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India 2020: The Road to East Asia - Key Stock beneficiaries

This report is referenced to our earlier, detailed report today, titled **India 2020: The Road to East Asia**, where our Global Strategist, regional economists and the India research team got together to provide a holistic view on the new government's economic vision, highlight the imperatives of its five year economic policy and assess the key challenges and opportunities in sectors of prime economic importance. Our global strategist, Sanjeev Sanyal highlights "A clear and internally coherent economic model is emerging from Prime Minister Modi's speeches and policy actions. The model includes export-oriented manufacturing, heavy infrastructure building and urbanization. In our view, this suggests a shift from India's current services-driven growth trajectory to an East Asian growth model based on the mass deployment of labour and capital. In this report we identify stocks which will be the key beneficiaries of the Modi administration's transition to an East Asian economic model.

India will need a dramatic improvement in transport connectivity together with addressing the skewed transport mode mix, currently biased towards roads Road construction will need to rise 5-fold to 30Kms/day from the current 6 kms/day. The Indian Railways will also need to build the capacity to evacuate more than 3x the current traffic of both passengers as well as freight by building high speed dedicated freight corridors and faster trains. **Larsen and Toubro**, **IRB Infra** and **Adani Ports** should be the key beneficiaries of policy moves on building transport infrastructure.

In the crucially important power sector an additional 100GW, (equivalent to 40% of current installed capacity) of power generation capacity will be required to meet burgeoning power demand by 2020 driving an increase in its power demand multiplier to a range of 1-1.2x from 0.8x currently. We estimate the need for an additional 310 mn tonnes of coal annually to fuel power demand growth of 8-9% by 2020. Once the pending issue of strangulated fuel supply is addressed we expect the policy focus to shift to (1) decentralized Renewable Energy, (2) expanding grid capacities through transmission highways, and (3) expanding the Private Public Partnership footprint in Distribution. **Powergrid Corp** should be the biggest beneficiary of the second generation reforms in the power sector.

With rising fiscal constraints, an increasing onus of financing the mega infrastructure investments will progressively lie on the private sector and in turn on the banking system, until new financial products for infrastructure financing take shape. We see the banking system annual credit growth moving towards at least 18% over the next five years, with credit/GDP rising from sub 60% currently to more than 70%. Indian policymakers will need to come up with innovative solutions to unlock longer-term sources of capital beyond the traditional reliance on the banking sector, accompanied by lower cost funding, particularly for infrastructure projects. **Axis Bank, ICICI Bank, SBI, PFC** and **REC** should be the key beneficiaries of India's big infra opportunity, given their domain expertise in Infra financing.

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Over the next five years we see the oil and gas sector emerge as the cornerstone of both energy as well as fiscal security. We see government focus on two critical objectives: (1) incentivizing higher domestic gas production, and (2) dramatically reducing fuel subsidies which in our view could release US$18-28bn annually by 2020. An environment of zero fuel subsidies could dramatically improve the financials of state-run oil and gas companies. The savings on unproductive and wasteful subsidy expenditure could be channeled towards higher expenditure on oil and gas exploration in India or abroad to help enhance India’s energy security. Even assuming ONGC and Oil India fund all the fuel subsidy, subsidy reduction could save a massive US$4bn annually (about 50% of their aggregate FY14 PBT) from 2020, for these companies. **ONGC** is set to emerge as the biggest beneficiary of this dramatic reduction in fuel subsidy over the next five years, in our view.

The next five years should see India replicate a multi year trend of materials intensive economic growth seen during the industrialization phases of its Asian peers. We see India emerging as an importer of up to 26mn tonnes of steel by FY20—equivalent to 18% of its forecast consumption. We also estimate India's iron ore requirements to rise by 57% and coking coal requirements by 42% from current levels, which could severely constrain the transportation infrastructure. We also see a strong shift in government policy towards incentivizing captive steel production and discouraging merchant iron ore exports. **Tata Steel, JSW Steel** and **UltraTech** should be key beneficiaries of India's move to materials intensive growth.

