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A Gap Analysis of FIIs Investments – An estimation of FIIs Investments Avenues in Indian Equity Market

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India embarked on a programme of economic reforms in the early 1990s to tie over its balance of payment crisis and also as a step towards globalization. An important milestone in the history of Indian economic reforms happened on September 14, 1992, when the FIIs (Foreign Institutional Investors) were allowed to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the stock exchanges in India and in the schemes floated by domestic mutual funds. Initially, the holding of a single FII and of all FIIs, NRIs (Non-Resident Indians) and OCBs (Overseas Corporate Bodies) in any company were subject to a limit of 5% and 24% of the company's total issued capital respectively. In order to broad base the FII investment and to ensure that such an investment would not become a camouflage for individual investment in the nature of FDI (Foreign Direct Investment), a condition was laid down that the funds invested by FIIs had to have at least 50 participants with no one holding more than 5%.

Ever since this day, the regulations on FII investment have gone through enormous changes and have become more liberal over time. From November 1996, FIIs were allowed to make 100% investment in debt securities subject to specific approval from SEBI as a separate category of FIIs or sub-accounts as 100% debt funds. Such investments were, of course, subjected to the fund-specific ceiling prescribed by SEBI and had to be within an overall ceiling of US $ 1.5 billion. The investments were, however, restricted to the debt instruments of companies listed or to be listed on the stock exchanges. In 1997, the aggregate limit on investment by all FIIs was allowed to be raised from 24% to 30% by the Board of Directors of individual companies by passing a resolution in their meeting and by a special resolution to that effect in the company's General Body meeting. From the year 1998, the FII investments were also allowed in the dated government securities, treasury bills and money market instruments. In 2000, the foreign corporates and high net worth individuals were also allowed to invest as sub-accounts of SEBI-registered FIIs. FIIs were also permitted to seek SEBI registration in respect of sub-accounts. This was made more liberal to include the domestic portfolio managers or domestic asset management companies. 40% became the ceiling on aggregate FII portfolio investment in March 2000. This was subsequently raised to 49% on March 8, 2001 and to the specific sectoral cap in September 2001. As a move towards further liberalization, the Finance Minister announced in his budget speech on February 28, 2002 that, "Foreign Institutional Investors (FIIs) can invest in a company under the portfolio investment route beyond 24 per cent of the paid up capital of the company with the approval of the general body of the shareholders by a special resolution. I propose that now FII portfolio investments will not be subject to the sectoral limits for foreign direct investment except in specified sectors. Guidelines in this regard will be issued separately."

Accordingly, a committee was set up on March 13, 2002 to identify the sectors in which FIIs portfolio investments will not be subject to the sectoral limits for FDI, under the chairmanship of Dr. Rakesh Mohan. Later, on December 27, 2002 the committee was reconstituted and Dr. Ashok K. Lahiri became the chairman. The committee has come out with recommendations in June 2004. The committee has proposed that, 'In general, FII investment ceilings, if any, may be reckoned over and above prescribed FDI sectoral caps. The 24 per cent limit on FII investment imposed in 1992 when allowing FII inflows was exclusive of the FDI limit. The suggested measure will be in conformity with this original stipulation.' The committee also has recommended that the special procedure for raising FII investments beyond 24 per cent up to the FDI limit in a company may be dispensed with by amending the relevant regulations.

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Meanwhile, the increase in investment ceiling for FIIs in debt funds from US $ 1 billion to US $ 1.75 billion has been notified in 2004. The SEBI also has reduced the turnaround time for processing of FII applications for registrations from 13 working days to 7 working days except in the case of banks and subsidiaries.

All these are indications for the country's continuous efforts to mobilize more foreign investment through portfolio investment by FIIs. The FII portfolio flows have also been on the rise since September 1992. Their investments have always been net positive, but for 1998-99, when their sales were more than their purchases.

