CHAPTER 1

India's Capital Markets

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India's economy has undergone a profound evolution over the last 15 years, due in large part to reforms instituted by Manmohan Singh, the current prime minister, a former finance minister and a respected international economist. These reforms have had significant positive impacts throughout the economy and, specifically, have led to the financial markets developing the institutions, regulations, and practices that have put it on par with the best practices of the world's most respected financial markets.

Reforms in India's capital markets from 1991 to 2006 include the implementation of advanced electronic trading systems in the two primary stock exchanges; demutualization of securities issues, allowing for straight-through processing and electronic settlement on a T+2 settlement basis; implementation of state-of-the-art built-in market security and safeguard mechanisms to insure the safety and integrity of the markets; and the development of a sophisticated set of securities regulations monitored and enforced by the very capable and professional securities regulator, the Securities and Exchange Board of India (SEBI).

This chapter will introduce the reader to the capital markets of India with a discussion about foreign investment, the forms it takes in India, its recent growth and certain measures of that growth, and the factors that stymied growth in previous years. The chapter will examine the sources of rising domestic demand benefiting the capital markets, and then explore the various risks to the market, both internal and external, that all sophisticated investors must understand, consider, and weigh when contemplating their comfortable level of investment exposure to this exciting market.

GROWTH OF FOREIGN INVESTMENT

Reforms instituted over the last 15 years have opened the economy to significantly more foreign investment by easing the rules and procedures for

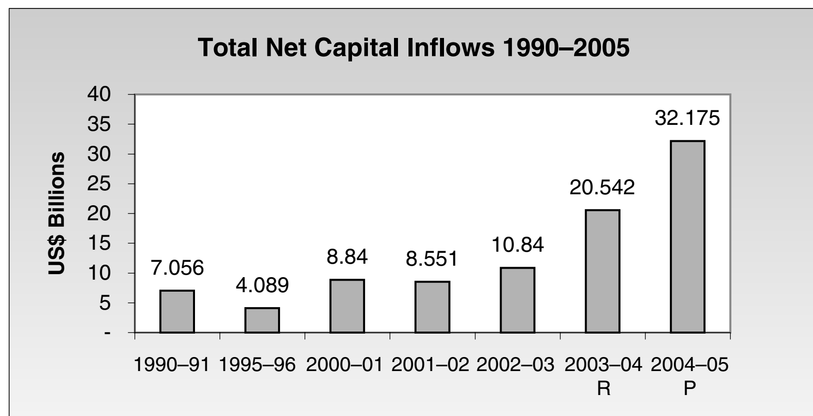

FIGURE 1.1 Total net capital inflows to India, 1990–2005.
Source: RBI 2004–2005 Annual Report, Capital Account Inflows.

both public and private investment. The increase in foreign investment is illustrated in Figures 1.1 through 1.4.

Figure 1.1 shows the growth of overall net capital inflows to India rising eightfold from US$4.09 billion in 1995–1996 to US$32.18 billion in March 2005.

Total equity inflows, made up of portfolio investment and foreign direct investment, have also grown markedly from the early days of reform to FY2005, although growth has not been steady. Figure 1.2 shows that total

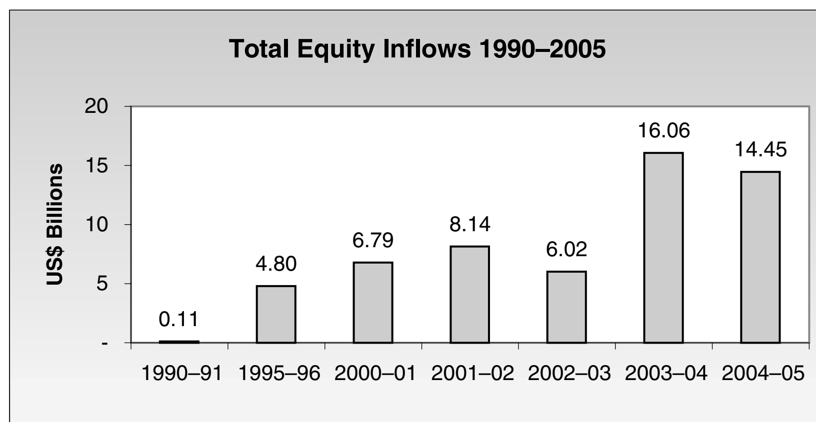

FIGURE 1.2 Total equity inflows to India, 1990–2005.
Source: RBI 2004–2005 Annual Report, Capital Account Inflows.

