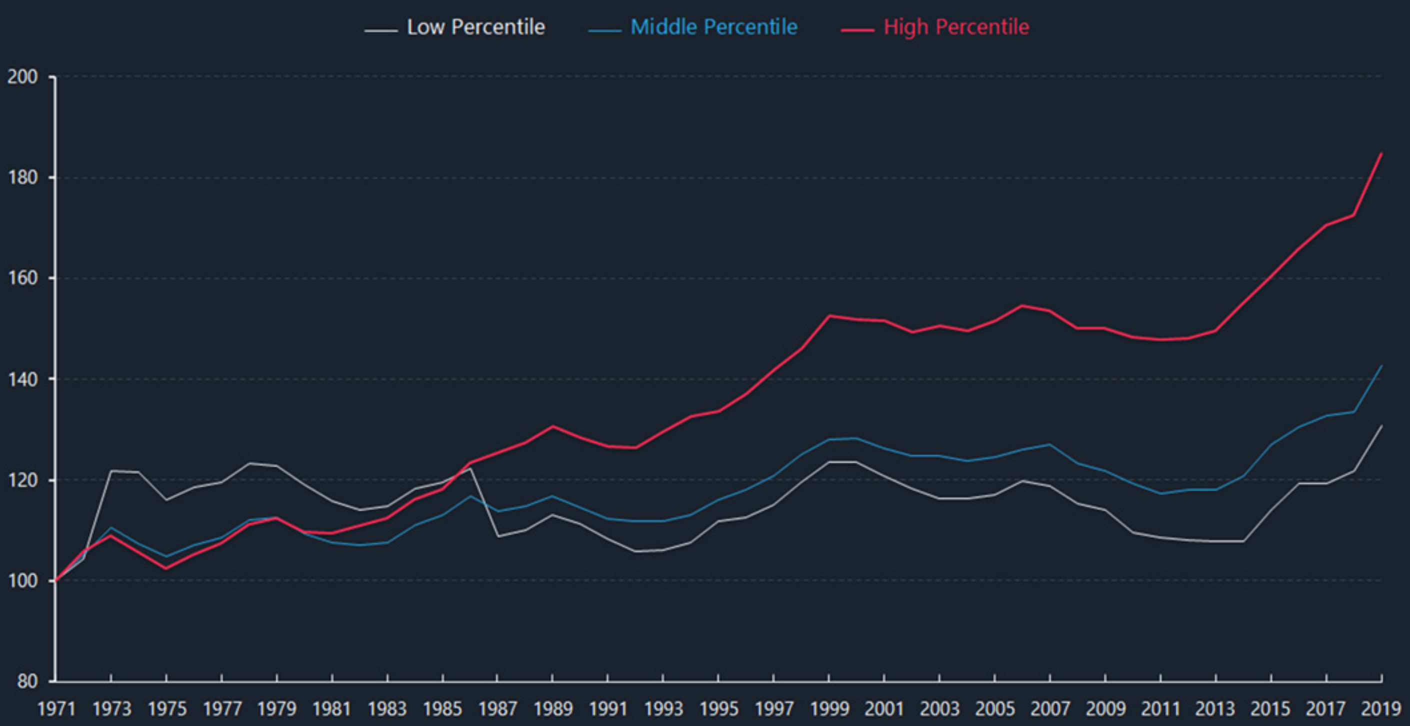
THE REASON FOR EVERYTHING

MONTHLY

NOVEMBER 2020

US Household Income Dispersion Inflation Adjusted: 1968 to 2019 - Rebased to 100



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This month in Global Macro Investor

Reliance Jio, The Digital Revolution
By Scott Malcomson

Scott Malcomson (@smalcomson) is the director of special projects at *Strategic Insight Group* and author of *Splinternet: How Geopolitics and Commerce Are Fragmenting the World Wide Web* (2016).

Raoul's note:

India is a subject I am passionate about and have written extensively on over the years.

Yes, I am half Indian so I'm biased, but I think that the unique demographic backdrop – where they are in both the development cycle and the technology cycle – is a hugely powerful bullish force.

I've talked a lot in the past about the Indian telcos and the Indian digital revolution and now it is all starting to come together. The moves Mukesh Ambani made in taking over the Indian telco and data market were breathtaking and how he paid off the massive debts in a matter of just a few months was the fastest corporate debt payback anywhere in history.

But it's more than that. India is creating a tech giant that owns everything from 5G to online retail. We should anticipate Jio will have such a dominant position in the largest opportunity in the world that they will be worth $1tn+ in no time. Ambani is building India's global super player.

You had better pay attention. To help get us up to speed, I asked Scott to write this article because it is also not only about India but also about global geopolitics, where again, India is uniquely positioned.

