Business Standard

A week with investors

India is well-positioned to benefit from a slowing China, provided it drives a growth and reform agenda

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I had the opportunity to spend a week in the US, attending conferences and meeting with global allocators. It was an interesting time to be meeting with investors. India had just announced the tax cuts and the UN general Assembly session was on in New York. The following are my takeaways as far as India goes.

1. There was strong interest in India, and in trying to understand the current situation. Most were pleasantly surprised by the tax cuts —not something they had expected from the Indian government. Questions were asked as to why a corporation tax cut, and not more focused demand creation measures. Most were intrigued as to why the authorities had not announced a middle-class tax cut or cuts in duties on certain goods and services. India is not known for being extra friendly to large corporations, MNCs and highly profitable companies, the main beneficiaries of these tax cuts. Some asked as to how companies will use the tax cuts and increased cash flows. As is well known, in the US, companies mostly pay out a tax windfall through higher buybacks and dividends. Investors were keen to know why Indian companies were different. There was excitement over potential further reforms. Strategic sale of government assets was seen as a big positive, as was talk of simplifying personal tax rates. Most felt that India still remains a very complex place. Lots can still be done to make it easier to do business in the country.

2. Most allocators accepted that India was at the bottom of the economic cycle. Five per cent GDP growth should be as bad as it gets. With both the fiscal and monetary policy levers now being pulled, the economy should begin to recover. It is also going to be one year since the NBFC crisis. The effects of the credit crunch will soon be in the base. Only a few thought that growth will not improve in calendar year 2020 . The fiscal was a concern but most felt the trade off, to risk a higher deficit to boost growth, was worth it. Every investor felt that the current posture of the Reserve Bank of India (RBI) to give equal weight to both growth and inflation was the right approach. A Fed-like dual mandate approach was much preferred to an ECB-like obsession with only inflation exhibited in the past.

3. There was concern as to why corporate profits have disappointed so significantly in India. Many asked as to whether there was some kind of paradigm shift driving lower corporate profitability in the country. Will there ever be regression to the mean? Everyone had seen the data or heard the numbers from India fund managers. In 2008, corporate profit-to-GDP in both India and the US was similar at about 7.5 per cent. Today, the same number in the US is over 10 per cent, while in India the profit share has collapsed to under 3 per cent. The tax cuts will drive an earnings upgrade, the first in over seven years. Investors accepted that the profit share cannot keep dropping. Most were willing to believe that we will see a period of strong corporate profits once the economy revives.

Illustration: Ajay Mohanty

4. Though investors were willing to accept that both the economic and profit cycle had bottomed for India, the concern holding them back from adding money to the country was valuations. Looking at India from a top-down MSCI index perspective, the market was simply not cheap enough. Neither on an absolute basis, nor when compared to the broader emerging markets universe. Only a few were aware of the damage to stocks, below the surface. The mid-cap indices are down 30 per cent, from their peak in January 2018, with small-caps down 40 per cent. Quality trade has gone to an extreme, with a large portion of the market now simply seen as uninvestable. The price damage in selected stocks and sectors has been simply breath-taking. Many stocks are falling on low volumes in the absence of buying. If global allocators can be convinced that once they go beyond the top 50 companies, the Indian market is actually reasonably priced, I would expect significant inflows. Valuation remains the single biggest pushback to increasing India weights.

5. There was deep disappointment over Indian corporate governance. Many were shocked with some of the recent instances of promoter fraud, leverage and balance sheet irregularities. Some of the disclosures in the financial services space in particular were deeply worrying. What were the auditors, rating agencies and regulators doing? The governance premium has increased and will continue expanding as more governance weaknesses are exposed. Allocators have been surprised by the extent of share pledges. Many argued India cannot be among the most expensive markets in the EM world with this level of governance.

6. Many allocators were aware that India was going through a clean-up of sorts, with many of the weaker companies and promoter groups being allowed to fall by the wayside. Most recognised that such a clean-up slows growth initially as the system adjusts. However, as the strong get stronger and gain share, the quality of growth improves and the economy recovers. Most also recognised that India has gone through a series of economic shocks over the past four years. First demonetisation, then the goods and services tax followed by the NBFC crisis. Thus the economy has not had the time to recover. Hopefully over the coming years, we can get back to a more normalised environment, and deliver our potential.

7. Most investors were surprised by the ferocity of the NBFC crisis. It truly has been a mini-Lehman moment for India. The crisis has effectively wiped out the business model of most of the wholesale players in the space. The cost to the economy has been enormous. Most blame the current slowdown largely to the funding challenges faced by NBFCs. Given the trust deficit, allocators felt that the RBI would have to provide comfort to investors on the quality of the underlying NBFC book. No one other than the RBI, they felt, could provide the comfort investors need to invest in the space. The only way the system will clear is by attracting private capital. Private capital has no trust in the rating agencies or auditors and needs comfort on the credibility of the disclosed asset quality and numbers. Only the RBI can break this knot. The dislocation obviously helps the two or three stronger NBFCs and the banks, as consolidation in the space is inevitable.

8. Most allocators were convinced that the tension between China and the US, was here to stay, irrespective of who is in the White House. Consequently, China will slow, and its economy has seen its peak growth. As it slows, at some point the leverage issues will surface. Most allocators were looking to increase their investments in Asia ex-China.

India has a real chance to attract flows over the coming year. Investors understand that both growth and earnings have bottomed and few are overweight the country. Allocators are looking for growth in a slowing world. Most still believe in the country's long-term potential. We are well-positioned to benefit, if we can only stabilise, not have another blow-up and be seen to drive a growth and reform agenda.

The writer is with Amansa Capital