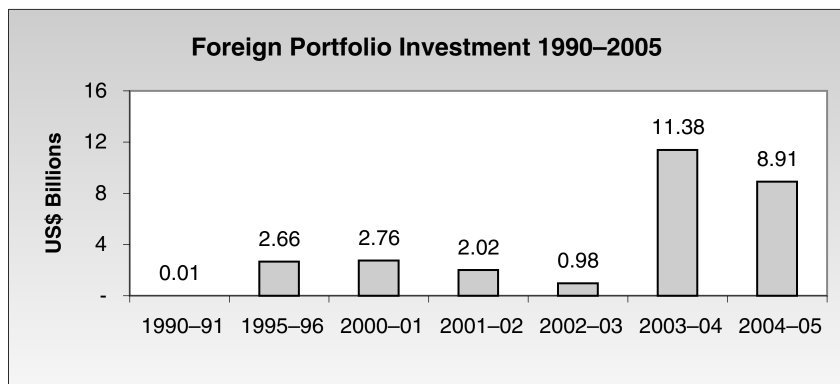

FIGURE 1.3 Foreign portfolio investment, 1990–2005.
Source: RBI 2004–2005 Annual Report, Capital Account Inflows.

equity inflows grew from US$4.8 billion in FY1996 to US$14.45 billion in FY2005, but fell 10 percent year-on-year (yoy) in FY2005 from a year earlier.

Foreign portfolio investment, representing foreign funds coming into the primary and secondary share markets, represented the bulk of the growth in equity inflows and saw a huge surge in interest, particularly in FY2004, when investment increased more than 1,000 percent to US$11.38 billion from less than US$1 billion in FY2003. Again, however, FY2005 demonstrated a

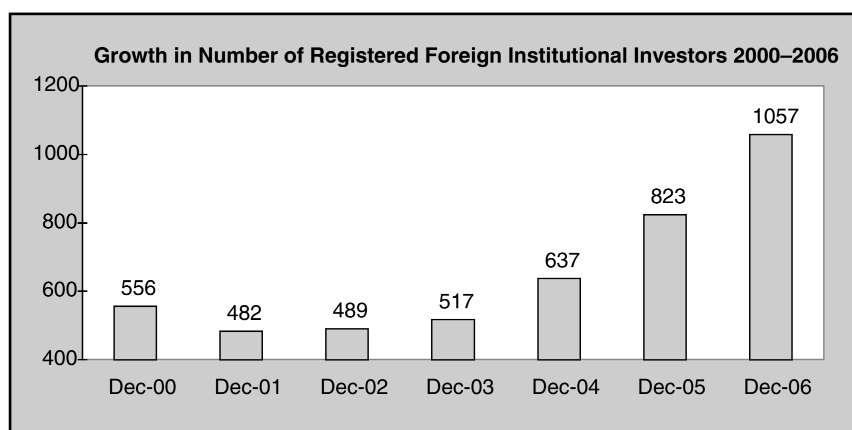

FIGURE 1.4 Growth in foreign institutional investor registrations, December 2000 to December 2006.
Source: The Bombay Stock Exchange.

year-on-year reduction, with net foreign portfolio investment falling 22 percent to US$8.91 billion.

The increase in net portfolio investment has been accompanied by a broader base of foreign investors. Regulations addressing investment in the primary and secondary public markets, monitored by SEBI through the *Foreign Institutional Investor* (FII) regime, have dramatically shortened the FII registration process from several months to a current benchmark of seven business days. This streamlined the registration process and, together with new awareness of the strength of the economy, has led to a steadily increasing number of FIIs, more than doubling in five years from 482 in December 2001 to 1057 in December 2006. Figure 1.4 illustrates this growth.

Foreign direct investment (FDI) has not mimicked the rising interest in portfolio investment and, rather, has experienced modest growth over the reform period from US$2.14 billion in FY1996 to US$5.53 billion in FY2005, an increase of just $2^1/_2$ times over the past 10 years. This modest rise, and fairly level FDI over the previous four years, is somewhat disappointing in light of such factors as: (1) the easing of the regulatory approval process, (2) the increased number of industries now open to foreign investment, (3) the rise in the percentage of domestic entities permitted to be owned by foreigners, and (4) the tremendous demand for infrastructure development. Furthermore, given the overwhelming growth of FDI in China during a similar period to nearly US$50 billion in 2005, FDI in India is severely lagging.

Some economists in India believe that the Reserve Bank of India (RBI) underestimates FDI by ignoring international standards of FDI computation set by the IMF by including only one component of FDI into its calculations, rather than including several other components commonly used by the IMF in its international standard for FDI comparisons. The one component used by the RBI is foreign equity capital reported on the basis of the issue/transfer of equity or preference shares to foreign direct investors. Some of the IMF-recognized components that India does not include when estimating its FDI inflows are:

- Reinvested earnings by foreign companies.
- Proceeds of foreign equity listings and foreign subordinated loans to domestic subsidiaries as part of intercompany (short- and long-term) debt transactions.
- Overseas commercial borrowings (financial leasing, trade credits, grants, and bonds) by foreign direct investors in foreign invested firms.
- Non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly held FDI enterprises, control premium, and noncompetition fees, as per the IMF's definition, which are normally included in other countries' statistics.

