



# MUMBAI MONITOR



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## QUARTERLY REVIEW: PROMOTING GROWTH WHILE MAINTAINING MACRO-ECONOMIC STABILITY

After a strong start to the year, the MSCI India 10/40 (NR) index corrected in March to end the quarter with a 5.10% gain in USD terms. The Indian rupee (INR) rose by 1.49% against the US dollar.

The Union Budget presented on 28 February managed to balance fiscal discipline with facilitating growth by focusing on infrastructure investment and improving the ease of doing business. The government held on to its fiscal deficit target of 4.1% of GDP for FY 2015. For FY 2016, the target was cut to 3.9% with an objective of 3% of GDP by FY 2018, one year later than previously planned. The infrastructure investment is due to be financed by the relaxed deficit target as well as lower crude oil prices (For an analysis of the budget, read the article on p3).

The Reserve Bank of India (RBI) cut its key repo rate twice over the quarter, reducing the rate from 8% to 7.50%. These cuts 'validate' the government's budget and confirm the central bank's shift towards a more accommodative monetary policy, which should help accelerate India's economic recovery.

At 5.4% YoY in February, CPI inflation remained within the RBI's comfort zone and was slightly above January's 5.2%. The core CPI number remained low at 3.9%, reflecting a disinflationary trend in the economy. Industrial production continued to expand modestly, advancing by 2.6% in January after a revised 3.2% increase in December 2014. Despite a 15% contraction in exports, the steep plunge in crude oil prices and limited gold imports helped February's trade deficit to narrow to USD 6.8 billion. Non-oil/non-gold imports rose by 9%, reflecting a pick-up in the real economy.

On the growth front, the Central Statistical Organisation revised the base year for GDP and announced changes in the methodology and presentation of GDP data. Under the revised methodology, growth is forecast at 7.4% for FY 2015, up from 6.9% in FY 2014. Under the previous methodology, growth for FY 2014 stood at 4.6%. The new growth calculations appear to be ahead of 'on-the-ground' levels of economic activity and their track record will be monitored closely for a while before they can gain full credibility.

Bloomberg is the source for all data in this article, as of the end of March 2015.

## QUARTERLY OUTLOOK: TOWARDS A GRADUAL RECOVERY - EARNINGS GROWTH TO DRIVE DIVERGENCE IN STOCK PRICE PERFORMANCE

Even after the latest rate cut, India's real interest rate remains largely positive at 2.1%, while in the US, short-term real rates are still negative (adjusted for CPI), so there is a comfortable margin for further cuts without jeopardising currency stability. However, RBI governor Dr Rajan made it clear that "further monetary actions will be conditioned by incoming data, especially on the easing of supply constraints, [...] continuing progress on high-quality fiscal consolidation, the pass-through of past rate cuts into lending rates, the monsoon outturn and developments in the international environment". On inflation, Dr Rajan confirmed that "softer readings on inflation are expected to come in through the first half of 2015-16 before firming up to below 6% in the second half". He updated the RBI's inflation target to 4% plus or minus 2% by the end of fiscal 2017.


The record USD 18 billion raised in the 2015 telecommunications spectrum auction should represent a short-term pain for long-term gain for the top three players as the level of spectrum pricing will likely make it very hard for smaller players to keep their spectrum when this comes up for renewal. We thus believe the auction outcome should accelerate secular consolidation in the industry.

India's current account deficit (CAD) narrowed to USD 8.2bn (1.6% of GDP) in Q4 2014, down from USD 10.1bn (2% of GDP) in the prior quarter. The deficit has been improving consistently, helped by the fall in crude oil prices, and it could even shrink to less than 1% of GDP in fiscal 2016. In real effective exchange rate (REER) terms, the INR has been appreciating ever since RBI governor Rajan took office. While the early appreciation was essentially a recovery from the fall in the summer of 2013, the INR has gained further, driven by favourable capital inflows.

India's macro and microeconomic indicators suggest that the recovery is likely to take time. While we are positive on the medium-term earnings growth prospects, we expect earnings growth to remain weak in the coming quarters. As such, the market may experience corrections in the short term as valuations have moved ahead of the earnings recovery. While the relatively low cost of money and lack of growth globally have contributed to this premium for growth, stocks may soon need the support of stronger earnings. Even though the government's reform agenda is moving ahead, investors may be expecting 'too much too soon' and the pace of actual reforms and the reacceleration of growth may cause disappointment.

