RBC BlueBay Asset Management

India: the next decade

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Published March 2024

Prior to British Rule, India was a rich and prosperous nation. The Mughals had unified the country and were responsible for building an extensive road system and creating a uniform currency. India supplied the world with agricultural produce as well as rich textiles. By the early 18th century, India's share of global GDP was above 20%, however by the time British Rule ended in 1947, this had shrunk to just 4%. Over seventy years on from independence, India's illustriousness is once again palpable.

> **"Having the largest and youngest population on earth of 1.4 billion people, the country's demographics are supportive of growth."**

Back in 2003, an Asian equities strategist discussed in a report how India was seen as the most attractive of Asia's stock markets yet also a 'tortoise' – in comparison to then-booming China, the 'hare'. The year marked the beginning of an 11-year private sector CapEx-led cycle, and this resulted in India outperforming the MSCI AC World Index by 460% during that period[1].

India today: an introduction

Two decades on, it's no exaggeration to say that 2023 was the year that India arrived on the world stage. From its role as G20 host to its successful moon landing, the country was put firmly in the spotlight. As well as emerging as an FDI destination, India became known for its geopolitical role as a counterbalance to China and its position as a major military partner. The country was also a beneficiary of the world's key technological, cultural, economic and sociopolitical developments shifting in favour of the Indian Ocean Rim Association.

Having the largest and youngest population on earth of 1.4 billion people, the country's demographics are supportive of growth and with the rise of Prime Minister Narendra Modi to power in 2014, India has seen almost a decade of stable politics, encouraging reforms on all fronts and a real GDP growth rate averaging circa 6%.

The country is also once again in the early stages of another private sector CapEx cycle, where corporate India has delevered from close to 1x gross debt-to-equity in 2015 to just 0.5x currently.

It's clear that India today is much more than just a bottom-up play, and the macro story – which always used to belong to China – is now equally compelling.

[1] MSCI. Performance is in USD terms.

What's driven the macro story?

In the near decade that Modi has been in charge, India has seen fundamental structural reform, allowing it to finally benefit from its positive demographics and intellectual capital. In this piece, we highlight the many reforms the incumbent government has pushed through, but three main reforms have been pivotal. Firstly, government investment in infrastructure has improved efficiencies in logistics in the economy and de-bottlenecked many industries. Secondly, the Insolvency and Bankruptcy Code, passed in 2016, has meant that company founders risk losing their assets if they default on loans improving financial prudency. And, finally, the Real Estate (Regulation and Development) Act ("RERA"), which also came into effect in 2016, has cleaned up the real estate sector. This has allowed greater transparency and fairness, which has resulted in a property market upturn after an 8-year hiatus.

India today is an emerging market, and GDP growth has compounded at a nominal rate of over 7% annual growth over the last decade. This makes India's economy the fifth largest in the world today at USD13.2 trillion, which is up from USD3.4 trillion a decade ago[2]. Given the projected growth rate of 6% over the next five years, India will be a standout amongst the world's largest economies and is set to become the third largest economy in the world by 2027[3]. Indeed, with the population starting to buy consumer staples in bulk and becoming ever more discerning in their purchasing habits, consumption now accounts for as much as 70% of GDP, with India hitting the USD3,000 GD per capita figure[4]. This is the level at which discretionary consumption meaningfully picks up.

Compelling investment opportunities

Meanwhile, the bottom-up, micro story remains a strong one, and great franchises with good management and robust corporate governance give us a plethora of investment opportunities. The stock market remains as dynamic as ever, with a flourishing start-up scene. There is also a growing mutual funds industry, which is the beneficiary of monthly systematic investment plan inflows. Consequently, the market is now largely driven by domestic investors, which was not the case two decades ago at the time of India being compared to the tortoise. What's more remarkable, however, is that foreign investors are not more overweight the market. Dedicated GEM funds are only slightly overweight, yet global equity funds are barely invested in India.

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Of course, as with any good story, India's next decade will not be without potential set-backs and risks. Modi, has a self-imposed age limit of 75 which he is fast approaching (at 74 years old). As such, there is always the risk of a lack of viable alternative or, more worryingly, that Modi decides to hold on to power and risks becoming ever more of a dictator, threatening the world's largest democracy. Indeed, the growing authoritarianism of the prime minister and his right-wing Hindu nationalist government have resulted in the Western press keeping a close eye on any potential missteps by his administration.

