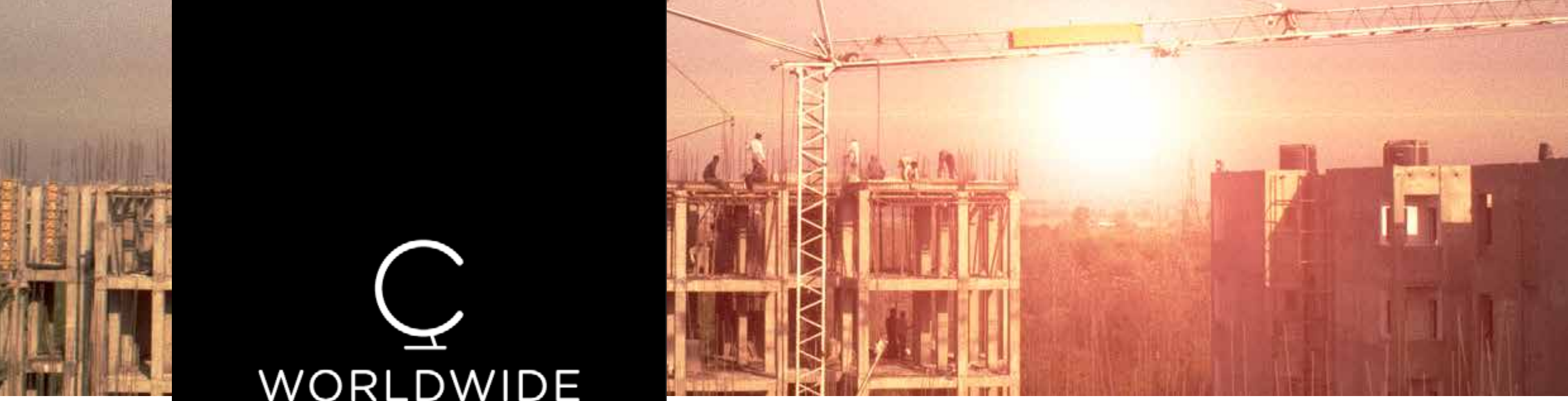

INSIGHT

India’s Impending Capex Recovery

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Key insights

- We see clear signs of a major emerging investment cycle driven by infrastructure spending.
- The rising rate of investment is visible in three key areas: the housing market, private investments and public investments. India is thereby well on the way to leaving behind the harsh second Covid-19 wave during the spring. The economy is growing, the tax revenues are rising and the government has committed to an investment program of USD 1.4 trillion until 2025. Companies have been granted incentives to expand production capacity to achieve better scale benefits. Finally, foreign direct investments in India have reached the highest level since the financial crisis as global companies want to diversify their supply chains.
- All these investments create the foundation for realizing India’s long-term and enormous potential.

As India emerges from the pandemic, we are witnessing early signs of an emerging led recovery. The capex downcycle has lasted far too long since peaking out in 2008, as shown in figure 1 (GFCF* to GDP** ratio, also known as the Investment Rate, peaked at ~36% in 2008). GFCF primarily consists of three key constituents – housing, private industry, and the government. The current recovery is visible in all the three constituents, and we expect this will lead to higher investment growth going forward.

