INDIA'S ASCENDANCY

Foreseeing India's leadership in emerging markets for the next decade

Marketing material for professional / institutional / accredited investors

Tim Love, Joaquim Nogueira and Rachit Chirania of GAM Investments' Emerging Markets Equity team believe India could lead emerging market outperformance over the course of this decade. They outline seven reasons why they think the country presents a rare secular and cyclical growth story at a time when major economies are struggling.

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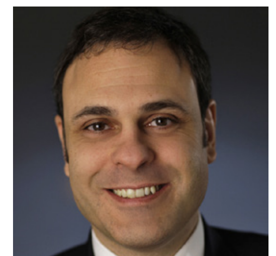

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1. Economic resilience in the face of series of global challenges

India has acted as a relative haven both during the Covid-19 pandemic and more recently during a period of heightened global geopolitics.

Its economic activity is already closer to its pre-pandemic path, and the country has demonstrated its resilience, despite a challenging global environment. The World Bank predicts India has the potential to be the world's third largest economy by the end of this decade, with its GDP expected to surpass USD 5 trillion by 2026.

Furthermore, it has avoided struggling with the higher inflation and banking sector systemic risks that many competitor countries are grappling with. In March, its CPI fell to 5.7% (year-on-year) from 6.4% in February and the Reserve Bank of India (RBI) is forecasting CPI of 5.2% with a real GDP of 6.5% for full year 2023/24. Industrial production of 5.6% in February year-on-year is helped by an expansionary PMI reading in March of 56.4. Services PMI is also strong at 57.8 for March. Nevertheless, the RBI may well remain hawkish a little longer and more rate hikes may be necessary to bring inflation back to its longer term 2-6% range.

The country's expected weight in the MSCI EM index could go well above 25% (versus circa 14%, as of April 2023) before the end of this decade on present market capitalisation and GDP growth trends.

2. Significant structural reform

India has achieved this resilient economic growth over the past few years with the help of a diversified, high value add economic shift facilitated by policymakers, who have been able to bring in various structural reforms, including:

a. Improved governance delivery. India's policymakers are striving to reduce the informal sector, which still employs a significant majority of workers, by reducing regulatory barriers and moving to a digitalised governance model. In 2009-10, when Aadhaar (the world's largest biometric ID system) was conceptualised, it was estimated that more than 400 million people in India did not have an individual identity document, while only 17% of India's population had bank accounts. Despite approximately USD 50 billion being allocated from taxpayers' funds towards social welfare programmes, widespread diversion and leakage occurred (in the range of 10-60%, depending on the programme) due to involvement of numerous intermediaries throughout the entire transaction process. As per recent government reports, Aadhaar has now documented the identities of more than 94% of India's population. Aadhaar also drastically reduced the cost of identity trust from USD 10-20 per transaction to USD 0.27. This was especially promising for India's rural population, many of whom struggle to access social and financial services. This gave millions of Indians direct access to government subsidies (rations, social pensions, cooking gas, fertilisers etc.) without having to rely on middlemen; the ability to access affordable formal financial services (like bank accounts) for the first time; and a way to prove their existence to access fundamental rights (such as voting, free education, jobs, etc).

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b. Rationalised labour laws and the creation of land banks to make land easily identifiable for industrial projects to facilitate smooth implementation.

c. The corporate tax rate has been reduced from circa 35% to 25% in 2019 and all indirect taxes have been subsumed into one tax for the entire nation to reduce system leakage. Further, the implementation of the Goods and Services Tax Council (GST) discouraged registered businesses from dealing with unregistered entities in the informal sector.

d. Removal of retrospective taxation law: India removed a controversial 2012 law that retrospectively levied capital gains tax on companies for the indirect transfer of their Indian assets. The law, which will now only apply prospectively, has been a major sore point with foreign investors for the better part of the last decade, damaging India's reputation as a stable tax jurisdiction and leading to protracted litigation.

