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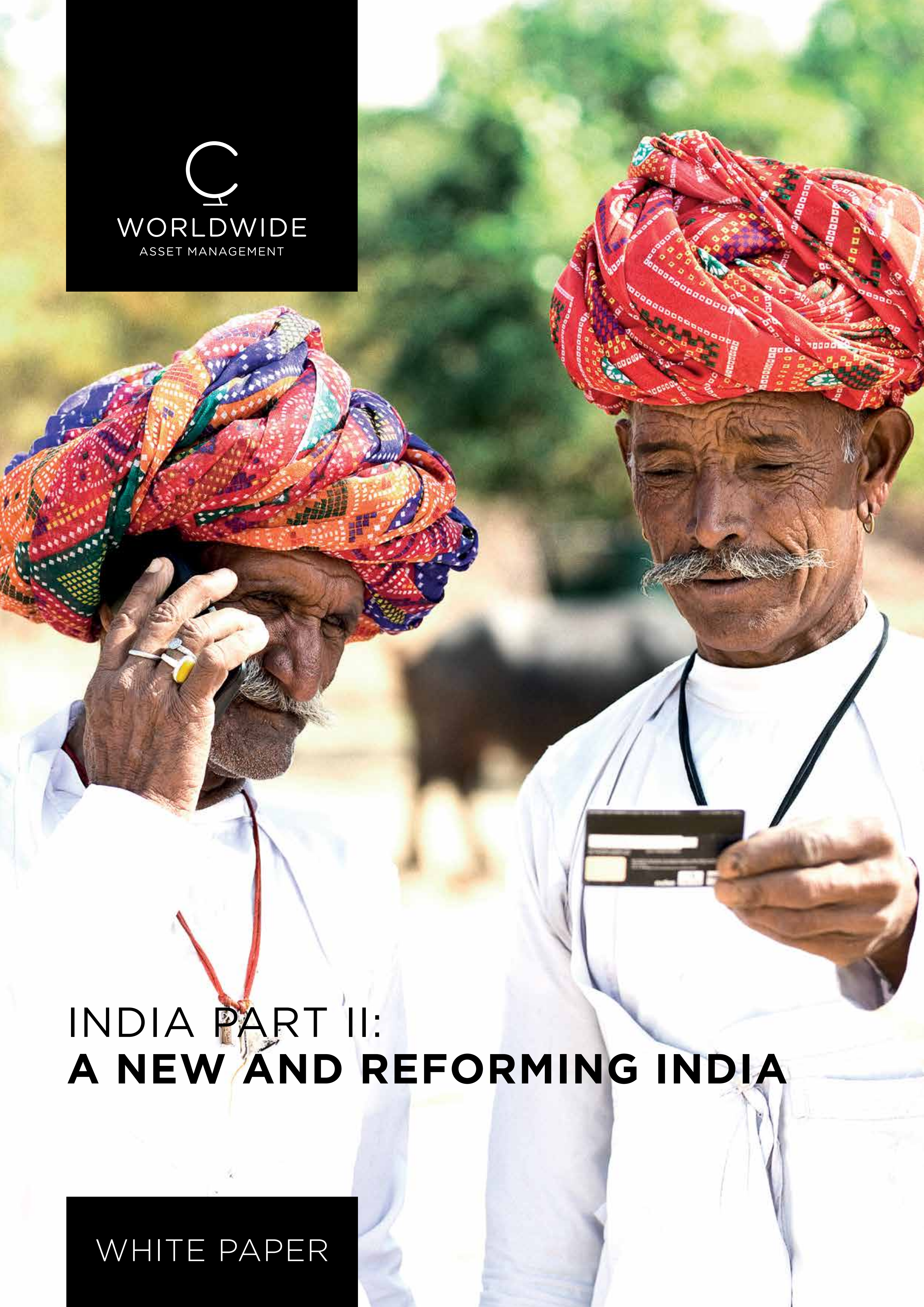

INDIA PART II:
A NEW AND REFORMING INDIA

WHITE PAPER

A New and Reforming India

By Portfolio Manager Abhinav Rathee, C WorldWide Asset Management.