We believe that, as long as the fundamentals are improving, such corrections may provide investors with an opportunity to enter the market or to reinforce their exposure since in our view, the outlook for Indian equities appears positive for the next two to three years due to lower commodity prices, progress on reforms, a loosening of monetary policy and, ultimately, accelerating growth. ■

Bloomberg is the source for all data in this article, as of the end of March 2015.



Are you positive on Indian equities?  
Why?  
Email us your thoughts.

## INDIA FY16 BUDGET: PROMOTING GROWTH AND COOPERATIVE FEDERALISM

The Union Budget for the fiscal year to March 2016 (FY16) successfully managed to maintain fiscal discipline and promote growth by focusing on infrastructure investment and improving the ease of doing business. It confirms our view that policy actions will be incremental and tactical rather than tectonic, aiming to gradually move India's economy back towards a sustainably higher growth rate. It also empowers state governments, opening the way to cooperative federalism.

### Maintaining fiscal discipline, with leeway to promote growth

Firstly, the government maintained its fiscal deficit target of 4.1% of GDP for FY15, underscoring its commitment to enforcing fiscal discipline. For FY16, the target was cut to 3.9% with an objective of 3% of GDP by FY18, one year later than previously planned.<sup>1</sup>

By doing so, the government aims to balance the need to continue fiscal consolidation and to create leeway in order to promote growth. It is worth noting that these budget assumptions appear better grounded than past assumptions, which makes us more confident that the government can avoid errors concerning the targets.

Achieving a higher growth rate is critical for India to ensure its 'demographic dividend' – a young population and a low and falling dependency ratio – does not turn into a burden because of insufficient job creation.

### A focus on infrastructure investment

To promote growth, the government is focusing on infrastructure investment, financed by the less stringent fiscal deficit reduction target as well as the fall in crude oil prices which should help trim the subsidy burden by 50% to INR 300 billion (USD 4.9 billion).<sup>1</sup>

In total, the government aims to allocate an additional INR 700 billion (USD 11.3 billion) to infrastructure investment in FY16 compared to FY15. It plans to set up a National Investment and Infrastructure Fund (NIIF) investing INR 200 billion (USD 3.2 billion) a year. Lastly, it wants to create tax-free infrastructure bonds to fund road, railways and irrigation projects.<sup>1</sup>

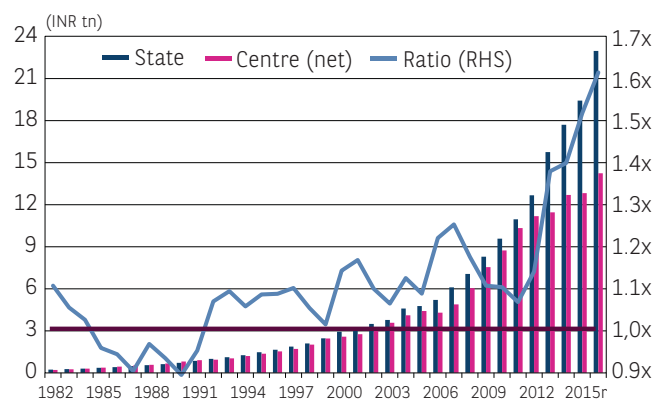
### Improving ease of doing business

Also critical to reviving capital expenditure, the government is introducing a 'plug-and-play' model setting out clear rules for large projects and listing all applicable norms and laws ahead of the bidding process. Companies will not need to continuously ask for permissions or clearance as long as they follow provided guidance. This should speed up the implementation process. Besides, companies should benefit from a cut in the corporate tax rate from 30% to 25% over the next four years.

### Opening the way to cooperative federalism

Another important step was the decision to transfer more responsibilities to the individual states by increasing their share of tax collections by 9%, in line with the recommendations of the Finance Commission. The share of states in total spending should rise to 1.6 times that of the central government. This marks a paradigm shift in the relationship between the central government and the states, which should promote efficient policy execution on a local level.