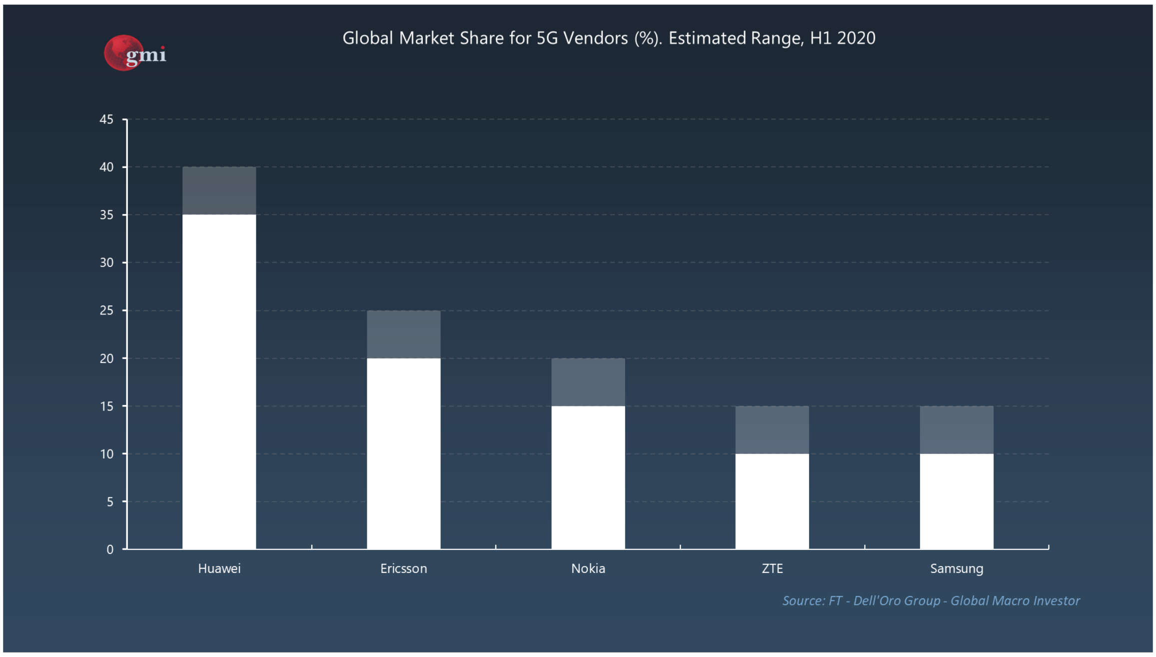
Reliance Jio, The Digital Revolution

The US-China decoupling story is often told as if the rest of the world does not exist but in India, it is seen differently. Under Hindu nationalist Prime Minister Narendra Modi, India is trying to carve out a third way, using market access as a tool to play the US and China off each other to the advantage of Indian companies. For now at least, Modi's main ally is India's richest man, Mukesh Ambani, whose extremely bold USD20b+ bet on Indian telecommunications seems to be paying off.

Telcos have long been an unsexy corner of the tech world. They make money by selling you connections. They are disincentivized to innovate, since all that R&D spending would likely result in their existing product of telecoms infrastructure becoming cheaper. Telcos have tended to be more build-and-hold, squeezing profit out of what they construct, for as long as they can.

