Integration of Domestic and International Capital Markets

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From early 2009, we have witnessed increasing revitalization of the domestic and international markets. Riding on the back of this wave, Indian companies are expected to raise nearly INR800 Bn from the initial public offer market in this fiscal year. More than half of this is expected to be from various public sector companies, and the remainder would be made up from private companies.[1] Many firms may also prefer the Qualified Institutional Placement (QIP) route to raise capital. The trend to seek private equity has been on the upswing, and liquidity of that form is now available for the Indian corporates, particularly in the infrastructure sector. Of late we have also noticed that several block trades are happening in the market, providing liquidity to promoters in order to deleverage debt and put increased equity into their businesses.

There will also be increased activity in the primary and secondary market because of the new rule passed by the government recently. According to this rule, it is mandatory for all listed firms to have a minimum 25% public holding. Listed companies having a public shareholding of less than 25% must eventually increase their shareholding to 25% a minimum increment of 5% per annum until this limit is reached or passed. This would make it necessary for many large listed firms, both public and private, to offer further shares to the public. There are a variety of means to do this, but the net effect will be a highly active primary and secondary market with increased liquidity and free float.

Increased FII Activity

Foreign Institutional Investors (FIIs) widely considered as the key drivers of Indian equity markets, are putting cash into raising their stakes in domestic companies. They are engaged in rebuilding their portfolios after recovering from the worldwide financial crisis. During the crisis, Indian stocks were sold and the money earned was taken to meet redemption pressure in their home countries. This trend has now reversed, with FIIs raising their stakes in two-thirds of the companies on the National Stock Exchange's Nifty index in the past one year. This trend is also similar for companies that form India's most tracked equity index, the Bombay Stock Exchange (BSE) Sensex. Of the 30 Sensex firms, 22 have so far revealed March quarter holdings and FIIs have increased their stakes in 15 of them. An analysis done by Mint reveals that of 298 of the 500 top stocks of the Bombay Stock Exchange (BSE-500) which have declared holdings for the December quarter reveals that FIIs have increased holdings in 190 firms.[2]

Analysts expect this trend continuing in the coming months and predict a further increase in FII stakes given stable foreign investment flows. According to data from the Securities and Exchange Board of India (SEBI), FIIs invested \$4.54 Bn in the three months from January to March 2010. Of this, \$3.07 Bn was invested into the secondary market and the rest to the primary market in the form of subscriptions to initial public offerings and qualified institutional investments.

In part thanks to this increased activity, the Indian government has divulged plans to raise INR400 Bn through divestment of its holdings in public sector undertakings in FY11.

Given the current level of activity, it is very likely that FIIs would be among the chief buyers. Firms as diverse as Hindalco, IDFC, Indiabulls Real Estate and Apollo Tyres have seen their FII ownership increase by 10 to 12%.

Table 1: List of Nifty Firms That Have Seen FII Stake Rising by More Than 1% During the March Quarter

	FII Stake (%)		
Company	March 2009 Quarter	March 2010 Quarter	Increase (% Points)
Hindalco Industries	10.32	28.94	18.62
IDFC	31.45	44.40	12.95
Axis Bank	23.43	33.13	9.70
Tata Steel	13.20	19.50	6.30
Sterlite Industries (India)	8.60	14.28	5.68
Jindal Steel & Power	18.60	23.46	4.86
Punjab National Bank	14.86	19.10	4.24
Hero Honda Motors	27.03	29.96	2.93
Ambuja Cements	21.40	24.14	2.74
Larsen & Toubro	11.90	14.44	2.54
ACC	10.26	12.56	2.30
Jaiprakash Associates	23.84	25.99	2.15
State Bank of India	7.97	10.11	2.14
Maruti Suzuki India	19.36	21.12	1.76
Reliance Industries	15.99	17.59	1.60
ICICI Bank	35.47	37.02	1.55
Infosys Technologies	34.86	36.36	1.50
Calm India	8.78	10.23	1.45
Siemens	2.34	3.59	1.25

Table 2: No. of Nifty/Sensex Firms That Have Seen Rise in FII Stakes in March Quarter

	Sensex	Nifty	BSE 500
No. of Firms That Declared Their Shareholding Pattern	22	35	298
No. of Firms Where FII Stake Has Increased Y-o-Y	15	23	190

Source BSE, (1)

Qualified Institutional Placement

In 2006 SEBI introduced the concept of a Qualified Institutional Placement (QIP). This was a boon for the Indian corporate landscape, as it provided a speedy way for raising capital. The place where QIP scores over other forms of capital raises is that it does not involve many of the common procedural requirements, such as the submission of pre-issue filings to the market regulator. This reduces the overall time taken, allowing companies to utilize much narrower windows of opportunity. This also has the added benefit of helping issuing companies price their issues closer to the prevailing market price. SEBI is able to permit this because the only buyers who are permitted to participate in a QIP process are Qualified Institutional Buyers (QIBs). This definition includes banks, mutual funds, foreign institutional investors, domestic institutional investors and hedge funds. Other than preferential allotment of shares, this is the only other method of speedy private placement for a firm to raise money quickly. Also, domestic and foreign institutional investors can both participate, which ensures that the potential universe of investors is much larger than that for an ADR/GDR. Due to all these reasons, this method has gained dramatic popularity in recent times.

