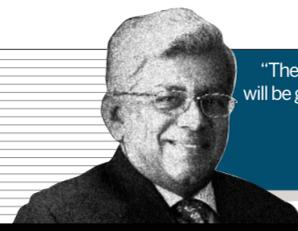


WILL INDIA MAKE IT?

2016



"There is a lot of optimism that the Modi government will be good for business... However, after nine months, there is a little bit of impatience creeping in"

DEEPAK PAREKH, Chairman, HDFC Ltd.

DON'T GO BROKE FOR GROWTH

Preserving macro stability in emerging markets may entail living with lower growth in 2016



Illustration: SHYAM

First, the good news. At the time of the taper, India was the poster-child of emerging market vulnerability. Now, less than three years later, as the Fed has embarked on rate normalisation, India has gone from sinner to saint. A return to macroeconomic orthodoxy since 2013—continuing fiscal consolidation, a new monetary policy regime, positive real rates—coupled with expectations of economic reform by the new government and a lot of good luck, in the form of the collapse in oil, has meant that India is now seen as the emerging market best prepared to withstand global shocks, whether emanating in Washington or Beijing. To grasp the quantum of the external adjustment, consider this: back in 2012-13, India's current account deficit printed at \$88 billion for the year. This year, it is on course to printing less than \$20 billion. In other words, the balance of payments is expected to remain in comfortable surplus even if the economy experiences a large portfolio outflow.

There's more good news. Even as growth has slowed in virtually every other emerging market (EM), India's growth has accelerated over the last year. While there are legitimate questions about whether the "level" of growth is really 7%, there is agreement that growth has been accelerating—reflected in firming urban consumption and capital goods production—in stark contrast to the slowdown in other EMs.

What's going on? How has India managed to buck the EM slowdown? To be sure, the government deserves credit for a series of reforms across sectors, which are likely to eventually translate into higher activity. But over the last year, the key driver of India's growth—and one that is conspicuous by its absence in most debates—is the dividend from lower oil prices. We estimate that the collapse in oil from \$110 to \$45 a barrel constituted a (massive) 2.1% of GDP positive terms of trade shock to the economy. Essentially, the economy received a 2% of GDP income windfall that would ordinarily have been transferred to foreigners in the form of higher oil import bill.

Of this windfall, nearly 1% of GDP accrued to the government in the form of lower oil subsidies and higher oil taxes, which it spent. Had it saved all of it, the fiscal deficit should have been almost 1 percentage point lower than original targets. This is not meant to be a critique of fiscal policy—indeed, the government lost access to the inflation tax and correctly identified the need for a public investment stimulus—but it does complicate future fiscal arithmetic.



SAJJIDZ CHINYOY, CHIEF INDIA ECONOMIST, JPMORGAN

WE MAY NEED TO SET OUR GROWTH SIGHTS LOWER, IN THE NEAR-TERM, AND CONTINUE CHIPPING AWAY AT SUPPLY-SIDE REFORM, TO BOOST PRODUCTIVITY AND MEDIUM-TERM POTENTIAL

Of the rest, we estimate that households got a 0.8% of GDP purchasing-power boost, from both the first round impact of lower fuel prices (which was small, given higher taxes) but also the second round effect of lower final goods prices (which was larger) as firms, faced with weak demand and the need to retain market share, passed on a substantial fraction of raw material savings to consumers in the form of lower prices. The Indian household's typical marginal propensity to consume is estimated to be about 0.7. So, between the government spending all of its oil windfall and households spending 70% of theirs, we estimate that two-thirds of the 2.1% of GDP windfall was actually spent. This assumes that the fraction that accrued to corporates (0.4% of GDP) was all saved.

What this means is that GDP growth was boosted about 130 bps over the last year, as two-thirds of the oil windfall was spent. Under the new GDP series, growth was estimated at 7.4% over the last four quarters. Ex-oil, therefore, underlying growth was closer to 6% (in the new series!) which ties in with very weak rural demand, and stagnating global trade.

Why is this significant? Because the growth dividend is a one-off. It's the change in oil prices—not the level—that drives growth. So, if oil stabilises, growth should slow next year, not for anything that has to do with global trade or weak exports, but simply the terms-of-trade shock rolling off. This will come as a sticker shock to most analysts that project a linear acceleration of growth. To be sure, a normal monsoon will help and exports could begin to gradually recover. But, it is unlikely that these forces can offset a 130 basis point drag. It is also true that oil can drift lower, but oil going from \$45 to \$35 is not the same as going from \$110 going to \$45!

