

Union Budget *fine-print*: Encouraging foreign flows

Positive for the medium term

The FY12 Union Budget contains a few proposals that signal the government's intent to augment foreign capital flows into India. A key proposal is to allow foreign investment into mutual funds, not just from institutions, but from any investor satisfying KYC requirements. While near-term flows may be impeded, we believe this is significant positive step in the long-term and would allow efficient Indian mutual funds to tap foreign markets directly. Among other key positives, the foreign limit on investment in corporate bonds has been hiked from US\$ 25bn to US\$ 40bn, while tax on foreign subsidiaries has been reduced to allow for repatriation of dividends. Overall, the budget lends an impetus to capital flows and brightens our outlook on the rupee.

Budget allows foreign (retail) investors to invest in Indian DMFs: The FY12 Union Budget has proposed to widen the scope of foreign investment into domestic mutual funds (DMF) from the institutional, sub-account, and NRI categories. It not only opens the door for foreign retail investors and endowments to invest into Indian equities, if only indirectly, but also allows for a wider potential universe of equity inflows for DMFs. While offshore EM- and India-based funds already offer multiple options for foreign investors to gain exposure to Indian equities, DMFs now have the opportunity to harness incremental capital inflows. In our view, this can materially increase the flow of capital into the country if Indian funds can market themselves well in foreign countries.

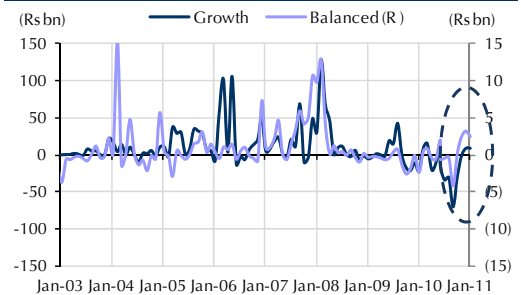
Several hurdles – Indian fee structure is higher...: DMFs are clearly not competitive when one considers the cost of managing funds. Even without front-load, fund management fees of ~2.5% compare quite unfavourably with the sub-1% structure usually seen with offshore funds. While rising competition would eventually rationalise costs, they remain a short-term deterrent. And the lack of 'differential share classes' in India, which enable significantly lower costs for institutions like endowments, does not help either.

...the laws complex, but local colour may help?: Taxation and KYC (know-your-customer) norms across geographies, issues like one- and two-way fungibility, lock-in periods, and many others need to be clarified, proper distribution networks set up before a 'push' product like mutual funds can be marketed to foreign audiences for sorely-needed funds. Perhaps the enviable record of some domestic funds could be the silver lining needed to get those funds.

Equity mutual funds could do with more domestic inflows: Last year's inflows of US\$ 29bn into the market from foreign investors contrasted starkly with the US\$ 6bn in outflows from DMFs, led no doubt by net redemptions of US\$ 4bn from growth and balanced schemes. While there's been marginal improvement over the last few months with a net inflow of ~US\$ 500mn over November–January '11, it's still a far cry from the US\$ 5.4bn of net inflows over the same period in 2007–08.

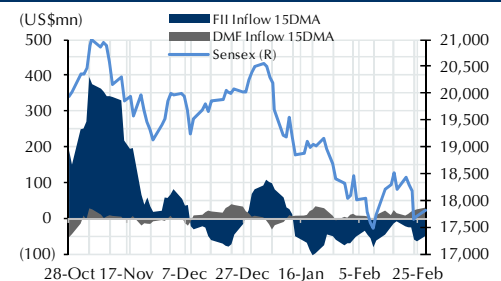
Hike in FII investment cap in corporate bonds another positive: The FII investment limit in bonds issued by infrastructure companies with residual maturity of five years or more has been hiked from the existing US\$ 5bn to US\$ 25bn (and thus the limit for total corporate bonds from US\$ 20bn to US\$ 40bn). This is yet another positive for capital flows and infrastructure funding in India.

Net inflow into Indian equity funds



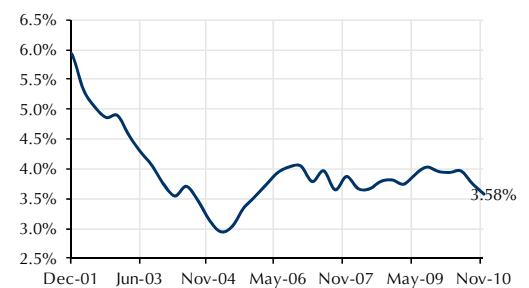
Source: AMFI

Indian markets and Foreign Institutional Flows



Source: RCML Research, Bloomberg

Falling share of DMFs in the BSE500 companies



Source: RCML Research, Capitaline





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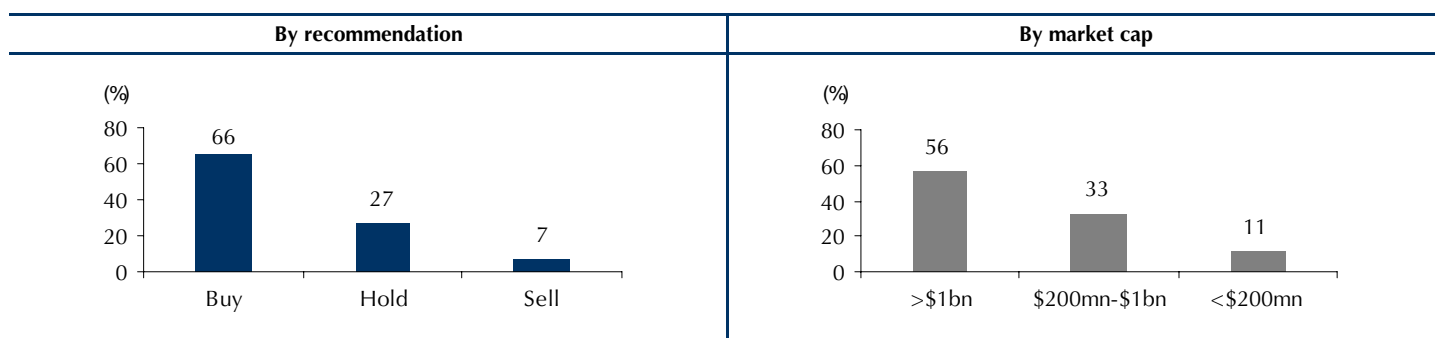
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