JCP Investment Partners - India 2015

India is shining again - hype or substance?   August 2015

Executive Summary

This report covers impressions, facts, reflection and analysis from travels through India in August 2015. Wes Campbell [Head of Institutional Business & Senior Portfolio Manager] travelled to Mumbai and Delhi to meet with local Indian companies [both listed and unlisted] across a range of industries, local advisers, journalists and various Indian Government bodies.

From an Australian investor's perspective, having travelled to China for many years and observed China's waning demand for our raw materials, one of the key aims of this trip was to learn about India's growth potential, specifically their infrastructure development plans and their demand for raw materials. Whether India is self-sufficient or will they require some of Australia's raw materials? Overall, the views expressed in this report are designed to provide impressions of India and its economic prospects from an Australian perspective.

Five major themes emerged from the wide range of meetings attended:

1. **India's economy is at the foothills of a much stronger growth trajectory**
2. **The government has the mandate, power and numbers to make meaningful change**
3. **Infrastructure development plans lay the foundations for future growth**
4. **Their young demographic represents India's greatest opportunity and risk**
5. **Impact on Australia: limited demand for our raw materials, apart from coking coal**

These themes are expanded on below using anecdotes from the trip.

In summary, much has been promised and expected from India over the past two decades, often being described as a country with enormous potential. To date this potential has not been delivered upon due to the lack of a strong government, however Modi's rise to power with a healthy majority in the lower house, and an expected majority in the upper house in the coming years, may finally give rise to India's great potential. The hype may in fact have some real substance this time.

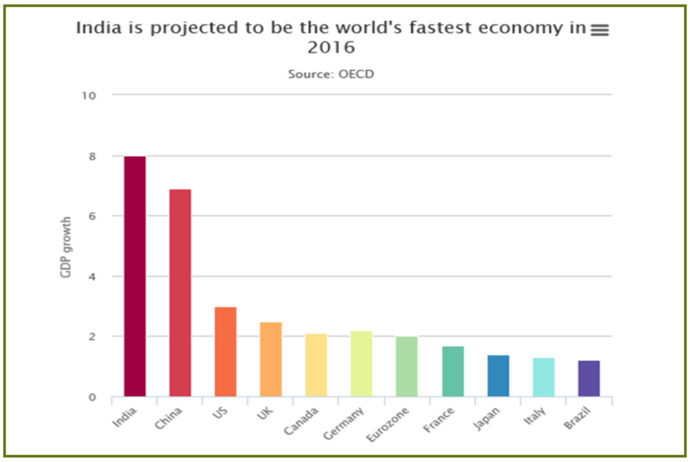
(Slums of Mumbai - Aug 2015)

1. India's economy is at the foothills of a much stronger growth trajectory

India's GDP crossed the US$2 trillion mark in 2014, according to data from the World Bank. After taking 60 years to reach the US$1 trillion mark, India added the next trillion in just seven years.

India's growth rate, at 7.4% in 2014, makes it the fastest growing major economy along with China (7.4% in 2014), which is US$10.4 trillion in size. The Indian economy, at US$2.06 trillion, has almost doubled in size since the financial crisis hit the country in 2008, and has more than quadrupled from the start of this millennium.

India is expected to surpass China as the world's fastest growing major economy in 2015, with the IMF forecasting growth will strengthen to 7.5% in 2015/16. The OECD thinks growth could hit 8% in 2016, returning India to the heights of 2004 to 2012, when output averaged 8.2% a year. Growth is expected to be driven by stronger investment following improvements to the business climate; however this improved sentiment has yet to translate into business activity, which was pointed out by many of the companies we met with.



India's vast population means that they remain a relatively low to middle income economy, with gross national income per person of US$1,610 in 2014, up from $1,560 the previous year. There is an expectation that the Indian economy is poised to surpass the GDP of Japan (3rd largest) and Germany (4th largest) in the coming years on the back of recent policy reforms and improved business confidence. Time will tell.

