

INDIA 2.0: POISED FOR GROWTH

It took India nearly 60 years from independence to grow its GDP to USD1 trillion but just seven years to achieve the next. India's full potential is yet to be realised. As the government rolls out its reform agenda, active management is needed to navigate macro challenges, market valuations and company fundamentals to identify companies that will thrive in the changing landscape.

With India and China poised to become the world's two largest economies by 2050, investors have often sought to draw parallels between these two giants. Drawing some lessons from China's growth playbook, we believe that there are three structural trends that can maintain India's high single digit growth rate over the next several years which can in turn help to underpin the valuations of Indian equities and bonds.

1. TRANSITING FROM A CENTRALLY PLANNED ECONOMY

India has a large, young and diligent population. However, a centrally planned economy in the past did not allow India to fully maximise its competitive advantages nor take advantage of



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its demographic dividend. India's early five-year plans, for example, promoted import substitution, extensive state ownership of production as well as complex controls and regulations governing the private sector¹. As a result, a highly regulated, over-bureaucratized system inhibited competition, innovation, efficiency and economic growth. Trade policies were designed to protect local industries from external competition through high subsidies and tariffs.

Over the years, both the Chinese and India governments have undertaken various reforms to open up their economies. In the last five years in



particular, the Modi government achieved rural electrification, direct benefit transfers for subsidies, LPG cooking gas (almost for all) and improved sanitation and hygiene across rural villages.

It also reined in inflation for food and protein, an achievement for an economy known for its double-digit inflation rates post the Global Financial Crisis. The overhaul of India's indirect tax structure and consolidation of its bankruptcy laws led to a marked improvement in the country's Ease of Doing Business score. Within two years, India jumped 53 positions in the World Bank Doing Business Index landing at the 77th place in 2018².

As the Modi administration continues to roll out crucial reforms after its resounding victory at the May 2019 national elections, we believe that India is on track to reach the next stage in its economic development. In the near term, the Indian economy is expected to grow 7.5% in 2020 and deliver earnings growth of 14%. See Fig. 1.

2. BUILDING A ROBUST INFRASTRUCTURE NETWORK

Research shows that investment in network infrastructure can boost a country's long-term economic growth as it helps to create economies of scale and enhance the country's competitiveness. Notably, the impact is stronger the lower the existing stock of infrastructure in the country⁴.

Just as better logistics and improved access to ports and roads helped drive China's growth in the last two decades, the Modi government had boosted infrastructure investment in the last five years by increasing the road network pan India. By doing so, the government hopes to bring down India's logistic costs. Ranked 44 in the World Bank Logistics Performance Index 2018, logistics costs in India are 13-15% of the product cost, while the global average is six per cent⁵. Meanwhile, there are still significant opportunities to invest in roads, railways, ports, freight, power generations, rural electrification, and irrigation facilities with the India government expected to invest USD750 billion - in these categories over FY2018 – FY2022 (See Fig. 2).

Indeed, a robust and reliable national infrastructure is needed to help achieve the government's goal of boosting the manufacturing sector to account for 25% of GDP by 2025. These infrastructure investments will form the backbone of India's future economic growth and create long-term value for Indian assets.

Fig. 1. Growth by region³

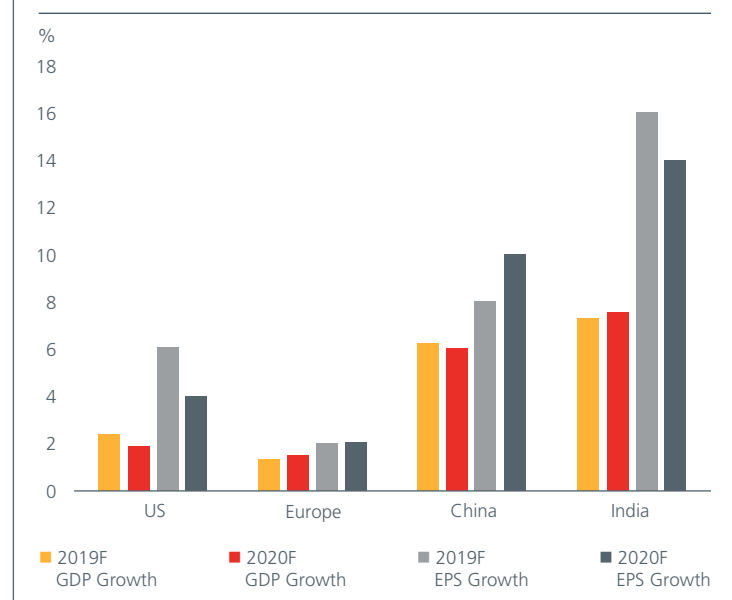
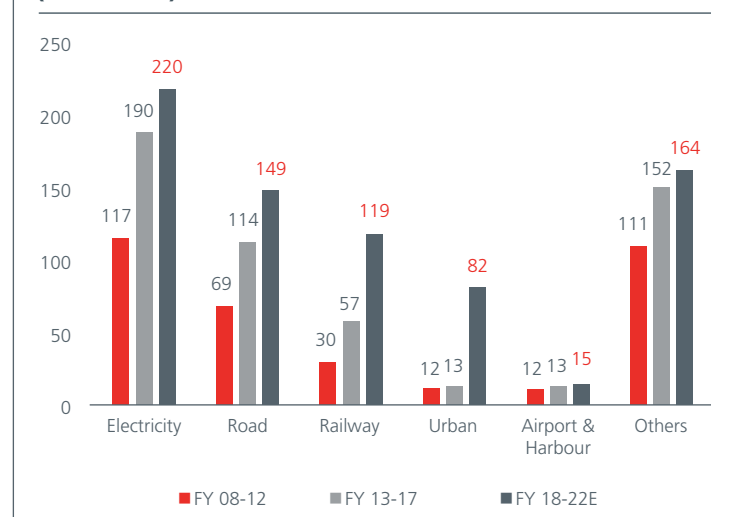


