Modi keeping India on right track

Contrary to some media commentaries, he is sacrificing short-term growth to achieve long-term structural changes which are certain to deliver huge dividends.

By Shiv Puri

THE lack of meaningful pickup in India's short-term GDP growth has some analysts and commentators getting impatient. I believe the direction of India's economic growth and reforms remain on track. No one could reasonably expect a complete economic turnaround in one year. The uptick in GDP growth from 4.5 per cent to 5.5 per cent (based on the old methodology) over the last one year is a good start.

Prime Minister Narendra Modi's government completed one year in office in late-May. The key takeaway is that Mr Modi is willing to sacrifice near-term growth in order to implement long-term structural changes. He is following a script for India akin to investor Charlie Munger's observation regarding great businesses - "almost all great businesses engage in 'pain today, gain tomorrow' activities". (Perhaps it's no coincidence they both describe the late Lee Kuan Yew as their role model for great governance.)

The Modi government has cut rural subsidies dramatically causing short-term pain in the rural economy. But this will structurally lower inflation and reduce entitlements. This is a long-term positive. Similarly, in the infrastructure sector, the growth has not yet picked up. This is because the government is not recapitalising the state-run banks that lent poorly in the last cycle. Instead the government has infused more capital into the strongest of the state-owned banks. Here again Mr Modi is setting up the right incentive system. Finally and most importantly, the days of crony capitalism are coming to a rapid end. The recently concluded telecom and coal auctions were done transparently via an online auction and raised more than US$50 billion in total, which is an excellent accomplishment.

The Modi government is putting the bureaucracy in overdrive and overhauling the system. Long term, that's very bullish. The dramatic improvements in inflation, fiscal deficit and current account deficit achieved over the last year provide a springboard for future sustainable growth.

The key Goods and Service Tax (GST) bill and land acquisition bill will likely be muscled through this fiscal year in some shape or another. The government has already pushed the mining bill, insurance bill, and monetary framework bill through Parliament and into law.

While all these points deserved positive media coverage, there were instead several negative reports over the past quarter. A recent long article in The Economist on the one-year anniversary of the government said Mr Modi's defect is that he is trying to govern too much on his own by excessive micro-management and concentration of power in the Prime Minister's Office or the PMO ("Modi's rule - India's one-man band", The Economist, May 23, 2015). We disagree. CLSA macro strategist Chris Wood said it well: "Given the realities of India, and given the Congress Party's entrenched socialistic vote-buying tradition since independence, it needs a benign dictator with a determined vision and a Thatcher-like ability to ignore daily media noise to change India." I believe India is fortunate to have a 300-person strong PMO that has resulted in unprecedented levels of communication and decision-making between ministries and the culling of poorly performing bureaucrats.

NO GHOST TOWNS

The theme of a recent full-page writeup in the Financial Times seemed to suggest development of ghost cities and highways to nowhere in India. It also mentioned that an overleveraged corporate India poses a risk to the financial system. In addition it suggests that there is no progress in the sector due to the conditions above. According to the FT article ("India infrastructure: Built on debt", Financial Times, June 22, 2015), "the scale of Jaypee's ghost city rivals that of some of China's famous unoccupied cities". That is inaccurate. Jaypee is an infrastructure developer that built a racetrack about 50 km from Delhi. It secured a deal with Formula1 (F1) and built a 5,000-unit residential complex around the track. The deal with F1 collapsed and the project failed to get much traction. This is no "ghost town" and any suggestion that India has "ghost cities" or "highways to nowhere" is just false.

A detailed analysis of housing finance companies and travels across the country makes one point clear - India needs millions of additional housing units. India needs many more roads, bridges, ports and power plants. The article goes on to state - "but for now, there is little traffic on the highway leading to Buddh - and even less on the pristine racetrack". Because of this six- lane highway, the five-hour journey from Delhi to the Taj Mahal in Agra is now cut down to two hours. The traffic on this highway is 16,000 vehicles a day and is up 20 per cent over last year. India needs many more such highways.

The article also noted that "construction in India's cities has not kept pace with the rapid growth in the urban population, and the state of public transport remains poor". This is a fact and this is exactly the opportunity within the infrastructure sector that will drive GDP growth. Indeed, in the railway sector alone, the government is planning to spend US$137 billion over the next five years. The Delhi Metro, as an example, was completed on time and on budget at a cost of US$4.5 billion in two phases over five years. It now transports 2.4 million people every day.

One concern is that the Reserve Bank of India's monetary policy is still hawkish despite the rapid decline in inflation. Thus, inflation has declined from over 10.0 per cent to 4.3 per cent. Despite a reduction of 75 basis points over the last year, the interest rate is still at 7.25 per cent. The high historical inflation rate was primarily due to large rural subsidies and high crude prices. Given the sharp reversal on both those fronts, it seems reasonable for interest rates to further ease going forward. But while the GDP data do not look so bad, the bottom-up picture shows a lack of pickup in earnings growth. Corporate profit is now down to 4.3 per cent of GDP, a level last seen in 2002. It is clear that when aggregate revenue growth picks up, most of corporate India will see expansion in margins driven by lower commodity prices and declining wage inflation.

COMPRESSED SPRING

In summary, the reason India is not seeing a sharp rebound is because monetary policy is tight, rural subsidies have been dramatically cut and the lack of a "bailout" to poorly run state-owned banks is delaying the infrastructure cycle. But this has only compressed the spring of earnings growth into the future, given the dramatic improvements in the macro conditions and overall governance.

From a stock market standpoint, the BSE500 index trades at 15 times forward 12-month earnings, and at a slight discount to the historical average of 16 times. The valuations on cyclically adjusted earnings are 30 per cent lower because operating margins are at 10 per cent, and not at their long-term average of 13 per cent. While the broader market has been largely flat year-to-date, there are still wonderful investment opportunities.

It is important to read business dynamics carefully and own quality companies that benefit from the changing landscape. It is also important to find companies that are at a nascent stage in their life cycle and which therefore have a long runway for growth. Such companies - which typically also have sensible, result-oriented management teams - can turn into "compounding machines" that can compound capital at a healthy rate for a long period of time

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