INDIA@100: BRIDGING THE CAPITAL GAP

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Key Findings

- By 2047, India will have 1.1 billion people in the working age group (15-64), which would be equivalent to 1.6 times the entire population of Europe. This will create an enormous amount of pressure on the labor market

- India needs to create 231 million jobs over the next 25 years to support its growing population, redress historical inequalities in its women labor force participation, and transition a part of the workforce from the agriculture to the non-agriculture sector

- India's real GDP needs to grow at an average rate of 10.8% annually until 2030, 6.5% between 2031 and 2040, and 4.2% between 2041 and 2047 to support the creation of 231 million jobs

- These growth rates will likely catapult India into a US$10 trillion economy by 2032 and a US$31 trillion economy by 2047. Subsequently, India's per capita GDP will increase to around US$ 18,600 by 2047, almost eight times the 2022 level

- To fuel this growth in real GDP, India's GFCF should be approximately 33% of its GDP. This translates to a cumulative capital requirement of around US$120 trillion over the next 25 years

- Domestic savings will fall short of investment requirements, hence foreign investments will have to play a critical role in bridging this investment gap. India will need a cumulative net capital inflow of US$11-18 trillion to fund its GFCF

- The 4.3% returns on foreign investment provided by India is pale in comparison to the 5.3% returns offered by Rapid Reformers, including Slovakia, Poland, Hungary, Estonia, and the Czech Republic, and the 5.5% returns provided by China

- One of the reasons for lower returns in India is the high level of valuations. The preponderance of businesses in the micro-category creates pricing pressures as too much private money chases too few investable opportunities, driving up valuations

- India needs to scale up 11.6 million micro entities into small ones, 1.2 million small entities into midsized ones, and 0.6 million midsized entities into large ones. That entails a US$11.5 trillion investment in fixed assets, of which at least US$ 4 trillion has to be external financing

- There is a huge whitespace left by traditional financial institutions in the MSME space, and private debt can bridge this funding gap

Introduction

India is estimated to become the most populous country in 2023, and its population is projected to increase by around 240 million in the next 25 years. The implications of this growth in population on the economy are multifaceted.

On one side, as the population grows, there will be increased demand for goods and services. Over the last decade, the size of India's consumer market nearly doubled to US$2.1 trillion, and it has progressed from the tenth-largest market to the fourth-largest consumer market in the world today.
By 2047, India's consumer market has the potential to be nine times its current size, at US$18.5 trillion, placing it behind the U.S. and China. A larger population will also lead to the emergence of new market segments as diverse groups of consumers with different needs and preferences come into focus.

Conversely, population growth creates an enormous pressure on the labour market. By 2047, India will have 1.1 billion people in the working age population between the ages of 15-64 years, which equates to 1.6 times the entire population of Europe. Despite steady economic growth, India will not be able to provide employment opportunities to all the young people entering its workforce. High levels of unemployment or even underemployment can have several social consequences. First, is an increase in poverty and income inequality, as those who are unemployed or underemployed may not have enough income to meet their basic needs. Next, this paradigm might lead to a decline in social mobility and an increase in intergenerational poverty, as people may not have the opportunity to improve their economic status through work. India already fares poorly versus its peers on social mobility metrics. For instance, data from the World Bank shows that for the 1980s cohort, only 8.7% of those born in the bottom half have reached the top quartile in education in India compared to an average of 14.8% in Rapid Reformers countries including Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia, and an average of 11.5% in China, Vietnam, and Indonesia. There are other potential consequences including a decrease in civic engagement and social cohesion which would further increase the risks of civil unrest and political uncertainties.

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The Jobs Imperative

India needs to generate 231 million jobs over the next 25 years to:

Support its growing population:

Latest available data from the International Labour Organization (ILO) shows that Labour Force Participation Rate (LFPR) stands at 52% in India compared to 73% in the U.S., 76% in China, and 78% in the UK. Even if India were to increase its LFPR by one percentage point every year until it reaches a LFPR of 70%, around 95 million non-agricultural jobs will have to be created over the next 25 years considering the rate at which the total population is estimated to increase.

