ISLAMIC INVESTMENTS OPPORTUNITIES IN INDIA

By: Shariq Nisar[1]

Abstract:

Over the last ten years Islamic finance has grown quite impressively. With the growth in Islamic finance the need for shariah compliant financial products have also increased very much. However, Islamic capital markets in various Muslim countries are still quite underdeveloped. In these circumstances there have emerged a number of Indices developed by Dow Jones, FTSE and others to track shariah compliant stocks from the world over. This paper using the shariah screening norms as adopted by the Dow Jones show that the Indian capital market also provides tremendous shariah compliant investment opportunities as compared to a number of Islamic countries.

1.0 Introduction

Slowly the world's economic centre of gravity is shifting away from the established, wealthy economies of Europe, Japan, and North America to the emerging economies like China, India, and South East Asia. China and India in particular are projected to become the two largest economies of the world in the next fifty years. China riding high on its manufacturing ability, has recorded tremendous economic growth in the recent past. But as far as foreign investments are concerned, it is still looked at with suspicion, mainly for its political setup and the economic model. On the other hand India the world's largest democracy, offers some very clear advantages. India is one of the fastest-growing large

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economies in the world. With a population of over 1.3 billion, with huge human and natural resources, and with costs that are at the very low end of the global average, India represents economic opportunities on a massive scale. Its legal framework, which protects foreign investments, is one of the best in the region. The economy offers an abundance of technical and managerial talent, with international experience. And most importantly, India has a demographic advantage that will see its working age population continue to grow in the next couple of decades.

Islamic finance, on the other hand is another great success story of modern times. Emerging modestly from a small town of Egypt, less than four decades ago, Islamic finance has already reached critical mass. Those busy mocking at it not long ago have now started practicing it. Everywhere Islamic financial institutions are now praised and awarded for their excellence and ethical concerns. But the real journey has just begun.

In these times Islamic finance needs to keep its feet firmly on the ground. Keeping itself informed with a high level of concern for equity and justice, differentiating between the lawful (*halal*) and the prohibited (*haram*) and a sense of responsibility towards the weaker sections, Islamic finance needs to continuously look at opportunities beyond the land of oil and gas. That India is one such land of opportunity is the purpose of this paper.

India started liberalizing its economy in 1991, when the current Prime Minister, Dr Manmohan Singh took over the charge of Finance Ministry. Under his direction the Central government embarked on large-scale economic reforms. India the world's largest democracy possesses political liberty, plural and mostly secular society and institutional framework that is best suited to a global economy. India's strength lies in bottom-up potential. Companies are well run and valuations are reasonable given current earnings' growth. The country has an enormous consumer market and relatively inexpensive labour force. Since economic reforms the country has grown at over 5 percent, and now expanding at close to 8 percent. Compare that to European growth of less than 2 percent

on a 10-year average, and U.S. growth of around 3 percent. India is predicted to be one of the world's two biggest economies by mid-century.[2]

2.0 Corporate Performance

Corporate India has been consistently showing good operational results. This, along with strong macroeconomic fundamentals, growing industrial and service sectors provides great potential for investment in the Indian economy.

Between March 2000 and December 2005, total sales of corporate India have grown from US$ 259 billion to US$ 488 billion, an impressive growth of 88 percent. In the current financial year between March to December sales have registered a growth of over 26 percent. Profit after tax (RAT) has jumped almost four times during the same period. Net worth of corporate India during the period of March 2000 to December 2005 has grown over US$ 100 billion, whereas, total assets have registered a growth of 85 percent during the same period.[3]

Table 1: India's Corporate Sector Performance

(Percent)

Year	Mar-01	Mar-02	Mar-03	Mar-04	Mar-05	Dec-05
Sales	13.97	-0.46	13.13	12.41	3.51	26.33
PAT	-1.37	12.14	52.33	65.77	20.99	9.51
Net Worth	8.49	2.02	11.27	17.22	1.14	25.98
Total Assets	9.29	6.22	10.96	13.24	0.89	25.75

Fresh investments in Indian corporate (Capital Expenditure) are on the rise at record speed. A recent survey by the Centre for Monitoring Indian Economy (CMIE) shows a 23 percent rise in outstanding investments under various stages of consideration and implementation. The survey captures 9,833 investment projects entailing a total investment of Rs. 24566.15 billion. During the previous financial year also new

[2] *Manufacturing in India: Opportunities, Challenges, and Myths*, KPMG, May 2005.