e. India is now the most populous country in the world: Narendra Modi, the Prime Minister, views the extra population as an opportunity to nurture, rather than as a hurdle. The Bhartiya Janata Party (BJP) insists that the world is looking to a resurgent India for leadership. As a secular society and a democracy, that is a key plus. But the challenges are also material, including the need to maintain press freedoms, and address endemic poverty, pollution and climate change as well as corruption concerns. Shorter term, unemployment is at 7% and IT, telecoms and outsourcing are not manpower intensive. Foreign direct investment inflows are also still clearly being affected by the memory of the Cairns Energy and Vodafone sagas.

3. India's demographics and longer-term secular support from compounding domestic consumption, coupled with higher premiumisation, formalisation and digitalisation

Currently, India's population is 1.428 billion (expected to peak at 1.6 billion in 30 years) versus China's 1.425 by mid-2023, according to the UN Population Fund. The third most populous country is the US at circa 340 million.

Critically, 40% of India's population is below the age of 25. The growth of India's population is 1.2% (since 2011) versus China's which fell in 2022. China's average age is 38 (versus India's 28) and by 2050, China's population is expected to trail India by 300 million.

The share of Indians who are 65 and older is likely to remain under 20% until 2063 and will not approach 30% until 2100, under the UN's medium variant projections.

We believe India's greatest strength lies in its domestic consumption, which makes up more than 60% of GDP and helps protect the economy to some extent from global economic events. Its per-capita income is widely expected to double from less than USD 2500 currently to more than USD 5000 and the number of households earning more than USD 35 000 is likely to rise fivefold by the end of this decade, setting the stage for a discretionary spending boom. India boasts a USD 600 billion retail market and its auto industry is one of the world's largest by number of vehicles manufactured. Further, it is home to more than one billion internet users and one of the world's fastest growing e-commerce markets. By 2030, more than 75% of Indians will be born in the late 1980s and onwards and this generation of millennial and Gen Z consumers already exhibit greater willingness to spend on 'best in class' offerings in every category be it cars, food, cosmetics or apparel. For example, in FY22, demand for premium car sales increased 38% year-on-year, while lower-priced car sales increased only 7%.

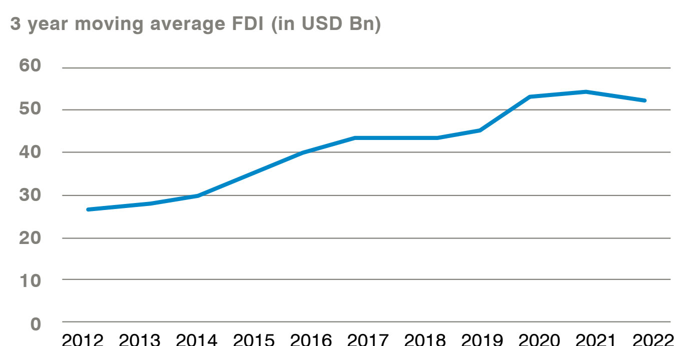
4. India's growing international role and geopolitical dynamics

We believe the country is positioned favourably, with strategic relations with most of the countries in the world. Due to ongoing war in Europe and growing discomfort between the developed world and China, India is emerging as an active player in global politics.

Recently, it has signed free trade agreements (FTA) with Australia and will most likely clinch a deal with the UK and Europe on trade barriers. Domestically, the current ruling party has been supportive of deep structural reforms and is most likely to stay in power beyond 2024. Even in the event of sudden political change, we do not expect any major deviation from the current governance model as the opposition parties recognise the importance of private capital, though their approach might tilt towards state-guided capitalism.

Western economies are keen to diversify away from China to hedge against future conflict. Those searching for stable FDI centres are finding India strong competition to China. Diversification is key.