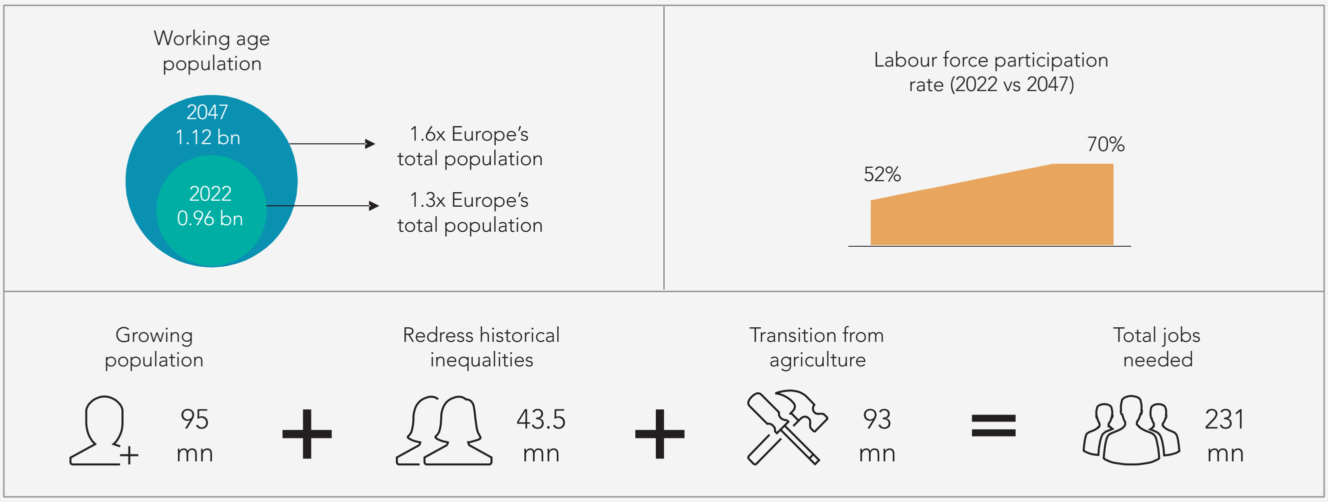
Redress historical inequalities:

While the male LFPR for India is on par with these countries, the female LFPR stands at 22% in India compared to an average of 70% in these three countries. Female LFPR declined from an average of 32% before the Global Financial Crisis to an average of 24% after the Global Financial Crisis. India must redress at least a portion of these historical inequities by creating at least 43 million jobs for its female population over the next 10 years.

Transition from the agriculture sector:

India also needs to reduce its share of population that is dependent on agriculture. Around 150 million people in India are self-employed in the agriculture sector. Data from the ILO shows that between 1991 and 2019, the share of employment concentrated in the agriculture sector reduced from around 63% to 43% in India. By comparison, the share reduced from around 60% to 25% in China. Developed countries typically have a share of less than 2%. If India were to reduce its share of agricultural employment to 15%, around 93 million new jobs will have to be created over the next 25 years just to transition a portion of the labour force from agriculture to industry and services.