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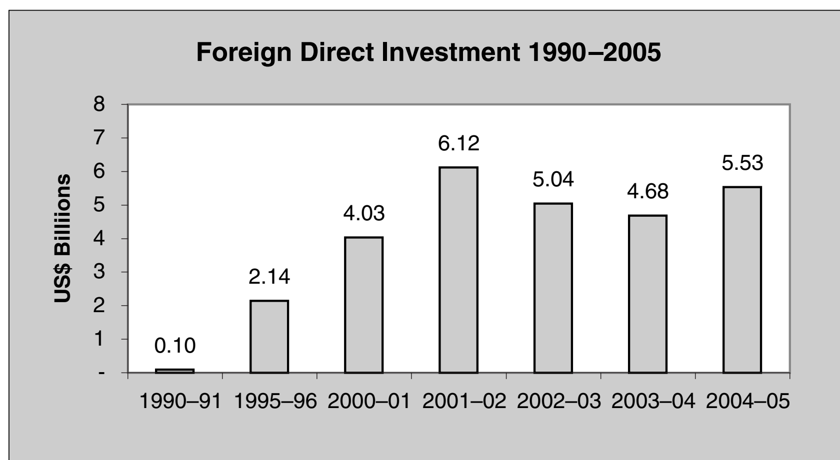

FIGURE 1.5 Foreign direct investment, 1990–2005.
Source: RBI 2004–2005 Annual Report, Capital Account Inflows.

The inclusion of these components would raise the reported FDI, but it would still lag China significantly. Figure 1.5 illustrates India's reported FDI from 1990 to 2005.

IMPROVED FOREIGN INSTITUTIONAL INVESTOR (FII) INTEREST AND ACCESS TO THE PUBLIC MARKETS

Foreign investment in India was limited previously due to two key factors:

1. ***External:*** Foreign investors believed that the market's liquidity was not large enough to, first, take a meaningful position and second, to be able to get out of that position in a timely manner without a significant market impact. This concern kept many large institutional investors away from the market.
2. ***Internal:*** There was fear and concern among Indian regulators and the financial community that the size and, therefore, power of the domestic Indian investor community, both retail and institutional, was too small relative to potential foreign institutional investment to absorb any meaningful foreign flows. In particular, there was fear that a herd instinct among foreign investors to get out of the market would lead to a severe market crash that would overwhelm the domestic investment

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community's buying ability and thus lead to a sharp, negative impact not just on public market investors, but in such a way as to reverberate throughout the economy as a whole.

These two factors—market liquidity and domestic investment activity—have both evolved and improved such that they are no longer impediments to greater FII interest in India or India's desire to attract greater FII investment.

Figures 1.6 and 1.7 illustrate the development of liquidity in India's public cash equity markets over the past six years. After experiencing a decline in 2001 and 2002, Bombay Stock Exchange (BSE) liquidity more than tripled from a low of US$69 billion in 2002 to US$215 billion in 2006. National Stock Exchange (NSE) liquidity for cash equities more than tripled from a low of US$139 billion in 2002 to US$426 billion in 2006.

In addition to cash equities, the liquidity in derivatives products, futures, and options, has also increased from less than US$9 billion in 2001 to over US$1.5 trillion in 2006, an increase of over 176 times. Figure 1.8 illustrates this dramatic growth in both the value and number of contracts traded on the NSE.

In addition, the market capitalizations of India's two primary stock exchanges, the BSE and the NSE, have also grown dramatically since 2001. BSE's market cap has grown more than sevenfold from US$111 billion to US$812 billion at the end of 2006, and the NSE has grown more than sixfold from US$123 billion to US$761 billion. This is illustrated in Figures 1.9 and 1.10.

