, this study has taken up the 30 companies included in Bse sensex which has a market capitalization of Rs. 1758865 Cr.at the end of 2006.Quarterly shareholding pattern information of Bse sensex companies is taken from CMIE data base. We looked at shareholding pattern of these companies from quarter Dec 2001 to Dec 2006. For each quarter percentage of share held by each category of shareholder as well as percentage change for the entire reference period is calculated.

5. EMPIRICAL RESULTS

Table-4 : Shareholding Pattern of Bse Sensex Companies (%)

Category	Dec01	Dec02	Dec03	Dec04	Dec05	Dec06	% change
Promoters holding	29.09	28.36	31.75	37.02	38.17	38.67	32.94
MF/UTI	7.43	6.43	4.82	4.09	3.89	4.66	-37.28
Banks.FIs. insurance co's	12.76	13.89	12.27	9.85	9.09	9.23	-27.66
FIIs	17.17	16.06	21.24	22.28	23.42	22.98	33.84
Corporate bodies	8.48	7.5	5.30	4.42	3.47	3.33	-60.73
Individuals	17.36	16.27	13.50	12.35	11.76	11.90	-31.45

It can be seen that the shareholding pattern of sensex companies has gone through a change since Dec 2003-04 (Table-4). The percentage of shares held by each of the categories of shareholders has registered a change. While the share of promoters and FIIs are increasing considerably, the share of MFs/UTI, banks, FIs and insurance companies and corporate bodies and individuals are on the declining spree. The FIIs have become the second largest shareholder in these companies after the promoters since 2003 (Table-4). Upto Dec 2002, domestic financial institutions (DFIs) were the second largest shareholder among the non promoters shareholder group (Table-5) .In Dec 2001, individuals were second largest shareholders slipped to third position in Dec. 2006.The largest decline is being observed in the shareholding of corporate bodies in non promoters-non institutions category. Their share recorded 60.73% decline over the period Dec 2001 to Dec 2006.Except the share of FIIs, the share of all other participants declined in non promoters' category during the study period. However, the share of DFIs has increased marginally from 12.98% in Dec 2005 to 13.89% in Dec. 2006(Table-5).

Table-5 : Comparison of shares held by Domestic Financial Institutional Investors (DFIs) and FIIs

Category	Dec 01	Dec 02	Dec03	Dec04	Dec05	Dec06	% change
DFIs+ MFs*	20.19	20.32	17.09	13.94	12.98	13.89	33.84
FIIs*	17.17	16.06	21.24	22.28	23.42	22.98	-31.20

*shares shown as a percentage of the total outstanding shares

In addition to FIIs, individuals and corporate bodies have also invested in the sensex companies. While the share of FIIs has increased by33.84%, the share of individuals and corporate bodies showed record decline of 31.45% and 60.73% respectively. However, from March 2006 to Dec. 2006, share of both FIIs and corporate bodies decline by 4.33% and 7.55% respectively (Table-6).

Table-6 : Shares held by Foreign Investors (%)*

Category	March06	June 06	Sept.06	Dec.06	% change
FIIs	24.02	23.13	23.56	22.98	-4.33
CBs	3.60	3.11	3.23	3.33	-7.5
Total	27.62	26.24	26.79	26.31	

* As a percentage of the total outstanding shares.

Last one year quarter- end analysis gives marginally optimistic results for domestic participants. Whereas the share of FIIs and corporate bodies have declined by 1.88% and 4.03 % respectively MFs ,banks and insurance co's share and individuals share increased by 19.79%, 1.55% and 1.19% respectively (Table-7). It appears that more and more people prefer mutual funds as their investment vehicle. This change in investors' behavior is induced by evolution of a regulatory framework for MFs, tax concessions offered by govt. and preference of investors for passive investing.

Table-7 : Shares held by various categories of shareholders (%)*

Category	Dec 05	Dec 06	% change
Promoters holding	38.17	38.67	1.31
MF/UTI	3.89	4.66	19.79
Banks.FIs. insurance co's	9.09	9.23	1.55
FIIs	23.42	22.98	-1.88
Corporate bodies	3.47	3.33	-4.03
Individuals	11.76	11.90	1.19

*As a percentage of total outstanding shares.

When we look at the frequency distribution of FII shareholding in these 30 companies (Table-8), we find that FIIs have increased their stake in these companies particularly after 2003. Since 2003, one company viz.Housing Development Finance Corporation Ltd. has more than 60% FII stake. Further, in as many as 12 companies, the shares held by FIIs are more than 10% of the total outstanding shares of these companies. Majority of the companies have FII stake in the range of 10%-20% respectively.

