

Foreign Institutional Investors: Investment Preferences in India

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Abstract

Foreign institutional investors have gained a significant role in Indian capital markets. Availability of foreign capital depends on many firm specific factors other than economic development of the country. In this context this paper examines the contribution of foreign institutional investment particularly among companies included in sensitivity index (Sensex) of Bombay Stock Exchange. Also examined is the relationship between foreign institutional investment and firm specific characteristics in terms of ownership structure, financial performance and stock performance. It is observed that foreign investors invested more in companies with a higher volume of shares owned by the general public. The promoters' holdings and the foreign investments are inversely related. Foreign investors choose the companies where family shareholding of promoters is not substantial. Among the financial performance variables the share returns and earnings per share are significant factors influencing their investment decision.

Key Words: foreign institutional investors, Bombay Stock Exchange, Sensex, share returns, earnings per share

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Introduction

In this age of transnational capitalism, significant amounts of capital are flowing from developed world to emerging economies. Positive fundamentals combined with fast growing markets have made India an attractive destination for foreign institutional investors (FIIs). Portfolio investments brought in by FIIs have been the most dynamic source of capital to emerging markets in 1990s. At the same time there is unease over the volatility in foreign institutional investment flows and its impact on the stock market and the Indian economy. The stock markets in India had to put up the burden in terms of being the second largest loser of foreign money in Asia accounting for 22% of the total net sales - April-May 2006. One of the reasons for the attack of Black Monday is claimed to be FIIs. Statistical records provided by Securities and Exchange Board of India (SEBI) indicated that both FIIs and domestic institutional investors together influenced market sentiment. As per the information provided in BSE India.com during the fortnight from May 16th to May 31st 2006, the withdrawals by FIIs were to the extent of US\$2.061 billion. This explains the fact that sales of FIIs had a major impact on the market and this impact led to the crash.

Apart from the impact they create on the market, their holdings will influence firm performance. For instance, when foreign institutional investors reduced their holdings in Dr. Reddy's Lab by 7% to less than 18%, the company dropped from a high of around US\$30 to the current level of below US\$15. This 50% drop is apparently because of concerns about shrinking profit margins and financial performance. These instances made analysts to generally claim that foreign portfolio investment has a short term investment horizon. Growth is the only inclination for their investment. Their strategy is –'Why take risk when you are not in profit-exit'. According to the industry experts, hedge funds played a very active role in Indian stock market since 2003 by entering both Indian cash and derivative market. The upward trend in the domestic market is due to hedge funds and not due to regular long-term FIIs. Thus the foreign portfolio investments are found to be very volatile in nature.

Despite these observations, countries and firms are interested in attracting foreign capital because it helps to create liquidity for both the firms stock and the stock market in general. This leads to lower cost of capital for the firm and allows firm to compete more effectively in the global market place. This directly benefits the economy and the country. Availability of foreign capital depends on many firm specific factors other than economic development of the country.

Contemporary research has investigated only the portfolio preferences of FIIs from the viewpoint of fund management companies. This paper attempts to examine the specific characteristics of the firms included in sensitivity index (Sensex) of Bombay Stock Exchange and their influence in attracting more foreign institutional investment.

Literature Review

As the Indian equity market is growing, the trend and future prospects in foreign institutional investments has become a topic of great concern. A recent research survey by Japan Bank for international operation (JBIC), shows that in the next 3 years, India will be the third most favoured investment destination for Japanese investors. A Smith Barney (a CITI group Division) study says estimated market value of foreign institutional investment in the top 200 companies in India (including ADRs and GRDs) at current market prices is US\$43 billion. This is 18% of the market capitalization of BSE 200.

It is established in literature that block shareholders influence the firm performance (Cho & Padmanabhan, 2001). Governance of listed companies plays an important role in foreign institutional investment decisions. Further more management of businesses run by family groups plays a distinctive role. When governments become block share shareholder their objective will be quite different from those of private investors.

Douma, Pallathiatta and Kabir (2006) investigated the impact of foreign institutional investment on the performance of emerging market firms and found that there is positive effect of foreign ownership on firm performance. They also found impact of foreign investment on the business group affiliation of firms. Aggarwal, Klapper and Waddock (2005) observed that foreign investors preferred the companies with better corporate governance. Investor protection is poor in case of firms with controlling shareholders who have ability to expropriate assets. The block shareholders affect the value of the firm and influence the private benefits they receive from the firm. Companies with such shareholders will find it expensive to raise external funds. Yin-Hua and Woidtke (2005) found that when company boards are dominated by members who are affiliated to the controlling family, investor protection will be relatively weak and it is difficult to determine the degree of separation of management from ownership. They also observed that firm value is negatively related to board affiliation in family controlled firms. Li (2005) observed that in case of poor corporate governance the foreign investors choose foreign direct investment (FDI) rather than indirect portfolio investment. It is generally believed that FDI could be better protected by private means.

