

Indian Infrastructure: A Decade in the Making

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The global investment landscape today looks quite unexciting. Consumers in developed countries have been maxed out for the better part of a decade. Notwithstanding the recent optimism in the US, it is highly unlikely that consumption growth will re-accelerate. The best scenario one can hope for is that consumption growth settles at a 1% to 2% rate and that fears of contraction subside.

Emerging markets face a completely different problem – that of China. China has been the engine of growth in emerging markets for the last two decades but the Chinese engine is now sputtering. China made a miraculous transformation of its economy by building infrastructure that is the envy of even the developed world. It fueled this growth with massive amounts of debt (most of it domestic, thankfully) and by borrowing growth from the future by conspicuous overbuilding. The problem with a capital or fixed hyper-investment model is that one cannot stop. If one stops then the entire economy stalls and crashes.

China has been adding capacity in roads, railways, ports, power, steel, aluminum etc. Each of these sectors depends on the other sector's "growth" to keep itself going. If one sector stops adding to capacity, the feedback loop stalls capacity addition in all other sectors. China has reached the point where the discourse has shifted from growth of capacities to utilization and shut down of capacities. For example, Chinese steel capacity exceeds 1 billion tonnes or about 50% of global installed steel capacity. China produces 825 million tonnes of steel. Chinese aluminum capacity exceeds 45 million tonnes which is once again more than 50% of global installed aluminum capacity. China produces about 30 million tonnes of aluminum a year. While steel capacity growth has completely stopped, China added 7 million tonnes of primary aluminum capacity last year. This year the discourse in aluminum has also shifted to capacity utilization and shut downs. Chinese consumer spending is a sideshow compared to its fixed investment juggernaut. Discussing Chinese consumer spending as a driver of China's economy is like discussing the restaurant industry in the Bay area as a driver of Silicon Valley.

I am not necessarily calling a bubble or a crash in China. The only point I am making is that the Chinese economy of the next decade is going to be very different from the Chinese economy of the previous two and that it will have major consequences for the world economy, especially for emerging markets. China will import a lot less of the primary commodities it had been importing during the previous decade. The buoyancy in commodity prices since the China scare of February 2016 appears to have been driven more by speculative activity in China than by a meaningful resumption in fixed investment or capacity growth. A resumption of the global commodity meltdown experienced in early 2016 will be devastating for emerging markets. China will also dump a lot more of its manufactured goods on the world market despite protectionist safeguards and duties. This will keep a lid on global capital investment and capacity expansion.

This brings me to my main topic – India. I have always maintained that India is a bottom up economy and unlike China, it does not have the ability to execute state diktat while ignoring

popular opinion. Therefore, it behaves a lot less like a focused corporation and a lot more like a feuding extended family. India is an emerging market and will get materially affected by the goings on in China. However, India is also emerging from a gut wrenching five-year slowdown and a clean-up of its banking system and its political system. India will remain a bright spot (albeit a small one) in the global investment landscape during the next few years. What then is likely to do well in India and what is likely to not do well?

The financial services and financial inclusion story in India is a little long in the tooth. It has been so difficult to deploy money in the Indian real economy in the recent past that all investment dollars have gone to the easy business of leveraged lending. Anytime financials start trading at more than three times price to book value, the risk reward asymmetry becomes inverted. When the entire financial system starts to trade at valuations of more than three times price to book value, investors should be prepared for a very long period of underperformance. It is possible that the economy keeps growing but financials underperform as their economic realities catch up with expectations built into their stock prices.

The non-cyclical consumption story in India also looks a little over extended. The problem with consumption in India is that it is a hundred small countries inside a large sub-continent. Purchasing power and consumer behavior and preferences are so heterogeneous that the addressable organized opportunity for individual players is relatively small. This has been anecdotally experienced by investors in Indian listed consumer stocks. Companies experience high double digit and even triple digit growth from small bases and their growth tends to taper off as they reach \$250-\$300 million in revenues. Unfortunately for investors, valuations continue to climb and it is not uncommon to find non-cyclical consumer names trading at between five and ten times multiple of revenues. Often managements find themselves under tremendous pressure to grow to sustain market valuations and expectations. This often results in sub-par decisions and diworsefications to capture unrelated and dissimilar lateral markets.

Large core industrials like steel, power, mining, chemicals and textiles are in unenviable positions. They are suffering from large domestic as well as global overcapacities in their respective sectors and the resulting absence of pricing power. This is unlikely to change even if the India economy grows dramatically. Global (Chinese) overcapacity is going to ensure that investors in these companies make sub-par returns on investment even in a growing economy. Manufacturing is therefore going to lag the economy and will not be a driver of economic activity in the first few years of the Indian growth rebound.

What will do very well in India then is anything that is cyclical but domestic and not influenced by global overcapacity. I believe that the Modi government's thrust on infrastructure building and housing for all by 2022 is going to become the engine of the Indian economy. This will liquefy the market for land in India and will create a real estate boom. A boom in land and real estate both in transaction volumes and prices is essential to create a wealth effect in the economy and to rekindle animal spirits. The wealth effect will result in explosive cyclical consumption growth in durable goods. This imminent boom in infrastructure and real estate has been a decade in the making. These sectors are however prone to excessive leverage and systemic corruption. They will eventually succumb to excesses like at the end of every economic expansion. Hopefully these sectors will be able to put in a few years of high quality growth before they succumb to excesses.

Indian markets will therefore remain volatile and large sections of the market will suffer with contagion from other emerging markets. The markets will be a paradise for stock pickers who

can stomach volatility and who can find idiosyncratic names that benefit from the growth in the Indian economy while remaining fundamentally insulated from global overcapacity.