TFP

the advisor

Autumn 2017

Punarjanm

(Hindi for regenerate)

A proud, ancient nation has re-emerged on the world's economic stage. It is an exotic place of wonder, beauty and of terrible, grinding poverty. India is also a promising investment opportunity.

While India's economy may be the world's seventh largest, prospective investors should harbour few illusions: the country has massive, perhaps insuperable, issues to address. India is in a tough neighbourhood with Pakistan to the west and China to the north. Always percolating below the surface lies deep prejudices - between Hinduism's four castes and amongst its various religions; it is the world's third most populous Muslim country.

Parts of India seem stuck in another century, with the north and east of the country lagging far behind. Poverty is endemic. Families still use child labour to reach subsistence levels. Child labour laws introduced in 1986 may have actually perverted their intent: child wages have since decreased so more children are in work today, at the expense of reduced school enrolment.[1]

Successful Indian firms must navigate different worlds. India's informal or shadow economy accounts for approximately 50% of GDP and 80% of jobs. Mind-numbingly bureaucratic red tape means the country comes well down the World Bank's ease-of-doing-business rankings. Gleaming office towers sit next to open sewers and millions of customers can only be reached by bad roads. The country's business leaders are conversant with their first world peers about returns on capital or about allocating capital efficiently. They have also mastered the country's lamentable infrastructure and huge informal sector.

Businesses that have overcome these challenges are unusually profitable. "Since 2001 the return on equity (ROE) of listed Indian firms has averaged 19%, eight percentage points above the figure for companies in developed markets and five pc above those in emerging ones. The leading private lender, HDFC Bank, has an 18% ROE, ranking tenth among the top 100 global lenders. Hindustan Unilever, a consumer-goods firm, has a 77% ROE, over twice that of its parent, Unilever. Even in basic industries, such as cement, returns have been relatively high."[2]

In most consumer industries, profits are enviable. Consumption should continue to grow robustly, but the government will have to lead infrastructure investment as the private sector is debt laden. In the long run large Indian firms could face a profits squeeze from competition for capital, land and natural resources, as well as from more efficient supply and distribution chains. To maintain high profit margins, firms will have to increase spending on innovation.

India's shadow economy, decrepit infrastructure, corruption and red tape also create huge obstacles for foreign entrants. Capital, land and energy can be almost impossible to obtain, unless entrants learn the lay of the land. Fortunately, these issues are being addressed.

Twenty-five years after India first starting economic liberalisation in 1992, the pace of expanding the formal economy is accelerating. A breakthrough came in 2012 when the courts began cracking down on graft and on crony capitalism. Courts have

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a backlog of 30m cases but the main negative has been the slow implementation of the legal reforms. Progress is especially lethargic regarding bankruptcy procedures in the credit portfolios of state-controlled banks. The government's assault on crony capitalism has reduced the ROE of publicly listed Indian firms from 26% in 2006 to 13% but they are still above global averages. Half of this decline is at companies regarded as corrupt, but it also impacts companies operating in the basic-materials, property, energy and infrastructure sectors, as well as at the state-owned banks that finance them. Nevertheless progress is underway.

A second notable reform was in November 2016 when Prime Minister Modi's government decided to retire old bank notes, making it precarious to hold unlawful cash. This reform has forced people to use e-wallets and card payments instead. Over the past year there has been a 13% increase in formal savings such as bank deposits, life-insurance policies and mutual funds. Cash in circulation has fallen from 12% of GDP to 10%. The value of digital payments have risen by over 40% and the number of taxpayers has almost doubled. E-commerce accounts for only 3% of retail sales but provides a new way to distribute products among India's millions. It also brings more people into the formal economy.[3]

A value-added tax, the GST, was launched on 1st July 2017 under the motto 'one country, one tax, one market'. This reform requires firms to reconcile their tax returns with those of their suppliers and customers. The GST is complex and proving difficult to implement but is helping to create a single national market. For tens of millions firms that operate informally, difficult decisions lie ahead. If they stay in the shadows they will be cut off from GST-compliant firms' supply chains. If they enter the formal economy, their tax costs will climb and employment could suffer as businesses fail. Other firms will have to consolidate. Nevertheless, businesses of all sizes are coming out of the shadows and into the GST tax net.

Perhaps the most impactful reform to date is the Aadhaar Act, a digital identity programme. Aadhaar mandated a biometric identification database that is authenticated by finger prints and retina scans - and covers 99% of the population over the age of 18. This allows almost everyone to open a bank account, get a loan, buy insurance, get a driver's licence, access a health clinic or open a mobile phone account with their id alone. Raoul Pol, a hedge fund manager, is particularly enthusiastic, "India has, without question, made the largest technological breakthrough of any nation in living memory. India has built the world's first national digital infrastructure, leaping at least two generations of financial technologies . . ."

India's rapidly growing digital payments market is expected to grow tenfold to $500 billion by 2020. A state-backed payments system, Unified Payment Interface, has also helped banks get involved by forcing wallet players to actively partner with them and adopt the platform. Payments can be processed just by using fingerprints or an Aadhaar number. Consequently, India has become the world's fastest growing Internet services market.[4]

Compared to the developed world, India's demographic profile is stellar. It is projected to become the world's most populous nation, overtaking China by 2025. More than 50% of its population is below the age of 25 and more than 65% below the age of 35 - which bodes well for higher trend, long term GDP growth.

Investors have been paying attention. India's equities have become dearly priced, valued at three times book value. This implies that long-term returns should be in the 17% - 20% range, which is probably not achievable. India's consumer businesses and its best banks also trade on high multiples of their profits.

The external environment has been helpful for the Indian market. US dollar weakness has eased pressure on corporate balance sheets. The decline in the price of oil is especially welcome given that India is perhaps the most prominent beneficiary among all the major global economies. The appreciation of the rupee appears to have run out of steam for the time being, bringing a fillip to exporters.[5]

The future for the world's largest democracy is one of massive technological advancements, with a higher trend GDP growth and with more tax revenue. Tax revenues will help fund infrastructure such as ports, rail, roads and healthcare to improve efficiencies. Technology will increase productivity and businesses could boom for decades to come.

There is little doubt Indian equities are in for an exhilarating, if occasionally stomach churning, ride in the years ahead. As with China twenty years ago, investors that stick with it are likely to be handsomely rewarded.

In an era of ageing developed countries with sclerotic-growth markets, India is, perhaps, the most attractive investment opportunity in the world.

Sources:

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