In early June, Indian Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) unexpectedly failed to secure a majority of seats in the country's election. As a result, the BJP will be more dependent on members of the incumbent National Democratic Alliance (NDA) to govern as a coalition over the next five years. Although growth in India has been robust, there has been clear outperformance of capital over labour, profits over wages, investments over consumption, and urban areas over rural. This surprising result has led many investors to wonder what is next for India, particularly whether there will be policy continuity, whether the government will shift to welfare measures, and what this means for its high-flying equity market. In this investment note, Rana Gupta, Senior Portfolio Manager, and Koushik Pal, Senior Director, Indian Equities, analyse the implications of the recent pivotal election and lay out a roadmap for how it may affect India's economic development and investment opportunities through the '5Ds' framework.

After elections: What's next for India?

In the recent Indian national election, the BJP-led NDA alliance was re-elected with a majority for a third consecutive term (NDA 3.0), with Narendra Modi as Prime Minister.

A key surprise in the election was the loss of the BJP's simple majority. The BJP, which leads the NDA alliance, won 240 seats, a loss of 63 from its 2019 tally, and was well short of the Indian Parliament's simple majority of 272 seats. The results surprised the market: exit polls released on 1 June predicted an average of 360 seats for the NDA alliance, with all exit polls pointing to the BJP achieving a comfortable majority on its own.

In the last two elections of 2014 (NDA 1.0) and 2019 (NDA 2.0), the BJP crossed the simple majority mark on its own and coalition partners had far less bargaining power.

While this is the first time Prime Minister Modi will need to actively work with his coalition partners, India has had a long history of coalition governments. Since 1989, regional parties have risen in prominence given India's culturally and linguistically diverse landscape, and coalition governments have been the norm. That trend paused in 2014 and 2019 as the BJP won majorities on its own.

However, in 2024, the coalition government has made a comeback. In such a governing structure, smaller parties often have political leverage, requiring a consultative approach to policymaking.

After a brief correction following the results, Indian markets re-captured the highs made after the exit polls. The NDA 3.0 government was sworn in on 8 June, soon after the election results. Although the number of ministers is higher than before (72 compared to 58 in 2019) to accommodate alliance partners, markets expected policy continuity with key ministers in areas like home affairs, finance, external affairs, defence, roads, and rail remaining unchanged. Our views on the implications of the elections for markets are slightly more nuanced and addressed next.

Implications of the general election

We note that the BJP's weaker-than-expected performance was in key states that are poorer, rural, more agricultural, and often have a labour force that lacks skills to help them become gainfully employed. The 2024 election occurred in the context of NDA 2.0, which was the pursuit of fiscal consolidation and growth through public infrastructure spending and incentives to encourage corporate capital expenditure. This resulted in investment-led growth and fixed capital formation.

However, consumption has underperformed since the pandemic amid a lack of government support. It did not materially improve (particularly at the lower end) from 2021 to 2024. In our view, this K-shaped recovery since 2021 might have impacted the electoral outcomes in certain states.

We believe NDA 3.0 will continue with policy objectives such as maintaining fiscal discipline, moderating inflation, and promoting private capital expenditure. A greater spending focus could return to areas like healthcare, affordable housing and workforce skilling, increasing long-term employability. We believe this will be the key to boosting consumption. To be clear: We do not expect NDA 3.0 to embrace populism but, instead, increase investment in labour force to complement its policies on capital stock creation during NDA 2.0.

While the government's economic policy direction becomes more apparent after the Union Budget is presented in the next month, we will attempt to provide more details on: 1) The economic backdrop and; 2) Potential steps to watch going forward. Lastly, we provide an update on incremental changes to our 5D themes.

The economic backdrop

To understand the overall economic policy setup of the two successive BJP majority NDA governments, we have put their agendas into two separate buckets:

1) **Policy priorities** that have driven overall economic policymaking.
2) **Fiscal priorities** that have driven how the government manages revenue and expenditure.

Policy priorities – Formalisation, Digitisation, and Manufacturing Revival

- During NDA 1.0 (2014-2019), the most defining policy features were promoting the digital economy and indirect tax reforms (introducing a nationwide goods and services tax), which formalised the economy. These results can be seen during Fiscal Year (FY) 2020 to FY2025 (estimated), when the tax-to-GDP ratio rose from 10.0% to 11.7%.

