India Capital
GROWTH FUND

HOODnote: India: Beyond the headlines

In the second note of this series, we look at what areas of transformation the Government is truly focused on. Since July, Prime Minister Modi has been criss-crossing the country, inaugurating over US$8bn worth of projects and with the election deadline looming in May 2024, it's estimated further projects valued at more than US$60bn will be inaugurated. It is clear the focus of the Government in it's election campaign will be on development and there is no slowing down in the pace of project completions and new project announcements.

Digilocker, the cornerstone of India's digital transformation journey

The robustness of India's public digital infrastructure has been well documented across the world. This infrastructure has been built in three layers being:

a) Identity

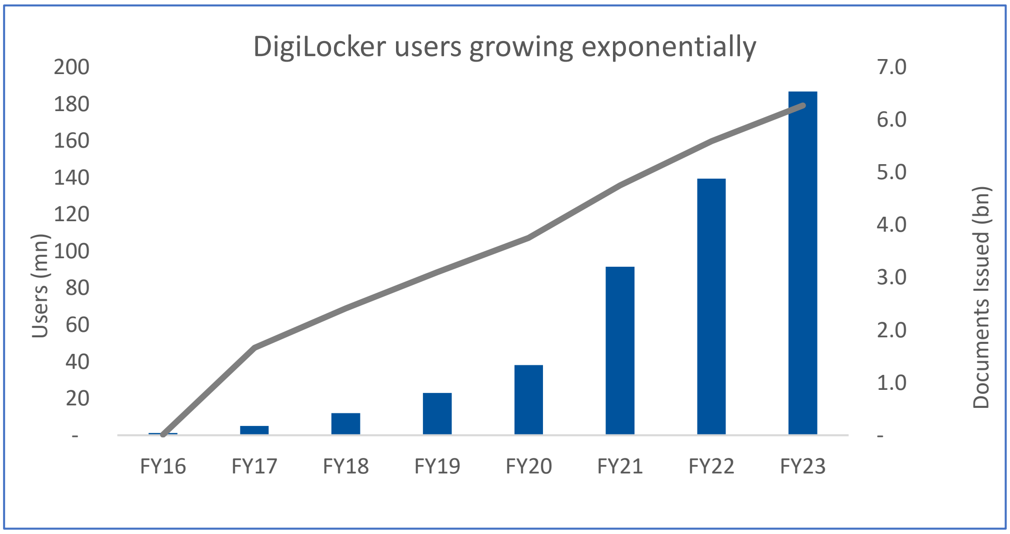
b) Payments

c) Data

Aadhaar (unique digital identity for all citizens) and Unified Payment Interface (UPI, the payments gateway) are well known. Aadhaar, is the foundation and used as an eKYC. It authenticates 80 million transactions a day and has helped open 500 million bank accounts, the majority of which are in rural and semi-urban India. UPI leverages on this and is currently used for over 7.0 billion real time transactions a month (45% of global volumes). Together they have transformed rural India through financial inclusion, formalising the economy and improving the administrative efficiency as all subsidy payments are transferred directly into the bank accounts of the beneficiaries.

However, it is the third layer which is less spoken about but which will drive the next leg of India's transformation. Digilocker is a key element of this. As the name suggests it is a digital wallet; an example of a Government cloud where you can store personal data securely. The only requirement is a phone to download the Digilocker app and the Aadhaar number to log in. The app can be used to download and store a range of documents including driving license, insurance policies, vehicle registration, education certificates, PAN card (Income tax card) etc. There are more than 1600 issuers of such documents integrated with Digilocker. For a consumer, it gives access and ability to share authentic digital documents anytime anywhere. Not only has it increased Government efficiency, but it has also reduced corruption as Digilocker minimises human interaction in document collection. With this facility, there is no longer any need to find a "Gazetted Officer" to attest a physical copy of the document. The documents on Digilocker are official and well accepted by all Government institutions.

While it has provided convenience, the true potential is still to be leveraged. One aspect of Digilocker is that it is a secured platform to exchange documents with real time verification and with user consent. The Central Bank has recently granted a license to a new set of institutions called "Account Aggregators" who can access and share the information with other institutions. When applying for a loan, all that is needed is to give consent to the account aggregator, and all the relevant documents are sent in real time to the institution directly from the source. This implies no paperwork, huge savings in processing time and eliminates fraud. The potential impact of this is unimaginable.



India - the next semiconductor manufacturing hub?

Manufacturing accounts for only 17% of India's GDP but for India to sustain its growth and generate employment, the share of manufacturing must increase. The `Make in India' initiative aims to reduce India's dependence on imports through local manufacturing in a few key sectors. One area of focus is electronic manufacturing, where efforts are underway to make India a global manufacturing hub. The target is to increase revenues to US$300bn by 2025, an ambitious threefold increase compared with the US$100bn in 2022.

The strategy is to start with assembly operations of electronic products like mobile phones, televisions, air conditioners etc. and gradually start local manufacturing of components like chargers, battery packs, displays etc. This would develop the domestic manufacturing ecosystem and increase value addition within the country. Mobile phones are a good example of this successful approach. Within a three-year period, India is already the second largest phone assembler globally, with 14% value addition being done locally. To put this into perspective, it took China 25 years to achieve a value addition of about 50% in mobile phone manufacturing.

To be a significant global player, establishing a semiconductor base is a necessity. In 2022, India's market for semi-conductors was estimated at US$27bn and is expected to reach ~US$64bn by 2025, with demand only set to increase further. Thus, it is critical to attract global players to India. To support this the Government has announced an ambitious US$10bn incentive package, offering a 50% subsidy on project cost. But will global players bite? It has taken China three decades to establish itself hampered by few companies controlling the technology, a highly complex manufacturing process, and added to which, post Covid, major economies want control of their supply chain.

