

# Foundations for growth

India's consumer theme has been the hot investment topic for some time, but opportunities in infrastructure have been ripening in the background and may be poised to outperform

By Kapila Gohel

With a population of over 1.2 billion people and a GDP growth rate of around 8%, India's growth story has been dominated by the rise of the consumer. India's population is becoming wealthier and industry experts predict the amount of household savings is set to double to \$2trn over the next decade. At the end of last year the MSCI India index was up 19.41% YTD.

Two sectors are benefiting directly from this domestic demand trend – the consumer discretionary and consumer staples sectors, both of which have significantly outperformed in recent years. "One of the key reasons for this outperformance is the fact that the income levels in India are on the rise," points out K. Ramanathan, CIO of single manager investments at ING Investment Management (India). "A robust, solid GDP growth, a high savings rate and an increase in consumer spending on a year-on-year basis have all contributed."

The composition of spending, even in the rural areas of India, has been changing, says Ramanathan. The proportion of spending towards basic necessities such as food and clothing has been going down while the percentage spent on discretionary items such as automobiles, watches and gold and premium clothing has been on the rise.

"Therefore, there's a real opportunity to in-

vest in the companies that will grow on the back of this consumer field of demand," adds M.K. Sinha, head of project equity at Infrastructure Development Finance Company (IDFC).

However, India will add more strings to its bow over the next couple of years, believes Ramanathan. One growth theme which has underperformed so far is that of investment, including infrastructure development, he says: "This includes companies in the power sector, companies in the infrastructure space such as cement companies – basically a whole range of companies which depend on orders from both the government and private sector."

The reasons behind this underperformance are twofold; first, typically such companies are highly debt intensive. India has had challenges with inflation and increased interest rates over the past year (see page 27).

"This is also one of the reasons why the consumption theme has played out rather well – companies in the consumer sectors do not have that high leverage and their ability to pass on increased commodity prices is much easier," he adds.

Whereas, in the infrastructure space, the commodity cost pressures combined with interest rate pressures are difficult to be passed on, hence there has been a de-rating of the sector. The second reason behind the under-

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- **K. Ramanathan**

they carry 70% of the total traffic in the country. “A quarter of India’s agricultural produce tends to rot because we can’t get it to the consumer centres



**K. RAMANATHAN**  
CIO, ING Investment Management

performance is that the order inflows into several of these companies have been muted.

“The government has been slow in engaging in the sector because it has been caught up in resolving other issues besides those that are economic. With the recent change in the role of ministers and the new energy which has been restored in the government, hopefully investment growth should be back on track,” says Ramanathan.

“From a two year perspective, I feel that the investment theme is going to outperform the consumption theme. However, over the short term, because of the continued regimen faced within the industrial sector, the consumption theme will continue to do well,” he adds.

### Infrastructure

India’s infrastructure space is riddled with challenges and needs significant investment. If India is to continue to grow at a rate of 8-10% in the future, reliable power needs to be made available, says Sinha at IDFC. “Power and roads are the two key areas,” he says. “Power is absolutely crucial. Going forward a lot of growth will be driven by the manufacturing space and reliable and cheap power is essential to fuel that growth.”

Moreover, India’s GDP relies heavily on agricultural production and exports, therefore, connectivity is another area that needs to be addressed, he says. Currently, only around 2% of India’s roads are national highways, and

on time. Neither can we export it. Improvement in the road sectors will on some level rebottle these constraints.”

More recently there has been the challenge of excess liquidity in the environment. “This excess liquidity has actually resulted in the public markets being very buoyant without necessarily understanding the underlying risks of the infrastructure space,” says Sinha.

Therefore, in the past firms such as IDFC have had difficulty in finding the right valuations in the private equity infrastructure space because the public market has overpaid for such deals. “Fortunately, in the last six months we have seen a significant correction in that space so hopefully that issue is behind us,” Sinha adds. “Going forward we are likely to see the public markets be a little more cautious before continuing with infrastructure valuations in India.”



**M.K. SINHA**  
head of project equity, Infrastructure Development Finance Company (IDFC)

## INDIA’S EQUITIES AND FIXED INCOME MARKETS

India’s equities markets are far more sophisticated than its fixed-income space, although fixed income accounts for around 70% of India’s mutual fund assets. “The equity market is very well developed and sophisticated in terms of a technology and settlement. I would go as far as to say that its screen-based rating system is one of a kind, and is not evident anywhere else,” says K. Ramanathan, CIO of single manager investments at ING Investment Management.

While inflation is still an issue in India, it is coming to a peak and a rally in the markets in the short term has seen investor sentiment turn positive once again. Several global investors that were previously underweight in India have now taken a neutral position, according to Ramanathan.

“Given the issues in Europe and US, India’s growth continues at a robust albeit slower pace and there is no other country or group of countries that is giving you 7-9% growth. So clearly the investment flows will continue to head towards India as opposed to developed markets. There are no doubts about that.”

Meanwhile, India’s fixed income markets are in need of a makeover, with only the government securities market being fairly well developed. “The corporate bond market is as good as a dead market in India,” says Ramanathan. “I’ve been hearing talks about developing this market for the past ten years but nothing seems to have materialised and the trading volumes have not changed for a decade.”

One of the reasons behind this is the type of players participating in the market, he says. “The insurance companies and pension funds are big buyers but they are not sellers, they need to take active positions. And secondly, these entities are restricted by asset allocations prescribed by the government.”

Pension funds today are not permitted to sell unless they have redemptions, precluding trading. These restrictions prevent those players from adding value to their portfolios by taking duration calls or trading calls. Clearly, a significant change in the thought processes of the government regulators is long overdue.

MSCI INDIA INFRASTRUCTURE INDEX (%) - AT 30 JUNE 2011  
SOURCE: MSCI