Executive summary

Never in the history of modern India has there been more reforms enacted over a 4-year period than since Prime Minister Modi took charge in 2014. Some of the biggest initiatives that will define the future of the country for decades to come have been implemented over the last 48 months. Insolvency and Bankruptcy Code (IBC), Monetary Policy Committee (MPC), Goods & Services Tax (GST), Jan Dhan, Universal Identity/Aadhaar (UID), Demonetization, Housing for All and Real Estate Regulatory Act (RERA) are some of the key reforms to have been implemented. Any major reform is essentially a shake-up of the status quo. Therefore, it tends to induce short to medium term pain to the economy, and it has also this time, but the underlying strength of the economy (an average GDP growth of 7.3% during this period) has made it more bearable. India has been the fastest growing major economy for 3 years in a row now despite the headwinds created by the reforms.

"If you do not change direction, you may end up where you are heading"

Lao Tzu

The Big-three

There have been numerous reforms that have been implemented but none that are more important than the 1) Bankruptcy Law (Insolvency and Bankruptcy Code 2016), 2) MPC (Monetary Policy Committee) and 3) GST (Goods & Services Tax).

1) **Insolvency and Bankruptcy Code, 2016, or Bankruptcy Law**

Innovation is incumbent on nations that aspire to break the shackles in order to make a quantum leap forward. Innovation also means rising entrepreneurship but that inevitably implies a higher degree of risk and hence failure. India has always lacked a robust system which could handle business failures more efficiently. With the new Bankruptcy law, India now has both the means and capacity teeth and bite for it.

> **The new law provides an effective time bound resolution to manage bankruptcies.**

Until 2016, it was nearly impossible for the banks to effectively resolve their persistent Non-performing Assets (NPA) problem. This made banks inherently risk averse towards funding newer ideas or entrepreneurs. A businessperson needed one of the following three traits for funding: 1) an impeccable track record over a long period of time, 2) an ability to manipulate the system a.k.a. crony capitalism, and 3) the ability to secure high cost equity funding from friends/family/VCs. With the new law in place life doesn't change much for the 'impeccable' companies (although over time it does provide a better ecosystem), but it is a form of death knell for the 'cronies' and a boon for the 'real' entrepreneurs.

The existence of these "cronies" made it a habit to borrow sums of money so large that their survival became the bank's problem. The story has repeated itself every 10-15 years through cycles. This stops now. The new law provides an effective time bound resolution to manage such bankruptcies. Banks are now empowered to resolve them either through liquidation and/or sale of the businesses.

Under the previous system, the defaulting owners continued to run the businesses as they saw fit despite the delays and defaults, while all that the banks could do was helplessly request repayments. Under the new bankruptcy law, banks can take over the assets thereby disposing of the erstwhile owners. Insolvency professionals, under the de facto ownership of the banks, take over the assets and day to day running of the company until a resolution is reached through special courts.

Over time these measures will instill confidence amongst the lenders and make them more open towards new ideas and businesses backed by good intentions and sound logic. This will encourage risk taking and innovation by providing competitive funding.

As per the finance ministry, since the law has been enacted special courts have recorded a total of 1322 cases totaling to USD 60 billion; 66 resolved and 260 ordered for liquidation. This has helped settle around USD 29 bn and recover USD 11.3 bn. The top 40 cases have been prioritized which constitute nearly USD 60 bn in debt.

The credit culture is changing fast – lenders no longer chase debtors, it's the other way around now!

2) Monetary Policy Committee or simply MPC, 2016

Inflation has been a persistent problem for India as it is for many other emerging economies. India's monetary and fiscal policy objectives were often at odds with each other. The politicians in the government favoured a loose fiscal policy to please voters whereas the central bank struggled with the consequences of higher inflation. Therefore, it meant that a period of inflation always followed a period of strong growth, sometimes rendering real interest rates negative. India's central bank, the Reserve Bank of India (RBI), had always done a good job of managing this but could never break the cycle because the fiscal and monetary policies were seldom in sync. India remained in the 7-10% inflation band which rendered borrowing costs high for all kinds of borrowers including the government. If the cost of funds is seen as a raw material for business activity it also adds to inflation in the long run as the prices of goods incorporate a higher cost of capital.