Table 1: Trends in FII investment

Period	Gross purchases (Rs. Mn.)	Gross Sales (Rs. Mn.)	Net Invest-ment (Rs. Mn.)	Net invest-ment* (US $ mn.)	Cumulative Net Invet-ment* (US $ mn.)
1993-94	55,925	4,663	51,262	1,634	1,638
1994-95	76,310	28,348	47,963	1,528	3,167
1995-96	96,935	27,517	69,420	2,036	5,202
1996-97	155,539	69,794	85,745	2,432	7,634
1997-98	186,947	127,372	59,575	1,649	9,284
1998-99	161,150	176,994	-15,844	-386	8,898
1999-00	568,555	467,335	101,219	2,339	11,237
2000-01	740,506	641,164	99,340	2,160	13,396
2001-02	499,200	411,650	87,552	1,846	15,242
2002-03	470,601	443,710	26,889	562	15,804
2003-04	1,448,575	990,940	457,645	9,949	25,754

** Net investment at US $ mn. at monthly exchange rate*
Source : SEBI Bulletin, October 2004

It can be observed from the above table that the portfolio investment inflows have always been on the increase. But the years 2001-02 and 2002-03 saw some reversal in the trend. From a net inflow of US $ 2.1 billion in 2000-01, such inflows declined to US $ 1.8 billion in 2001-02, and further dropped to US $ 0.562 billion in 2002-03. The decline is because of the lower portfolio inflows, as a result of which the net investment has dropped in these years. However, this decline witnessed a sharp reversal in the year 2003-04. FIIs have made a net investment of Rs. 45,764 crores during this year registering a growth of 1602% over the previous year, creating a record in the history of FII investment in India. Gross purchases in this year amounted to Rs.144,857 crores, a growth rate of 208% compared to the year before. This trend continued in April 2004, only to suffer reversal again during May and June 2004, when the net investment became negative. Fortunately, this year from July 2004 has been seeing a net positive portfolio flows by FIIs. As of September 2004, the net FII portfolio investment stands at US $ 27,637 million. This study is undertaken to assess what is the net FII investment in specific companies vis-à-vis the FII investment cap in them. This is done to bring to light that though the FII investment, if studied over time in India, shows a positive trend of increase in general, they are still insufficient and very much below the level envisaged and permitted by the regulations. If it is so, then increasing the FII investment cap per se will not just be helpful. The country has to work on specific measures to encourage more FII investments.

The Study

The study has undertaken an analysis of the FII investment gap in the companies included in the S&P CNX 500 index of National Stock Exchange, by comparing the FII investment in each of these companies as of September 30, 2004 with the FII investment cap. The FII investment gap, the difference between the investment allowed under the FII investment cap provision for the company and the actual investment, is estimated in terms of the market value prevailing as on the estimate date of September 30, 2004. Information on the shareholding pattern of these companies as of September 30, 2004, the closing market price of these shares is downloaded from the NSE site, www.nseindia.com. Since information is not available for 31 companies they are excluded from the study. In all the findings of this study relates to 469 companies included in the S&P CNX 500 index of National Stock Exchange as of September 30, 2004. The information on the FII investment cap for each of these companies is assessed from the Reserve Bank of India site, www.rbi.org.in The reason for choosing the companies included in this index is because this index is fairly comprehensive and includes companies from different sectors in the same proportion of how they are in the population of all the listed companies.

Sample Profile

The FIIs hold 8.12 per cent of the total outstanding shares of the 469 companies studied as of September 2004, emerging as the biggest institutional investor, ahead of the mutual funds, domestic financial institutions and the private corporate bodies. In an overall ranking they occupy the third position after the promoters and the Indian public holding higher levels of investment than FIIs.

Table 2: Shareholding Pattern

Category	Total shares outstanding (in mn.)	Percentage of shares held
Promoters	33,975	58.23
Mutual Funds	1,650	2.83
Domestic Financial Institutions	4,090	7.01
FIIs	4,735	8.12
Private Corporate Bodies	2,240	3.84
Indian Public	8,960	15.36
NRIs/OCBs	795	1.36
Others	1,900	3.26
Total	**58,345**	**100**

However, when the companies are grouped into those included in the S & P CNX NIFTY index(referred to as NIFTY companies from now onwards) and those which are not included, a specific concentration of FIIs investment in NIFTY companies. The FIIs shareholding is around 13.85 per cent in NIFTY companies as against 4.30 per cent in the Non-NIFTY companies.

