ADCB Asset Management

India, a giant on the move
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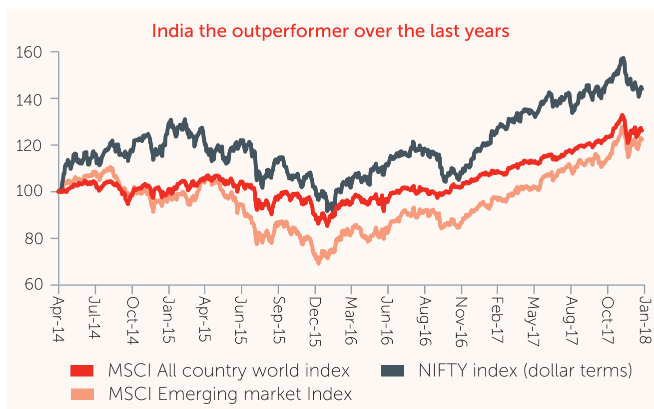
I. Daunting challenges amidst extraordinary opportunities

Today India attracts global investors' attention like few other countries. This should not surprise. First, India's growth rates seem bound to outpace those of most other countries, including China, and this should last for a considerable period of time. Second, like China and unlike any other country in the world, India is huge. Precisely because of the country's enormous long-term potential, for us India has always been a core holding, a strategic asset which you do not immediately dispose of at the slightest rise in market volatility. When in May 2014 we decided to go overweight Indian equities we did of course have some tactical reasons too. At the time, the incipient slowdown of growth in China did not bode well for most emerging markets. India being less dependent on China, the Indian equity market was to benefit from the subsequent correction in commodity and energy prices. In 2016 it was to recover faster from the correction emerging equities suffered in 2015.



Source: Bloomberg, ADCB Investment Strategy

In February I travelled to India and met key government ministers as well as senior corporate leaders in Delhi, Mumbai and Bengaluru. It was a good opportunity to verify the premises on which our India call rests. This report summarizes the main findings of my trip and discusses India's long-term prospects and enduring challenges.

India is of course *not* a risk-free enterprise and the country's challenges remain daunting. As is often the case, one's biggest challenge is simultaneously one's biggest risk *and* one's biggest opportunity. If India manages to productively employ the fifteen million new workers that every year join its workforce, growth is certain to remain spectacular. But will the country be able to do so in an era of rapid technological change and growing automation? We think that the government is taking the necessary measures and creating the right institutions to allow the economy to efficiently absorb the growing population. The steady growth in relatively stable foreign direct investments, as opposed to the more volatile flows into the country's listed equity markets, confirms that we are not alone in this thought. Yet, the sheer magnitude of the country's demographics, combined with the fierce competition of other emerging economies, implies that more needs to be done, and with continuing urgency.

Perhaps more interesting, and certainly more encouraging, are our findings on the political economy front. There is a wide consensus that the Modi government has triggered an unprecedented reform momentum in the country. We are not in denial of the current government's major contributions to fiscal consolidation and long-term structural reforms. We would like to point out, however, that since 1991 India's reform process, for sure at times way too slow, has nonetheless always moved in the right direction, regardless of the political color of the ruling coalition. In 2013, one year before Mr. Modi came to power, it was the Singh government that took important measures in the fiscal and banking sphere. The Modi government aptly and swiftly built on its predecessor's work to increase the speed of the reform process.

There are two things that have radically changed in our opinion. First, technological change is allowing the central government directly to reach out to the masses, bypassing local administrations. It is also allowing the economy to leapfrog traditional production and distribution methods. Second, India – once the leader of the so-called non-aligned countries – has become the preferred Asian strategic partner for all Western powers and Japan. Rising antagonism between the United States and China will further foster this process, and Mr. Modi is determined to turn it to the country's economic advantage.

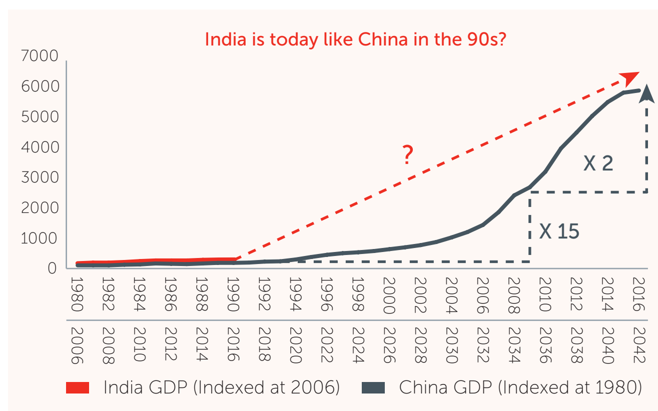
Whilst we do provide comments on our preferred sectors, this report does not contain specific investment recommendations. Our Relationship Managers and Investment Advisors will of course be delighted to guide you in that regard. Also, the ADCB House View is currently underweight emerging markets. Whilst we believe that India will weather the near future better than most other emerging markets, it is unlikely to be immune from downward pressure on the overall asset class. In the long-term India continues to make a lot of sense. In the short term, one might better pursue Indian equities as a long position in combination with a short position in another emerging market.

I hope you will enjoy reading this report. Whilst all errors contained in it are mine only, I would like to thank both my ADCB colleagues and NYU Abu Dhabi students and colleagues for their constructive comments.

Luciano Jannelli
Head Investment Strategy

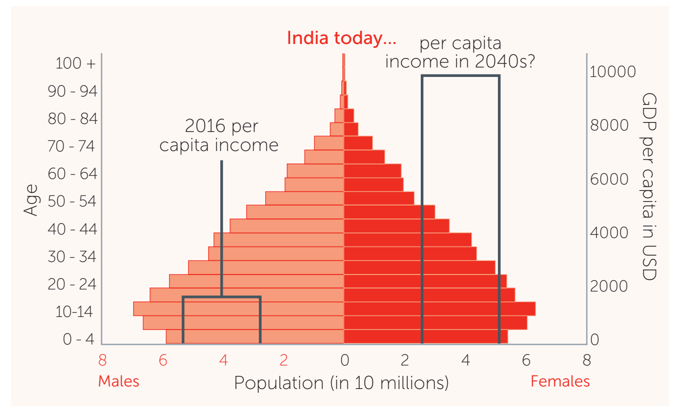
II. Is India today where China was in 1990?

The question that comes today to the mind of many investors is whether India is now where China was in the early 90s when the latter managed to kick off a growth process, which in two decades would have multiplied the size of its economy by a factor of fifteen. Following the Global Financial Crisis of 2008, China's growth rate has been slowing significantly from the double digits to a more sustainable rate which currently stands close to 7% on an annual basis. Even at those rates though, China's economy has more than doubled over the last 10 years.

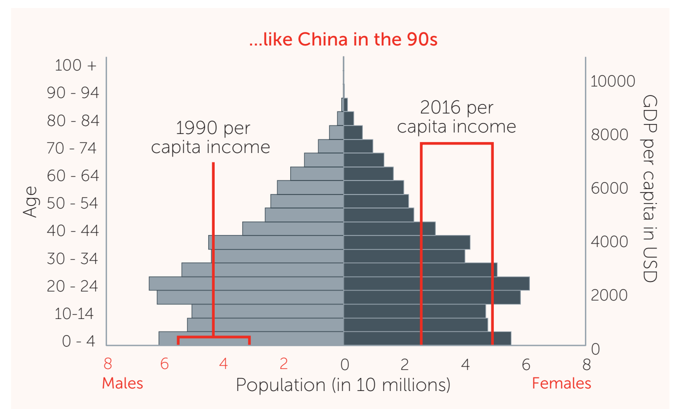


Source: Bloomberg, World Bank, ADCB Investment Strategy

What makes today's India similar to yesterday's China? India today has – like China in the early 90s - a very low per capita income. And like China in the early 90s, India today looks set to pump over the next 10 years 15 million workers and consumers per year into the economy. In other words, the sheer size of India makes it a candidate to catch up with China and become the largest, or second largest, economy of the 21st Century.



Source: United nations, World Bank, ADCB Investment Strategy



Source: United nations, World Bank, ADCB Investment Strategy

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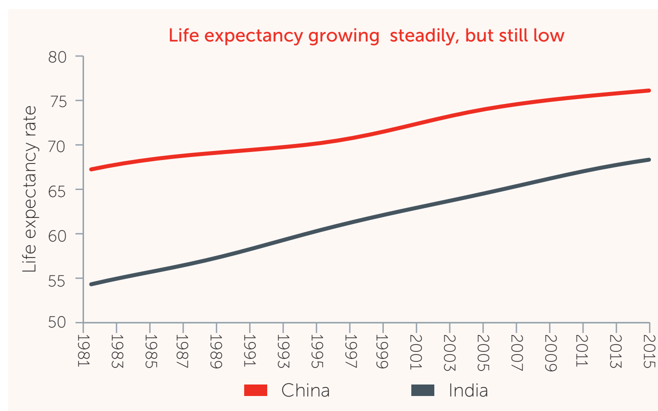
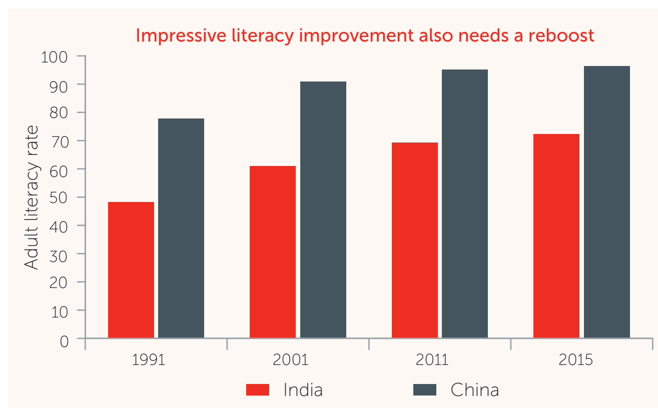
II. Is India today where China was in 1990? (continued)

It is all about the people and their environment

Of course, it is one thing to have a huge growth potential. It is something quite different to put that potential to work. A country's capacity to exploit its own growth potential rests on two factors. First and foremost, there is the human factor. How healthy is the population? How capable is that population, what are its skills? Below charts show that India still has a long way to go in order to raise the living conditions and skill sets of its population.