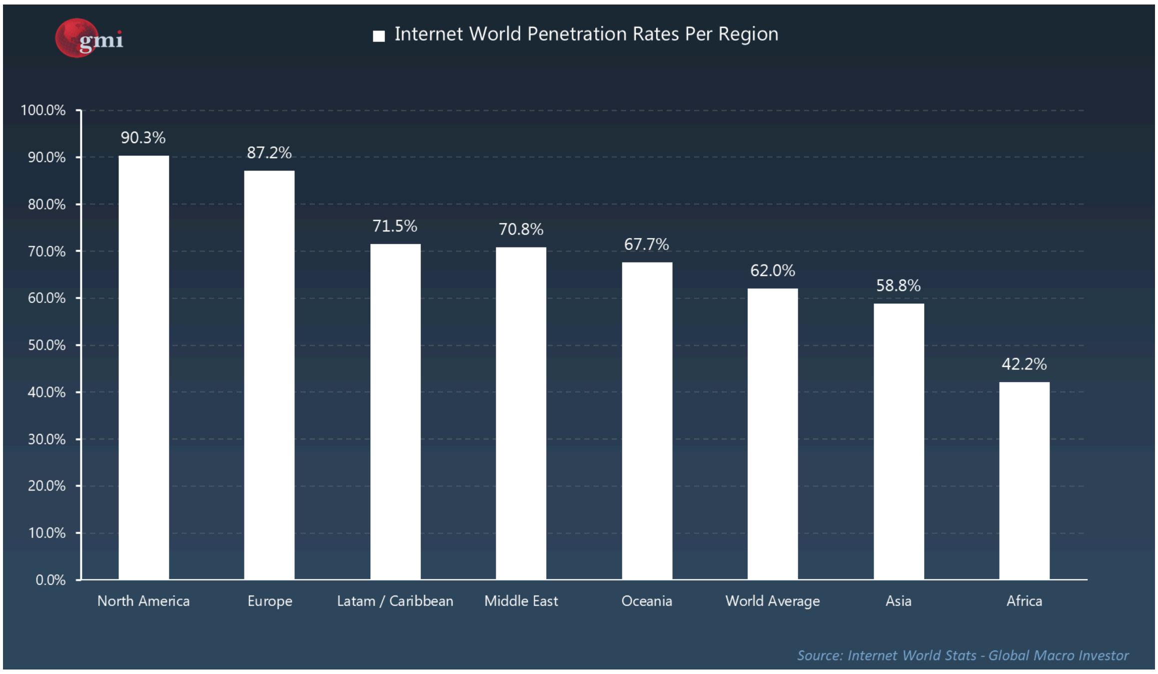
And until Mukesh Ambani and his tech arm, Reliance Jio, came along, India was no different. Silicon Valley has never been very interested in the telco business model and telcos weren't particularly interested in innovation; AT&T spun off Bell Labs, which eventually ended up part of Finnish telco Nokia, Google bought Motorola for patents but sold it off to China's Lenovo.

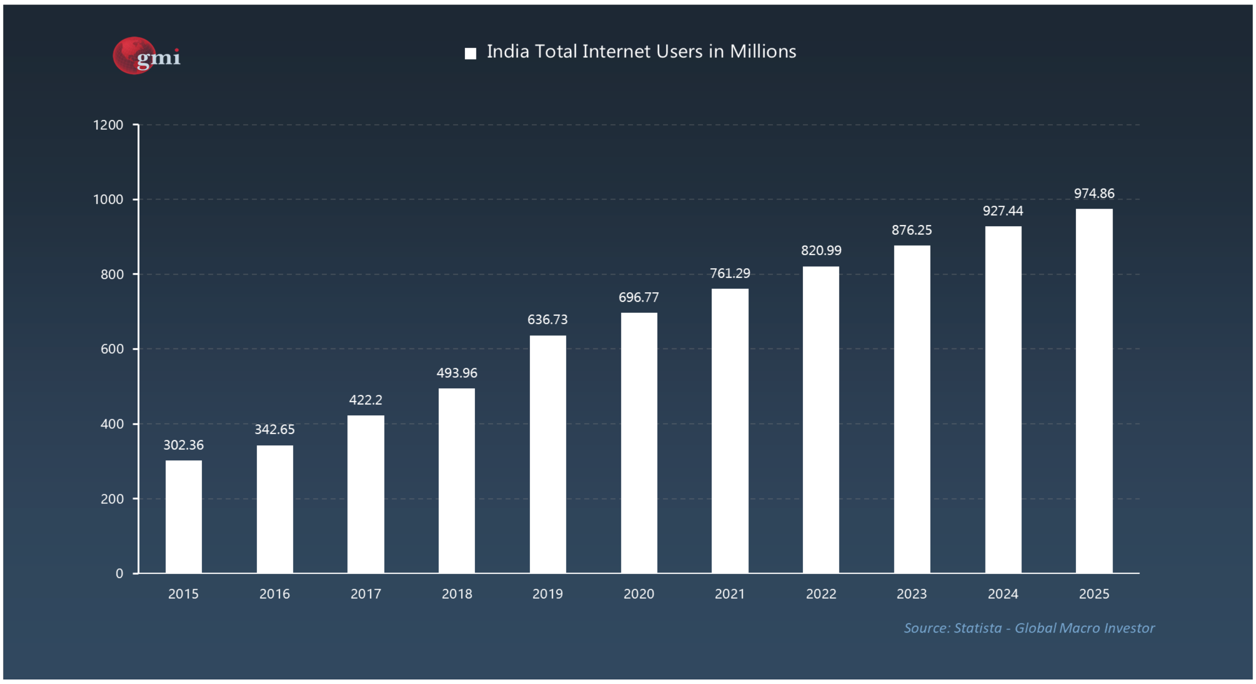
This is part of the reason why the United States does not have a 5G telco provider to compete with the Finns (Nokia), the Swedes (Ericsson), the Chinese (Huawei and ZTE) nor the Koreans (Samsung)…



India did not have a potential 5G player either, until the recent (2016) arrival on the market of Reliance Jio. Until then, the dominant infrastructure providers, working through local companies, were China's Huawei and ZTE. Now that Reliance Jio has shown that there actually can be a new kid on the telco block, Silicon Valley, led by Facebook and Google, is piling in with multi-billion-dollar investments in Jio. With that kind of backing (plus Qualcomm and Intel, and a long relationship with Samsung), Jio is preparing to take on the Chinese giants.