Table 3: Shareholding Pattern in NIFTY Companies

Companies	FIIs Shareholding (in mn.)	Total outstanding shares (in mn.)	FIIs Shareholding as a % of total outstanding shares
NIFTY	3,227	23,285	13.85
Non-NIFTY	1,508	35,060	4.30
Total	**4,735**	**58,345**	**8.12**

The table above shows that the FIIs investment is certainly more concentrated in the NIFTY companies than in Non-NIFTY companies. But, this analysis is not complete because a mere comparison of the number of shares held by FIIs is meaningless as the market price per share varies across companies and it takes different quantum of money to acquire the same number of shares in different companies. Hence, this analysis is further extended to include the monetary value of the FIIs investment as of September 30, 2004 by multiplying the number of shares held by the closing market price per share as of the same day. This will give an understanding of the value of the FIIs investment at market value as of a particulate date. This is done as a proxy as the cost of their investments in each of these companies is not readily available.

Table 4: Value of FIIs Investment

Category	FIIs Shareholding (Rs. In mn.)	FIIs Shareholding as a percentage of the total value
NIFTY	1,328,556	85.16
Non-NIFTY	231,520	14.84
Total	**1,560,076**	**100**

Table 4 clearly brings out that when the shareholding of FIIs is analysed in terms of the market value of their investment as of September 30, 2004, about 85 per cent of the total value of their investment is held in NIFTY companies and only about 15 per cent is in Non-NIFTY companies. This shows, once again as mentioned above, that there is a clear concentration of FIIs investments in few chosen companies. A separate analysis of the NIFTY and Non-NIFTY companies bears evidence to this fact. About 25 per cent of the total market value of the FIIs investments is in just two companies namely Infosys and Reliance Industries where the investment is about 14 and 12 per cent respectively. 50 per cent of the total market value of the FIIs investment is only in 6 companies namely Infosys Technologies (13.87%), Reliance Industries (12.44%), ICICI Bank (7.51), HDFC (7.05), ONGC (5.25%) and Satyam (4.88). The total value of the FIIs investment in these companies is around Rs.677,516 million. When the companies are arranged in a decending order of their FIIs investment, it is found that 21 of the companies account for around 81.67 per cent and the balance 29 companies share only 18.83 per cent of the total market value of the FIIs investments, each one accounting for less than 1.5 per cent. In the bottom 13 companies, the FIIs investments is less than 0.5 per cent. Dabur India, Tata Chemicals, VSNL, Colgate-Palmolive and Britannia enjoy less than 0.1 per cent of the FIIs investments in value terms. In the Non-NIFTY category the top five companies which are the most favoured destinations for FIIs investments

are Container Corporation, Bank of Baroda, Canara Bank, I-Flex and Asian Paints. As many as 71 companies of the 416 companies in this category have absolutely no FIIs investment in them.

The Analysis

The objective of the study is to bring to light the investment gap in the FIIs investments by comparing the current investment levels of FIIs in the chosen sample companies against the cap allowed. The cap on the individual companies has taken into account the generic cap of 24 per cent prevailing and also the increase of the cap to the sectoral cap by the individual companies by passing of resolution in the Board and General Body.

Table 5: Cap and Gap Analysis of FIIs Investment

(No. of shares in mn.)

Category	Total out-standing shares	Permissible Investment for FIIs (Cap)	FIIs share-holding	Gap Avai-lable for Investment
All Companies	58,345	17,123	4,734	12,389
NIFTY	23,285	7,937	3,227	4,711
Non-NIFTY	35,060	9,186	1,508	7,678

It may be noticed from the above table that the percentage of the investment gap in case of NIFTY companies is around 59 and is 84 for the Non-NIFTY companies. The total gap in respect of all the companies works out to 72 per cent. This is in line with the findings presented in Tables 3 and 4, where it is brought out that the FIIs investments in NIFTY companies is higher than in Non-NIFTY companies, both in terms of number of shares held by them and the market value of these shares.