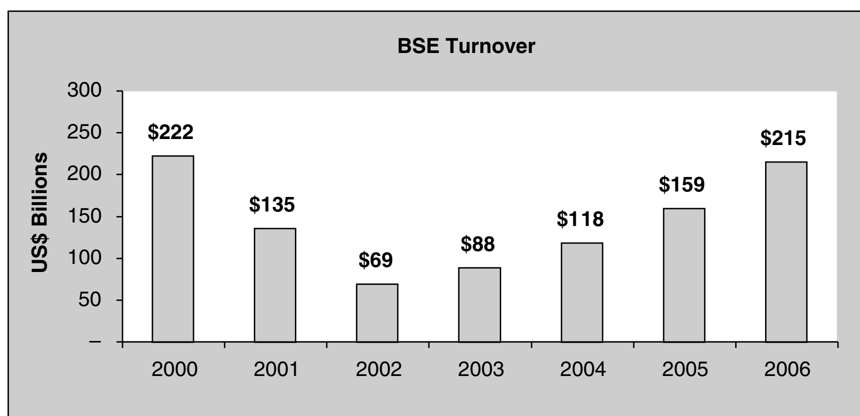

FIGURE 1.6 BSE market turnover, 2000–2006.
Source: The Bombay Stock Exchange Limited.

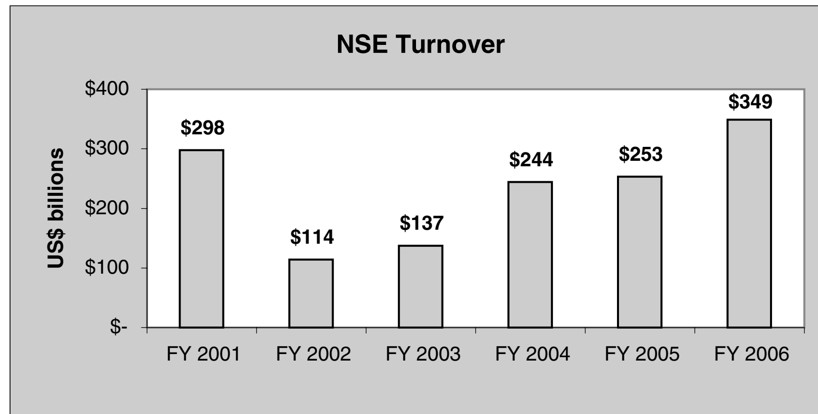

FIGURE 1.7 NSE market turnover, 2001–2006.
Source: The National Stock Exchange.

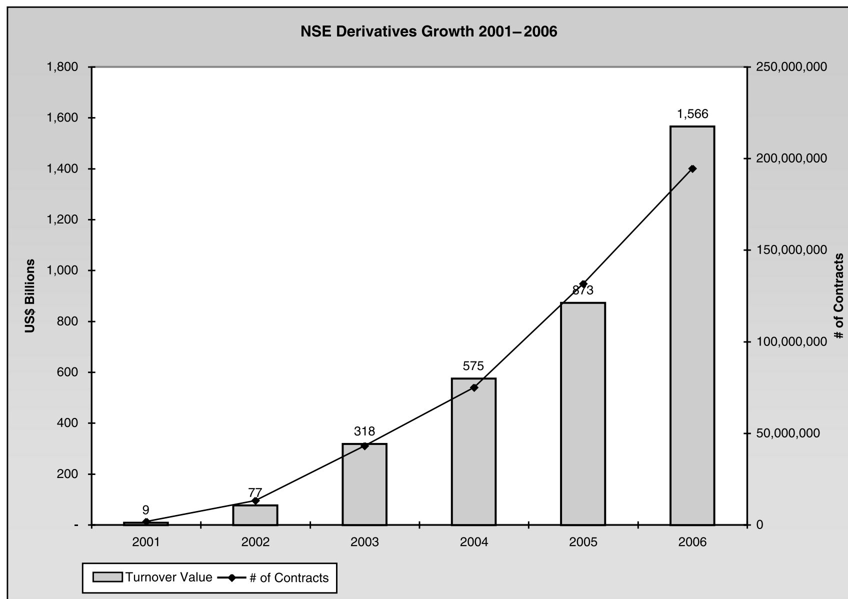

FIGURE 1.8 Growth of NSE derivatives turnover 2001–2006.
Source: The National Stock Exchange.

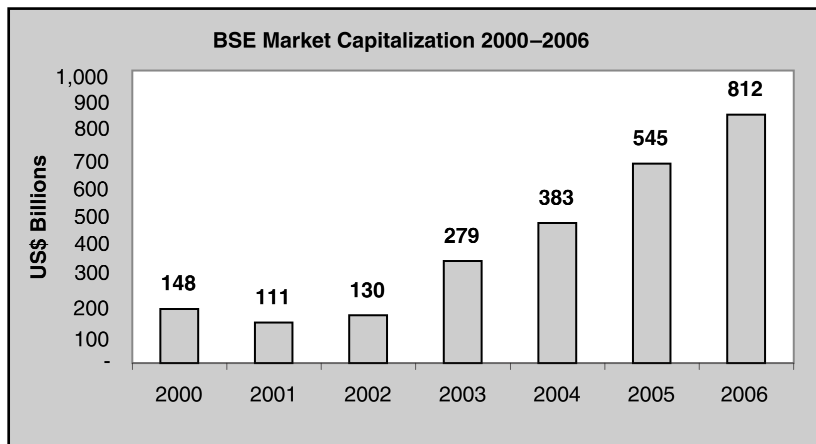

FIGURE 1.9 Growth of BSE's market capitalization 2000–2006.
Source: The Bombay Stock Exchange Limited.

