New government fires investor enthusiasm for Indian stocks on reform hopes

The landslide victory of the pro-business Bharatiya Janata Party (BJP) in India’s May general election has transformed investor sentiment towards India. We believe the new government could enact much needed reforms to stimulate investment and unlock India’s economic potential.

The Indian economy has been weighed down in recent years by both political and economic problems, which have dragged growth substantially below its potential. Deterioration in the fiscal and external accounts and an alarming rise in inflation with ensuing interest rate hikes by the Reserve Bank of India (RBI) have created stagflation type conditions in the economy and made the economy vulnerable to external shocks. This duly happened last year when India came to be regarded as one of the emerging economies most at risk once the tapering of quantitative easing (QE) got underway in the US.

Figure 1: Indian GDP has fallen to its lowest level in over 10 years

The lack of an effective response by the previous government also exacerbated the slowdown. A mixture of several major corruption scandals and political deadlock under coalition politics resulted in several years of policy paralysis. Much needed action to spur investment and to tackle structural supply-side bottlenecks in inflation and infrastructure were simply stuck in government.

Landslide victory for BJP brings in strong government

Summer 2013 proved to be an inflection point for the market with the economy bottoming out and inflation beginning to fall in response to monetary tightening. Furthermore, the period also saw the appointment of a new and highly-regarded governor of the RBI, Raghuram Rajan, once the chief economist at the IMF, stabilised the rupee and the current account by stemming capital outflows and reassuring the market with an explicit inflation targeting policy.

But while these developments were important, the outcome of the May 2014 election proved the real game changer in restoring investor confidence. After 550m votes were counted, the BJP emerged with an overall majority and Prime Minister Narendra Modi now heads the first government in 25 years that is not hostage to coalition politics. Moreover, India has a majority right-of-centre administration for...
the first time since independence. Thus, the prospect that the government has both the desire and ability to implement pro-business economic reforms has ignited the enthusiasm of investors.

The hopes for Modi are so high because of the reputation he gained as a pro-business administrator. Serving as chief minister of Gujarat, one of India's fastest-growing and most business-friendly states, Modi focused upon improving infrastructure, agricultural productivity and the profitability of state-owned enterprises. Investors anticipate that he will target the same goals in national government and seek to reduce the vast subsidy bill for items such as food and fuel. Modi has also vowed to eradicate corruption, condemning the previous government as being too "addicted" to graft to tackle the issue.

Against such high expectations, we have yet to see any major announcements and indeed the BJP’s first budget, announced in July, disappointed. The apparently slow start perhaps reflects India’s gargantuan and stubborn bureaucracy and the need to overcome vested interests and the competing forces of the central and state governments. Nevertheless, the administration’s intent is certainly clear and we have already seen evidence of Modi’s “minimum government, maximum governance” mantra including the merger and streamlining of the coal and power ministries and the reduction of red tape to help accelerate government approvals. While these measures are lower profile, they are a step in the right direction and will improve the functioning of the current government system.

Economic growth and the pace of reform to accelerate?

We anticipate that the pace of reform will accelerate as the government addresses the fundamental problems plaguing various ministries and the economy and that growth will subsequently pick up. Investments could well lead the recovery, especially considering that new project starts have fallen to historical lows. While the return of government investment will very much depend on when the government loosens its purse strings and on effective implementation of infrastructure projects, the return of the private sector requires a revival of “animal spirits” among both consumers and corporates. We expect this to boost not only corporates’ desire to invest in their businesses again but should also feed through to better earnings. Having visited the country to meet a number of companies shortly after the election results, it would seem that improvements are beginning to appear in terms of business and consumer sentiment.

Figure 2: New project starts unlikely to fall further; any pick up will potentially drive future growth

![Figure 2: New project starts unlikely to fall further; any pick up will potentially drive future growth](image)

The hard data also points to a recovery coming through in the fiscal year beginning in March 2015. Capital and consumer spending are starting to revive albeit slowly and we expect to see earnings results improve. Margins and returns are at 10-year lows with potential for upside as revenue growth strengthens, spare capacity is used and returns trend back to more normalised levels. Moreover, India is well positioned in terms of monetary policy given that it has already been through the tightening cycle and inflation is easing. Indeed, India could be one of the few countries where the central bank can loosen monetary policy going into 2015, when the developed markets are likely to be entering a tightening phase.