The Jobs Imperative: India needs to create 231 mn jobs over the next 25 years

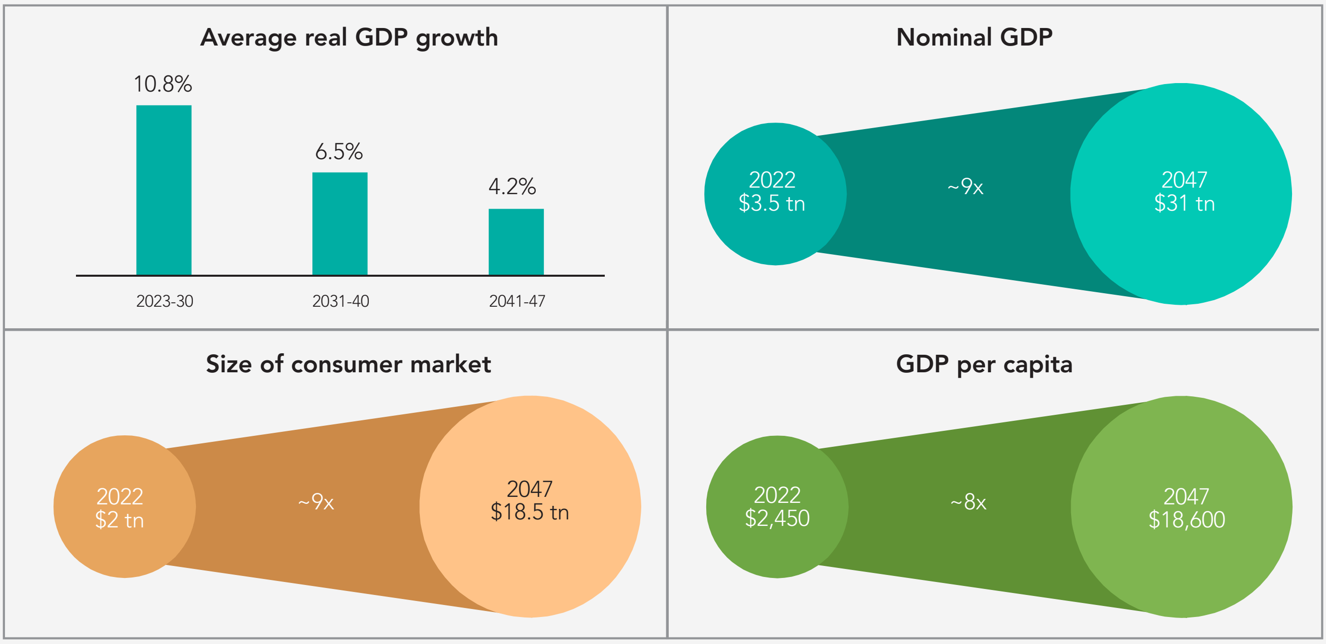


Source: UN, Dun & Bradstreet

The Growth Imperative

Between 1992 and 2019, India created 1.3 million jobs per percentage point of growth in its Gross Domestic Product (GDP). If India can maintain the same level of employment elasticity, then its real GDP needs to grow at an average rate of 10.8% annually until 2030; 6.5% between 2031 and 2040; and 4.2% between 2041 and 2047 to support the creation of 231 million jobs. These growth rates will likely catapult India into a US$10 trillion economy by 2032 and a US$31 trillion economy by 2047. Subsequently, India's per capita GDP will increase to around US$ 18,600 by 2047, almost eight times the 2022 level.

The Growth Imperative: India needs an average real GDP growth of 7.3%, annually, between 2023 and 2047