The task is proving challenging. Of the three proposals received for the incentive scheme when it was announced, none passed muster with the Government. However, the Government remains determined. During his recent trip to the US, Mr Modi, signed a technology partnership with the US Government for semiconductors, agreeing something similar with Japan. This is aimed at ensuring there are no hurdles on transfer of technology. Key government ministers are directly negotiating with global semiconductor manufacturers, rolling out the red carpet for them. The impact is already visible with the first set of commitments coming in. Micron, headquartered in the US has committed US$ 2.7bn to set up an assembly, testing and packaging facility (phase 1 to be commissioned in 2024). Semi-conductor toolmaker Applied Material, also headquartered in the US, has committed an investment of US$ 400 million to establish its largest engineering center in India. The Government claims this is just the beginning, with two mega deals for fabrication manufacturing on the horizon before the end of the year.

What is working in India's favor is the size of the domestic market and the skilled base of chip designers already working in this industry. But with every developed country vying to have semiconductor facilities being set up in their own country, will the Government succeed? This is a space one needs to watch.

A new approach towards Free Trade Agreements (FTA)

The Government has undertaken a strategic shift in criteria around FTA'S in the past two years following poor past experience. Historically, a majority of the 13 FTA's with India did not benefit the country as imports shot up with no material gains in exports. The result of this experience was that in 2020, at the last minute, India opted out of joining the Regional Comprehensive Economic Partnership (RCEP). This is the largest free trade partnership in the world that includes fifteen Asia-Pacific economies including China. Concerns about a worsening trade balance, particularly with China were cited as the main reason. This has proven costly as India lost out on the export of services and post Covid, multinational corporations (MNCs) went looking for alternate manufacturing hubs to China. Consequently, countries like Vietnam, Thailand, Cambodia have an edge as part of the RCEP when MNCs are looking to undertake the China+1 strategy.

There is a realisation that for India to attain its growth targets, its meager 2.6% share of global exports must increase. Learning from past mistakes, India is adopting a new approach to FTAs. Previous FTA's were mainly with eastern countries under the `look East' policy. The focus is now on identifying dependable and durable supply chain partners that can offer business possibilities and access to technology. Priority is being given to goods and services that are desirable for export such as textiles, pharmaceuticals, IT and agriculture. Since this policy shift, India has moved swiftly and has already signed FTAs with UAE in March 2022 and Australia in June 2022. This was to be followed by the FTA with UK, which has been delayed by challenges in UK domestic politics. The UK FTA is now on the fast track and is expected to be the most comprehensive FTA for India so far, paving the way for all future FTAs including those with the EU and Canada.

So where are we now? After 11 rounds of negotiations, 19 out of 26 chapters are finalised. The issues remaining relate to investment treaties, intellectual property rights and rules of origin. These are expected to be resolved in the 12th round of meetings, which is ongoing. It is hotly anticipated that the FTA will be signed by Diwali (November 2023) and aims to benefit both countries in trade, investments and employment. For India, there is a lot of opportunity, a great example is Welspun India, a portfolio company in India Capital Growth Fund (ICGF), which is the largest home textile company globally, but while dominant in the US, it is weak in UK and EU. The reason being that Bangladesh, Sri Lanka, and Vietnam enjoy duty free access to the UK whereas Indian textiles attract an import duty of 9.5%. The FTA would create a level playing field. Also, India is the third-largest exporter of services to the UK and the FTA could potentially broaden access to the UK market for services firms in India. For the UK, duty reduction on Scotch whisky (150% import duty in India at present) is one of the big focus areas. India is the largest importer of Scotch whisky in the world (yet imports are only 3.3% of domestic consumption) and practically 100% of this is from the UK.

The Government's focus on accelerating growth in the Indian economy has been evident in the first half of 2023, with many data points reflecting improved momentum in the economy. There are two key elements to highlight here:

1. While the initial growth was driven by Government led investments in infrastructure, it is now broad based and visible in the private sector spends. Both positive corporate earnings and uplift in business confidence are reflective of this.
2. There is increasing comfort that this is not a short-term trend but appears more sustainable. This can be corroborated easily with various data points – credit growth at a 7 year high, order books of Capital Goods and Infrastructure companies reaching new highs, corporate earnings ticking up, to name a few.

The India growth story continues to gain strength with stable flows from Domestic Institutional Investors (net inflows of US$ 13bn in 2023 till date, and a return of buying from Foreign Institutional Investors (net inflows of US$ 17bn for the same period). We remain confident that these sustained flows will reduce volatility in the Indian market for the foreseeable future.

Finally, the small and mid-cap segment of the market has performed much stronger than the large caps. The sustained inflows in domestic mutual funds (some of which are in dedicated small/mid-cap funds), valuation mispricing and better earnings growth have supported this performance.

India Capital Growth Fund (ICGF)*, the LSE listed Investment Trust focused on mid and small cap Indian Equities, managed by Ocean Dial Asset Management has delivered a 115.7% increase in net asset value (NAV) over the last 3 years, ahead of the benchmark which has returned 105.9% in GBP terms. It's shares have rallied to deliver 130.2% to shareholders, significantly ahead of its benchmark (105.9%) Data as at 31st August 2023.

To learn more about why we are so excited about the Indian economy and the mid-small cap space or to subscribe to our monthly newsletter, please click here.