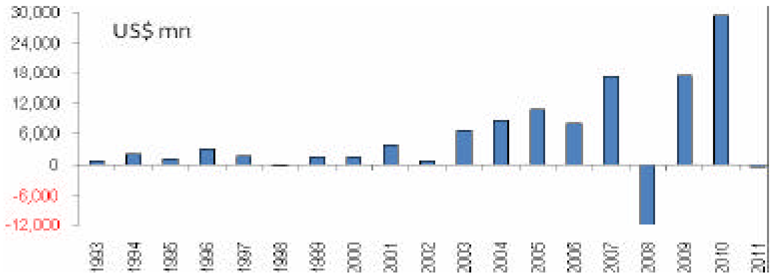
Integration of Domestic and International Equity Markets

Kalpana Morparia
Chief Executive Officer-India
J.P.Morgan India Pvt.Ltd.

India opened its equity markets to Foreign Institutional Investors in the early nineties as part of a larger liberalization program. Portfolio inflows were modest to start with. In the initial years, Markets had to cope with multiple issues including the Asian financial crises and the technology bubble. Within India, the corporate sector had to adjust to increasing global competition in the after math of liberalization and coalition Governments. Consequently a large part of the investments were focussed on a few sectors viz. the IT services and Healthcare sectors.

But since the early 2000's, a step up in India's growth rate and an increase in global risk appetite has resulted in a substanital pick up, both in portfolio investment flows and the sectors targeted. India's demographic dividend and the concomitant growth in the services sector, phased liberalization of the financial sector and the requirement for infrastructure have been 'hard to resist' themes for global investors.

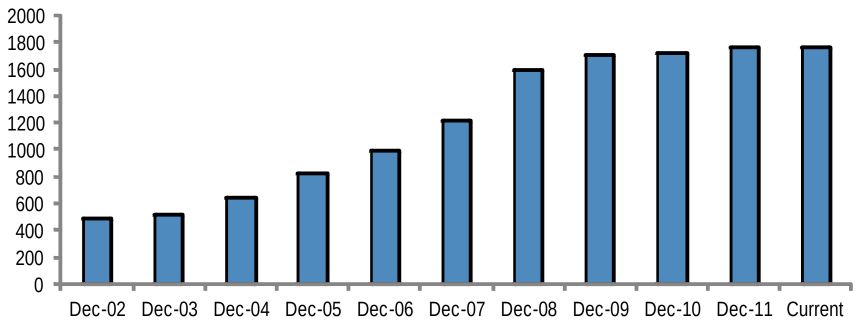
FII Portfolio Flows



Source: SEBI

The increased interest in Indian equities is reflected not only in the absolute value of portfolio inflows, but also in a near five fold increase in the number of FIIs registered with the equity markets regulator – the Securities and Exchange Board of India (SEBI) over the last 10 years. Currently about 2000 FIIs, domiciled across different parts of the world, are registered with the markets regulator.

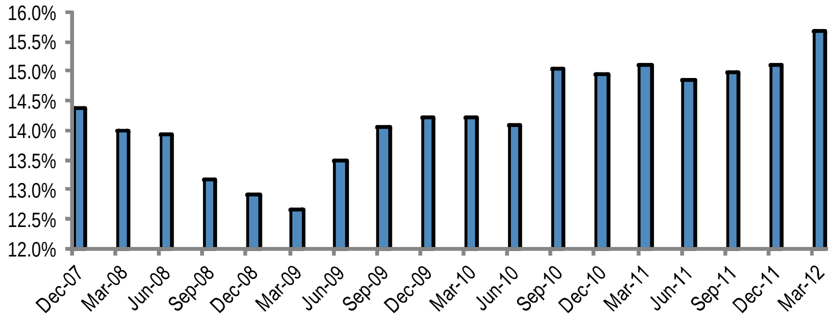
Number of Registered FIIs with Sebi



Source: SEBI

Changes in global risk appetite and Government policy not with standing, portfolio flows into India have been on a structural uptrend over the last decades, with only two years of outflows. Consistent inflows over the last decade has resulted in FII ownership of the Indian Corporate sector increasing to nearly 16% - an all time high - at the end of FY2012. The performance is despite turbluent global financial market conditions over the last 4-5 years. FIIs also account for nearly 18% of the daily trading volumes in Indian equities.

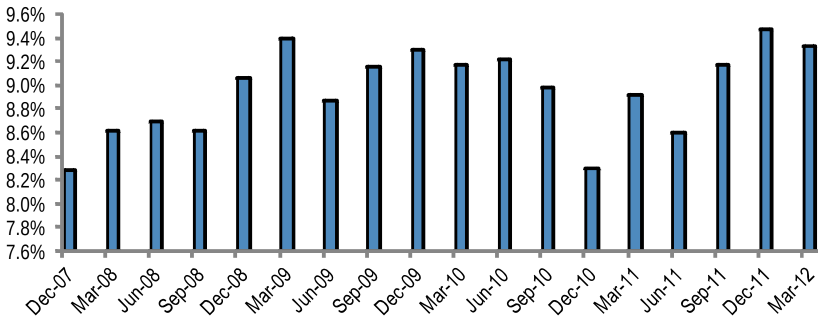
FII Ownership - BSE 500 Companies



Source: Prowess, J.P. Morgan

It is worth highlighting that current FII ownership of India equities at 16% is comfortably higher than that that of Domestic Instituitional Investors (DIIs) at about 9%. The share of DIIs has not changed for about three years now.