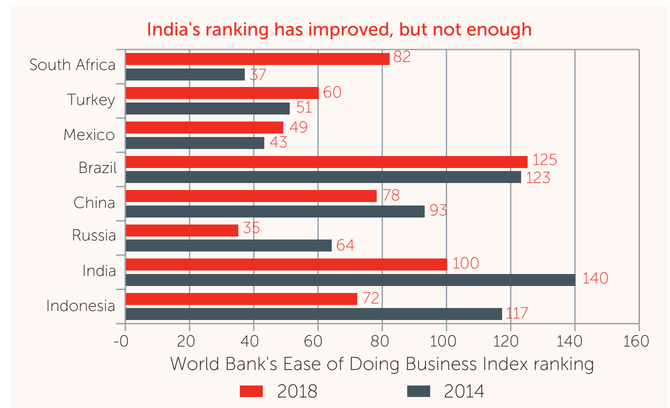


Source: Bloomberg, ADCB Investment Strategy



Source: World bank, Bloomberg, ADCB Investment Strategy

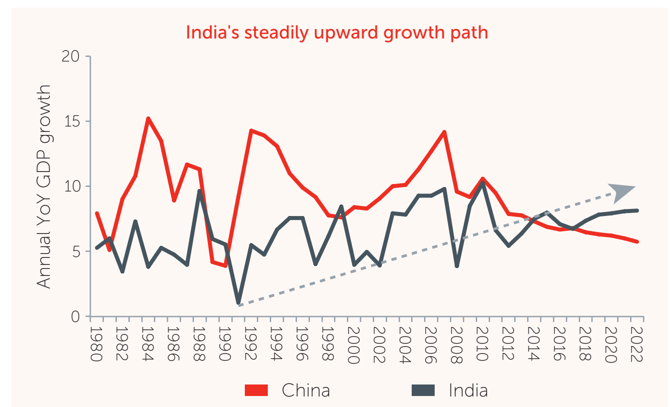
The second factor is the institutional and social environment. What institutions and social norms are in place to allow the population to extract the most of itself, in terms of activities and transactions that add value? Here too, it appears that India can do better. True, the country has dramatically improved in cutting red tape and eliminating other institutional and social barriers to entrepreneurial activities, as can be seen by the fact that it jumped from the 142nd place to the 100th place in the World Bank's Ease of Doing Business Index. Yet, with such ranking India is still far behind other important emerging markets, as can be seen from the following chart.



Source: Bloomberg, ADCB Investment Strategy

India did have three decades of gradual reform

In truth, it would be ungenerous to state that India has done nothing to boost growth. In fact, the continuous reforms of the last three decades – however slow and gradually implemented – did lead to a significant jump in the country's growth rate.



Source: Bloomberg, ADCB Investment Strategy

India still has a long way to go in order to raise the living conditions and skill sets of its population.

II. Is India today where China was in 1990? (continued)

India Reform History

Pre-1991

1980s - 1990s	Foreign debt-fueled growth leading to the 1991 balance of payments crisis

Pre-Modi Reforms

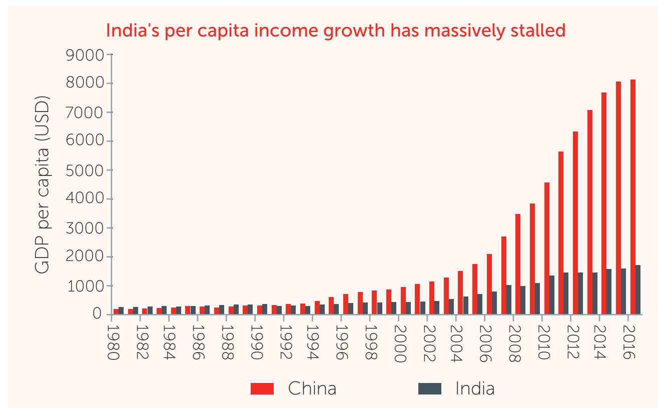
1991	Abolition of license raj, liberalization of domestic prices, reduction of import duties, FDI liberalization, reduction of taxes
1993	FIIs meeting certain minimum standards were allowed to invest in Indian equity market and later also in debt instruments through secondary market purchases.
	Managed Float regime of Indian rupee
1998	Introduction of the Foreign Exchange Management Act
	Introduction of National Highway Development Project
2001-2002	Privatization of four loss-making public sector units-BALCO, Hindustan Zinc, IPCL and VSNL
2003	Fiscal Reforms and Budget Management Act with an aim to reduce India's fiscal deficit
2005	Introduction of Overseas Citizenship of India allowing non-resident indians to work or invest in India
	Special Economic Zone (SEZ) Act
	Right to information act
2006	MG National Rural Employment Guarantee Act – labour law and social security measures ensuring the 'right to work'
2009	Set up of Unique Identification Authority of India (UIDAI) utilizing the Aadhaar system
2012	Liberalization of FDI in single brand retail trading in which FDI up to 51 per cent is permitted subject to specified conditions of mandatory sourcing of at least 30 per cent of the value of products sold from Indian small industries/village and cottage industries, artisans and craftsmen.
2013	Link Aadhaar to Direct Benefit Transfer programme

Modi Reforms

2014	Jan Dhan Yojna- providing access to formal banking services to all previously unbanked indians
	Significant removal of fuel subsidies
	FDI limit into railways extended up to 100%
2015	Fully opening of the coal mining sector to private/foreign investment
2016	Demonetization
2017	Implementation of Goods and Services tax
	Recapitalization plan for the public sector banks
	RERA (Real Estate Regulation and Development Act) & affordable housing
2018	Relaxation of foreign investment rules in aviation (including divestment of state-owned Air India airlines), retail (100% in single-brand through automatic route) and construction sectors (100% in construction development projects)
	National Health Protection Scheme (Modicare)

II. Is India today where China was in 1990? (continued)

The key concern, however, is another one. The improvement in growth, remarkable in many respects, has not been sufficient to accommodate for the needs of the country's growing population[1].



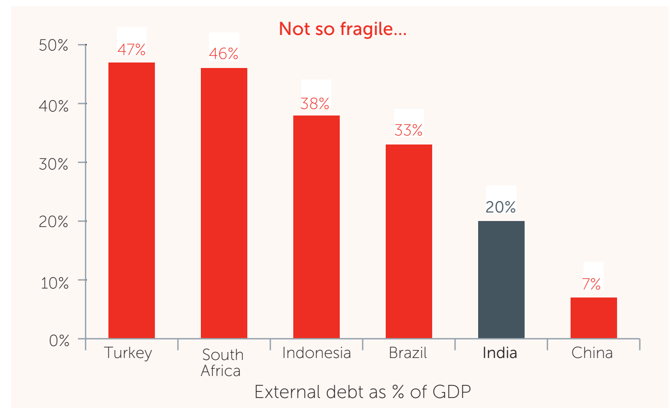
Source: World bank, ADCB Investment Strategy

India's capital markets are more similar to China and less to other emerging markets, in that they are less exposed to global financial shocks

In 2013 India was classified amongst the so-called "Fragile Five" countries, together with Brazil, South Africa, Indonesia and Turkey. These five countries had in common widening fiscal and current account deficits and, as such, faced increased capital outflows and downward pressures on their currencies. It is important, however, to point out that the fiscal and current account balances of a country are flow concepts, as they represent respectfully the difference between the governments' revenues and outlays, as well as the difference between exports and imports and inward- and outward factor income. Deteriorations in fiscal and current account balances can be overcome with appropriate fiscal and monetary measures. This is exactly what India did following the 2012-2013 depreciation of the Rupee, with growth subsequently picking up again and the country's asset prices enjoying a remarkable revaluation.

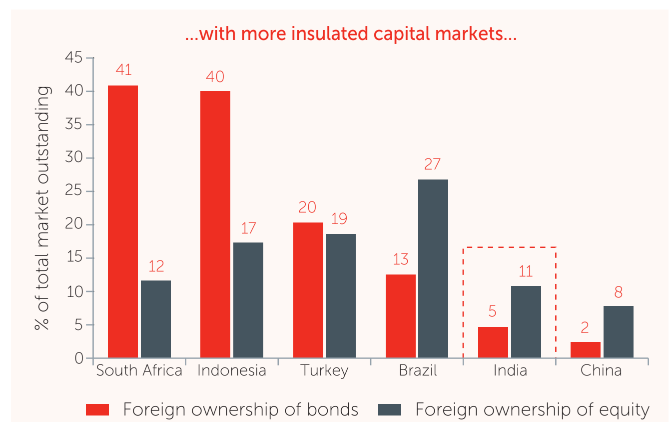
What sets the country apart from most other emerging markets are stock concepts, namely a historically low level of external debt, consisting almost exclusively of long-term commercial corporate borrowings, as well as relatively low levels of foreign ownership of domestic securities.

Indeed, amongst the larger emerging markets only China has a smaller external debt as a share of gross domestic product.



Source: Bloomberg, ADCB Investment Strategy

It is perhaps not entirely surprising that lower external debt levels come together with more insulated capital markets. As can be seen from the below chart, India has a very low level of foreign ownership of bonds and stocks, again second only to China.



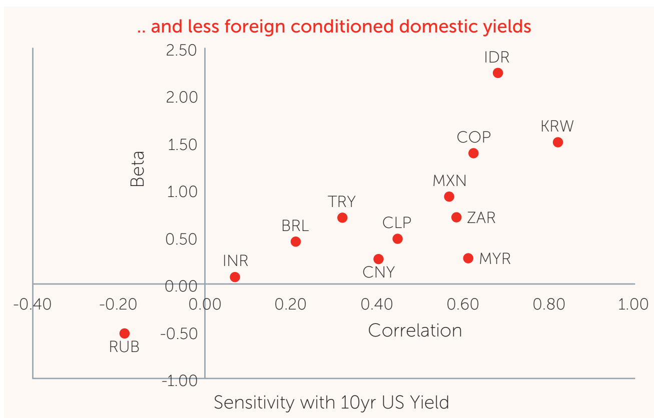
Source: IIF and various central bank sources, ADCB Investment Strategy

The fact that few foreigners have significant stocks of tradable Indian securities and that the country has a low stock of foreign debt makes any crisis related to fiscal and current account deficits, more manageable. Indeed, in any moment of increased volatility in global financial markets, India's financial markets and its economy are more resilient for the simple reason that they will face less offshore liquidation by foreign entities. Not surprisingly, the last time India suffered a full blown Balance of Payments crisis, necessitating a capital injection from the International Monetary Fund, was in 1991 before the country initiated its first reforms. Indeed it was that crisis that triggered the start of a reform process that, albeit with its inevitable ups and downs, was never abandoned since.

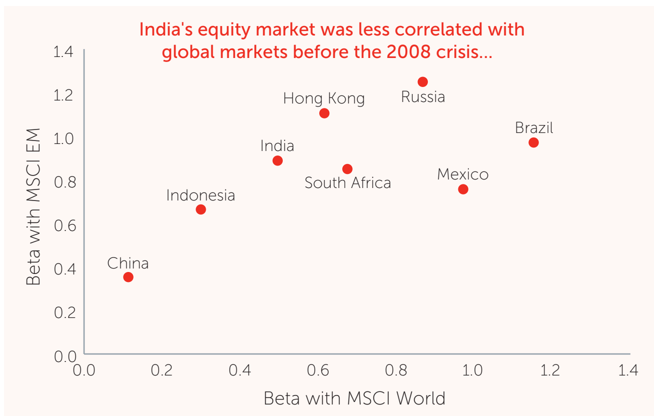
1 This concern was dramatically reflected in Mr. Modi's recent speech at the 2018 WEF in Davos where he argued that what for foreign investors meant "ease of doing business" for the Indian people translated into "ease of living".