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Furthermore, the RBI's policy objectives were unclear. Sometimes it was inflation, other times it was the currency and reserves. The Monetary Policy Committee (MPC) defines it now.

Under the MPC, the RBI's primary objective have been defined as keeping inflation at 4% with a range of +/- 2%. The Committee has equal representation with the government and the RBI. This ensures that there is greater coordination between fiscal and monetary policy as both the RBI and the government are on the same page, by law. Transparency is also ensured as the minutes of the meetings are subsequently made public with an adequate delay.

The MPC has already made a positive impact. India's inflation band has structurally declined down from a 7-10% range to a 3-5% range. Forex reserves are now a healthy USD 400 bn (vs USD 260 bn in FY13) and the fiscal deficit is seen at 3.4% for FY19 (4.9% in FY13). With the passage of time this will bring down real interest rates and positively affect asset prices in the economy.

3) **Goods & Services Tax or GST, 2017**

GST is the single biggest tax reform in the country, historically. GST means 'one nation, one tax' and this positively impacts the economy in multiple ways – greater formalization, improved ease of doing business, speedier movement of goods and removal of administrative bottlenecks. More importantly, it changes the country at a very fundamental level of resource mobilization because it enhances the federal structure of a diverse country.

India is made up of 29 different states and 7 union territories (quasi-states). Some of these states have nothing in common except being Indian and hence different priorities at different times. In the pre-GST era, tax collection was decentralized (collected by states and center separately) but government spending was centralized (New Delhi made the important spending decision for the entire country). GST reverses this on its head. Under GST, tax collection is centralized but spending is decentralized as states enjoy greater financial autonomy.

Pre-GST, there were approximately 1200 tax slabs which are now subsumed under one simple GST with 5 tax brackets of 0%, 5%, 12%, 18% and 28%. Often various business needs of warehousing and manufacturing were guided by tax management rather than business needs. Trucks would wait for hours, if not days, every time they crossed over from one state to another as the tax regime changed. All that changes with GST. Truckers now cover more distance every month than before. ASSOCHEM, an industry body in India, believes that India's logistics costs are 14% of GDP vs a desirable 8% – GST helps address that. Companies are rationalizing their warehousing and manufacturing units thereby improving productivity.

Most importantly, GST has stirred the hornet's nest of the tax-evading informal economy. The government estimates 87% of firms (constituting 21% of the gross industry revenues) in the country are a part of the informal economy. More and more businesses are now forced to comply with the tax laws because tracking has become easier while tax evasion has been made that much more difficult. Since inception, the number of tax returns filed by businesses and the registered tax payer base has surged by 250% and 50%, respectively. Clearly India hasn't added these many new businesses in such a short time – it is greater compliance.

Additionally, the prices for many products and services have come down due to the standardized tax brackets. The gains from this will flow down to the consumer and the economy at large.

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The other major reforms

There have been many other noteworthy reforms and initiatives taken by the government over the last 4 years apart from the Big-three reforms explained above.

Demonetization

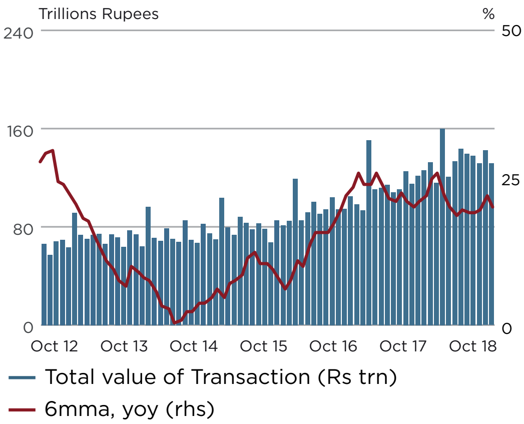
In an audacious move, in November 2016, that shocked and surprised the world, India banned Rupees 500 and Rupees 1000 notes as legal tender which is now commonly known as

Demonetization. This constituted nearly 86% of the currency in circulation. It was a move that made the skeptics believe that it would cripple the impending economic recovery. But it was not the case. The economy recovered almost fully within 6 months while demonetization left a positive impact on tax collection and financial inclusion.