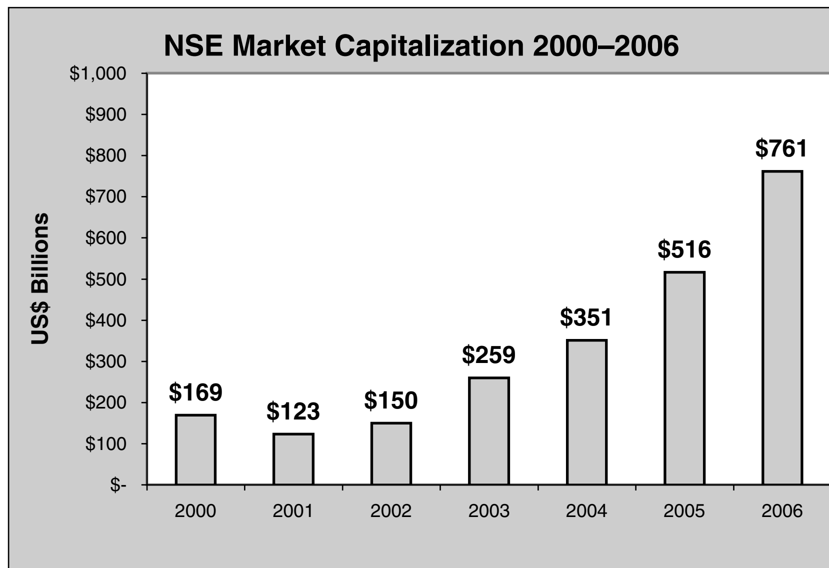

FIGURE 1.10 Growth of NSE's market capitalization 2000–2006.*
*The figures for this chart were converted from the original rupee-denominated figure to US$ using a Rupee:US$ exchange rate of 45:1. This rate is used throughout the book.
Source: The National Stock Exchange.

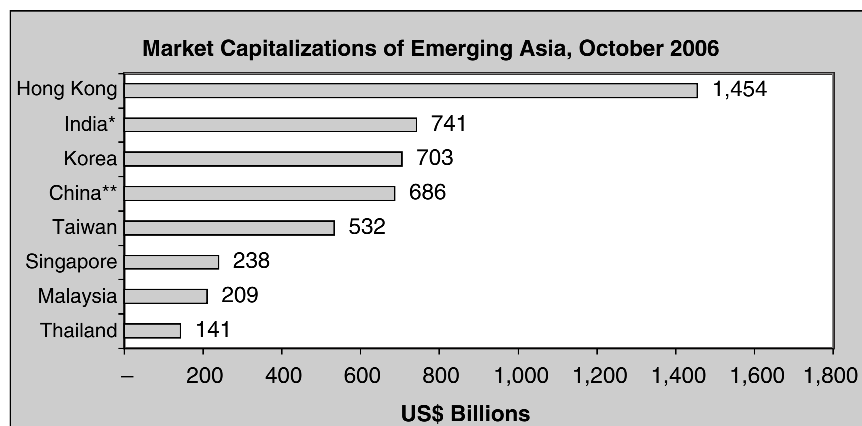

FIGURE 1.11 Comparison of India's BSE market capitalization versus Asian developing markets.
*The figure for India represents the BSE only, given the high percentage of dual listings with the NSE.
**The figure for China represents the Shanghai and Shenzhen Stock Exchanges.
Sources: The stock exchanges of BSE, HKEX, KSE, TSE, KLSE, SZSE, SSE, SET, and SGX.

Figure 1.11 places India's market capitalization in context relative to other Asian financial markets that have attracted considerable foreign interest and portfolio investment over the last decade. Further perspective as to India's market size can be gleaned by comparing it to the market capitalization of Brazil's Bovespa, another emerging market commanding much attention among global investors. At the end of January 2007, the market cap of the BSE was US$852 billion, or 14 percent higher than that of the Bovespa, at $745 billion.[1]

RISING DOMESTIC INVESTMENT DEMAND

Large and growing domestic investment demand in India has helped to alleviate concern among many domestic investors that the purchasing power of domestic investment funds could be overwhelmed by foreign flows, particularly selling flows. The expected significant increase in domestic investment demand over the next five years is the result of a strong economy, a growing middle class of 300 million people, rising incomes, booming domestic

retail consumption, and strong household savings rates. Sources of domestic demand include:

Growth of retail investment in the public markets: India enjoys a domestic savings rate of close to 25 percent, but only 2 percent of household savings enters the public markets through direct retail investment in the stock market. This compares to an average of approximately 10 percent in other markets. Domestic retail investors are expected to begin to increase direct investments toward the global norm, thereby enhancing investment demand.