Source: UN, Dun & Bradstreet

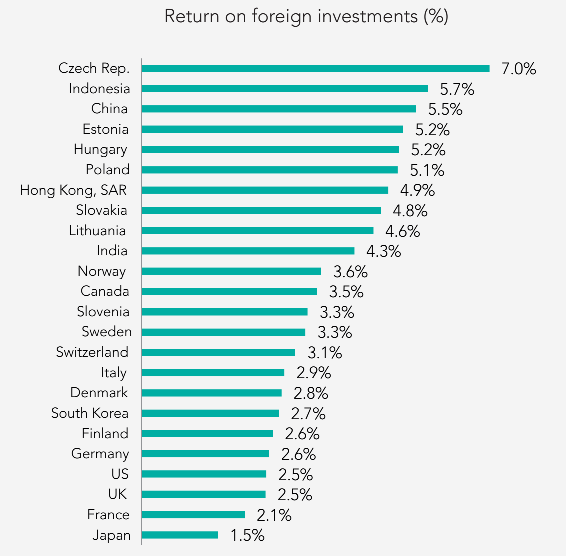
The Capital Imperative

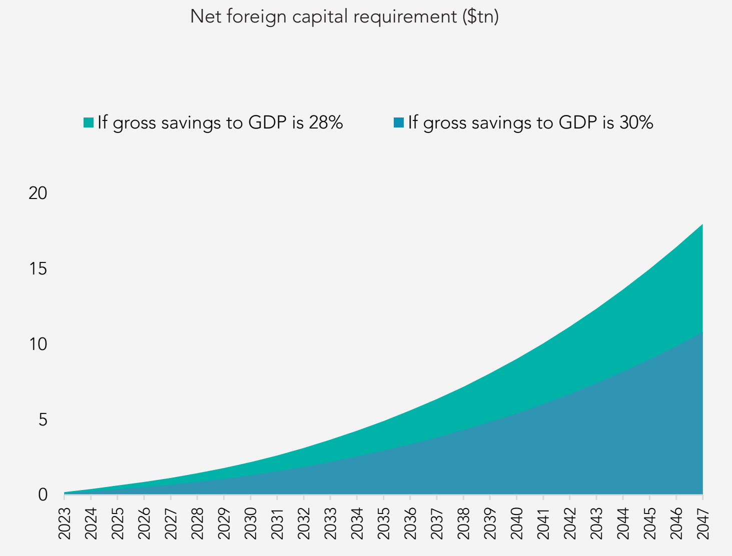
The manufacturing and construction sector will play a key role in absorbing the surplus labor from the agriculture sector. Unlike the services sector, manufacturing and construction sectors require relatively high levels of Gross Fixed Capital Formation (GFCF). In addition, the government aims to increase the share of value added by manufacturing to 25% from the current 14%. Hence to bridge this 11 percentage points gap and to absorb the surplus labor from agriculture, India's GFCF should be approximately 33% of GDP. This translates to a cumulative capital requirement of around US$120 trillion over the next 25 years. Domestic savings constitute a significant portion of the investments in an economy. The average savings-to-investment ratio post the 2008 Global Financial Crisis has been at 1.02 in India, indicating a high level of domestic savings that is available for investment. However, this has been a result of a faster pace of decline in the investment rate than the decline in savings rate. Between 2009 and 2021, investment rate declined by

5.4 percentage points while savings rate declined by 3.3 percentage points. Given India's need to expand its investment rate to approximately 33% from its present rate of 28%, domestic savings will fall short of investment requirements.

