JON THORN/INDIA CAPITAL

The new govt just needs to do one thing: bring in GST

By Joji Thomas Philip
joji.p@livemint.com

SINGAPORE

India Capital co-founder and director **Jon Thorn**, who has two decades of experience investing in Indian equities, says he has never in the past been so optimistic as he is now about the country's future. India now has a pro-growth and "do-a-lot" government, and is also at the bottom of a cyclical trough, said Thorn in an interview. India Capital invests exclusively in Indian equities.

Edited excerpts from an interview:

How long do you think it will take to get the corporate earnings growth going?

Earnings per share (EPS) growth has continued throughout this slowdown, but just at a slower rate. Indian companies are usually very good at managing their profits. If the Narendra Modi-led government gets off to a quick start, which we believe it will, then EPS growth can accelerate quite fast. Equities are right to discount a better outlook...

How important will rupee stability be for a corporate turnaround this fiscal year?

A stable rupee is what all industrialists want. It depreciated fast, then rose fast. What was that about? It fell because investors were too pessimistic about India and has now risen as investors have seen what will start to happen. For industrialists, volatility adds to the cost base. We will see but if anything, the risk is now on the upside, and as people get closer to the reality of this change, they will want to invest more in India, and that will create demand for rupees.

It is early days yet, but will corporate earnings from the June quarter show that corporate recovery is well and truly underway?

No, not yet. June will show an unexpected rise, we think, but it is in effect half a quarter, as the election result came out on 16 May. September (quarter) is what we should start to look closely at...

As growth comes back, which are the sectors and which companies will emerge as winners? As an investor, where will you put your monies?

We are overweight on banks and financials. There are two kinds of banks—the ones in good shape and those which are not. No one has to buy the second group. We are focused on the next 5-10 years of loan and deposit growth, and that is where we can compound our capital as the better banks will pull ahead of the rest. Otherwise, auto, industrials—these are places where growth will come through most clearly.

You have been investing in India for a long time. What are the signals that investors are looking for to return? What is the investors' wish list from the new government?

In the 20 years I have been doing this—we started in 1994—I have never been so optimistic about what can happen. Most non-specialists have still not understood what has happened, and I think even some specialists are a little shell-shocked. Get it—we have an effective pro-growth and a do-a-lot government, at the bottom of a cyclical trough. If you would not want to invest in that general situation, please let me know what it is you are looking for as a trigger to invest? It's the fate of many investors, however, that they will wait and see and will, therefore, receive lower returns.

Considering the recent e-commerce deals, and the investments that are coming into this space, do you think this sector is set for explosive growth? Are we seeing the second round of an e-commerce boom in India? Should e-commerce FDI (foreign direct investment) be first off the block for the new government?

The first should be construction as that sector can produce a lot of jobs and fast. E-commerce does not produce so many jobs. This sector can grow very fast, though on the back of increasing Internet and smartphone penetration—this will be one of the key growth areas, and especially with such a young population.

The Indian markets are at an all-time high, but why are there no initial public offerings (IPOs)?

It is too soon to show up. Yes Bank just did a $500 million placement of new equity and that was five times oversubscribed. More follow-ons will happen, and fast, as a result of that. Supply will certainly come and valuations will rise.

Do you see the Sensex at 40,000 over the next two years? If not, by when?

It can happen. I don't know what the market can do, but it can certainly go up a lot from here. Two to three years is possible.

Will Prime Minister Narendra Modi face an uphill struggle to stimulate a rapid recovery as his government has inherited a difficult economy?

The exact opposite. It all depends on whether you think that the cause of the slowdown was India's structural economic problems, or a complicated amalgam of cyclical ones. In our view, it is all cyclical. This has been very much the minority view, with most people jumping on the "India has blown it" bandwagon. There was little evidence for that, and there was good evidence for the opposite, cyclical view—a number of policy mistakes combined with a global cycle combined with inaction at the centre.

