CHAPTER - 1
INTRODUCTION

1.1 INTRODUCTION:

Since 1991, Foreign Direct Investment (FDI) has become a main source of foreign capital flow for developing economies and a leading source of external financing (Seethapathi K, 2006). When India liberalized its policy towards foreign investment in 1991, there was a positive response from capital exporting countries. FDI to developing countries since the 1990s is on an increasing trend.

The reliance on FDI is rising heavily due to its all round contributions to the economy. Since liberalization i.e. 1991, FDI inflows in India is on an increasing trend. The FDI Inflows in India increased from Rs.409 crores in 1991-92 to Rs.6,916 crores in 1995-95 and Rs. 12,645 crores in 2000-01 to Rs. 24,613 crores in 2005-06 and Rs. 123,378 crores in 2009-10 which signifies towards positive response from capital exporting countries (Fact Sheets on FDI, Department of Industrial Policy and Promotion).

Foreign investment can be broadly in the form of Foreign Direct Investment (FDI) or Foreign Indirect Investment. The term FDI refers to a long term investment made by a foreign investor whose aim is to have a controlling stake in the operations of the business. They share both risks and returns of the business.

FDI offers a bundle of benefits such as transfer of capital, technical know-how, access of international markets and change in management practices. Thus, FDI can have a direct impact on the performance of any
company. Particularly, pharmaceutical industry can be viewed with all these features as compared to other industries.

The important effect of FDI is its contribution to the growth of the economy. The rise in volume of FDI is accompanied by a marked change in its composition. FDI has an impact on country’s trade balance, improving labor skills and standards, transfer of technology and innovative ideas, infrastructure development and the general business environment. Foreign direct investment (FDI) is considered to be the lifeblood for economic development as far as the developing nations are concerned.

Apart from liberalization, the FDI flows in different regions and countries depend upon the factors like global economic trends, stock market movements and the elimination of hurdles such as political instability, issues in corporate governance, terrorism risk etc. create conducive atmosphere for higher FDI flows (Srujan.A, 2006).

FDI could benefit both the domestic industry as well as the consumer, by providing opportunities for technological transfer and upgradation, access to global managerial skills and practices, optimum utilization of human abilities and natural resources, making industry globally competitive, opening up export markets, providing backward and forward linkages and access to international quality goods and services and augmenting employment opportunities. For all these reasons, FDI is regarded as an important vehicle for economic development particularly for developing economies. FDI flows are usually preferred over other forms of external finance because they are non-debt creating, non-volatile
and their returns depend on the performance of the projects financed by the investors. In a world of increased competition and rapid technological change, their complimentary and catalytic role can be very valuable.

1.2 GROWING IMPORTANCE OF FDI:

The importance of FDI is not restricted only to the financial capital that flows into the country, but FDI inflows can also be a tool for bringing knowledge, managerial capabilities, product design, quality features, brand images, channels for global marketing of products, etc.

The role of FDI as a source of capital and technology has grown over time. As other sources of capital have become scarce, FDI became necessary for developing economies to grow rapidly to integrate with international trade and compete with developed economies (Pramod Kumar, 2006).

The liberalisation of government policies that restrict foreign direct investment (FDI) is a recent phenomenon. Although trade policies have been liberalised for many years through the elimination of quotas and the reduction of import tariffs, liberalisation of investment policies is more recent, stimulated by the World Trade Organisation (WTO) in 1995. Liberalization of FDI policies offers opportunities for firms as well as threats. If FDI (and trade) liberalization result in faster growing national economies, then firms face larger, faster-growing markets domestically (Feinberg & Majumdar, 2001). In addition, more foreign-invested firms mean more potential customers locally with strong purchasing power, and more chances for linkages with them. If technology spillovers occur
from foreign firms to other firms in the industry, then those firms can achieve better technical performance.

Three decades ago, Ray Vernon wrote about the difficulty in choice faced by developing countries regarding FDI policies. This difficulty in choice moves around three conflicting objectives. The first is the desire for rapid growth; the second is the desire for an equitable distribution of income, and the third is the control of one’s own destiny.

