

Letter From India

**Standard Life
Investments**

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India's economy is
back on track

A tax for all

Building for the future

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View From Above

India's economy is back on track

Prime Minister Modi rode to power in 2014 on a wave of popular support. His pledge to remake India resonated with voters tired of political gridlock and sluggish economic growth. Three years on and India's economy is back on track. GDP in the first quarter came in at a reported 7.1% – making it the world's fastest-growing major economy. Inflation remains under control thanks, in part, to the tumbling oil price. This has allowed the Reserve Bank of India to cut interest rates.

As for Modi himself, he continues to slowly make good on his reform agenda, launching measures to tackle endemic corruption and tax evasion. The task is a sizeable one: India's informal or 'unorganised' sector accounts for an estimated 50% of GDP and a whopping 90% of employment. Modi's policies to address the problem include his controversial demonetisation initiative and the announcement of the landmark Goods and Sales Tax (GST). Both these policies are designed to force the unorganised sector into the 'organised' sphere, thereby expanding the tax base and levelling the playing field for businesses.

I applaud both these initiatives, although admit GST is merely a starting point rather than the panacea investors had hoped for. Nonetheless, it is yet another sign that Modi and his government are serious about reforming India, which is good news for the country's economy and for investors both at home and abroad.

**“Modi and his government are serious
about reforming India”**



Market Overview

As policy initiatives go, Prime Minister's Modi's snap demonetisation announcement on 8 November 2016 was certainly eye-catching. It saw all 500 and 1000 rupee notes, which accounted for 86% of total currency in circulation, cease to be legal tender at the stroke of midnight on the same day. The move was designed to promote digital payments in order to tackle corruption and tax avoidance. Was Modi's gamble worth taking?

The government certainly seems to think so, highlighting it as a decisive assault on the black market, bribery and terrorism. However, a number of economists have been stinging in their attacks, with one calling it "sickening and immoral". In my view, while the move has affected short-term discretionary spending, it should enlarge the tax pool and bolster the economy in the medium to long term. Indeed, after the initial disruption, we are already seeing signs that the market has started to normalise.

A tax for all

Perhaps of greater importance was the announcement of the long-awaited GST, which came into effect on 1 July this year. This is one of the most significant reforms in India since the 1990s and seeks to replace India's byzantine tax structure with a single market. A 'destination tax', it will involve goods and services being taxed across the entire supply chain.

Traders, as a result, will have to register in order to do business. Again, this is an attempt to crack down on the unorganised sector. For the organised sector, the elimination of multiple state-border checkpoints – the bane of many industries – will make the transport of goods easier. It also removes numerous internal barriers and levies, reducing companies' logistics and compliance costs.

The policy, however, is far from perfect. Given the sheer scale of the task, GST will take time to fully implement. Different goods will also be taxed at different levels, making categorisation cumbersome. Toys, for example, will have three different tax levels, with ever-popular chess facing a 20% tax hike. Meanwhile, authorities' readiness for GST varies between regions and industries.

Despite these headwinds, I think GST is a vital step forward and will remove several impediments to economic growth. It will also close the competitive gap between organised and unorganised businesses, with the latter's cost base rising as the new taxes come into effect. Further, GST has the potential to create a virtuous cycle, as higher tax collection leads to heightened infrastructure spending, which in turn grows the tax base.

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Investment Insights

Building for the future

Part of being a successful fund manager is getting to really know the companies in which you invest. With that in mind, I recently travelled across numerous Indian states to assess the on-the-ground impact of demonetisation and check the preparedness of numerous companies for the upcoming GST regime. My findings were illuminating and I discovered many interesting investment opportunities.

An example of the sort of company that looks set to benefit from the new GST is Greenply Industries, which makes plywood and MDF. While prevalent in many developed nations, take-up of MDF has been slow in India, despite the material's numerous advantages over low-end plywood (weight, strength, ease of use). Greenply has spent aggressively on marketing to create awareness of the benefits of its products, increasing demand for MDF. As for the GST, it will make it easier to track products and act as a deterrent for tax evasion, which will increase costs for unorganised firms used to cash-in-hand transactions. This will improve the competitiveness of organised players, such as Greenply, allowing them to gain further market share.

Piping up

Within the plastics industry, we are also seeing an increasing swing towards organised corporations, as consumers increasingly demand better quality, branded products. The narrowing of price differentials in the wake of GST should accelerate this transition. Indeed, the organised sector is expected to increase from 60% of the pipes market to 75% by 2026. A key player here is Supreme Industries, which makes pipes, protective packaging and furniture. Again, the company has a good management team at the helm and we would expect it to take increasing market share as demand for plastic products grows. The government's ambitious 'Homes for All by 2022' should further drive this demand, notably for its piping products.

Final thoughts...

I'm glad to report that the Indian growth story remains firmly on track. The economy is in relatively good shape, while monetary policy is supportive. Prime Minister Modi has shown that his reform agenda was more than just campaign rhetoric. His demonetisation move was certainly controversial, but should bear fruit in the long run. Meanwhile, GST is an important step in overhauling the country's tax regime. Against this backdrop, I continue to see numerous exciting opportunities from across the business world. I look forward to sharing more of these in my next Letter from India.



Dr Mark Vincent
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GEM Equities

"Finding numerous opportunities across India"

"The India growth story remains on track"

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