India 2020: The Road to East Asia

Our global strategist Sanjeev Sanyal highlights "One of the immediate problems faced by the new government is the significant slowdown in economic activity in recent years. A poor emerging economy like India is always in search of growth as it is needed for increasing per capita income. However, there is an additional reason for wanting to revive growth – the need to generate employment". As the latest Economic Survey puts it “The defining challenge in India today is that of generating employment and growth”. Part of the urgent need for employment generation is due to the country’s expanding working age population. Between 2015 and 2020, the working age population (defined here as 15-59 years) will rise from 804mn to 856mn. This requires 10mn additional jobs per year until the next elections to keep up with demographic expansion alone.

So, what does the government need to do in order to get firms to invest again? The first and most obvious thing would be to finish the various stalled infrastructure projects. The capital invested in these projects can be made to generate output. This would also help the banking system which has seen an increase in its non-performing loans as a consequence of the various delays. However, the longer-term agenda would be to make it easier to do business in India. While a generic improvement in the business climate would be welcome, Prime Minister Modi’s speeches and actions suggest a more specific economic model. As explicitly stated in the Independence Day speech, one component of his economic model is an emphasis on export-oriented manufacturing. Notice that this is not about agnostic free markets but about creating competitiveness by investing in industry clusters. Another component is investment in heavy infrastructure ranging from power to railways. A third element is labour reforms. This is an area that previous government considered too politically sensitive but has already been opened up for reform by the NDA government both at the state and central level. These reforms are clearly a prelude to the mass deployment of labour. Finally, a repeated emphasis on building and expanding cities – urbanization being the spatial manifestation of industrialization. Not only are these elements internally consistent, they also look very much like the economic model used by East Asian countries to rapidly modernize themselves. In other words, for the first time since Nehru, we have a wide-ranging, internally consistent economic model. Moreover, this model follows a well trodden path

This report is referenced to our earlier, detailed report today, titled India 2020: The Road to East Asia, where our Global Strategist, regional economists and the India research team got together to provide a holistic view on the new government's economic vision, highlight the imperatives of its five-year economic policy and assess the key challenges and opportunities in sectors of prime economic importance. In this report we identify stocks which will be the key beneficiaries of the Modi administration's transition to an East Asian economic model.

Infrastructure

The NDA government's proposed strategic transition towards an East Asian model of labor-intensive manufacturing growth cannot be achieved without making substantial investments in transportation Infrastructure, which remains woefully inadequate to meet even current needs, leading to time delays and high transaction costs, making Indian manufacturing severely uncompetitive. Various studies on the opportunity cost of India's inefficient transport infrastructure peg the loss of GDP to transport constraints around 2-3.5%. A fast-growing, assertive middle class, large-scale mobility of working population to longer distances and growing demographic pressure, will further accentuate India's transport infrastructure bottlenecks unless the government embarks on an urgent game plan to build vital transport infrastructure. While transport capacity constraints have been blamed for India's woeful transport inadequacies, we believe that poor transport mix between rail and roads has played an equally important role in making India's transport infrastructure inefficient. Over the years, the share of railways in freight transport has fallen steeply from 89% in 1951 to only about 36% by 2008, while the share of road transport has risen to over 50% in the same time period.

In our view India will need a dramatic improvement in transport connectivity together with addressing the skewed transport mode mix. It has been well articulated that road construction will need to rise to 30Kms/day from the current 6 kms/day. Indian railways will also need to build capacity to handle more than 3x the current traffic of passengers and freight by building high-speed dedicated freight corridors and faster trains. Ease of goods and passenger movement will be complemented through passing of the new goods and service tax set to reduce/replace local tax levies at production centers with direct levies at consumers thereby closing the leakages in logistic costs currently equivalent to 14% of GDP (amongst highest globally) to less than 7-8%. **Key beneficiaries: Larsen and Toubro, IRB Infra** and **Adani Ports.**

Utilities

Executive summary – Roadmap for 2020

The Indian power sector has outlived the first generation of reforms started in 2003, and is today crucially awaiting its second generation of reforms. Power generation de-licensing, now needs to be followed through with de-licensing of resources and retail power distribution. We welcome the government's strategic intent to achieve 24x7 power availability. Given the successful implementation of this target in Gujarat, we do not see why this cannot be replicated across the country progressively, albeit with considerable effort.