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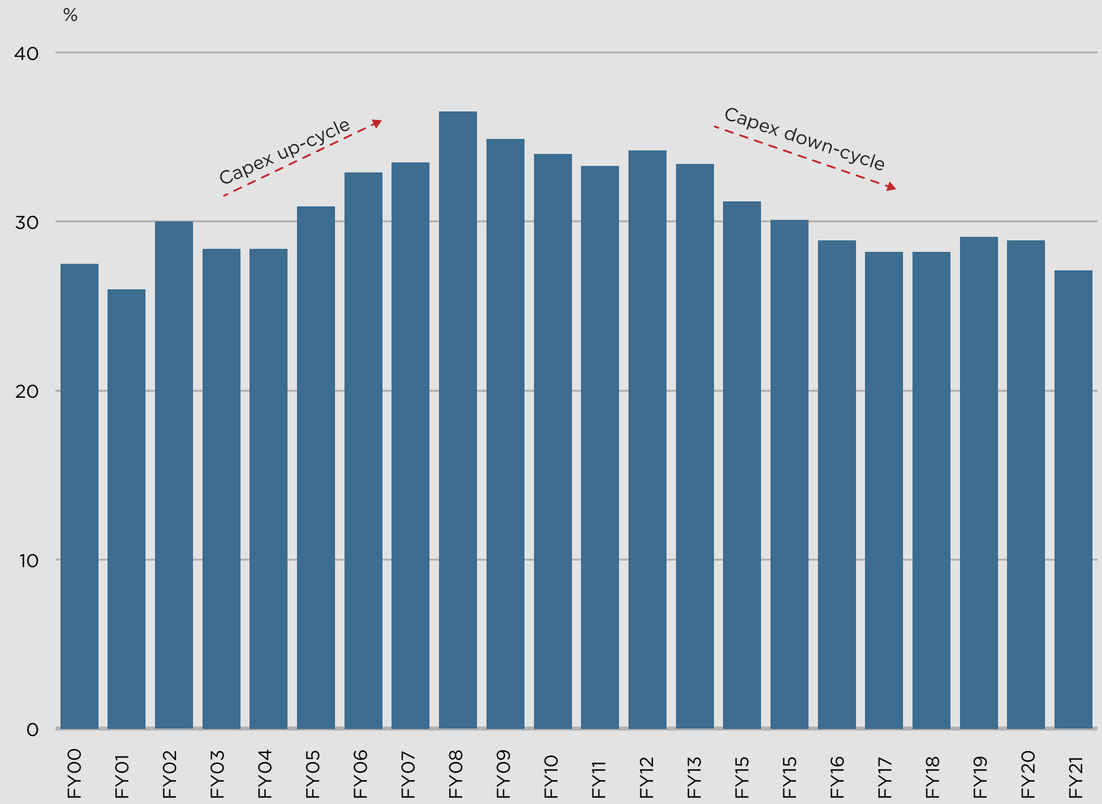
Housing

A quick look of the GFCF composition illustrates that housing plays the most significant role in the investment story with a nearly 40% contribution, as shown in figure 2. India’s real estate market has witnessed significant consolidation triggered by leveraged balance sheets, funding challenges and poor governance practices. The introduction of key reforms such as the Real Estate

*GFCF — Gross Fixed Capital Formation
**GDP — Gross Domestic Product

Figure 1: GFCF as a % of GDP

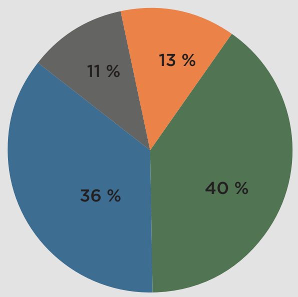


CFCF as a % of GDP

Source: MoSPI, Jefferies, October 2021

Figure 2: GFCF breakdown by institutions

CFCF in FY20 = Rs 58 trn



Govt. owned companies General govt.
Private Corporations Housing

Source: MoSPI, Jefferies, October 2021

Regulatory Act (RERA) and Goods & Services Tax (GST) have played a significant role in improving the transparency in the sector. This has come at the expense of the unorganized and weak players in the industry.

The housing situation is now improving. Buoyed by the pandemic- induced demand for larger and more spacious homes in the congested cities of India, the sector has received a much-needed boost. The Housing affordability ratio at 27%, vs 58% at the peak of the economic cycle in 2008 (lower number indicates higher affordability and vice-versa), indicates the best affordability in decades and appears to have clearly bottomed-out. The stock of unsold inventory has been declining since 2017 and in the key markets demand far outstrips new supply leading to a further decline in the available inventory. Our anecdotal evidence corroborates the start of positive pricing actions – a key determinant of the sentiment. This will culminate in higher investments in the sector.

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Private Industry

Global demand has improved at such a strong pace that supply shortages are prevalent everywhere. Numerous economic recovery trackers now peg the Indian economy to have exceeded pre-Covid levels even as some segments of the economy remain restrained. The strong economy bodes well for higher capacity utilization and high prices improve the outlook for further capacity expansion. Additionally, the reassessment of the current order of global supply chains is leading to increased interest in India and a rise in foreign direct investments (FDI) are a testimony to the same (India's Gross FDI as a percentage of GDP at 3.1% is the best since the financial crisis in 2008).

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The Indian government has announced aggressive plans under the National Infrastructure Pipeline with a total sanctioned outlay of USD 1.4 trillion until 2025.

The Production Linked Incentive program has served as a shot in the arm for the industrial sector in India. The program is intended to invigorate manufacturing in India for both the export sector and the large domestic market by providing incentives for large scale manufacturing in over 10 sectors such as electronics, batteries, auto/auto components, textiles, pharmaceuticals, and food products. The corporate tax cuts announced in October 2019 make the tax regime amongst the most attractive in the India.