Gross domestic product 2014		
Ranking	*Economy*	*(millions of US dollars)*
1	United States	17,419,000
2	China	10,360,105
3	Japan	4,601,461
4	Germany	3,852,556
5	United Kingdom	2,941,886
6	France	2,829,192
7	Brazil	2,346,118
8	Italy	2,144,338
9	India	2,066,902
10	Russian Federation	1,860,598
11	Canada	1,786,655
12	Australia	1,453,770

(Source: World Bank)

India's many strengths lay in its relatively legitimate political system, youthful population and substantial technological and entrepreneurial resources. Inflation has fallen by half to around 5%, after hovering around 10% for several years. The decline has allowed the country's central bank, the Reserve Bank of India, to cut interest rates joining other major economies in the prevalent easing cycle. The government has made significant efforts to ensure its public finances are on solid footing, with the central government's fiscal deficit falling to 4.1% of GDP in 2014/15, helped largely by lower oil prices given that India imports up to 80% of its oil.

Investment as a share of GDP represents approximately 28%. To see GDP growth rise above 10%, investment as a share of GDP needs to be greater than 35%, as it has been in China for many years. There is little scope however to follow China's export led manufacturing growth due to a lack of labour intensive industries and relatively high wage costs versus some of their regional peers. Instead a mixed approach is thought to be the best hope, via expanding participation in global markets in both industry and services.

According to a meeting with Mint, India's second largest business newspaper, the Indian economy is experiencing a cyclical recovery; however this is yet to be reflected in corporate earnings. Corporates are not borrowing or investing as yet and it's expected to take time for business investment to pick up. Similarly, the Steel Authority of India noted that they are not yet seeing evidence of activity picking up, but sentiment is certainly showing strong positive signals. Adding weight to this, ICRA, an independent and professional investment information and credit ratings agency, established in 1991, described the current macro environment in India as "a significant improvement on last year". The current account deficit has benefited from lower commodity prices, allowing cheaper imports. A lower inflation environment, improved liquidity, and improving consumer confidence are all signs that the economy is moving in the right direction.

2. The government has the mandate, power and numbers to make meaningful change

One of the key limitations for India in achieving their perceived potential has been the absence of a strong government. This impediment was removed in May last year, when Indians voted an unprecedented mandate to Prime Minister Narendra Modi. Modi was elected with a landslide majority on his reputation for cutting red tape and eliminating graft, earned when he was the Chief Minister of Gujarat from 2001 to 2014.

India's reputation for poor leadership dates back to their independence from the British in 1947. India followed a socialist agenda that dominated the first three decades of their post-independence. India then faced a balance of payments crisis and a looming default, which forced the government to abandon its socialist stance. This led to the country's watershed moment in 1991, when the economy first embarked on its journey of embracing market forces. India's direction of travel throughout the nineties was clear but the speed was highly variable. From the 2000s, India began to boom, however their economy floundered under an increasingly corrupt Congress government in the wake of the financial crisis.

The country is now at an inflection point. Modi's Bharatiya Janata Party (BJP) took office in May 2014 with the largest electoral majority in three decades. India's population (currently 1.2bn) is very young, restless and ambitious, which will drive change. The electorate is now more informed and better connected than during previous electoral cycles. For example, the proportion of electrified households has risen to 80% in 2014 versus 55% in 2001; TV penetration has risen to 65%, leading to increased literacy, whilst mobile phone penetration is approaching saturation levels, with close to 900m subscribers. These improvements in connectivity and communication helped install a government with an overwhelming mandate from the Indian people to deliver jobs and higher living standards.

Modi has a thumping majority in the lower house and is expected to get majority in upper house in 2018, which will enable the BJP to pass legislation with ease. Modi's BJP has begun a number of significant reforms given their strong mandate for change. A crackdown on corruption has led to some Indian corporates complaining that "this government is hopeless", as they are forced to adapt to a new (less corrupt) way of doing business. Conversely, multi-nationals, such as Star India (owned by 21st Century FOX) are of the opinion that India is on the right track and doing business in India is now getting easier. This is a welcome view given India is ranked 142nd in the world (from 189 countries in the survey) in terms of ease of doing business according to the World Bank Group.

The Modi government understands that the government's role in the economy needs to shrink and as such the government is taking steps toward privatisation, albeit not dramatic moves. The government is also looking to implement a number of reforms to support the opening up of their economy, such as key laws concerning land boundary agreements, mining (specifically the opening up of coal mines), tax reform and the opening up of various sectors to foreign investment such as insurance.

