Make in India – the rise of Indian manufacturing

Ewan Thompson, Fund Manager, Global Fundamental

In the first of a new series – 'A New India', fund manager Ewan Thompson looks at the investment case for India's burgeoning manufacturing sector as the country makes strides in becoming a key player in global supply chains.

From made in China to *Make in India*

With India this year officially overtaking China to become the world's most populous nation, it is often this demographic story and the country's huge domestic consumer market that garners the most headlines. Yet, while historically India has been much less frequently associated with manufacturing prowess, with China being considered the so-called 'workshop of the world', over the past decade this story has quietly been reversing – a targeted policy programme in India to grow high-value manufacturing exports coinciding with a reluctance of global corporations to rely solely on China.

The recent announcement that the Chinese government had banned iPhone use across all departments provides a timely reminder of the seemingly constant deterioration in the geopolitical and industrial relationship between the world's two largest economies. 'Made in China' of course had become a byword for the specific aspect of globalisation that saw a significant proportion of global supply chains re-routed through China, taking advantage of its huge low-cost labour pool to manufacture products cheaply and export them to the rest of the world.

However, as relations with China have become ever-more fraught, concerns over China's at-times capricious industrial policy have grown, leaving global companies wondering whether they had become too dependent on China. Moreover, steadily rising labour costs in China, have gradually eroded the strategic advantage China once enjoyed. 'Made in China' has been replaced with 'China +1' − the strategy that seeks to diversify business by channelling investments into manufacturing sectors of other developing economies, particularly those in Asia such as Indonesia, Thailand and − of course − India.

What is India doing?

The rise of India as a manufacturing base is not just a question of push factors (from China), but also the outcome of a considered strategy by the Modi government to create an attractive investment base for global manufacturing. India's huge labour pool and vast domestic market are obvious attractions, but a key catalyst to building on these resources was the launch in September 2014 of the *Make In India* programme − just months after Modi's emphatic electoral victory earlier that year − to "transform India into a global design and manufacturing hub". India is something of an oddity among developing economies in that it has an unusually developed service sector and, if anything, has historically had a comparatively small manufacturing sector. *Make In India* set out to change this.

The policy has also been at pains to emphasise the importance of being competitive in terms of quality, not just on price − shifting up the value chain is a key goal. Critical elements of this policy have been building out the physical and digital infrastructure required for value-add manufacturing in the 21st century, encouraging domestic procurement for government projects and taking steps to reduce the complexity of doing business, most notably the dramatic simplification of the tax code in the landmark Goods and Services Tax legislation of 2017.

The powerful effects of setting the right conditions for investment can be seen in the rapid growth in hi-tech exports, which have strongly outperformed during the post-pandemic recovery. While hi-tech manufacturing and services exports made up 59% of total exports 10 years ago, that figure has risen to nearly 70% today *(source: HSBC – India's Digital Date, May 2023)*. The arrival of global capability centres, captive technology facilities of large global companies, could signal global multi-national corporations' enthusiasm for having a definitive footprint inside India and reverses a trend of 10-15 years ago where companies were largely selling their Indian operations to local players to manage.

Sona Comstar – entering the global stage

While the macro backdrop for investment in India has been improving steadily, there has also been a matching upgrading of company manufacturing capabilities and ambitions. We believe that areas especially fertile for investors are those where increasing complexity and specialisation of production create positive mix effects − establishing a protective moat around the business to fend off competition and entrench companies deeper into supply chains, leading in turn to higher returns on investment.

In our view, a good example of this process of upgrading complexity and ambition comes in the form of **Sona Comstar** – an automotive systems and components manufacturer based in Gurgaon, just south-west of Delhi. The company originally began manufacturing simple bevel gears for the likes of local auto producers Tata and Mahindra, before moving on to differential assembly – differential gears allow the outer wheel to rotate faster than the inner wheel while turning. By using the bevel gear components to put them together in-house, auto manufacturers that used to buy gears from Sona and the housing from other players could now buy the assembled product straight from Sona, creating what we regard to be significant value for the company – differential assembly creates up to five-times higher value products.

From these early beginnings in India, the company now derives c.70% of revenues from overseas with the remaining 30% from India. The company is increasingly targeting higher-value segments, potentially allowing it to grow revenues rapidly in a low-volume growth industry. For Sona Comstar, value is far more important than volume – looking to grow share within each vehicle. New products include electronically locking differentials (EDL), epicyclical gears and spiral bevel gears. As complexity increases so too does price, with EDL selling for 8-10 times the price of regular gears.

The dominant player in India, Sona Comstar has seen its market share of differential gears rising from 47% in 2018 to 55% last year *(source:* disclosed at company meeting, September 2023*)*, led by new orders, especially in the electric vehicles (EV) segment – Sona is a key supplier to top-tier EV manufacturers. While the advent of electric vehicles has been an opportunity to its gears business, we believe it to have also been a threat to Sona's starter motors segment (only required for internal combustion engine vehicles). And yet the arriving new technologies have potentially presented further opportunities with Sona pivoting its motor business to EV traction motors – currently a small proportion of revenues, but a much larger share of order book. Indeed, Sona has also developed strategic partnerships to develop magnet-less motors, which could remove 20-30% of the cost of an EV motor.

In many ways, we believe that Sona Comstar exemplifies this wider trend of *Make in India* – moving steadily up the value chain, boosting returns, and partnering with global manufacturing giants. Indeed, the company is eligible for Production Linked Incentives (PLI), a key government initiative to give companies incentives on incremental sales from products manufactured domestically, intended to boost the manufacturing sector and reduce imports. With its marriage of low-cost of production with high value-add products to become a key player in global supply chains, we consider Sona Comstar to represent the opportunities and ambitions of both *Make in India*, and also more widely the New India.

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