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BizNotes
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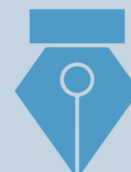
MONTHLY VIEW

FROM THE FUND MANAGER DESK



Will the emerging market crisis touch the Indian Shores?

The crisis is deepening in emerging markets. The crack is widening far beyond the obvious names like Pakistan and Nepal. When a celebrated economy in the not-too-distant past is at the door-steps of IMF, one can understand the extent of crisis in the emerging markets. What was once extolled as a miracle economy, Bangladesh could now be bordering on an IMF bail-out? Such is the scorching heat across emerging markets. In such a scary situation, one can't help, but start digging deeper for any hidden macros risks in India. Could the consensus view of a relatively stable macro for India be clouded by few serious misgivings? Or, has India's macro really come of age from those fragile days of 2013? Let us dive in and explore.

Emerging market crisis follows a very familiar pattern. In times of high liquidity cycle (while Fed is easing), money supply is abundant and it reaches far-away shores to seduce the usual EM suspects to go for an over-drive on consumption-driven growth with borrowed capital. In a playbook style, falling dollar index, rising local currency, cheaper imports, lower interest rates, etc. all play together to fuel local consumption. In times of abundant liquidity, currency valuations get distorted to artificially high level so as to hide the underlying twin deficit problems (Current account and fiscal) that usually the case for most of the emerging markets which import much more than what they export. When the music stops, which usually does when Fed starts the tightening, the reverse dynamics of rising dollar index, falling local currency, surging interest rates, etc. pushes up the hidden vulnerabilities to the surface. In these times, markets start looking closely at some of the metrics like dollar debt to GDP, current account deficit, level of forex reserves, upcoming dollar debt payments, etc. with a microscope. If market smells a rat in any of those metrics, it beats down the currency in a vicious cycle to bring the country down to the brink of bankruptcy. This usually happens in a self-fulfilling feedback loop fashion with a falling currency triggering outflows which in turn fuels further fall in currency that in turn aggravates the already aggrieved twin deficits, inflation, etc.

So, the key thing is the confidence of investors in the macro metrics. If it is broken, it triggers a

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vicious cycle as explained above. The confidence comes from various factors that include level of forex reserves, credibility of central bank in handling inflation, dollar debt to GDP, short-term debt payments, manageable current account, etc.

Where does India stand on these?

Level of forex reserves are reasonably high at over eleven months of imports (even after its recent depletion in defending the Rupee). Similarly, India's dollar debt is at a manageable level of around 15% of GDP, far lower than many Asian peers. India's central bank enjoys high credibility in tackling inflation risks. These are positives for India. But there is one sticky spot for India. That is, India's historical vulnerability from high current account deficit (CAD) that suddenly shoots up during such crisis times, especially when crude goes beyond 100$ level amid weakening Rupee (as 80% of India's energy requirements are imported). This has always been a potential landmine for India, especially during Fed tightening cycle. Will this time be different?

To answer this, let us go back and look at the key difference between 2013 and now in terms of CAD vulnerability. Not to forget that India was clubbed as one of the countries in Fragile Five in 2013. The key macro difference between 2013 and now, comes from the differing trajectory of growth between crude and the software exports. Software exports in dollar terms have more than doubled in this period while crude imports in dollar terms have stagnated or marginally declined (even at this elevated level). Looking at the data points, software exports have surged from 70Bn dollars (approx.) level in FY14 to 178Bn dollars (as per Nasscom) now (FY22) whereas energy imports (including LNG) have declined from 140Bn dollars level in FY14 to 130Bn dollars in FY22. This has brought in a huge comfort in easing our macro vulnerability from Oil risks. Today, software exports income covers more than the total oil bill by a factor of 1.3 times (even at this elevated oil price of 100$+) from a precarious situation in FY14 when oil bill was 2X of software exports income. This comfort is only going to increase multifold with the projection of over 300Bn dollar+ annual exports by 2025 as per Nasscom projections, given the huge super digitization cycle globally. Also, bear in mind how oil import as a share of total imports has come down from 30% level in

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FY16 to over 21% level now (FY22). It doesn't stop here. India's focus under the current political leadership on renewables, ethanol blending, CNG infrastructure, potential leadership in green hydrogen, sourcing oil at discount from Russia etc. will further strengthen India's macro architecture. Needless to say that India has come a long way in its macro stability esp. in its external financing and CAD management.