Land: the Modi government plans to abolish the consent clause for vital investments, which will free up companies to acquire land in rural and agriculture regions, enabling the establishment of factories, which can provide employment and contribute to growth. At present acquiring rural land for factory use is difficult as it requires 75% approval from the land owners of the surrounding area intended to be purchased. Removal of the 75% approval requirement will open up land to offshore factory development. According to the Editor from The Economic Times, multinationals such as Foxconn, Posco and Volkswagen are awaiting changes to this bill prior to embarking of investment. The Chief Economist from the Economic Research Unit of India suggested to us that without this change corporates will find it difficult to acquire the land needed for factories and development, and the government will also have difficultly acquiring land needed for infrastructure development. With these agendas in mind he was of the view that the bill will pass.

Coal: liberalisation of India's coal sector is clearly underway. The government has allowed private companies in power, cement and steel to acquire their own coal mines through e-auctions, publicly announcing they will approve a new coal mine to be opened every month until 2019. India has the fourth largest proven coal reserves in the world, but to date has run a supply deficit thereby needing to import ~200m tonnes of coal per annum. Resolving this supply bottleneck is one of the Modi government's highest priorities. A key area of focus has been the opening up of critical coal mines and the development of railway lines to support the transportation of this increased coal production. The government expects coal production to increase by up to 70%, to 1bn tones by 2020. Imports are now stagnating as Coal India increases its production (now up 11% yoy). Renewable energy is crucial also, with the government committed to exponentially increasing the installed capacity of renewable energy generation (from 32GW to 175GW by 2022).

Power: a key outcome of opening up the coal sector in India is to deliver improved access to power for the population. "Power for all by 2019" is a policy target, given that 78% of the population have access to power for only 8 hours per day. According to power and coal experts from Deloitte Touché Tohmatsu India, 2030 is a more realistic expectation of when such a target will be achieved. This is not the first time such ambitious plans have been articulated, with the "Power for All by 2012" initiative launched in 2008. The benefits of improved access to power are clear: electrification increases the number of hours that can be worked in a day, improves household automation, while also reducing the effects of weather. India's energy demand is expected to grow to 370mtoe (exceeding Germany's 2015 demand) to reach 1183mtoe by 2025 according to Wood Mackenzie. After China, India will be the second largest growth region in terms of energy demand. The coal mining licence auctions which commenced in February may help, but much will depend on getting railways in place to deliver coal to power plants. Fulfilling the pledge to greatly expand solar (from 4 GW to 100GW by 2022) will also be important.

Despite India having 250gw of power capacity, 25gw is not currently used due to slippage from theft and corruption. According to the energy companies and industry experts we met, their belief is that the generation and transmission mechanisms are fine, but that it is distribution where the problems exist. Subsidies are also bringing challenges - rural areas are provided with subsidies for power, however this money is not making its way back to the power companies, so they cut power to these rural areas. Their proposed solution is to build a separate feeder system for the agriculture sector to identify who is getting access to free power, which will enable them to charge correctly.

Tax Reform: the Modi government is also looking to implement tax reforms: lowering the corporate tax rate from 30 to 25% over the next 4 years and implementing a GST (proposed GST rate is 16%) from April 2016, which will help widen the tax base further. Most people we met with felt that the GST was the most important reform on the government's agenda and consensus amongst them was that the bill will pass. An opposition Member of Parliament we met with suggested that "the current version of the GST bill is more acceptable to the opposition party and should get through". The GST could add 1-1.5% to GDP and will replace the VAT, which ranges from 4-12%.

Foreign Investment: the government has eased foreign direct investment (FDI) regulations, which has seen FDI grow 47% in 2014. Modi has made a point of travelling offshore to encourage foreign investment in India's economy. An opposition Member of Parliament described Modi as "an avid traveller, he has given more speeches to external parliaments than his own". Consistent with his reputation, Modi's focus has been on cutting red tape, with restrictions on FDI lifted from 26% to 49% for defence and insurance industries, whilst lifting restrictions on investment in railways remains in progress. The land bill discussed above is an important part of encouraging foreign investment going forward, as is the government's "Make in India" campaign, which includes textiles, ship building, and various other industries chosen for import substitution, welcoming foreign investment.

Criticisms of Modi encountered from the various meetings were that time is not in his side, he alone can't bring change (he is perceived as a one man band), and he needs to use markets as an agent for change – e.g. private companies could compete to make the railways more efficient.