Maturing of the mutual fund industry: While mutual funds have been operating for several years, they are only now coming into their own. Approximately 3 percent of household savings enters the market through mutual funds, and this figure is expected to rise due to several factors in the industry. Many new funds are being launched, funds are posting strong nominal returns in line with booming market indexes, more products are being created, and more marketing is being conducted, which will likely attract more money.

Development of the insurance industry: The insurance industry is growing via both domestic companies and the entry of more foreign insurers into India. The industry is finally taking off and accumulating a surplus, much of which is expected to be invested in the domestic market.

Expected easing of restrictions on pension fund investment options by the government: Currently, all public pension funds are limited to investing in government securities, with no funds reaching the public stock markets. Furthermore, private pension funds also have restrictions on their investment options that require a significant share of their funds to be invested in government securities. There are expectations in the market that the government is considering a loosening of these investment restrictions, which will permit pension funds, both public and private, to invest a greater percentage of their funds in listed stocks.

Expectation that banks will increase exposure in the listed markets: Presently, domestic banks leave a large majority of their assets in government securities. Banks are widely believed to be underexposed to the markets and are likely to begin to increase this exposure over the next several years.

In addition to the above expected sources of domestic demand alleviating many concerns regarding the domestic ability to not be overwhelmed by

foreign fund movements, recent anecdotal evidence has shown that domestic investor demand has, in fact, been able to not only absorb the foreign funds for sale, but also to push the market higher. A market sell-off in the spring of 2006 due to foreign selling was viewed as an opportunity for domestic buyers, who absorbed the selling and caused the market to rally. Such anecdotal evidence has supported the easing of not only opinions, but also the practices of regulators and other market participants toward foreign institutional investment.

MARKET RISKS

When evaluating investment prospects, investors must understand and evaluate the risks in a market in order to determine the most prudent and lucrative ways to exploit the investment potential. Risk is not bad in itself, but risk must be identified, understood, defined, and incorporated into a sound investment strategy.

A positive view about prospects for the Indian economy, and by extension, for the financial markets is due to the following factors cited by key market participants: the consistency and strength of earnings growth, a long-developed culture of entrepreneurship, a competitive business environment, the loosening of business restrictions, the strength of the fundamentals underpinning the economic expansion, rising incomes, exploding domestic consumption, and the "flattening of the world" in terms of communication and globalization, as described by author Thomas Friedman in his book *The World Is Flat*. Furthermore, the economy has been resilient to many recent shocks, and many investors and economists expect 8 percent GDP growth (GDP growth was 9.2 percent in the second quarter of FY2006–2007) to continue for many years to come.

Volatility of stock prices in the emerging markets is a risk that must be understood. Despite the positive views among so many key Indian market participants, an April/May 2006 correction in global emerging markets caused by fears of rising interest rates did not spare India's markets. The Indian market, at the time up 34 percent year-on-year, had been one of the world's best performers going into the correction; but then, like other emerging markets, it experienced a volatile period with the benchmark Sensex index falling from a then YTD high in May 2006 of 12,612.38 to a YTD low in June 2006 of 8,929.44, down 44 percent from top to bottom. The Sensex finished the calendar year 2006 at 13,786.91, up approximately 47 percent since December 2005. The broader indexes also experienced sharp volatility, as shown in Table 1.1, with the greatest volatility shown by the BSE Small Cap index, which experienced a swing of 76 percent between the

TABLE 1.1 2006 Stock Price Volatility in BSE Indexes

	2005	2006						
				Year High		Year Low		
Index Name	Year-End Close	Year-End Close	YOY Return	Value	YOY % Chg	Value	YOY % Chg	High/Low Swing (%)
BSE Sensex	9,397.93	13,786.91	47%	14,035.30	49%	8799.01	−6.37%	60%
BSE 100	4,953.28	6,982.56	41%	7,106.59	43%	4471.51	−9.73%	59%
BSE 200	1,186.23	1,655.74	40%	1,684.99	42%	1058.66	−10.75%	59%
BSE 500	3,795.96	5,270.76	39%	5,354.58	41%	3360.85	−11.46%	59%
BSE Midcap	4,427.03	5,805.18	31%	6,070.53	37%	3692.15	−16.60%	64%
BSE Small Cap	5,943.11	6,892.32	16%	7,872.80	32%	4480.45	−24.61%	76%
Sensex P/E	18.07	20.18		21.48		17.9		
BSE 100 P/E	16.47	18.84		20.41		16.67		

Source: The Bombay Stock Exchange Ltd.

year's high and low. The market's high P/E ratios, the one cause for concern expressed by a few cautious economists, dropped from the low 20s for the BSE 100 in May, to 16.67, and then back to 18.84 at the end of 2006.