A demonstration of the practicality of these options was given during the summer of 2009. Several companies, especially in the real estate sector, were starved of money in the slowdown and were finding it difficult to stay afloat. The revival in market sentiment came as a boon to these companies, which seized the opportunity to raise money within a short time frame. This cash was required mainly to retire expensive debt, allow the companies to restructure their balance sheets and finance their growth plan.

Growth of Registered FIIs

Earlier, corporations wishing to gain wider access and exposure to the investor base that exists in Western markets typically chose to either pursue the GDR/ADR route or issue FCCBs. However, in recent times this view has been changing. This change in viewpoint is because the institutional investor base has been evolving continually. The number of foreign investors has been increasing in recent years, with more than 1000 new FIIs registering with SEBI in the last 5 years. Many of the largest private equity groups and wealth funds have now registered with SEBI and are actively pursuing investment opportunities in India.

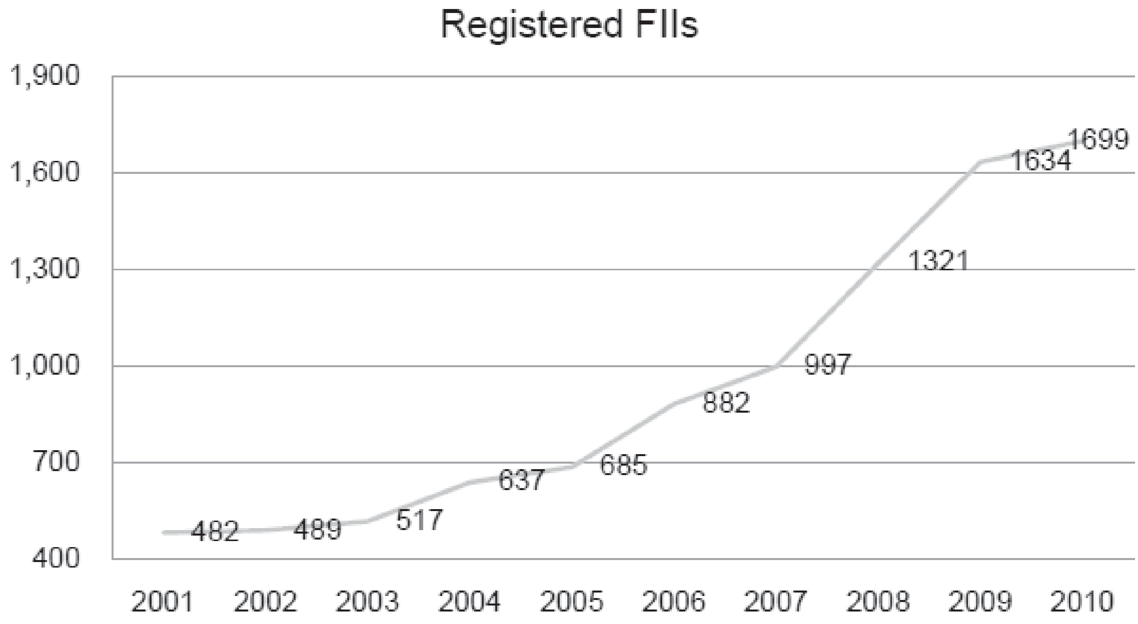

Figure 1: Growth of FIIs registered with SEBI
(Source: SEBI)

As can be seen from the graph above, the number of FIIs registered with SEBI has almost quadrupled in the last 10 years. Thanks to this, firms listing domestically are able to gain access to global investors.

Foreign Exchange Trading

Another factor that has resulted in the growing attractiveness of the Indian market is the increase in foreign exchange trading activity. The rupee has shown a stable and appreciating trend against foreign currencies like the dollar. This is primarily because of a consistent domestic growth that makes India an attractive investment destination. Investment funds seem to be more comfortable on Rupee exposure based on the strength of the GDP and of the economy. The regulators and market players have also been proactive in putting into place tools and mechanisms to help mitigate forex risks. Thus, the increased activity in the forex sphere is helping in a significant way to integrate domestic and international capital markets.