The benefits of this initiative were enjoyed by the financial services industry. The inflows of deposits for the banks meant higher fee income growth. Banks sold mutual funds, insurance and other investment products in hordes. Importantly, the spending behavior of consumers has changed from conducting transactions in physical currency to electronic/plastic currency (through debit/credit cards, mobile wallets, payment systems, electronic transfers, etc. – see figure 1). India is rapidly transitioning towards being a cashless society.

Figure 1

Sustained growth in digital transactions



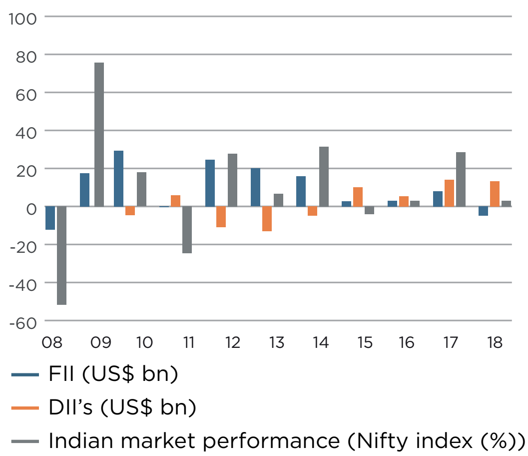
Source: IDFC Securities as of Nov. 2018

Demonetization brought a wave of deposits to the banking sector. Part of these deposits were channeled into various financial products but most notably towards the mutual fund industry. This resulted in stronger than ever inflows for the Indian domestic mutual fund industry. Even as Foreign Institutional Investors (FII) sold around USD 4.4 bn in 2018, the Indian equity market held up because of active buying by domestic investors.

To put this in context, the last time FII sold Indian shares was in 2008 and the markets cracked by over 50% (as shown in figure 2 below). Domestic Institutional Investors (DII) did not have the financial means to participate in the 2008 market rout but they do now – with monthly inflows in excess of USD 1 bn per month. As a result, MSCI India outperformed the MSCI Emerging Markets Index by 7.4% in 2018.

Figure 2

DII absorb recent selling pressure from FIIs



Source: IDFC Securities as of Dec. 2018

Pradhan Mantri Awas Yojana, or, Housing For All

It would be somewhat obvious to state that India has a major housing shortage. One simply needs to drive around the country to witness the growing seriousness of the problem. The government has estimated that the housing shortage amounted to 29.5 million rural and 20 million urban homes. For the first time, the government has put together a comprehensive policy to identify and address the problem.

Under the rural housing program, the government provides an upfront grant and subsidizes the loan for construction of the house which is then 'geo-tagged' for tracking the progress. By March 2018, 10.7 million homes had been constructed in 36 months. The target for an additional 10 million by March 2019 seems achievable especially since 10.7 million new applications were already registered by June 2018.

Under the urban housing program, there are different sets of schemes from slum redevelopment to new construction. Families looking to utilize the benefits are categorized under different economic strata and their principal and interest subsidy is linked accordingly. It has required greater participation from the private sector and the growth in recent quarters has been very encouraging. All major and some minor developers are now actively running portfolios of projects under this scheme.

A boost to the housing market has a multiplier effect on the economy and job creation. It also has a direct impact on sectors such as steel, cement, tiles, paints and other building materials as well as financial services. As per the leading mortgage financier, mortgage penetration in India is still at a mere 10% which is amongst the lowest in the world.

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Real Estate Regulatory Act, or, RERA

Any reform in the housing sector would be incomplete without an effective regulatory framework. In aggregate, Indians possess approximately 54% of the USD 8.5 trn household assets (~3x GDP) in real estate but until recently there was no mechanism which protected home buyers (ironically, only 16% of the household assets are held in the form of bank deposits but that is very effectively regulated by the RBI). Given the fragmented nature of the industry, it was common to hear stories of long delays, fraud, land grabs, poor construction, developers defaulting et al. from the buyers. RERA aims to bring discipline amongst developers and to protect the interests of home buyers.