The RBI in mid-2003 revised the data on FDI from the financial year 2000-01 by adopting a new definition of FDI in accordance with IMF norms. The estimates made earlier were based only on equity investment by foreign companies. The revised data on FDI now include all items indicated under equity capital (except non-cash acquisitions). The equity capital of unincorporated entities includes the equity capital of foreign banks’ branches in India. The new method of accounting also includes “reinvested earnings” and “other capital” as two additional categories of investments made by these foreign companies. While reinvested earnings refer to retained earnings of FDI companies, “other capital” covers intercorporate debt transactions between related entities.

1.3 INDIAN PHARMACEUTICAL SECTOR:

The Indian Pharmaceutical sector in the forefront of science-based industries in India with wide range of capabilities in the field of manufacturing drugs and technology. It is a highly organized sector, estimated at $ 4.5 billion with an annual growth rate of around 8% to 9%. It ranks among the top sectors in the world, in terms of technology,
quality and wide range of medicines manufactured (Pharmaceutical and Drugs Manufacturer, 2009).

The sector drastically expanded in the last two decades. It is highly fragmented with more than 20,000 registered units. The top 250 pharmaceutical firms control 70% of the market requirement. It is an highly fragmented market with heavy price competition. The sector in India meets around 70% of the nations demand for pharmaceutical medicines. There are about 250 large units and about 8000 Small Scale Units, which form the core of the pharmaceutical industry in India including 5 Central Public Sector Units. (Pharmaceutical and Drugs Manufacturer, 2009).

The Indian pharmaceutical sector is an interesting and relevant context for several reasons. The Indian pharmaceutical industry is one of the most vibrant knowledge driven industries in India with consistent growth over the past thirty years. Today, more than 90 percent of the modern medicine consumed in India is produced locally. India is among top 5 pharmaceutical producers worldwide in terms of volume and ranks among 15 in value. It is one of the top 20 top exporters of bulk actives and dosage forms. Indian exports are destined to around 175 countries around the globe including highly regulated markets of Australia, Europe, Japan and US.

There are 10563 pharmaceutical manufacturers across the country, out of which 8174 (77.4%) companies manufacture formulation drugs and remaining 2389(22.6%) are engaged in manufacturing of bulk drugs. Almost two-third of the total number of manufacturers belong to the
states of Maharashtra, Gujarat, West Bengal, Andhra Pradesh and Tamil Nadu [National Pharmaceutical Pricing Authority, 2007]

The Indian pharmaceutical industry has already made a firm mark on global markets. Pharmaceuticals' exports grew from Rs. 373.3 millions in 1973-74 to 23,856.392 millions in 1996-97 and 1,68,935.982 millions in 2008-2009 (Apr-Dec). The pharma products from India over the years is between 2% to 3% of the total exports from the country. (MCI, 2009).

The policy environment in India towards both technology and FDI was liberal during 1960s, the policies were made stringent during 1970s, attempts were made at liberalization during 1980s, and the liberalization took place during 1990s. But during this period, the policy environment was characterized by lack of transparency and discretionary control. This environment has had profound effects on the investment and research activities of both MNCs and domestic pharmaceutical firms in India.

The pharmaceutical sector is research and development-intensive, and multinational companies have a presence in the Indian market. The Indian pharmaceutical sector also has a long history of multinational participation in both manufacturing and research and development.

The Indian pharmaceutical sector is also subject to a complex and changing mix of sector-specific policies aimed at the objectives of equality of income distribution and self-determination. All the policies that affected firms, both foreign and domestic in the pharmaceutical sector, have the combined intention of developing domestic industry and making drugs available to India’s poor. The policies also have the effect of de-
linking firm ownership from ownership of technology and ultimately muting firms, incentives to innovate. In weak appropriability environment, knowledge could potentially flow freely creating spillovers not only between MNCs and Indian firms, but also between Indian pharmaceutical firms that are successful in undertaking R&D, such as Cipla Pharmaceuticals, Ranbaxy Pharmaceuticals and Dr. Reddy’s Laboratories. (Management Accountant, Nov 2010, Special issue on Indian Pharmaceutical Industry)

**1.4 SUMMARY OF REVIEW OF LITERATURE:**

The topic of FDI has well studied from different perspectives. Some of them have focused on analyzing the theories of FDI. (E.g. Calvet, 1981), whereas, some have focused on understanding, analyzing, empirically examining the determinants of FDI and very few studies have focused on analyzing the of FDI on firm performance (E.g. Shapiro 1983; Chhibber and Majumdar, 1998).

