

EMERGING MARKETS DEBT

Making India a Global Growth Engine

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MACKEY SHIELDS
A NEW YORK LIFE INVESTMENTS COMPANY

India—Can the World’s Largest Democracy Become the Growth Engine of the Next Decade?

It is late January 2023. A US-based short seller named after the exploded German airship Hindenburg publishes a scathing report on dubious corporate practices at an Indian conglomerate. By the time the market fully internalizes the report’s findings, the stock price fall for the group exceeds USD 100bn and yields for bonds issued by the group reach double-digits. Its owner, Gautem Adani after whom the conglomerate is named, gets relegated from the world’s fourth richest person to merely an also-run in the league table of global billionaires.

As this story unfolded, we were left wondering if this provides a watershed moment for Indian capitalism and if the development model of allowing large conglomerates to drive growth in the country has been dealt a fatal blow. In this paper, we examine the state of Indian capitalism and how it interlinks with the political landscape and whether India can really provide a future global growth engine in a multi-polar world.

India After independence—from License Raj to Free Markets

Shortly after India gained independence from Great Britain in 1947, a system of strict government control of the economy was introduced and kept in operation from the late 1940s to the mid-1990s. Often referred to derogatorily as the ‘Licence Raj’, the system had many parallels with the Soviet blueprint of economic administration. Some important distinctions and local flavorings meant that the Indian variant of socialist,

almost communist economic organization focused on optimizing the plight of the poor Indian farmer, and not so much that of the industrial worker. A proletariat in the Soviet sense didn’t exist in the largely subsistence farming society of the early Indian republic. Other features of the License Raj will seem familiar to any student of Soviet state organization; for example, a Planning Commission that centrally administered the economy and formulated India’s Five-Year Plans, and an obsession with spurious measurements and statistics. Only in 2014 did Narendra Modi’s government decide to wind down the Planning Commission and replace it with the National Institution for Transforming India (NITI - Aayog), a Think-Tank more akin to a Council of Economic Advisors that exists in many countries.

In today’s India, the after-effects of the now abolished central planning system are still evident. During the years of the License Raj, only those sufficiently connected to the political and administrative elites were granted permission to produce and engage in other business activities. This gave ample space for corrupt practices and the payment of backhanders and generally led to poor allocation of resources. It also stymied the pursuit of efficiency in production and distribution of goods and

FIGURE 1: THE NEW INDIAN ECONOMIC THINK TANK
 NITI AAYOG



Source: [NITI AAYOG website](https://www.niti.gov.in/)

services. If a central authority effectively decides what a firm can make, it makes little sense to find ways to achieve the task more efficiently. It is in this context that we have to embed our discussion of Indian capitalism, its conglomerate structures and what they might mean for the growth outlook as the country unleashes the forces of competition and more decisively integrates with global supply chains. Also, for historical reasons the country has yet to fully embrace global financial markets and fully open up its capital account. For example, India has not yet issued sovereign bonds at the federal level in foreign currencies, which would provide useful benchmarks for corporate issuers from the subcontinent, even if no direct foreign currency financing is needed.

Conglomerates in the Present Day

Indian conglomerates might seem an oddity in a world of ultra-efficient capitalism. Most similar structures in other countries succumbed to the axe of the corporate restructurer with the realization that the sum of their parts is worth more than the holding structure. The historical context described above is important as to why these organizations existed in the past, but in order to understand why they are still operating today we have to dive into the present day realpolitik of Indian economic and industrial strategy. The government of Narendra Modi, who won the Presidency in 2014, has focused its economic policies on privatization and liberalization, but has also favored national champions. This has provided ample political support for the tycoons, and when Modi introduced the 'Make in India' initiative in September 2014, domestic conglomerates were particularly well positioned. Despite the policy not specifically being aimed to promote the behemoths that grew under the Raj, they nevertheless benefitted disproportionately due to their superior knowledge of home market needs, norms and customs.

