Multiple Perspectives. One Approach.℠

Taking India's pulse.

The challenges are considerable, but so is the potential.

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In May 2014, Narendra Modi made history when he was elected India's Prime Minister with a significant margin. "Good days are coming," he tweeted. Today, the mood is less upbeat. Impatient with the slow recovery in economic growth and corporate profitability, and the seemingly subdued pace of reforms, questions are being raised about his ability to drive change.

There is no denying that there have been some disappointments. Key pieces of reform legislation pertaining to land, labour and tax have stalled. Bold measures to transform state-run banks are still absent. And Modi has failed to build a strong team of technocrats to implement his vision.

But to be fair, part of the problem is that expectations were too high – perhaps unreasonably so. As chief minister of the state of Gujarat, Modi delivered good governance and believed in responsive and effective government machinery. His actions since taking office have not been very different. It is too soon to write off Modi altogether, given that many of his reforms are long term in nature. Investors who are overly fixated on the short term could miss out on potentially large and enduring gains.

Reforming India, bit by bit

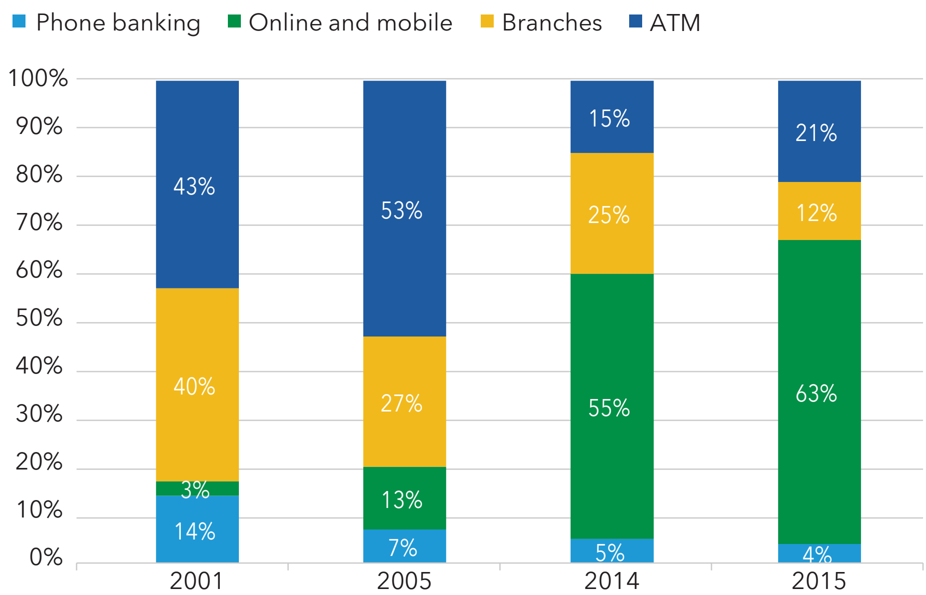
Modi rode to power on the twin planks of good governance and development. Many of his policy initiatives reflect these planks. It is also clear that they mark a major departure from the past and set India on a new course.

Farewell to subsidy leakage and corruption?

One big change is to India's subsidy architecture. The country's massive subsidy programmes often breed corruption and are prone to leakages. To combat these problems, Modi accelerated the issuance of unique identification numbers for all residents and restarted direct cash transfers for the cooking-gas subsidy, which the previous government had suspended after half-hearted efforts. This saved Modi's government nearly US$2 billion in the first year as leakages were plugged.

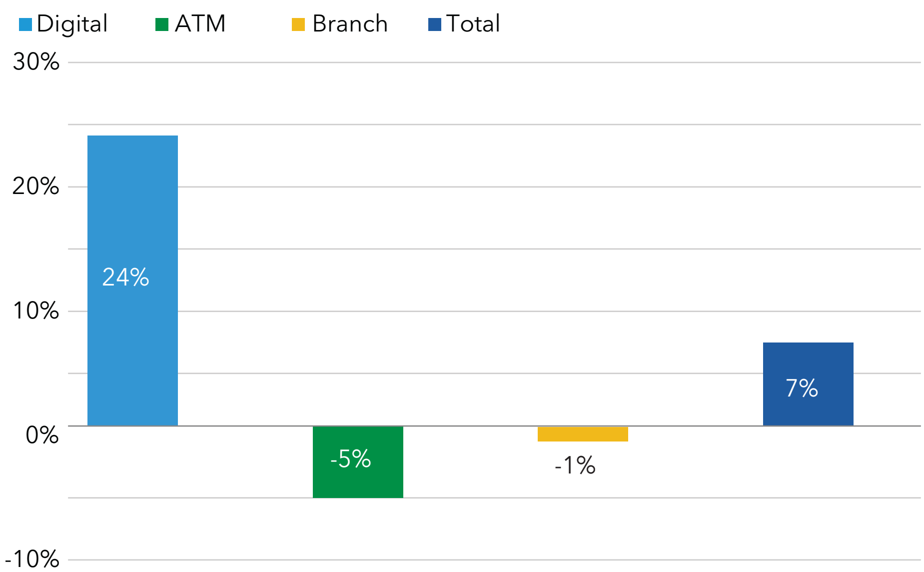
Such targeted subsidy delivery has been made possible with a financial inclusion