The new cash enabled Reliance Jio to retire the USD20bn in debt that it had built up to take over Indian telecoms. Reliance Jio – with its aggressive buildout, pricing (six free months of 4G Internet), smartphone strategy (smart feature phones) and handset marketing – was key in taking India's Internet use from 342m in March 2016 to 560m in Q1 2020, nearly half of it with Jio. India is now the second largest Internet market in the world – and Internet penetration is still just at 50%. Even if Ambani's Jio falters, he has already executed one of the most daring corporate strategies of this young and daring century...





State secrets

So, what has made the telco space interesting again, and will it last?

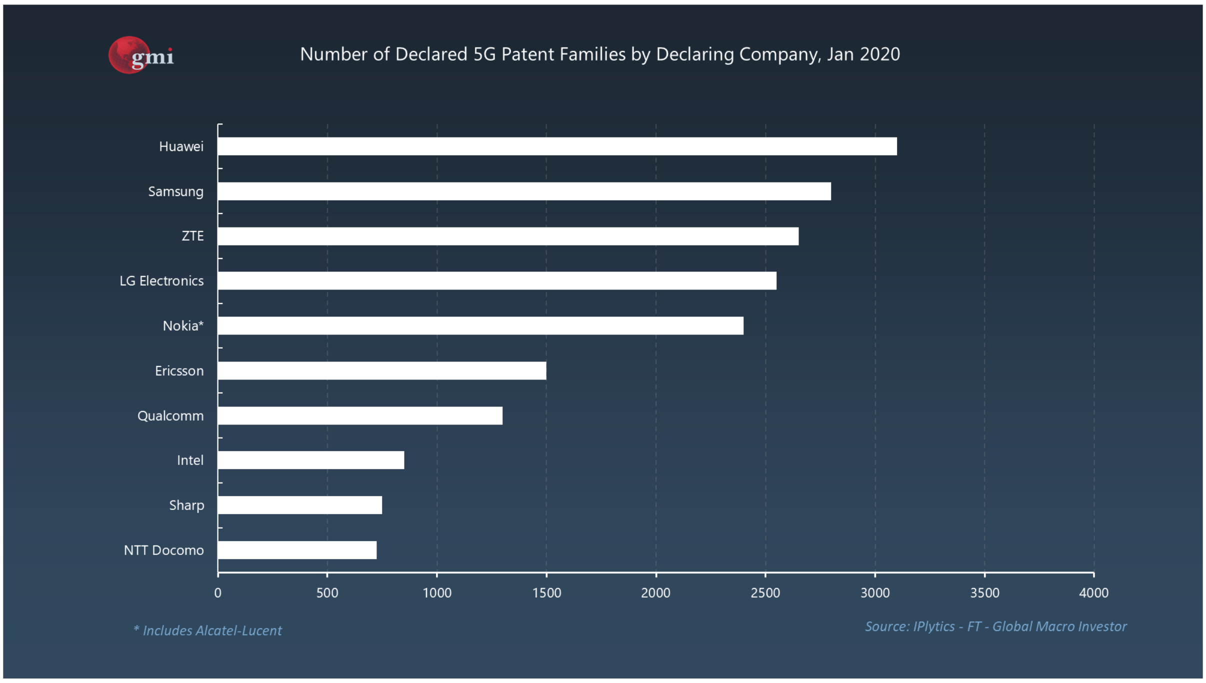
Since the 1990s and the advent of the Internet, the Chinese Government believed that developing leading-edge technology and keeping its own networks safe from intrusion and influence from abroad were twin goals. The Internet was born from state-supported innovation undertaken as part of American competition with the Soviet Union. Whatever the next tech generation might be, China wanted to be developing it as part of its competition with the US.

Its strategy was to bring in foreign partners and their IP (there was a Shanghai Bell), and to subsidize local companies to compete with each other over the protected domestic market until the winners could effectively dominate (or replace) any foreign partners.

When mobile phones took off, the main beneficiaries of this process were Huawei (employee owned) and ZTE (government owned). The three regular mainland telcos are themselves all government owned.

This part was not really unique to China. The global players in soup to nuts 5G networks are Nokia (part owned by the Finnish state) and Ericsson (part owned by the Swedish state), as well as Samsung, a massive, opaque South Korean *chaebol*, which is to say very closely connected to the Korean state. Telcos in general have always existed in a close relationship with states in the netherworld of communications "utilities" – as was once true of *American Telephone & Telegraph*. The Chinese difference was mostly of degree, not of kind.

