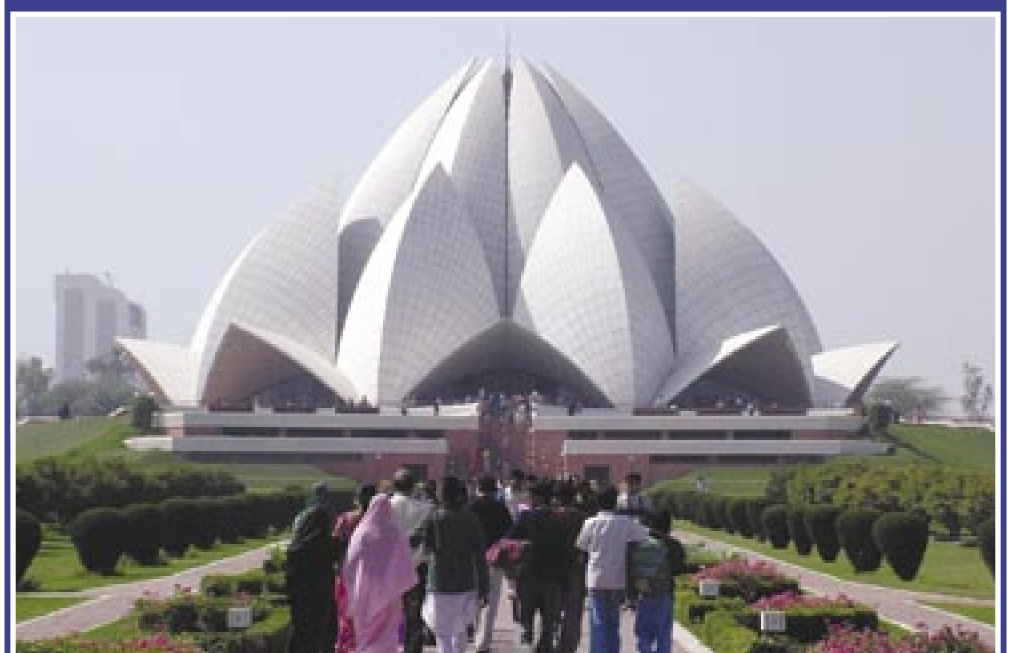
India raises its status on the global stage



Vipul Mehta explains why India is rapidly becoming an attractive alternative to China and how it could even outshine the UK and US in the global marketplace

Over the last few years, India has attracted considerable attention in the political and cultural, as well as the financial world. It was about a thousand years ago that India was the most powerful economy in the world and it now seems to be taking the first steps towards following China as the second emerging superpower in the world. A strong investment case for India flows from the strong and sustainable economic growth, which, combined with the profitability-focused Indian corporate world, has resulted in commendable returns both for the direct investor as well as the portfolio investor.

Growing economy

An endless list of problems since independence caused Indian economic growth to average below 5% right until 2000. It was only in the current decade that the seeds of liberalisation sown in the early 90s started bearing fruit and the economy started growing at about 8%. A remarkable transformation from an agri-economy to a services-oriented economy should ensure sustained and non-cyclical growth of above 7.5% for the next few years. A lot of this current and future prosperity could be attributed to the "young" demographic profile of the Indian population, with 65% of the population being "economically active" in the year 2015. A number of GDP growth drivers seem to be firing at the same time and they include:

- Huge spending on the currently appalling infrastructure
- Surging corporate capital expenditure on increasing capacities
- An exponential rise in consumer spending
- Strong momentum in outsourcing
- A revolution in agriculture

If these were not enough, the new drivers emerging to further speed up the economy include unprecedented spending on organised retail, and huge demand for and development of real estate and supply chains and logistics.

Soon India will touch the US$1trn mark as an economy and in about three decades it will leave behind all except the USA and China in terms of size.

From being a near bankrupt economy, India now has the foreign exchange reserves to last more than a year of imports, a competitive interest rate, tariff and tax rate regime and stable inflation. A stable if not appreciating rupee and a clear foreign investment regime add to the attractiveness of the India investment case. A country hugely deficient in oil, India sailed through a $75 per barrel oil shock, even while getting ready for energy security.

India is one of the countries least vulnerable to global slowdowns and shocks, especially compared to the other export-oriented emerging countries. With only a sixth of India's GDP coming from exports, India is a domestic economy and would probably benefit from a global slowdown, given that it is a low cost service-provider to the world.

A politician and entrepreneur

It is stating the obvious to say that politics has been the Achilles heel for India's progress. The reform agenda is moving at a slow pace and a number of crucial necessities like pension and labor reforms have not even seen the light of the day, while progress on infrastructure and the opening up of the country to direct foreign investment have been much slower than desirable. India has been governed by coalitions – more often than not fractured ones – for more than a decade now and has seen many governments and prime ministers. However, there has been absolutely no reversal of any of the reforming liberalisation and furthermore the country's inhabitants have got used to this method of governance. There has been slow but sure progress, the most important being that of connectivity, with phenomenal progress on telecoms and roads. It now seems unlikely that politics can derail India's growth trend, as even politicians realise that the only path back to power is people's progress.

More importantly, the existing Indian entrepreneurial culture has been strengthened. In the face of all the hurdles created by the renowned bureaucracy in India, the Indian entrepreneur and the Indian corporate have learned to find solutions, become lean, mean and competitive, and focus on profitability and they are now becoming global. Two firms, Reliance in manufacturing and Infosys in services, epitomise the revolution in the Indian corporate world. Today the Indian entrepreneur is innovative, focused, competitive and ready to take on the world, reflected in the close to $20bn of attempted takeovers in the last year.

