Exchanges at Goldman Sachs
What India's Digital Transformation Means for Markets, Investors and Economic Growth

Tim Moe, Chief Asia Pacific Equity Strategist

Santanu Sengupta, GS Research's India Economist

Sunil Koul, Senior Asia Pacific Indian Equities Strategist

Allison Nathan, Host

Recorded: November 29th, 2021

Allison Nathan: This is Exchanges at Goldman Sachs, and I'm Allison Nathan, a senior strategist in Goldman Sachs Research. Today, we're going to take a closer look at a country that's going through a digital transformation that's reshaping its markets and economy: India.

To do that, I'm joined by three people from Goldman Sachs's Global Investment Research Group. Tim Moe, our chief Asia Pacific equity strategist; Santanu Sengupta, our India economist; and Sunil Koul, a senior Asia Pacific Indian equities strategist. Tim, Sanjanu, and Sunil, welcome to the program.

Speaker: Thanks, Allison.

Speaker: Thanks, Allison. It's great to be here.

Speaker: Thanks, Allison.

Allison Nathan: Tim, you and your team just published your 2022 outlook for the Asia Pacific region. Start by giving us a sense of where countries in the region stand in terms of the pandemic recovery and where India falls in all that.

Tim Moe: Well, the pandemic recovery is a key part of our outlook for 2022. And just to paint the background sketch very quickly, the key issues that are affecting markets in 2022 are generally slowing growth and generally rising rates because inflation prices have been building and monetary policy is starting to normalize. So we have a somewhat more downbeat view. Not absolutely negative. We think markets will deliver positive returns, but generally a somewhat more downbeat view just because slowing growth and rising rates typically aren't the best backdrop for equity markets.

And this is where the pandemic response comes in because not everyone is at the same stage of recovery from the pandemic. So we have an indicator we call our ELI, which is the Effective Lockdown Index that our economists produce. And it basically measures from zero to 100 the degree to which economic activity is being impaired by the various shutdown measures that have been put in place to combat the spread of COVID.

And just to give a couple of “for instances,” we've seen a number of places -- I mean, China, for example -- having a very strong lockdown early on but currently at the level of 5 on a zero to 100 scale.

Now, most of South Asia, however, did not address the delta variant very well, and so they had belated increases and surges in the virus outbreak. And that in turn has meant that the economies are lagging in terms of their recovery. Now, what was headwind this year in 2021 is actually going to be a tailwind or positive going into 2022 because you get some delayed recovery momentum. India's going to have that, and Santanu is going to talk about that just a moment. And parenthetically, the ASEAN economies also are going to have an increase.

So just to give one or two numbers here, for Asia ex-Japan overall, we're looking at 6.8% growth in 2021. That's going to come down to about 5.7 led by a very significant drop in China. In contrast, for example, the ASEAN economies are going to grow from a 3.2% up to 5.3. And without foreshadowing too much of what Santanu is about to say, India is going to increase probably about a percentage point from 8% to 9.1. So the bottom line here is that that delayed recovery from COVID is actually going to work to the benefit of India and some of the other South Asian economies next year.

Allison Nathan: Santanu, so can you give us some more detail about the Indian economic outlook and what you're expecting?

Santanu Sangupta: Sure. Thanks, Allison. So as Tim mentioned, we are seeing a GDP growth in 2022 at a shade over 9%. We see three factors primarily driving this growth. One, consumption will come back to trend as the economy reopens fully next year. We're also seeing some nascent signs of an investment cycle recovery driven both by a housing market revival and increased corporate capex.

And finally, in the near term, we are seeing a push to growth from higher government capex as taxes so far have been running ahead of budget estimates, but the government spending has lagged. Now, this growth is likely to come with higher inflation in 2022 versus 2021. We are actually expecting core inflation to remain elevated pretty much through the whole of next year. Again, two reasons. One, as manufacturers pass on the input cost increases due to higher commodity prices to consumers and core services inflation also increases as the economy reopens fully.

Hence, we are expecting the RBI to normalize monetary policy. We have called out four stages of the monetary policy normalization. Remember, India did a lot in terms of liquidity loosening and cutting the reverse repo, which is bottom of the policy corridor, into the pandemic. So we are seeing a reversal of that liquidity, loosening now. So liquidity will tighten over the course of next year. And we are expecting the reverse repo to normalize first.

Then in 2022, Q2 onwards up to Q4, we are expecting three rate hikes from the central bank, cumulative 75 basis points in 2022.

