India: Reforms are here to stay

Julian Mayo and Adrian Lewis

The world's largest exercise in democracy will soon be run once more, as Indian voters go to the polls in April and May. Around 900 million people are eligible to vote at one of the nation's one million polling stations. As ever in politics, attention is focused on personalities, in this case even more so than usual. This is due to the strong personality of the current Prime Minister, Narendra Modi, and also because of the rapid rise of social media in India. The country already has over 400m internet users and 280m mobile broadband consumers. This focus on personalities is, in our view, exaggerated. Our recent visits support our view that the election result may not be as important as most observers seem to think.

This is because whoever is elected to run India for the next five years is likely to benefit from the reforms already undertaken. Analogies are inexact, but the economic reforms in Britain under Margaret Thatcher and continued by John Major were largely incorporated into the New Labour policies of their opponent, Tony Blair. Similarly, Bill Clinton, a Democrat, built on the liberal economic policies of the Republican Presidents Ronald Reagan and George Bush Snr. Despite the somewhat divisive nature of his leadership, there is a widespread consensus in India that Modi's key policies are necessary to enable this vast country to catch up with other Asian economies, most notably China. These policies are simple but powerful:

1. Installing a bankruptcy process and recognising bad loans.

2. Introducing the GST (goods & services tax) which should lead to an improvement in tax collection.

3. Connecting villages with roads and rail, providing power and toilets.

4. Giving individuals a biometric identifier and bank account.

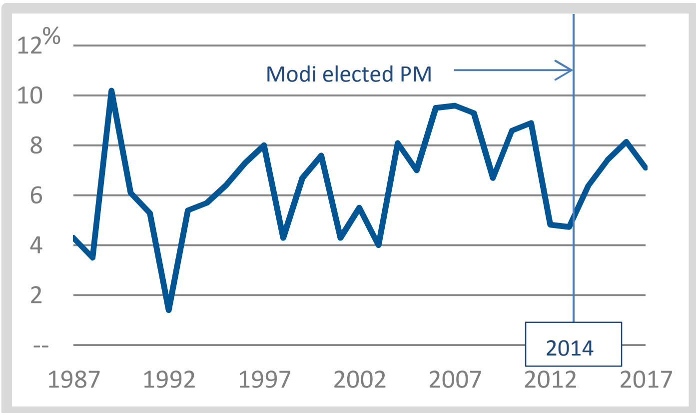
These policies have already led to growth rates which are higher than the longer term average, but not significantly so. Over the last five years, growth has averaged 7.3%, compared to a 30 year figure of 6.7%.[1]

Crucially, this growth has mainly been focused in the poorer states, such as Bihar and Uttar Pradesh, where their GDP per capita has increased from under USD1000 towards the national average. This should have the effect of broadening the consensus that the reforms will prove to be durable.

A major acceleration in growth from richer states is yet to come. Overall, in some respects the achievements of the Modi administration so far appear modest:

1. Real GDP growth hasn't broken convincingly up above 7% despite a still low base, with GDP per capita at USD8,000, based on purchasing power parity. This is still low when compared to China's USD20,000, the EU average of USD49,000 and the US at USD65,000.[2]

INDIA's REAL GDP GROWTH



Source: Bloomberg

2. Despite this economic growth, nationwide industrial capacity utilisation has remained below 80% for at least the last five years despite a decline in gross fixed capital formation (to GDP) from 35% to 31%.

3. Partly due to problems in public sector banks, the overall bank sector remains weak and undercapitalised, despite very low consumer finance penetration. For example, the ratio of mortgages to GDP remains below peers at 10%. This compares to 26% in the case of China.

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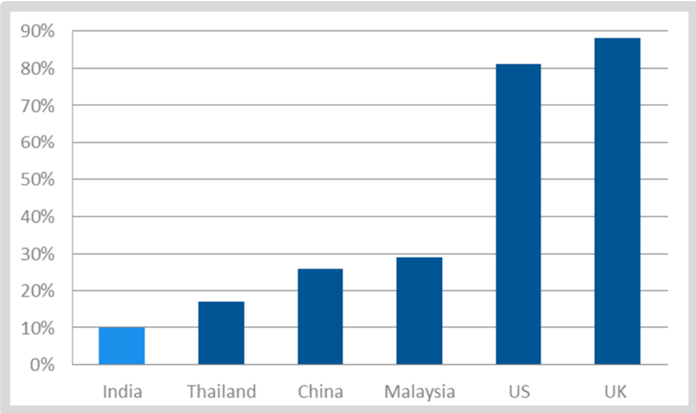
RATIO OF MORTGAGES TO GDP



Source: Fiera Capital

4. Transport is underdeveloped: logistics costs are high and rail freight market share is still only 20% of the total.

5. India's society has yet to make the great leap from the primary to the secondary, let alone, the tertiary sector. The early stages of China's reforms under Deng Xiao Ping resulted in the agricultural sector becoming more efficient and jobs being created in manufacturing. Even now, agriculture still accounts for 49% of jobs in India, compared to 8% in China and only 2% in the USA. Manufacturing remains only 18% of GDP despite the government's 'Make in India' programme.