### Share of states in total spending to rise to 1.6x that of the Central government



Source: Budget documents, RBI, Credit Suisse estimates, March 2015

The states have been responsible spenders, with the fiscal and revenue deficits declining by 0.6% and 0.9% respectively between FY10 to FY15.<sup>2</sup> Moreover, over the last few years, a number of states recorded growth rates which by far exceeded the all-India average. For instance, in Gujarat, where Prime Minister Narendra Modi used to be Chief Minister, gross state domestic product growth in FY03-12 stood at 10.3% versus 7.9% for India.<sup>3</sup>

Thus, higher allocations by the centre to the states in the FY16 budget should give higher flexibility and control to the states in their expenditure. If the states manage to use a significant portion of the additional funding from the centre for capital expenditure, this could be the much required nudge to revive the investment cycle.

### Towards a gradual growth recovery

This balanced budget confirms our view that policy actions will be incremental and tactical. Most importantly, it provides a clear roadmap to build the foundations for sustainable 7%-8% growth in the coming years. We believe this is positive for long-term investors. ■

**Will a cooperative federalism approach impact India's growth rate positively?**  
Email us your thoughts.

1. Source: India Budget Speech, 28 February 2015  
2. Source: Bloomberg, April 2015  
3. Source : Bloomberg, State of Gujarat, May 2014

## ASSESSING INDIAN GOVERNMENT ACTION AND THE COUNTRY'S READINESS FOR A US RATE HIKE

After close to one year since it took office in May 2014, India's government has made a fairly good start on its five-year economic agenda. This matters because financial markets had high expectations given the election campaign's focus on the economy, and Prime Minister Narendra Modi's track record as Chief Minister of Gujarat (one of India's fastest growing states). We welcome the government efforts to tick most reform and execution boxes, though the pace has been gradual.

### Taking stock: the reforms so far

One of the reform measures worth mentioning is inflation control. This is being achieved by reducing support price hikes to the bare minimum and focusing on fiscal consolidation. Tax reforms are being introduced with a push to implement the Goods & Services Tax by the fiscal year to March 2017 (FY17).

Other measures include direct benefit transfer to reduce benefit losses and thus curb the overall subsidy bill. 'Jan Dhan Yojana' aims to give every household a bank account as a first step towards financial inclusion besides helping with direct benefit transfers. 'Swachh Bharat Abhiyan' is an effort to clean up India with a view to improving health, hygiene and productivity. 'Make in India' is a thrust to enliven and move manufacturing to India to create jobs, raise exports, reduce imports and build skills. 'Digital India' is an aggressive effort to wire up India through broadband access across rural areas.

Further measures include 'Skill India', smart cities, housing for all by 2022, greater ease of doing business, more transparency in the allocation of natural resources and banking reforms.

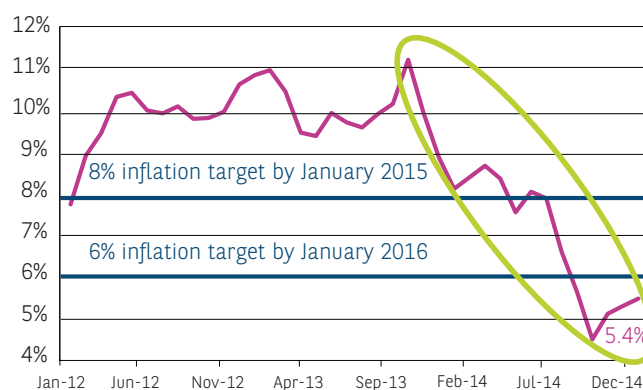
### Laying the ground for a sustainably higher growth rate

These initiatives not only envisage government spending, but also are participative and inclusive and should entail investment by banks and the private sector along with the government. We believe the various measures when implemented over the next few years should provide significant gains in terms of higher, more balanced and more sustainable economic growth. However, some of the measures will be time-consuming and benefits should become visible only gradually. The challenges faced by the government are: the ability to pass some bills in the upper house of the parliament where it does not have a clear majority, the risks related to timely execution of the initiatives and global market conditions.

