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INVESTMENT NOTE **27 FEBRUARY 2015**

Hermes: Avoiding the potholes on the road to sustainable Indian growth

By Gary Greenberg, Head of Hermes Emerging Markets

"Eight months ago, India was caught up in a wave of Modi-infused euphoria as the BJP party swept to power. 'The good days are coming' was the campaign rallying cry. Markets believed it – the Sensex rose to record highs after the election victory. Eventually, of course, optimism meets reality. At the Annual Budget Saturday, India's new government will have to balance its (business) stakeholder expectations with the reality of political and economic compromises. However, considering the announcements made yesterday by the Railway Minister of a two-fold jump in rail investments to over US$120 billion, it is clear that this Government has the potential to deliver positive surprises.

"On the eve of Modi's election, we asserted that if India were to benefit from real long-term structural transformation, Modi needed to tackle India's deficit, cut red tape, modernise its cities and unleash India's land, coal, oil, and gas reserves.

"Tomorrow, Modi's first annual Budget will reveal how his Government is tackling some of these key issues. There are indications that there will be some tax exemptions for the middle class, efforts to improve the education system and promote skills development, as well as further measures to make it easier to do business in India. Specifically, first, we may hear about way to facilitate land acquisition on which the government has faced fierce opposition and about fiscal incentives to promote manufacturing. Second, there should be more detail on the creation of 'smart cities' and plans for a network of several thousand kilometres of superhighways, in addition to signalling how the chronic deficit in power supply is being tackled, with transparency about coal allocations being particularly important. Also, we expect the government to indicate how it intends to increase electricity transmission and distribution capacity. Investors in particular would like to see more evidence of a decisive end to the previous government's expansion of India's welfare subsidies –this will be a balancing act for the government as Modi does not want to be seen as an oppressor of the poor.

"India's new government under Modi and the BJP has been successful so far in controlling inflation (helped by falling oil prices and moderating food inflation) and the current account deficit is at a comfortable level, exempting India from the "Fragile Five" classification. However, there are several factors preventing the Modi Government from delivering big stimulus programmes to revive the economy. These include the need to contain the fiscal deficit, stress in infrastructure and related sectors (private sector players in these sectors are highly leveraged), and weakness in the state-owned banking system. The reality is that the need to spend money on infrastructure is constrained by limited tax revenues.

"Modi's Government has made it clear that it will maintain prudent fiscal management and work on reducing the fiscal deficit. This has disappointed many market participants, who had hoped for a large economic stimulus programme to spur growth in the economy. In addition, legacy problems in the infrastructure and materials sectors limit the banks' ability to increase lending. The banking sector in India has nearly US$85 billion in non-performing assets and restructured loans.

The road to economic transformation

"Patience is a virtue, and both investors and the Indian public must put reform in context. India is still mostly a rural economy, with over 60% of the population dependent on agriculture, while manufacturing provides less than 20% of GDP. India cannot industrialise at the rate of China as its legislative process takes time and government cannot make unilateral, centralised decisions. Still, the nation’s dependency on agriculture needs to decline as a proportion of GDP and the share of economic growth generated by manufacturing increased to over 25-30%, particularly since India needs to create 15-20 million jobs every year to absorb its demographic dividend.

“The slower-than-expected rate of reform in Modi’s first year has been disappointing for investors, whose high expectations may not transform into higher earnings in certain sectors. These include areas that we have avoided – such as industrials, capital goods and consumer staples companies – in the near term. However, during our visit last month, extensive conversations with companies and government officials lead us to conclude that the Indian economy is firmly on a path of sustainable growth, one with steps that we describe as c*orrection, transition and growth*.

“These three aspects seem like steps, but they are contemporaneous. The “corrective” measures , namely amending the unfriendly and onerous Land Acquisition Act, the Goods and Services Tax, and labour laws, will take a long time to materialise. Historically, these populist roadblocks have prevented India from unleashing her true economic potential. Some of these reforms are truly transformational and it is commendable that the Modi Government has initiated them early in its five-year term.

“The “transition” to a manufacturing economy is already underway in the current environment with some positive initial steps, and growth will be an outcome of this process. Once the correction and transition stages are advanced (we expect this to happen in three-to-five years’ time), we expect that India will be able to sustain a high real GDP growth rate of over 6%.

“The winners that emerge from this transformation will be efficient and sustainable businesses, some of which we own, and which we hope to acquire more of when they dip to attractive valuations. But this is a long-term trend requiring a long-term approach. A short-term fix won’t result in enduring benefits given the scale of the challenges India faces, but if Modi remains committed to prudent and creative long-term reform, the opportunities for India and investors in its market could have the potential to rival China’s economic development, and substantially exceed its returns to investors.”

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