India Rising – Stay Overweight

Sharmila Whelan, 7 June, 2024

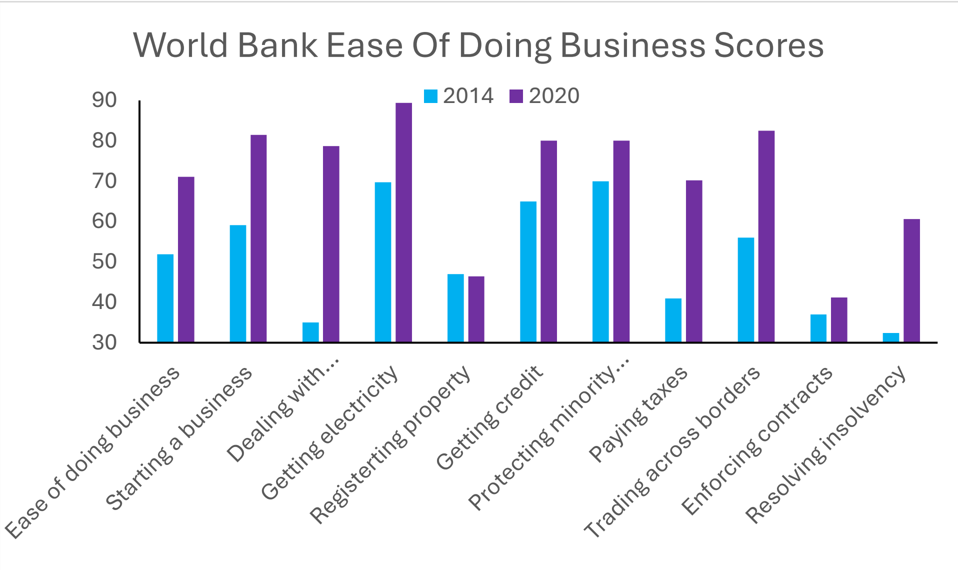
Is the India growth story going to be derailed? This is the foremost question on the mind of India investors following the shock general election results which saw BJP and its allies capturing 293 Lok Sabha seats, well short of Modi's predictions of 400 plus, and the BJP losing its parliamentary majority for the first time since 2014. The short answer to the question is no. India is rising and remains the best structurally driven multi-year growth story in Asia. Three reasons.

First, the hard structural reforms are done. The investment led business upcycle underway is evidence of this. It is more than a cyclical upswing. Modi has permanently changed the India game, how she does business and competes. Centralised control is out, competitive federalism and capitalism in. The state's role has been evolving for some years from a growth driver to a growth enabler. And it has all been about creating the incentives to crowd in private investment.

The reforms implemented, starting 2016, in response to the bust of the last credit fuelled investment super cycle which led to the twin bad debt (public banks and private capital goods facing corporates) crisis have been far reaching. The 2016 Insolvency and Bankruptcy Code, forced corporate India to restructure, consolidate and unwind excess capacity. The introduction of GST on 1 July 2017 and the September 2019 corporate tax reform which bought down the rate from 30% to 22% in line with regional peers, were critical. In 2019 and 2020 parliament passed four labour codes consolidating 44 existing labour laws. In March 2020 the Production Linked Incentive scheme opened up and incentivised investment by foreign and domestic investors in 14 critical industries including advanced manufacturing, electronic vehicles, renewables and high tech. Digitalisation has been adopted enthusiastically and effectively. The digitalisation of tax returns, business licensing, web based one stop shops for permits and project approvals have all contributed to reducing red tape and corruption. And there is the government's huge public infrastructure investment drive.

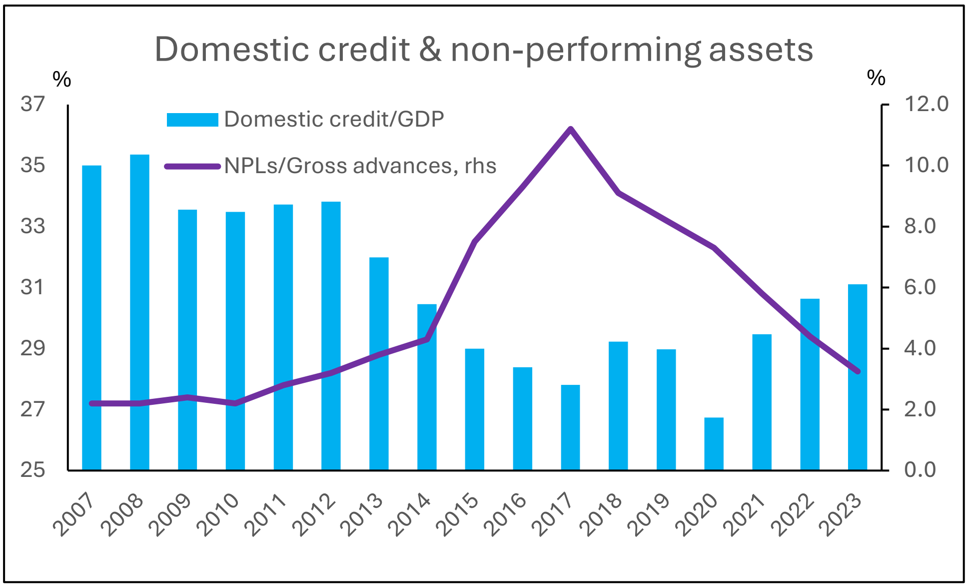
A decade of steady structural reforms has reshaped the business operating landscape. India's World Bank Ease of Doing Business score has improved dramatically, overall (71.1) and across key metrics (Figure 1) and is well above the East Asia & Pacific average (63.3)