### Inflation targeting

Recently, the RBI, India's central bank, and the government finalised the monetary policy framework introducing inflation targeting to end a long history of volatile price rises. The CPI inflation target was set at 4% plus or minus 2% for FY2017 and beyond after aiming to bring inflation to below 6% by January 2016<sup>1</sup>

### Inflation on track to achieving RBI target



Source: Bloomberg, March 2015

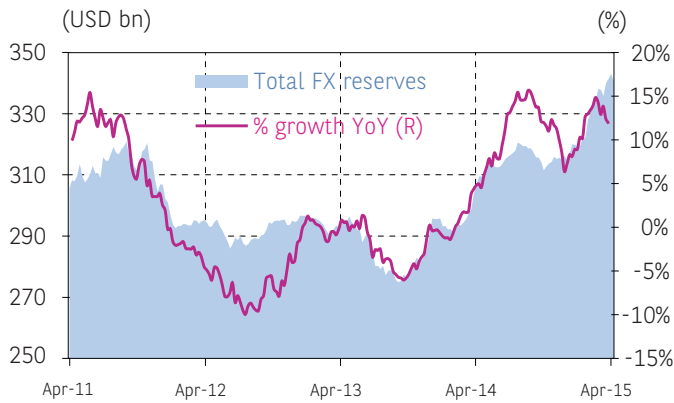
Inflation targeting, more commonly seen in developed economies, should result in a stable inflation rate while optimising the trajectory of long-term GDP growth. With inflation decelerating in the last few quarters, the time appears to be right for a country to start pursuing inflation targeting. For this to be successful, a coordinated effort by the government and RBI is required: the RBI has to deliver on its broad and comfortable target of 4% (+/-2%) and operate consistently and transparently in terms of communication with the market about its approach, while the central government should deliver on fiscal consolidation.

### India looking well prepared for a Fed rate hike

India is on a much better standing now compared to mid-2013 when market talk of the US Federal Reserve tapering its quantitative easing programme caused a sharp market correction. Many emerging market currencies plunged versus the US dollar, but since the rout, the Indian rupee has been one of the most stable currencies thanks to RBI measures to shore up the country's foreign exchange reserves, curb gold imports and holding on to higher interest rates despite falling inflation.

1. Source : Bloomberg, April 2015

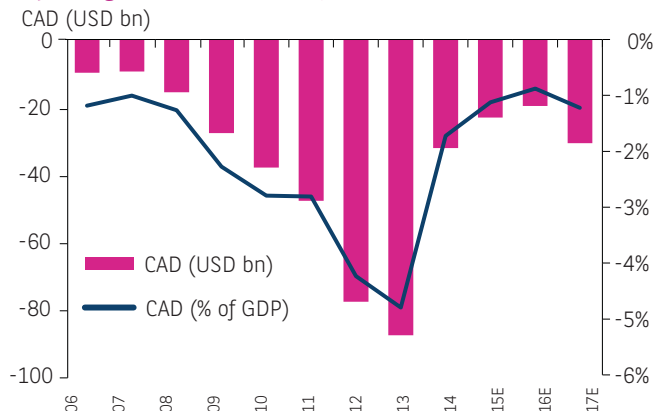
**All-time high forex reserves**



Source: RBI, RCML Research, April 2015

Softer commodity prices, especially oil, have helped to lower the budget and trade deficits. All this has resulted in near all-time high forex reserves and a fall in current account deficit to manageable levels of less than 2% of GDP.

**Improving current account deficit**



Source: CEIC, Macquarie Research, April 2015

**On the path to recovery**

While fiscal deficit is contracting more slowly as the government focuses on reviving growth, it is at a manageable level, in our view. The economy is on the path of recovery which should boost corporate earnings growth. Lastly, the new government's credibility has played a major role in keeping investor sentiment positive and supporting the equity market and will likely continue to do so as the government more than ever remains committed to reforms. ■