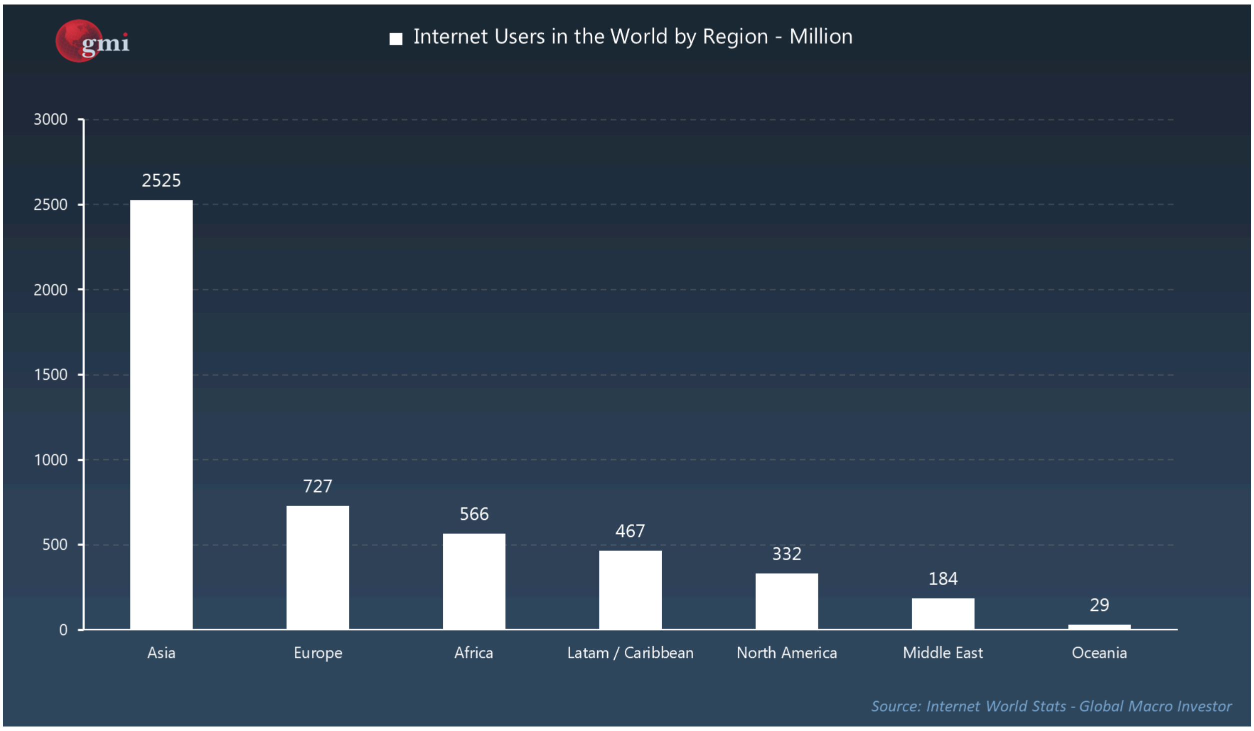
But there were some unique aspects to Huawei and ZTE. They were seen as worryingly beholden to the Chinese Government, not just in the US – which never let either into its networks - but also in India, where the security services always thought they were a threat. They both stressed R&D, patents, and being active on international standard-setting bodies. And they had the full support of the government in bringing mobile-telephone networks to poor countries as well as rich...



Huawei and ZTE, like most of the well-known Chinese tech companies, built their businesses for poor people at home, with very little regulation (such as for privacy) and tight margins, pushing for scale and scrabbling for market share.

When such companies moved on to Southeast Asia, South Asia, Central Asia, Africa and Latin America, they were finely tuned to provide high-end products to low-end consumers. They made keeping costs down part of their corporate culture and of their brand.

And no one else was really interested in doing the same thing at the same price...



So between them, Huawei and ZTE brought the Internet, via the mobile networks they built, to most of what used to be called *The Third World,* even to places like India whose security services did not trust them.

In effect, Chinese State Policy had created a global market for mobile Internet services. Many people could get interested in that.