[3] *Centre for Monitoring Indian Economy* (CMIE). Note: data comprise total of 9691 companies.

investment recorded 29 percent growth. These investments have been the highest over the years and reflect stronger investments momentum in the country than witnessed anytime in the past. Sector wise over 31 percent investment is dedicated to manufacturing; 27 percent to electricity; and 26 percent to services. Irrigation, construction and mining account for the remaining 15 percent.

3.0 Capital Flows

Throughout the world FDI inflows has been stagnant for the last four to five years. In fact after three years of consecutive decline, global inflows of FDI marginally rose in 2004 to $648 billion. This growth reflected increased flows to a number of developing countries. Inflows to developing countries surged by 40 percent, to $233 billion, as a result, the share of developing countries in world FDI inflows rose to 36 percent, the highest level since 1997.

In terms of the most attractive investment locations, India's high ranking is marked remarkable in a survey conducted by UNCTAD, which shows that 42 percent Experts on FDI has put India as the third most attractive location after China and the US. In the same survey MNCs have put India as the second most attractive location for FDI after China.[4]

In the year 2004-05 total net capital inflows to India was $ 32 billion of which about 45 percent was in the form of non-debt inflows. FDI inflows during the year 2004-05 stood at $ 5.5 billion, which was 18 percent higher than FDI in the previous financial year. In 2001-02 FDI ($6.1 billion) constituted 71 percent of the total net capital inflows into the country. Since 2001-02 total FDI inflows in the country was US$ 21.38 billion.[5]

In fact huge capital inflows in the country mutely reflect the strong economic fundamentals as well as the confidence of foreign investors in the ability of Indian economy to match the expectations. Net Foreign Institutional Investments (FII) inflows

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[4] *World Investment Report 2005*, p. 66.

[5] *RBI Annual Report 2004-05*, Reserve Bank of India, Mumbai 2005, p. 285, table 1.56.

into India have increased steadily since 1999-2000 to reach an annual peak of US$10.25 billion in 2004-05. Cumulatively, FII investments as on December 31, 2005 have been US$ 41.10 billion. In December alone FIIs pumped over US$ 2 billion.[6] The number of registered FIIs in India has shot up in the last two years. According to the Securities and Exchange Board of India (SEBI), as on December 31, 2005, over 800 FIIs were active in the country of them over 300 have been registered since April 2004.

4.0 Stock Markets Performance

Among the 23 stock exchanges that India has three are major and two are among the five largest in the world. By end December 2005 total listed companies in India were 8281. Bombay Stock Exchange (BSE) established in 1875 is the oldest in Stock Exchange in Asia. It is India's biggest bourse, in terms of listed companies (4661) and market capitalization. Kolkata Stock Exchange has 2620 companies listed on it, whereas, National Stock Exchange (NSE) had 1000 companies listed on it at the end December 2005. NSE is the youngest to be incorporated in 1992 with an active support of the central government and its maintained institutions. By number of transaction NSE and BSE respectively occupy third and fifth largest in the world.[7] Market capitalization of total listed companies in India has jumped from US$ 119 billion in March 2001 to over US$ 564 billion at the end of December 2005, an increase of 373 percent.