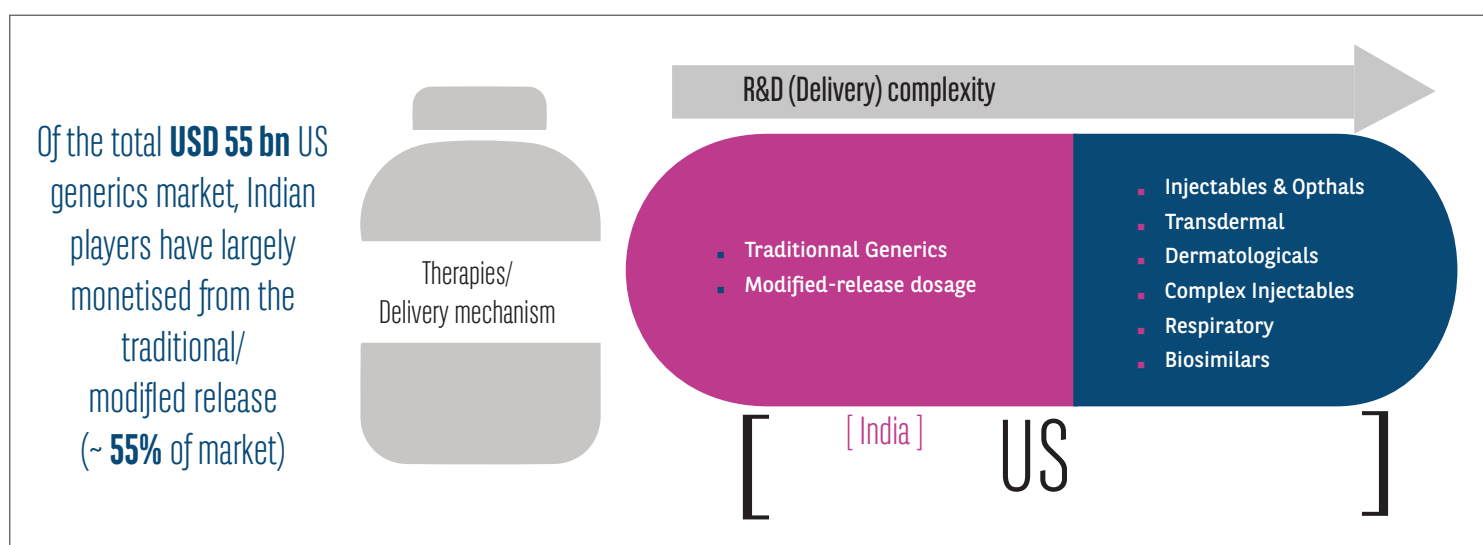
Compared to mid-2013, do you think India is better prepared for a US rate hike now? Share your thoughts with us.



## INDIAN PHARMA COMPANIES EYE BIGGER SHARE OF US COMPLEX GENERICS MARKET

US generics have been at the forefront of growth for Indian pharmaceutical companies, and in our view, will remain a prominent earnings driver for these companies. With the US being the world's largest generics market (USD 55 billion in 2014, according to IMS Health), Indian companies have increased their market share in volume terms in US generics from 16% in 2008 to currently 21% plus (total prescriptions - TRx).<sup>1</sup>

In this market, the share of complex generics has increased from 33% in 2008 to 50% now<sup>1</sup>. Moreover, competitive intensity in these products is fairly low (4-7 in each product), implying higher pricing and market share potential.



Source: Axis Capital, March 2015

Barring the entry of few selected products into the complex generics segment such as complex injectables – Doxil (Sun Pharmaceuticals), Vidaza (Dr. Reddy), derma (Sun Pharmaceuticals along with Taro) – most of the revenue for Indian players comes from traditional release products which cover only half of the US generics market.

Complex generics segments are attractive because of the currently low competitive intensity, which implies better pricing as well as ability to garner market share. This is evidenced by the fact that in most complex generics segments, the generics market share is concentrated among the top five players. At present, domestic drugmakers get less than 15% of their US revenue from sales of complex generics in the US.<sup>1</sup>

### WHAT IS COMPLEX ABOUT COMPLEX GENERICS?

Complex generics include these product segments:

- Technically difficult formulation technology, such as liposomes, nanoparticles, microspheres, etc.
- Difficult to synthesise/scale-up APIs, namely, peptides, low molecular weight heparins, chiral chemistry, etc.
- A differentiated route of delivery, such as ophthalmic, locally acting drugs, injectables.
- Complex drug device combinations such as inhalers (DPI, MDI), nasal sprays and transdermals.