Furthermore, Indian conglomerates operate many legacy business lines, awarded to them under the central planning regime. These are often in capital intensive sectors, where high barriers to entry protect their market share. This is particularly relevant in the metals and mining sector, as well as some areas of manufacturing, energy production and logistics. Often monopolistic in nature during the licensing period, these business lines gave conglomerates a significant head-start after deregulation was rolled out in the early 1990s and again under Modi in 2014. But conglomerates still needed to pivot

FIGURE 2: PRESENT DAY INDIAN CONGLOMERATES



their focus to adjust to new challenges, and some have been more successful than others at achieving the task. Tata group for example can trace its origins to supplying steel for railways in colonial times, but it is now a major player in IT, consulting and outsourcing. The group realized that by using the competitive advantages of the subcontinent, for example the vast pool of Indian English speakers and a typically high level of tertiary education, they could build operations that compete globally. While generally successful at home in transforming its business for the 21st century, Tata also tried to bring their domestic knowledge of existing business lines to ventures abroad. In 2007 the conglomerate acquired the Dutch-British steelmaker Corus. They have yet to make this acquisition successful; the British operation has been loss making for most of its time under the new ownership, needing frequent capital injections and constantly teetering on the brink of bankruptcy. However, in what can be seen as a full commitment to business turnarounds, the Corus debacle has not deterred Tata from taking on the ultimate domestic challenge in corporate restructurings in 2022: Air India. (See Figure 3)

Overall, rejuvenation is part of Indian culture and also deeply engrained in corporate practices. Tata and others have stayed nimble in the face of changing winds for Indian capitalism, notwithstanding poor investment decisions abroad. However, the Indian investment case will remain unique as opportunities need to be considered on their own merit at the entity level, while also taking into account what influence conglomerate structures can exert on the investment outcome from a top-down perspective. The Adani story is a case in point.

FIGURE 3: TATA ACQUISITIONS

CORUS STEELWORKS IN PORT TALBOT | WALES, 2007



Source: iStock by Getty Images

Adani—Burning Its Wings by Flying Too Close to the Sun?

The Adani group is a relatively recent entrant into the small cohort of Indian business empires. Its founder Gautem Adani also epitomizes the rags-to-riches story that is part of the national psyche, depicted in many Bollywood movies, most famously in the 2009 Oscar winning film ‘Slumdog Millionaire’ by Danny Boyle. Starting out as a diamond sorter, Adani moved on to trading the precious stones. He then ventured into exporting and importing plastic polymers. A huge beneficiary from economic liberalization, he expanded his trading operations to metals, textiles and agricultural products in the early 1990s. In 1994, the government of Gujarat awarded Adani the contract for managing the Mundra Port which he developed to become operational in 1998. To this day, the port and its associated special economic zone remain the crown jewel in the Adani portfolio of businesses, generating significant free cash flow. Adani later expanded into power generation, airport infrastructure, real estate, cement and many other business lines. Staying close to the centers of power, first in his home state of Gujarat where he forged deep ties with Narendra Modi, then on the national stage when Modi and his right-wing Bharatiya Janata Party took over, Adani is well known for being a master operator, able to navigate the treacherous waters of Indian capitalism better than most.

The Adani group is organized into several so-called verticals with energy & utilities and transport & logistics the most relevant business lines. Within the verticals, several separate entities have issued bonds in external markets, in some cases backed by regulatory regimes. For example the state regulator

AIR INDIA | 2022



Source: iStock by Getty Images

for electricity in the state of Maharashtra (MERC) governs in large part the revenue and cost structure of Adani Electricity Mumbai. Others, such as the Ports & Special Economic zone are significantly profitable amid the strong growth for Indian exports. Across the verticals, Adani Enterprises, an entity listed on the Indian stock market acts as an ‘incubator’ for new business ventures. Corporate governance practices were weak even before Hindenburg issued its scathing report. Allegations of stock price manipulation, related party transactions and dubious business practices at some of the entities in early stages of development were at least to some degree known beforehand. A limited free float, scant equity analyst coverage and low trading volumes for listed entities of the Adani group led to only limited ownership of the groups’ stocks among global investors. However, strategic investors, for example the Qatari Sovereign Wealth Fund (QIA) and its Abu-Dhabi equivalent (ADIA) play an important role as shareholders in some Adani entities. In our analysis we concluded that investments into any of the Adani entities should be restricted to the debt backed by either strong stand-alone cash flows or within a regulatory framework. Generally, we prefer entities that have strong strategic shareholder support.

