India in a Sweet Spot

In the 2014 Indian general election, Narendra Modi led his party, the Bharatiya Janata Party (BJP) to a landslide victory. Prime Minister Modi has developed a reputation as a forward thinking, business-friendly leader, and has a track record of success as Chief Minister of the state of Gujarat. Mr. Modi's BJP party took 52% of the seats in Parliament in the election, marking the first time since 1984 that a party had won enough seats to govern without the support of other parties. In the past 30 years India has been ruled by coalition governments that lacked the leadership to pass significant reforms to liberalize the economy. With hopes that the new Modi government will create significant structural reforms, along with the country's improved macro stability, India is in a sweet spot. In a time when Brazil's economy is riddled with challenges on multiple fronts, Russia is facing weak oil revenue and Western sanctions, and China's economy is slowing, India is poised to become a leader in emerging markets. In this month's Thinking Man, we go through a Q&A about the new government, potential reforms, and risks to the India story.

Question 1: How does Mr. Modi's time as Chief Minister of the state of Gujarat offers a guide to his approach to the bigger job of fixing India's economy?

Mr. Modi was in large part elected because Indians wanted to see the country run more like the state of Gujarat. With only 5% of India's population and 6% of the country's land mass, the state accounts for 22% of the country's exports, and 10% of its workforce. The state also boasts stronger GDP growth than the rest of the country. What did Mr. Modi do to facilitate this? 1) Creating reforms and incentives for companies to do business in the state 2) Building up the state's infrastructure and 3) Using IT to keep the state moving forward. Mr. Modi made it easier for companies to do business in the state through both specific incentives and broad reform. One example is by making land easily available for commercial development. Tata Motors had plans to build a manufacturing plant for their low cost mini car, the Nano, in the state of West Bengal in 2008. The company faced highly publicized resistance from the local governments over land disputes. Mr. Modi swept in by reaching out directly to Ratan Tata, head of the Tata Group, and offering him a factory-ready plot for Tata and its suppliers in his state of Gujarat. Tata happily accepted.[1] Mr. Modi has cultivated these types of working relationships with top Indian business leaders, which has been key to his success in linking the government with the corporate sector. Mr. Modi also made it easier for companies to obtain permits, licenses and meet environmental clearances. Over the last few years, new factories sprung up quickly in the state, contributing to the booming economy.

The Thinking Man's Approach

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Since the May 2014 election of Prime Minister Modi, all eyes have been on India. In this month's Thinking Man, we walk through a Q&A addressing various topics around the India story, including Mr. Modi's leadership and reforms to encourage international investment and domestic growth. We highlight certain themes of the Modi government, such as focusing on developing strategic relationships with top business leaders and encouraging growth of India's IT ecosystem to help propel Indian companies across sectors. Lastly, we discuss some of the challenges facing Modi and discuss our views on investing in India.

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Mr. Modi has also focused on addressing basic infrastructure in Gujarat: the state had a deficit of electricity generation in 2002, and now has a surplus, even with the increased needs of the large corporate sector. Roads have been improved and water supply is ample. Finally, Mr. Modi wanted to keep Gujarat forward moving by applying information technology to various government services, which he felt would make civil servants more accountable and limit corruption.[1]

Question 2: The Indian economy has had a structurally low Investment/GDP ratio. In this new era, is India starting to see an uptick in foreign investment?

Yes. The Modi government has encouraged foreign investors by 1) relaxing foreign investment rules and addressing issues with tax policy and 2) encouraging multinational companies to bring operations to India.

Foreign investments rules have been relaxed for insurers, defense contractors and real estate companies. For example: on December 24, 2014, India's cabinet approved an ordinance to raise the limit on foreign direct and portfolio investment in insurance companies from 26% to 49%. Insurance penetration in India is one of the lowest in the world, and India's Finance Minister Arun Jaitley believes that the country, "could attract $6 billion to $8 billion of foreign investment in insurance alone over the next few years."[2] In addition to eased foreign investment rules, there is also a broad tax overhaul underway- with India working on agreements with the US, Britain and other European nations to address issues and concerns foreign companies have had with transfer pricing.