Between March 2001 and December 2005 BSE market capitalization has recorded a jump of over 400 percent, whereas the same for NSE has been over 300 percent. Book value of BSE listed shares has almost doubled from merely US$ 86 billion in 2001 to over US$ 167 billion in December 2005. At present P/E of BSE stands at 18.27 with the price to book value (P/B) ratio being 3.32. BSE thirty share index (Sensex) has grown from 3972.12 in December 2000 to 9397.93 at the end of December 2005. Market capitalization of BSE Sensex has swollen over 363 percent during the period of March

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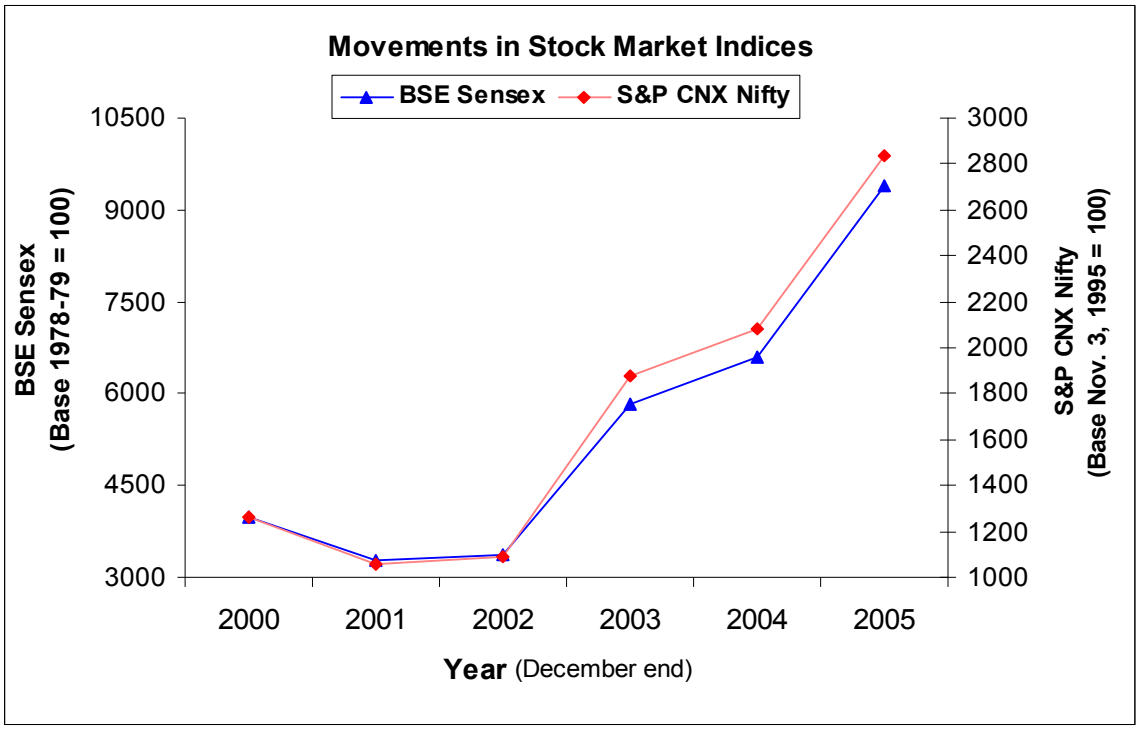
[6] Securities and Exchange Board of India (SEBI).

[7] *Economic Survey 2004-05*, Ministry of Finance, Government of India 2005, p. 76.

2001 to December 2005. Trade volume of Sensex has grown over three times from US $ 107 million to over US$ 371 million during the same period.[8]



NSE, which is the third largest stock exchange in the world after Nasdaq and NYSE has given an average return of 124 percent between December 2002 to December 2005. Its fifty share index (S&P CNX Nifty) closed at 2836 at the close of market in 2005. Traded volume of NSE has grown from US$ 130 million in March 2001 to over US$ 406 million at the end of December 2005. At end December 2005 NSE's P/E multiple stood at 17.07 with a Price to Book Value at 3.74.[9]

5.0 Islamic Investments Opportunities:

To assess the extent of Islamic investment opportunities on the stock market one has to look at the availability of stocks which conform to the norms stipulated by the Islamic shariah. When we talk about shariah compatible stocks, at least three important criteria to

[8] Bombay Stock Exchange

[9] National Stock Exchange

bear in mind are: (i) business of the company, (ii) nature of contract under which the invested capital of the enterprise is mobilized, and (iii) shariah compatibility of trading practices of the concerned shares of the company.