Fig. 2. Government expenditure on infrastructure (USD billion)⁶



3. LEVERAGING THE BENEFITS OF FINANCIAL INCLUSION

Besides market reforms and infrastructure, financial inclusion is also key to bridging the social divide and achieving a well distributed, robust and sustainable economic growth.

Two schemes in India - Aadhaar and Jan Dhan have helped to drive financial inclusion, particularly in the rural and semi-urban areas. Aadhaar is a unique identity system which allows Indian residents to prove their identity to get jobs, open bank accounts, travel by rail, and to get various entitlements as well as government benefits directly into their bank accounts. Jan Dhan, on the other hand, is a financial inclusion programme which aims to expand and make access to financial services such as bank accounts, remittances, credit, insurance and pensions affordable.

Jan Dhan has led to the opening of nearly 300 million bank accounts since 2014, bringing a completely new class of previously unbanked people into the banking system. Fig 3. shows that financial inclusion is on an uptrend in India, driven largely by an increase in deposit accounts between FY2013 and FY2016. By combining Aadhaar and Jan Dhan, Indian residents can now receive benefits directly from the government, bypass agents and avoid leakages, which can in turn facilitate consumption.

UPGRADING CONSUMPTION

India's 1.3bn population base is young with a median age of 27 years. This presents a large and growing consumer base. With more Indians joining the workforce every year, the penetration level for consumer goods will keep rising, driving the private spending boom over next few decades.

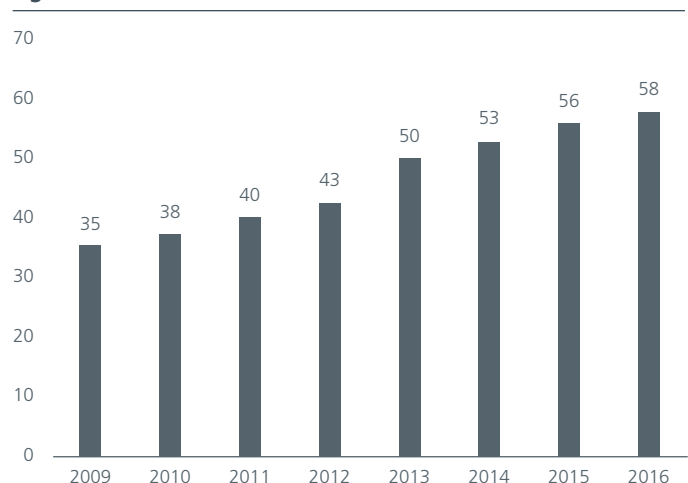
Consumption in India, in our view, is now at the inflection point where China was 20 years ago, when consumption in the world's second largest economy took off. With rising disposable incomes, we expect India to witness a shift in its consumption basket, notably from staples to

services. For example, India's coffee market is estimated at USD928 million (2019) and expected to grow at a 4-year compounded average growth rate (CAGR) of 6.6%⁸. This has in turn led to the emergence of local coffee chain stores that offer budget coffee with a localised flavour, giving the traditional masala tea a run for its money.

In addition, with India's digital leap, e-commerce sales are expected to rise to USD200 billion by FY2027 from USD15 billion in FY2017⁹. The e-commerce boom is fast creating a level-playing field for merchants and customers. Online food delivery, for example, is a typical online-to-offline service in which food vendors utilise the Internet to take orders from and deliver food to remote customers. The online food delivery market in India is expected to grow at a compounded average growth rate of 16% and reach USD17 billion by 2023¹⁰. Improving terms of trade for small merchants and enterprises, the broadening of job creation and in turn the transformation of social structure are by-products of this new trend which will create a new breed of customers in the future.