Figure 1: 3-year moving average foreign direct investment (in USD billion)



Source: GAM, Bloomberg, Reserve Bank of India, as at 31 December 2022

5. India is a beneficiary of global supply chain diversification and hedging

We believe India will be a key beneficiary of transition to a multi-polar world. This trend has further accelerated owing to geopolitical issues in China and Europe, as described above. India, together with Vietnam, is likely to be a beneficiary as companies continue to diversify their supply chain to mitigate political risk. The Indian government has placed its focus on the supply side and since 2019, it has progressively cut corporate taxes to attract manufacturing investment (a special lower rate of 17% was announced) and lifted public capex as a share of GDP to a near 17-year high.

India has also introduced World Trade Organization (WTO) compliant production-linked incentive schemes to take advantage of the decentralisation of supply chains. This will help to bridge cost inefficiencies from manufacturing domestically and help to build an ecosystem in the process. Companies will have to bid to participate in the scheme with production targets and timelines. On an aggregate basis, most of the schemes having been allotted beneficiaries with total expected outlay of USD 24 billion by the government. Total capex envisaged would be USD 27 billion with a production target of circa USD 350 billion.

The logistics sector in the country is largely unorganised and fragmented, resulting in a high cost of 14-15% of India's GDP compared to 7-8% in developed nations. The government is aiming to bring this down to a high single digit (around 8% of GDP) – in line with developed countries via infrastructure development and process-related reforms. We estimate that these measures have the potential to lift manufacturing's share of GDP to more than 20% by 2030 from around 16% currently.

India's age dependency has been declining since the 1970s and is expected to continue until 2040. According to UN estimates, by 2030 India will emerge as one of the largest suppliers of labour, accounting for almost 23% of the increase in the global working-age population. Its wage rate per employee is among the lowest in the world, which creates a competitive advantage for Indian firms to lower the cost of production. In 2021, the manufacturing wage for India stood at USD 0.8/hour, lower than Indonesia at USD 1, China at USD 7.1 and Korea at USD 22.3.

Indian merchandise exports have surged to USD 429 billion in FY22 after stagnating at around USD 300-330 billion a year from FY16 to FY20. The export basket mix has seen slow-paced diversification and the share of high-skilled manufacturing exports such as engineering, auto and pharma rose to more than 35% in 2022 (versus 26.9% in 2009), while that of low-skilled manufactured goods (eg textiles and jewellery) decelerated to less than 20% (versus 28% in 2009). Finally, Indians form the world's largest diaspora group at around 18 million and India is set to become the first country ever to receive USD 100 billion in FY23 in remittances according to a report by the World Bank.

6. Banking reforms are a major help

Banking and lending institutions form an important pillar for any country to drive economic growth.

This sector in India has staged a drastic turnaround recently. Gross non-performing assets (NPA) for Indian banks have reduced from highs of 12-13% in 2016 to 5.8% in 2022. Net NPA currently stand at 1.7%, implying a provision coverage of more than 70%. Further, currently no public sector bank is under the prompt corrective action framework (this is a preventive action that places a weak bank under the central bank's watchlist, and measures are taken to restore its financial health). Capital adequacy of banks rose from 14.1% in 2021 to 15.7% in 2022, and further to 16% in September 2022.

We are seeing retail credit growing strongly at 19.7% year-on-year year-to-date (November 2022). Corporate debt to GDP has reduced to circa 47% in 2022 from highs of 62% and therefore after undergoing a phase of deleveraging over the past few years, India is now in a better position to embark on re-leveraging.

We are more bullish on private banks due to their strong underwriting practices, professional management and digital progress. Their deposit market share has consistently improved from 18.2% in 2012 to 30.4% in 2022. Similarly, their domestic market share has gone up from 18.9% to 38.1% in the same period. All these gains have been at the cost of state-owned banks whose lending decisions are habitually influenced by lawmakers. Despite this trend, these state banks continue to grow at high single digits, demonstrating what we believe is a massive opportunity in the banking space.