Keeping the above three criteria in mind a thorough study of Indian stock market was conducted. In the process about 1500 companies listed on BSE and NSE were examined. Findings of this study are described in the following sections. However, before we come to the results of the study, a few words are called for about the qualifying criteria and the tools (ratios) used to measure the Islamic compatibility of the listed companies.

At present there are number of institutions that are active in tracking shariah compliant stocks the world over. Few major among these are the Dow-Jones Islamic Market Index (DJIMI), US; the Shariah Advisory Council of the Securities and Exchange Commission (SEC), Malaysia; and the Meezan Islamic Fund Criteria, Paksitan.

As far as primary activities of the company are concerned all institutions agree that at least the primary or core activity of the company should not breach Islamic law.[10]

- Then there are companies whose main activity is not un-Islamic but a part of their income is not purely Islamic or a minor part of it comes from un-Islamic activities, for example hotel, sugar, entertainment etc.
- Further there are companies whose primary business is purely Islamic but they have huge cash flows and as part of their treasury management, they keep their monies in bank and earn interest.
- Then there are companies whose main activity is not un-Islamic, they do not have large interest earning but their activities to a large extent are financed by loans on interest.

[10] For example, if the primary activity of the company is production, distribution or trading of any un-Islamic item it would disqualify the stock. Hence stocks of all conventional financial institutions that are engaged in interest-earning activities, of companies producing or distributing un-Islamic products such as pork, liquor, tobacco etc. would disqualify the company on the first criterion that is economic activity.

- Also there are companies whose assets comprised largely of receivables and cash.

All such companies violate one or other criterion on which the Islamic compatibility of a company is judged.

Different scholars have set different criteria for selecting the qualifying stocks. It is obvious that in the real financial world against any criterion one will find a continuum of companies ranging from those which fully qualify with no infractions to those that are completely disqualified due to gross violation of the criterion. So the assessor has to set qualifying limits in terms of minimum ratios or percentages whereby the qualifying stocks can be screened out of non-conforming stocks. Dow Jones, SEC, Malaysia and Meezan all have their own qualifying norms. However, broadly speaking they use more or less the same methodology or criteria. We, in our study, have used the qualifying criteria as practiced by DJIMI, which are as follows:

5.1 Un-acceptable Business Activities

DJIMI, which in its shariah board has some of the most respected scholars of the Islamic financial world, has termed some industries as inconsistent with shariah percepts. Therefore investments in these stocks are not permitted. These industries are alcohol, pork-related products, conventional financial services (banking, insurance etc.), entertainment (hotels, casino/gambling, cinema, pornography, music etc.), tobacco, and weapons and defense industries. In addition, in our screening, we have excluded the sugar industry too as the units in this industry almost invariably produce potable alcohol as a byproduct from the molasses generated in the production process.

5.2 Un-acceptable Financial Ratios

After removing companies with un-acceptable primary businesses, companies are further put to test on the following financial ratios.

5.2.1 Debt to Assets

Exclude companies if Total Debt of the company divided by its Trailing 12-Month Average Market Capitalization is greater or equal to 33 percent

5.2.2 Impure Income

Exclude a company if cash plus interest bearing securities are equal or greater than 33 percent of Trailing 12-Month Average Market Capitalisation.[11]

5.2.3 Receivables to Assets

Exclude companies if Accounts Receivables divided by their Trailing 12-Month Average Market Capitalisation is greater than or equal to 33 percent.[12]

6.0 Shariah Compliant Stocks in India

When we put to test the 1000 companies listed at the National Stock Exchange (NSE) on the basis of the abovementioned parameters, we found that 335 companies qualified on shariah parameters. Market capitalisaton of the qualifying stocks was 61 percent of the total market captalisation of the NSE listed companies. Surprisingly, the growth in market capitalization of shariah compliant stocks was found to be more impressive than the growth in market capitalization of non-shariah compliant stocks.