Even as the recent inflation scare indicates higher interest rates, contextually rates will remain low compared to history. Corporate balance sheets in India are the least levered over the last 10 years, while the corporate earnings cycle is bottoming-out. Additionally, the net working capital for the industry has improved by half in the last 10 years. This implies that there is adequate borrowing capacity to fund any new investment. Finally, early data shows an emerging uptick in private projects under implementation.

Government Capex

The Indian Finance Minister presented a momentous budget in Feb 2021 clearly laying out the intention and the plan for an investment-led recovery in India. The Indian government plans under the National Infrastructure Pipeline with a total sanctioned outlay of USD 1.4 trillion by 2025. Correspondingly, government capex has seen a surge over the last year. The multiplier of this expenditure is around 2.4-2.6 i.e. for every dollar the government spends in building infrastructure, it creates around 2.4-2.6 dollars worth of activity in the economy.

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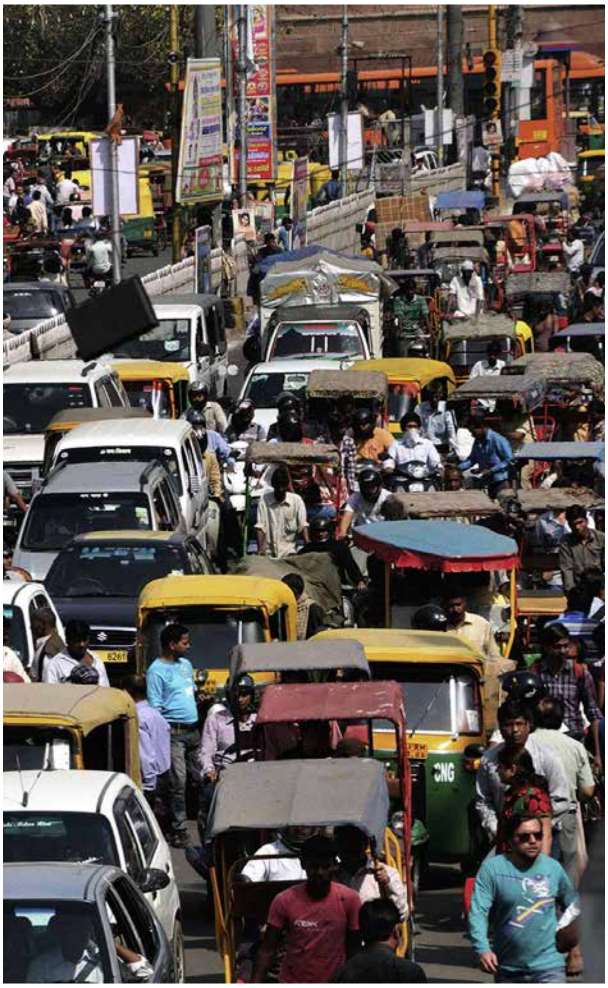
One of the initiatives that will support the large infrastructure spending is the creation of the National Monetization Pipeline under which the government plans to monetize many of its assets through divestments or privatization. The recently concluded sale of Air India, the heavily debt ridden state carrier, was a seminal moment as it marks the start of the process, with a coporationthat was deemed the most challenging. Privatization has other benefits since it often improves the productivity of the privatized assets.

The recovery has also increased government revenues, which have experienced some of the best months for indirect tax collections this year despite the overwhelming second Covid-19 wave. It is evident that the government is using all revenue levers at its disposal to expand the economy through investments.



Conclusion

Rising energy prices are a potential challenge for a net energy importer like India. In the past, it has led to persistant inflation eventually leading to currency weakness and higher interest rates. But unlike the earlier times, India's forex reserves are now formidable, which helps to balance external shocks. At nearly USD 640 billion of reserves, they are the fourth largest globally.

Our anecdotal evidence now corroborates with the high frequency economic data. Most companies we have spoken with are either considering a capacity expansion or already executing it. The early signs of an impending investment cycle are becoming more apparent. Supportive policy, rising demand and attractive funding are in alignment – many of the pieces in the puzzle are now coming together. Additionally, to sustain higher levels of structural growth, India will have to invest and create substantial capacity across the broad spectrum of investment infrastructure. This supports the realisation of the untapped growth potential of India.

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