Modi's abandonment of the secular legacy of Jawaharlal Nehru, India's first prime minister, and his redefinition of India as a Hindu nation have intensified discrimination against minorities. Furthermore, lifting a large swathe of the population out of poverty is not an easy task and the country's twin deficits (current and fiscal deficits) make this even more difficult. For now, however, India remains a large ally of the West, which seeks Modi's backing in a world where the balance of power hangs precariously. More importantly, India's economic rise under his administration has been nothing short of remarkable. Under Modi's visionary leadership and policymaking, ranging from infrastructure to foreign policy and social development, India's economy has transformed.

Here we dive deeper into the many facets of the economy that are simultaneously flourishing. These give us the confidence to say that this next decade belongs to India.

[2,3] Jefferies, February 2024.
[4] World Economic Outlook (October 2023) - GDP per capita.

India today: a deep dive

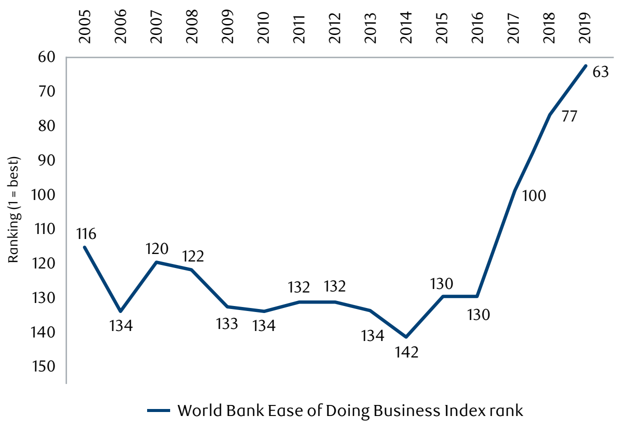
India has built more infrastructure in the last decade than in the previous 70 years. The pace of capacity addition is swift and is translating into efficiency gains as well as lower logistics costs. For example, in the last 10 years, 600,000km of optic fibre cable has been laid which has resulted in a surge in mobile phone users from 300 million to 800 million, and the cost of internet data has become the lowest in the world. Cumbersome processes and red tape have been eliminated, and in 2022 India combined all approvals for government clearances making it online and digital.

> **"India has also leveraged its huge annual cohort of engineering graduates and its strength in coding and IT, and it has created what is dubbed the 'India Stack'."**

Four new codes have been enacted to simplify the forty-plus labour laws, and consequently India has risen substantially in the World Bank's Ease of Doing Business Index, from 142nd ranking in 2014 to 63rd as of 2019[5] (Exhibit 1).

India has also leveraged its huge annual cohort of engineering graduates and its strength in coding and IT, and it has created what is dubbed the 'India Stack'. This is a digital and online public utility, available to all Indians. It stores the population's ID and social security numbers, and its capabilities include, but are not limited to, the enablement of payments, transactions and tax collections. It means that, in under a decade, every Indian now has a unique identification number ("UUID"). This makes it easier for labour to move from state to state, eliminates cumbersome bureaucracy, and makes travel, mobility and payments effortless.

Exhibit 1: India jumps to 63rd position in World Bank's Ease of Doing Business Index



Source: World Bank data (2005-2019), as at 2023.

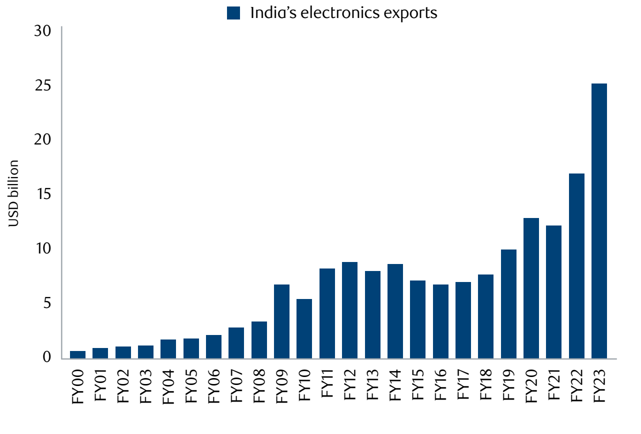
The result has been a meaningful pick-up in tax collections. As the economy formalises, these tax collections will continue to build, fixing one of India's weaknesses, namely its fiscal deficit. With large swathes of the economy still in the informal sphere — over 90% in grocery and consumer staples for example — plugging these leakages through reforms such as demonetisation and tax reforms, as well as digitalising the economy through the India Stack, will have a meaningful impact. The twin impact of increased tax collections and improving ease of doing business has resulted in a scaling up of the manufacturing base. Building out India's largely small scale manufacturing base has been a focus of the current administration.