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[11] Earlier DJIMI was screening companies on the basis of their gross revenue to total, which was earlier fixed at 9 percent then reduced to 5 percent of the gross income of the company. We have followed the 5 percent criterion, which said that exclude the company if its impure (interest) income is equal or greater than 5percent of its total revenue. We have not used the new criterion as we feel that linking this to market capitalization will make the screen unnecessary biased in favour of market capitalisaton, which very often might not reflect the fundamentals of the company but the sentiments of traders and speculators. Moreover, the argument for changing the criteria has also not impressed us. For more details on this please see, Ali, Salman Syed, *Islamic Capital Market Products: Developments and Challenges*, Islamic Research and Training Institute, Islamic Development Bank, 2005. For argument on changing the criterion, please see, Obaidullah, M., *Islamic Financial Services*, Islamic Economics Research Centre, King Abdul Aziz University, Jeddah, Saudi Arabia, 2005, p. 219.

[12] Again in this case DJIMI has changed the criterion and linked this also to market capitalization, which earlier was linked to Assets. This has made DJIMI criteria very liberal and biased in favour of developed capital markets. We in our screen have excluded companies if their receivables were equal or greater than 45percent of their total assets.

Another remarkable finding of the study is that even when the number of shariah compliant stocks was very limited the share of shariah compliant market capitalization never went below 50 percent of the total market capitalization. In fact the current share of shariah compliant market capitalization (61percent) is highest even when compared with the number of Islamic countries such as Malaysia, Pakistan, Bahrain etc. where share of shariah compliant market capitalization was 57 percent, 51 percent, and 6 percent respectively of the total market capitalization.[13] Sector wise computer software, drugs and pharmaceuticals and automobile ancillaries were the largest sectors among the shariah compliant stocks. They constituted about 36 percent of the total shariah compliant stocks on NSE.