The Present Review of Literature on Foreign Direct Investment is broadly classified into

i. Studies on FDI in general

ii. Impact Studies of FDI

The review of literature reveals that the topic of ‘Foreign Direct Investment’ has widely studied at macro and micro level across all the industries and countries. There are mixed results and conclusions. The methodology and models used in most of the studies are subject to limitations in terms of data availability and application of best possible econometric models.
1.4.1 Research Gap

In Indian context, due to the change in Foreign Direct Investment policy across the industries and difficulty in obtaining the firm level data for a longer time period, it is recommended that there is need to study the impact of FDI on performance of the firms (Chibber and Majumdar, 1999).

It is found that there is a heavy need for studying the impact of Foreign Direct Investment on export performance of a specific industry. (Siddharthan and Nollen, 2004, Kumar and Siddhartha, 1994, Lall and Mohammad, 1983, Zheng, Siler and Giorgioni, 2004).

From the above review of literature, it is found that the topic of ‘Foreign Direct Investment’ has been widely studied at macro and micro level across all the industries and countries. There are mixed results and conclusions. The methodology and models used in most of the studies
are subject to limitations in terms of data availability and application of best possible econometric models.

Many of the studies have recommended that future firm-level studies should analyze the possible interaction between foreign competition and domestic firm’s performance (Shapiro, 1983; Trevino, 2002).

It is found in most of the studies that the impact of FDI has been assessed on the macro-economic factors such as GDP, growth rate, forex earnings, employment rate, inflation rate, poverty etc. as well as microeconomic factors such as labor productivity, firm level imports, exports, spill over effect (operational efficiency, managerial efficiency) etc., but firm level studies to assess the impact of FDI on the financial performance of FDI-based companies has not been conducted. There is also a need for assessing the impact of FDI on the financial performance of the firms with special reference to a particular industry (Sudershan K, 2007)

To fill the gap in literature, the present study is carried out focussing on FDI in Indian Pharmaceutical Sector its impact on the growth of the sector in the post-liberalization scenario.

1.5 NEED FOR THE STUDY:

The importance of FDI extends beyond the financial capital that flows into the country. It is observed that the presence of foreign ownership in the ownership pattern of the firms showed relatively superior performance of those firms than other firms. global managerial skills and practices, optimal utilization of human capabilities and natural resources, making industry internationally competitive, opening up
export markets, providing backward and forward linkages and access to international quality goods and services and augmenting employment opportunities. Hence it is interesting to study the role played by FDI in a world of increased competition and rapid technological change. Hence it is interesting to study the role played by FDI in a world of increased competition and rapid technological change. The extent to which FDI contributes to the growth of economy in general and Indian Pharmaceutical sector in particular especially in the context of post-liberalization scenario is seen as a major area of focus. There is a need to assess the impact of FDI on the financial performance of FDI-based companies individually. There is also a need for assessing the impact of FDI on the financial performance of the firms by establishing a relationship between quantum of FDI and its impact on the financial performance and growth of FDI based companies Indian Pharmaceutical Companies Individually and Indian Pharmaceutical Sector collectively.

1.6 OBJECTIVES OF THE STUDY:

The objectives of the study are

1. To study the trends of FDI inflows in India in general and pharmaceutical sector in particular in the post-liberalization scenario.

2. To assess the financial performance of select FDI-based companies in the Indian Pharmaceutical Sector.

3. To make a comparative analysis of the financial performance of FDI-based companies and Non-FDI based Companies in the Pharmaceutical Sector in India.
4. To assess the impact of FDI inflows on the growth of Pharmaceutical Sector in India.