We reckon that apart from re-starting stalled projects, an additional 100GW of power generation capacity is required to meet burgeoning power demand by 2020 as India embarks upon an era of manufacturing-led growth, driving an increase in its power demand multiplier to a range of 1-1.2x from 0.8x currently. We estimate an additional need for 310 mn tonnes of coal annually to fuel the existing and new capacities for meeting power demand growth of 8-9% by 2020. Alleviating coal supply shortfalls will remain critical to India's energy security and will need innovative solutions including enlarged private sector participation in coal mining. We believe that de-bottlenecking fuel constraints should be the highest priority for the government in the immediate term followed by a progressive focus on unleashing the second generation of reforms.

Once the pending issue of strangulated fuel supply is addressed we expect the policy focus to shift to (1) a strategic thrust on decentralized renewable energy, (2) expanding grid capacities through transmission highways, (3) expanding the Private Public Partnership footprint in distribution by amending the Electricity Act to separate supply and wires business, and (4) building long-term energy security through development of 3rd generation of nuclear power technology. **Key beneficiary: Power Grid Corp.**

Oil and Gas

For the first time since independence, the oil & gas sector has emerged at the centre focus of both, the government's energy, as well as fiscal security. Over the next one year we see the government building a strong national consensus on the need for incentivizing higher domestic production and achieving a dramatic reduction in fuel subsidies, in a progressive manner. Over the next five-year period, this should have a material impact on the fiscal deficit and divert close to US$18bn annually by 2020 (relative to FY13, which we believe was the worst year for fuel subsidies) from wasteful subsidies to financing infrastructure projects. Over the next five years the government's oil and gas policy is expected to focus on:

1. Incentivizing domestic gas production to reduce India's hydrocarbon import intensity through raising gas prices from existing USD4.2/mmbtu.

2. Streamlining regulatory processes in exploration and production and improve co-ordination between petroleum, environment and defense ministries to reduce existing long gestation periods between the award of blocks and actual production.

3. A progressive rationalization of fuel subsidy potentially extinguishing government's fuel subsidy bill and releasing resources to fund infrastructure.

Even assuming ONGC and Oil India fund all the fuel subsidies, fuel subsidy reduction could save about US$3.5bn annually (45% of FY14 PBT) from 2020, for these companies. **Key beneficiary: ONGC.**

Metals and Mining

The next five years should see India replicate a multi-year trend of materials intensive economic growth seen during the industrialization phases of its Asian peers. The most recent example of this trend was China, where the country broke out to a ten-year period of materials intensive growth after its GDP/capita PPP crossed the threshold of US$2500. A strong thrust on infrastructure, urbanization and construction is expected to be highly materials intensive and will see India's steel and cement demand intensity rise sharply from historical averages as these initiatives take off in a meaningful manner. We expect this to be strongly visible from FY18 onwards, by when many of the large infrastructure projects including the Delhi Mumbai Industrial Corridor and the Diamond railway quadrilateral take off. A big thrust on roads and urbanization will also drive higher materials intensity. Between FY18 and FY20 we see Indian steel demand outpacing production by a wide margin.