In our view, this development will single-handedly change the contours of India's macro risk profile. This change is the most under-debated and least understood across investment community. Add to this the Indian companies' and banks' rising credit profile on the back of huge cleanup of corporate and bank balance sheets. With NPA cycle behind, risk of potential accidents in the financial sector receding (such as ILFS in the 2018 tightening cycle), India's macro seems to be among the few shining spots for global investors. This is probably the reason why India witnessed investments of near 34Bn dollars in the PE-VC (28% growth YOY) space in the 1st half of calendar year when FIIs were busy pulling out over 25Bn dollars from the equity markets.

This emerging comfort on macro stability, progressive policy environment, Rupee's relative strength and positive long-term growth prospects etc. probably could be the reasons for the rising confidence from domestic investment community and for the huge resilience Indian markets have demonstrated during the current crisis. Next few months will tell us whether this prognosis is right or wrong. Interesting times to watch out for!

Happy Value Investing!!!

ArunaGiri. N

CORPORATE NEWS

- **Tata Motors** is eyeing a 5x growth in sales of electric vehicles (EVs) from the current levels by the end of 2023-24, the automaker's chairman N Chandrasekaran told the shareholders at the 77th Annual General Meeting (AGM). Tata Motors has hired global management consulting firm McKinsey & Co to restructure its commercial vehicle (CV) business for better profitability without compromising market share.
- **Dr Reddy's Laboratories Ltd** said the US health regulator has issued Form 483 with two observations after inspecting its manufacturing facility located at Srikakulam in Andhra Pradesh for violation of USFDA.
- Packaged consumer goods company **Bajaj Consumer Care** is looking at sustained investments in the premium personal care space, digital-first brands and banking on rural buoyancy to return over the next few quarter.
- **Pricol** has entered into Licensing Agreement with BMS PowerSafe SAS, France, for providing battery management system to the original equipment manufacturers in Indian market and International markets, across all vehicle segments.
- **State Bank of India** has hiked its Marginal Cost of funds-based Lending Rate (MCLR) by 10 basis points (bps), effective July 15. The overnight, one-month, and three-month MCLR now stand at 7.15 percent.
- India's cement industry will add 80-100 million tonnes (mt) of capacity by 2024-25 (Fy25), driven by increased spending on housing and infrastructure, Aditya Birla Group Chairman Kumar Mangalam Birla said in the latest annual report of **UltraTech Cement.**
- **Tata Power** announced that it has inked a pact with the Tamil Nadu government to invest Rs 3,000 crore for setting up a new facility to manufacture solar cells and modules in Tirunelveli district of the state.

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MACRO NEWS

- The Finance Audit and Investment Committee (FAIC), an advisory body to the **Employees' Provident Fund Organisation (EPFO),** has examined and approved the request to change the maximum to 20%. The EPFO's top decision-making body, the Central Board of Trustees (CBT), will review and approve the FAIC's recommendation.
- **Government** cuts windfall tax on fuel exports as global crude oil prices fall. New Delhi reduced the windfall tax on diesel and aviation fuel shipments by Rs 2 per litre & scrapped completely an Rs 6 per litre levy on gasoline exports, according to a government notification. It also cut the tax on domestically produced crude by about 27% to Rs 17,000 a ton.
- **The Asian Development Bank (ADB)** slashed its growth forecast for India to 7.2 percent for FY23 from 7.5 percent estimated earlier citing higher than anticipated inflation since April and subsequent monetary tightening by the central bank.
- **OPEC** forecast that global oil demand will rise further next year, but at a slightly slower rate than in 2022, with consumption supported by better containment of the COVID-19 pandemic and still-robust global economic growth.
- The **Reserve Bank of India (RBI)** has recommended to the government that it should frame regulations for cryptocurrencies and prohibit them. The government, however, seems to be of the view that a "global collaboration" is needed for any effective regulation or ban.
- Amid a fall in global prices, the **Government** directed edible oil manufacturers to further cut the maximum retail price (MRP) of imported cooking oils by up to Rs 10 per litre within a week, and maintain a uniform MRP of the same brand of oil across the country.

FUNDS FLOW DATA

Data as on 28th Jul 2022

FUNDS FLOW DATA (Rs in Cr)		
Category	**MTD**	**YTD**
FII	(1,462)	(2,18,821)
DII	10,547	2,42,514
Total	**9,085**	**23,693**

DEBT & FOREX MARKET

Data as on 28th Jul 2022

DEBT / FOREX MARKET			
Category	**Day**	**1 Mnth**	**3 Mnths**
10 Yr Yield	7.33	7.47	7.16
Re / US $	79.63	78.97	76.66

MARKET VIEW

Is mild recession in US a good playbook for India?