The Conglomerate-Led Development Model

The growth model that favors a group of well-connected conglomerates has served India well in certain sectors since deregulation was rolled out. Particularly it has helped to offset certain structural weaknesses and developmental downsides of a vast democratic country. For example, streamlined decision making and superior financial management with access to bigger pools of capital have often offset downsides from rent-seeking behaviors. One example is the re-

development of Dharavi, one of the largest slums in the world which currently houses approximately 1 million residents in ramshackle dwellings, often with poor or no sanitation. So far the project has failed every time it was attempted due to political obstacles created by the one million voters who collectively don't want to vacate the area and are experienced in flexing their political muscle.

Enter Adani Real Estate, who with political backing might be able to pull off the feat that has eluded every developer before. In November 2022, the property unit of Adani Enterprises won a 50 billion rupee (ca. \$600m) tender to redevelop Dharavi, in what could become the largest urban regeneration project worldwide. However, after the Hindenburg Research report, two immediate questions arose: does Adani have sufficient capital or access to capital to fund the project and will the political connections necessary for implementation be forthcoming? The answers will serve as a litmus test for the durability of Adani Real Estate on the one hand and on the other hand act as an indicator if Adani's political connections

suffered only a minor impingement or a more substantial body blow due to its missteps.

India on the World Stage

As a large and mostly inward focused country, India has not played a significant role on the world stage before the Bharatiya Janata Party (BJP) and Narendra Modi came to power in 2014. Previous administrations focused their attention on the long festering conflict with Pakistan in Kashmir and occasional clashes along the India-China border. A strict policy of nonalignment with either bloc during the Cold War kept the subcontinent out of most strategic considerations. Since assuming office, Modi has turned India into a strategic player with a highly effective foreign policy. He has faced down India's archrival Pakistan as well as China, deploying the army in 2020 to confront a border violation that previously would have likely been tolerated. The skirmish even resulted in a gain of previously disputed territory.

FIGURE 4: DWELLINGS IN THE DHARAVI AREA OF MUMBAI



Source: iStock by Getty Images

In December 2022, India took an ambitious agenda to the rotating presidency of the G20. The most recent summit of finance ministers and central bankers in Bengaluru (formerly known as Bangalore) focused its discussions on trying to resolve the debt impasses for countries in default (e.g. Zambia, Ghana and Sri Lanka). Discussions made progress during the summit, but as China is an important creditor and has strategic interests as part of its “Belt and Road” initiative, it was unlikely that India as the host nation would be afforded a major diplomatic victory.

India's Long Term Potential

In the medium term, India could become a third superpower politically and perhaps we are at the cusp of a truly multi-polar era. The sub-continent’s vast and still growing population, its significant portion of English speakers and huge numbers of well educated, highly skilled workers can combine with the famous Indian entrepreneurial spirit to create a political and economic force to complement—or perhaps rival—China and the United States. How this power play pans out will shape the political, geopolitical and economic landscape for decades to come.

