India bull run part I: Structural changes propelling India toward multiple-year bull market

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In many of our previous posts, we have pointed out the case for Indian equities.Some of the focus has been on macro aspects, some on reforms and the rest on market trends. In this post, we highlight the structural changes that are propelling India toward a multiple-year bull market.

We recently spoke with Ridham Desai, who heads Morgan Stanley's India Equity Research. Desai recently made headlines when he said "India's market can triple in next five years." We agree with Desai on his bullish outlook for India, and in our opinion India's earning expansion and equity inflows will be propelled by two fundamental shifts in the economy.

In this post, we cover change #1, the structural fixes that the government made over the last few years. In our next post, we will cover change #2, the surge of investments in equities by domestic investors over the next few years, something that Desai brought up.

Source: WisdomTree 30/06/2017

Top structural shifts with long-term benefits

Over the last few years, the Modi government has laid the foundation to revamp India's economy. This includes:

Indirect taxation overhaul: Goods and Services Tax (GST) bill

- This is one of the biggest tax overhauls done by any nation and will have a far-reaching impact on the economy.
- Under the country's federal taxation structure, businesses previously had to keep track of a laundry list of taxes as they move from state to state. This meant serious inefficiencies in the system and encouraged tax evasion, especially by smaller businesses that found evading taxes easier than reporting.
- On July 1, India brought all of its 29 states and seven union territories on board and implemented what is called a GST. In simple terms, this is unification of a taxation regime and the taxation of all goods and services under just two roofs—State and Central.
- This implies easier tax policy, which would lead to higher tax reporting and auditing and would bring the entire country under one tax ambit.

- India's economic expansion can go up by 1% to 2% because of the increased efficiency in the system1.

Digitisation everywhere

- One of the biggest hurdles for India's growth has been its untracked informal economy, which constitutes roughly 85% of its $2.4 trillion GDP2. We live in the age of data, and a lack of data makes it difficult to improve an existing system.
- India is on the verge of completing a digital biometric (retina scan and finger print) system called Aadhaar. This will be mandatory for all the ways in which an individual interacts with the overall economy. From opening a bank account to filing a tax return, this unique identifier will be needed for everything.
- For a country as large as 1.2 billion people3, this means zillions of data points over the next few years for machine learning algorithms, making India a diamond mine for data analytics.
- This also means much more targeted responses by the government, from directing subsidies to the needy to catching the corrupt.
- In addition, a push for digitisation in governance for banking has implied cleaner and transparent work in the public and private sectors.

Financial sector reforms

- India has been liberalising its economy by opening up various sectors to foreign investors and introducing various reforms. However, one area that deserves special attention is the Financials sector.
- Over the past few months, the government has implemented a host of Financials sector reforms, implementing a bankruptcy code, merging foreign direct investment (FDI) and foreign institutional investment (FII), mandatory banking under a public welfare scheme and balance sheet cleanup programs.
- **Bankruptcy code:** Enables a faster exit mechanism for banks when loans go bad. With confidence in the liquidation process, banks can now lend more comfortably, leading to credit growth. A bankruptcy code also helps in restructuring existing bad loans. I expect credit expansion driven because of this increased confidence.
- **Merging FDI and FII:** By merging individual caps for FDI and FII investments in banks into a composite cap, the Indian government has created room for foreign investors to invest in FIIs or liquid equity/bond markets.
- **Mandatory banking:** Called Jan Dhan Yojna in Hindi, this is a push by the Modi government to include everyone under a formal banking system. As of the last data from January 2017, about 270 new million accounts had opened and flushed India's banks with 665 billion rupees of liquidity4.
- **Balance sheet cleanup:** Reserve Bank of India has been working actively with banks to stress test, identify and restructure bad assets, making India's banks healthier.

Conclusion

Each of the steps above indicates a fundamental shift in the way the Indian economy has behaved in the past. These structural changes will be propellers that accelerate India's economic engine, which has just started to warm up.

Since India grew 6% to 7% for the last decade with a mere 3% of its employable population paying taxes, with 85% of economy untracked, with banks having no hope of recovering assets gone bad and with more than half of the population having no bank account, it is not difficult to guess how the country will grow after all of these parameters change forever.

1 NCER, Morgan Stanley, as of 30/06/17.

2 World Bank, as of 30/06/17.

3 World Bank, as of 31/12/16.

4 Government of India, as of 30/06/17.

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