While India's top 40 cities are expected to present a USD1.5 trillion consumption spending opportunity by 2030, many thousands of small developed rural towns can also drive an equally large spend in aggregate¹¹. While these consumers can afford and aspire for goods and services used by their urban peers, the potential spend can only

Fig. 3. India's financial inclusion index⁷



be realised if infrastructure improves and there is better access to organised and online retail. Today, a developed rural household spends one-and-a-half to two times less than an urban household with the same income (See Fig. 4)

UNCOVERING LONG TERM VALUE

We believe that India's full potential has yet to be realised. As long as the government remains committed to its reform agenda, the three-pronged approach of opening up the economy, building out its infrastructure network and increasing financial inclusion should continue to drive economic growth over the long term and attract foreign investors. Foreign Portfolio/Institutional Investors (FPI/FII) have been one of the biggest drivers of India's financial markets and have invested around USD171.81 billion in India between FY02-18. In February 2019 alone, net inflows from foreign portfolio investors in India reached a 15-month high of USD 2.49 billion¹³.

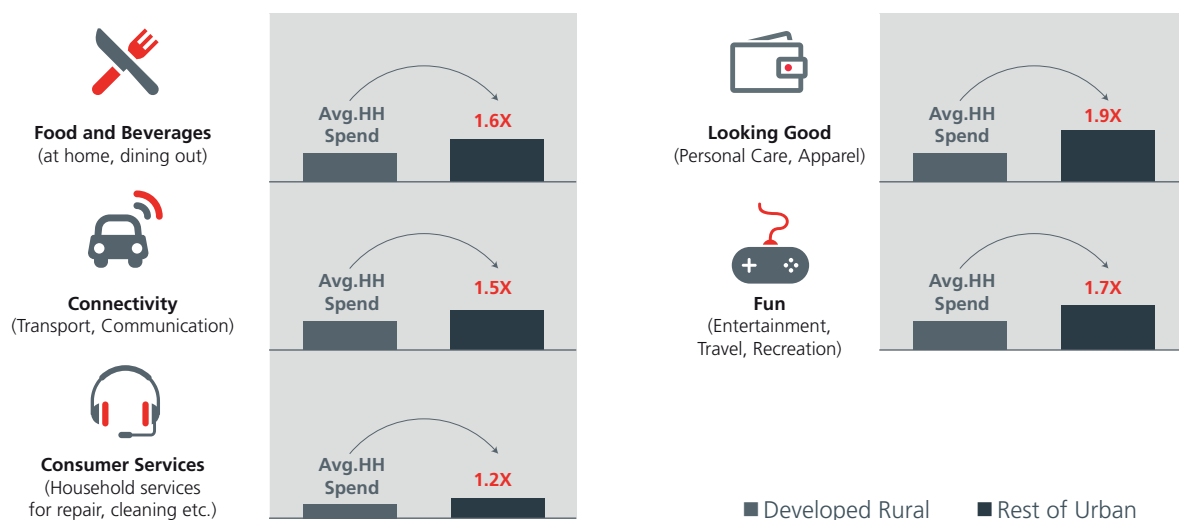
In the near term, challenges remain – creating millions of jobs each year, reining in the fiscal deficit and tackling asset quality and capitalisation issues within the banking sector. The recently announced budget provided few answers to

how the government would balance potentially conflicting goals of stimulating growth while limiting spending.

At the point of writing¹⁴, valuations of Indian equities are not cheap at 1.5 standard deviations above its five-year average or 50% premium above the MSCI Emerging Markets Index. This suggests that investors will need to tread carefully to uncover true value. For example, despite the headline woes in the Indian banking sector, the profitability of selected banks may surprise on the upside due to lower slippages and credit costs. There could also be some quality names emerging in the mid cap space. It is also interesting to note that the divergence between the large cap (NIFTY 50) and mid cap (NIFTY Midcap 100) indices is close to a historical extreme with the difference in returns on a 1-year rolling basis about 13%. Relative valuations between the mid and large cap indices have also corrected back to 2014 lows.

Meanwhile, domestic inflows also offer some support as investor interest in equities grow on the back of the weak property market and sluggish gold prices. Flows from the Employees' Provident Fund Organisation (EPFO), Systematic Retirement Plans (SIPs) and buyback is estimated to be around USD 24 billion/year and likely to be sticker¹⁵.

Fig. 4: Average spend - developed rural vs urban household¹²



Sources: ¹Ibid ²World Bank. October 2018. ³Earnings growth estimates from Goldman Sachs as of 21st June 2019. GDP growth estimates from International Monetary Fund (IMF): World Economic Outlook "Growth Slowdown, Precarious Recovery", April 2019. ⁴Infrastructure and Growth: Empirical Evidence. OECD Economics Department Working Papers No. 685 ⁵World Bank. October 2018. ⁶CRISIL Infrastructure Yearbook 2018, October 2018. ⁷S&P Global Company, CRISIL. CRISIL Inklusiv – India's Financial Inclusion Index. ⁸Statista. ⁹India Brand Equity Foundation. May 2019. ¹⁰Market Research Future ¹¹World Economic Forum. Future of Consumption in Fast Growth Consumer Markets: India. January 2019. ¹²Bain PRICE Consumer Survey 2018 (n=5100). Figure shown is representative of the upper-mid income levels. ¹³IBEF. ¹⁴10 July 2019. ¹⁵Citi Investment Research. July 2019.

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