The India Premium

Earlier an argument in favor of raising capital by listing abroad was that the presence of more sophisticated investors would lead to higher valuations for a company, boosting the price per share and potential capital inflow. This was borne out by several important issues where it was made clear that there existed a significant arbitrage opportunity because of the difference in valuations in the Indian market as compared to other global markets.

This trend has been reversing of late. A case in point is Infosys, which is listed on Indian exchanges and it is also traded as ADRs in the United States. As can be seen from the figure below, over the last 10 years, the arbitrage between the ADR and the domestic stock price has continuously been decreasing so as to be almost nonexistent now. This clearly demonstrates that that with greater liquidity and easing of regulations, differences between Indian and other major global markets have reduced.

Figure 2: Infosys India Vs India ADR stock price arbitrage (Source: Factset)

Secondary Market Activity

Many firms that list in Indian markets also see large amounts of trading in the secondary market post listing. Over the last few years, domestic institutional investors have been increasingly active in this sphere, especially with the growth in the number of pension funds, insurance companies and mutual funds. These are large cash rich entities which actively look for investment opportunities that offer potentially superior returns to them and their subscribers. These institutions find such domestic offers particularly attractive, and typically make large block purchases of shares through this avenue. It is seen that FIIs are also a major participant in such activity, and many FIIs make transactions worth millions of rupees in a single day on the BSE. This also shows the greater degree of integration we are seeing, as FIIs have begun to view Indian markets as an active market in which an astute investor may reap rich dividends. On a global scale too, the importance of the Sensex as an equity tracking index has gone up which can be measured by the fact that it is now actively tracked, especially across the Asia-Pacific region.

The National Stock Exchange of India is the fourth largest in the world in terms of trading volume in the cash market. It is also the largest exchange in India for cash and equity derivatives. In the exchange-traded market, the biggest success story has been derivatives on equity products. Index futures, index options and options and futures on individual securities were all introduced by end 2001. Derivatives on stock indexes and individual stocks have grown rapidly since inception.

In Favor of Listing Abroad

Even though there exists a very favorable environment for listing in India, there may still be a few reasons why certain firms may choose to file for an IPO abroad. For example, a major mining company with global operations might prefer to list on the London Stock Exchange (LSE) rather than on Indian exchanges. The reason could be simply to facilitate global benchmarking against peers because the LSE is where most of the world's largest mining companies are listed. Similar constraints may also apply to other firms.

A firm may have significant assets located outside the country. It may have a large base of clients, office buildings and other assets which may be located outside India. Listing abroad would make the firm much more accessible and visible to the consumers located in that geography. It would be a branding exercise for the firm in that it would convey a sense of the firm wanting to make its presence felt. Firms could also benefit from lower costs of capital due to global investors having easier access to larger amounts of funds than their Indian counterparts do. This would serve to provide a more liquid equity, with higher daily trading volumes. Another consideration could be future foreign acquisitions. If a firm wants to pursue a strategy of inorganic global expansion through acquisitions in a target market, it might make sense to list in the same market. This could result in various procedural synergies being generated. Yet another reason for companies to list abroad could be to ensure convenience in handling and disbursing ESOPs to its overseas employees.

A firm may also want to list abroad to take advantage of the positive signaling benefit. Typically listing in markets that are more sophisticated entails higher and more stringent disclosure requirements. Firms can signal their effort to strive to higher standards by providing improved information to potential customers and suppliers. For example, a firm may choose to adopt US GAAP as its internal accounting principles. Firms would also benefit from the increased media attention, higher analyst coverage, better analyst forecast accuracy and higher quality of accounting information that listing abroad would bring in. In this way, the firm may succeed in drawing in investors who might have been otherwise reluctant to invest. Listing abroad gives retail investors in the US, European and Japanese markets who are interested in an Indian company a chance to participate in its growth. This has the added benefit of giving the company a diversified investor base. This mechanism is important because generally retail investors from US, Europe and Japan are not be able to participate in domestic issuances.

Conclusion

In recent times, we have been seeing greater integration of global and domestic markets. Clearly, global investors are moving to the domestic markets to take advantage of reasons such as increased liquidity and physical and future options. Domestic valuations are more in line with global peers, reducing the arbitrages that earlier existed. All these make a compelling case for companies to tap the domestic markets for their capital needs. However, because of the reasons mentioned above, Indian companies will continue to access the international markets as well from time to time.

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[1] Indian companies may raise up to Rs 2 lakh cr from primary market in next 3 years - Economic Times - 9th June 2010

[2] FIIs rebuild India portfolio - Livemint.com - 18th April 2010