Raj against the machine

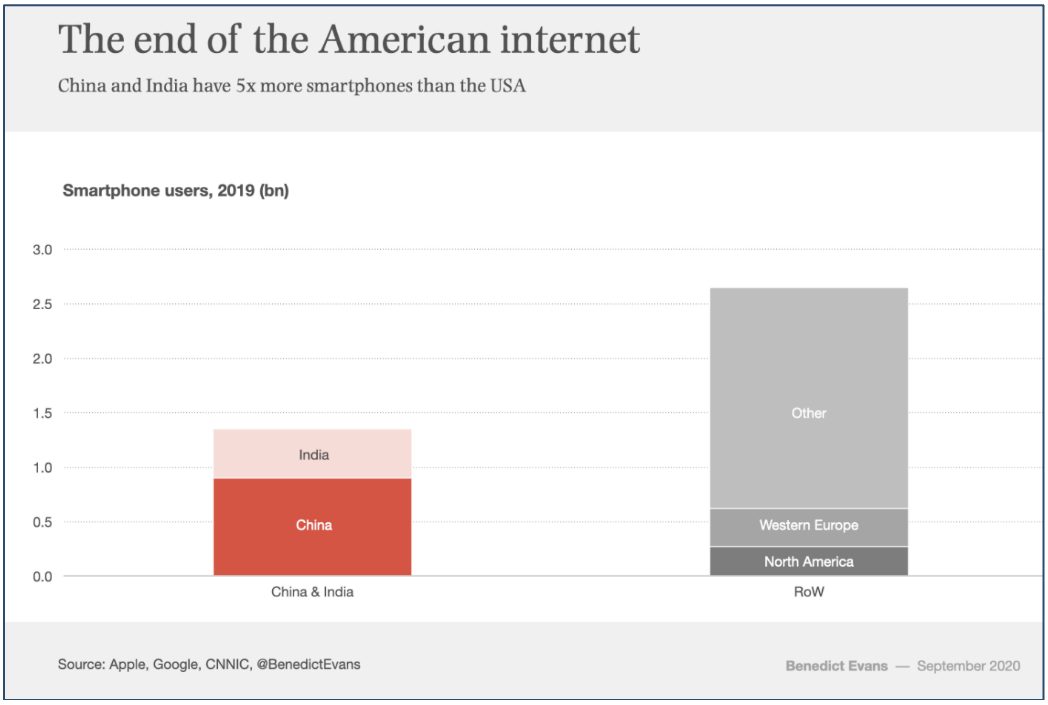
In the teeth of warnings from India's security services, Huawei and ZTE both helped build India's early mobile Internet through deals with its rather sleepy telcos, who had to navigate the bureaucracy of regulations and licenses that evoked the pre-1991 "license Raj" often blamed for what was called the (slow) "Indian rate of growth."

Mukesh Ambani, the head of India's Reliance Jio, was born in 1957 as the eldest son of what would become a very wealthy family. When his father died intestate, family war ensued until the mother brokered a truce in 2005.

Mukesh got the textiles, oil refining and petrochemicals businesses, the core of the family wealth. His brother, Anil, got telecommunications. They agreed to ten years of non-competition.

Mukesh started Reliance Jio in 2007 but built it very slowly. Then, after the non-compete expired, the company exploded onto the Indian scene. Ambani took on over $20 billion in debt to build out a mobile network, offering affordable voice and data plans (free high-speed Internet for the first six months) and quality Internet-ready feature phones.

By 2019, India's Internet market was second only to China's in size and double that of the US...

