MONEYLIFE ADVISORY
MAS WEALTH

The New Growth Model

Dear Fellow Investors,

For the sixth month in a row, a strong rally has gripped the Indian market. A lot of older investors are nervous while those with just a few years of experience are sanguine that India's long-term growth story is unfolding as expected and the market will keep going up. To believe in strong secular growth, we first need to understand and believe in our growth model. I am not at all clear as to what is India's growth model, because the government does not reveal much about its thinking. After searching for answers for years since 2014, the Modi government seems to be believe that massive government expenditure will lead us to prosperity supported by 'seat-of-the-pants' decision-making. Hence, the sharp focus on defence, railways, urban infrastructure which are all big-bang spending opportunities directly overseen by the central government. Budget 2023-24 announced a stunning capital outlay of Rs10 lakh crore, of which, allocation for the railway ministry is Rs2.40 lakh crore, a whopping 75% jump over FY22-23. The Defence Production and Export Promotion Policy 2020 (DPEPP) has set an ambitious revenue target of Rs175,000 crore (US$25bn-- billion) by FY24-25, implying a 15% CAGR (compounded annual growth rate) between 2019 and 2025. Procurement from domestic industry would double to Rs140,000 crore by FY24-25.

It is not clear whether this growth model (fuelled by government expenditure has been fully thought through), or it is the default model. The entire growth of the 2014-22 period has come from government borrowing and spending. Indian households and businesses have contributed a negligible amount to the growth. Therefore, the government has been forced to take on the burden of creating growth through the tax-and-spend model. There are obvious limitations to this model in a structurally weak economy, comprising a bloated state (propped by high-interest costs and high government salaries), weak rupee and a private sector that is kept uncompetitive by red tape and high cost of infrastructure. Feeble institutions (legal and administrative) make it hard to increase state efficiency too, no matter what the intent. The heavy hand of the state has rolled the dice of growth.

An unexpected outcome of this model is an extraordinary bullishness has gripped a certain segment of the Indian market. While the larger companies are merely chugging along, the stock prices of smaller companies are shooting up like wild weeds for the sixth month running. From early April when the current rally started, the Nifty50, is up only 14.1% while Nifty500 has rallied 19.7%. Meanwhile, the Nifty Microcap 250 has zoomed 60.3%! More importantly there is a pattern among the biggest gainers. These are all directly or indirectly linked to massive government spending that started a few year or two ago. This includes: 1. Railway modernisation which benefits stocks such as Jupiter Wagons (309%), Texmaco Rail (261%) and Titagarh Rail (207%); 2. Government enterprises such as Mazgaon Dock (233%), Indian Railway Finance Corporation (190%) and Rural Electrification Corporation (134%); 3. Infrastructure companies benefiting from government plans such as Patel Engineering (270%), a construction company with a focus on hydro power sector; Genus Power (227.6%) which specialises in smart meters, HBL Power (183%), which is focused on batteries, defence and railway signalling.

For example, if pipes and tubes are doing extremely well, it is because of the Jal Jeevan Mission. Companies doing government work are also getting paid quickly, which is also a major departure from the past. A small listed company, Zen Technologies, which has forecast a sharp rise in its revenues told analysts that it gets paid within 45 days of invoicing, thanks to the efforts of the Defence ministry. These are the reasons why companies from three segments—defence, railways, urban infrastructure (including road, power, metro rail projects, water and sanitation)—constitute a mad bull market.

In the past two decades, four sectors grew massively due to demographic tailwinds: software, pharmaceuticals, consumer goods and financial services, including banking. They also benefited from the lack of government intervention. India's private sector has never previously benefited from a well-managed, strong and secular growth due to government schemes and spending. In the past, growth due to government initiatives was limited to roads, power and mining. In each of these sectors, shady business houses walked away with large, gold-plated projects with the help of collusive bureaucrats and bankers. But they often failed to deliver due to inefficiency and corruption.

Today, massive spending on select sectors and Production-linked Incentives (PLI) to boost manufacturing in 14 sectors has led to more broad-based and significantly larger opportunities for all. But private companies operating in these areas, are small to medium enterprises, because they never before had a growth opportunity that is a significant multiple of their current operations. Hence, a sharp upsurge in the stock prices of this group of smaller companies as the market is confidently discounting several years of growth.

The question in everyone's mind is, will this be sustainable? The answer is not simple. The current model remains hostage to multiple factors, in the absence of any effort to reduce the cost of overhead, logistics and other frictional cost of doing business. In order to create a sustained, self-reinforcing growth cycle and for spending to continue we need: One, tax revenues to remain buoyant. Revenue from Goods and Services Tax (GST) is continuing to rise on a year-on-year basis, but has plateaued this year. Direct tax revenues are flat for the first four months, even as total government expenditure has jumped 23 percent, mainly due to a 52 percent increase in capital expenditure. Two, the value of rupee, which indicates the competitive strength of the economy, has remained weak and is getting weaker under the pressure of higher oil prices and lack of export competitiveness. Three, government spending, usually lack oversight and only time will tell what is the net impact of spending on railways and infrastructure. The benefit of defence expenditure is easier to visualize in terms of lower imports, higher exports and expanded domestic manufacturing. In effect, while the corporate sector has benefited from massive capital expenditure, leading to sky rocketing stock prices, investors would do well do keep an eye on the macroeconomic picture and government finances, not just corporate profits, for signs of trouble. After all, as smart investors would remind you, "everything is cyclical". In other words, when the cycle is rising, no one foresees or considers what could turn the cycle down. But they inevitably do, especially those created by the government.

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