We believe this is a game-changing reform in the sector and will bring about a much-needed consolidation in the industry (the largest developer in the country has under 2% market share). After the initial adjustment phase, revival in the real estate sector seems imminent. Also, affordability is the highest in recorded history and accordingly pre-sales volumes are at a 5-year high.

"E-governance is easy governance, effective governance, and also economic governance. E-governance paves the way for good governance".

Narendra Modi

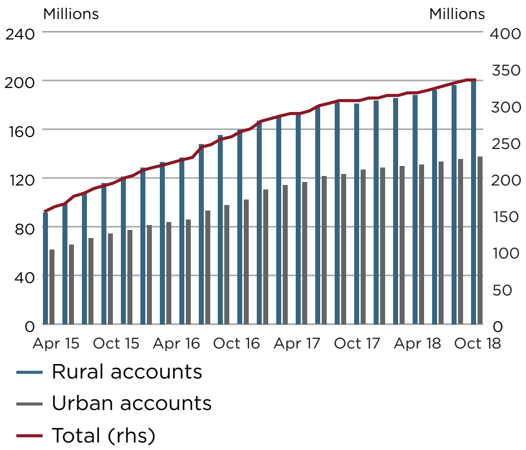
Inclusion is the future - The J-A-M Trinity

One of the biggest feats achieved by India in recent times is the integration of three important initiatives into a neatly woven trinity with the aptly named acronym J-A-M. J stands for Jan Dhan Yojana or Banking Accounts for the Poor (Financial Inclusion), A stands for Aadhaar or the Universal ID/Social Security Number (social inclusion) and M stands for Mobility (Digital Inclusion).

In 2014 the Government announced the Jan Dhan Yojana program whereby every poor person should have a bank account even if it meant an empty one without an income source. The enrollment was a big success with nearly 350 million new bank accounts being opened since launch of the program which added USD 12 bn (~0.45x the GDP) to the banking system's deposits – see figure 3. During the same time, Aadhaar achieved over 95% penetration levels. In a country with the lowest telecom tariffs in the world almost everyone owns a mobile phone – see figure 4 and 5. Such high penetration levels across bank accounts, Aadhaar and mobile phone connections meant that they could be interlinked now. It made policy implementation easy and effective. The government now uses this linkage to directly transfer benefits such as subsidies, grants, entitlements, refunds and scholarships directly to the intended beneficiaries through the Direct Benefit Transfer or DBT Scheme.

Figure 3

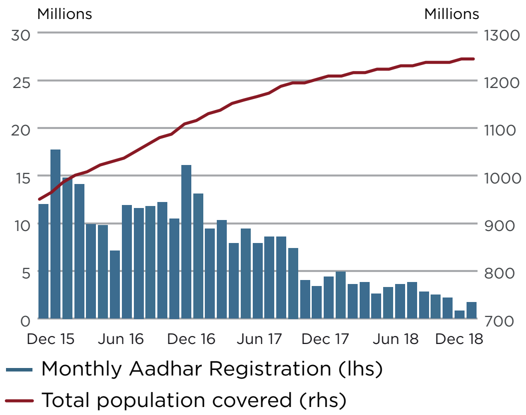
Jan Dhan Accounts



Source: IDFC Securities as of Dec. 2018

Figure 4

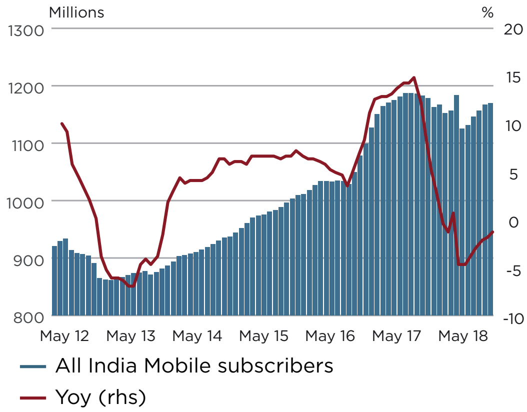
Monthly Aadhaar Registrations



Source: IDFC Securities as of Dec. 2018

Figure 5

Mobile subscribers



Source: IDFC Securities as of Oct. 2018

In the early 1990s the then Prime Minister of India Rajiv Gandhi famously said that for every dollar spent on the poor only 10 cents made it to the beneficiary. The rest was the leakage in the system as the benefits traversed through intermediaries. DBT has now changed that.