Based on our estimated rise in India's materials intensity, an assessment of its supply-side constraints and stretched balance sheets of incumbent companies (which are only now coming out of a five-year, debt-funded capacity expansion), we see India emerging as a large importer of steel in FY19-20. We see India importing as much as 26mn tonnes of steel—equivalent to 18% of its forecast consumption—despite our assumption of production rising by 53% from now. We also estimate India's iron ore requirements to rise by 57% and coking coal requirements by 42% from current levels, which could severely constrain the transportation infrastructure—particularly railways and ports—if sufficient investments not made in logistics. If investments are not made in the logistics sector the cost of production for Indian steel will rise sharply, diluting India's iron ore advantage. We also see a strong shift in government policy towards incentivizing captive steel production and discouraging merchant iron ore exports. **Key beneficiaries: Tata Steel, JSW Steel** and **UltraTech Cement.**

Banking and Finance

How will India fund the proposed mega investments in infrastructure, commensurate with the needs that accompany its transition towards an East Asian manufacturing model? This is the most crucial issue ahead of Indian policymakers. With rising fiscal constraints, an increasing onus of financing these investments will progressively lie on the private sector and in turn on the banking system, until new financial products for infrastructure financing take shape. In the absence of deep and liquid bond markets and alternate modes of financing, the banking sector has been the key provider of finance to the infrastructure sector. This is clearly not a sustainable mechanism given the asset liability mismatches that accrue from financing long gestation infrastructure projects. Indian policymakers will hence need to come up with innovative solutions to unlock longer-term sources of capital beyond the traditional reliance on the banking sector, accompanied by lower cost funding, particularly for infrastructure projects.

We also believe India must enact policy that is conducive to deeper and more liquid bond markets which would allow greater facilitation of investment flows to infrastructure projects. Increasing the FDI limit in insurance as proposed by the new government would be a very good starting point in achieving this objective. The new RBI administration under Dr Raghuram Rajan has demonstrated the ability to rise to this challenge and we expect a progressive policy roadmap towards achieving the end objective of financing infrastructure growth at an optimal cost and through avenues beyond the banking sector.

In due course, as the bond markets deepen, companies may find it cheaper to borrow from the bond markets rather than bank loans. However, banks would continue to be key investors in the bond markets along with other entities like insurance companies, mutual funds and pension funds. Disintermediation via deeper and stronger bond markets should further lower funding costs for borrowers.

Strong loan growth over the coming years will require proportionate increase in capital levels of banks. Government may find it difficult to hold on to its current shareholding in PSU banks as it will need to inject large doses of capital. Consequently we expect the government to consider diluting its stake in PSU banks initially to ~51% and eventually even below that threshold. While building a political consensus on diluting government stake below 51% will need considerable effort, we see this initiative being taken up earnestly by the middle of the government's current term. **Key beneficiaries: Axis Bank, ICICI Bank, SBI, PFC and REC.**

Autos

The Indian auto sector is a case study for successful liberalisation. The central government set the ball rolling around 1985 as it eased quantitative restrictions and progressively relaxed licensing norms. It culminated with automatic approval for 100% FDI in 2000. Today, the sector boasts a presence of strong domestic players and most global OEMs. It has also catalyzed a thriving auto component industry. Looking forward, GDP growth will provide a natural impetus to domestic demand to grow at 12-14% p.a. In exports space, India's key competitor is Thailand, which has risen to become a global top-10 auto exporter on the back a focused government policies.

Appendix 1

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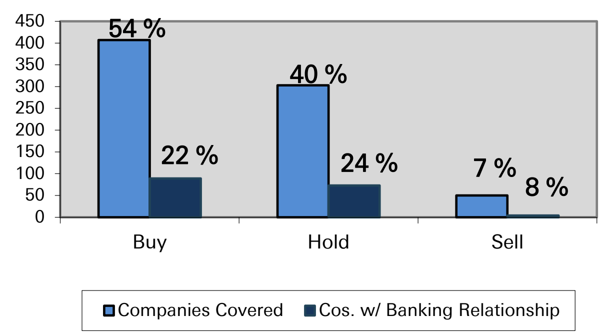

Asia-Pacific Universe

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