II. Is India today where China was in 1990? (continued)

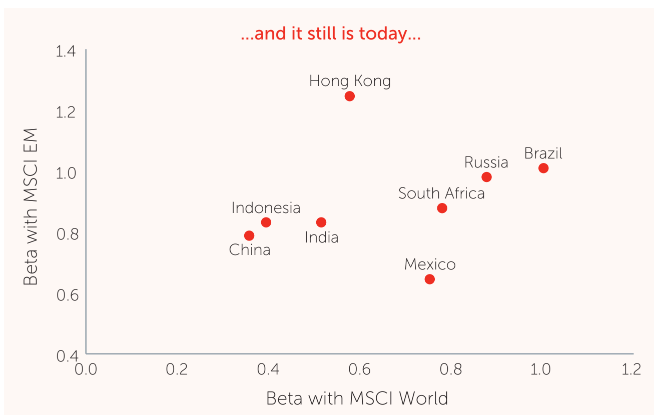
Below charts clearly show that India's capital markets are less correlated with the ups and downs of global markets, when compared with most other important emerging markets. The fact that the country's capital markets are less conditioned by the developments in global interest rate levels and in global equity markets, makes India's domestic financial conditions less vulnerable to global shocks.



Source: Bloomberg, ADCB Investment Strategy



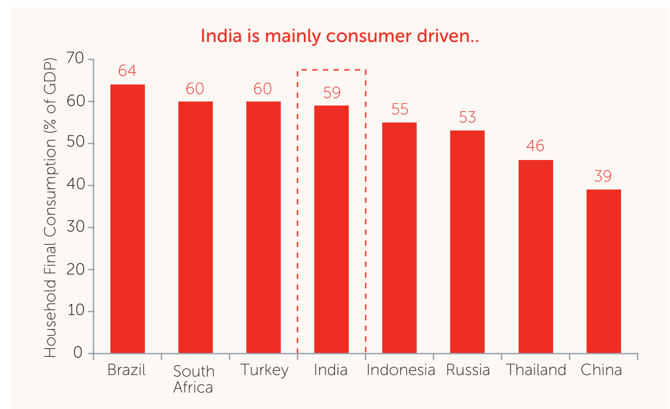
Source: Factset, ADCB Investment Strategy



Source: Factset, ADCB Investment Strategy

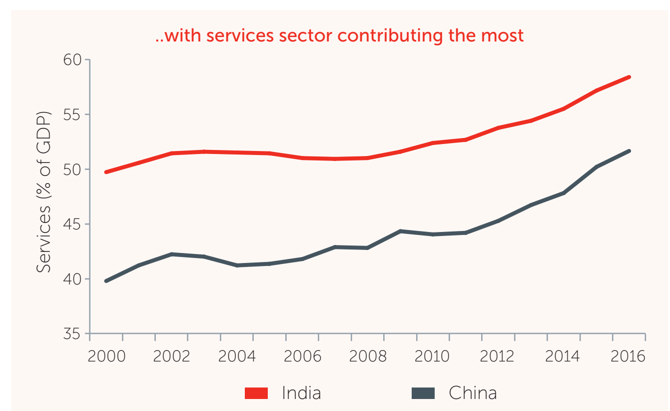
India's domestic economy is more balanced and therefore less prone to massive growth corrections than China

It is however not only India's capital markets to be relatively insulated from external shocks. Also its domestic economy is less affected by global events. It is in this regard that India's economy is arguably more stable than China's, and that its growth prospects are right now more sustainable. Growth in India has been mainly driven by domestic consumption, rather than by investments. India's private household consumption stands at 60% of gross domestic product, which is amongst the highest levels in emerging markets, whereas China's private household consumption stands at only 40% of gross domestic product.



Source: World bank, ADCB Investment Strategy

China's growth tilt towards investments rather than consumption is of course well known as it is the result of the country's choice to become one of the world's largest exporters of manufacturing goods[2]. In India on the other hand, services have been an important contributor to domestic growth.

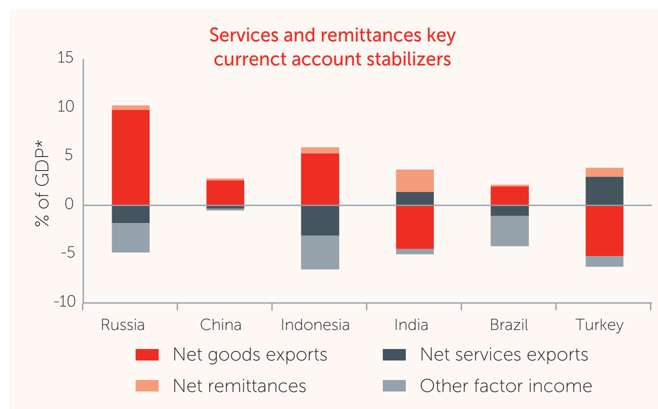


Source: World bank, ADCB Investment Strategy

2 It should be noted that China's lower propensity to consume is not a function of a higher level of per capita income, i.e. a higher income level allowing Chinese households to put more money aside for savings, thus consuming less as a share of income. Historically China's savings rate has always been higher than India's also in the 80s when India's per capita income was higher than China's. Since the 80s savings rates have in fact significantly grown in both countries, only to come down after the 2008 Global Financial Crisis. China's higher level of savings and capital formation appears more to be based on its export-led manufacturing growth model. Indeed, the country's share of consumption is also lower than that of countries with comparable per capita income levels, such as Brazil, Turkey and Russia.

II. Is India today where China was in 1990? (continued)

It is important to note that India's significant services sector – together with the remittances of Indians working abroad – has been the key contributor to the country's income from abroad. It remains to be seen if Mr. Modi's *Make in India initiative* can increase the country's exports of goods so as to allow the overall trade balance and current account to deliver more consistently a surplus rather than a deficit (until now the reduction in the deficit has mainly been a function of falling oil prices). What can be said at this stage is that the services sector and the remittances have been key elements in supporting the country's external balance.



NOTE: * yearly average from 1980-2016
Source: Economic Intelligence Unit, ADCB Investment Strategy

Also India's manufacturing exports happen to be well diversified with the largest single goods export accounting for a mere 14.6% of overall goods exports, compared to 20.7% median for BBB-rated countries, a 20.4% median for the BRIC countries, and a 34% median for emerging markets[3].

India versus China: might the turtle yet catch up with the hare?

One of the key arguments one hears from India's corporate leaders is that the reforms of the Modi government are irreversible. Governments different from the current NDA coalition might slow the reform process, but they would be loath to undo laws liberalizing foreign investments and cutting red tape. Whilst we recognize the increased momentum for reforms initiated by the Modi government, in this report we argue that the country's reform direction has shown itself quite independent from the political color of the ruling coalition[4]. The country's main problem has always been speed and implementation of reform, and the current prospects for acceleration are not only driven by the commitment of Mr. Modi's government, but also by "exogenous" developments such as technological change and the geopolitical repositioning of the country.

At any rate the disappointing reform speed of the past, but also the country's consistent efforts in the right direction are probably a specific characteristic of policy making in what is on one hand a very heterogeneous and poor country - with 1.2 billion people speaking 22 languages and earning on average approximately 100 US dollar per month – and on the other hand constitutes a bicameral parliamentary democracy composed of 29 states yielding considerable power[5].

Democratic decisions require consensus building – the convincing of the electorate, parliament and various interest groups – not only when it comes to doing the reforms, but also when it comes to undoing them. Most reforms have brought economic progress and, as such, one might argue that it is actually even harder to undo them than to do them[6].

The fact that India today has a more balanced economy than China's puts the latter more "successful" growth story in perspective. China's excess of investments over consumption is of course not a problem in and by itself. Neither is the country's massive share of the global output of manufactured and semi-manufactured goods. Rather, the country's development policy's bias towards capital accumulation in specific sectors has over the last decade led to inefficient investment spending such that the total debt over gross domestic product has spiraled out of control. One could counter-argue that China's current imbalances are simply the result of the fact that the country has very rapidly moved into a more advanced stage of development, and that India is still very far away from that stage of development. Yet, it is worthwhile to notice that China's high total debt over gross domestic product stands also out compared to emerging markets with a comparable p.c. income level, such as Brazil and Turkey, as well as compared to more advanced economies.

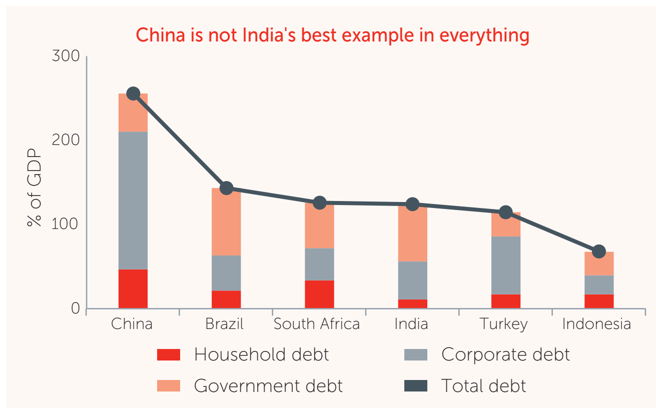
3 Single goods export defined at the 2-digit United Nations Standard International Trade Classification Code (Source: The Economist Intelligence Unit).

4 As can be seen from the table on page 5, FDI liberalization – which recently received a major boost by the Modi government – was in fact initiated by the Congress government as far back as in 1991.

5 In fact over the years power has moved from the states to the centre, and back. At this moment, the world's largest democracy looks set for a prolonged period of power moving again back to the centre, although this is of course not certain.

6 It is also true that governments in India, including the current one, tend to dilute reforms in the run-up to elections by re-introducing subsidies (e.g. by setting minimum agricultural prices) or increasing handouts to specific interest groups. However, whilst it is true that such measures have often temporarily unsettled the country's fiscal balances, it should be pointed out that such temporary deviations from the reform track can be observed in almost all developing and non-developing countries, democracies or not. What matters is that the thrust of the Indian reform path since 1991 has been unequivocally of liberalization in the economy and rebalancing of the fiscal accounts.