Table 6: Gap Analysis of FIIs Investment at Market Value

Category	Gap Available for Investment (in mn.number of shares)	Gap in Market Value# (Rs. in mn.)
All Companies	12,389	2,711,522
NIFTY	4,711	1,338,886
Non-NIFTY	7,678	1,372,637

*# Gap shares * Market price per share as of September 30,2004*

This finding presented above is not surprising. Though the number of shares available for further investment by FIIs is less in NIFTY companies than Non-NIFTY companies, in terms of value the difference is not very wide as the average market price per share of the NIFTY category is very much higher than that of the Non-NIFTY category.

The top 5 companies where the gap is at the maximum in NIFTY category of companies are Bharti Televentures, Reliance Industries, ONGC, Hindustan Lever and Wipro. In the Non-NIFTY companies the top 5 companies are Mphais BFL, Neyveli Lignite, LIC Housing Finance, Tata Teleservices(Maharastra) and Himachal Futuristic.

Findings

1. The FIIs investments are highly concentrated in terms of their market value in a very small number of companies.
2. There seems to be a clear distinction in the FIIs shareholding in NIFTY and Non-NIFTY companies.
3. There is a wide gap between the actual investments by FIIs and the investments allowed as per the cap.
4. The gap in their investments exist both in NIFTY and Non-NIFTY companies.
5. The investments that may further be made in these 469 companies analysed is as high as Rs.2711 billion (works out to around US $ 60,244 million at an assumed rate of Rs.45/US$) which, when compared to the current figure of net equity investment of FIIs in all the companies through portfolio investment scheme as of September 2004 is Rs. 1115 billion.

Discussion on findings

The FIIs investments, though shown an increasing trend over time, are still far below the permissible limits. This means, the convergence of the sectoral cap for FIIs and FDI investments alone may not really help bring in more funds unless some specific measures are taken up. One such measure in this line could be the newly announced INDONEXT, the platform for trading the small and mid-cap companies which might bring some focus on these companies and hopefully add some liquidity and volume to their trading, which may attract some further investments in them by FIIs. However, the real answers to the questions

(Contd. to pg. 09)

Business income from securities transactions

Where the securities transactions attracting STT result into business income for any person or entity, they will now be allowed income tax rebate under section 88E of the I.T. Act. The amount of rebate will be limited to the STT paid on such business transactions or the average income tax on such business income, whichever is less. The proportion of tax attributable to these business transactions will be worked out on pro-rata basis depending on contribution to total income. This may lead to disputes in the case of entities like brokers who carry out both brokerage and proprietary trading from a common establishment. Bifurcating the expenses may become an issue in such cases.

Where a client has already made a claim for rebate under Section 88E of I.T. Act and also gets a refund of STT, it may become difficult to reconcile such refunds and rebates, particularly because client registrations with brokers are not always on the basis of PAN alone and refunds of STT will be routed through exchanges or mutual funds.

Market Response to STT

Certain categories of investors felt that they may have to bear higher incidence of STT. Mutual fund investors are subjected to STT twice – first when the mutual fund itself trades and pays STT, thereby impacting the NAV and subsequently when the investors purchase or sell units on the stock exchange or sells directly to the mutual fund. Similarly arbitragers, who take delivery in cash market, will be paying STT @0.15%, although practically their transactions comprise of simultaneous sale and purchase in different markets. There was a view that STT would adversely impact the market volumes and movement. However, the experience after 1st October, the day STT became effective, has put to rest all such concerns.

Other changes

Other than levy of STT and changes in income tax treatment, the Finance Act has also changed the rate of Service Tax on brokerage income of members of exchanges from earlier 8% to 10%. An education cess @2% has been levied on income tax and service tax.

Conclusion

The scheme of STT is easy to administer and does not leave scope for tax avoidance. All categories of investors/ traders including FIIs, will be taxed uniformly. The FIIs, which have advantage under international direct tax treaties for income tax purposes, will be taxed for the first time. This tax is also easily replicable for transactions on commodities exchanges like NCDEX and MCX, which have been witnessing healthy growth in recent times. Thus, STT has enabled the government to generate revenue in a neat and efficient manner accepted internationally. The relief given in the capital gain tax and rebate under Section 88E is also likely to give a boost to investment activity.

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(Contd. from pg. 06)

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on how to attract more FIIs investments lies to some extent on finding the basis of selection of companies for investment by FIIs which the author is pursuing currently.

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