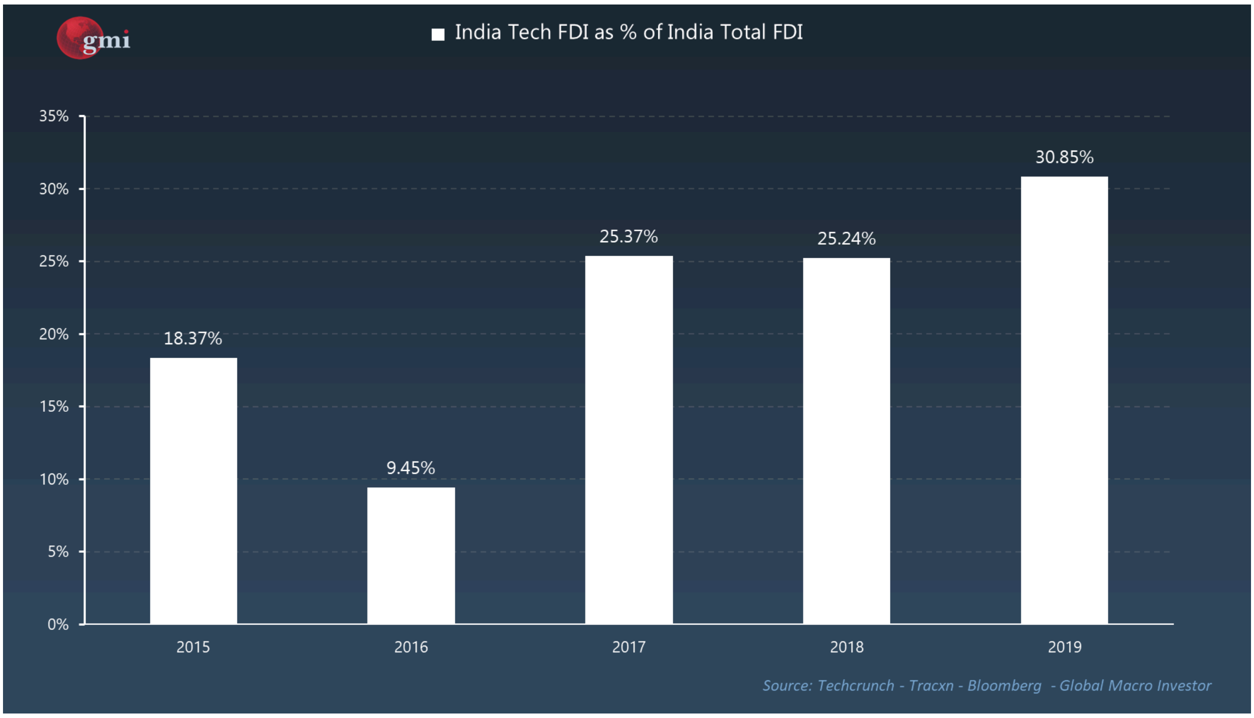


Anil Ambani had effectively gone bankrupt. Chinese State Banks, who had helped finance Anil's telco deals with Huawei and ZTE, now sought over $760 million in unpaid debts. Meanwhile, Mukesh Ambani was the fifth richest man in the world. The license Raj had lost; Jio won.

Patriot games

Part of Mukesh Ambani's success was down to his political acumen and relationship with Narendra Modi, who became prime minister in 2014. Modi's nationalist politics at first seemed preoccupied with the US which, while generally pro-India was also close to India's difficult neighbor, Pakistan. Modi cultivated China's President, Xi Jinping.

Chinese tech investment flooded into the burgeoning subcontinental tech scene. But so did American money. Modi cultivated Donald Trump, too...



How did Modi's nationalism fit with all this foreign involvement? Not easily. Ambani's Reliance Jio seemed to represent a way to Indianize the tech sector. That had long been Ambani's goal: to do for India what Huawei had done for China.

Ambani billed Jio as free of Chinese technology, for which Trump praised him. It wasn't entirely true. KaiOS, the JioPhone's operating system, for example, was from a company whose main shareholder was a Chinese company whose own shareholders include Chinese state funds (another key shareholder in KaiOS was Google). But Ambani's intention to build an Indian tech ecosystem around Jio was undoubtedly genuine.

Indian-Chinese border tensions in May 2020, as well as clashes in June and later, coincided perfectly with Ambani's big push to bring in US investment – Facebook, Google, Qualcomm, Intel, Silverlake, KKR – to retire his debt and bring new expertise to his empire building. Interestingly, leading sovereign funds from the UAE (Mubadala and Abu Dhabi Investment Authority, for a total of USD1.95bn) also bought into Jio. The UAE, like other MENA states, is currently dependent on Chinese tech and disinclined to join Washington's tech wars, but there's nothing wrong with a little geopolitical tech hedging.

As the border conflicts with China continued, the Indian Government moved against Huawei and ZTE as well as ejecting Chinese apps from the marketplace (though not some very popular ones with large Indian equity participation). India-China relations plummeted.

The next billion

Jio's US investors gained a privileged position in a vibrant company in the second-largest Internet market in the world (and growing) in a country whose population exceeds that of all of Africa.

They also bought a chance to develop products for the bulk of the world's population, outside of the rich world (already covered) and China.