7. We expect India to lead global growth led by the energy transition

India committed at COP 26 to increase its non-fossil energy capacity to 500 GW and to fulfil 50% of its energy requirements from renewable sources by 2030. In the last six years, India's installed renewable capacity has gone up by more than 2.5x (currently around 140GW). We believe hydrogen, which carries four times more energy than gas, offers a significant opportunity for India. Interestingly, the development of hydrogen infrastructure can leverage existing gas and electric hardware limiting the time needed for adoption.

The energy transition theme is a huge positive for the country as it benefits terms of trade and external balance sheet metrics and will help to lower import dependence across oil (80%), gas (55%), coal (25%) and green transition components (95% solar modules). We believe this will reduce the country's oil dependency and will positively contribute to its terms of trade, as well as reduce inflation volatility and create new markets for electric vehicles and hydrogen powered vehicles.

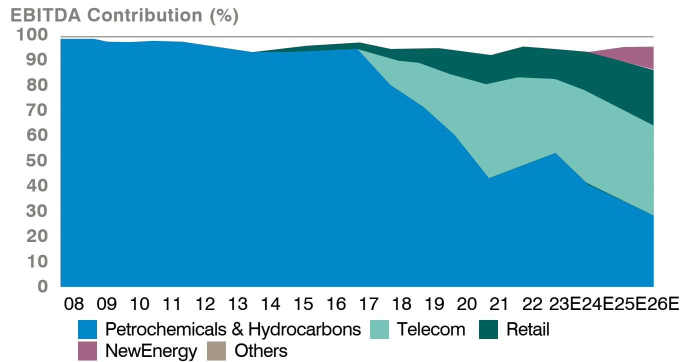
India has real drivers for change, given it has 63 of the top 100 most polluted cities in the world.

Case study: Reliance is one of our favourite transition stories

Reliance Industries is transforming itself from primarily an energy extractor and processor to a more modern, technology focused and environmental conscious consumer-facing business. More than 80% of the company's capital expenditure over the next few years is projected to be in the new energy, telecoms and retail businesses, and its ambition to achieve carbon neutrality before 2035 is bold among its peers. The company aims to create an entire ecosystem of non-polluting energy with a focus on manufacturing integrated solar photovoltaic modules (including polysilicon, wafer and cell manufacturing), hydrogen electrolysers, fuel cells and batteries to store energy from the grid. It has started developing its green energy giga complex on 5,000 acres of land in state of Gujarat and will establish 20 GW of solar energy capacity by 2026. Its blueprint includes expansion up to 100 GW by 2030 once proven at scale which can be then converted to carbon free green hydrogen. (For reference, India's cumulative PV installations hit 64.38 GW at the end of February 2022, according to the latest figures from the Ministry of New and Renewable Energy. India added 13.9 GW of solar capacity in just one year, comparable to the UK's entire solar capacity in 2021).

Reliance has built strategic partnerships with innovators in this space and invested circa USD 1.5 billion to build on its technology until now. We also see the possibility of an IPO of its digital and/or retail business within the next two to three years.

Figure 2: Reliance's hydrocarbons and petrochemical business is estimated to reduce from 54% in FY23 to 29% by FY26



Source: Bernstein, GAM.

The GAM Emerging Markets Equity team recently visited solar cell and panel manufacturing plants in the eastern state of Gujarat to develop an understanding of the latest and emerging technology in this space. Visiting Gujarat ports, home textile manufacturing plants and many other companies in a recent trip to investigate alternative energy industrial transformations, we also saw the positive real impact of FDI flows, domestic capex and government infrastructure initiatives in reality.

Source: GAM.

Summary

India was overvalued, overowned and overloved in the Covid pandemic as a safe-haven investment, but following a period of derating, we believe the rare and cyclical growth story we have outlined above has not yet been priced in. As always, selectivity remains key and we currently see the best opportunities in the mid-cap sector.

Sources

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3. Morgan Stanley, Credit Suisse

For more information, please visit GAM.com

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