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By Simon Down, Senior
Portfolio Manager
Andrew Holland, CEO,
Ambit Investment Advisors

Nikko Asset Management

INDIA – MODI MAGIC, THE GST GAME CHANGER

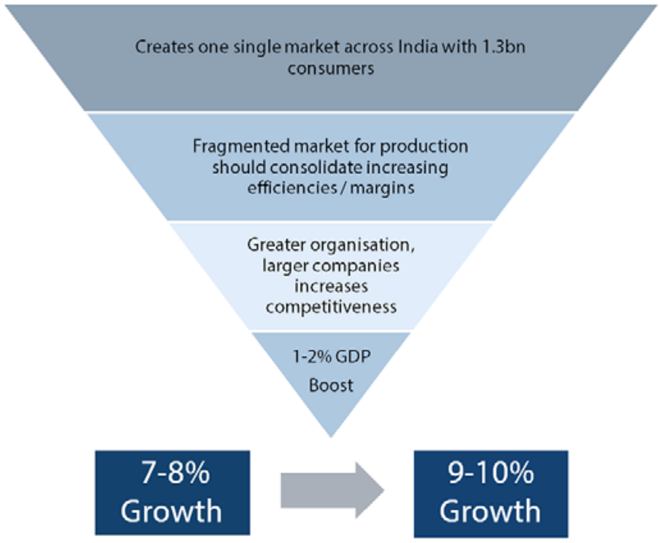
After a slow start to the year, India has experienced a flurry of activity in recent months. A new central bank governor and progress on a number of critical reforms has provided a boost to Prime Minister Modi and sets the base for the start of campaigning for major state elections in 2017 and, ultimately, the next general election in 2019. Given this news, Andrew Holland, CEO of Nikko Asset Management's joint venture with Ambit Investment Advisory, and Simon Down, one of our senior portfolio managers in London, update their analytical series on India – for reference see:

India: Modi Mania, December 2015
https://en.nikkoam.com/articles/2015/12/india-modi-mania

The Goods & Services Tax (GST)

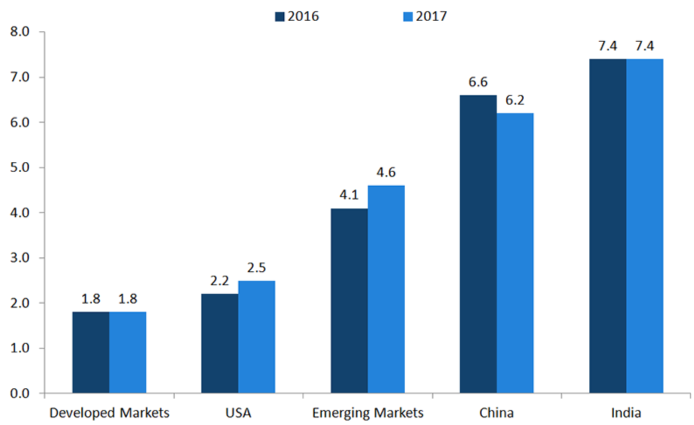
After years in the making, the GST has now passed through parliament, marking a huge milestone in Modi's reform pathway. The new tax is expected to come into effect in April 2017, although it could end up taking a little longer. India has a complex tax system, with taxes imposed at both central and state levels and largely at the point of production rather than consumption. The GST will effectively amalgamate these taxes to create a single indirect tax rate on a country wide level, creating the world's largest single market with 1.3bn consumers.

The new GST will simplify the system for companies and at the same time make avoidance much more difficult. The Ministry of Finance believes that the economic efficiencies resulting from the tax could boost GDP by up to 2% per annum for a number of years from increased export competitiveness, more efficient allocation of production resources and lower costs/greater profits, which will attract more investment to India.



Even if the GST were to only boost growth by the lower end of forecasts it would be a significant positive, India is already expected to grow at the fastest pace in the world amongst major economies. Under more optimistic scenarios India will experience significant benefits over time. The single market could see sweeping consolidation and the creation of large corporations that will not only serve India more efficiently but also be far better placed to face outwards and enter overseas markets.

India GDP Growth Relative Forecasts



Source: IMF

Although the GST is a potential game changer for India and the most significant reform since 1991, it is also not the only progress that the country has experienced in recent months. There are additional major measures which are changing the medium term fundamental outlook.

The Bankruptcy Law 2016: This bill was a key part of outgoing central bank governor Rajan's drive to reform the banking sector and consolidates the complex bankruptcy system into one single code. This will reduce the time it takes to close companies and stop companies from being asset-stripped, which has historically resulted in very low recovery rates for bankrupt firms. This should improve economic efficiencies and help banks clean up non-performing loans on their balance sheets, but more importantly it will help boost confidence amongst lenders and make them far more willing to lend, especially for infrastructure projects. It currently takes around 4-4.5 years to resolve a bankruptcy in India vs. 1.5-2 years in China. Under the new laws there are strict time periods with a 180 day initial time limit which can be extended by an adjudicator by a further 90 days in special circumstances.

Sovereign Gold Bonds: Launched in November 2015, the Sovereign Gold Bond scheme was designed to reduce the demand for physical gold in India, which has historically been a major import and resulted in pressure on the country's current account position. After a slow start, the latest offering in July raised 9.19bn INR which is the equivalent of 2.95 tonnes of gold. Gold imports in the first six months of the year dropped to 20 tonnes, down 79% from the previous year, so this new investment vehicle has changed the importance of gold to the Indian current account position in a meaningful and likely sustained way. It also directs resources from imports towards financing the government's fiscal position.

