Asia Asset Management EST. 1995
The Journal of Investments & Pensions
September 2019

ROAD WARRIOR

Lessons from traffic jams

In India, there's no substitute for deep knowledge in order to invest successfully

*By Haseeb Malik**

Sitting through India's infamous traffic jams in its bustling cities has provided ample time to think about how to best navigate this market in all ways physical and financial.

India is unique in so many ways, not least economically and financially. It is simultaneously a significant player on the world stage and a somewhat self-contained economic island.

The opportunities are virtually limitless for institutional investors that are well set up, but the challenges we face tend, like the country itself, to be one of a kind. To operate successfully in this intriguing and diverse market calls for a deep-rooted knowledge that takes time to acquire. There are no short cuts.

For us, there are three drivers of the Indian opportunity set, each relating to areas in which the economy has encountered turbulence in recent years: high levels of non-performing loans (NPLs) that burden the banking system; lack of liquidity following serious difficulties for non-banking financial companies (NBFCs); and stress in the real estate market.

Let's take those in turn. First, NPLs are a legacy of the period following the 2008 global financial crisis, when India was experiencing very rapid growth. In that timeframe, the amount of debt in the system grew as a result of fast economic growth and a need for capital expenditure (capex) to build industry and infrastructure.

Problems started when a number of projects encountered delays, such as waiting for approvals and a shortage of raw materials. Delays in these capex-heavy projects ultimately resulted in a longer timeframe to generate income, and loans became non-performing. It has led to a classic example of 'good asset, wrong balance sheet'.

Second, NBFCs are institutions, sometimes referred to as shadow banks, that extend loans, but many do not take in deposits and instead rely on capital market financing. NBFCs have been an important source of lending in the Indian financial system for the last five years but more recently, in a hunt for yield, they tried to fund themselves with cheaper capital in the form of short-term commercial paper.

But commercial paper matures on average in three to six months, while NBFC lending runs anywhere from 24 months to seven years. And when one of the major NBFCs ran into trouble last autumn, this mismatch was exposed and the commercial paper market dried up.

Finally, the real estate sector, after years of high growth, is starting to show signs of stress in a country where local market dynamics are far more nuanced than in other developing nations. A great deal of development happened very quickly, particularly in high-end residential real estate, leaving a general over-supply of projects and a number of developers over-leveraged. The sheer rate of construction in cities like Mumbai and Delhi has radically changed their neighbourhoods, mandating a physical presence to truly understand the rapidly evolving and increasingly complex real estate market.

Set against the backdrop of bank lending hobbled by NPLs and NBFCs also reducing their role as lenders, you can see why borrowers – including those in real estate – need to find alternative sources of credit.

However, these and other difficulties elsewhere in the system should not be the only measure of the opportunities in India. That would be a very short-sighted approach, particularly given that the government is proactively trying to solve the problems the credit system is facing.

Take NPLs, for example. Under different circumstances, they could have posed a systemic risk to the banking system. While substantial difficulties remain, various policy tools, including the new nationwide bankruptcy code, are a step in the right direction to address this problem, and balance sheets are gradually being cleaned up.

In short, we anticipate continuing opportunities to present themselves and, as these become better known, for more investors to focus on India. However, we believe it is important to remember that being successful in the Indian market involves grappling with complexities on the ground, staying extremely disciplined in one's approach, and spending a lot of time getting to know the counter-parties and players involved.

We have hired with that in mind, assembling Singapore and Mumbai-based teams with experience structuring deals in the region, local knowledge and language skills required to avoid certain pitfalls, and a global perspective to compare risk across geographies.

A last observation would be that much of our approach can be traced back to having, in the early years, sat in a lot of traffic jams. Our presence on the ground has positioned us to better understand and capture some of the best opportunities in the market while maintaining our global standards of doing business. We also came to know the times in which traffic was flowing in the wrong direction and therefore when we ought to stay put.

Not a bad model for doing business in this remarkable country. ■

** Haseeb Malik is partner and head of Asia corporate and traded credit at Värde Partners, based in Singapore.*