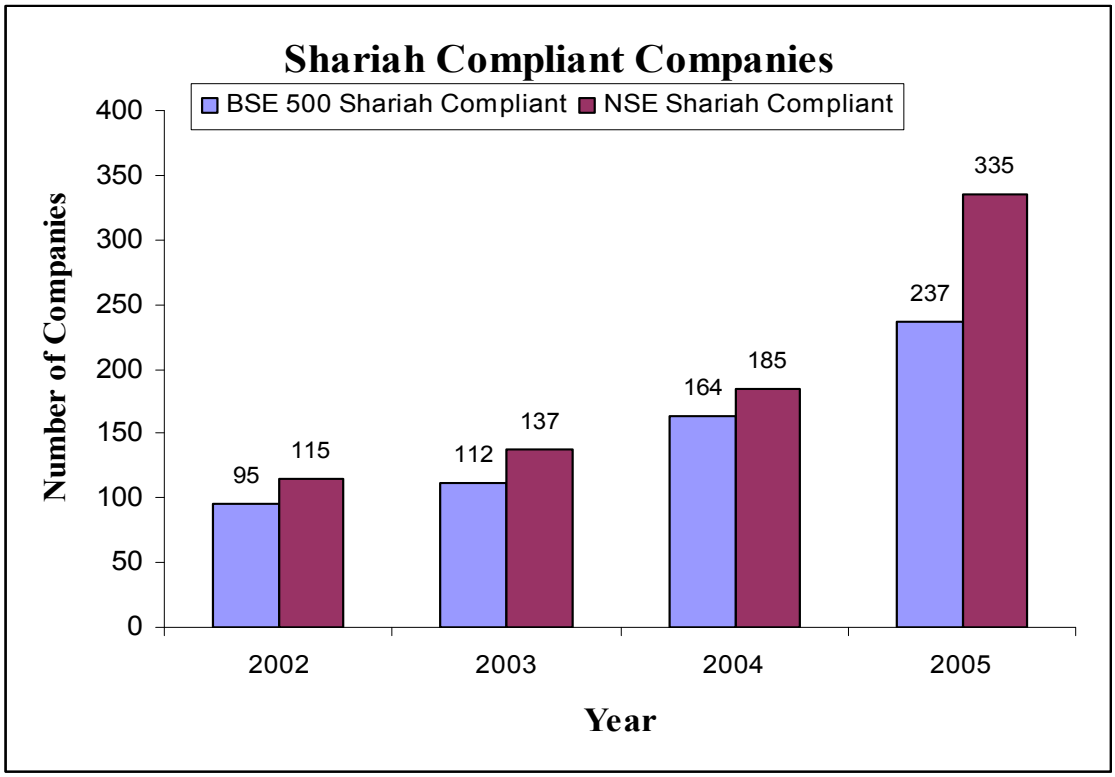

Table 2 shows the year wise performance of shariah compliant stocks at the NSE. In March 2002 only 115 companies were qualifying as shariah compliant. But as the market India started performing better and the stock market rose, the number of shariah compliant stocks increased from 137 in March 2003 to 335 in December 2005.

[13] *Islamic Capital Market Products: Developments and Challenges*, Islamic Research and Training Institute, Islamic Development Bank, 2005, p. 23.