Figure 1. Structural reforms bear fruit



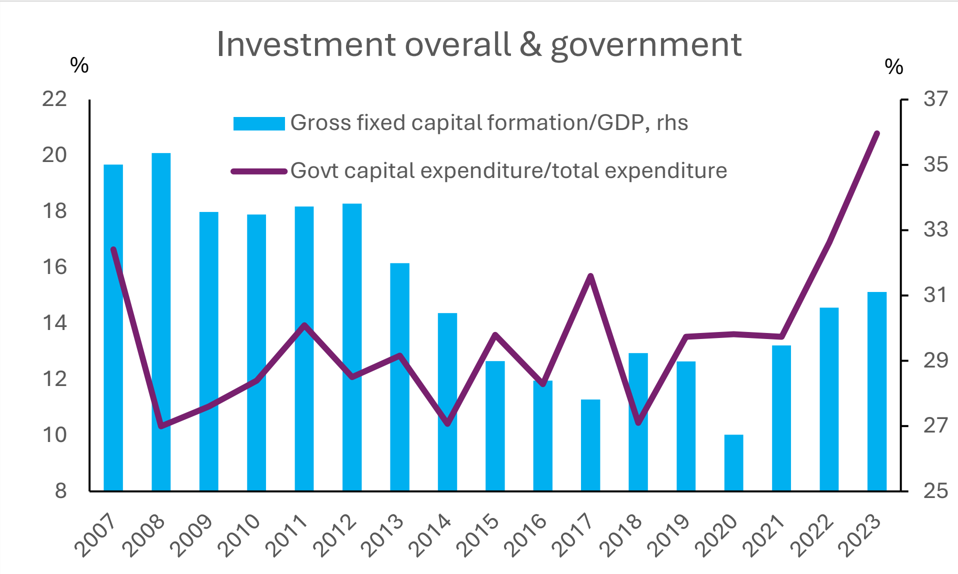
Second, bank and corporate balance sheets are in rude good health, and strongly positioned for growth (Figure 2). Bank non-performing loans are at an 11-year low, capital adequacy ratios well above RBI regulatory requirements, NPL provisioning ratios at 75% and profitability strong. Banks can and are lending. Borrowers are able to take on debt. Corporates are underleveraged, as are households. The corporate sector has fully recovered from the twin-debt crisis. Balance sheets have been repaired and profitability restored. The corporate profit cycle is in upswing. Cash flow, free cash flow and retained earnings are above the pre-pandemic seven-year average. Key industrial sectors – cement, airlines, steel and telecom – have consolidated. Interestingly large firms continued to pay down rather than pile on debt through the pandemic when the Reserve Bank of India introduced a range of emergency credit facilities. Importantly, despite the rise in policy interest rates, the cost of capital, real, remains appropriately priced to support lending and investment.

Figure 2. Firms & households under-leveraged, banks able to lend



Third, the much-delayed investment upcycle is now firmly entrenched, with the private sector (corporates and mortgage borrowers) increasingly taking over the lead from government. Figure 3 shows the investment to GDP ratio is rising and the proportion of fiscal resources directed towards development capital spending – roads, railways, ports etc - rising sharply. India's infrastructure assets have grown. Compared with FY15 today there are 48% more kilometres of national highways. Over the same period, cargo traffic at major ports has increased by 24% the kilometres of electrified rail route by 127% km, the number of airports has doubled while aircraft movement measured in million tonnes is up 56%.

Figure 3. The next investment led business cycle has begun



Following the elections investors are worried about land reforms being placed permanently on the backburner and about fiscal slippage. Their concerns are understandable. The election results showed farmers and rural voters are disgruntled and so are the unemployed youth. Rising income inequality and the pace of job creation – unemployment for the 15-29 age group is running at more than double the national average – were two contributory factors to the BJP's poor ballot box performance.

The failure to reform land acquisitions laws will not derail the India economic story, simply because the most critical structural impediments to growth have been addressed. There will be a focus on delivering more equitable growth. Here again though the cyclical buoyancy of tax revenues should allow the government to increase spending without compromising fiscal responsibility. Pertinently for investors the government's pro-business, pro-growth policy stance as a primary means of delivering jobs and prosperity is unlikely to change, even with the BJP alliance's reduced parliamentary majority. The days of unfunded fiscal spending to drive growth are behind. Neither the federal nor state governments can afford it. Crucially the mindset has changed.

Stay overweight India, for she is rising. Any dips in the stock and bond markets, are opportunities to increase exposure.