**We believe complex generics have significant entry barriers due to:**

**Long product development timeline**

For instance, we believe it took Sun Pharmaceuticals more than seven years to develop liposomal doxorubicin (Doxil).

**Dedicated capacity requirement, needing upfront capex:**

Lupin has built a dedicated facility for ophthalmic and oral contraceptives in Indore. Similarly, Dr. Reddy has invested in a large injectables facility in Vizag.

**High costs of clinical development, sometimes requiring clinical trials as well**

This adds an extra cost for developing the product (up to USD 5 million vs. less than USD 1 million for a simple product).<sup>1</sup>

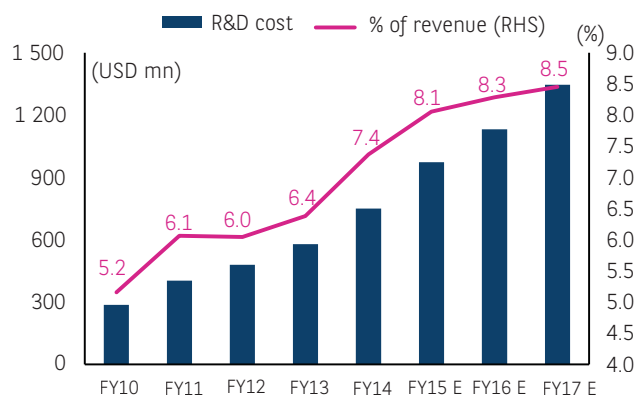
**Strong distribution reach/relationship**

Some complex generics require branding (such as oral contraceptives) or need to be distributed through an institutional channel (government tender, hospitals, etc.).

**Increase in R&D expenditure reflects the focus on complex generics**

R&D investment by Indian healthcare companies has accelerated significantly in the last five years. This can be largely attributed to the shift in focus of US filings towards the complex generics portfolio. For example, there was 32% growth in R&D expenditure for the sector over the last four years compared to only 21% growth in top-line revenues in the same period.

**Significant increase in R&D spend over last 5-7 years**



Source: Axis Capital, March 2015

We expect R&D expenditure for Indian companies to further increase as:

- They continue to focus on high-cost and complex generics opportunities
- USFDA (US Food and Drug Administration) has increased its batch requirement (to three per strength compared to one) as well as accelerated its stability data requirement (now six months compared to three months). This would raise the cost of filing Abbreviated New Drug Applications (ANDAs) in the US and the impact would be more significant for smaller companies such as Alembic Pharmaceuticals (ALPM) and Torrent Pharmaceuticals (TRP) that want to scale up US filings.
- Generic Drug User Free Amendments (GDUFA) fees for each (ANDA) and Drug Master File (DMF), as well as for facilities, would further add to US filing costs.

**India has the second highest number of USFDA approved plants**

We believe that the USFDA has always maintained high quality and compliance standards which it has enforced stringently. However, due to resource constraints (less manpower), it was not able to meet the targeted timeline for overseas facility inspections (at par with US-based facilities).

India has the second highest number of USFDA approved plants (after the US). Hence the relevance of Indian facilities is high in the global context. Despite accounting for 22% of USFDA approved facilities, India's share in total Current Good Manufacturing Practices (cGMP)-related inspections by the USFDA is only 6%-7%.<sup>2</sup> By 2017, the USFDA intends to bridge the wide gap through a higher budget as well as additional resources (opening local offices in India, China, etc.). For instance, it has increased its staff to 19 (from 12), opening another office in Hyderabad (in addition to ones in Delhi and Mumbai).

The growing contribution of average US sales from 18% in FY 2009 to 33% in FY 2014<sup>1</sup> has helped many companies to improve profitability by tapping into first-to-file opportunities and foray into limited competition products.

We believe Indian companies now have significant scope to bridge the relatively wide gap between their value share (10%) and volume share (21%) of the US generics market over the next five years. A focus on complex generic products should help Indian pharmaceuticals to close this gap. It should also help companies to raise the revenue per ANDA and improve profitability. ■

**Do you think that US generics will continue to be a driving force of growth for Indian pharmaceutical companies?**

Share your views with us now.

1. Source: Motilal Oswal March 2015, Company Annual Reports  
 2. Source: Fda.gov, February 2015





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