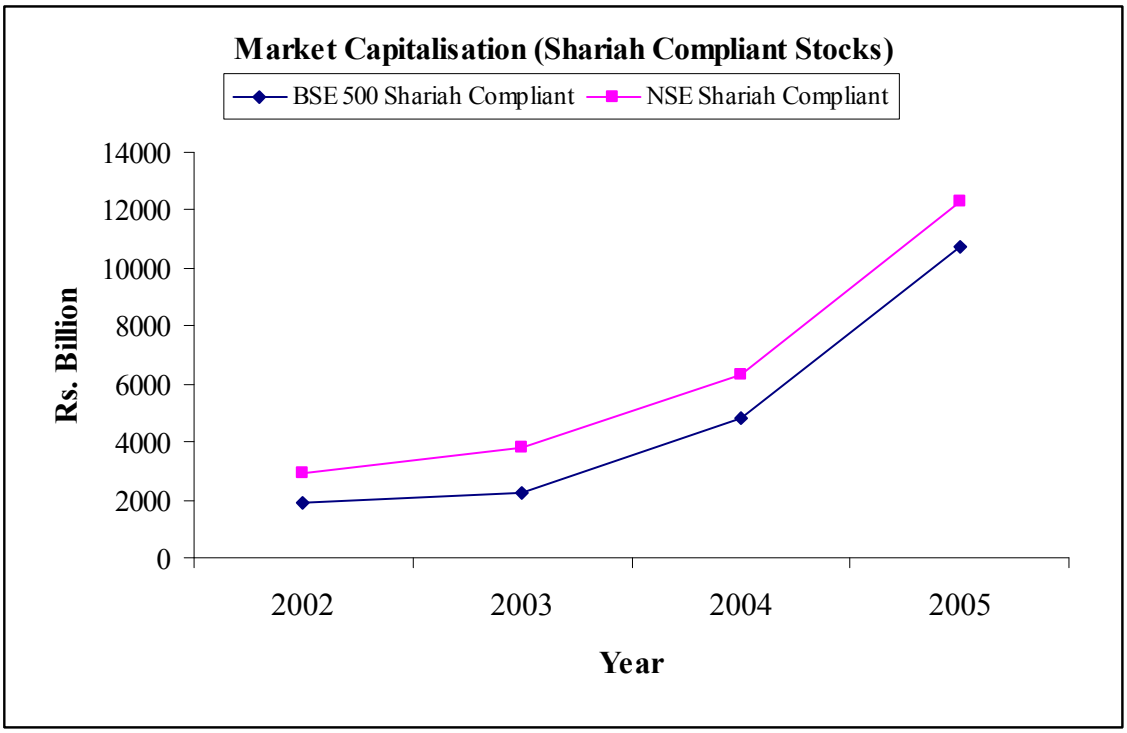

Table 2: National Stock Exchange Listed

Year	Mar-2002	Mar-2003	Mar-2004	Mar-2005	Dec-2005
Total Number of Companies (Listed at NSE)	988	988	988	988	1000
Shariah Compliant Companies	115	137	185	237	335
Total Market Cap (Rs. Billion)	5728.96	7005.99	10366.13	15265.83	20171.72
Total Market Cap Annual Growth (percent)	-20.02	22.29	47.96	47.27	32.14
Shariah Compliant Market Cap (Rs. billion)	2895.64	3801.57	6305.17	8910.54	12311.13
Share of Shariah Compliant Market Cap (percent)	50.54	54.26	60.82	58.37	61.03
Shariah Compliant Market Cap Annual Growth (percent)	-26.77	31.29	65.86	41.32	38.19

(Source: CMIE). Number of listed companies keeps varying. During the study period, initially the number of total listed companies at NSE was 988, which later on rose to 1000.

The same test was applied to BSE 500 (by and large India's 'Fortune 500'). The results (Table 3) suggest that here again the performance of shariah-compliant stocks was better than the performance of non-shariah compliant stocks. From merely 95 companies in

March 2002 the total number of shariah compliant companies on BSE has risen to 112, 164, and 196 at the end of respective financial year up till 2005.

Table 3: Bombay Stock Exchange (BSE 500)

Year	Mar-2002	Mar-2003	Mar-2004	Mar-2005	Dec-2005
Total Number of Companies	500	500	500	500	500
Total Shariah Compliant Companies	95	112	164	196	237
Total Market Cap (Rs. Billion)	4634.1	5411.41	8804.52	13635.74	18262.52
Total Market Cap Annual Growth (percent)	-20.95	16.77	62.70	54.87	33.93
Shariah Compliant Market Cap (Rs. Billion)	1894.78	2234.73	4824.04	7393.16	10728.21
Share of Shariah Compliant Market Cap	40.89	41.30	54.79	54.22	58.74
Shariah Compliant Market Cap Annual Growth (percent)	-32.84	17.94	115.87	72.57	45.11

Source: CMIE

At BSE out of 500 total 237 companies qualified on shariah parameters as at end December 2005. The Share of shariah compliant market capitalization with respect to the total market capitalization of the selected companies varied between 40 percent and 58 percent during the period of study. Here again the rate of growth achieved by shariah compliant stocks was better than the rate of growth achieved by non-shariah compliant companies. On BSE sector wise drugs and pharmaceuticals constituted the largest number of qualified stocks followed by computer software and automobile ancillaries.

7.0 Conclusion

India as compared to many other developing countries has been a star performer in recent years, both in terms of returns and attracting funds from overseas. Favorable demographics, wide opening of the economy and global competitiveness have put India on the economic radar of the global players. Leading indicators and available information both suggest that the Indian economy is poised to build upon the gains in macroeconomic performance secured in the recent past. Robust strengthening of manufacturing activity,

high corporate profitability, buoyant equity markets, robust merchandise exports and imports and lead indicators of service sector activity all point to a brightening of prospects for the Indian economy in the future.

Consequently, the return from the equity market has also been very handsome. Islamic financial institutions that are looking for investment opportunities beyond the Arabian Gulf can find Indian stock market a very good place to put their funds. Shariah conscious domestic investors can also find Indian stock market a better place to invest. They all will find a large number of stocks consisting various sectors from IT, drugs and pharmaceuticals, automobile to core sectors like energy, cement, steel and mining etc. In fact the Islamic options available in India are wider and much better than the availability of the same in many Islamic countries.