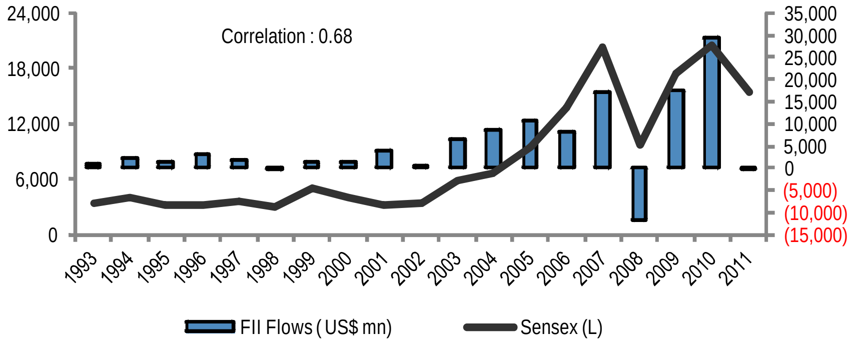
DII Ownership - BSE 500 Companies



Source: Prowess, J.P. Morgan

While FII ownership of Indian equities has gradually risen to about 16% over the last few years, their influence on market sentiment and performance has been more significant.

FII Flows and Sensex Performance



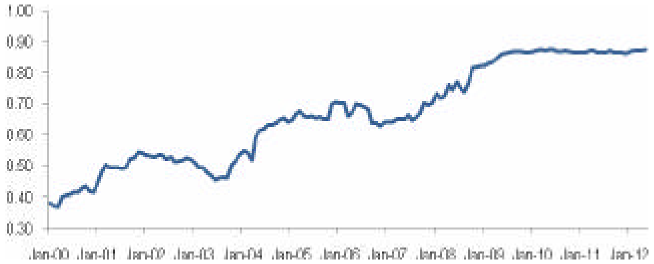
Source: SEBI, Bloomberg

The annual performance of the Sensex is reasonably correlated to FII flowss, while the relative importance of DIIs has waned - a trend that clearly established the FIIs as trend setters as compared to other market participants.

This trend is also seen in the primary markets. Anecdotal evidence suggests that FIIs usually anchor IPOs, provide the initial impetus and set the trend in terms of pricing. Local investor follow up has typically followed late into the issuance process and has been substantially influenced by FII action.

Given the increasing infleunce of and dependence on FIIs, it should come as no surprise that the corelation of Indian equities performance to that of peer group has risen from relatively insignificant levels at the beginning of the last decade to meaningful levels over the last few years. A J.P.Morgan study also reveals increasing linkages in terms of sectoral performance too.

Correlation – MSCI India vs. MSCI EM



Source: Bloomberg

The integration of our domestic and global equity markets is a trend that is likely here to stay. India is in a high growth and capital intensive phase of development. The need for and dependence on external capital at this stage is well documented, given the savings-investment gap and the current account deficit.

Other supplementary factors enabling to bind our equity markets with global markets are rising trade linkages and the growing appetite among Indian companies to acquire assets overseas – either to secure raw material or to acquire technology and brands.

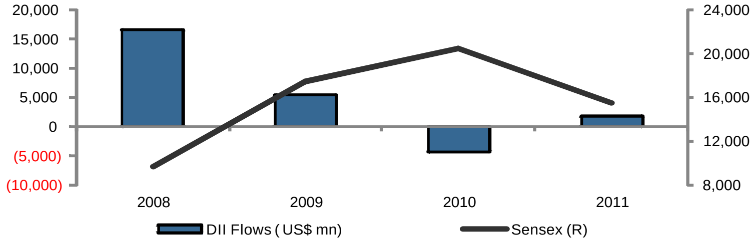
Managements of Indian companies have also explored listing securities in overseas markets to attract the attention of wider investor base. In the early to mid nineties the preferred option was Global Depository Receipts (GDRs). Subsequently activity shifted to the American Depository Receipts (ADR) market. The trend was driven initially by IT services companies wanting to secure valuations in line with their global peer group (these were typically listed on the NASDAQ). Recently managements of companies in the Energy and Mining sectors have listed assets in the UK for similar reasons. Going forward the trend will likely continue and gather momentum given the increasing global ambition of Indian Business Groups. Policy makers will at some stage have to consider permitting dual / multiple listings to ensure that issuers can take advantage of the benefits that different markets have to offer.

Over the future, Government policy should and will likely remain supportive of attracting foreign portfolio inflows to enable the Corporate sector to access capital at competitive rates from a wide investor base. Early this year, the Government opened up our equity markets further to attract inflows from Qualified Financial Investors (QFIs).

The importance of foreign portfolio capital is expected to sustain and increase. But brings with it, increased vulnerability to global risk appetite.

In this back drop, policy makers would be well served to focus on building a healthy domestic investor base. Domestic investors are at this stage substantially under invested in equities as an asset class. A muddled macro and some changes pertaining to distribution have resulted in savings being largely diverted to Gold and Fixed income. A change in the skew is essential to ensure a balanced savings profile and adequate growth capital for the economy.

DII Flows and Sensex Performance



Source: SEBI, Bloomberg