The May/June 2006 market correction was very much an international phenomenon caused by fears of rising interest rates in the United States and Japan. However, there are several potential India-specific domestic risks to the economy, although most domestic participants had not given them enough weight to lead to a reduction of their exposure. In the contrarian investor viewpoint, the seemingly unanimous bullishness on the Indian economy prior to the correction would be a signal that it was an ideal time to reduce exposure and possibly even look to short the market. The correction was not caused by such thinking, but was certainly a catalyst for those concerned about the market to quickly exit positions. While the Indian market had apparently stabilized from the correction by June 2006 and resumed its upward movement, any overview of India's market would be deficient without noting some of the domestic and international risks that investors should consider.

The following is not an exhaustive or comprehensive list of market risks, but rather some issues that investors must consider when evaluating exposure to India's economy.

Internal Factors

Infrastructure Infrastructure is the first and most-often-cited risk to India's economy. The nation's rapid growth has put a heavy strain on the already stretched facilities. Power and electricity, telecommunications, roads, and airports all desperately need dramatic upgrades due to years of neglect. Frequent power outages require businesses, particularly manufacturing, to maintain backup power generation. The generally poor state of roads—only about 48 percent of the nation's roads are paved—has severely hampered efficient and cost-effective distribution and movement of goods, and port capacity is struggling to accommodate an increase in sea traffic. The good news is that the present government is aware of the problems and has begun addressing them by proposing budgets, reforming infrastructure funding rules, easing investment limits, and exploring public/private partnerships. However, if the reforms fail and/or needed investment doesn't pursue infrastructure projects, the weak infrastructure could become an impediment to continued economic growth.

Government Bureaucracy While much progress has been made to streamline government bureaucracy, considered by many to be one of the most bloated in the world, there is still a great deal of inefficiency experienced by businesses as they try to navigate through the system. Despite reducing

the time to start a business from 71 to 25 days, the World Bank's *Doing Business Report 2007* ranks India at number 134 of 175 ranked countries on ease of doing business.

National Budget Deficit The national deficit is being widely watched not only for its potential to negatively impact growth, but also as a sign of the government's fiscal discipline. At the beginning of FY2007, the combined public debt of the federal and state governments stood at 82 percent of India's GDP. This represented a 20 percent increase over the past 10 years.[2] In addition, there was a deficit of 4.1 percent of GDP in FY2006. The government has targeted the FY2007 deficit to narrow to 3.8 percent, and parliament passed a law to trim that deficit to 3 percent by FY2009. These deficit and debt burdens are viewed as potential problems that could impact infrastructure and education reforms and eventually weigh down the market.

Politics and Populism Some influential politicians, including Sonia Gandhi, current president of the Congress Party and one of the most powerful politicians in India, have failed to see the trickle-down effect from the recent expansion and have begun to question the advantage of economic liberalization and globalization for the vast rural population, representing 60 percent of India. If Ms. Gandhi and others decide to take a strong stand, the government will have a difficult time pushing through additional reforms, much less maintaining the present ones. Furthermore, the nature of coalition governments is that small parties essential to the coalition often wield considerable leverage over the government. In July 2006, a small yet important coalition party, the Dravida Munnetra Kazhagam (DMK) party, caused the government to halt all privatizations, pending further review. Privatizations have raised approximately US$12 billion[3] for the government since reform efforts began in 1992, and halting them may negatively impact budget and spending plans. Other such demands from within the coalition could further impact the economic reform efforts.

Demographics Fifty-four percent of the population is under 25 years of age, and 31 percent is under 15 years of age. They must be educated and prepared for employment. Yet, while education at the top levels rivals the best in the world, the capacity, quality, and breadth of access to education for the masses must be improved dramatically. If the economy does not grow fast enough to absorb the growth of the working-age population, estimated at many tens of millions of new people each year, social unrest could develop, which might impede or even reverse some of the recent economic reforms that have driven the strong growth.

The extremes between the very rich and very poor are very acute in India. According to *Forbes* magazine, the number of U.S. dollar billionaires in India doubled in 2006 to 23, and their combined net worth of $99 billion now surpasses that of former Asian leader Japan's 27 billionaires. In the meantime, the latest World Bank estimates report that the percent of the population below the poverty line is 29 percent, and 47 percent of children under five suffer from malnutrition. Many in India fear that this extreme divide, if not addressed, is another potential source of social unrest.