Financial markets

All the above virtues need an avenue for investments to be made and returns to be generated. Direct foreign investments in India are still slow but are steadily inching upwards. Debt markets are not yet fully developed. Private equity markets are thriving, but India needs a lot more long term investment like that from private equity firms, insurance companies and pension funds for the country's needs. However the equity markets have been flourishing over the last few years and continue to present one of the best investment cases in India. Over the last decade, India has been developing sophisticated equity markets, including all the aspects of trading, settlement, derivatives and so on. They have grown in size from a measly $100bn to more than $800bn, making them now the third largest in Asia. Most importantly though, the Indian equity markets give a plethora of choice to investors both in terms of size and sector.

With an even distribution between sectors like banking, software, consumers, industrials, and healthcare, the markets offer significant diversification benefits. With more than 35 companies with a market cap in excess of $5bn and more than 2,000 companies trading regularly out of the 6,000 listed companies, opportunities abound for every category of investor. It is therefore not without reason that the Indian markets have quadrupled in the last four years and have been consistently amongst the best performers in the emerging markets over a much longer period.

Earnings, valuations & liquidity

In the long run, markets continue to be driven by fundamentals, earnings growth and valuations. After the dizzy rise in the markets, existing and potential investors are asking whether there is still a case for investment in India. Broad-based earnings for the Indian markets have been growing in excess of 20% for the last four years and are expected to grow at similarly high rates in the foreseeable future. In addition, returns on equity are in excess of 20%. There is no reason why this cannot continue with nominal GDP growth in the range of 13% and the private sector continuing to gain ground at the expense of the public sector. With Indian corporates being so conservative, earnings upgrades are almost an unwritten rule and that continues to make the Indian market attractive. The current valuation of the market is comparable to its Asian peers, in spite of a much higher growth rate, and cheaper comparable to its own history.

Foreign investments still only account for a fifth of the total market cap and only a handful of foreign firms are currently present in India. Increasingly, more and more of them are being lured to the growth rates of the Indian markets. Domestic investors are increasingly investing in equities and that is a secular trend providing a cushion to the Indian markets.

The risks to the market are external, including global terrorism and extremely high oil prices. Internally, the markets should be resilient to all but the most negative of environments. Not too many markets in the world offer such a combination of virtues as growth, quality, diversity and attractiveness. It might not be difficult to see India regaining its status in the world as an emerging superpower – possibly not an engine to the world like China, but a consistent and steady performer on the world stage. The elephant has begun to move and the world will take notice.

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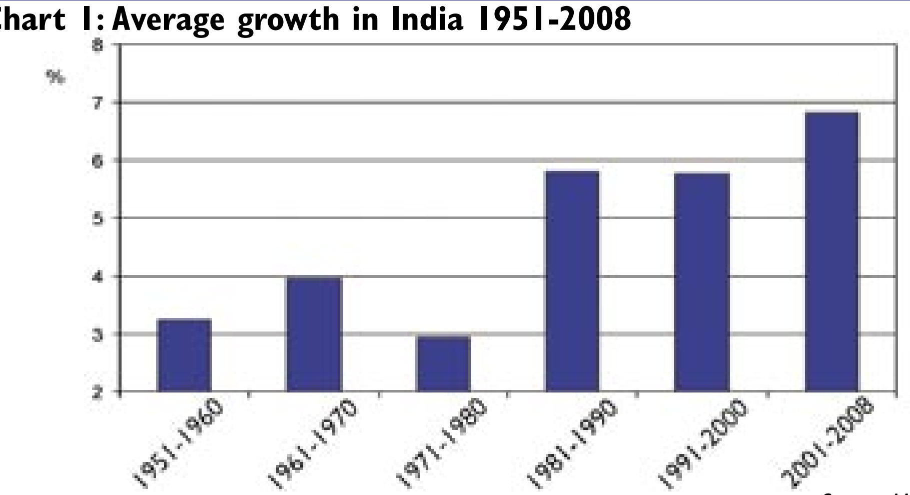
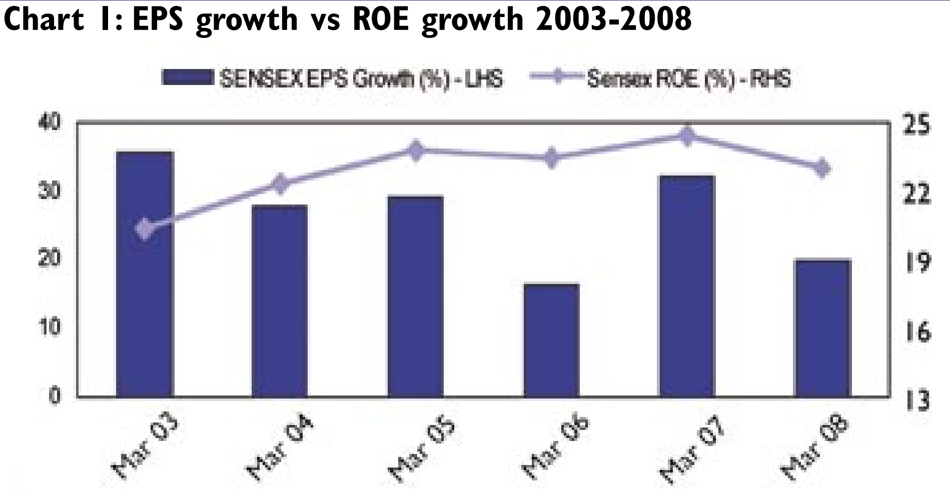
Chart 1: Average growth in India 1951-2008



Source: Mercer

Chart 1: EPS growth vs ROE growth 2003-2008



Source: Mercer