

Inde: cap sur une croissance portée par les réformes

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- Since Mr. Modi's overwhelming electoral win in 2014, he has aggressively pursued reforms, including recent demonetization of large currency notes, upcoming General Sales tax restructuring, and a new Companies Bankruptcy code.
- While creating short term pains such as cash-crunch in the economy and hurting consumer exposed sectors including staples and real estate, the reforms represent an opportunity for the South Asian country to correct some of the logjams ailing its economy, and set itself on the path of reform-led growth.
- Indian Equities performed flat at best in 2016 (vs. strong performance of peer Emerging Market indices) and compared to their historic valuations they now appear more reasonably valued.
- The current attractive valuations represent a unique buying opportunity in sectors including Auto, Media, Energy and Financials.



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"While the given diary of Indian reforms brings short term pains, in the long term they are likely to have positive impacts on growth. Our bottom up views are constructive on selected sectors and companies, with a focus on self help stories that can sustain policy pains."

Key reforms: short term pains

Demonetization is a latest key reform and perhaps a black swan event for many. On November 8th, India's Prime Minister Mr. Modi announced that Rupees 500 (equal to \$7.37) and Rupees 1000 (equal to \$14.74) notes will cease to be a legal tender on 30th December. He simultaneously announced issuance of new Rupees 500 and Rupees 2000 banknotes, in exchange of the old banknotes. Official rationale was to curtail the shadow economy, and crack down on the use of illicit and counterfeit cash to fund illegal activity and terrorism. Estimated 86% of the total money supply of Rupees, holders were told to either exchange them with new notes or deposit at banks. This created a wide spread chaos in a country where 80% of villages do not have a bank. Business disruptions were reported with day-to-day transactions suffering from a dramatic currency shortage. Discretionary sectors suffered a c.40% YoY drop in sales during November-December period. On the positive side, massive amount of funds are reported to have flown to banks, significantly pushing the deposits rate higher. What remains to be seen is the progress on essential policy goals including uncovering tax evasion, cracking down on graft, fake currency notes and black money in a country where black economy represents circa 20% of the total \$2.1 Trillion GDP (nominal, 2016).

A key reform expected in 2017 is the restructuring of General Sales Tax (GST), in a drive to do away with an outdated and muddled scheme of multilayered taxes across Indian states. We view this as a positive. A standardized tax regime will reduce bureaucratic tangles and improve the 'ease of doing business' in India. Being able to cover larger domestic activity under the tax umbrella will allow Indian Government greater fiscal capacity for development needs.

Another structural reform program in the making is a new companies bankruptcy code, that will help banks more conveniently recover bad debt from distressed companies. Ideally loan growth should be sustained with this step.

Behavioral changes

Some note worthy behavioral changes are underway, resulting from the latest wave of reforms.

A key positive side effect of demonetization and perhaps a game changer is the acceleration in behavioral shift towards formal and digital economy in a largely unbanked country. It is estimated that only circa 30% of Indian population is banked. India's drive towards becoming a 'cash-less society' might seem overwhelmingly far fetched, but not impossible.

Implications for Indian Equities

With corrections post demonetization mostly concentrated in consumer sectors including Staples and Real Estate, India's broader indices finished 2016 largely flat, underperforming peer emerging markets including Pakistan, Russia and Brazil. Historically an expensive market with some 20% premium over developed markets, Indian equities now command a c.10% premium. MSCI India now trades at 13.5x 2018E earnings, versus an average 14.5x forward one year earnings valuation that the index has traded over the past decade. Putting the historic premium valuation into perspective, Indian Equities have delivered historically better earnings growth compared to both developed and emerging market peers. Lately, even after the EPS cuts consensus EPS expectations are for a 19% growth in 2017, versus 14% for MSCI EM.

Notwithstanding the ambiguity of the growth shock caused by the demonetization, and the confusion surrounding various reforms during the coming quarters, we expect the demonetization related liquidity crunch to be limited to a few quarters, and expect the Indian equities to start outpacing peer emerging markets on their rebound during the second half of 2017. A recovery driven by constant growth in EPS, especially from sectors including Media, Energy, Utilities and Auto.

Lastly, the recently released Union Budget has turned out to be fairly balanced (vs. previous fears of a populist Budget) and provides continuity to Narendra Modi's economic policy direction. With no long term capital gain tax on the Indian equities, it is clearly encouraging for the asset class. It is also reassuring for selected sectors such as Banks, which will benefit from various stimuli for rural masses, incentives for affordable housing, and goals to increasing overall credit creation in the country.

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