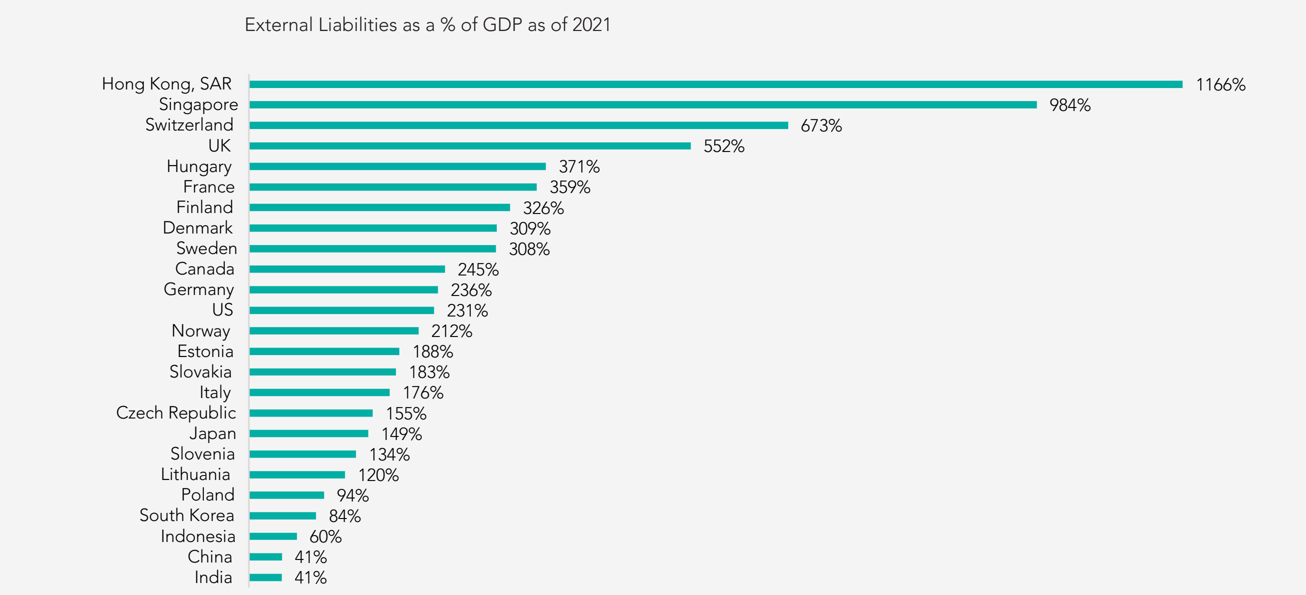
Foreign capital will have to play a critical role in helping to bridge this investment gap. Assuming that net capital inflows to India continues to remain at its decadal average of 3% of the GDP, a cumulative net capital inflow of US$11 trillion will be channeled to India over the next 25 years. This implies that the domestic savings will then have to remain at 30% until 2047. However, with a rise in GDP per capita and subsequent increase in social mobility, the savings rate may decline in the coming years as consumer spending goes up. In a scenario where savings rate declines to 28% of GDP, then India will need a cumulative net capital inflow of US$18 trillion to fund its GFCF. This is a huge requirement given that India's gross foreign capital as of 2021 stood at US$1.3 trillion.

India requires a cumulative net foreign capital of at least US$11-18 trillion to fund its GFCF