Dahlquist et al. (2003) analysed foreign ownership and firm characteristics for the Swedish market. They found that foreigners have greater presence in large firms, firms paying low dividends and in firms with large cash holdings. They explained that firm size is driven by liquidity. They measured international presence by foreign listings and export sales. They reiterated that foreigners tend to underweight the firms with a dominant owner. Covrig et al. (2007) concluded that foreign fund managers have less information about the domestic stocks than the domestic fund managers. They found that ownership by foreign funds is related to size of foreign sales, index memberships and stocks with foreign listing.

Li and Jeong-Bon (2004) found that foreign investors tend to avoid stocks with high cross-corporate holdings. They suggested that FII are likely to be efficient processors of public information and are attracted to Japanese firms with low information asymmetry. Morin (2000) explored the influence of French model of shareholding and management on FII. They commented that France has undergone rapid change from a financial network

economy to a financial market economy. The new pattern has broken the traditional system of cross holding and facilitated the arrival of FII who bring with them new techniques and demands efficient corporate management.

What could be firm level factors that influence foreign capital from an economic standpoint is the question yet to be answered. Outside investors will lower the price they pay if they fear consumption of private benefits of control family. Choe, Kho, Stulz (2005) found that US (United States) investors do indeed hold fewer shares in firms with ownership structures that are more conducive to expropriation by controlling insiders. In companies where insiders are dominating information access and availability to the shareholders will be limited. With less information, foreign investors face an adverse selection problem. So they under invest in such stocks.

Leuz, Nanda and Wysocki (2003) further asserted that the information problems cause foreigners to hold fewer assets in firms. Firm level characteristics can be expected to contribute to the information asymmetry problems. Concentrated family control makes it more likely that information is communicated via private channels. Informative insiders have incentives to hide the benefits from outside investors by providing opaque financial statements and managing earnings. Haw, Hu, Hwang and Wu, (2004) also found that firm level factors cause information asymmetry problems to FII. Their paper found evidence that US investment is lower in firms where managers do not have effective control. Foreign investment in firms that appear to engage in more earnings management is lower in countries with poor information framework.

There is a growing literature on the determinants of global investment flows and allocations. Prior research focused on international portfolio flows and examined the relationship between portfolio flows and stock returns. Most of these studies have analysed global and country level factors that influence investment allocations. This paper investigated empirically the firm specific variables, which influence the investment decision of foreign investors.

Methodology

Selection of Sample and Sources of Data

BSE Sensex is a basket of thirty large liquid stocks representing leading companies from nineteen sectors in India and is regarded as the pulse of Indian markets. The index is scientifically designed based on globally accepted construction and review methodology. It is widely reported and accepted both in the Indian and international markets. Hence in this paper, twenty-five Sensex scripts have been taken as a sample for the period of 2001 to 2006 (information was not available for five firms for the specified time period). The information about ownership structure, financial performance and the stock returns of the sample companies is collected from CMIE Prowess package.

Panel data analysis

As foreign investment is recognized to be an important source of finance, it is essential to understand the factors that influence the foreign investors' portfolio decision. The review of research papers reveals that foreign investors may not prefer companies with family

ownership. To understand whether this finding is true with respect to BSE Sensex companies, the shareholders were categorized into four groups: promoters, foreign investors, financial institutions, and general public. Further promoters were categorized into three groups: family groups, government and foreign promoters. The share holding of the respective groups is taken in percentage form to control the firm size. The relationship is observed through the correlation and regression coefficients.

Corporate performance will be the major influencing factor for investment decision of any investor. Aggarwal, Klapper and Wyszocki (2005) studied the impact of six firm level variables on portfolio investment of fund companies. Their variables are: value of equity in US dollars, annual dividend yield, total debt to market capitalization, annual stock return, price to book value, and return on equity. In this paper five firm specific variables have been taken and data is collected on quarterly basis. The variables are share returns, earnings per share, price earnings ratio, book to market price and quarterly yield. All these variables are collected for each quarter for five years from 2001 to 2006. The information is collected for twenty quarters for each of twenty-five Sensex companies. Thus there are two kinds of information: cross sectional information reflected in between the companies, and time series with in company information over time. Panel data regression technique is used to understand the relationship between this two-way information.

