A New India: the return of the investment cycle

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In the second article of our series – 'A New India', fund manager Ewan Thompson examines how years of steady repair has now set the Indian economy up for the next long-term investment phase.

When we consider India's potential over the coming decades, one of the critical factors required to drive this growth is sufficient infrastructure to realise the clear underlying potential the country has. Already the largest country by population and the fifth largest economy, Goldman Sachs predicts the nation will overtake Germany, Japan and China to be the world's second largest by 2075.

Roads, railways and ports are required to transport goods around India's huge domestic market as well as import key components and export finished goods to the world − and realise India's ambitions to grow dramatically as a manufacturing hub (see previous article). Energy infrastructure is also vital to secure India's successful transition to upper-middle income economy status, whether that be energy generation capacity and a shift towards renewable energy − a huge challenge given the scale of India's coal-fired energy production base − or transmission and distribution to companies that need it and also to rural households long cut off from basic necessities such as electricity.

Given such a significant long-term need for infrastructure, it seems somewhat surprising to consider that India until recently was, if anything, suffering from the effects of *over* capacity. The decade from 2004-2014 saw a dramatic boom in Indian investment, with fixed-asset investment increasing notably as a percentage of overall GDP, rising from 26% in 2001 to as high as 36% in 2008 and remaining at elevated levels until 2013.

This investment was supported by significant bank lending, with corporates taking on debt in order to fund expansion projects as overall capacity utilisation in the economy moved up to 80% in 2011. However, as the after-effects of the Global Financial Crisis and global liquidity crunch continued to bite, the Indian economy eventually succumbed, with many of the hallmarks of misallocated capital: corporate balance sheets were over-extended, bank non-performing loans began to rise and the property market stagnated with unsold inventories rising steadily and price appreciation stalling. Indeed in 2013, India suffered the ignominy of being included in the so-called Fragile 5 emerging market economies perceived as exceptionally vulnerable to external shocks in the Federal Reserve Taper Tantrum of that year.

The next long-term investment phase

For the last decade the ubiquitous question for investors in India has been when will the investment rate recover? The arrival of the business and market-friendly BJP party and PM Narendra Modi in 2014 offered the prospect of turning the investment cycle around. However, the best part of a decade since has been spent essentially repairing the economy − pushing through vital but at times painful reforms such as the revamping of the byzantine tax system under a new Goods and Services Tax (2017) and also the Insolvency and Bankruptcy Code (2016) to aid the cleansing of non-performing assets in the financial sector. Alongside came efforts to unwind huge debts in the then-dysfunctional power sector. While the initial market reaction to Modi's arrival was ecstatic, the Indian market largely trod water from 2015-2019, both in absolute terms and relative to wider emerging markets as the economy went through a half-decade of repair.

While the Covid pandemic hit the Indian economy hard, as it did almost everywhere else, and the second wave of the virus took a significant health toll on the country in March 2021, the economy has in fact been in rude health from this point forward, with the cyclical recovery from nationwide shutdowns coinciding with a powerful structural recovery from the years of steady repair.

One of the key elements of this recovery is the resurgent property market, with affordability having hit the most attractive levels in twenty years and unsold inventory at a 12-year low. India's private sector has seen one of the most significant levels of deleveraging of any global economy in the past ten years, while the banking sector has been fully cleaned up with lenders extremely well capitalised to fund the next phase of investment. Power plant load factors, having dipped as low as 59% in 2021 are now back towards peak levels, necessitating a significant new investment cycle in energy generation. Renewable energy will be increasing steadily in the generation mix, rising from 13% today to 23% by 2030.

Given the resurgence of the investment cycle in India, the industrial sector has been a key beneficiary of this upswing, and a specific sub-sector is cables and wires. The segment enjoys a large, resilient and growing end market that stands to benefit from long-term trends such as renewable energy buildout, shifting overhead power lines underground and the digitalisation of the economy. Moreover, the organised sector is able to grow market share at the expense of smaller and more informal players, which make up approximately one third of the market. Whereas the unorganised sector has struggled with commodity price volatility − for example copper − the leading companies have the distribution reach, strong balance sheets and brand to prosper over the cycle.

KEI Industries – a beneficiary of the structural increase in investment levels

KEI Industries is the second-largest electrical wire and cable operator in the market, with a core strength being a low-cost manufacturing base thanks to its large scale as well as backward integration into the supply chain. It is also one of the few companies able to make high voltage electrical cables above 220kV (and one of a very small number globally that can manufacture extra-high voltages (EHVs) above 400kV).

The company has been growing its business rapidly by expanding through the retail channel, aiming to take this segment from a third of revenue to a half. The retail channel enjoys faster growth, along with better margins and lower working capital requirements, allowing both improvements in returns on investment and cash flow generation. Recent meetings with the company underscored the degree to which demand across all end markets has improved dramatically − be it commercial or residential property, or infrastructure projects such as suburban train projects and highways. Most importantly, order visibility confirms the return of demand from the private sector to match the heavy infrastructure investments undertaken by the government to kick start the cycle in recent years.

The Indian investment story has many exciting pathways ahead as the country enjoys an ever-growing presence on the global stage and in the global economy. All of these pathways will ultimately be facilitated by the execution of the required infrastructure projects to support this growth. A decade ago, the Indian economy was not in a position to meet these requirements, weighed down by over-indebted companies and banks struggling with non-performing loans. The subsequent years of steady repair have now set the economy up for the next long-term investment phase, with companies such as KEI Industries enjoying a significant opportunity to benefit from the structural increase in investment levels over the coming years.

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