Looking at population and GDP figures, India at the moment produces a relatively low output per capita of just under USD

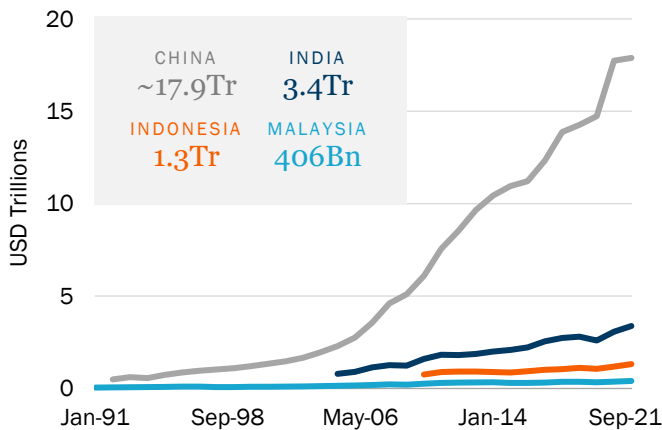
2500, or approximately half of Indonesia’s. China and Malaysia are well ahead at around USD 12,000 per capita.¹ In our view, significant potential for catching-up with Asian peers exists and is credibly underpinned by the structural reform agenda put forward by Modi’s government. De-regulating, liberalizing and opening up markets for goods and services could propel India’s growth for the next decade; the path for productivity gains when emerging from a rural economy is after all well-trodden. In fact, structural growth improvements were an important reason for the upgrade of India’s GDP growth forecast by the International Monetary Fund in its World Economic Outlook presentation (October 2022) amid a sea of downgrades elsewhere.

Growing Fast in Absolute Terms, Significant Catch-Up Potential

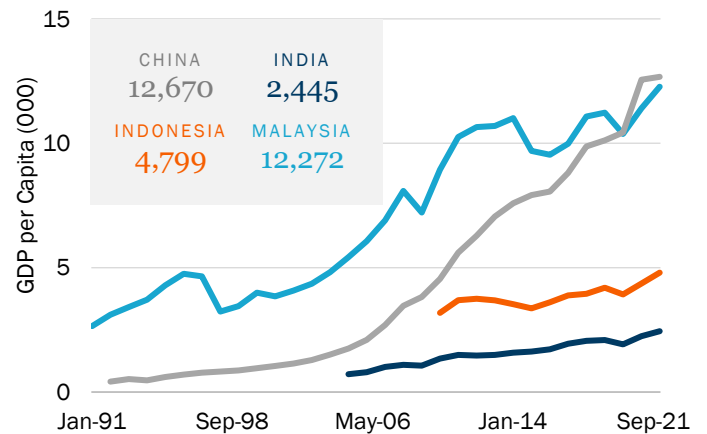
So far, India’s economy has grown to 3.3 trillion in US dollar terms (left-hand chart below), approximately doubling over the last decade, while during that time India grew slower than its peers in Asia on a per- capita basis (right-hand chart below), but partly this is reflective of demographic trends. Given the relatively low absolute level of GDP per capita and taking into account urbanization trends, we think it is plausible to expect a reversal in growth rates over the course of the next decade in favor of India.

FIGURE 5: STRONG LEVERAGE RATIOS BY HISTORICAL MEASURES

ABSOLUTE SIZE



GDP PER CAPITA ACROSS ASIA



Data as of January 1, 2022

Source: Bank Indonesia, China National Bureau of Statistics (NBS), Department of Statistics Malaysia (DOSM), Indian Ministry of Statistics & Programme Implementation (MoS&PI), Statistics Indonesia (Badan Pusat Statistik, BPS)