The dependent variable is the percentage of foreign investor's shareholding in the sample unit. Company is unit variable and quarter is time variable. The analysis is given in three parts measuring time series effect, cross sectional effect and random effect. Tables 1 to 6 present the results of the model using cross sectional time series analysis.

Description of Model and Variables

In this paper firm specific characteristics (ownership structure, financial performance and stock performance) have been analysed. The relationship between these attributes and foreign institutional investment has been examined.

Ownership structure

A firm's ownership structure influences its performance for several reasons. Differences in identity & concentration among owners determine their relative power, incentives and ability to monitor managers. Shareholders such as family groups, financial institutions, government, and individuals have their own divergent goals. It is examined whether the ownership has any influence on the investment decision of foreign institutional investors.

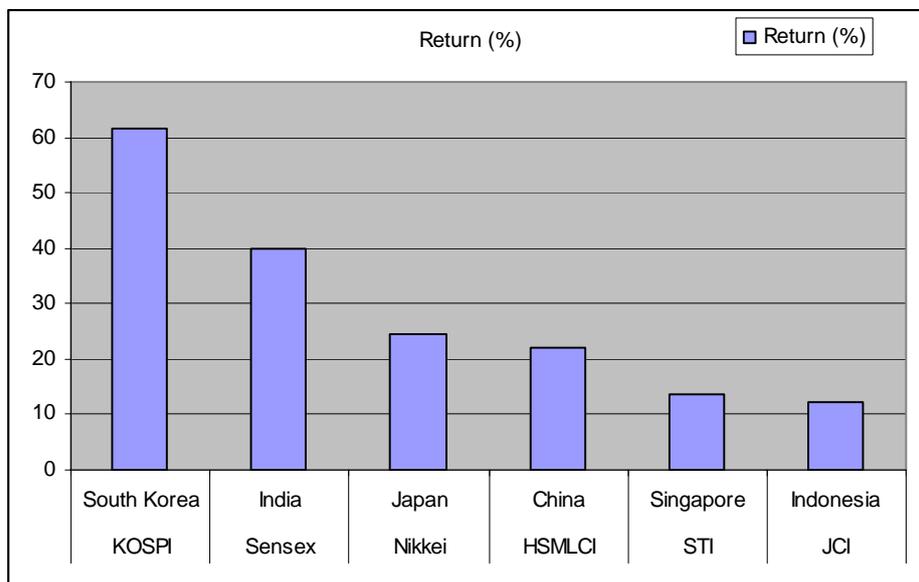
Corporate performance

It is important to understand the factors that can cause investors to stay away from providing capital to foreign firms. Prior research observed that more foreign funds were invested in firms with larger market capitalization, higher dividend yield and higher leverage. The measures of performance considered in the previous research studies have guided the selection of the ratios.

Share Returns

Ahmadjian and Robbins (2005) observed foreign portfolio investment in the Japanese economy during the 1990s. Their analysis of 1108 firms between 1991 and 2000 showed that foreign investors were more interested in investment returns than in long-term relationships. They also found that contribution and influence of foreign funds was weak in closely-knit companies with close ties to domestic financial institutions and corporate groups. Stock market performance indicates the investor's perceptions about the company. Market prices reflect not only the performance but also investor's expectations about the future performance. Figure 1 shows that the market returns in India in the year 2005 are around 40%.

Figure 1. Returns of stock markets across countries in 2005



Earnings per Share

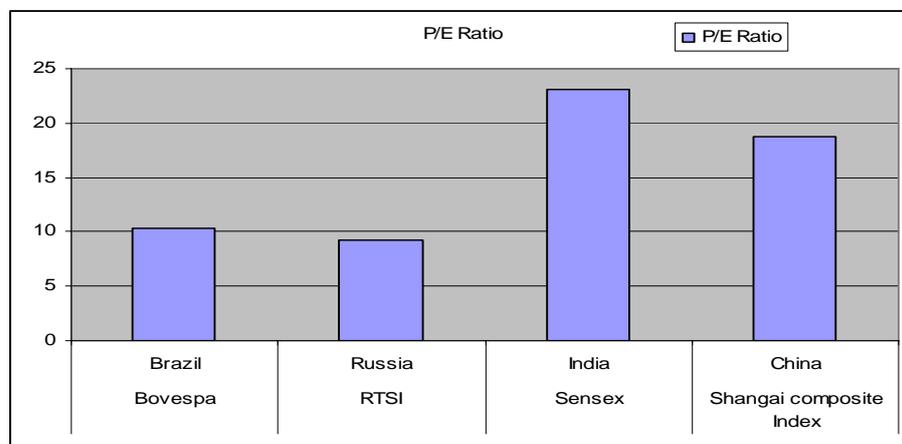
Source- Business today

The investors will assess the performance of the company and one significant indicator of financial performance often used is earning per share.