Allison Nathan: Okay, thanks for that. So, Tim, maybe you can talk a little bit more about the markets' perspective. You gave us the thumbnail sketch, but we've recently downgraded our view on Indian equities to market weight from overweight. So what were the specific drivers behind that downgrade?

Tim Moe: So in one word, Allison, it's valuation. It's a valuation call. Sunil can go into more detail on the medium-term outlook and obviously Santanu has just sketched out the cyclical expected recovery, which also will be reflected underlying earnings growth. So we're actually fundamentally quite constructive in India.

The problem is the market has done very well. And just to give a couple numbers on that, it's the top-performing market in the region this year, up 30% in round numbers and actually up more than 40% since we upgraded it a year ago at this time. So given that very strong performance, valuations have expanded and the market's trading currently at 23 times forward earnings. That's 2.3 standard deviations above its longer-term mean. And very importantly, it's trading at well over a 60% premium to the

P/E of the rest of the region. It actually just peaked about 65%. And that's well above the previous peaks, which were in the sort of 40-50% range.

So this is purely a call saying, look, love the market, but it's a bit ahead of itself. It needs to kind of bide its time to allow fundamentals to catch up. That's really the essence of it.

Allison Nathan: Right. So basically you're saying that the positive fundamentals are already priced in?

Tim Moe: That's right. We think that, for the time being, those fundamentals are priced. As time goes on, then there will be more to go for because we think there still will be continuing growth. But we do need to be mindful of how much we're paying at the current time. And I would also add that we expect there's going to be a large IPO issuance calendar. So from a technical demand-supply perspective, there could be a little bit of cannibalization of secondary market performance by the primary market issuance. So there's additionally a couple of the factors that impelled us to take this move.

Allison Nathan: So Sunil, let's bring you into this conversation to talk a little bit about some of the topics that Tim just hit on. If you think about the medium to longer term outlook, there are some positive structural trends. You recently wrote a report looking at the digital transformation of India, which certainly seems to be a bright spot. And then Tim just touched on the strong IPO calendar. Maybe you can start by talking a little bit about what's driving that IPO activity.

Sunil Koul: Yeah, thanks, Allison. I mean, let me just put some IPO numbers into context that Tim just mentioned. So we have seen close to 15 billion-dollar IPO activity this year already, which is a record number and more than the last three years combined. So that's a lot of IPO activity already this year. We are expecting another $20 to $30 billion per year over the next two years. So pretty strong IPO pipeline there.

To your question what's driving this, I would say it's the combination of a few factors. I guess part of it is that we are at that inflection point where a lot of these startups are sort of getting to reasonable scale from an India standpoint. What I mean by that is that, if you look at the number of unicorns we have got in India, which is basically the private companies who have got at least a billion dollar valuation now, we have about 70 of them now and obviously counting. But about half of them got to the billion dollar valuation this year alone. And there are many companies who are basically hitting $100 million in revenues. And so the companies basically feel, look, I mean, we've got end of scale and with the kind of high valuations they are getting, many of them are feeling kind of IPO-ready right now.

I guess the other factor is that regulations were changed earlier this year in March. And so it has made it easier for these tech startups to list on the main exchange. So that's why I think we're seeing so many companies going public now, even though if you look at the last few years, the space has actually been quite active in terms of the private equity and VC players, and it seems like the action is now shifting to the public markets here.

Allison Nathan: And where are you seeing the activity most? Is it concentrated in certain sectors?

Sunil Koul: It's concentrated in the new economy sectors. So if you look at the top five categories, which is basically your fintech, your ecommerce, your SaaS and enterprise services, your education tech, your food tech, which is broadly classified as IT and IT-enabled services, that's more than 80% of the deal pipeline this year. So we are clearly seeing that the contribution of the new economy sectors in the market is actually rising.

Allison Nathan: And how will that rise of the new economy affect -- you know, what were some of the knock-on affects? How will it affect capital markets in particular?

Sunil Kohl: Yeah, I guess one of the key takeaways from the India digitalization report is that we think there will be significant changes in the capital markets over the next two to three years. Just to give you some numbers here, we think the size of the Indian capital market will rise from current $3.5 trillion to well above 45 trillion by 2024, which will basically make India from number seven currently in terms of its ranking by market cap, to fifth largest market after US, China, euro area, and Japan.

In addition to this increase in market cap, India's weight in the global indices will also rise both in the global benchmarks but also in the emerging markets. So for example, for the emerging markets, we expect India's weight to go from 12% to about 15% in two to three years.

I think the more important point is that the new economy weight of India indices, we think that will rise from current 5% to perhaps 15-16% in the next three to four years, which will in turn have implications for fundamentals, right? Because if you look at a lot of these new economy companies, they are growing very fast in terms of their topline kind of revenues.