3. Infrastructure development plans lay the foundations for future growth

Improved infrastructure: predominantly rail and roads should help lay the foundations for future growth in India as the government plans to increase infrastructure spending from its current 5% of GDP to 10% by 2017. In April 2015 government spending was up 28% yoy and FY16 planned expenditure is up 36% yoy.

Rail: India has 65,000 kms of existing rail infrastructure versus 112,000 kms in China. The rail infrastructure in India is government owned and starved of capital due to inefficiencies and cross-subsidisation of tariffs. Coal deliveries are delayed by overcrowding at ports where wagon shortages, rail line capacity issues and bottlenecks add to vessel waiting times. India is a third slower and a third costlier than China to deliver coal via rail. These inefficiencies have led to the end of forty years of government control of the coal industry, with coal mine auctions taking place as discussed above. In a conversation with an opposition Member of Parliament the view was clear that "Railways have tremendous potential if harnessed right, in terms of linkages opening up and improved productivity". The Railways Minister has pledged Rs140bn of capital spending over the next 5 years; however despite FDI being promoted in the sector, full privatisation is unlikely, given that the railway industry is one of the largest employers in India with a very powerful union. This has made Public-Private Partnerships (PPP) projects difficult so far, although some are in draft phase. Construction is at an advanced stage on 3 new train lines, due to come on line in 2017, with an additional 52 new lines identified to be built, however given railway line corridors are fairly restricted, the industry is attempting to lay lines next to existing lines.

Roads: We met with the Chairman of the National Highways Authority of India from the Ministry of Road Transport & Highways. He noted that a huge amount of liquidity was available from the central government for road construction. This year they will be developing 10,000 kms of new roads, versus 8,000 kms last year, whilst in FY17 he expects that India will construct an additional 15,000 kms of new roads, with spending on roads expected to nearly double from Rs9bn to Rs17bn.

A consistent view from companies we met with was that the new government and its agenda is helping to facilitate road construction more efficiently. Punj Lloyd Ltd, who provides integrated design, engineering, procurement, construction and project management services in the infrastructure sector, suggested that the government was encouraging Build Operate and Transport (BOT) contracts; where the contractors no longer carry the toll risk (instead the tolls go to the government, who then pays a fixed amount to the contractor for 15 years). IRB Infrastructure Developers suggested that land acquisition costs are easing and that the government had changed its stance to be more facilitating.

According to UltraTech Cement, the infrastructure reforms will be good for the cement industry given that most of the roads in India are cement based, (not bitumen like offshore), as cement roads are longer lasting. India comprises 195kgs of cement per capita, versus the global average 500kg per capita.

UltraTech feel that they are on the cusp of an increase in the demand cycle for cement given the government has majority and the projects being undertaken will start having an impact in years 3, 4 and 5 of their term, which equates to 2017-2019. 2018 is when they expect incremental demand to exceed incremental supply.

In support of the infrastructure timeline outlined by UltraTech Cement above, a meeting held with SBI Capital Markets, an infrastructure investment bank, suggested that the meaningful infrastructure story was still a year to year and a half away. The recent budget demonstrated the government's intention to kick start infrastructure investment and unblock the pipeline. By increasing public spending, creating new infrastructure funds and laying out the foundations for a stronger, more transparent PPP process, the government seems committed to addressing the key challenges that have long been raised by international and domestic investors.

4. Their young demographic represents India's greatest opportunity and risk

India has the youngest population on the planet, with the median age in 2014 estimated to be 27 years. Along with their youth, Indians are restless, ambitious and better informed and connected than any previous generation. This powerful cohort is demanding better technology, internet connections, education, hospitals and reliable power. The literacy rate of India has shown a significant improvement of almost 9%, increasing to 74.04% in the census of 2011 from 65.38% in 2001.

Such a young demographic presents an enormous opportunity for India; a Member of Parliament stated during one of our meetings, "growth should be driven more by consumption given the aspirations of the young generation who wish to borrow, spend and improve their lives".