II. Is India today where China was in 1990? (continued)



Source: IIF, ADCB Investment Strategy

Indeed, it seems that at least to some extent China's imbalances are the inevitable by-product of a political process of direct intervention in business decisions[7], which might at times supercharge the economy, at times paralyze it. The best example of China supercharging its economy is of course the massive jump in credit growth directly and actively promoted by the government in the aftermath of the 2008 Global Financial Crisis. It resulted in the country's total debt to GDP ratio growing from 162% to 266% in the space of 9 years. The best example of the government's actions risking to paralyze growth is the recent crackdown on corruption, combined with a heavy dose of micro-management of the economy at various levels of local government authority. However one looks at it China's government has forced the country into a growth model where over the last years excessive investments have been officially accounted for as value creation, whereas in fact they resulted in a waste of resources. The unwinding of China's huge debt mountain will now result in a massive reduction in growth rates. Predicting the future is always hard, but India's growth model might yet prove to be more sustainable, although it will still take many years before the "turtle" India catches up with the "hare" China[8].

As in many emerging markets monetary stabilization in India has often been hostage to food and energy inflation

7 Whilst it is true that China successfully and gradually liberalized its economy through the 80s and 90s, after 2005 the Hu Jintao administration halted privatizations and increased control over both state-owned and private enterprises as well as local governments. This trend of re-centralization and increased state intervention is taking on new highs under current strongman Xi Jinping.

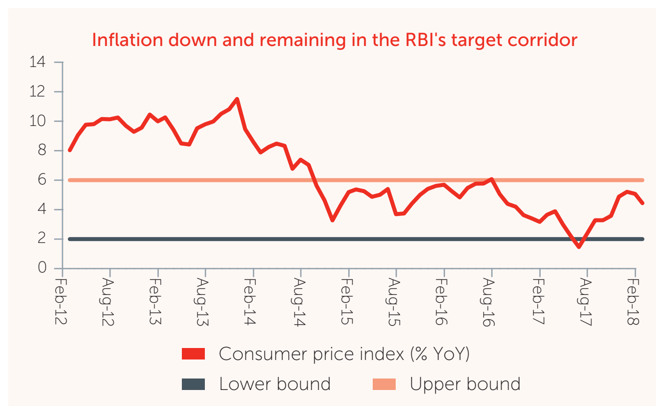
8 The ADCB House View is that in 2018 China will start massively reigning in excessive and unproductive investment spending. This will happen because the government is convinced that only such action will allow the country, albeit it at the cost of short-term disruptions, to maintain a stable long-term growth trajectory, and thus escape the so-called middle income trap and catch up with other economies such as Japan and South Korea. In any case, and whilst we believe that the government will be able to avoid the extreme scenario of growth implosion due to political paralysis, China's growth rate is bound to significantly come down, which will probably be bad for China equities, and certainly be bad for equities in certain emerging markets that are highly exposed to China.

III. The Modi reform momentum

Lower oil price has facilitated monetary stabilization and fiscal consolidation

As in many emerging markets monetary stabilization in India has often been hostage to food and energy inflation, two components of the overall price basket that play a more modest role in advanced economies. As such the decline in the oil price between 2014 and 2015 has greatly facilitated not only the reduction in inflation but also of the current and fiscal account deficits. Whilst this is true, it needs to be pointed out however that the improvement on the inflationary front, as well as of the fiscal and external balances, started before the decline in the oil price, indeed before the current government came to power in May 2014.

A critical part in the inflation fight has been played by the Reserve Bank of India (RBI) which, after having massively brought down its policy rate in the aftermath of the 2008 Global Financial Crisis, started to aggressively hike rates as early as March 2010, almost doubling them to 8.5% by October 2011. The governments of Mr. Singh and Mr. Modi have since done their part tempering increases in minimum support prices in the agriculture sector and promoting more efficient management of food stocks, thereby driving inflationary expectations further down.



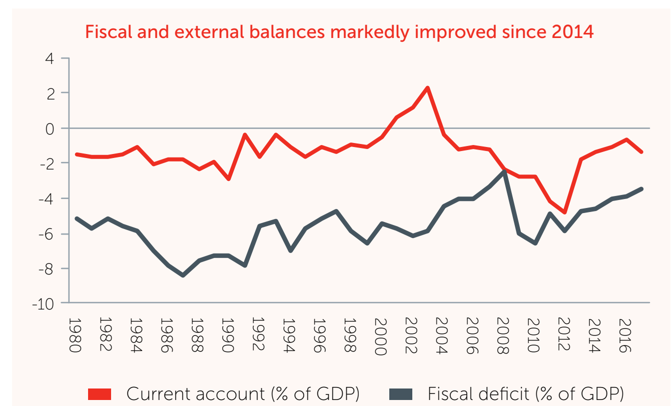
Source: Bloomberg, ADCB Investment Strategy

Since 2005 the RBI has adapted a flexible inflation targeting framework which defines the price stability objective in terms of a lower bound at 2% and an upper bound at 6%. Recently price pressures have increased, mainly on account of a jump in administered prices, higher prices of vegetables, as well as a rise in global oil prices. Moreover, now that the government has raised the minimum support price for agricultural commodities it is highly likely that inflation will remain close to the upper bound. To the extent that the government remains able to stabilize the fiscal deficit, and provided we do not see a sharp rise in the oil price, the price rises should not go beyond that bound. A return to double digit inflation is at any rate unlikely.

As is clear from the above considerations in India fiscal consolidation and price stabilization go hand in hand. Whilst it is true that India's overall public debt over gross domestic product ratio at 68% is relatively high, it should be pointed out that most of that debt is in local currency[9]. Nonetheless the persistently high level of the fiscal deficit has been a major drain for the current account and thus a key element of vulnerability. The fiscal consolidation measures adopted by the Singh government between 2012 and 2013 managed to more than half the fiscal deficit by the end of 2013. The Modi government then took advantage of the decline in the oil price to eliminate a significant part of energy subsidies which, together with divestment of the telecom spectrum further improved public finances (although the latter was a one-off measure and as such should not have a permanent impact on fiscal consolidation). More importantly, demonetization and the introduction of the national Goods and Services Tax (GST), as well as other anti-tax evasion measures, should have expanded the national taxpayer base. According to the government direct tax collection surged by 12.6% in fiscal 2016-17 and by roughly 18.7% in fiscal year 2017-18. These figures are, however, limited to the impact of demonetization and have yet to be confirmed. The impact of the GST has not yet been quantified.

Increased spending, such as amongst others the recent increase of agricultural support prices – ensuring a 50% mark-up over cost prices - is already bringing the deficit for the fiscal year 2017-2018 to 3.5% of gross domestic product, in excess of the original 3.2% target. It still looks likely though that the government will be able to stay below 3.5% of gross domestic product for the coming years.

The current account has not only improved on the back of fiscal consolidation. Key components of that reduction have also been weak (import intensive) business investment, as well as lower oil prices and less demand for gold (which constitutes a major import item in India). It would be prudent to argue that these three drivers are now less likely to exercise a positive impact on the current account balance. As such, as with the fiscal balance, also for the current account balance one should expect a sideward movement, rather than continuing improvement.



Source: CEIC, ADCB Investment Strategy

9 Indeed, whilst the domestic share of public debt stands at approximately 50% of gross domestic product, the external share is below 20% which is less than half of the median for emerging markets.

III. The Modi reform momentum (continued)

A quick look at our emerging markets "heat map" is quite reassuring for India in terms of the near term stability prospects for its capital flows, and thus the resilience of its currency and domestic rates, the only red indicator being overall government debt which, as mentioned, is mainly local.

External and debt indicators	China	India	Indonesia	South Africa	Russia	Brazil	Turkey
External debt (% of GDP)	7%	20%	38%	46%	32%	33%	47%
Import coverage ratio (months)	22	10	9	6	18	29	5
Short-term Ext debt (% FX reserves)	32%	24%	34%	80%	16%	13%	134%
Govt Debt (% of GDP)	47%	68%	29%	54%	16%	81%	29%
Economic indicators							
GDP growth (%, 5yr avg)	7.2%	6.9%	5.0%	1.6%	0.8%	-0.1%	5.8%
Headline inflation (%, 5yr avg)	2.1%	6.5%	5.2%	5.6%	7.5%	6.4%	8.7%
Fiscal balance (% of GDP)	-3.4%	-3.5%	-2.4%	-4.3%	-1.5%	-8.0%	-2.0%
C/A balance (% of GDP)	1.4%	-1.4%	-2.2%	-2.3%	-2.1%	-0.4%	-4.7%

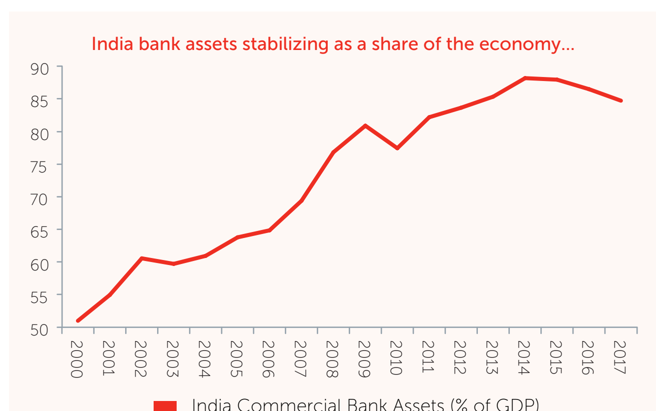
Source: Bloomberg, IMF, ADCB Investment Strategy

Very Bad | Bad | Neutral | Good | Very Good

Indian banks taking the cure...[10]

Like for all countries, the health of the banking system and the credit cycle outlook are key in determining the outlook. In India both bank credit to corporates and capital spending have stalled over the last years. Indeed, since 2016 Indian bond markets have issued more paper than banks have extended credit, reflecting also the fact that most capital spending has been by large companies, rather than small ones.

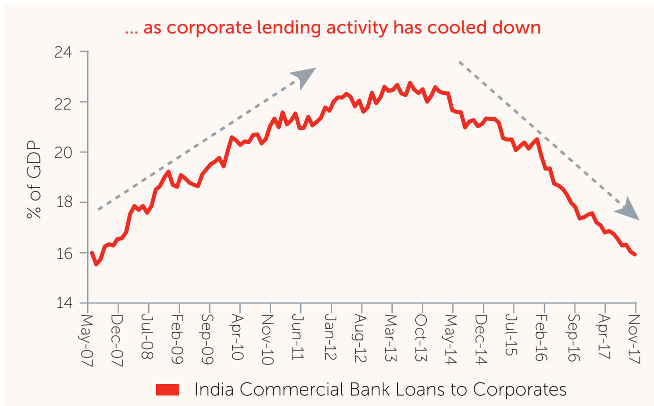
Unfortunately, during the so-called emerging markets boom which lasted from the collapse of the dotcom bubble to the taper tantrum, i.e. roughly from 2003 through 2012, India – like many emerging markets – went through a credit binge which also led to capital being misallocated in key sectors of the economy. As the following charts show, this development led to a massive jump of banks assets as a share of the national economy, which however has been cooling down and stabilizing for the last five years.