Foreign capital plays a critical role in bridging the investment gap



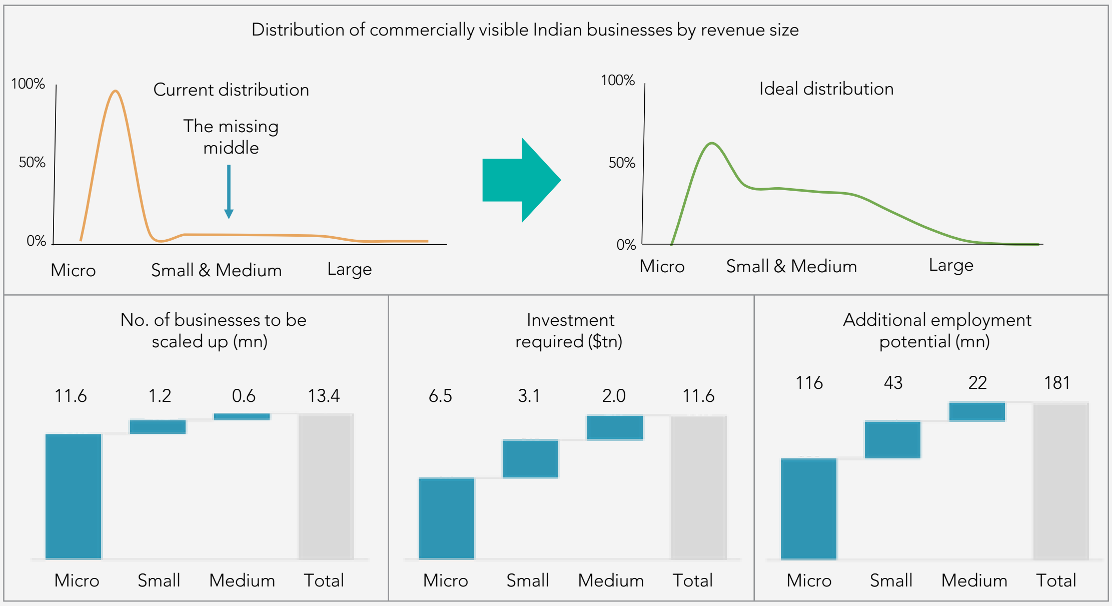
Source: IMF, Dun & Bradstreet

The role of foreign capital in India's economic development has been relatively less compared to other countries. External liabilities as a percentage of GDP as of 2021 stood at 41% in India compared to an average of 178% in rapid reformers. India needs to augment foreign capital inflows by creating more pockets of opportunities that generate higher returns. Dun & Bradstreet's analysis shows that all foreign investments in India between 2000 and 2021 yielded an average return of 4.3%. By comparison, the average returns provided by the G7 countries, including the US, UK, Japan, Germany, France, Italy, and Canada, was 2.5% during the same period. Higher returns are underpinned by a strong GDP growth of 6% in India compared to 1.3% in the G7 countries. However, India's returns pale in comparison to the 5.3% returns offered by Rapid Reformers, including Slovakia, Poland, Hungary, Estonia, and Czech Republic and the 5.5% returns provided by China.

One of the reasons for relatively lower returns in India is the high level of valuations. Investors are fishing in a small pond as India faces an acute challenge of the missing middle in its business distribution. Dun & Bradstreet research suggests that there are over 105 million entities in India. However, a majority of these are street vendors and non-permanent entities which do not employ any labor. Excluding such survivalist entities, there are around 33.2 million commercially visible entities. Of these, 95.5% are micro, 4.1% are small, 0.3% are mid-sized, and only 0.1% are large. By contrast, developed markets have 55% micro entities, 39% small, 4% medium, and 2% of large entities. The preponderance of businesses in the micro category creates pricing pressures as too much private money chases too few investable opportunities, driving up valuations.

It is imperative for India to scale up its MSME segment to create more jobs, reduce income inequality, and improve competitive pressures. India needs to scale up 11.6 million micro entities into small sized ones, 1.2 million small entities into medium sized ones, and 0.6 million mid-sized entities into large ones. That entails a US$11.5 trillion investment in fixed assets. We have observed that, typically, 65% of the expenditure on new fixed capital investments is funded by retained earnings. Hence, Indian MSMEs need external financing worth at least US$4 trillion to scale up these 13.4 mn businesses.

The Capital Imperative: India requires $11.6 tn investment to scale up 13.4 mn businesses



Source: Ministry of Corporate Affairs, MOSPI, World Bank, Dun & Bradstreet

Globally, private debt has emerged as one of the fastest growing alternate asset classes. On one hand, the demand for private debt is growing because of the apparent advantages such as speed and certainty of loan execution. On the other hand, there is a huge whitespace left by traditional financial institutions in the MSME space. Banks and other formal lending institutions operate within an ecosystem of credit guarantee, adherence to the various guidelines, regulatory compliance, monitoring end use of funds, financial information dissemination and reporting financial data and frauds. However, various studies reveal that the banking sector faces several limitations in sanctioning loans to the MSMEs. Very often, banks have raised concerns over compliance towards documentation, regulatory adherence and financial discipline followed by MSMEs. However, the issue of finance by MSMEs can be solved profitably. Dun & Bradstreet research finds that the minority of Indian micro enterprises that do have access to external finance report 19% Return on Capital Employed compared to only 2% for micro enterprises that do not have access.

This is a huge opportunity for lenders: the higher profitability can be shared with lenders to serve debt which in turn can be at higher interest rates. The median interest incidence incurred by a sample of over 8,000 firms in the last five years stands at 9%, an attractive rate of return even if one adjusts for currency risks. India is one of the few markets with the ability to provide much greater returns while absorbing capital inflows comparable to those of developed countries. This is a difficult chance for private debt funds to pass up. However, given the level of information asymmetry, especially, in a developing market like India, investors can reap the benefits of the opportunities only by leveraging the expertise of local partners who can provide a more nuanced understanding of the local market, identify pockets of opportunity, and conduct the necessary due diligence to safeguard the capital.

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