In a short span of time DBT has made important contributions:

- Leakage in the system plugged - DBT savings are estimated to be around USD 13 bn (0.5% of the GDP)
- 85 mn users removed from the beneficiary list across two key ministries alone – fake accounts, surrendered, dead/migrated
- Over 4x increase in the number of beneficiaries – increased from 108 mn in 2013-14 to 463 mn in 2017-18
- Covers 485 schemes across 63 ministries
- Examples of targeted schemes launched: Ujjwala 53 mn new free cooking gas connections for the poor; Mudra – 48 mn loans for micro enterprises to boost entrepreneurship sanctioned last year

This has also helped strengthen credit offices and improved the ease of verification for credit requests. The time taken to approve loan applications has dropped from 3-4 days to under 10 minutes.

This has expedited the shift from unorganized loan sharks to formal lenders boosting system level productivity and greater financial inclusion.

Impact

It is clear that some of these reforms and initiatives will shape the future of the country. Reforms are already beginning to bear some fruit now. As per the World Bank's Worldwide Governance Indicators (WGI), India stands out amongst its peers and the region – see figure 6.

Figure 6

WGI Ranks

Indicator	Country	Year	Ranking (100-percentile is best)
Voice and Accountability	Upper middle income	2012	49
		2017	48
	South Asia	2012	33
		2017	37
	India	2012	61
		2017	60
Government Effectiveness	Upper middle income	2012	52
		2017	51
	South Asia	2012	36
		2017	37
	India	2012	49
		2017	57
Regulatory Quality	Upper middle income	2012	48
		2017	49
	South Asia	2012	27
		2017	31
	India	2012	35
		2017	42
Rule of Law	Upper middle income	2012	48
		2017	48
	South Asia	2012	34
		2017	37
	India	2012	53
		2017	53
Control of Corruption	Upper middle income	2012	49
		2017	48
	South Asia	2012	32
		2017	34
	India	2012	37
		2017	49

Source: World Bank as of Nov. 2018

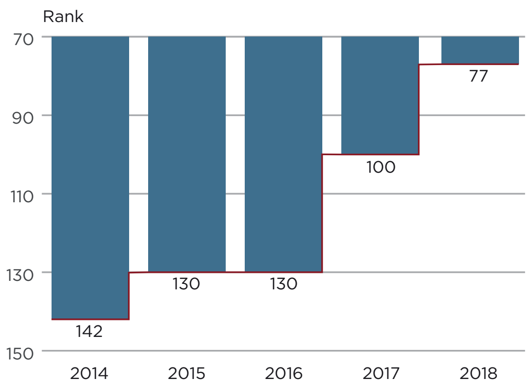
The improvements seen over a 5-year period have been significant and today the country's Governance indicators are at levels comparable to countries that are much more developed.

> **Some of the biggest initiatives that will define the future of India for decades to come have been implemented over the last 48 months.**

These improvements evidently have a positive impact on business sentiment. India has been the biggest gainer this year (and last year too) in the World Bank's Ease of doing business rankings. This is the biggest jump by any country in 2 years. In 2017, India's Ease of doing business ranking improved from 130th to 100th – a 30 rank improvement – as shown in figure 7 below. By 2018, this was bettered by another 23 ranks to 77th. The government's plans are to be in the top 50 by the end of 2019.