Multi-national corporations are also bringing their business to India. GM is expanding in India's auto market, as the company predicts it will be one of the world's largest three auto markets by 2020. GM is investing over $1 billion in its Indian operations and is adding factory plants in two different locations.[3] Mr. Modi is encouraging this trend, and in September 2014, announced a formal "Make in India" campaign in which the government pledged to provide benefits and assistance to companies who will manufacture their products in India. Some recent participants include Samsung, which announced its plan to manufacture its Indian smartphone, the Samsung Z1 in India, and Hitachi, which pledged to increase its number of employees in India by 30%. The latest participant, Huawei, a Chinese telecom company, announced last week that it will invest $170 million in a new research and development campus in India.[4]

Question 3: Are there examples at a micro level of the type of action Modi's government is doing with large local companies?

Modi's "Make in India" campaign moves beyond just a play for foreign investment, it also aims to encourage Indian corporations to increase their importance and scale through 1) strengthening the IT ecosystem 2) investment in large domestic companies and 3) focusing on new industries.

Modi's taken measures to give a boost to Indian corporations across many different sectors by enhancing The Indian Information & Technology "Eco-system". India's technology sector is a globally competitive sector, and its growth is key to making India one of the world's most important

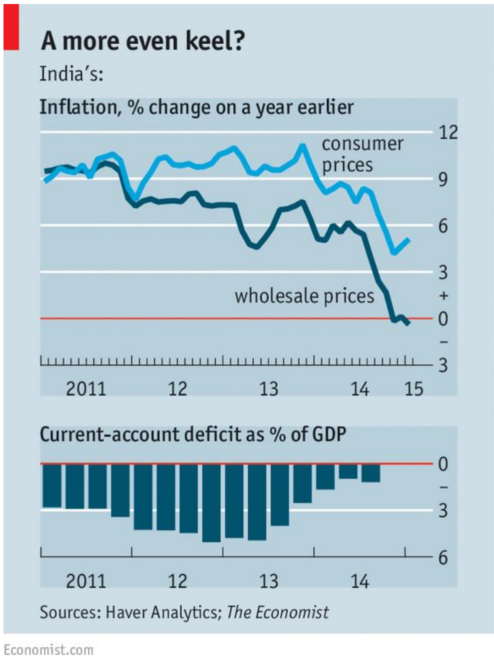
[1] "The Gujarat Model"
[2] Rajesh Roy and Raymond Zhong, "India Approves Ordinance to Increase Foreign Investment in Insurance," The Wall Street Journal 24 Dec. 2014
[3] Keith Brasher, "As Rivals Falter, India's Economy is Surging Ahead," The New York Times 17 Feb. 2015
[4] Nivedita Bhattacharjee, "China's Huawei makes $170 million 'Make in India' investment," Reuters 5 Feb. 2015

economies. An illustration of this is Mr. Modi's initiative, "Innovate in India." Mr. Modi has developed a relationship with Vishal Sikka, CEO of Infosys, India's third largest IT company. Mr. Modi met with Mr. Sikka in January 2015 to ask him to help lead efforts in technology starts up for the country, and Infosys has agreed to create a fund of over $500 million to invest in Indian start-ups in the fields of artificial intelligence, automation and next-generation technologies.

India's largest domestic companies are poised to benefit from new government contracts that the Modi government plans to give them over their foreign counterparts. Take the defense industry as an example: India is currently the world's largest importer of military equipment, leaving a large opportunity for an Indian company. Rajan Tata, head of the Tata Group took this opportunity and signed a large defense contract with the Modi government. The company announced on February 2015 that defense and aerospace will be a focus area and expects 2015 revenues of over $400 million.[1] The government has passed legislation allowing Indian companies to participate in commercial coal mining (a previously government regulated industry). There are many other infrastructure projects, such as construction of roads and expansion of electricity and water supply, which Indian companies can benefit from.[2]

Mr. Modi has also made efforts to ramp up India's weak manufacturing sector by focusing on new high-growth sectors, such as renewable energy. India is trying to attract the "next generation of industries" as it tries to compete with China as a world manufacturing power. In January 2015 there was evidence that these efforts have started to pay off: US based solar power developer SunEdison and Indian billionaire industrialist Gautam Adani announced a $4 billion joint venture in an Indian solar power factory. The same week, Hong-Kong based China Light and Power also announced plans to invest as much as $2 billion in a new coal-based power plant in Gujarat.[3]

Question 4: How is India dealing with its inflation problem and budget deficits? Steps in the right direction towards tackling India's inflation problem actually came before Mr. Modi's election. In September 2013, Ragu Rajan was named as the new Central Bank Governor of the Reserve Bank of India. Mr. Rajan has been vociferous about imposing greater monetary discipline, dealing with the country's inflation problem. Since that time inflation has been reduced from double digits to around 5%, and the current account deficit meaningfully reduced (see chart on the right).