The PLI scheme, which was rolled out in 2020, offers cash incentives for three to five years on the incremental sale of goods manufactured in India. 14 sectors have been targeted, ranging from mobile phones, to solar, pharma, white goods, and semiconductors. The aim is to bolster the following key areas: energy transition (EV and solar), import substitutions, the manufacturing base and exports, higher value-add employment, and semiconductor capabilities.

Whilst having high aspirations in relation to semiconductors, the scheme lends itself more to the low-end manufacturing base, where India has a real labour arbitrage opportunity, given that there is a 50% differential in terms of labour costs between India and China. Consequently, one area that has seen success is the electronics manufacturing of mobile phones.

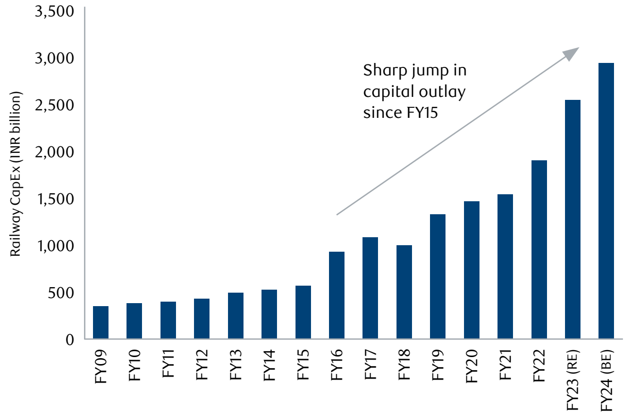
[5] As of 2021, the World Bank stopped producing the 'Ease of Doing Business Index' as its methodology is being revamped.

Exhibit 2: India's electronics and semiconductor story unfolding



Source: CMIE, as at October 2023.

Exhibit 3: Railways – strong uptick in capital outlay since 2015



Source: Government documents, Nuvama research, as at October 2023.
Note: RE = revised estimate, BE = budgeted estimate.

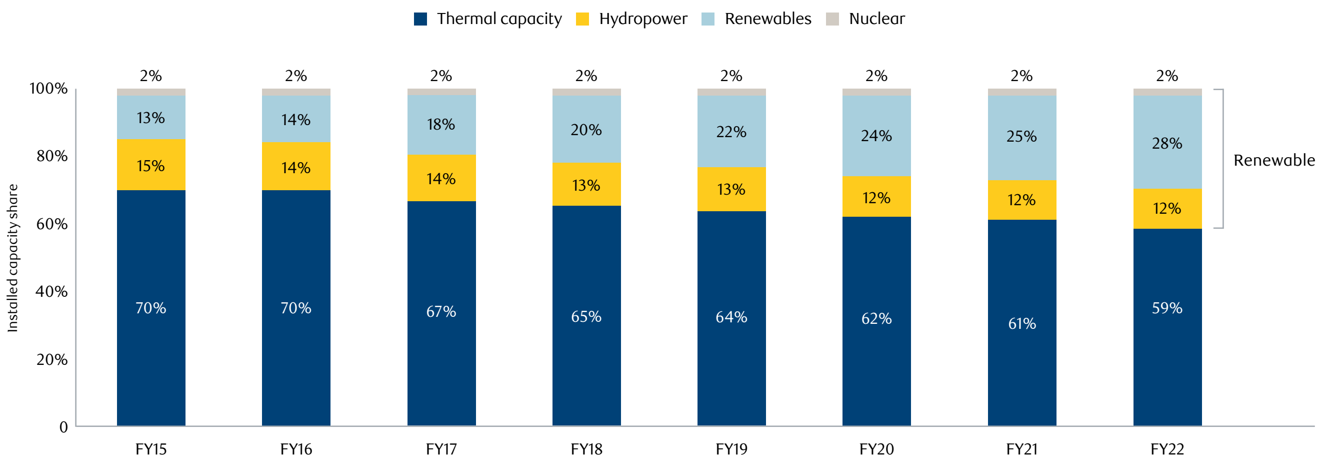
There has been an almost doubling of incremental capacity in mobile phones manufacturing since 2020, and we have seen many MNCs commit to Indian CapEx plans, ranging from Samsung Electronics to Pegatron to Panasonic, as well as many smaller scale domestic companies. Clearly things are moving in the right direction, partly as result of MNCs' 'China+1' strategy, although the scale is still very small compared to other nations. For example, electronics exports out of India have now hit USD24 billion (Exhibit 2), which has doubled in the last two years, but compared to China at USD900 billion and Vietnam at USD124 billion this is still a long way from what manufacturing success stories can achieve.

