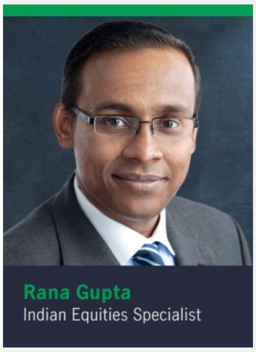
Manulife Asset Management

Investment Note

10 May 2019

India's unique opportunity to lift growth



The closely watched general election in India is underway. In this investment note, Rana Gupta, India Equity Specialist, surveys the policies of the two main political parties. He also looks at economic opportunities that await the new government. Overall, Gupta believes that the new government could build a growth-oriented agenda based on existing structural reforms, a collection of policies which he calls the Four "F's", which has laid the foundation for India's sustainable growth. To lift growth, recycling assets, attracting capital and building incomes will be the new government's most important tasks.

Before this election — Past five years: A solid foundation for long-term, transient challenges

Over the past five years, we believe that the "Four F's[1]" have laid a solid and strong foundation. Collectively, the collective policies have formalised the country's economic structure, widened its tax base and pushed up tax-to-GDP ratios. As a result, the government has been able to increase public investment without incurring higher fiscal deficits. In addition, reforms around the resolution of corporate bad loans have led to a healthier banking system. A more formal economy, better public spending backed by revenue and healthier private sector banks underpin the foundation.

However, such transformational reforms have caused some short-term challenges: incomes are lower due to a slowdown in the informal sector and lower food prices globally, while discretionary consumption is weaker on the back of a downturn in disbursements by non-banking financial companies (NBFCs).

After this election — Next five years: India should grow on a strong foundation

India's general election is currently taking place, with the seven-phase process running from 11 April to 19 May – the results are due to be announced on 23 May. Our base case scenario, supported by publicly available opinion polls[2], is that the ruling National Democratic Alliance (NDA) coalition could return to power. That said, whoever forms the government will have a unique opportunity to build upon

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[1] The Four "**F's**" are **F**ormalisation, **F**iscal stability, **F**inancialisation, and (Re)**F**orms on banking asset quality, see an earlier note published on 14 January 2019, we outlined how the "Four F's" have laid the foundation for sustainable growth.
[2] Source: CLSA, 16 April 2019.

the existing reform agenda, which we call the "Four F's", which have laid the foundation for India's future sustainable growth.

Immediately after elections, the first task of the incoming government will be to effectively implement the fiscal stimulus policies announced by the current government[3], which could not be fully implemented due to the elections. On the monetary front, the Reserve Bank of India (RBI) injected liquidity and cut rates to bolster growth. That said, some of the RBI's actions were less effective, as cash in circulation goes up during elections, tightening liquidity in the system. This scenario should be reversed after the elections as we expect cash in circulation to fall and liquidity to ease.

Over the long-term, the new government will need to build higher income if it wants to lift economic growth rates. Indeed, we believe that the policy initiatives of the current government and the election manifestos of both the Bharatiya Janata Party (BJP)[4] and the Indian National Congress (INC)[5] have one point in common: the new government will focus on income growth, although their approaches will be different.

In the following section, we will examine some proposed policies of the BJP and the INC.

Policy priorities of the two main parties: BJP and INC

Overall, both parties are committed to remaining on the current government's fiscal consolidation path. At the same time, each has ambitious growth agendas for the next five years, promising to increase public spending and raise manufacturing's share of GDP. These goals are crucial for robust job creation, higher incomes, and better savings, which, in turn, should boost the country's rate of investment.

The two political parties have already unveiled some ambitious proposals:

- The BJP has pledged to spend US $1.4 trillion (roughly 8% of GDP according to our calculations) on infrastructure investment over the next five years. This is compared to the current public sector gross fixed capital formation (GFCF, i.e. net investment) of 7.0%–7.5% of GDP. Beyond that, we believe that the BJP's proposed social-spending programme and its expansion of income transfer plans (a quasi-universal basic income transfer plan, refer to Appendix)[6] will cost less than 0.5% of current GDP.
- The INC's income transfer plan for the bottom 20% of families is estimated to total 1.5% of current GDP. However, the INC has stated that it will subsume other central and state subsidies into this programme. Therefore, the overall fiscal impact is expected to be much lower than 1.5%.

For more details of the policy differences, please refer to the Appendix section.