1. Source: National sources. Data as of January 1, 2022

Growth Driver—Productivity Gains From Urbanization

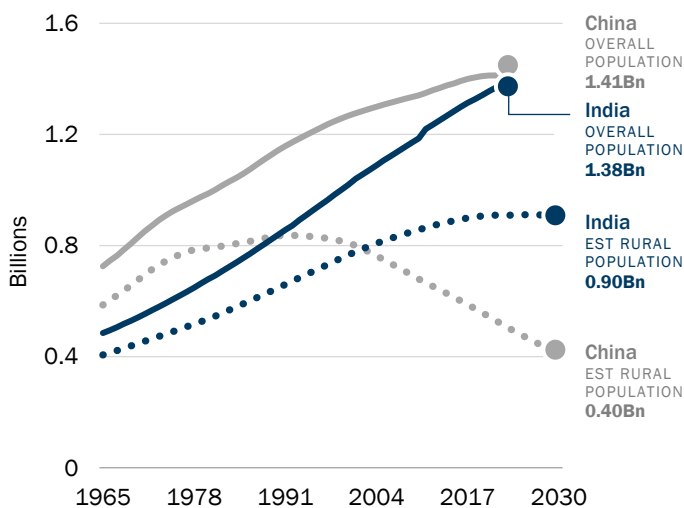
India has a significantly higher proportion of rural dwellers compared with other countries in Asia. The share of the population still living in agrarian settings, which in the early 1980s was approximately 80% (which was similar to China's percentage), still hovers at around 65%. Compare this to China today, where that percentage has fallen to about 36%.² The mass-migration of approximately 400 million Chinese citizens from rural settings into urban centers has unlocked enormous productivity gains that have eluded India. In fact, according to estimates by the World Bank, the absolute number of Indians living in rural settings is currently peaking at around 900 million citizens, only expected to slowly decrease over the next few decades. In China, this process started in the early 2000s; over the next 20 years, the rural population fell from about 800 million to around 400 million today. But even if the current trend of migration into urban settings does not accelerate, population growth and existing pathways should keep potential growth rates elevated for the foreseeable future.

Growth Driver—Green Energy

India is poorly endowed with natural resources and imports most of its hydrocarbons. While it mines some ores and coal

domestically, the country still needs to purchase significant amounts of raw materials abroad. Recognizing this, Indian authorities have embarked on an ambitious journey to defossilize electricity generation in India, as the power sector is one of the largest consumers of fossil fuels. For this purpose Indian authorities have put a framework in place that favors renewable energy providers at the off-take. Other incentives and a heavy lean on clean energy providers from political powers have incubated a significant renewable energy sector. At present, India is the 3rd largest market for renewable energy, and domestically in India just over one quarter of total installed capacity is from renewable sources.³ The sector's funding model is unique in the sense that once a renewable power project becomes operational, it is often bundled together by the power company into a so-called 'Restricted Group', or RG for short. As operating costs are often minimal and revenues are predictable, in many cases via long-term Power Purchase Agreements (PPAs), these RGs are perfect candidates for bond market financings. As a result of the enthusiastic embrace of the global bond market by Indian renewable power companies, a large investable universe of green energy bonds has emerged. The Indian green energy bond universe of RGs and some holding company debt have found keen buyers among the many sustainable and green bond funds that have been launched in recent years. Challenges, for example the poor condition of distribution companies as the main off-taker counterparties, a certain naivety when appointing senior leadership positions and the Adani saga have meant that careful security selection within the sector has been very important to capture returns.

FIGURE 6: INDIA AND CHINA POPULATIONS



Source: World Bank

Benefitting from Indian Investment Opportunities

The Indian investment universe is unique even within emerging markets. Where else can one find a market without a sovereign US dollar bond curve, but a deep investable universe of many different renewable energy companies? For the size of the country and its bond market, the absence of a US dollar denominated yield curve is peculiar and creates its own challenges, as investors find it harder to price, trade and compare corporate bonds. Relying on proxies, such as the state-owned Export-Import Bank, is not optimal as a change in banks' credit risk can happen irrespective of a change in sovereign creditworthiness. Conversely, the lack of a US dollar denominated sovereign bond curve creates opportunities for

2. World Bank (<https://databank.worldbank.org/>), China National Bureau of Statistics (NBS), Indian Ministry of Statistics & Programme Implementation (MoS&PI), Department of Statistics Malaysia (DOSM)

3. Source: World Bank

us as investors, as a deep understanding of sovereign risk and how it affects credits under coverage is perhaps even more important in the absence of an easily observable yield curve.

On the local currency side, investing faces the obstacle that financial flows into and out of the country are tightly regulated and need to clear often formidable administrative hurdles. In other words, the capital account is relatively closed. This makes accessing the domestic market for foreign investors much more difficult than elsewhere in Asia and other regions. The main index provider for emerging markets, J.P. Morgan for example, offers a variant of its local currency benchmarks that excludes India, recognizing the difficulties in replicating a benchmark that would contain Indian rupee denominated bonds.