We have seen significant investments in two key areas, namely infrastructure and power, and since 2015, we have witnessed a sharp five-fold increase in railway CapEx (Exhibit 3). This was much needed given the congestion and the increased traffic requirements post independence.

This CapEx budget is therefore likely to stay elevated for the next 20 years. Impressively by 2025, India is expected to be the only large country in the world with a fully electrified rail network.

India is nearing completion of two of its Dedicated Freight Corridors ("DFC"). These are dedicated to freight traffic only, with no passenger trains, thus allowing the trains to run at much faster speeds of up to 200km/hr. Currently the DFCs nearing completion are north to west (Delhi-Mumbai) and north to east (Delhi-Calcutta) and a further two linking north to south and east to west are being planned. With each corridor spanning 1,400km and an average train speed in India of around 45km/hr, it can currently take up to 4-5 days to get from Delhi to Mumbai. Post completion of the DFCs, these journeys will take less than one day. Currently having the highest logistics costs globally at approximately 13%, this will help bring down costs significantly to around the world average (7%).

Exhibit 4: Already 42% of installed capacity is in renewables



Source: HSBC, as at February 2023.

Power has also seen significant investments, with so much made in transmission and distribution that India has gone from a perennially power deficit country, with frequent blackouts, to one that has been in power surplus since 2018. Impressively, 42% of installed capacity is already in the renewables field (Exhibit 4), putting India in third place globally, after China and the U.S.. Renewable tariffs are also the cheapest in the world in India and the majority of additional power capacity is being made in renewables. Furthermore, India's COP26 promise targets for non-fossil fuel capacity to reach 500GW by 2030, from the current 160GW today.

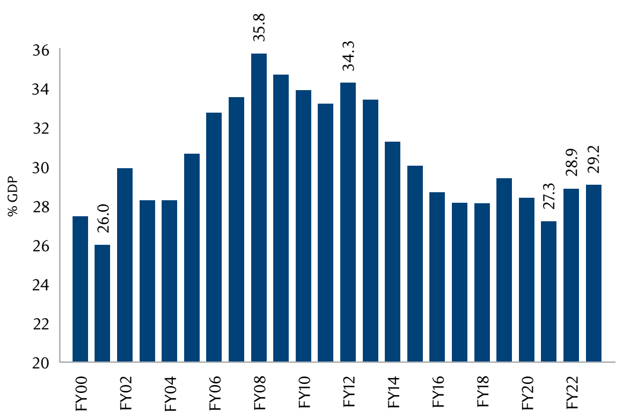
> **"Renewable tariffs are also the cheapest in the world in India and the majority of additional power capacity is being made in renewables."**

Indian corporates have deleveraged, the banking sector is highly capitalised, and incentives/subsidies abound. The overall result has been a resurgence in capacity expansion. As a % of GDP, gross fixed capital formation is hitting 29.2% in 2023, up from a low of 26% (Exhibit 5).

In fact, CapEx has more than doubled in the period between 2012 and 2022, and although it was mainly driven by central and state government spend in areas such as railway, roads, telephony, water and sanitation, there is a more meaningful uptick in private CapEx as of 2023, in part supported by the PLI scheme (Exhibit 6).

