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Narendra Modi government is moving into pay-off stage: Jon Thorn

Co-founder and director of India Capital Fund Management on how benefits of what the NDA has done so far by way of reforms will become visible and incremental

Jon Thorn says the only truly national lever that Narendra Modi has is competition among the states for the centre's money, and between themselves for FDI.

Singapore: The Narendra Modi government is moving into the "pay-off stage", where the benefits of what it has done so far in its tenure by way of reforms will become visible and incremental, says Jon Thorn, co-founder and director of India Capital Fund Management Ltd. In an interview, Thorn cited the example of coal auctions. "The new transparent online auction of mines is producing results—coal imports are down 27% year-on-year (y-o-y), yielding savings of $4 billion. This is the sort of pay-off we want," he said. Edited excerpts:

Do you sense some disappointment among investors and economy watchers with regard to the Modi government's inability to pull off large-ticket reforms?

I would say there is instead a misunderstanding regarding what big-ticket items India actually needs and also a misconception that big-ticket items produce actual results in India, as opposed to the nice PR (public relations) notices that many investors seem to need. India needs better economic plumbing, unblocking of the pipes that already exist. That is happening quite effectively. It needs that before the PR companies get hired.

The recent insolvency bill was mega. In 180 days, any company put into the insolvency process has to be resolved: one of the fastest procedures in the world. Alongside that is the opening up of asset reconstruction companies to foreign investors! 'Wow', I thought- 'that is really clever'. It's not very flashy, is it? But it's going to work very well. Were any 'investors' pushing that plan? No, it was purely a government plan.

Then there is the opening-up of various industries to more foreign investment, more single-window approvals, the positive courting of the US, Japan and China for cooperation and investment. Back in fiscal 2011, FDI (foreign direct investment) into India was only $19 billion. Last year, India, overtaking China, came out as the highest-ranked country by greenfield capital investment with $63 billion of FDI. Now, in India, we can see global e-commerce firms investing billions of dollars. Amazon has invested or allocated $5 billion. That's a lot and goes a long way in India! They all think India is the next big thing.

A year since your last interaction with us, we are still debating the goods and services tax (GST). Do you see all parties reaching a consensus on capping the GST rate in the bill? Can the country meet the April 2017 deadline, and do states have enough time to pass their own GST legislation and put in place the systems necessary for the final roll-out?

It can all be done. Both sides using fiscal consolidation as a political football is not helpful for most Indian citizens. But it happens. Most states have been on board for a while with a few holdouts; the structure of state-centre fiscal mash-up has already been clearly set out and the states have a lot to gain from this. It will happen, but we will see when. We are more optimistic now for this current session than before.

As someone who has tracked India for a long time, do you think that going forward, after GST, the government may not undertake big reforms since it is already past its prime?

I think the Modi government is moving into the pay-off stage where the benefits of what was done before become both visible and incremental. For me, the big change was the de facto energy policy, especially coal. Coal produces 65% of India's energy and the more that can be sourced domestically the better for both employment and the balance of payments. Under the opaque process of allocating mines previously, little extra coal, if any, was produced. The new transparent online auction of mines is producing results—coal imports are down 27% y-o-y, yielding savings of $4 billion. This is the sort of pay-off we want. I think the reforms that will come through next are meant to be more constructive for the election in May 2019—the hard stuff has mostly been done.

The only truly national lever that Modi has is competition among the states for the centre's money, and between themselves for FDI. The latter is one of the steps that states can use to demonstrate their performance to an electorate. Modi understood that during his 11 years running Gujarat—he has done quite well to re-calibrate the dynamics between states on that basis.

As someone who invests in Indian equities, where do you see the markets headed—near-term and long-term? What are the sectors you are bullish on? What according to you are the sectors that are still undervalued?

The market will do its own thing. Different companies will do their own thing. If you have the assumption of strong and accelerating and widening growth, then growth proxies will work better. That's what we see; so we like, as we liked for a few years now, private sector banks and autos. We don't like FMCG (fast-moving consumer goods), pharma, etc., as the "safety" trade is a dangerous one at these valuations in this changing landscape. We especially like trucks.

If growth really is starting to kick in along with infrastructure, then some sectors look cheap, long-term. Again, autos, some cement producers—but not the big national ones. We very much like specialty chemical producers especially, Camlin Fine Sciences Ltd, which addresses a global opportunity in specialty chemicals, and where India has both a sustainable cost arbitrage and a science lead over anywhere else. It feels a bit like IT (information technology) outsourcing in the late 1990s. We were the second foreign investor in Infosys (Ltd), and we see some of the same attention to quality in some of those companies, especially Camlin.

Does India stand out when investors are risk-averse? How do global investors view India?

I am very glad we only do India and that we are doing India now. I don't know how a global investor gets out of bed in the morning. You would be looking forward to what, exactly? Perhaps a "comforting" comment by some central banker?