- During NDA 2.0 (2019 – 2024), the most defining policy features were a sharp reduction in the fiscal deficit, at the same time, an increase in public infrastructure investment, and incentivising companies to create capital investments that would increase manufacturing's share of GDP.

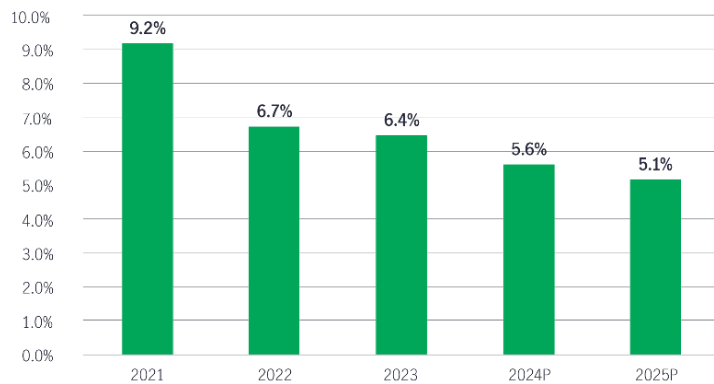
- As a result of these policies, India became a more tax-compliant, and a more formal/digital economy with better public infrastructure. Moreover, due to the 'China + 1' policies adopted by multinational corporations, Indian companies started to put up capital stock to capture import substitution, increase domestic value add, and seize export opportunities.

- In our view, this policy tilt led to the significant outperformance of investments over consumption, which created a K-shaped recovery. It was further exacerbated by the setback in consumption faced since the pandemic and the relative attractiveness of capital vis-à-vis labour. However, on the positive side, most of the heavy lifting for private capital expenditure to emerge in priority areas like domestic manufacturing, renewable energy, electric vehicles, semiconductors, electronics has already been done.

Fiscal priorities – Sharp deficit reduction and favouring capex over revenue expenditure

- During NDA 2.0 (2019-2024), particularly in last four years, the government sharply reduced the fiscal deficit from roughly 9% of GDP in FY21 to 5.6% in FY24. This is projected to decrease further to 5.1% in FY25 and 4.5% in FY26, effectively halving the deficit (as a % of GDP) in six years (see Chart 1).

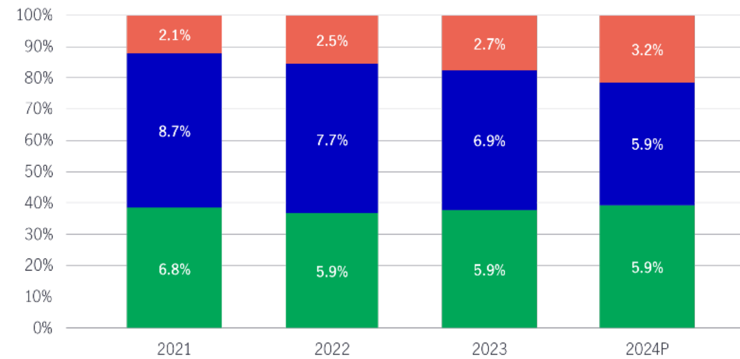
Chart 1: India's gross fiscal deficit, 2021-2025(P)[1]



- With better tax compliance and tax revenues post-formalisation, expenditure management was heavily tilted towards capital expenditure, reflected in the three-year CAGR (March 2021-24) of around 31% in capital expenditure, as opposed to approximately 4.3% CAGR in revenue expenditure.

- This has resulted in the capital expenditure- to-GDP ratio rising from 2.1% in FY21 to 3.2% by FY24 and is projected to further rise to 3.4% by FY25. In contrast, revenue expenditure declined from 15.5% of GDP from FY21 to 11.9% by FY24. Even within revenue expenditure, the discretionary portion (excluding interest and salaries), which promotes long-term investment in availability, labour employability fell from 8.7% of GDP in FY21 to 5.9% by FY24.