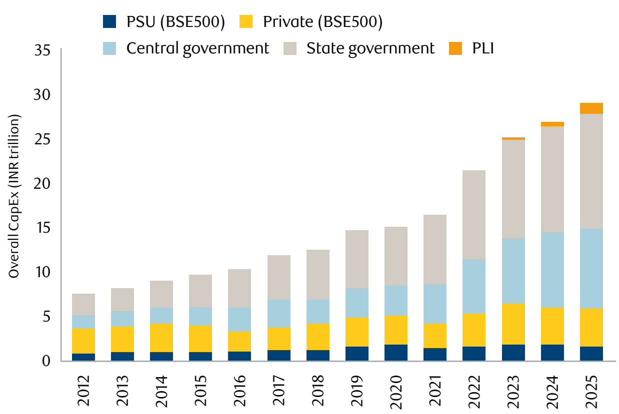
The comparison with China is often made. Clearly, manufacturing has driven China's economic growth since admission to the World Trade Organisation ("WTO") in 2001, whereas India's manufacturing employment has stagnated for the past 15 years.

Exhibit 5: India's CapEx cycle picking up (GFCF* as % of GDP)



Source: MOSPI, CEIC, Jefferies, as at 2023.
*GFCF = gross fixed capital formation.

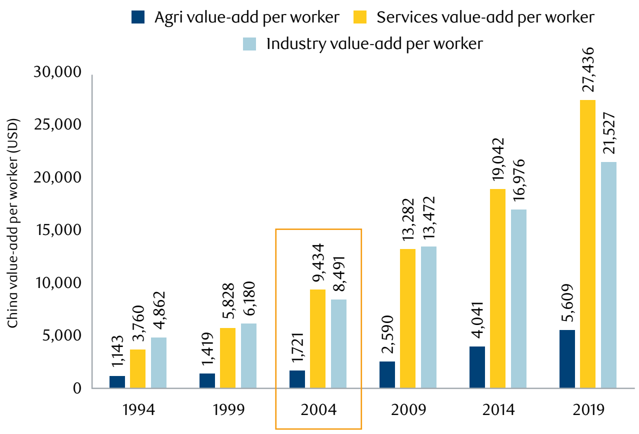
Exhibit 6: Synchronised CapEx boom (government & private)



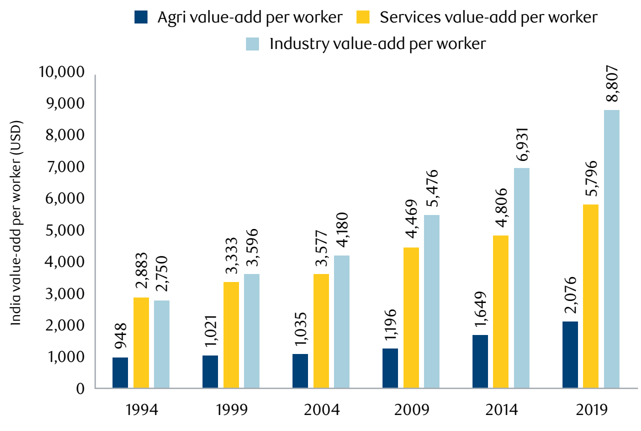
Source: RBI, Goldman Sachs Global Investment Research, as at January 2023. Note: Private CapEx excludes spectrum payments by telecoms players.

Exhibit 7: China versus India's value-add per worker

China's value-add per worker



India's value-add per worker



Source: World Bank, Investec Securities' estimates, as at January 2023.