India's manufacturing appears to be in recession and the construction sector is on the brink of one. With monetary policy expected to remain tight in the near-term due to stubbornly high inflation pressures, where do you think growth will come from?

Manufacturing is not in a recession, the PMIs (purchasing managers' indices) have mostly been been above 50, meaning expansion. Construction has been bad but this can change quickly. Monetary policy has loosened as the SLR (statutory liquidity ratio) was just relaxed. The issue of inflation is linked also to the monsoon; and while the last one was great, the two previous ones were both bad in their own ways. This has the biggest single impact on 60% of the population, which lives in the countryside, and leads to the rise in food prices. We are already seeing very strong growth in the rural economy due to the good monsoon (last year), and a change in policy direction can kick-start construction. In our view, growth is slowly but surely increasing.

What are the key fiscal fixes this government will need to address on priority?

All governments do far too much tinkering, which makes them think they are doing something to fix individual issues or policy misses, when they just add up to an increase in the aggregate fiscal burden. The new government just needs to do one thing and that is bring in and fully implement the general sales tax, the goods and services tax (GST). Once that happens, then tax revenue should rise and there will be a universal sales tax that can help fund the states.

Reserve Bank of India (RBI) officials have reiterated their target of bringing headline Consumer Price Index (CPI) inflation to 8% in January and 6% by early 2016. What are the key risks that can fan price pressures?

The key variable for inflation is the monsoon—each year is different. Supply lags are also a factor and that can only be solved by allowing growth to happen; all these factors are not too hot/not to cold—it's not a recipe.

Do you think another rate hike may well be warranted, especially if the government doesn't tighten the fiscal reins as promised?

Not at all likely, I would say. RBI just lowered SLR, which frees up some of banks' balance sheets and, therefore, allows more lending, which has the same effect as a rate cut. Our view is the earlier tightening was overdone but what governor (Raghuram) Rajan did was smart. At this point, growth needs to be allowed to happen and a rate rise would be the single worst thing do.

How important is public sector disinvestment?

Critical. They have said they will do it—and we hope to see them do it soon. Banks, in particular, will be in the forefront of reducing government stakes...

What according to you are the key reform areas that could improve the rupee's medium-term outlook? Where do you see the rupee—medium and long-term?

Energy is the key to long-term sustainable growth. Without that, it will not happen. Today—9 June—the President spoke in Parliament and said the government will soon come out with a national energy policy—this will be a framework for underpinning growth. He mentioned that the government would seek to accelerate the coal industry and would bring in private capital into it. This is critical to achieving the spurt in economic growth that they elected to produce. The BJP (Bharatiya Janata Party) tried to bring such a coal Bill when they were last in power, in 2000. They were in coalition then and could not get their partners to agree to it. I think this will happen really fast now. So if this happens, then a lot of capital will flow into the energy sector. This will very much help underpin the rupee by underpinning the outlook for growth. The rupee is not freely convertible but it is a lot freer in its movement than most Asian currencies. I don't see a need for any major technical or policy actions, and I think this structure keeps the government a little more focused on doing the right policy thing.

Do you think the next five years in India will be similar to the late 1990s or early 2000s—in terms of growth? What are your projections/estimates for India's gross domestic product (GDP) growth?

GDP growth is currently 4.7%. A few years ago, it was 11%. It has halved. It can double. The last time the BJP was in power, they benefited from a global growth cycle and they enacted pro-growth policies. They will get a little help from global growth this time around, but not so much. Europe is not in such great shape, for example. But they have the ability now to really push the growth button, and I cannot see why they will not. It can be 10% within two years. A large part of the reason is pent-up investment and demand, which have both slowed sharply. If the animal spirits are unleashed, then both investment and demand could tick up to historically high levels.

Your key expectations from the upcoming budget?

We cannot know what will be in the budget, but I would like to see a clear pathway to GST, energy liberalization, and the restarting of government held-up infrastructure projects. If they can get that into the budget, the market will fly again. If not, we shall have to see. It's been a long 10 years waiting for this, half the time we have invested in India. The next five years will be something to savour.

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