Chart 2: Government expenditure: Rising capex at the expense of lower discretionary revenue expenditure, 2021-2024(P)[2]



Result: GDP growth driven by investments, with low inflation and healthy external balances

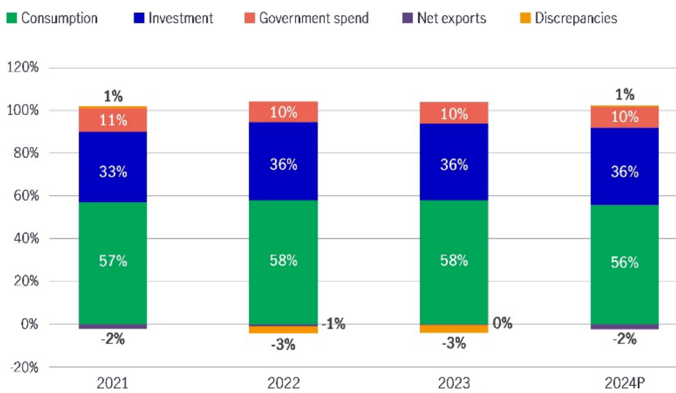
- The results of the above policy framework are visible with investment-driven real GDP growth as the economy recovered from post-COVID. India is the fastest-growing major economy during this period, with a CAGR growth rate of 8.3% (March 2021-24), with a healthy current account situation, balance of payment surplus and low inflation.

- GDP growth has been driven by investments that have risen at a CAGR of 11.8% since March 2021, and the share of investments to GDP has increased by around 300 basis points to 36% from 33%. Meanwhile, consumption growth underperformed real GDP growth, rising at a CAGR of 7.4% since March 2021. Thus, its share fell from 57% to 56% of GDP during the same period (see Chart 3).

[1] Source: Ministry of Finance.

[2] Source: Ministry of Finance, Kotak estimates.

Chart 3: Factor share in real GDP, 2021-2024 (P)[3]



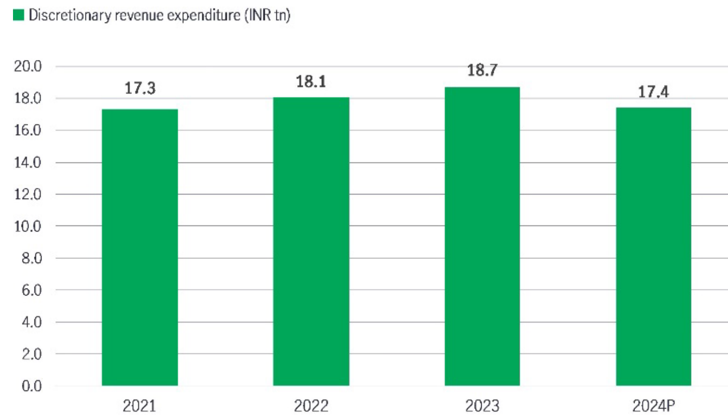
Potential steps to watch going forward

Looking ahead, we need to underline the distinction between the new government's two pillars of economic management, i.e., policy and expenditure priorities.

The government's core economic agenda of growing manufacturing and driving growth through investments will remain *unchanged*. These objectives align with the government's long-term vision of growing domestic manufacturing, thus reducing net exports and increasing energy independence through a green transition. We also believe the foundation for private capital investment in the aforementioned areas has already been laid.

However, the government may reprioritise how it manages discretionary revenue expenditure, which has remained essentially flat over the last three years in absolute terms (see Chart 4).

Chart 4: Discretionary revenue expenditure has stagnated, 2021-2024(P)[4]



We may see the government allocate more resources towards the long-term development of labour in rural areas by providing more resources to healthcare, skills development and housing during upcoming budget in July. We believe it can do this *without* deviating from its fiscal consolidation targets, as the government now has significant resources including, but not limited to, strong tax collection and significantly higher-than-expected dividend income from Reserve Bank of India.

In our view, NDA 3.0 realises that the response to lower-than-expected electoral outcomes need not be populism, which could erode the macro policy and fiscal framework built over the past 10 years. At the same time, the consumption question needs to be addressed for sustained and balanced long-term growth.

As discussed above, the solution runs through the labour market. The key to boosting employment is not just capital investment leading to higher growth but also complementing this progress by making labour more available and employable.