Price Earnings ratio

Price earning ratio indicates the growth of market price in relation to the earnings of the company. It establishes the relationship between the earnings and the market price. In the year 2005 the price earning ratio was high at 23.1 (depicted in Figure 2) in BSE Sensex, which could attract more foreign Investments. The research analysts reported that in the year 2006, the ratio was trailing at around 19%.

Figure 2. P/E Comparisons for the year 2005



Source- Handbook of Statistics on the Indian securities market, 2005

Price to book value

Over 80% of the reporting parameters used to manage the company are designed to gauge returns to shareholders. Most management decisions are therefore biased towards delivering short-term value to them. An income statement or balance sheet does not reveal the company's ability to create value for customers, employees or shareholders.

According to the OECD, most companies are well aware that the facts and figures contained in the financial reports fail to capture fully the 'essence' of their operations. This fact is particularly evident in the case of companies whose book value is markedly different from the market value. The book value of the equity measures approximately the capital contributed by the shareholders, whereas market price of the equity reflects how productively the firm has employed the capital contributed by the shareholders as assessed by stock market. The ratio of price to book value gauges whether the market valuation of the company is relative its worth or not.

Yield

Yield has been computed to measure the shareholders returns. It is computed based on dividends and share price appreciation to reflect the overall return to the shareholders. All these ratios are computed quarterly.

Empirical Results

Among the twenty-five Sensex companies there were seventeen companies in which promoters are from family groups and three companies had the government as the promoter. Two companies had foreign promoters and three companies did not have any promoter holdings. The percentage share holding of these individual groups is taken as a variable for the purpose of the analysis.

In this paper the summary statistics as given in Table 1 explain that around 20% of the capital comes from foreign institutional investors on an average among Sensex companies. The promoters contribute around 30%, the financial institutions provide 17 % and public share is 30% (remaining from other sources).

Table 1. Descriptive Statistics of Independent variables used in the study

	Minimum	Maximum	Mean	Std. Deviation	Variance
FII	0.02	66.02	20.36	13.02	169.63
Independent Promoters	0	83.96	21.42	20.14	405.65
Government Share Holding	0	84.11	8.30	22.72	515.98
Foreign Promoters	0	51	3.03	10.99	120.80
Financial Institutions	0.56	72.62	16.78	11.97	143.23
Public Share Holding	1.45	66.03	32.11	13.05	185.02
Quarterly Share Return	-49.21	18.31	-1.48	5.71	32.59
EPS	-5.11	39.1	9.79	7.85	61.67
P/E Ratio	7.18	60.4	22.25	10.72	114.98
P/B ratio	1.21	19.69	5.45	3.68	13.51
Yield	0	4.38	1.47	0.97	0.94

The panel data for twenty-five companies and twenty quarters is analysed both to understand the time series and cross sectional impact. Time series regression in panel data estimates the (xtreg, fe) coefficients of Beta and Alpha assuming that the units (ui) are fixed quantities. In cross sectional analysis (xtreg be) the means are calculated for each of the units and the model estimates Beta values. The random effects estimates give a weighted average of these two results. Tables 3, 4 and 5 present the relationship between FII and the ownership pattern. The relationship between FII and financial performance indicators is given in Tables 6, and 7.

The regression coefficients of ownership variables on FII for time series analysis is presented in Table2, Table 3 provides cross sectional coefficients and Table 4 exhibit results of random effects. The T and F statistics given in Table 3, 4 and 5 explain that there is no influence of foreign promoters or that of financial institutions on foreign institutional investors. There is inverse relationship between the promoter share holding and foreign institutional Investment. This is in conformity with the theoretical construct that the foreign investors do not prefer the companies where family shareholders dominate. The regression coefficient is significant between Public share holding and foreign institutional investment both in time series (Table 3) as well as cross sectional analysis (Table 4). This infers that higher the publicly traded shares in a firm high will be the foreign investment.