[3] The current government had proposed fiscal support to augment farmers' income and give tax breaks to the middle class in the budget.
[4] The leading party of the NDA – the current ruling alliance.
[5] INC is the main opposition party and the leader of the opposition United Progressive Alliance (UPA).
[6] PM-KISAN income transfer scheme, MAM estimates.

Building a growth agenda – capital attraction

To boost India's economic growth rate, resources (capital) needs to be mobilised. The marshalling of resources will be the key to lifting growth rates, rather than which party or coalition forms the government. To begin with, a more formal, rules-based economy with good progress in infrastructure over last five years provides a solid foundation and a unique opportunity. We have identified three ways the next administration can attract capital and build an effective growth agenda: improving government efficiency and asset divestiture, enabling private capital expenditure (capex), and leveraging manufacturing opportunities.

1. Improving government efficiency and asset divestiture

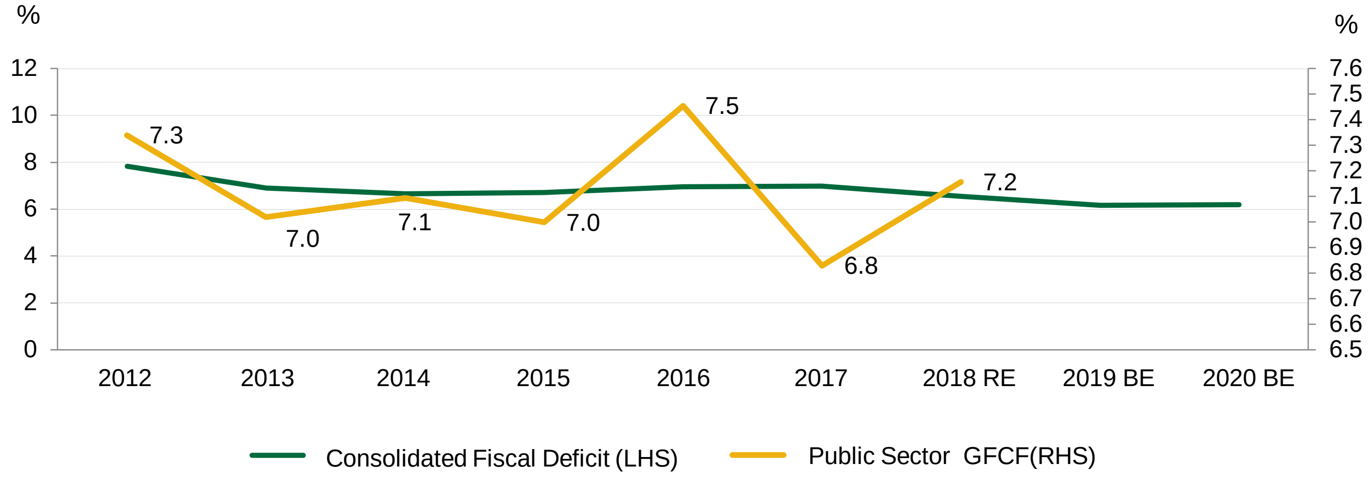
We believe that the spending priorities of both parties can be financed through various means of government fundraising without the need for additional borrowing. Potential sources of government revenue include:

- An increase in tax revenues through improved tax compliance: The government has already made significant progress in this crucial area with the revenues collected to GDP ratio increasing from 16.2% in 2015 to 17.4% in 2018, and is estimated to reach 18.3% in 2019[7].
- Subsuming government subsidies into income transfer schemes: We believe there is certainly room for further savings with the efficient delivery of public benefits. Reforms to the JAM Trinity[8] have saved an estimated INR 1.2 trillion (US$ 17 billion) through the implementation of direct benefit transfer that has eliminated ineligible beneficiaries[9].
- Asset divestiture: The current government is considering the divestment of its stakes in public sector units (PSUs) and other privately listed companies. If it retains a 51% position in PSUs and sells its entire stake in other non-government companies, the potential divestment opportunity may be as high as US$ 51 billion[10] (approximately 1.7% of GDP). However, if the government's holding is lowered from 51% to 40%, an additional US$ 82 billion[11] may be raised (around 2.7% of GDP). Outright privatisation of loss-making PSUs may boost sentiment but could face political challenges.
- Increased private investment in state-owned infrastructure, including railways and power facilities: This process has already started in power distribution, where private companies are bidding for projects in some states. The government could also monetise existing infrastructure assets by selling income generating infrastructure assets (e.g. toll roads) to get yield for global investors.

Public sector investment has remained relatively strong (see Chart 1), and we believe this could continue with more capital becoming available through the recycling or monetisation of assets.