While the consensus expects the current focus on capital expenditure over consumption to continue, we think policymakers will address the consumption question by increasing expenditure to increase the availability and employability of the labour market. This will complement its earlier policies of creating fixed-asset investments and promoting sustainable,

[3] Source: Ministry of Finance, Kotak estimates.

[4] Source: Ministry of Finance, Kotak estimates.

well-balanced growth in a populous democracy like India.

In the following section, we will discuss the incremental changes to our previously introduced **5Ds** framework: **D**igitisation, **D**eglobalisation, **D**ecarbonisation, **D**emography and **D**eficit Reduction to reflect our current view on the economic policy priorities of NDA 3.0.

Incremental changes to our 5D themes

We expect that our 5D themes, which identify key investment themes in Indian equities, will remain relevant. The possible changes discussed above will present new opportunities that we aim to capitalise on, as well as some potential risks to watch out for. We discuss these briefly below:

- **D**igitisation – Opportunity set to remain unchanged, potentially gets better**.**
    - We expect the irreversible changes made under digitisation to remain unchanged. The disruptors benefitting from this theme (food platforms, fintech and logistics) will continue consolidating within their target markets. Any change in the government's spending patterns could, if anything, benefit some of these platforms with their deep networks. These platforms will do even better if broader consumption revives.

- **D**eglobalisation – Risks from elevated expectations for an increase in the government's capital expenditure**.**
    - We see limited room for government capital expenditure to grow (as a % of GDP) from current levels. Therefore, engineering companies whose order books directly benefit from government spending may be at risk from expenditure reprioritisation amidst high expectations and valuations.
    - On the other hand, the government's improvements to digital and physical infrastructure, and its formalising incentives relating to the production of electric vehicles, semiconductors, electronic goods, renewable power, engineering goods, have already established a background for private capital expenditure. In these areas, we remain positive on the bottom-up themes discussed above.

- **D**ecarbonisation – Opportunity set remains unchanged.
    - We expect India's energy demand to continue increasing at a healthy pace. Diversifying India's energy mix away from imported fossil fuels will remain one of the strategic priorities for any government in India.
    - We think that that well-capitalised state-owned utilities and other private players will participate in and benefit from the green transition and resulting capital expenditure in power generation and transmission.

- **D**emography – Opportunity set may broaden.
    - If our thesis on government spending aimed at developing labour to complement the capital focus of its earlier versions plays out, this could lead to broad-based consumption growth over the medium term.
    - Currently, consumption growth is skewed by mid-to-higher income consumption due to better income growth in corporate India.

- **D**eficit Reduction – Bullish on savings institutions but careful about possible tax changes.
    - As discussed earlier, we think the government has fiscal room to finance social programmes and investments in labour by re-balancing its expenditure mix. As the deficit narrows and savings improve, institutions that run on savings, such as banking, financial services, insurance, should enjoy structural tailwinds.

- However, we also do not rule out a tail risk of increased taxes on the higher income and/or increased capital gains taxes on equities. While this is not our base case, we believe it will be important to monitor developments.

We remain constructive on India's economic growth, corporate earnings growth, growing domestic equity savings, and Indian equities.

However, we also need to be mindful, and will be carefully watching the following risk factors over the near-term:

- Rise in crude prices above $100 for a sustained period;
- Any unfavourable change in taxation policies;
- Loss of BJP led NDA alliance (ruling at Centre) in upcoming key state elections in Maharashtra, Jharkhand, Haryana which is going to take place in 2024.

Conclusion:

In conclusion, we believe some reprioritization of expenditure to improve the employability and availability of labour during NDA 3.0 will compliment the NDA 2.0 policy of capital stock creation. We don't think the government will resort to blatant populism, which can impact overall stability.

Overall, we think that with 7% real GDP growth, India will remain one of the fastest-growing major emerging markets. This should also support early to mid-teens earnings growth. With its large US $3.9 trillion economy, a market capitalisation of US $4.8 trillion, healthy earning growth, robust corporate balance sheets, and an ROE of more than 15%, the potential for its equity market to create long-term wealth remains healthy. These factors, along with rising domestic savings being deployed in equities, should continue to support India's premium multiple among emerging markets. Within that supportive framework, we expect that themes linked to our updated '5D' framework should continue to perform.

Important Note

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