Table 2. Time series regression

Dependent Variable - Foreign Institutional investment						
(Xtreg fixed effects)						
	Correlation	Coefficient	t values	p>t	F value	f>t
Independent Promoters	0.0661	-0.096	-3.15	0.002	9.9	0.0018
Government Share Holding	-0.7439	-0.715	-3.16	0.002	9.99	0.0017
Foreign Promoters	-0.0218	-0.126	-0.64	0.521	0.41	0.52
Financial Institutions	0.1674	-0.05	-1.48	0.14	2.19	0.13
Public Share Holding	0.5399	0.1135	4.35	0	18.91	0

Table 3. Cross Sectional Regression -Xt reg between effects

Dependent Variable - Foreign Institutional investment						
	Sd(u _i +avg(e _i))	Coefficient	t values	p>t	F value	f>t
Independent promoters	12.044	-0.1411	-1.08	0.29	1.17	0.2912
Government Share holding	17.76	-0.144	-1.35	0.191	1.82	0.1906
Foreign Promoters	12.47	-0.1024	-0.45	0.659	0.2	0.6592
Financial Institutions	12.2	-0.2882	-1.18	0.248	1.4	0.2483
Public Share holding	8.966	0.4337	4.72	0	22.27	0.0001

Table 4. Panel Data Regression – (random effects)- (u_i ≈ Gaussian)

Dependent Variable – Foreign Institutional investment		Corr(u _i ,x) = 0 (assumed)			
	Coefficient	z values	p>z	chi square	p> chi sq.
Independent promoters	-0.099	-3.31	0.001	10.98	0.009
Government Share holding	-0.2481	-2.56	0.011	6.54	0.0105
Foreign Promoters	-0.1163	0.78	0.436	0.61	0.4359
Financial Institutions	-0.0554	-1.63	0.103	2.66	0.1029
Public Share holding	0.1375	5.42	0	29.36	0

Table 5. Time series regression (Xtreg fixed effects)

Dependent Variable - Foreign Institutional investment						
	Correlation	Coefficient	t values	p>t	F value	f>t
Quarterly Share Return	0.0061	0.1159	2.97	0.003	8.82	0.0031
EPS	-0.0579	0.1899	4.85	0	23.54	0
P/E Ratio	-0.7018	-1.0585	-4.47	0	20.02	0
P/B ratio	-0.81	-4.5634	-4.58	0	20.93	0
Yield	-0.1747	0.716	1.1	0.273	1.2	0.273

Table 6. Cross Sectional Regression -Xt reg between effects

Dependent Variable - Foreign Institutional investment						
	Sd(u _i + avg(e _i))	Coefficient	t values	p > t	F value	f > t
Quarterly Share Return	12.5529	1.399	0.32	0.753	0.1	0.7529
EPS	12.5805	0.0094	0.02	0.984	0	0.9837
P/E Ratio	12.5617	0.0618	0.26	0.795	0.07	0.795
P/B ratio	12.5806	0.0074	0.01	0.991	0	0.9914
Yield	12.466	-1.793	-0.65	0.521	0.42	0.5211

Table 7. Panel Data Regression - (random effects) (u_i ≈ Gaussian)

Dependent Variable - Foreign Institutional investment		Corr(u _i , x) = 0 (assumed)			
	Coefficient	z values	p > z	chi square	p > chi sq.
Quarterly Share Return	0.116	2.98	0.003	8.85	0.0029
EPS	0.1885	4.84	0	23.42	0
P/E Ratio	-0.4955	-2.94	0.003	8.64	0.0033
P/B ratio	-1.4615	-2.55	0.011	6.51	0.01
Yield	0.05825	0.92	0.359	0.84	0.3588

The time series regression coefficients of performance variable on FII are given in Table 5, cross sectional results in Table 6 and random effects in Table 7. The results given in both Table 5 and 7 confirm that among the various performance variables price earning ratio and earnings per share have significant influence on FII.

Limitations of the study

However these findings could not be taken for making generalizations because:

- Sample is small and consists of only twenty-five companies
- The study is based on Sensex sample. The Sensex companies have an external image that they are the best performers in the country. If the sample companies consist of probably a heterogeneous group then the results may give better insight in to relationship of the specific variables.

Findings and Conclusion

Domestic sources of outside finance are limited in many countries, particularly those with emerging markets. Through capital market liberalization, foreign capital has become increasingly significant source of finance.

In developing countries like India foreign capital helps in increasing the productivity of labour and to build up foreign exchange reserves to meet the current account deficit. Foreign Investment provides a channel through which country can have access to foreign capital.

There are speculations of wider range on the expectations of foreign institutional investors. It is required to understand when they withdraw their funds and when they pump in more money. Higher Sensex indices and high price earnings ratio are the country level factors attracting more foreign investment in India.

This paper empirically observed that the foreign investment is more in companies with higher volume of publicly held shares. The promoters' holdings and the foreign investments are inversely related. As has been observed in the governance literature the foreign Investors choose the companies where family shareholding of promoters is not substantial. Among the financial performance variables the share returns and Earning per share are more influencing variables on their investment decision. This provides a pointer for further research that market performance is the strong basis for attracting more foreign investment for the individual companies. The foreign institutional investors with draw their money when the stock market performance starts sliding down.

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