1.7 HYPOTHESES OF THE STUDY:

After the detailed review of literature and certain assumptions, the following null hypotheses have been framed for the study.

$H_01$: There is no significant impact of FDI on the profitability of select pharmaceutical firms in India.

$H_02$: There is no significant impact of FDI on the liquidity of select pharmaceutical firms in India.

$H_03$: There is no significant impact of FDI on the solvency of select pharmaceutical firms in India.

$H_04$: There is no significant impact of FDI on the efficiency of select pharmaceutical firms in India.

$H_05$: There is no significant impact of FDI on the R & D expenses of select pharmaceutical firms in India.

$H_06$: There is no significant impact of FDI on the growth in exports of select pharmaceutical firms in India.

$H_07$: There is no significant impact of FDI on the sales of select pharmaceutical firms in India.

$H_08$: There is no significant impact of FDI on the capital employed of select pharmaceutical firms in India.

1.8 METHODOLOGY OF THE STUDY:

The present study examines the impact of Foreign Direct Investment on the growth of pharmaceutical Industry in India. The data collected is
analyzed using selected financial ratios for assessing the financial performance of select FDI based companies and the regression analysis was run to assess the impact of FDI on the growth of Pharmaceutical Sector in India. FDI as defined by OECD and IMF has been taken into consideration. According to OECD and IMF “A foreign direct investor is an entity (an institutional unit) resident in one economy that has acquired, either directly or indirectly, at least 10% of the voting power of a corporation (enterprise), or equivalent for an unincorporated enterprise, resident in another economy”. (IMF-BMP5, OECD (2008)).

The study is based on analysis of firm level data of select FDI companies in the Pharmaceutical Sector in India. The study is carried out with the help of secondary data.

Secondary Sources of Data: The secondary data has been collected mainly from sources given below

- Centre for Monitoring of Indian Economy (CMIE-Prowess Database)
- Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry, Government of India
- Annual Reports of companies
- Reserve Bank of India (RBI)- database

1.8.1 Sample Selection

The present study focuses on one specific industrial sector i.e the Indian Pharmaceutical Sector. There are 236 companies listed in Indian Pharmaceutical Sector, from these listed companies, there are 201 companies consistently listed and from these companies a sample of 170 companies has been considered, from which 18 companies are identified
as FDI-based companies and the remaining 152 companies as Non-FDI Companies. The Pharmaceutical companies in India consistently listed for a period of 10 years from 2001 to 2010 and whose data is available at least for a period of 5 years are considered for the study.

1.9 SCOPE OF THE STUDY:

The scope of the study is confined to financial performance of select FDI based pharmaceutical companies consistently listed in NSE and BSE. The ownership pattern of the companies has been considered for identifying and classifying FDI based companies (based upon IMF BOP Definition). The study is conducted for a period of 10 Years i.e. 2001-2010.

1.10 LIMITATIONS OF THE STUDY:

In this study, only those pharmaceutical companies consistently listed for a period of 10 Years i.e. from 2001-2010 and whose data is available at least for a period of five years are considered for the study. Further, this study is based on secondary sources of data only. A questionnaire based survey of FDI based companies would have provided some more insight into assessing the impact of FDI on the growth of the sector.

1.11 CHAPTERISATION SCHEME:

The study has been divided into eight (8) chapters as mentioned below.

Chapter 1: Introduction

Chapter 2: Review of Literature

Chapter 3: Foreign Direct Investment in India: Concept,
Regulatory Framework and Growth

**Chapter 4:** Indian Pharmaceutical Sector: An Overview

**Chapter 5:** Financial Performance of Select FDI-based Companies: An Analysis

**Chapter 6:** A Comparative Analysis of the Financial Performance of FDI and Non-FDI based Companies.

**Chapter 7:** Impact of Foreign Direct Investment on the Growth of Pharmaceutical Sector in India

**Chapter 8:** Summary, Findings, Suggestions and Conclusion.

Bibliography

Annexures