Source: CEIC, ADCB Investment Strategy

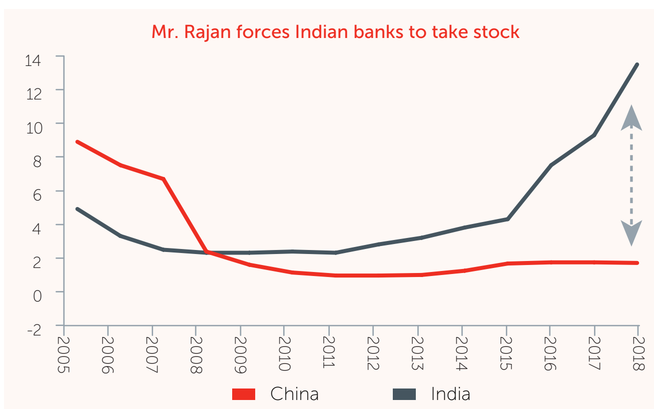
10 The next two sections draw heavily from research and analysis provided by BCA Research

III. The Modi reform momentum (continued)



Source: CEIC, ADCB Investment Strategy

In the aftermath of the 2013 taper tantrum the Reserve Bank of India, under the leadership of Raghuram Rajan, forced the country's public banks to take very high provisioning levels for such bad assets. It is worthwhile to notice that bad credit provisioning is often a matter of policy and that, as such, it might not be as aggressively pursued in every country. This most likely explains why the share of bad loans in China is "officially" so low compared to India. They simply have not been accounted for.

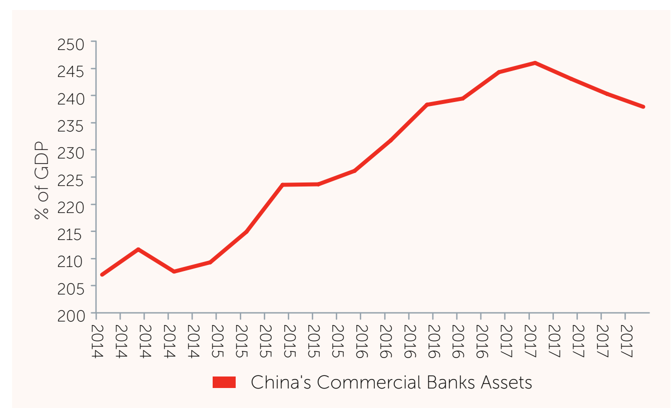


Source: CEIC, ADCB Investment Strategy

Indeed, unless the management of Indian public banks is of extremely low quality compared to the management of Chinese banks, something that seems implausible, India appears to have been willing to recognize its banking problems and tackle them, something China is still struggling with. This then explains why the above mentioned commercial loans book of India's banks has dropped from more than 22% of gross domestic product to approximately 16%. In China that figure still stands at an astonishing more than 100% of gross domestic product. In fact, rather than quality of management, the share of bad loans in public banks is usually a function of the "political" role public banks are called to play by the authorities to promote growth and development. As such, the best leading indicator for bad loans should normally be the rapid rise of the banking system lending activity, whether it is for India, China or any other country. The virtual absence of bad loans in a country where bank lending is in excess of 100% of gross domestic product is just puzzling.

Source: CEIC, ADCB Investment Strategy

By the same token, China's bank assets today count for still more than 230% of gross domestic product, compared to the aforementioned less than 85% of gross domestic product for Indian banks.



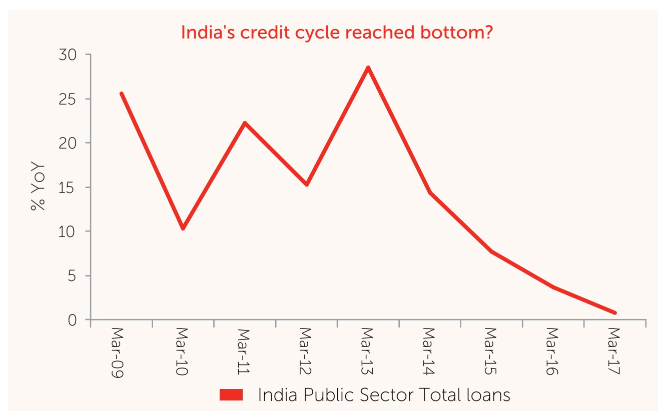
Source: CEIC, ADCB Investment Strategy

China's bank assets today count for still more than 230% of gross domestic product

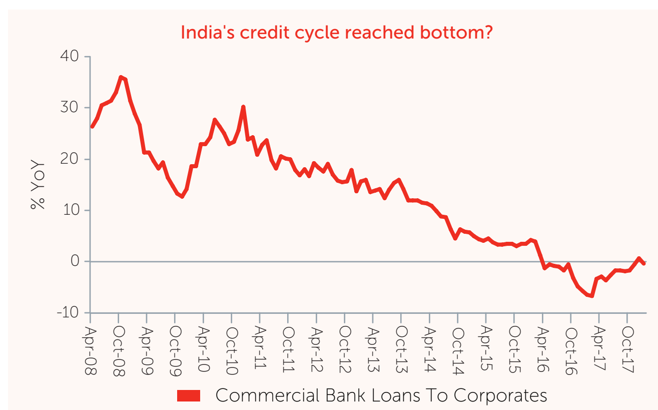
III. The Modi reform momentum (continued)

Indian banks gearing up for renewed lending after the government's recapitalization?

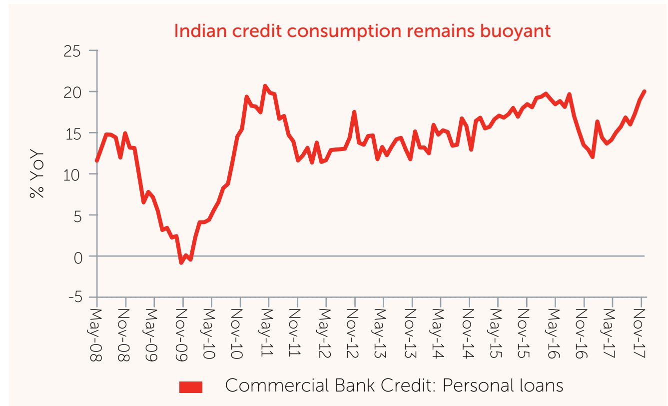
By any standard of comparison, one would thus draw the conclusion that India is much more ahead in its credit cycle, and its more timely adjustment process is laying the groundwork for renewed bank credit activity and support to the economy. Critically, the government's recapitalization plan of 2.11 trillion rupees should raise the public banks' ratio of total equity capital-to-risk-weighted assets ratio from the currently estimated 8% to more than 11%, i.e. well above the regulatory minimum of 9%. All other things equal, banks in India should thus resume their lending activity, giving not only a very welcome boost to cyclical growth, but critically raising productivity and potential output levels, which have been depressed by the protracted lack of lending and investments[11].



Source: CEIC, ADCB Investment Strategy

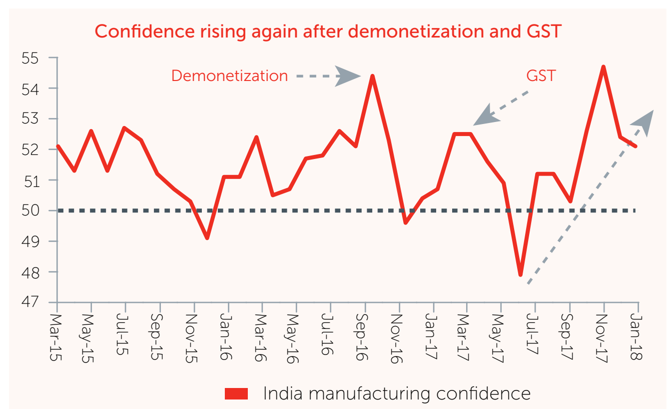


Source: CEIC, ADCB Investment Strategy



Source: CEIC, ADCB Investment Strategy

The uptick in the corporate credit cycle, combined with the resilience of consumer loans, is thus kicking into the business confidence cycle which, following the disruptions caused by demonetization and the introduction of GST, seems finally bent on a renewed cyclical recovery, pushed also by increased government stimulus. This makes India in 2018, and possibly in 2019, a relatively interesting trade within the emerging markets space. Indeed, whilst India is mainly geared on a rebound of its domestic economy, most other emerging markets are much more exposed to commodities and the tightening Chinese economy.



Source: Bloomberg, ADCB Investment Strategy

Most other emerging markets are much more exposed to commodities and the tightening Chinese economy

11 Critically, neither Indian nor Chinese banks look currently to be interesting investments. Any realistic hypothesis of necessary, i.e. well north of 10%, asset impairments would, assuming a PB value of around 1.3, implicate a valuation reduction of more than 10% for Indian banks, and more than 20% for Chinese banks. Chinese banks would suffer more as authorities are additionally cracking down on their significant off-balance sheet activities, which are not accounted for in this analysis. As for the Indian banks, it would be politically embarrassing for the government if the recapitalization would be done without diluting the current shareholders. It is therefore more prudent to state that the recapitalization will allow India's banks to resume lending again, but bank shareholders will nonetheless suffer from their past sins.

III. The Modi reform momentum (continued)

Modi government goes full speed on transportation infrastructure

Perhaps the best indication of the government's commitment to finally attack the country's, hitherto endemic, infrastructure problem is not just the budgetary allocation of over 1 trillion US dollars over the next five years, corresponding to approximately a yearly 9% of the country's gross domestic product. As important is the new approach towards foreign technology and financing partnerships. This approach is not only about liberalizing foreign investment, such as the elimination, subject to some remaining approval procedures, of limits in the railway, construction and mining sectors. What matters more is the quality of foreign involvement, such as the allotment of entire projects to single counterparts (or at least a coordinated consortium) so as to avoid the waste of time and reduction of pricing power inherent in cutting projects in pieces and mandating different firms[12]. At the same time the government is looking to give foreign investors better guarantees on the returns on their investments in these prospectively huge public-private partnerships.

The government is keen on pointing out what has already been done with a view of cementing the credibility of its commitment. The aviation industry has already 500 planes operating in the sky. It ensures 200 million rides annually generating 1.8 trillion rupees which is equivalent to the total revenues of the country's telecom and railways business. The industry has currently ordered 950 additional planes and aims to quintuple its annual rides to 1 billion over the next 15 years. The privatization of Air India and slated development of a significant number of new airports will be important soon-to-be next steps in this direction. Since 2014, road toll revenues have grown from 1.5 billion US dollar to 5 billion US dollar per year, providing more predictable cash flows. Over the same period capital spending in the railways network has risen from 8 billion US dollars to 23 billion US dollars.