Energy Requirements The fast-growing economy is developing a rapid and expanding need for energy. China and India together account for a significant rise in the global demand for oil and have been very competitive in locating and locking up oil supplies around the world. In addition, India is seeking to expand its civilian nuclear power capacity. India and the United States have negotiated a nuclear parts trade deal which, at the time of the writing of this book, requires a ratification by both countries' legislatures that is controversial in both countries. Should either legislature reject the trade deal, the consequences to the Indian economy may be felt beyond just the energy issue, and influence trade as well. In addition, Australia is the world's largest supplier of uranium that is needed to fuel nuclear reactors and, like the United States, Australia has domestic regulations restricting such trade with nonsignatories to the Nuclear Non-Proliferation Act, of which India is one. If India incurs energy shortages, such restrictions will impede its ability to continue to grow at its current pace.

External Factors

Oil Prices While the economy has so far been resilient regarding rising oil prices, the impact of continued high prices will likely affect growth in several ways. First, the domestic price of oil and gasoline is held stable by subsidies to shield consumers from true market prices. These subsidies are increasing directly with the rising price of oil. While these subsidies are directly borne by the large domestic oil companies in their bottom lines, they are indirectly borne by the government, the major shareholder of the domestic oil companies. To the extent that this impacts the government's budget or deficit, it will impact spending. Second, higher oil prices must eventually flow through to businesses and consumers, which would affect capital spending and consumption and negatively impact economic growth.

Pakistan While relations with Pakistan have been improving over the last several years, the relationship requires constant attention and is by no means trouble free. Tension continues regarding Kashmir, and uncertainty remains

about the policies of any post-Musharaf Pakistani government. The July 2006 series of train bombings in Mumbai have been blamed on a Pakistan-based terrorist group (at the time of this writing), putting a further glitch in relations and causing some India–Pakistan conciliation talks to be interrupted. While many Indians dispute that Pakistan negatively impacts India's market, foreigners note the uncertainty, and from an investor's point of view, uncertainty raises the risk premium.

Market-Specific Risks

Expectations versus Fundamentals India's benchmark indexes, even given the May/June 2006 correction, have risen to what many believe are unsustainable levels. The BSE Sensex and the BSE 100 Index had P/E multiples at the end of 2006 of 22.51 and 19.93, respectively. Some analysts think these multiples, and hence company valuations, are not justified by the fundamentals of the underlying companies. Furthermore, there is concern that investors, and some domestic analysts, are not adjusting their expectations, expressed as market multiples, and thus price targets to those fundamentals, as logic would dictate. Rather, they are irrationally doing just the opposite: They are playing with the fundamentals[4] to make them appear higher and thereby fit them into their inflated expectations, and then feel justified by the inflated expectations and associated higher prices. This would inevitably lead to disappointment when earnings are announced and then followed by steep declines in share prices. The existence of this contrary view in the market should be noted by investors.

Supply/Demand Mismatch There is concern that if domestic and foreign investment enters the market too rapidly and in significant quantities the supply of attractive investment opportunities would further increase P/E multiples. This would lead to: (1) unsustainable prices and valuations, (2) the risk of further sharp stock price corrections from high levels, (3) significant losses for domestic and foreign investors, and (4) undesirable volatility. Furthermore, this would likely result in discouraging investors from participating in India's markets, which would impede capital market–funded growth. The counterargument to this is that there are numerous sources of future equity supply that are beginning to enter the market that may effectively fill much of the demand. There are still a number of new sectors that will absorb much of the new money. These include the civil aviation market, which is one of the fastest growing in the world, and the retail sector, presently a largely private, mom-and-pop industry of 12 million shops only just beginning to organize into public chains as retail consumption takes off. Currently, the public retail chains represent just a small percentage of

overall consumer activity. In addition, there are several important industries not yet well represented in the stock markets, such as the real estate, telecommunications, and power sectors. Assuming the government continues privatizations, there is anticipation that the government will begin to privatize its vast holdings in the banking and power sectors.

SUMMARY

Economic reforms initiated by the government 15 years ago have led to a dramatic transformation of the once-socialist centrally planned economy into a dynamic, capitalist, entrepreneurial, competitive engine of wealth creation. Firmly established as a key player in the global economy, India is poised to produce sustainable economic growth of 8 percent in the years to come. The financial markets have responded with one of the world's best performances over the last several years and an easing of the rules for foreign institutional participation. The rebound from the sharp May/June 2006 correction shows the growing resilience of the stock markets and growing investment appetite among domestic investors. While risks to this potential economic growth and the stock market exist, India presents a compelling investment opportunity to the savvy investor who can adeptly navigate these risks.