Table-8 : Frequency distribution of FII shareholding in Bse sensex companies

Class interval	Dec01	Dec02	Dec03	Dec04	Dec05	Dec06
0-10	11	12	8	5	5	4
10-20	12	12	11	11	11	12
20-30	4	2	8	10	7	6
30-40	2	2	0	0	4	5
40-50	1	1	2	2	1	2
50-60	0	1	1	1	1	0
60-70	0	0	1	1	1	1

6. CONCLUSIONS

The foreign portfolio flows have become the important source for strengthening and improving the functioning of the domestic capital markets. There is a general understanding that Indian stock market is primarily driven by FIIs, we find that the FII investment in the Bse sensex companies is about 34% of the total outstanding share, which is not significant as compared to the size of our capital market. The figures at the macro level also suggest that the relative share of foreign portfolio flows is marginal. According to the no. of transactions, Bse occupied 6th position in 2006. In terms of listed companies, Bse ranks first in the world. India has a turnover ratio of 94.2% which is quite comparable to the other developed markets like the U.S.A. and U.K. which has turnover ratios of 129.1% and 141.9% respectively. According to Standard and Poor's Fact book, India ranked 17th in terms of market capitalization and 18th in terms of total value traded in stock exchanges and 20th in terms of turnover ratio as on Dec. 2005.Further, share of domestic financial institutions in these companies is declining since 2003 (except 2005-06) while FIIs are occupying significant place. However, last one year quarter- end analysis gives somewhat optimistic results for DFI. We must take appropriate steps to improve investors' awareness in order to expand equity cult among the small savers. Recent trend of increased investors' preference to participate in equity markets through mutual fund conduit would enhance institutional investment in equity markets. The institutional and regulatory architecture should facilitate this further as this would counterbalance and cushion the impact of the swings in the stock prices.

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involving a competing acquisition proposal, Novelis may be required to pay Acquisition Sub a termination fee of $100 million or, in certain circumstances, to reimburse costs and expenses of HINDALCO and its affiliates, to a maximum of $15 million. In connection with this process, Novelis has incurred or will incur fees and expenses, including a termination fee with an unsuccessful bidder.

HOW THE FUND WILL BE ARRANGED BY HINDALCO:

Hindalco borrowed almost $2.85 billion of the balance ($300 million was being raised as debt from group companies and $450 million was being mobilized from its cash reserves). The second part of the deal was $2.4-billion debt on Novelis's balance sheet. Hindalco would have to refinance these borrowings, though they would be repaid with Novelis's cash flows.

CHALLENGES THAT HINDALCO WOULD FACE IN INTEGRATING THE OPERATIONS:

Hindalco's consolidated debt-equity ratio may skid from about 0.5:1 to well over 2:1. The estimated interest costs on $2.85 billion will lie between Rs 700 crore-800 crore. That is almost one third of the Rs 2,500 crore net profit generated by Hindalco in 2006-07. Rating agency, CRISIL placed its long-term rating of 'AAA/Stable' on Hindalco. It is expected that with this rating Hindalco's long-term ratings will come under pressure.

BENEFITS OF ACQUISITION TO BOTH COMPANIES:

The acquisition would make HINDALCO the global leader in aluminium rolled products and one of the largest aluminium producers in Asia. With post-acquisition combined revenues in excess of $10 billion, HINDALCO would enter the Fortune-500 listing of world's largest companies by sales revenues.

The acquisition would establish a global integrated aluminium producer with low-cost alumina and aluminium production facilities combined with high-end aluminium rolled product capabilities. With the acquisition, the current market capitalization became over $7.5 billion. With this, HINDALCO becomes world's largest aluminium rolling company, one of the biggest producer of primary aluminium in Asia and India's leading copper producer.

Novelis shareholders received $44.93 per share (including 15% premium) in cash which is a handsome amount. HINDALCO has also taken $2.4 billion of debt which is good for Novelis.

CONCLUSION:

The acquisition is expected to produce the synergy that Birlas were looking for in the flat products segment. The combination of HINDALCO and Novelis will establish an integrated producer with low-cost alumina and aluminum facilities combined with high-end rolling capabilities and a global footprint. The complementary assets and expertise of the team will provide a strong platform for growth and success. Novelis has excellent synergies with HINDALCO and opens new global markets for value-added high-end aluminium rolled products and aluminium can recycling. The Novelis acquisition provides it with capabilities in technologically sophisticated rolled aluminium products. The acquisition gives enormous geographical market and product synergies. Novelis is the global leader in the value-added high-end aluminium rolled products and aluminium can recycling. HINDALCO is consistently increasing its share of value-added products, which today stand at nearly 60 per cent. The Novelis acquisition gives it an instant leg-up with its technologically sophisticated rolled aluminium products capability, apart from a scale and a global footprint.

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Further, majority of the companies have FII stake in the range of 10-20%. These figures suggest that relative share of FIIs in Indian companies is marginal. The govt. should take concomitant policy efforts in terms of improving financial regulation and corporate governance to encourage individuals as well as institutional investments.

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