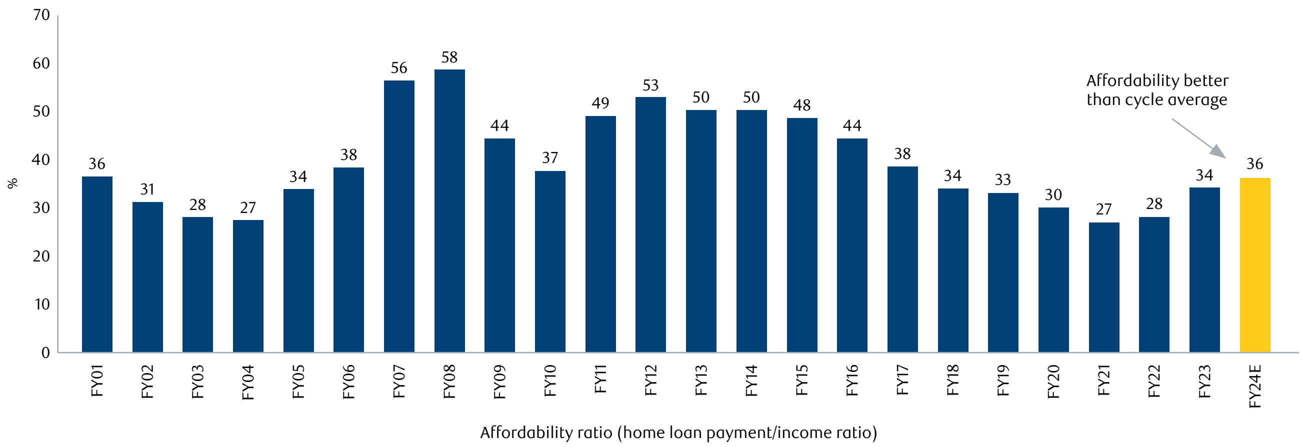
However, the above-mentioned developments, combined with the geopolitical shift away from China by multinationals, means that India now finds itself at the inflection point that China found itself at in 2004, at a time when its industry and services value-add per worker increased exponentially (Exhibit 7).

Another significant development over this last decade has been the rise in financial inclusion. The assets under management of domestic mutual funds have increased more than five-fold in the past five years, more than double the growth in bank deposits. The Systematic Investment Plan ("SIP") initiative has been a major driver of this, pushing up the growth in household savings. It is not surprising then that housing affordability is high, and we have seen a meaningful pick-up in housing sales in the last three years (Exhibit 8).

The twin deficits — the current and fiscal account deficits — persist and are stubborn. In 2023, India ran a fiscal deficit of 9% and this remains a real sticking point that needs to be addressed. The country's current account is also always in deficit, as India is not only a large net importer of oil, and thus largely at the mercy of the oil price, but also dependent on imports overall, with imports 50% higher than exports. In 2023, the current account deficit trended close to breakeven as services exports remain robust, but it is one that must be watched.

"The assets under management of domestic mutual funds have increased more than five-fold in the past five years, more than double the growth in bank deposits."

Exhibit 8: India's housing affordability is high



Source: HDFC, SBI, Jefferies.

India's housing affordability ratio, measured as mortgage payment as % of income, declined from 53% in FY12 to 27% in FY21 and was 34% in FY23 ended 31 March. The affordability ratio is estimated by Jefferies' India office to rise to 36% in FY24, assuming an 8.75% mortgage rate. This remains below the average of 40% between FY01 and FY22. The lower the score, the higher the affordability. Note: Jefferies forecast for FY24.

Furthermore, India has always leveraged its sizeable and young labour pool in its industrial strategy. However, its aspirations to become a manufacturing hub also dictates the nation's need to invest in automation and technology to be globally competitive. Any delay in this investment will curb these aspirations.

"India is entering an election this year and even if Modi's Hindu nationalist party, BJP, remains ahead in the polls, his re-election cannot be guaranteed."

Finally, Modi has been critical to the policy reform India has undergone. A change in the premiership or the political status quo may carry significant uncertainty in India's trajectory. India is entering an election this year and even if Modi's Hindu nationalist party, BJP, remains ahead in the polls, his re-election cannot be guaranteed. At 74 years of age, there is talk of succession planning, which also carries a risk.

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Veronique is a portfolio manager on the RBC Emerging Markets Equity team at RBC GAM and is currently responsible for research in India. Prior to joining the firm in 2015, Veronique was at a large independent brokerage and investment group in Asia, where she was responsible for Asian ex-Japan equities for 15 years. During this time, she developed significant expertise in Asian equities, as well as a deep understanding of the region's corporate culture and economic development. Veronique began her career in the investment industry in 2000.

Publication date: March 2024

RE/0059/03/24

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