Moreover, over the next years, the continuous improvement of the country's transportation infrastructure is likely to benefit from the increased political alignment between the states and the center. Indeed, when Mr. Modi became Prime Minister in 2014, the BJP (which is the dominant party in the NDA coalition) had power in only 7 states with just a 21% share of the national population. Today his party claims power in 19 of 29 states accounting for 68% of the national population and 60% of gross product. Whilst this political alignment can benefit many policy areas, since it should now also be reflected in an alignment between the lower and the upper houses of parliament, it is obviously quite important for the development of the country's transportation infrastructure.

12 The best example here is perhaps the Ministry of Railways' intent to award one single contract for the construction of the high speed bullet rail project. The rapid realization of a passengers only high speed network will have the added benefit of a significant improvement of the punctuality of freight delivery on the "old" rail network (given that passenger trains have obviously been systematically prioritized over cargo trains on the hitherto shared and overburdened network). In addition to dedicated freight corridors the ministry is also planning to outsource the management of railway station sites, so as to create "station malls" with restaurants, shops and other entertainment facilities.

Formalizing the economy through tax harmonization and fighting evasion

Through 2017 there has been a lot of bad news regarding the so-called demonetization and the introduction of the national Goods and Services Tax (GST). The main goal of these two measures was to reduce the shadow economy and increase the taxable basis of the economy. The jury is still out on the overall success of these measures. Demonetization in particular caused considerable disruption to the economy when it was introduced.

The purpose of demonetization was to crack down on the shadow economy, as well as outright illegal activities, by replacing all old 500 and 1000 rupee banknotes by new 500 and 2000 rupee notes. It was announced by surprise on November 8 2016 by the Prime Minister Narendra Modi. The forced conversion passed through the immediate invalidation of the old notes and took place between November 9 2016 and November 24 2016. It was saluted by a 6% correction of the stock market and caused significant disruption if not a total halt to many of the country's widespread small scale cash-based economic activities. Through the spring of 2017 there were cases of cash shortages in the country and the country's gross domestic product rate of growth fell. The disruption inevitably fell hardest on the more vulnerable elements of the society, many of whom faced sudden disappearance of their basic sources of income. Several people were reported to have died from standing hours in queues in order to change the notes or because hospitals refused medical assistance in exchange for cash. The death reports have never been confirmed by the government.

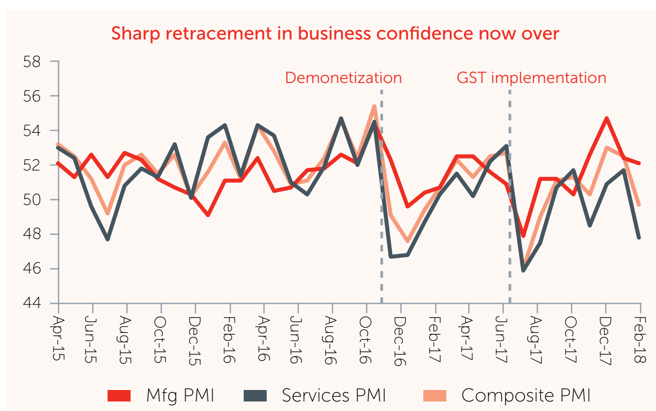
Significant execution issues aside, perhaps the most disturbing aspect of the entire operation was that approximately 99% of banned notes ultimately was deposited in the banking system or converted into the new notes, suggesting that there had hardly been any crackdown on the informal economy, or on illegal activities. Supporters of the operation on the other hand argue that it has nonetheless come together with an expansion of the banked population and the tax base.

The purpose of the GST was to unify the nation's indirect tax system for the sale of all goods and services in the country (with the exception of financial securities which remain regulated by the Securities Transaction Tax). The new tax, which required amongst others also constitutional legislation, was introduced on July 1 2017 and replaced a myriad of old levies ranging from the central excise duty to the services tax, additional customs duties, different surcharges, state-level

III. The Modi reform momentum (continued)

value added taxes, octroys and others. The new single indirect tax system will undoubtedly in the future facilitate business doing in the country, as well as allow the national government to harmonize tax policy across the country. Here too, however, execution issues appear to have been widespread resulting in disappointing revenues. Those revenues were ever so disappointing since there had been no increase in spending in the run-up of the GST introduction. Supporters of the operation argue that the number of enterprises registered for taxation rose from 7 million to 10.5 million. Whilst that still represents only 16% of the country's enterprises, it is nonetheless a jump of 50%. It is also argued that making hitherto non-formalized companies GST-complaint, and providing them with a nationally unified tax scheme, entails at least for those firms, a quantum leap in tax collection and tax administration. Over a longer horizon it should facilitate those businesses' access to credit. For the economy it should thus result in more lending and more economic activity, with more taxes and less court disputes.

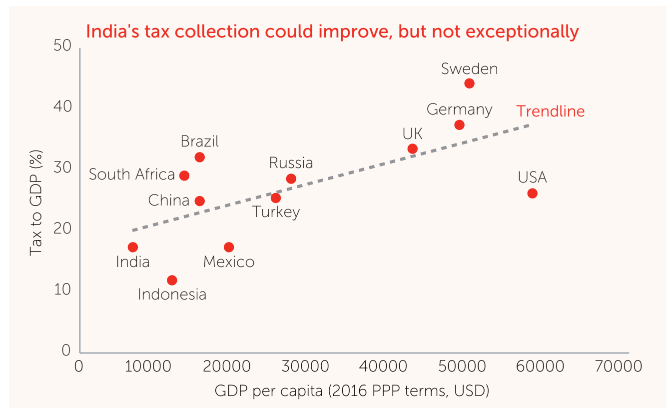
Again, whilst the jury is still out on the overall success of both demonetization and the GST introduction, we would argue that the latter in particular is likely to benefit the country over the long term as it gives the central government much more leeway in organizing tax collection across the country. It is also worthwhile to note that the disruption caused, in particular by demonetization but to some extent also by the GST introduction, is now definitively behind us.



Source: Bloomberg, ADCB Investment Strategy

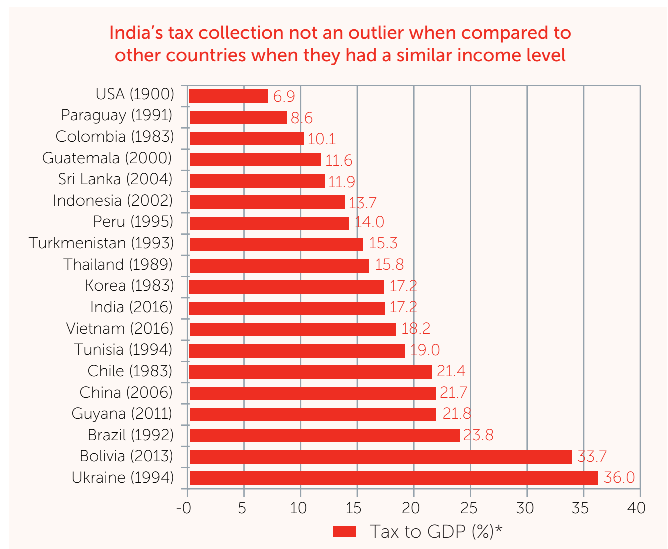
Tax collection is to some extent important...

Another important point to make is that increased tax collection is, yes, important for India, but that one should not overstate the tax collection issue as being the most important developmental problem for India. In fact, the amount of tax that India collects as a share of gross domestic product, whilst definitely worthy of improvement, is not out of touch with what one would expect given the country's level of per capita income.



Source: OECD, UNU-WIDER tax database, IMF WEO, Mint, ADCB Investment Strategy

Indeed, as the next chart shows, other countries had lower tax collection levels when their income level was similar to India's current income level, and they still managed to grow their economies (notably the United States!).



Note: Tax to GDP (%) when the GDP per capita was equal to that of India in 2016
* including social security contributions.
Source: UNU-WIDER database, Maddison Project, Mint, ADCB Investment Strategy

> One should not overstate the tax collection issue as being a key developmental problem for India

III. The Modi reform momentum (continued)

...economic and financial inclusion is more important

The true meaning of formalizing the economy in an underdeveloped and rural economy should be less about taxation and more about financial inclusion. Financial inclusion, in fact, similar to the move from barter to money in prior centuries, increases economic efficiencies for all those involved. It is here that new technologies can help a lot, helping the government to ensure that subsidies and other benefits – which conceptually are negative taxes – arrive directly to the desired beneficiaries, increasing not only social justice and economic efficiency, but also reducing corruption. But new technologies can do more. They can even allow the Indian economy to leapfrog existing modes of delivery of products and services, such as for instance the traditional banking system.

Formalization in this sense has arguably occurred through three concurring factors. First there was Aadhaar, in the words of World Bank Chief Economist Paul Romer "the most sophisticated ID program in the world". Second, there has been a massive jump in the penetration of relatively cheap smartphones across the country. Third, there has been the introduction of Pradhan Mantri Jan Dhan Yojana, a money scheme promoting banking accounts for vast masses of people who were previously entirely excluded from the financial system. The widespread utilization of smartphones allows the scheme's beneficiaries to easily hook up with their Aadhaar-linked banking accounts.

There has been of course significant criticism of the utilization of a biometric identification system, such as Aadhaar, to collect information about the population and make its participation conditional to the possibility of receiving not only a banking account without the need of a minimum balance, but also benefits such as energy subsidies and work allowances. Nonetheless, and in spite of continuing litigation and parliamentary opposition (in particular from the upper house), Aadhaar and Pradhan Mantri Jan Dhan Yojana are by now irreversible realities. Aadhaar was conceived in such a way as to allow people to easily enroll independently from their level of literacy, such that by now the entire resident population of India, about 1.2 billion people, has an Aadhaar ID.

Pradhan Mantri Jan Dhan Yojana still struggles to achieve perfection. The promised overdraft facilities and free insurance coverage do not always seem to work, as the banks have retained discretion in the determination of eligibility. At the same time, with a view of profiting from the offered benefits, individuals who already have banking accounts have also enrolled into the scheme. Yet, for all the criticism that the scheme has received, it is estimated that since its launch in August 2014 it has resulted in the opening of approximately 300 million accounts for a total value of about 12 billion US dollars for families who previously did not have banking accounts. That is about 25% of the country's population.

As for the privacy concerns raised by Aadhaar's biometric classification of the country's resident population, they are in and by itself legitimate. It is only naturally that they have been raised both in the parliament and through the judicial system, given that India is a constitutional democracy. One might add though that India is a democracy with a very poor population. As such, priorities would arguably be different than in many advanced economies. That is not to say that Indians would not care about the privacy of their personal data. It simply means that food and energy considerations remain such a major issue for a very big part of the population, that privacy concerns tend to take a backseat.