[7] Source: CEIC, Kotak Institutional Equities estimates, April 2019.
[8] Linking of bank accounts (**J**an dhan) with unique ID (**A**adhar) and also with **M**obile transaction platform.
[9] Source: As of February 2019: www.dbtbharat.gov.in
[10] Total market cap as of 31 March 2019, sourced from Bloomberg, as of 29 March 2019.
[11] Total market capitalisation is sourced from Bloomberg, as of 29 March 2019. Stake data is sourced from Kotak Institutional Equities.

Chart 1: Fiscal deficit and GFCF as a percentage of GDP[12]



Even if the incoming government tilts more towards benefit transfer, funded through recycling or monetisation of assets, it will help rebuild income and will eventually create demand, jobs and savings.

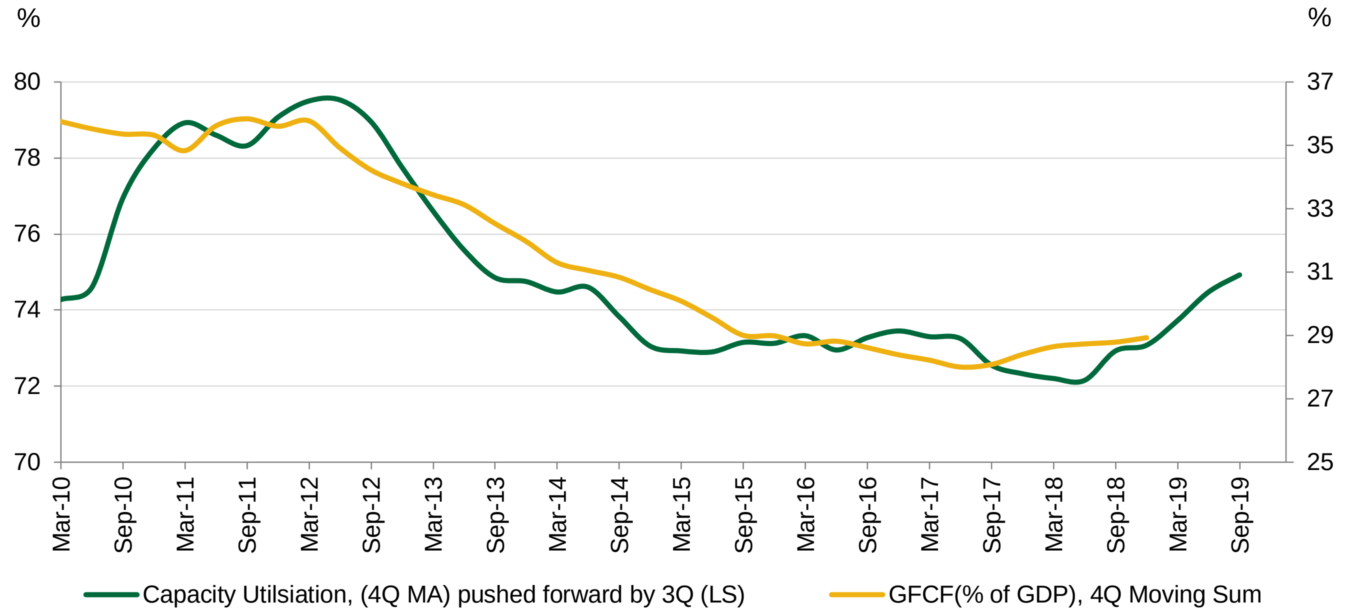
2. Enabling private capex

Despite stronger public sector investment, overall gross fixed capital formation (GFCF) has fallen over the past five years due to weak capex. But this is also changing.

Private capex has been weak for the past five years due to industry overcapacity and stagnant real estate prices due to policy-related disruptions (economic formalisation reforms). However, we see green shoots emerging in both areas. Signs of overall capacity utilisation are increasing, which means an improvement in industry-linked private capex should not be far behind (Chart 2). For real estate, we are witnessing industry consolidation after economic formalisation reforms – the next phase should be the resumption of capex.

[12] Source: CEIC, Kotak Institutional Equities estimates, April 2019. “RE” refers to revised estimate and “BE” refers to budgeted estimate.

Chart 2: Rising capacity utilisation should lead to sustained recovery in GFCF[13]



As the private sector assesses capex, it also needs access to capital at a reasonable price. Thus, we believe it is imperative for the government to raise resources by monetising assets and leaving more savings for the corporate sector. A revival of private-sector capex will lead to job creation, better incomes, and higher savings.