India’s long-term potential remains clear: the so-called “demographic dividend” of a relatively young and fast-growing working population; low levels of consumption with household penetration of many goods remaining low and giving huge scope for increased consumer spending; the potential for a big increase in infrastructure spending, which can ease structural bottlenecks and is a key focus of the new BJP government; while India’s democratic tradition encourages greater transparency and accountability than is seen in some other Asian countries.
Investment ideas
As the new government settles in and begins to put its stamp on policy it will create investment opportunities not only in the domestic economy but also in sectors exposed to government-led reform, which is a theme that is becoming more prevalent in Asia as sluggish growth has encouraged governments to reassess their economic models. Below we have identified various ways in which we can participate in India’s brightening outlook:

- **Improving economic activity**: We favour banks such as ICICI and HDFC Bank, whose fortunes are directly linked to the economy. These institutions maintained their asset quality during the downturn and we anticipate that lending opportunities, particularly in corporate, consumer and infrastructure-related areas, will improve as economic activity accelerates and the new government puts incentives in place to encourage lending. As an example, the government recently exempted long-term bonds from the mandatory regulatory norms such as reserve ratios if the money raised is used for the funding of infrastructure projects.

- **Consumption recovery**: We are also targeting companies that should benefit from a recovery in consumer spending, particularly in urban areas where high inflation and a weak economy have dampened real wage growth. The penetration rate of vehicles is low in India, even relative to other Asian countries at 20 per 1,000 people. As consumption recovers, helped potentially by lower financing rates, a return to the structural growth story should benefit India’s biggest carmaker Maruti Suzuki.

- **Infrastructure**: With a renewed focus by the government to address some of the structural bottlenecks in the economy, areas such as roads, rail and affordable housing should see a meaningful uptick in investment. The US$25bn Dedicated Freight Corridor (DFC) is one rail project under construction that will connect East and West India and at least halve delivery times while quadrupling capacity. We would expect more such projects to be launched and spending to flow through to the likes of Larsen & Toubro, a market-leading engineering and construction business, and Ultratech Cement, India’s biggest cement company.

- **Subsidy reductions**: We expect diesel subsidies, which have already been lowered, to be reduced dramatically with prices reaching market levels before the end of the year. The burden of fuel subsidies has been shared between the government and upstream, state-owned companies. This has proved a drag on the latter’s earnings and clouded visibility as the subsidy system was very opaque. As subsidies decline, upstream businesses such as ONGC, India’s largest oil and gas exploration company, should benefit.

- **Exporters**: We also favour some exporters, which continue to win international market share and enjoy good earnings visibility. Thus in IT services, an area where Indian companies are doing very well, we like HCL Technologies, where revenues and earnings have been expanding at stellar pace. Along the same lines, we also like the pharmaceuticals businesses Lupin and Sun. Both are benefiting from the strong growth in the US generics market by launching niche, generic products when established products go off patent. Both continue to enjoy excellent earnings growth and visibility.

The main risks to India’s positive outlook
As ever with emerging markets when reform is on the agenda, delivery is the key. Governments are generally quick to promise change but can be slow to follow through. In the case of India, given that equity markets have already risen sharply on the promise to renew the economy, they could react just as swiftly to any setbacks to the reform process. The risk is that initiatives by the central government may simply fail to have an impact on the ground given the layers of officials they will have to penetrate. Modi may find it much harder to push through reforms at the national rather than the state level. The government’s measures may also drag on economic growth in the short term. Thus, reducing subsidies could affect consumption, particularly in rural areas, and push up inflation and prevent the RBI from lowering interest rates as quickly as it would otherwise be able to do. Finally, India remains vulnerable to external shocks, such as a sharp normalisation of US interest rates or a hike in oil prices, given that the country is a capital and energy importer.

While there will be speed bumps in the road to economic recovery and there will be times when market expectations and reform implementation do not align, the direction of travel is clear and we believe that the Indian economy will be able to find its feet again at a higher and more sustainable growth rate. This should feed through to earnings and a recovery in return on equity (ROE), which in turn should be rewarded by the equity markets. India was one of the first emerging markets to enter the slowdown and, under the right policy environment, it should be one of the first to recover.