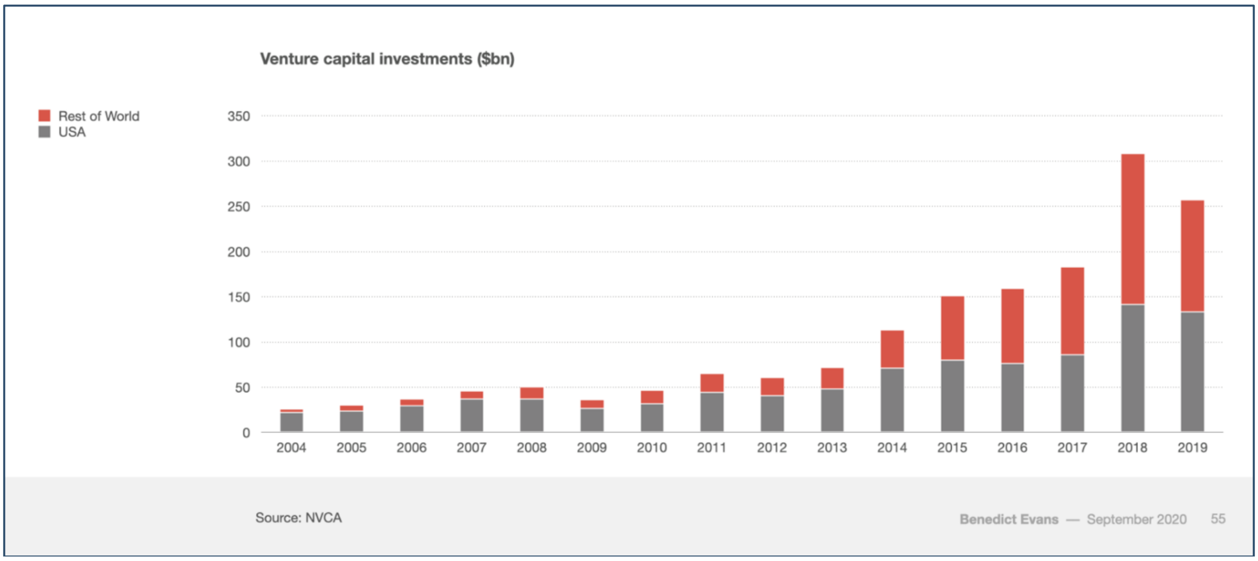
China continues to have top American companies operating within the country, including Microsoft, Amazon, Tesla and Apple, but an awareness has settled in that this is on sufferance. Were a foreign company to gain market share in China, it would be unclear how long the Party would allow the situation to last. (This is true to a degree for Chinese companies too.) There will be no "winning the Chinese market".

There's still plenty to fight for, as in India. And Jio and its American partners are looking forward to all those markets that Huawei and ZTE created, partly at the Chinese Government expense.

Brilliantly and provocatively, Ambani is saying that Jio will use all "indigenous" Indian tech to build 5G products and systems for India first, then for markets in Africa, Latin America, and Asia, which were just a few years ago – back when the China ExIm Bank was still lending to his brother Anil – the Huawei/ZTE domain.

The arrival of top-level tech competition in Africa, Latin America and Asia, if it happens, could be a rare positive outcome of US-China decoupling, and all the more positive for being unintended.

It is even possible that, without investments like the pile-in to Jio, the US and China could, over time, find themselves left out...



How?

On the reasonable assumption that Europe joins Japan, Taiwan, South Korea, Australia, the United States, Britain and Canada as basically a no-go area for Huawei, ZTE, and possibly other leading-edge Chinese companies, then the big Chinese tech companies will find themselves shut out from some major lucrative markets, leaving them to their competitors.

In theory, Chinese tech could compensate with the markets it already dominates in Latin America, Southeast Asia, Africa, the Middle East, Pakistan, Central Asia and, increasingly, Russia. If that were to happen, Chinese Communism might fulfill the promises it has intermittently made to the Third World since 1949.

But the CCP might find that level of ongoing subsidy difficult and even unpopular to maintain. Besides, Chinese tech service titans (as distinct from infrastructure providers) have had very mixed luck in those markets; the rest-of-world has its own ambitions for self-sufficiency, or at least for shaping its own tech futures.

India has shown the way, as has, more quietly, Southeast Asia; no one wants to choose between the US and China, they want to have their own businesses, and increasingly they do.

For US tech, and for China prior to the border clashes and the rise of Jio nationalism, India is partly a FOMO play. There will be more.

Scott Malcomson (@smalcomson)

BACKGROUND

Raoul Pal has been publishing Global Macro Investor since January 2005 to provide original, high quality, quantifiable and easily readable research for the global macro investment community hedge funds, family offices, pension funds and sovereign wealth funds. It draws on his considerable 29 years of experience in advising hedge funds and managing a global macro hedge fund.

Global Macro Investor has one of the very best, proven track records of any newsletter in the industry, producing extremely positive returns in eleven out of the last fifteen years.

Raoul Pal retired from managing client money at the age of 36 in 2004 and now lives in the tiny Caribbean island of Little Cayman in the Cayman Islands.

He is also the founder of Real Vision Television, the world's first on-demand TV channel for finance: **www.realvision.com**

Previously he co-managed the GLG Global Macro Fund in London for GLG Partners, one of the largest hedge fund groups in the world.

Raoul moved to GLG from Goldman Sachs where he co-managed the hedge fund sales business in Equities and Equity Derivatives in Europe. In this role, Raoul established strong relationships with many of the world's pre-eminent hedge funds, learning from their styles and experiences.

Other stop-off points on the way were NatWest Markets and HSBC, although he began his career by training traders in technical analysis.

Should you wish to receive information about membership please email us at **info@globalmacroinvestor.com**. The number of members is STRICTLY limited; only a few spaces are available each year as the membership is essentially full. A waiting list will apply if there are no spaces currently available.

Raoul Pal, Global Macro Investor, Cayman Islands
9th November 2020