So, what is the optimal policy response in the wake of any slowdown? If growth slows and commodities remain benign, it is possible that some monetary space could open up but, given the 4% medium-term inflation target and a Fed hiking cycle, any easing—if at all possible—is expected to be modest.

Instead, the focus will inevitably turn to fiscal policy—which finds itself in an unenviable position. On the one hand, having relaxed the fiscal road-map in the last Budget, it is important for credibility to adhere to the revised road-map. Furthermore, any unanticipated increase in government borrowing is likely to exacerbate the supply-demand mismatch in the bond-market,

put further upward pressure on G-Secs and corporate bond yields and, thereby, raise borrowing costs for the private sector, precisely when corporates are moving towards more wholesale funding given limited transmission in the banking sector. So, the risks of crowding out are real.

On the other hand, sticking to the fiscal road-map would mean a fiscal consolidation of 0.4% of GDP, which would further impinge on growth—particularly because, with nominal GDP growth so weak, the adjustment would need to be done largely on the expenditure side where multipliers are higher. This would make fiscal policy sub-optimally pro-cyclical at a time when output gaps are negative.

Is fiscal policy therefore caught between the devil and the deep-sea? There is a way out. An asset swap: stepping up disinvestment and other asset sales to simultaneously maintain public investment levels (on which the government has truly delivered this year, and where multipliers are high in the medium-term) while simultaneously reducing the deficit. This would allow the government to stick to its fiscal road-map but consolidate without imparting a drag on economic activity. It is a win-win scenario. Any hesitancy in selling stakes in commodity-companies this year should recognise that commodities could go even lower next year as China slows further!

But, there needs to be a larger realisation—8% growth was possible when the world was growing at 4% in the mid-2000s. It is not possible when the world is growing at just over 2%, EMs are in a morass, and global trade is contracting. So, we may need to set our growth sights lower, in the near-term. And continue chipping away at supply-side reform, to boost productivity and medium-term potential. The coming year, 2016, promises to be a turbulent year as the Fed withdraws the ventilator, monetary policy divergences within the G3 accentuate, and China continues to re-balance. What we need to avoid is a repeat of 2008 when, at the first hint of a slowdown, a large fiscal and monetary stimulus was mounted under the assumption of large output gaps. All that did was to, inadvertently, sow the seeds of the 2013 mini-crisis. The unfortunate reality is India, like other emerging markets, may need to live with lower growth in 2016, to preserve the very macro stability gains that have held us in such good stead the last three years, and will be so crucial for survival next year.

Indian PE headed for consolidation

The past (2001–2007): The Indian private equity (PE) market started with a lot of promise in early 2000, with several successful investments in the succeeding years. However, with interest levels of global investors peaking in 2005-06 and the resultant capital overhang, the legacy of Indian PE hasn't been particularly glorious. The Indian market was plagued by a plethora of PE funds with lot of dry powder, resulting in too much capital chasing too few "quality" companies. The market has been highly intermediated which, when combined with the dynamic of large amount of capital and few quality companies, resulted in high entry valuations and made it difficult to generate desired returns. Additionally, the bulk of PE deals in India were passive financial investments for minority stakes and hence, the general partners (GPs) had limited influence on the operations of their portfolios as well as creating an exit. In addition, given the infancy of the industry in India, most of the talent had limited long-term investing track-record, which also contributed to a top-down approach. As a result, Indian GPs have returned just about 40% of the total capital invested during the 2001-07 vintage.

The apocalypse (2008–2013): The Indian PE industry witnessed structural changes from early 2009, which continued till recently. With a history of poor performance, most global funds increasingly became dormant in India, whereas Indian GPs struggled to raise their first or follow-on funds. Given a combination of rich multiples paid in the past and the IPO market drying up, most firms found it difficult to secure exits. The performance pressures were further exacerbated by the rupee depreciation of ~40% against the dollar, further eroding the already *sub par* returns. The ensuing Darwinian consolidation led to a visible reduction in the competitive intensity, with very few funds participating in this investment cycle.