So if you just look at MSCI India as a headline index, we think its revenues can increase by as much as 20% over the next two to three years. Obviously, I think earnings will grow over time because a lot of these market leaders right now are still unprofitable, but we think they will turn profitable in the next two to three years. So the earnings will also rise, but this is something which is not in any of the analysts' numbers. So there could be an upside surprise once that comes in.

So I think as we were saying earlier, this is very positive for India over a medium- to longer-term basis. But one thing I would highlight here is that many of these new economy companies, they're actually trading at expensive valuations compared to the public equities. So investors need to be a little bit more selective and mindful of valuations. So we think there will be great opportunities for investors to make money as long as they don't overpay for growth. So that's something I would say needs to be kept in mind regarding the valuations.

Allison Nathan: And Santanu, if you think about these shifts in the public and private markets that Sunil just talked about and the revenue flows they will create, will there be an impact on economic growth? Is that part of a positive medium- to longer-term story for the country?

Santanu Sangupta: Yeah, sure. So I'll just put some numbers into perspective. So India is one of the largest Internet markets in the world, second only to China, about 800 million are Internet users. It's grown about five times over the last five years. About half a billion now are smartphone users. And there was this sharp drop in mobile costs and, you know, making it one of the cheapest markets in the world, which accentuated this trend, right?

So this has caused the rapid switch to online in many of the sectors. This includes education, food delivery. Sunil talked about ecommerce and fintech. What COVID did was obviously it accelerated this further because amidst the containment measures and the shift to work-from-home or stay-at-home, this just grew even faster.

This overall is expected to have positive impact on services growth. But also over a period of time, this should increase productivity growth in the economy. Our Internet analysts think that the ecommerce adoption can double over the next four years or so, and we are expecting therefore more investment in infrastructure and logistics to overcome bottlenecks in these sectors to aid this ecommerce boom further.

Finally, in terms of delivery of public goods, that is likely to become easier and subsidies become more targeted with various technological and financial innovations. So a couple of examples are a unique biometric identification system, which is the Aadhaar, which has about 1.3 billion people registered currently. And a Unified Payments Interface for cashless digital payments to targeted customers.

Allison Nathan: So let's take a step back for a minute. How did India go from a country where its GDP per capita is still relatively low to a country that could enable these different unicorns and digital economy players to launch successful businesses? Sunil, maybe you can talk a bit about how did it accomplish that transformation?

Sunil Koul: So we had a whole section on this in our report in terms of what's enabled and helped these startups to grow and launch successful businesses. I think it essentially revolves around the availability of capital from these private equity and venture capital players that I talked about earlier, the rise of the entire India Internet ecosystem, and this faster shift to online after COVID that Santanu was describing earlier. The favorable regulations that we talked about.

But perhaps I think one of the most important factors, which is worth mentioning here, is this entire innovation in the payment infrastructure. So just as an example, one such innovation is India stack, which is basically a set of open APIs, which links to a unique biometric identification, we call Aadhaar, with our bank account and your mobile number. And then basically it's a cashless payment layer on top of it, which is called UPI, unified payments interface. So that basically has exploded in the last three to four years.

So if you look at India right now in terms of its digital payments, the UPI has overtaken both the credit cards and the debit cards put together. And it now actually accounts for more than half of the overall digital payments in India. So I guess what it does is that, if you are a fintech company or say if you're an ecommerce player, it reduces your cost of setting up operations. You can now acquire customers at a much lower cost and more efficiently, so your customer acquisition cost actually comes down. If you are an ecommerce player, you can sign up a large number of merchants on your platform, and so it essentially helps these startups to gain scale pretty rapidly.

Just to mention here, our Internet and banks analysts have done a deeper dive on this topic. So if people are interested, it's worth taking a look.

Allison Nathan: So clearly there's a lot of positives with the rise in the Internet ecosystem in India, and we see its potential to transform the economy and markets. But are there risks around that? Santanu, maybe you can talk a little bit about some of the risks you're focused on.

Santanu Sengupta: So Tim and Sunil talked about valuation earlier and what that could mean for equities, but remember from a macro standpoint, significant foreign inflow of money chasing these digital assets leading to consistently high balance of payment surpluses can become a problem of plenty for the central bank as, ideally, India wouldn't want too much currency appreciation when it's trying to promote export growth.