A strong institutional framework is generally a precondition to durable economic success. Whilst the transition takes time, by some measures India is starting to evolve.

1. The 'business as usual' approach is being transformed, from a crony-based mindset to something more disciplined based on the threat of losing one's assets and wealth via the bankruptcy court.

2. Partly as a result, India's ranking in the World Bank ease of doing business index rose from 100th to 77th in 2018, having been 142nd as recently as 2014. Gains have come from the reduction of restrictions in construction permits, while the country also scores highly in areas such as access to credit and electricity and has improved, from a low base, in terms of ease in starting a business. Modi's ambition is for the country to enter the Top 50.

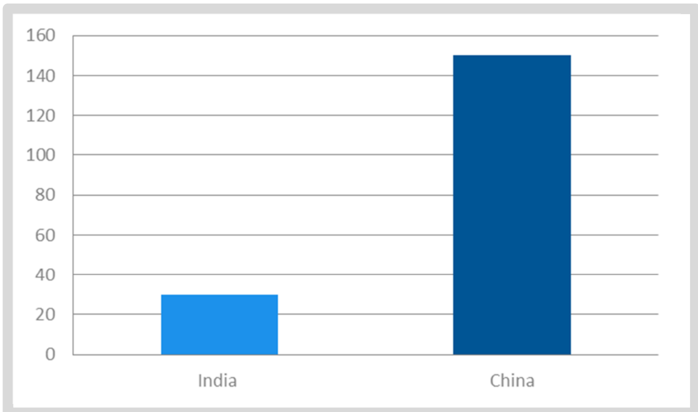
3. Tax revenues rose from 10% of GDP in 2014 to 12% by March 2018 and as the GST stabilises and the organised sector takes market share, it will increase further, helping to improve the country's fiscal position.

4. As the finance sector develops, we expect credit to become an increasing driver to the consumer sector. The housing market is likely to be a driver here: India's population is growing at 1.3% per annum. With rising incomes, this is creating demand for an additional 10m homes each year.[3]

5. Investments currently underway will complete in the next few years and should provide a boost to economic growth. Examples are the Dedicated Freight Corridors, two key new railway routes which aim to improve rail freight productivity and reduce nationwide logistics costs. The first line is now over 50% complete, with the first phase expected to be opened by March next year.

6. Large numbers of customers are buying their first fridges and air conditioning units and the demand for electricity is set to grow rapidly. With better roads and more disposable income, car ownership is likely to see strong growth:

CAR OWNERSHIP PER 1,000 PEOPLE



Source: Fiera Capital

7. The country is becoming more connected digitally: the government's Digital India initiative, launched in 2015, aims to provide digital infrastructure to every citizen. India is expected to have 1 billion mobile subscribers and over 650m smartphone subscriptions by 2020.[4]

India is the second-largest country exposure in our core emerging market strategy and it is a longstanding overweight position relative to the benchmark, with a focus on businesses likely to benefit from the growth in domestic demand.

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The backbone of our EM core growth portfolio's positioning in India is with two leading retail private banks, Kotak Mahindra Bank and HDFC Bank. The low base of their market share (2% for Kotak and 8-9% for HDFC Bank) mean they have a runway for sustained growth as they meet the needs of the emerging aspirational middle class in India, with a focus on risk-adjusted returns. Power Grid and Container Corporation, held in the portfolio, are also set to benefit from the anticipated structural growth. More villages connected to power is leading to first time purchases for fridges, lights, fans and there should be a multiplier effect leading to requirements for more grid expenditure. The completion of the Dedicated Freight Corridors over the next few years should drive returns for Container Corporation which handles about 75% of India's rail freight.

India is at the early stage of its transition from an agricultural based economy, but is making encouraging strides in the right direction. Measures include strengthening the rule of law, contract enforcement and urban planning. These should result in further rises in living standards, job creation, incomes and the profits and cash-flows of companies we have invested in, regardless of who wins the election.

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Disclaimers

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Sources:

1– Bloomberg

2 – IMF

3 – IHFL

4 – KPMG

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