Perversely, India's young demographic could also be their achilles heel. Within the next 15 years, India will have the largest, and among the youngest, workforce in the world, with the working age population projected to grow over 200m to reach 1 billion people by 2035. This will represent one fifth of the world's working age population. Providing adequate employment for so many people will be an enormous challenge. Without employment, consumption becomes difficult and the young demographics aspirations will not be met, potentially leading to social unrest, and ultimately lower growth. It is clear that so much is riding on the government's ability to deliver an economy able to provide adequate levels of employment for its growing youthful workforce.

The Chief Economist from the Economic Research Unit of India suggested that so far we have seen jobless growth in India and that while structurally Modi is doing the right things, the key is to find employment for their young people. In addition to the lack of jobs he feels that there is also a lack of skills, so the government is trying to develop skills. Given industrialisation started very late in India, opportunities for large scale labour intensive style industries such as manufacturing will only open up if space is vacated by peers in the region. The Chief Economist sees potential for young people more through entrepreneurship in the service sector, which will need to shift from agriculture over time, which currently employs 55% of Indian workers.

Other sectors expected to provide for employment include the IT sector and ecommerce, which is growing at 10 times the pace of other industries. India is at an inflection point of consumption moving online, which will allow them to leapfrog traditional tech themes and embrace new disruptive technologies with greater access ease facilitated by an underdeveloped landscape. For example, Indian mobile phone penetration (over 900m subscribers) means they will not require the traditional copper fixed line infrastructure used for telecommunication adopted by most western countries. Additionally, the 900m smartphones may mean that India does not need to build out a traditional supermarket chain, instead leapfrogging directly to online channels. India's attractive demographic should lead to 300m + new online shoppers in the next 15 years, with enormous growth in bank accounts (only 30% of the population have a bank account) and credit cards (only 20m people have a credit card).

Logistics suppliers are also needed for the rapidly growing ecommerce sector. Changes to the land acquisition bill (as outlined above) will help with the development of these industries, as will the changes to FDI, evidenced by the "Make in India" campaign which recognises that the youth need to be employed, thereby encouraging multinationals to build manufacturing bases and factories in India. The services sector is the sector most likely to grow employment as India strives to be the service centre for the world.

5. Impact on Australia: Limited demand for our raw materials, apart from coking coal

India's ambitious infrastructure development plans detailed above will be heavily materials intensive. Steel demand is likely to increase significantly to support the infrastructure plans, which will naturally flow on to increased demand for the two key commodities that produce steel: iron ore and coking coal.

India currently has total steel capacity of ~100mt; however utilisation is only running at ~80%, producing roughly 80mt of crude steel per annum. This equates to steel consumption per capita of approximately 65kg, whereas China has steel consumption per capita of approximately 550kg and the global average is approximately 200kg per capita.

According to Jindal Steel and Power, India's steel industry has had a challenging few years. Steel consumption in India grew at 9%p.a. between 2002-2011, and then fell to 3%p.a. between 2012-2014. The fall in steel demand caused steel prices in India to fall 30-40%, whilst costs of production increased, causing some smaller steel companies to fold.

Both Jindal Steel and Power and The Steel Authority of India whom we met were far more optimistic about the future. They expect demand to increase given the positive messages being outlined by the new government.

Growth is starting to return, with The Steel Authority of India suggesting that steel production increased 7% in Q1 this year and expectation is for it to grow 7-9% in the medium to longer term. The government's ambitious growth and infrastructure plans have resulted in the government targeting steel production of 300m tonnes by 2025. Both Jindal Steel and Power and The Steel Authority of India felt that this target looks very optimistic and that 155m tonnes by 2020 was more realistic, while the 300m tonne target may be achievable by 2030. The Chief Economist from the Economic Research Unit of India was also of the view that the 300m tonne target by 2025 was unrealistic, believing it would be more like 160m-180m tonnes. If steel capacity increases to only this amount, then India will be forced to import steel to support their infrastructure plans by 2020.

Steel imports are already hurting the steel industry in India. According to The Steel Authority of India up to 1m tonnes of steel is being imported every month, which grew by 74% last year and 56% so far this year. The majority of steel imports are coming from China, given up to 50% of their steel capacity is laying idle. This is presenting a huge challenge for the Indian steel sector, who are pressuring the government to impose increased protectionist policies to help avoid the dumping that is occurring. Post the recent devaluation in the Chinese yuan, which looks set to surge Chinese steel output, the Financial Services Secretary of India, Hasmukh Adhia, stated the nation is being forced to consider steel safeguard duties and more anti dumping curbs.