The promise (2014–19): India's macro benefited with the new government elected in 2014, combined with benign oil and commodity prices. The NDA government re-initiated the reform agenda. Sustained low prices of crude oil and global commodities helped tackle India's current account and budget deficits, and have provided the government the necessary funds to invest in infrastructure and have helped decrease the inflation rate. This allowed the central bank to initiate rate-cuts and kick-start investment. Challenges in the other emerging markets (China, Brazil, Russia) have allowed India to become "relatively" more attractive for foreign capital.

Select GPs have started differentiating themselves through focused strategies (e.g., control deals) and sector selection (healthcare, etc) and, in few cases, successful track-records. In addition, home-grown GPs, with local decision-making facilitating quick movement, and competitive positioning in the mid-market deals, became very relevant in the Indian market.

Even as these structural and macro changes were underway, the Indian PE industry's performance bounced back in year 2015. Buoyant capital markets helped PE funds record a five-year high of exits worth ~\$5.2 billion in the first 6 months of 2015, as compared to ~\$4.2 billion for all of 2014. Investments also boomed

to \$13.8 billion in the first 3 quarters of 2015. Besides the upcycle in the investments, India PE also witnessed the willingness to underwrite deals with different risk-reward trade-offs. Instead of just backing mature business models, the Indian markets saw GPs willing to take exposure in companies with evolving business models, especially in the consumer technology space. This was primarily driven by bulging cheque sizes and valuations of such companies and increased global interest in the sector.

The Indian promoter's thought process has also matured considerably, i.e., in terms of being more open-minded on ceding control, thanks to succession challenges, over-leveraged balance-sheets, etc. The Indian promoter—PE relationship also has evolved significantly. While, till a few years ago, promoters saw PE as just passive equity capital, they are increasingly looking to partner with GPs. They want investors to be able to add value beyond providing capital, especially from a strategic perspective as they scale up. Second, promoters are also willing to cede control by selling larger stakes to trusted GPs, or even partner them. Both of these are significant mind-shifts as the Indian market has historically been a minority-deal-driven one, with limited interference of GPs in the operations of the portfolio companies.

To sum up, the Indian PE industry, though troubled by a poor legacy, is making the requisite changes and mind-shifts, which would result in a consolidation in the industry. This would improve the overall attractiveness and sustainability of this asset class, and finally provide profitable returns to the long term Limited Partners who invest in this space (and are carefully selecting the GPs they support).

With contributions from Nishant Sharma and Sunish Sharma, Kedaara Capital Advisors LLP



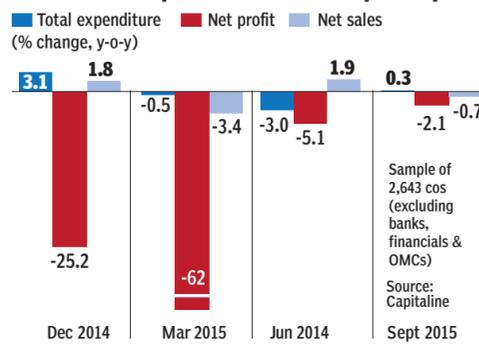
MANISH KEJRIWAL, MANAGING PARTNER, KEDAARA CAPITAL ADVISORS



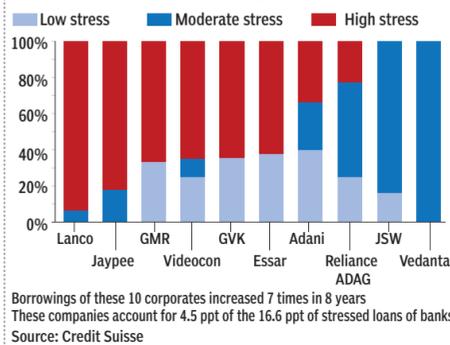
Illustration: SHYAM

DATA DRIVE

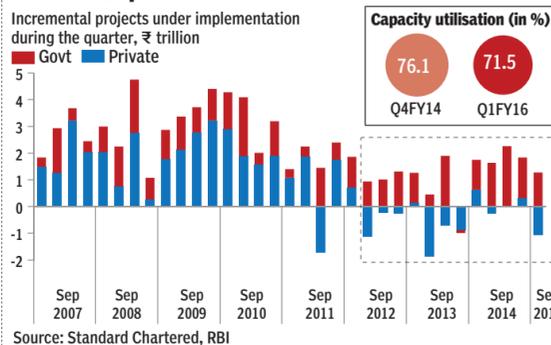
Costs down but profit flat because of poor topline



House of debt looks shakier



Investment poor



Deal flows rise