Digital banking will determine tomorrow's winners
The changing nature of bank engagement



As at March 2015. Source: HFDC Bank

Year-on-year growth



Note: Data based on the number of financial transactions performed by individual customers. As at June 2015. Source: Axis Bank

plan to ensure that every household has a bank account. Since Modi took charge, 176 million households have opened their first bank account; health and accident insurance schemes, available at nominal cost, are linked to these accounts.

With these reforms in place, the government is now moving towards cash transfer of other subsidies like food. In doing so, it not only tackles leakages and corruption but also eases the heavy subsidy burden, which should help fiscal consolidation over the long run. These game-changing reforms, together with moves to deregulate petrol and diesel prices, could cut India's subsidy bill by about 10% in fiscal year 2015.

Equally important, the old way of doing business is changing. Crony capitalism, a ubiquitous feature of India, has ebbed. Recently, the government, through a transparent e-auction process, successfully sold resources such as spectrum and coal – without any controversy. Contrast that with the telecoms scandal in 2008, and the alleged coal scam between 2004 and 2009. A new law to seize illegally acquired or undisclosed foreign assets is further evidence of the government's resolve to reduce corruption.

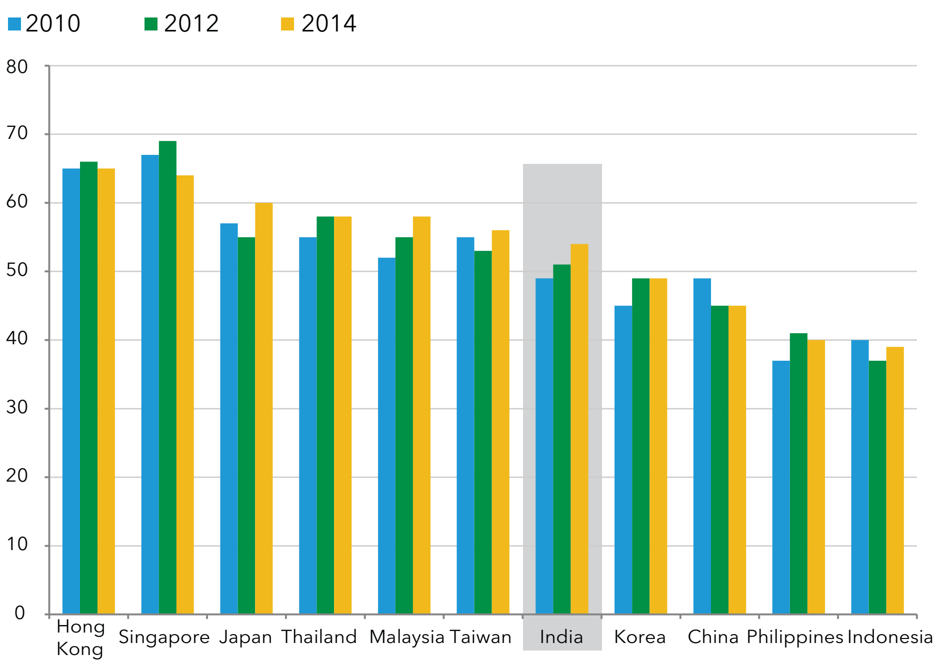
It is worth noting that by building a tightly knit and overtly centralised administration, Modi has been running a corruption-free government for the past 18 months. Whether he stays the course will determine India's trajectory over the next 10 to 15 years. A less corrupt India should result in better allocation of capital and resources and will prove more attractive to foreign investors.