Iron Ore: in regards to iron ore, we discovered that India is largely self-sufficient, and has reasonably good quality iron ore, with a high Fe content in the 60-65% range, which is equivalent to good quality Australian iron ore from the Pilbara. India produces approximately 160m tonnes of iron ore annually and they export about 30m tonnes of this. Production has fallen from a high of 210m tonnes, impacted by the decline in steel demand between 2012-2014, however mines are now re-opening in anticipation of increased demand driven by the infrastructure development plans. The Chief Economist from the Economic Research Unit of India also stated that India has sufficient good quality iron ore that they source domestically. As a result of their self-sufficiency, India's infrastructure boom may not translate into increased demand for Australian iron ore, which is unfortunate for our domestic economy.

Coking Coal: Despite having the fourth largest coal reserves in the world, much of India's coal is thermal coal (used to generate power/electricity) rather than coking coal (used with iron ore to make steel). Feedback from steel sector experts from Deloitte Touché Tohmatsu India suggested that India does not have any good quality coking coal and that India is reliant upon Australia for coking coal, currently importing up to 42m tonnes per annum from Australia. This view was backed up by the steel producers we met, with The Steel Authority of India suggesting they get 90% of their imported coking coal from Australia, primarily from Queensland, via a consortium of suppliers where BHP have a 40% share. Any coking coal sourced locally in India typically has a high ash content (18% versus 9% in Australia), which increases their costs.

Imports of coking coal from Australia are expected to double to around 85m tonnes by 2025 according to a number of the industry contacts we met. The steel producers said they had shared these growth plans with their major suppliers in Australia. This demand is expected to have an impact on pricing, with some of the steel producers expecting prices will increase to $120-130/t (versus current spot price $84/t) in a few years, a clear positive for Australian coking coal producers.

Oil and Gas: As mentioned earlier, India imports 80% of their oil, so a lower oil price environment is hugely beneficial for their economy. Plans are underway to increase imports of gas, with 30% currently imported from Qatar and plenty more growth expected as pipelines improve. As industrial growth increases, gas demand will increase, which will lead to demand for Australian gas, however at present imported gas from Australia costs $12, versus the spot price of $8 in India, so it doesn't make sense to import Australian gas at present.

Conclusion

Much has been promised and expected from India over the past two decades, often described as a country with enormous potential. That potential has not been delivered upon due to the lack of a strong government, however Modi's rise to power with a healthy majority in the lower house, and an expected majority in the upper house in the coming years, may finally give rise to India's great potential.

It will be interesting to observe India in the next few years to assess the development of their ambitious infrastructure plans and the impact of the Modi government's majority power. By 2018/19 we may see India's much touted 'potential' translate in to real substance; a time when there should be some clear evidence of these plans being put in to action. From an Australian investor's perspective, clearly opportunities exist in supplying coking coal to India to help fuel their infrastructure projects, plus gas supply is a possibility longer term. Australian companies will be permitted easier access to do business in India in the coming years given the opening up to FDI and changes to their land acquisition bill. Our challenge is to identify these companies doing business in India and assess their leverage to the growth potential that clearly exists.

List of Meetings - Mumbai

SBI Capital Markets (Infrastructure Investment Bank)

IRB (Infrastructure Developers)

ICIC Bank (Commercial Bank)

Star India (owned by 21st Century FOX)

Mint (India's second largest business newspaper)

Edelweiss (Asset Reconstruction Company)

Deloitte Touché Tohmatsu India (Experts in power and coal)

Credit Analysis & Research (Credit Ratings Agency)

UltraTech Cement /Aditya Birla (Cement / Construction Company)

List of Meetings - Delhi

Prof. Rajeev Gowda, Member of Parliament in opposition

ICRA (Credit Rating Agency)

Editor for The Indian Express ("The thinking man's paper in India")

Chairman National Highways Authority of India, Ministry of Road Transport & Highways

Punj Lloyd Ltd (integrated design, engineering, procurement, construction and project management business in the infrastructure sector)

Steel Authority of India Ltd

Chief Economist, Economic Research Unit, Joint Plant Committee, Ministry of Steel, Government of India

Jindal Steel and Power Ltd

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