So unsterilized ex-interventions in the FX market would increase domestic I&R liquidity. And that becomes difficult to manage at the time, especially when the central bank is trying to normalize monetary policy. So the central bank then has to think about many more sterilization tools and so on. So that would be one key macro risk to keep in mind.

And secondly, what we would have in mind is services wage inflation, particularly in these digital economy sectors, will rise. And we're seeing it already, a lot of that in the software services sector. And that can potentially feed into wage inflation in other sectors as well. So those are the two risks that I would keep in mind going forward.

Allison Nathan: So we think about the opportunity and risks that we've discussed. My mind goes to China. China, of course, is the poster child for digital transformation. So Tim, maybe you can talk a little bit about what India's going through, you know, is similar or different to China's journey. And if we think we're likely to see other ASEAN countries follow suit.

Tim Moe: Absolutely. And I think China really is the analog that many people, including us, are looking at. So we did a detailed piece on China specifically about a year ago where we really focused on this digital transformation which has taken place. And just to enumerate that, we saw that, for example, 10 years ago, China's Internet sector weight in the overall market was 5%, and it's risen up to about 43% currently.

And you can take a broader definition of what we call New China, and that sort of includes areas like not just tech but obviously healthcare and other consumer-facing businesses. That was about 20% 10 years ago. Now it's 65%. So you've had this total transformation of the index from what previously was dominated by old economy, lumbering companies, you know, banks, energy, steel, etc., to very much high-growth digital economy-focused players. And that's been transformative for the market.

And it's resulted in China posting the best 10-year CAGR of earnings of all the markets in the region and has generated significant amounts of wealth. So to give one example, since 2005, New China is up about 20 times whereas Old China is up three times. So it's been tremendous kind of wealth-generating phenomenon which is taking place.

This has obviously not been lost on people. And what we're seeing in India is a very clear analog. Now, we're not saying it's going to be exactly the same because obviously the countries are different, circumstances are different, and starting points are different. But you have a number of very appealing commonalities -- very large domestic population, as Santanu and Sunil have been noting. You've got this appealing digital stack and underlying set of technologies which enables companies to build and scale rapidly. And you've got the idea of sort of being a fast follower. Someone else has established the precedent that it's easy to kind of copy that and then perhaps leapfrog that.

So you've got a lot of circumstances that are in place for an acceleration and this digital transformation to take place. Now, it may not happen exactly the same way. Almost it's guaranteed that it won't. But the potential for significant improvements to people's livelihood, for economic development, and for equity market investors for significant wealth creation we think is very much there. And that is really central to our positive view on the medium-term investment case for India.

Now, interestingly and happily, we're seeing this also in some other parts of the region, to your question. So we just recently upgraded our view on ASEAN. And that's partly for cyclical reasons coming out of COVID. You get some positive momentum next year in both the economy and in terms of earnings.

But importantly, there's also a digital story. I'll just give you one statistic here, which is that currently the Internet sector is about 4% of the ASEAN index. That's very soon going to go to 20% and with upside. As you get the fuller inclusion into the index of the market cap of some existing players and the likely listing of others that are waiting in the sidelines, much as Sunil was mentioning for India.

And then just finally, to sort of just add a little bit of icing to the cake, we've seen a similar transformation in Korea, for example. Korea was typically known as sort of this super deep cyclical globally sensitive index dominated by shipping companies and steel companies and engineering construction companies. Now, the new economy part of the Korean index is rising rapidly, and I'll leave you with just one statistic. There's a so-called BBIG Index -- batteries, biotech, Internet, and gaming. Five years ago, that was 5% of the market, now it's 20%.

So you're seeing this kind of digital fluorescence take place really throughout the region. China's been the leader, but now it's spreading out elsewhere. And we think that's going to be the root of some tremendous investment opportunities as we look out over the next 5-10 years.

Allison Nathan: Well, we will certainly be watching the extent to which India and other ASEAN countries, as you just said, Tim, follow in China's footsteps in this regard. Tim, Santanu, and Sunil, thank you for joining us and sharing your views.

Tim Moe: Thank you so much, Allison.

Santanu Sengupta: Thanks, Allison.

Sunil Koul: Thank you.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment. This podcast was recorded on Monday, November 29th, 2021.

completeness of the statements or any information contained in this podcast and any liability therefore; including in respect of direct, indirect, or consequential loss or damage is expressly disclaimed. The views expressed in this podcast are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this podcast. In addition, the receipt of this podcast by any listener is not to be taken as constituting the giving of investment advice by Goldman Sachs to that listener nor to constitute such person a client of any Goldman Sachs entity.

This transcript should not be copied, distributed, published or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this transcript and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. The views expressed in this transcript