The truth is that very rapid technological change in the digital sphere, at an unprecedented scale and speed, has allowed vast masses to economically transact in the formal economy. This has been achieved from one day to the other. Against the backdrop of such an enormously beneficial shock, it should perhaps not surprise that Aadhaar was allowed, by law or by fact, to gradually "conquer" the country's entire population. In reality Aadhaar is not a partisan solution produced by the current government. It was initiated in 2009 and already in 2012 Prime Minister Manmohan Singh tried to launch an Aadhaar-linked scheme for the direct transfer of benefits to specific categories of citizens. Formalization of the country's economy through financial inclusion of large masses that were hitherto excluded from the financial system has been facilitated by both the new digital technologies and the will of the country's ruling class. It will not be reversed.

From data richness to permanent wealth creation?

One of the most intriguing speculations about India's digital revolution is whether it can morph into an industrial revolution, permanently lifting the bulk of its population out of poverty. According to Nandan Nilekani, co-founder of Infosys, and one of the key persons behind Aadhaar, the key difference between emerging markets and advanced economies is that the former are becoming data rich before becoming economically rich. Per capita income for Indians is on average 1500 US dollars but the amount of data that Indians generate is the same as the data generation of the average person in the US. The idea here is that, thanks also to programs like Aadhaar, people can use their own data to improve their lives; they become empowered to get access to better services. According to Mr. Nilekani, India will go from being data poor to becoming data rich in the next three years. At that point there will inevitably be arbitrage opportunities between the

III. The Modi reform momentum (continued)

digital world and the non-digital world, i.e. between data richness and economic richness, for the simple reason that data grows at 450%, whereas the overall economy grows at "only" 7%. These developments, like all technological shocks, are of course very difficult to predict. Whether data wealth will immediately transform into permanent economic welfare is perhaps unlikely. But it is fair to say that the current digital revolution can trigger many more economic transformations that we can now imagine.

Popular is not necessarily populist

In 2014 many observers considered Mr. Modi to be an Indian type of Ronald Reagan or Margaret Thatcher. The reality of course was bound to be different. The US and the UK in the 80s were wealthy societies where income inequality was at an historical minimum. India is a very poor society with a highly uneven income distribution, with the bottom 50% of India's population consuming just 10% of the total pie. Especially the rural masses (making up two thirds of India's population) are very poor. Rural Indians consume on average just 16 US dollar per month compared to 28 US dollar per month average for all Indians. That average consumption of 28 US dollars per month, not the 16 US dollar average monthly consumption of the rural masses, is about one half of what the average Indonesian consumes, one quarter of the Chinese, and one tenth of the average Thai consumer.

Thus, whilst the current government has a clearly pro-business tilt, it cannot and will not ignore those popular instances that push for more redistribution. For political reasons and for economic reasons, given that in an economy that has a clear tilt towards private consumption rather than exports, massive growth ambitions can only be sustainably realized if the growth process is inclusive. And in a country where the bottom 50% of the population consumes just 10% of the domestic output, this is unlikely to happens without some re-distribution.

As for the current political situation, it is clear that the run-up to the 2019 elections might over the next year and a half tilt the government policy towards an increase in handouts and a (at least temporary) move away from politically more sensitive reforms, such as land and labor reforms. It should be pointed out that at this stage only the provision of agricultural support prices, stipulated at 50% over and on top of the production cost seems to have to some extent a meaningful impact on the fiscal budget.

Other "popular" measures are limited to the setting of medium-term development targets, rather than creating a massive shift in the short-term budgetary policies. These are "hard" things such as the linking of each household to electricity, gas and water networks, as well as a road to every village, but also "soft" things such as health insurance for every household and, where necessary, educational support.

As for the latter, softer elements the government can already bank (quite literally) on the success of the Pradhan Mantri Jan Dhan Yojana initiative. The National Protection Health Scheme (NHPS) – dubbed Modicare – should become effective towards the end of 2018 and is admittedly a very ambitious program. It aims to provide coverage to the most vulnerable 100 million families, consisting of about 500 million individuals representing approximately 40% of the population. Comparisons with Obamacare have of course been rife, in particular with regard to the size of the population covered (which in the case of Obamacare has been estimated at "just" 24 million). The more important elements of comparison are of course the fact that per family coverage is capped at 7'700 US dollar, whereas Obamacare is uncapped even in case of chronicle diseases. The government will invite bids from insurance companies to cover the 100'000 million families considered. Whilst funding details have not yet been revealed, the overall cost of the scheme could be envisaged in the order of about 2 billion US dollar per year, which is close to 0.1% of gross domestic product: a considerable, but not impossible sum. To put things even more in perspective, and perhaps to firmly debunk the characterization of the scheme as being "populist", it might be worthwhile to point out that currently India's public health spending stands at 1.15% of gross domestic product and that the government aims to bring it to 2.5% only by 2025. A far cry from US healthcare spending, standing at 18% of gross domestic product.

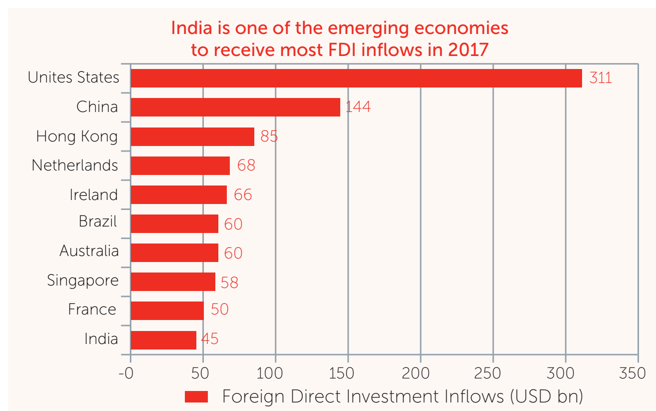
The government's educational targets are perhaps the more interesting since they aim at tackling the country's biggest challenge, namely reducing illiteracy and ensuring that the 15 million individuals which over the next decade will enter the labor force on a yearly basis, have the skill sets to compete in the global economy and are able to earn a decent living. We will discuss this challenge in more depth in the risk session. Here it suffices to say that, as with banking and health insurance, and indeed also the distribution of subsidies, here too the government aims to (at least partly) bypass local administrations by using modern digital technology to directly provide education online. Moreover, the government intends to loop in private companies that provide vocational training which focuses on practical applications, rather than theory and more traditional academic notion sets. In other words, as with banking, healthcare and education the government intends to avail itself of new technologies and private institutions so as to leapfrog existing methods of distribution, and thereby bypass traditional providers of those services. As such, and whilst the

details of the scheme have yet to be revealed, the cost of raising educational support for the poorer families should not significantly upset the government's budget.

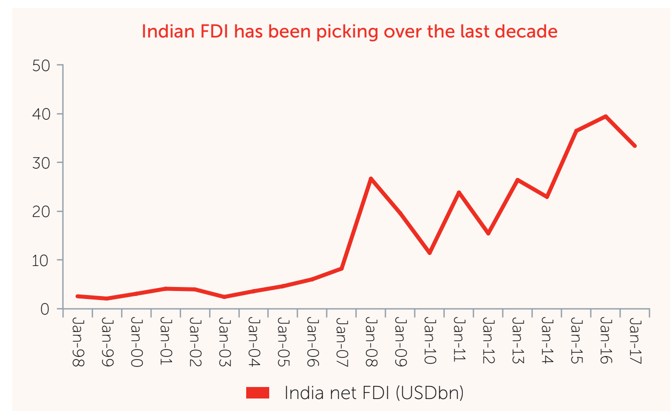
Surge in foreign direct investment confirms investors' confidence

In addition to the surging stock market, also foreign direct investments have risen substantially with India being among the biggest recipients of foreign direct investments.

And here too it is important to stress that whilst there has been a strong pick-up in FDI with the NDA coalition pushing reforms, FDI has been steadily pocking up for about a decade now. As mentioned, of all the types of capital flows that a country can enjoy, foreign direct investments are the most sticky since – unlike portfolio flows in listed assets – they cannot easily be undone. Thus, unlike the latter, they tend to remain whenever a global financial risk momentum arrives, thereby additionally contributing to the stability of a country's external balances.



Source: UNCTAD Global Investment Trends Monitor, ADCB Investment Strategy



Source: Factset, ADCB Investment Strategy

IV. Risks and missing reforms

What to do with India's abundant labor force

As always, behind the biggest opportunities lie often also the biggest risks. India's massive economic opportunities, indeed its enormous potential wealth creation, rests on the assumption that its growing population will be absorbed by a productive economic system. It is important to stress the word "productivity" for India today does not have a problem of unemployment, but rather a problem of underemployment (which actually means hidden unemployment). With a 4.9% unemployment rate everyone who wants a job in India can find one. The problem is *what kind* of job. And of course, low quality jobs implicate low wages, such that the country really has a national wage, rather than a national job problem. In other words, an average 7% yearly growth of gross domestic product might simply not be enough to provide all yearly newcomers with an economically valuable job. The improvement of the country's literacy rate has thus a quite dramatic urgency.

On the positive side, one can argue that rapidly accelerating digitalization should push through effective online vocational training, in particular also for women and girls, thereby perhaps rendering obsolete prior obstacles to illiteracy such as the country's very high student to teacher ratios. On the other hand, no one really knows to what extent further progress in digitalization and artificial intelligence might upset the demand for a labor force population whose skills still need significant upgrading. It is important to note that, notwithstanding the government's *Make in India initiative*[13], the country has not been able to significantly increase its share in the global output of manufacturing goods.

Political risk might be overstated

Whilst the educational and literacy challenge is daunting, the political risks might have been overstated as the country prepares for the elections in spring 2019. For one thing, and however impressive the reform rhythm of the current government, the progress over the last decade cannot be attributed to one political side alone. In addition, as we have already highlighted in other parts of this study, much progress has been achieved thanks to the advances of technology, mainly digitalization, leapfrogging old economic and political institutions. It is difficult to see why and how a different government would undo that.

The reality is that, notwithstanding some regional setbacks, the current coalition appears to have few credible challengers at the national level. There is more, even if the majority in the lower house could shrink, the current coalition is anyway strengthened by the fact that it controls 19 out of 29 states and that, as such, it will also control the upper house for the coming years.

Political risk, however, is not only about which coalition holds power. Power can induce complacency. For all the progress made, corruption in India has not been eradicated. At the level of the federal government a lot has been achieved, in particular through the introduction of competitive, standardized and transparent auctions for contracts for anything from infrastructure to cement to spectrum, and thus the abolition over their discretionary allotment by the government. At the level of the state governments though many corrupt practices persist.