Both of these are significant medium term positives which will, along with the GST support growth over the medium term. There is also positive news in the short term though. The Monsoon started off badly but July has seen the fifth highest rainfall since the early 1990's, over 6% above the average level for the month. This has brought about a boom in planting for crops such as rice, pulses, oilseeds and sugarcane. Government employees will also get a significant boost in August as a result of the 7th Pay Commission. This will bring significant salary hikes for government employees but critically they will be implemented from the 1st January 2016 with employees receiving the whole backdated pay as a single lump sum in their August pay.

So what challenges remain?

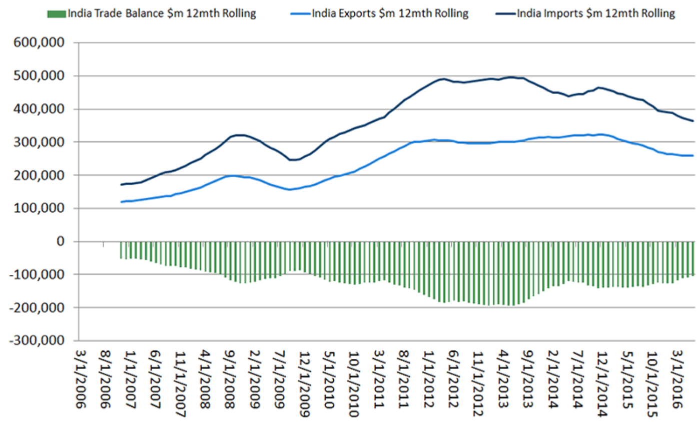
With all of this positive news it's important to also recognise the challenges that India still faces.

The new central bank governor is still to be announced, although it's widely expected that he or she will be a highly credible figure and a positive replacement for Rajan. The new governor will face a very different framework than previous governors however, which could be challenging. A new central bank framework to be introduced later this year will shift from the governor being completely in control of monetary policy to a six person voting committee made up of both Reserve Bank officials and members of the government. The central bank also remains committed to moving to an inflation targeting regime (4% +/- 2%) which is a significant change.

One area that India needs to keep pushing forward on is trade. The government has been incredibly successful in bringing down the country's current account deficit, which has in turn seen volatility in the Rupee decline sharply. This has been implemented by restricting imports with key policies such as the Sovereign Gold Bonds helping on this front and the country also benefiting from lower global oil prices.

The challenge now is to increase exports and the government has set a target of increasing exports to $900bn by 2018-2019, increasing the country's share of global exports to 3%. The GST will certainly be a positive as will continued infrastructure construction, which will assist its international competitiveness. India is also now starting to benefit from policies implemented over the last 12-18mths with policies such as labour reforms benefiting key industries such as textiles. Despite this, there is still a long way to go before the government looks on track to achieving its goal.

India: Imports / Exports & Trade Balance



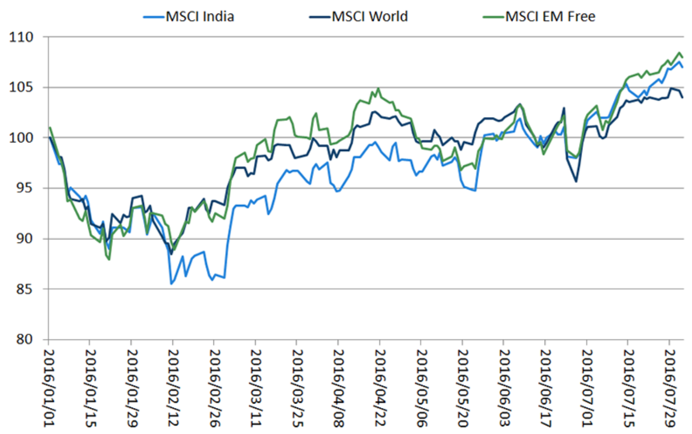
Source: Bloomberg

Another concern is on Foreign Direct Investment (FDI). India has experienced strong FDI inflows in recent years but has seen bitter disputes with some companies over issues such as taxation. The government is now looking to provide itself with greater protection and wants to replace existing bilateral investment treaties with a new treaty. In order to do this they have activated early termination clauses on 47 of its current treaties and have now started to negotiate with foreign governments on the new treaty. Previous investments will continue under the old agreements, so only new investments will be affected.

It is likely that uncertainty surrounding this policy will dampen FDI inflows for India over the coming 12-18mths, especially as some countries appear to be unhappy with India's treaty changes and are, thus, unlikely to move quickly on agreeing the new deals.

Equity markets performed poorly at the start of 2016, underperforming other global markets. As investors have recognised that the GST is gaining traction though and with growth performing well they have gained ground and caught up with other global markets to record strong gains on the year. This could well mean that the positive news on the GST is already priced into equity markets and that for now they are fully valued.

Equity Performance YTD (USD %)



Source: Bloomberg

Conclusion

In the medium term the GST is a game changer for India and if implemented well it could propel the country to a new level of growth and quickly push India up world GDP rankings over the coming years. But implementation is critical and the full benefits of the GST may take many years before they are seen in full as it will take time for corporate consolidation and the full efficiencies of the single market to develop.

With inflation turning upwards and the economy stimulated by the 7th Pay Commission the central bank are now unlikely to cut rates further, but the high level of yields still makes India attractive from an income perspective for investors given its relatively low volatility relative to its EM peers.

The Rupee will be supported by the positive measures, but the central bank will limit gains and look to build FX reserves. This could change though if India does start to see success on growing its exports and the country can move towards a trade surplus.

Equity markets look fully valued for now, but we see some areas of value such as pharmaceuticals. The positive news flow could see further gains but it could be wise to look for a better entry point than current levels. If there is a correction though we believe that this would provide a very attractive opportunity for investors who are looking at the long term story and are able to wait for the full benefits of the GST to impact the economy.

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