We get out of bed and have the strongest GDP (gross domestic product) growth in the world, an Econ 101 slowdown ending and—we assume—an economy starting to accelerate, and some of the best-managed companies in the world with very little debt.

To the extent that any investor knows and/ or understands these things, then they will allocate to India. And vice versa. I assume that increasingly they will become comparatively aware of this new India and, therefore, absolutely convinced they should buy it. How can they come to the opposite conclusion? If (Federal Reserve chief Janet) Yellen, (European Central Bank president) Draghi and (Bank of Japan governor Haruhiko) Kuroda were to promise liquidity forever, then maybe that is as exciting.

Otherwise, I look forward to tomorrow morning and assuming, God willing, that I can get out of bed, then I know that growth and profits will be on the breakfast table, rather than the rash promise of a failed liquidity continuity. No contest.

But looking at data, credit demand has almost collapsed, and banks are only parking deposits in government securities. We don't see any borrowing linked to industrial activity. How is this possible in an economy that is supposedly expanding at a 7.6% pace, according to official estimates?

There are two things there—one, banks, and two, growth. Within banks, there are two kinds of banks—government, PSU (public sector unit) banks and private sector ones. We like the latter a lot and don't like the former even more. Within the private sector banks as a group, credit growth is running at 22% y-o-y, which is nice, and so are the earnings that flow from that. Lying at the bottom of the well are PSU banks, and I would be unwilling to look at what is going on down there. Things are starting to improve in PSU bank-land, as a result of a number of factors, including (Reserve Bank of India) governor (Raghuram) Rajan cleaning them up, and just simple growth, but we are unwilling to believe PSU bank happy days are here again until we see the data.

Regarding GDP growth, as you know the formula was changed. That's a subject for another day, but like-to-like comparisons are difficult and it probably feels more like a 5% GDP than an 8% GDP. But it is undeniably accelerating—all leading indicators are strongly up. For instance, cement production is at a four-year high; heavy truck sales growing at 28% are at a five-year high and electricity generation growing at 15% is the highest it's been for 22 months. This is what an accelerating economy looks like.

So, what can revive credit? Spectrum auctions/make in India?

Those leading indicators are the first light in the morning, again, after getting up. Nominal GDP growth is also strongly up, and that is the cash economy which matters to the everyday person. If the leading indicators are strong, then the rest of the economy is strong, necessarily, but we will see the resulting revenue and earnings in due course.

It has been 25 years since India started liberalizing its economy. You've been investing in India for nearly 22 years. Has the country done enough? Do you think we need a similar movement to reform agriculture in India?

The process began with the foreign exchange crisis in 1991: India couldn't meet its external payment obligations 25 years ago on 27 June. There have been extraordinary gains for India since then. But there have been stops and starts in economic reform since then and the engine has idled for far too long. But India is a complex democracy and things need to be done by consensus, and the consensus has in general not delivered enough: that is, I think, the obvious takeaway from Modi's election result two years ago. Once the political agenda changes—and it arguably now has—then the question of "when" further reform and growth will be delivered rather than "if" comes clearly into view. Agriculture is changing, and we see that in both the arrival of smartphones, which are very empowering, and the UID (unique identity), where certainly almost every adult in the countryside now has a unique ID and can, therefore, open a bank account and get the benefits they are entitled to. As opposed to not getting those benefits or benefits minus some "friction". That single factor—a UID-enabled cash flow increase—is changing things fast. Over one billion UIDs have been issued! Quite a delivery of infrastructure.

Government and private sector studies suggest that nationwide implementation of food subsidies through direct transfer of benefits to UID-linked accounts could save more than $3.7 billion per year through a combination of lower administration expense and reduced theft. At full potential, it's estimated that direct benefits transfer can save the government more than $15 billion every year, a full 1% of GDP.

Is global growth as bad as the rhetoric suggests?

In our view, 'No'. There is a real chance a major market event could happen, triggered by a number of factors; but, of course, that is always potentially the case. Imbalances are always present and there are certainly more of them. However, these imbalances and many of these market and economic risks are not unknown. Two key factors which, in our view, are positive, lead us to think there is a lot on the plus side vs the negative side of the ledger.

Firstly, trade between developing countries is now 40% of their exports, the balance going to the G-7, up from 23% 15 years ago. So, if you assume the OECD, or whatever the proxy for the developed world, is not in so great shape—ZIRP (zero interest-rate policy), QE (quantitative easing), demographics, etc.—almost the other half of the world—and rising—is doing more trade than before. Also, the fall in the price of oil is a plus for everyone except the oil producers.

Also, we would say that the Fed is "easy"—and how could one be awake and not say that—and, while there will of course be "black swans", and some things will evolve worse then expected—many candidates—but central banks in the developed world are all "easy", not "tight". Too "easy", yes, but that's a different problem.