For the global markets, the worry has shifted from inflation to growth. With the crack in the commodity index, the incremental news flow is likely to turn positive. If this trend sustains, in all likelihood, this will make Fed to become less hawkish going forward. In such a scenario, though growth will continue to be a worry, esp. for developed markets, risk of deeper recession in US will recede because of reducing chances of Fed going overboard on rate hikes and tightening. As reflected in the commentary of the latest policy meeting, Fed is already turning less hawkish in its outlook. The emerging view is that the mild recession in US may turn out to be good for India given its negative impact on commodities and India's relatively resilient domestic demand.

This is in a way is reflecting in the market sentiment now. In July, Nifty is already up by over 5% and BSE small-cap index is up by over 6% (as on 27th July). Nifty is up by over 10% from June lows. Markets seem to have started rewarding stock-specific actions. If one looks at the number of stocks that are hitting 52week highs, they are gradually gathering momentum. This should be positive for bottom-up stock-specific strategies like ours. For the first time in nine months, FIIs have become net buyers in the last few days of July, though not in a considerable way.

This does not mean all risks have gone away. Given the dire situations in Europe because of supply chain issues of Gas, especially in Germany etc., global financial accidents could still happen. Same way, the property sector problems and its impact on growth in China etc., need to be watched closely. But going by our experience in past cycles, none of these macro issues are likely to have a lasting impact beyond few quarters. What is critical is to stick to the investing process and stay invested thro volatility given the sweet-spot India is in the weakening global macro.

MARKET VIEW

VALUE EXTRACTS

Value Extracts

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the ***"VALUE INVESTMENT"*** point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article from BQ Prime titled **"DESH – A Fresh Shot At Revamping SEZs In India?"** by ***"Mahesh Jaising"***

"Value investors thrive not by incurring high risk (as financial theory would suggest), but by deliberately avoiding or hedging the risks they identify."

- Seth Klarman

Special Economic Zones are viewed as engines of industrial and economic growth worldwide as they have played critical roles in the regional development of economies across the globe. India was one of the first countries in Asia to recognise the effectiveness of the Export Processing Zone model in promoting exports, with Asia's first EPZ set up in Kandla in 1965.

The success of SEZs is dependent on multiple factors such as strategic focus, regulatory framework, governance and value proposition. As India targets becoming a $5 trillion economy by FY 2025, both manufacturing and services sectors must contribute to this growth in proportion to the total GDP as it stands today. One of the stated objectives of the SEZ Act enacted in 2005 was the encouragement of manufacturing. However, data suggests that the policy has not completely delivered the desired results.

Out of 376 notified SEZs, 268 are operational as of date

SEZs in India *(As Of June 30, 2022)*

Status	Number
Formal approvals	425
In-principle approvals	35
Notified	375
Operational*	268

**As of March 31, 2022*
Source: Ministry of Commerce & Industry

India's SEZ scheme also came under the World Trade Organization's scanner for violating the WTO norms of restrictive trade practice. In order to overcome these challenges, the union budget mentioned that the SEZ Act of 2005 would be replaced by the Development (Enterprises and Services) Hubs Bill, 2022. The DESH Bill proposes to enable states to become partners in the development of enterprise and service hubs and will cover all large existing and new industrial enclaves to optimally utilise the available infrastructure and enhance the competitiveness of exports.

Why India's SEZ Model Needs To Change

Key Focus Areas Of SEZs
Direct and indirect employment and skill development in semi-urban/rural areas
Growth of international trade by way of exports of goods and services
Development of infrastructure for export
Legal framework that is adept at keeping pace with technological and business changes
Need For Revamped SEZ Policy
Regional and sectoral imbalance (5 states contribute to majority of investments and dominance of the IT/ ITeS sector)
Complexities in undertaking domestic and international businesses through same units
Need for infrastructure with flexibility for domestic and export operations
Automation of approvals and compliances and speedier process of approvals with active state participation

Source: Deloitte India

Many proposals in the draft are from the 2019 report of an expert committee headed by Bharat Forge Chairman Baba Kalyani. The committee had suggested SEZs be converted into 'employment and economic enclaves' (3Es) with an extension of tax sunset clauses, simplification of processes, tax benefits for the services sector, broadening the definition of services, allowing multiple services to come together, facility of sub-contracting for customers outside 3Es/SEZs.

The proposal is to change the focus from exports to economic activity, employment, investment, and global value chains interlinkage among others, apart from the greater involvement of the states.