No demographic dividend without investments and jobs

Investments are the engine of economic growth and job creation. Encouragingly, tangible efforts are being made to boost that on the policy and legislative fronts. The private sector is unlikely to kick-start the investment cycle given overcapacity in certain areas, the decline in global commodity prices, and the overleveraged balance sheets of many infrastructure developers, construction and commodity companies. Hence the government has forged ahead with sizeable project spending in sectors like roads, railways and defence.

Taking steps to turn India into a manufacturing powerhouse, the 'Make in India' campaign was launched in 2014 with the goal of raising manufacturing's share of gross domestic product (GDP) from 17% to 25%. A strong manufacturing sector is essential if India is to harness its demographic dividend. Modi's hectic schedule of overseas visits is indicative of his aim to deepen global economic engagement and in turn attract investments in manufacturing.

The governance scorecard: better, but not best



As at September 2014. Source: Asian Corporate Governance Association

On the legislative side, the government has succeeded in increasing foreign direct investment limits for different sectors. It has also ramped up efforts to improve the business climate by cutting red tape, transferring decision-making power to the state level, promoting federalism and competition, and using technology to drive transparency and speed up decision-making. In areas where Modi has failed to amend the law (such as land and labour), the government is urging states to carry out their own reforms and has pledged to be supportive.

As investors, there is one obvious follow-up question: who wins, and who loses? In my view, the chief losers are the crony capitalists; not all will be able to adapt to the new India. Sector-wise, the real estate and gold sectors could face the greatest near-term impact because both have been repositories of 'black money'. By contrast, multinational companies will be big beneficiaries. They will find it much easier to operate if India scraps red tape and lifts its restrictive rules. There are also clear long-term winners in the consumer and financial services sectors thanks largely to rising affluence.

Taking the long view

Reforms aside, investors will do well to remember the longer-term trends in India's favour. One such is demographics. There are two facets to this, namely a young India that is aspirational and technology-savvy, and the emergence of the working Indian woman on the back of greater educational and professional opportunities.

With over 600 million people below the age of 25, this decade and the next offer a golden opportunity to equip India's youth with the right skills and build a strong workforce, thereby reaping the much-touted demographic dividend. There is a caveat for politicians: these youngsters, eager to embrace change, may have little patience with a government that takes too long to fulfil its promises.

Women on the march

The changes affecting Indian women are profound. Long held back by discrimination, they are steadily gaining access to education and jobs in coveted fields such as finance and technology. These changes are expected to accelerate rapidly over the next decade and beyond, giving women a pivotal role in India's economy and its growth.

This is significant because India is home to 586 million women, or slightly more than 17% of the global total. It has 173 million girls below the age of 15, about one-fifth of the worldwide total. Some studies estimate that if Indian women were to achieve the same workforce participation rate as men, the country's GDP could rise by as much as 27%.

The rising participation of Indian women in the workforce could bring wide-ranging and compelling investment opportunities. As women enter the workforce, household income will grow and consumption patterns will change. This is a trend we have seen in many other countries. For example, demand for quality healthcare will rise as families have greater financial wherewithal. Likewise, the need for financial services will expand, while travel and tourism spending will grow.

Another striking trend is the penetration of technology and mobile phones. India is transforming into a networked society at an unprecedented pace. The mobile phone has helped the country leapfrog the fixed-line technology and enabled it to largely eschew the desktop era. The numbers are eye catching: around 6 million new internet users are added monthly – most of them through mobile phones. This technology revolution will have a significant impact on digital or mobile banking and e-commerce, especially as smartphone prices continue to fall with players like China's Xiaomi and India's Micromax in the market.

Caveat investor

India's long-term potential notwithstanding, investors should tread carefully. India can be a dauntingly complex environment to navigate for those without a deep familiarity with its industries, companies, and their dominant shareholders. Corporate governance standards are uneven, albeit improving. The country's bureaucratic maze can also create much uncertainty, though the situation is becoming better.

No surprise, then, that India is a market that favours skilled active managers who can filter the wheat from the chaff. Investors with a passive approach, on the other hand, expose themselves not only to the good but also the bad and the ugly. In fact, studies have shown that most actively managed funds in India have fared better than their passively managed peers.

One important consideration for those keen to invest in India is to look for experienced partners who understand the country and its nuances well, and have access to differentiated sources of information that can help to connect the dots. This will enable them to strip out market noise, discern long-term trends and make informed investment decisions.

Taken together, India is a country particularly suited to those with a long view. The country's vast potential makes it hard to ignore, while its changes offer exciting investment opportunities that the long-term investor would not want to miss.