We maintain India offers unique investment opportunities. We expect Indian bond markets to grow substantially as the economy advances further away from the central planning period towards a full-fledged market based setup. Its GDP growth rates are very likely to stay high, by virtue of a growing population and the migration from rural to urban settings. If the evolution of the bond market just keeps pace with the advance in overall economic output, many more securities will likely become available for investors. Furthermore, as growth drivers broaden out, we are confident in predicting that capital needs arising from the Indian economic development story can provide many additional investment opportunities in new issuers and sectors. In the process, we see capital markets deepening further, as funding needs for infrastructure, the advancement of the green energy transition and for more traditional corporate purposes get addressed. Indian corporate treasurers have already embraced innovative funding solutions, for example by bundling green energy projects into Restricted Groups and then tapping bond markets to free up capital for further greenfield projects in solar, wind or other renewables. The embrace by the Adani group of private markets, where they recently completed a USD 750m funding round for Mumbai Airport, takes financial innovation even one step further.

Security Selection as an Important Driver for Returns

The unique features of the Indian bond market raise the importance of specific security and entity selection when choosing how to position portfolios. Sovereign risk can never be ignored in any emerging market, and in India this task encompasses a need to understand state and municipal level

rules and regulations. For example, when looking at the renewables sector, the relative health of state-owned electricity distribution companies has been a major factor in determining investment outcomes. Power producers with larger exposures to weaker off-takers fared worse than peers with exposures to distribution companies in stronger states. Furthermore, when the Indian Supreme Court ruled that distribution companies had to implement payment plans to clear the past-dues, previous underperformers caught up with peers. We maintain that a nimble approach to the investment analysis that can capture catalysts stemming from legal or regulatory changes works best in a market as diverse as India's.

An important investment consideration in the presence of conglomerates is the analysis of Environmental, Social and Governance (ESG) factors. In particular, a deep understanding of corporate governance practices and where they might fall short has proven crucial to understanding Indian credit risks. Conglomerates are often privately owned and are regularly not subject to the same scrutiny as their publically traded peers. Their disclosures, ESG reporting and investor engagement are sometimes lagging behind, and when investing, understanding top-down contagion risk that might arise from the holding company is very important. The market reaction to the Hindenburg report highlighted how this can transpire, in spite of the stand-alone soundness of the ports and retail electricity business within the Adani group. However in emerging markets, corporate governance practices can be fluid and change quickly. Here we were encouraged to hear during the recent Adani group investor roadshow, led by the Group Chief Financial Officer Jugeshinder Singh, that head office with support from Gautem Adani himself is looking to structure its different holding entities to better align them with modern day best practices.

Conclusion

We believe investing in India can be very rewarding for the patient investor. A selective approach with a focus on understanding all layers of sovereign risk that leads the analysis of corporate issuers is more likely to be successful. Even if, as this piece has argued, India might be on the cusp of a potentially transformational phase of long, sustained per-capita GDP growth, picking the right ideas from an ever growing universe can amplify the return capture and avoid pitfalls. However, navigating the subcontinent requires special

expertise and a deep understanding of the investment proposition.

Liberalization under Narendra Modi has put the conglomerate business model at higher risk, but superior access to capital markets, innovative funding solutions and connections to political centers of power will keep the tycoons relevant for some time. Even if the Hindenburg report doesn't neutralize the conglomerate way of organizing businesses in India, evolving their corporate structures has been identified as a priority in the report's aftermath.

Finally, focusing on the analysis of Indian sovereign and domestic credit risks could be a fallacy. As the case of China has shown, many other emerging markets significantly benefitted from the much deeper integration of Chinese firms into global supply chains after entry into the World Trade Organization in 2001. In our assessment, India, while already a leader in services, can become a much more significant source of global aggregate demand for goods and services. How to benefit from this megatrend will remain one of the central investment considerations in the future.

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