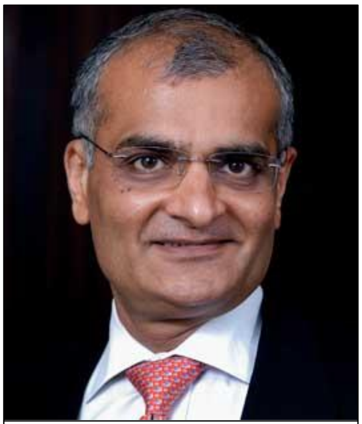
India's Age of Compounding



Rashesh Shah
Chairman & CEO
Edelweiss Group

The Indian Economy is at an important juncture in its evolution. The confluence of a number of fundamental changes, including structural reforms like Goods and Services Tax (GST), Bankruptcy Code & RERA (Real Estate Regulatory Authority) regulations, growing retail participation in capital markets and the digitisation of the economy, coupled with India's strong GDP growth has created a potent mix for the next phase of scale-up driven by the power of compounding.

Typically, compounding relies on three factors – size, rate and time. India stands out on all these counts – we are one of the largest economies in the world with a Gross Domestic Product (GDP) exceeding USD 2 trillion and a growth rate which is among the fastest in the world. At the same time, this strong rate of growth will continue for a sizable period of time with the government undertaking a slew of reforms. Together, these three levers will drive India's growth creating India's ***Golden Age of Compounding***.

India's Golden Age of Compounding

A quote that is often attributed to Albert Einstein quotes, "Compound Interest is the eighth wonder of the world." While Einstein might or might not have said that, the statement's validity sustains and India's economy will witness and benefit from the power of compounding. With the triumvirate of size, rate and time clicking together, we expect the Indian economy to touch USD 5 trillion by 2025[1]. At that point of time, we could be adding USD 1 trillion to the economy every 18 months! That is akin to saying we would be adding one India of 2007 (when India's GDP touched USD 1 trillion) every 18 months to our economy. By 2040, India could potentially be one of the three largest economies in the world with a GDP of USD 20 trillion[2].

A large part of this progression would be driven by a few factors which are already in play – **households' shift from savings to investment, democratization of credit** and reforms like GST, Bankruptcy Code, etc.

Financialisation of Savings

Real estate and gold were the traditional asset classes where Indians used to plough their savings over the years. However the asset mix has started changing with domestic flows into the equity market rising incrementally over the last couple of years. While there have been surges in domestic flows into equity earlier, this time the change is structural in nature due to a variety of factors. Sustained investment for an extended duration of time, significantly better performance of equity as an asset class compared to classes like real estate and gold, lower equity ownership of Indian households compared to global peers, low share of savings in the typical household asset profile and increased awareness, access and belief in India's equity market opportunity are some of these factors.

This structural change is clearly reflected in the numbers from the Mutual Fund (MF) Industry as well. From around Rs 6 trillion in March 2012, the MF Industry's Assets Under Management (AUM) has seen a three and half fold increase in a span of five years to around Rs. 20 trillion in July 2017. The number of mutual fund folios have quadrupled in the last three years from 0.3 million to 1.3 million[3]. Monthly SIP flows are now around Rs. 4,500 crore – an annual inflow of more than Rs. 50,000 crore[4]! From a long-term perspective, MFs in India still have a lot of potential. Mutual Fund's Total AUM/ GDP in the US is around 90%, 69% in European Union, above 50% in Brazil, while in India it is still around 13%. The scope for growth is obviously very high.

The growing awareness and interest in financial markets, along with a proven regulatory framework will have a related positive impact on investor interest in other financial assets like insurance and bond markets. With growing acceptance in the power of investing, retail investors will be open to exploring newer and more innovative avenues of investment. At the same time, regulators and organizations are making a concerted effort in educating the investor on financial investments where the under-penetration provides ample room for growth and expansion.

Democratisation of Credit

The financialization of assets is only one part of the India growth story. An equally important facet is around the democratization of credit allocation in the Indian economy. Earlier, a significant portion of banking credit was largely extended to top 100 business houses. However, today the gap has been successfully bridged with credit being offered to the under-funded retail segment, both business and personal.

Furthermore, with the sizeable leveraging ability of households, coupled with the falling interest rates, the Indian household is ready to borrow more. Today, the government balance sheet is already being leveraged for considerable capex investments and corporate balance sheets are also leveraged but with substantial expansion expected in a couple of years. In this scenario, Indian households are the only segment with borrowing capacity currently. There is a significant untapped opportunity available in the retail lending space to help seed and support local business microsystems. SME lending is, in fact, a form of retail lending where the personal and the business balance sheets of the self-employed entrepreneurs co-mingle.

This demand for higher credit by households has been further supplemented by a variety of efforts taken by the government towards universal financial inclusion. The introduction of Aadhaar coupled with the JAM trinity has helped bring a huge part of the population under the financial net. With the continued strengthening in CIBIL, improved credit underwriting mechanisms and the use of a wider variety of data points to assess the credit worthiness of both individuals and small businesses, access to credit is expected to increase significantly for the credit-deficient sections of the society and lead to a broad-basing of credit allocation in the economy.

While a broad-basing amongst credit takers is on the way, there has also been a significant broad-basing in credit givers to the Indian corporate. Bond markets particularly have come up in a big way in the last couple of years as a viable capital avenue for corporates. Several reforms have been undertaken for this shift to happen – however, there are still some reforms which could transform the bond market in India. These reforms can potentially alter the credit landscape in the country and accelerate India's compounding effect. If done timely and in a concerted manner, there is a good chance that we will hit the USD 5 trillion mark even before 2025.

Looking Beyond

With such a wide variety of factors seemingly falling in place, there is significant cause for optimism for India. Fundamental structural changes are re-shaping the economy and cyclicals are starting to become stronger. With the global economy also starting to recover, the cumulative effect should drive the economy to new heights.

Amidst all this, it is important to remember that to truly understanding the India story, requires bifocal vision – one which can cut through the short-term volatility and challenges and look at the long-term trend, which has always been upwards. Because near-term volatility is inherently visible and long-term growth usually invisible, a truly all-encompassing bifocal vision helps assess the economy in a comprehensive manner. In this situation, the mantra should always be to play the long-term positive trend and manage the short-term uncertain volatility, rather than the other way round, which people often tend to do. If the short-term is managed well and the long-term played to its optimum, it is a great time to be a part of the India growth story and to reap the growth dividend along with the economy.

India has all the ingredients required to become a global financial hub of the future. What is required is to create an enabling and conducive economic environment that can utilize India's core strengths to create a distinctive competitive advantage. This has to be achieved through a variety of government and regulatory reforms, many of which are already underway. With this combination of reforms and the India hinterland growth, we are well on our way to becoming a global financial superpower.

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[1] Edelweiss Research
[2] Edelweiss Research
[3] CMIE, Edelweiss Research
[4] AMFI, Edelweiss Research