Figure 7

India's ease of doing business ranking

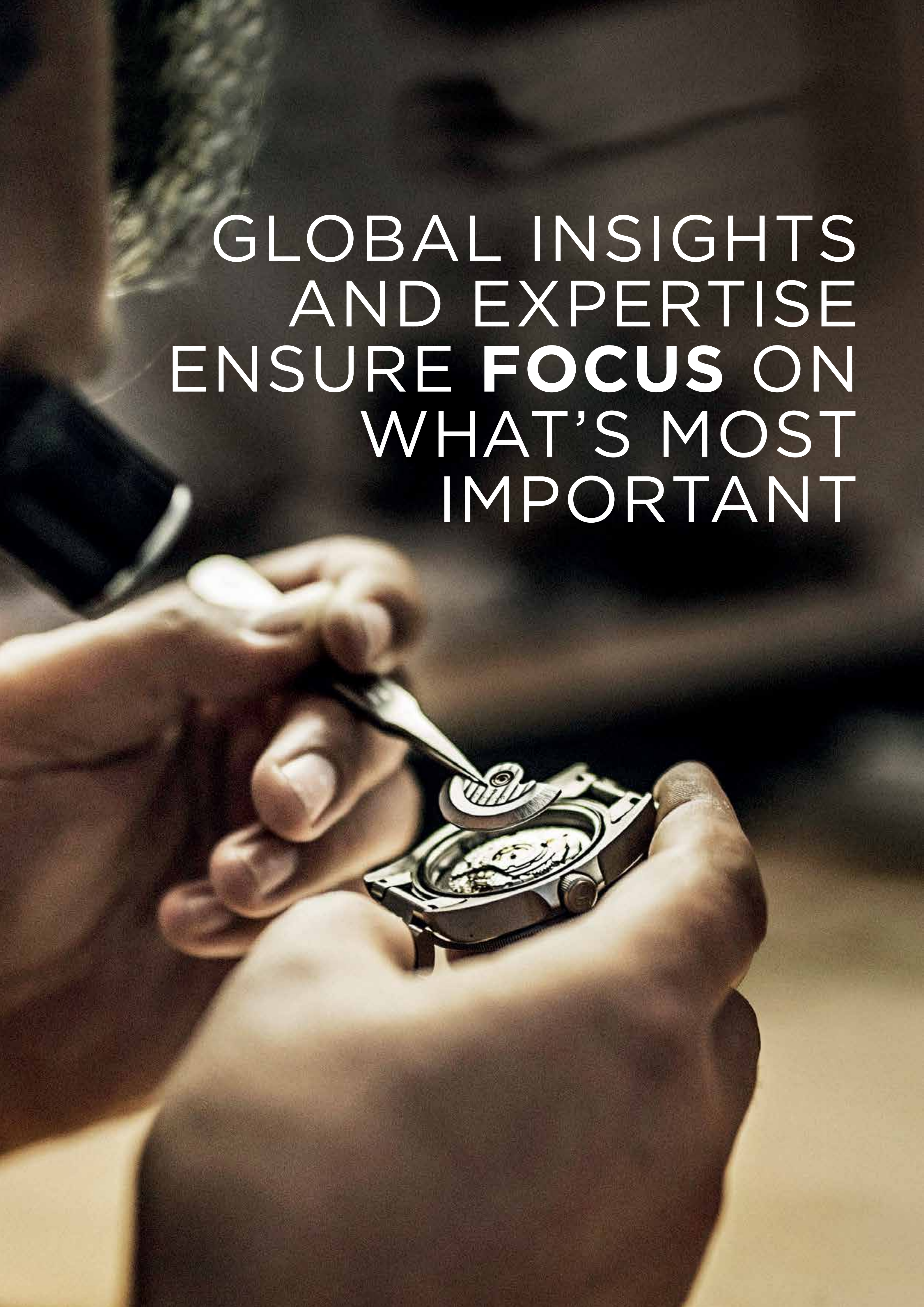


Source: World Bank as of Nov. 2018

Conclusion

The trend is quite clear. In the next decade India will stake its claim in the global economic landscape. From a USD 2.6 trn economy now, it is on course to become a USD 5 trn economy by 2025. The volatility due to short-term issues such as elections, oil and other external factors should be viewed as an opportunity to invest in India. The tailwinds from the reforms will provide investment opportunities across three broad themes of – Financial Inclusion, Formalization and Housing. We must judiciously participate in this long-term opportunity called "India". We see India as a structural growth opportunity and potentially the best investment opportunity of the coming decade.

GLOBAL INSIGHTS AND EXPERTISE ENSURE **FOCUS** ON WHAT'S MOST IMPORTANT



C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S
Dampfaergevej 26 · DK-2100 Copenhagen
Tel: +45 35 46 35 00 · Fax: +45 35 46 36 00 · VAT 78 42 05 10
cworldwide.com
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