The country's budget deficits are being helped by lower fuel prices. India's reliance on imported oil has heavily weighed on growth- last summer, oil was $100 billion drag on the economy, roughly 5% of the entire country's GDP. After the crash in crude oil prices, fuel costs for trucks and cars have been enormously reduced, pulling down transport expenses and inflation as well as reducing the cost

[1] "Tata group sees Rs 2,500 crore revenues from defence, aerospace in FY'15," The Times of India 17 Feb. 2015
[2] Brasher
[3] James Crabtree, "India solar panel deal illustrates foreign interest," Financial Times 12 Jan. 2015

of government fuel subsidies. This in sum has a large effect on budget deficits: Mr. Rajan said, "We've got essentially a $50 billion gift for the economy." [1] Analysts also cite expected increases in investment to ease budget deficits. In the recent budget released by Mr. Modi, the government announced a large capital spending plan with a projected 25% increase vs. previous year. There has already been an important acceleration in new project starts.[2] Increased foreign investment (as discussed in Question 2) will also ease deficits.

Question 5: What are the main challenges facing Mr. Modi?

India is the largest democracy in the world with 1.27 billion people and sits in 142nd place out of 189 countries in the World Bank's ease of doing business rankings. Analysts across the board see the risk to the India growth story as the loss of reform momentum due to either politics in parliament or demand for populist policies. It is key that Mr. Modi maintain political support to his ideologically-neutral platform on improved governance and improving the "cost of doing business" (i.e. faster lead times to creating new businesses, getting permits, licenses, environmental clearances and such).

Mr. Modi's party, the BJP, must work to ensure that any far-right ideological Hindu nationalist pursuits do not get in the way of his platform of economic reform. Mr. Modi suffered a setback in the Delhi elections a few weeks ago, some say because of the recent extremist rhetoric of some of his party members. Also, last week the state of Maharashtra (Mumbai is the capital) passed a law against the consumption of beef. Mumbai is India's financial capital, home of the nation's largest stock exchange and a hub of international business in India. A Hindu nationalist policy like this can be viewed a backwards step to the world, and these types of issues are distractions for Modi and his government's focus on reform.

Conclusion

In our Investment Outlook for 2015, we mentioned Emerging Markets would have a tough environment but there would be "cherry-picking" opportunities. India is our favorite pick. The final question we asked ourselves is how to get exposure to the Indian capital markets?

We discussed this with Melissa Ma, Chief Investment Officer of Asia Alternatives, who has invested in India for over 10 and who years believes that public equity offers the most value. Ms. Ma commented that private companies in India are too highly valued (they demand valuations similar to their public equity counterparts and investors are not compensated adequately for risk or illiquidity). The exception she sees is early stage tech companies.

Despite the run up in public equity valuations over the last year, we still see this as a good entry point to add exposure to Indian public equity. Structural reforms are just starting to take place. Indian companies are set to benefit over the next few years as a result of these reforms and greater economic growth. Earnings growth in India is set to be the highest in Asia over the next few years, with Goldman Sachs expecting over 15% growth over the next 2 years.

This positive view of growth going forward is supported by valuations. While the trailing 12 month PE ratio in India is slightly higher than the US (20.8 vs. 18.6) the PEG ratio (price to earnings growth ratio)

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[1] Brasher

[2] "Global Economics Weekly, Issue No: 15/09," Goldman Sachs Economics Research, 4 March 2015

shows India as much more attractive than the US (1.53 PEG for India vs. 2.12 PEG for US). The PEG ratio integrates forward looking expectations on earnings: we used Bloomberg's composite estimates which integrates views from several top analysts. Bloomberg estimate earnings growth over the next 3-5 years earnings per share for Indian equities will be at 13.8%, and for the US 8.7%. [1]

[1] Bloomberg

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