Matthews Asia

# Matthews Asia Perspective

## Progress on India's Reforms and Sustainable Innovation

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***In this Q&A, we speak with Peeyush Mittal about his insights on investing in India.***

**There have been many reforms in India under Prime Minister Narendra Modi. What is happening today? How is it affecting corporate India?**

Key reforms under Modi have included the Goods and Services Tax, the Insolvency and Bankruptcy Code, and Demonetization. Let's look at each:

- **Goods and Services Tax (GST):** The GST has been the single biggest and most disruptive change to how business is conducted in India. When the GST was implemented, a compliance structure under GST known as the E-way bill also was rolled out. Under GST, transporters are required to carry an E-way bill when moving goods, and this has been touted as an anti-evasion measure. Given the proximity to general elections next year, however, enforcement of compliance is not very strict at this point, but this is expected to change afterward. GST has changed small business behavior. There is greater tax compliance and lower rates of tax evasion. In line with that, corporate India (meaning organized publicly traded stocks) has benefited as volumes have moved from unorganized to organized firms. The full impact, however, is yet to be seen.
- **Insolvency and Bankruptcy Code (IBC):** While most investors are aware of it, the code's importance is not fully understood. In the past, many corporations considered credit from public sector banks as "free money" that they didn't need to return as laws were not stringent enough on the recovery side. After the implementation of IBC in 2016, however, there has been a sea change: the government has clearly indicated (via IBC) that willful default will lead to adverse consequences for such promoters. We have already seen a couple of cases where they have lost their business/assets due to failure to pay their dues. This is unprecedented in 70 years of independent India and is likely to benefit the banking sector at large.
- **Demonetization:** Many questioned whether it constituted a true reform. At the time, the Indian government suggested it was an effort to reduce cash in the system. For a short period of time, the government accomplished its goal. It appears, however, that there is an equivalent or even greater build-up of cash in the system now. But in general, there is a greater awareness of electronic forms of payment and consequently rapid growth in digital transactions. Digital transactions are beneficial for most consumer-facing business (banks included) as they create data that can be used to better understand consumer behavior.

In terms of incremental reform, given that the next general election will take place in six months, it is unlikely we will see any meaningful changes. We might see some populist measures from the government aimed at winning votes.

### In what sectors are you seeing business innovation? Is this expanding the opportunities for investors?

We believe there is a lot of innovation in India that is expanding opportunities for investors:

- **Retail:** Grocery shopping is changing in urban markets away from mom-and-pop stores to big box retailers due to the ease of shopping and a wider variety of choices at similar to cheaper prices. Big box retailers are pushing their own brands of bulk items with the promise of better quality. This is finding strong traction in the market.
- **Fast food/restaurants:** With higher discretionary income and double-income families, there's a greater emphasis on dining out. A growing number of restaurants offer foreign cuisine, which was not the case a few years ago. Road congestion has been a deterrent to the dining out trend, but the advent of delivery businesses is helping sustain and further fuel the growth of fast food outlets and restaurants.
- **E-commerce/internet:** There is proliferation of internet-only companies offering products and services of all kinds. There is a plethora of businesses in private hands in this space that have attracted private equity investors. We hope some of these businesses will look to tap public markets in the coming years.
- **Payments/transactions:** Digital transactions are growing more rapidly than cash transactions due to innovations such as the QR code. Many of these innovations in the payments/transactions space are being brought forward by start-ups and already publicly listed banks.
- **Pharmaceuticals:** The industry remains focused on manufacturing generics. We are beginning to see many more companies, however, indulging in novel chemical and biological entities. One such company has a new chemical entity (NCE) molecule in Phase III in collaboration with a U.S. company, which is a first for an Indian pharmaceutical firm. Clearly, there are now more opportunities for investors in the pharmaceuticals and health care space.

### What are the market implications of the resignation of India's central bank governor?

The primary reason behind Urjit Patel's resignation was the Modi government's desire to exert control over the Reserve Bank of India (RBI) and its decision-making. It is not clear what the ultimate implications will be. In the interim, the outlook for easier monetary policy and lax lending by public sector banks ahead of the next general elections should provide positive support to the market. However, the longer-term impact of the loss of the central bank's autonomy would clearly be a negative. For investors, anything that creates fear is welcome since it makes the price (valuation) more favorable to the buyer.

Patel continued the tight monetary policy framework that was put in place under his predecessor. While it was widely speculated at the time of Patel's appointment that the real interest rates framework would be diluted, the record suggests that it was not the case. We would argue that the RBI has been more conservative and hawkish than it should be.

### Does India remain relatively immune from some emerging market problems, such as a strong U.S. dollar and the U.S.–China trade war?

Let's address the two issues independently:

- **U.S. dollar:** A strong U.S. dollar (USD) and weak Indian rupee (INR) pose a challenge to the Indian economy and specifically to the Indian consumer. India has a strong dependence on imported crude oil, and as the INR depreciates it raises the import bill for the country. A depreciating INR has an inflationary impact in India and a negative impact on consumption.
- **Trade war:** If the U.S. moves away from a reliance on imported products from China, it may open opportunities for Indian businesses, although the benefits would be seen only in the medium to long term. And if China becomes a more open economy, it may provide more opportunities for Indian companies seeking business within China. We are already seeing some change to this effect in India's pharmaceutical sector.

### Economic growth in India is at 8.2%. Is this a peak?

India's GDP series is still evolving. GDP figures as published by the government are not believed by everyone since the Modi government changed the methodology and there was not much public data provided for validation. There has been a great debate within the country on this topic. Under the current GDP series we have seen GDP growth in excess of 8% a few times already. This was in an environment where private capital expenditure has been nonexistent and exports have been fairly muted (given a weak Europe). Leading indicators suggest that private capital expenditure is improving, albeit gradually. Furthermore, reforms like GST are still a work in progress and we are far from seeing its full benefit on the organized corporate sector. Another important movement on the ground is investments ir infrastructure/logistics. As part of the Make in India program, the government has realized the importance of improving ground logistics. As a result, a fair amount of investment is taking place, which is likely to have a positive impact on GDP once it is completed. That said, the GDP series is likely to be volatile until the next general election.

### The stock market has also performed well. How do valuations look?

Large-cap valuations look reasonable, trading in line with 10-year valuations and with reasonable growth expectations for earnings next year. Small-cap valuations are the opposite: they are trading at around 20% above their historic range and have unreasonable growth expectations embedded in those high valuations.

### What is your current portfolio positioning?

We take a bottom-up, active approach to portfolio construction. We seek to invest in businesses with strong and sustainable franchises that can deliver a good return on capital (far in excess of their cost of capital), and with management teams that respect minority shareholders, have good capital-allocation skills and sound corporate governance.

We have been allocating to large caps over the past 12 to 18 months and continue to find opportunities in this space. We are more constructive on mid caps as the market correction over the past 12 months increases the opportunity set. We have been adding to positions of companies that are fundamentally good businesses but have been out of favor due to internal or external issues. Given our long-term focus, we are able to take advantage of such short- or medium-term market dislocations with these stocks.



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