This type of risk to the country's development will in our view stay with the country for a considerable time to come. Having said so, here too the new technologies are giving a helping hand simply by ensuring that all transfers of benefits, whether it be subsidies, or in the future healthcare and educational support, can go directly to the interested beneficiaries without the involvement of local officials and indeed the transfer of sums in cash.

Reforms beyond the 2019 election

More than an extra dose of new reforms, the country needs swift and effective execution of all the reform initiatives already undertaken. This holds true from maintaining fiscal sustainability and removing further red tape to re-capitalizing the public banks, to tax collection, the effective allotment and timely realization of the country's strategic infrastructure projects, as well as ensuring that investor rights are protected, to name just a few.

More labor reforms are necessary too, although the government will not pursue a US style "hire and fire" type of legislation. The key objective, in the words of the government is to simplify the regulatory framework and ensure that rules can be enforced. Senior officials however do not consider the current framework to constitute an impediment to investing. Further land reforms are also on the agenda since too much land is still fragmented, preventing the set-up of new industries. It needs to be said though that with the recently introduced allowance of land requisition prices at 4x market value, a major impediment to public infrastructure progress has now been removed.

13 Which aims at increasing the country's manufacturing sector from 16% to 25% of gross domestic product.

V. A radically new global context

US geopolitical repositioning enhances India's strategic position

The last couple of years have seen, across the world, a rise in nationalisms and a weakening of traditional strategic alliances. A relatively poor and hitherto non-aligned country with a huge market potential might well profit from such developments.

Increasing China-US tensions inevitably implicate that China becomes less and less attractive as a hub for US investments in China. For those US companies who aim to have a regional headquarter in a relatively large country, India would be the natural alternative, in particular if the business environment continues to improve together with the growth prospects of the domestic market. Bilateral trade between the US and India has already increased six-fold since 2006 and could expand further as the two countries have a few important complementarities to exploit. The US tech industry continues to rely on India talent at all ladders of the industry's value chain, both at the level of outsourced labor in India and at the level of Indian workers in the US (a key test bank will of course be President Trump not excessively tightening H1-B visas, which are held by 70% of the 4 million Indians living in the United States). The United States on the other hand would be interested to be an important energy provider to India, in addition of seeing her as an ally in the containment of China and Pakistan.

But it is not only the US who has an eye on India

The prospects of increasing international trade disruptions, and potentially even a global trade war, clearly pushes more countries to look with interest at India, a market that on one hand is still one of the most insulated from global trade, on the other hand might well be the world's third largest by 2030. As such India is in a relatively strong position to negotiate partnerships. This has already now determined a paradigm shift in the country's foreign policy away from the focus on non-alignment and independence to strategic alliances, mainly with Japan[14] and the US, but also with the United Arab Emirates as well as major European economies[15], and recently even Israel.

14 Japanese companies are playing a major role in the construction of the country's fast speed railway.

15 France is partnering with India to develop the country's nuclear energy provision.

VI. Where to invest?

India scores relatively well when it comes to protecting investors' right

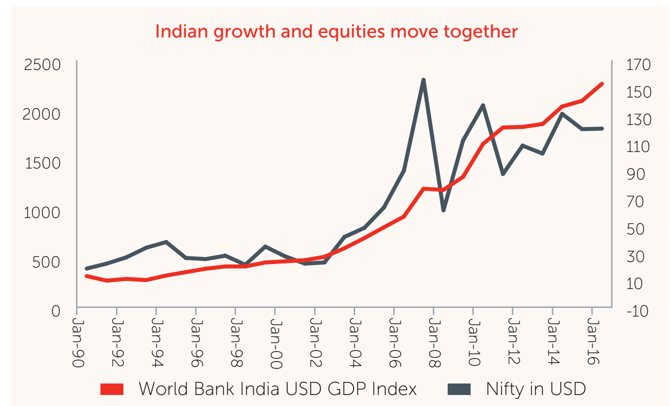
It might be worthwhile to start the investments section with the simple observation that India scores relatively well when it comes to protecting (minority) investors' rights, even if traditionally it has always been relatively closed to foreign investors. Indeed, for all of its struggle to climb up the World Bank's Ease of Doing Business Index, in the category of protecting minority shareholder interests it ranks a remarkable fourth place. India has had quarterly reporting requirements in place over the past 10 years, leading many other emerging markets. Also, the role of auditors has been notoriously strong in acting as gatekeepers for investors.

Against this backdrop the introduction of the new bankruptcy law, together with the recapitalization of public banks, is adding to a further improvement of investors' confidence, which has been confirmed by the bond market growing to 16% of gross domestic product (and critically replacing the country's troubled banks over the last years, albeit only for the financing of larger corporations), as well as by increased equity issuance. Indeed, in 2017 there has been more equity issuance than in the six prior years combined. Authorities continue to work on the efficiency of the capital markets by further reducing listing periods, and streamlining the application procedures for foreign ownership. More work is being done to introduce derivative markets.

Equities remain the best option in India

In a country whose growth model rests on the domestic economy, bond markets should be an interesting option since currency strength should be a key pillar of such growth strategy, and thus inflation reduction should put long-term downward pressure on yields. The reality is that India, although no champion in the exporting of manufacturing goods, relies still heavily on exporting cheap labor and cheap services. Inflation is likely to stay relatively higher such that the currency's long term path is still one of structural depreciation. Also because of that reason the Indian authorities have been traditionally loath to foster foreign investments in local currency markets, as such investments might bring more in terms of destabilization than growth. Hard currency bond markets are also little developed. The likelihood of a strengthening US dollar would anyway warrant caution against emerging markets bond investments not only in the more vulnerable countries such as Turkey and South Africa but even in the more insulated ones such as India.

Equity investments are less vulnerable against inflation and currency devaluation risks. As the following chart shows, in the long term equities have always caught up – and at times run



Source Bloomberg, ADCB Investment Strategy

ahead – of economic growth. Either way, the stock market in India has been able to capture the nation's creation of value.

Given the almost one-to-one ratio at which gross domestic product has grown with the stock markets since the first 1991 reform measures, and with current market cap at 2+ trillion US dollar and gross domestic product at 2.5 trillion US dollars, it seems that the equity market has actually a bit fallen behind. At any rate, the close relationship currently implies a 7 trillion US dollar wealth creation opportunity, assuming that the economy continues to grow at a 7% clip, taking the economy to 10 trillion US dollars within the next 20 years.

In search for the best domestic sectors

The key question then is where to invest in the country's equity market. In general of course one would aim at equities that have a strong exposure to the domestic economy, such as real estate, banks, consumer goods, telecom and healthcare.

Real Estate

The problem with real estate is that the sector still has significant restrictions against foreign ownership, which however still leaves open proxies such as the country's larger cement companies (which might profit from recent consolidation) or, alternatively, securitization.

Banks

The problem with banks, in particular public banks, is that they are likely to suffer equity dilution from the impending government recapitalization, such that it might yet be better to wait a bit (as we discussed in the prior pages). At best Indian banks could be interesting as the long component in a long-short trade where Chinese banks would be the short component.

VI. Where to invest? (continued)

Over the longer term, the banking sector, even in a country as large as India, should have significant consolidation prospects. Public banks have an almost 70% of market share versus private sector banks holding approximately 30% share (dominated by 6-7 players as the process to gain banking licenses in India is incredibly stringent).

Growth prospects are obvious across all revenue lines. The country's credit to gross domestic product penetration stands at a mere 56%. As for payments, mobile transactions are expected to grow by 150x in five years, from the current three billions per year to approximately 450 billion by 2023.

The number one risk for India's banks growth prospects, however, is the same as for other banks in emerging underbanked economies, namely the risk that Fintech providers will leapfrog their traditional methods of delivery of banking services at reduced costs for the consumer who is not, like in advanced economies, a captive client of an existing traditional banking structure. In other words, in India's remote rural areas the new Fintech technologies will be certainly transformative, but hardly disruptive (for there is nothing to disrupt).

Consumer goods

In reality, the consumer remains one of the "biggest opportunities across sectors" as discretionary spending is bound to increase across the larger population. The country's savings rate remains high but falling and more wealth is being transferred from "flight to safety" investments like gold and real estate to financial assets. Aviation and railways would of course also benefit from growth and demographic expansion. At a general level it might be even more interesting to go beyond the traditional infrastructure plays and see how digitalization can leapfrog and disrupt traditional modes of delivery to the growing mass of consumers, and which companies would specifically profit from that.

In the consumer goods space, for instance, online penetration is still extremely low, whilst distribution through brick and mortar supermarket chains never took (and thus never might take) off as in advanced economies. Indeed 80% of Indian distribution still takes place through traditional rural "mom and pop" shops. Linking the latter to a more efficient distribution system, rather than replacing them by larger supermarkets, might be one venue to exploit the new technologies. Any such venue should also consider that a pan-India strategy might run into troubles, given the country's extraordinary diversity. It will be better for consumer goods companies to opt for a decentralized management approach, which takes into account the specific cultural characteristics of each location.

Within the consumption sector it makes also sense to spend a few words on the car industry (and that would then have implications for the steel and aluminium industry too). Ten years ago, India had 1 million vehicles while China had 700'000, but this relationship was then totally reversed as China's auto industry took off alongside massive infrastructure investment while India stagnated. This is of course bound to change as the government prepares to spend 1 trillion US dollars on infrastructure and Tata Sons is committed to doubling their capacity in steel over the next three to five years, whilst pushing towards electric vehicles in order to align with global environmental standards, to which the country has signed on.

Telecom

Telecom has over the last year seen massive consolidation and capital spending, leaving the space essentially in the hands of three players. The sector is still likely to profit as there is hardly an end in sight in the growth of mobile users and data traffic demand. Picking the winner in this constantly transforming landscape however will be less easy.

Education

The need to train and re-train India's growing labor force is daunting as literacy levels remain low and at present there is a surplus of unskilled workers relative to demand versus an estimated 30% shortage of skilled and semi-skilled laborers in India's economy. This disparity is likely to grow if education does not improve (see also the above section on risks for what is arguably India's number one risk and opportunity).

In order to circumvent what would be arguably inescapable bottle-necks, the focus is increasingly shifting away from the traditional schooling institutions to online vocational solutions, provided by newcomers like Teamlease Services. In the past 18 months Teamlease University has enrolled 52 thousand students in 18 months (admittedly a small number in the Indian context), operating under an apprenticeship model.

Healthcare

In the pharmaceutical sphere (generic, as well as biopharmaceutic and biosimilars), Indian companies have since long been pioneers in the reduction of costs. They are now frenetically trying to do it across the entire healthcare sector. Here too, the focus is shifting on the best possible exploitation of increased medical data availability and online provision of services at home, whenever possible. And again, here too the chance of rapid penetration of the new approaches is higher since there are less traditional hospitals to disrupt, less regulatory requirements to overcome, and less established interest groups to combat.

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Important Information

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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