Paradigm Shift From Export Focus To Economic Growth And Employment

The DESH bill proposes a far wider objective of boosting domestic manufacturing and job creation through development hubs than the SEZ Act did. DESH seeks to overcome the bottlenecks present under the existing SEZ laws by complying with the global trade rules of WTO, among other challenges. Here is a sneak peek of industry expectations on the key changes to the framework:

Thrust on optimum utilization of infrastructure: SEZ units are capital intensive and a lot of SEZ space has been created in India. However, a large portion of these areas has remained unoccupied.

It is expected that the DESH Bill will allow partial denotification of unutilised land spaces from the scheme even if the resultant built-up processing area does not hold contiguity, after such denotification. This ought to give a boost to large existing and new industrial enclaves to optimally utilise available infrastructure, particularly in the post-pandemic period and given the dynamic working approach of companies.

Services and IT hubs are expected to be the biggest beneficiaries of this proposal.

Key Framework Of The New 'DESH' Policy

Migration from export focus to economic and employment generation	Move away from supply-driven approach of setting up of new hubs
Enabling framework for ease of doing business, One-stop-shop portal	Leveraging the fast expanding domestic market, ecosystem for startups and MSMEs

Source: Deloitte India

VALUE EXTRACTS

It is also hoped that in order to encourage better utilisation and development, the norms for the usage of non-processing areas for dual usage are made more flexible.

Indian Rupee billing and free flow of goods or services to the domestic market: Receipt of foreign currency has been a matter of contention in recent times under the SEZ scheme where authorities have been seeking to levy a penalty for domestic invoicing. This issue is likely to be addressed by DESH Bill, by doing away with barriers to domestic supplies and allowing the movement of goods and provision of services to the domestic market. In fact, it is also proposed to do away with the Net Foreign Exchange criteria in line with the stated objective of moving from an export focus to economic and employment generation.

Repayment of only duty foregone for domestic clearances: A key change expected in the DESH Bill is that the units making domestic supplies will only be required to pay back “duty foregone”. This will allow companies to make use of underutilised capacity to serve the domestic market and incur duties only on imported inputs and raw materials instead of on the final product. This change makes the proposed DESH Bill at par with the Manufacturing and Other Operations in Warehouses Regulation.

This major shift in the basis of payment of duty, as against the current requirement to apply full customs duty by treating supplies from SEZ as “imports”, opens up a huge benefit for companies needing the flexibility to export and cater to the domestic market.

This should result in more “make in India” activities under the DESH Bill.

Broad-banding and push for multi-sector spaces: The proposed legislation also seeks to emphasise promoting not only manufacturing but trading and provisions of services too, by broad-banding the definition of services and allowing multiple services to come together. Further, units are currently required to have a separate earmarked area for trading and warehousing. This was necessary as the free trade warehousing zones were set up in sector-specific SEZs. It is expected that the legislation will allow all units to operate as multi-sectoral units in line with the change made to the SEZ legislation in 2019.

Continuation of indirect tax duty and GST benefits: It is expected that the DESH Bill will also continue to extend customs duty exemptions to the hubs/units, enabling them to remain competitive in the global space. The benefit of zero-rated supply (no tax) is also likely to be extended on supplies made to hubs/units. The hubs/units can continue to procure goods or services without any payment of GST under the new regulations as well.

One-stop-shop portal and ease of doing business: The new scheme is also expected to have increased automation through a single integrated portal for all compliances and approvals. The move is likely to encourage the integration of the customs portal with the platform for such hubs. The report of the Baba Kalyani-led committee also recommended clear guidelines for time-bound approvals and a larger role of development commissioners in facilitating approvals to reduce the role and dependency on the Board of Approval and the Unit Approval Committee. This is also critical given that one of the objectives of the scheme is to enable Centre-state partnership in the monitoring of these hubs.

Way Forward – Enhanced Industry Engagement And Effective Implementation

While the DESH Bill will certainly provide a much-needed impetus to SEZs and enable the utilisation of vacant spaces, it is also likely to provide adequate opportunities for companies to redesign their supply chains.

Specifically, companies will be able to plan their production and evaluate ways to adequately use the domestic market for increasing business. Lastly, the expected change in the framework will also hopefully give rise to the setting up of incubation centres in the hubs and allow startups and MSMEs to take advantage of the benefits that the DESH Bill will provide.

VALUE EXTRACTS

India is at a crucial juncture in its economic growth trajectory. This new policy, with its strengthened and forward-looking measures, is likely to play a very important role in the growth and development of sectors across manufacturing as well as services. The success of the scheme will depend on its implementation and it is expected that the government would, once the Bill is finalised, focus on this front with active engagement with industry. Quick redressal of any teething issues, especially from a procedural and rule-set standpoint, will serve as the litmus test for the success and adoption of the scheme by industry.

- Article by Mahesh Jaising

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