3. Leveraging manufacturing opportunities

India can also bolster economic growth by leveraging manufacturing opportunities. In particular, we are carefully watching China's transformation to a more innovative, value-add, and green economy.

This conversion, coupled with rising labour costs, means that a portion of lower-value manufacturing jobs currently based in China could move to other countries. India is well-positioned to benefit from this development, with the country's electrical power surplus, large working-age population, and recent business environment improvement reforms all providing support.

India boasts the third-biggest consumer market in Asia after China and Japan[14]. Multinational companies view large domestic volumes, along with potential exports, as highly lucrative. The Indian smartphone market illustrates this commercial opportunity. Indeed, we have seen leading smartphone manufacturers, such as Foxconn, Xiaomi, and Samsung establish operations in the country. Although the value-addition of current production is still low, we believe it's a good start. Furthermore, foreign companies that establish operations in India not only help the economy through increased investment and employment but also augment savings with the attraction of foreign direct investment.

[13] Source: CEIC, Haver, RBI, Morgan Stanley Research, April 2019.
[14] Source: World Bank Databank, as of December 2017. India is the third largest economy in the Asia Pacific region.

Market Outlook

Our outlook is constructive over the medium to long term due to the right structural reforms being in place. The current headline valuation of the market is at 15.5 times earnings[15]– this seems reasonable as it is only around 5% higher than the 10-year median valuation.

We believe that short term volatility around election results can't be ruled out. That being said, medium to longer-term outlook will continue to be driven by the incoming government's policies and global developments.

Our medium to long-term sector view is as follows:

- Private Sector Banks: We have a favourable opinion on Private Sector Banks, as they are the primary beneficiary of banking sector reforms. Our view is that they can gain both deposit and loan market share from weak state-owned banks and non-banking financial companies (NBFCs). Additionally, corporate-focused private sector banks could witness a sharp drop in provisions for bad loans as asset quality improves.
- Industrials: We are also constructive on industrials given our belief that the incoming government will focus on capex spending and a manufacturing revival will help support employment and income growth.
- Consumer: We like select consumer names where the organised sector is gaining market share as a result of economic formalisation policies. These industries include jewellery, apparel, and home improvement. Also, we are positive on sectors that would benefit from increased public spending, such as electric consumer durables given the introduction of electrification programmes.
- Negative View: We have a near-term negative view on autos and non-banking financial companies (NBFCs). This is due to NBFCs are still facing pressure on the liability side post a default incident by one infra-financing NBFC. As a result, NBFCs have sharply cut disbursements. Furthermore, we remain cautious on global cyclicals like metal and energy, not only because of underlying commodity-price volatility but also due to the high financial leverage of these firms.

Conclusion

With the existing structural reforms and a stable government over the next five years, India has the opportunity to achieve a higher growth trajectory. In our view, appropriate policy pivot from the new government to free up resources to invest in infrastructure (hard and soft), coupled with further improvements in the business environment, is the right recipe to realise this unique opportunity.

[15] Bloomberg, MSCI India Index, updated as of 1st April 2019

Appendix: Selected policy positions from election manifestos[16]

	BJP	INC
Fiscal stance	• No specific fiscal deficit target mentioned, but the focus on fiscal consolidation will remain	• Achieve a 3% fiscal deficit by FY2021
Income transfer	• Pensions for small farmers above 60 years of age (around 10% rural households) and small shopkeepers • Extend INR 6,000/annum income support scheme (PM-KISAN) to all farmers (currently only given to small farmers)	• Income support of INR 6,000 per month to the weakest 20% of Indian households (50 million) • Farm loan waiver
Infrastructure	• INR 100 trillion (US$ 1.4 trillion) of investment in infrastructure by 2024 • Double the length of existing national highways • Housing for all	• Electrify all households and villages
Economy	• Work towards increasing the GDP share from manufacturing • Increase GDP to US$5.0 trillion by 2025 and US$10 trillion by 2032 from the current US$2.9 trillion	• Increase manufacturing share of GDP to 25% from 16% • Savings rate target at 40% of GDP • GFCF target at 35% of GDP
Employment	• New industrial policy to be announced • Public procurement and government incentives to boost industrial job creation • Skilling for 600,000 people per annum	• To fill a total of 2.4 million central and local government vacancies by March 2020 • Create an additional 1 million government jobs at the village level • Raise employment eligibility under NREGS by 50 days from the current 100 days

[16] Source: BJP, INC, CLSA, April 2019

10 May 2019

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