Why India and why now

Although participating in Indian equities is a true test of the nerves, this is a thrilling a time for investors to be exposed to the world's largest democracy.

Few foreign institutional or retail investors have ever backed this market unreservedly. In fact, the last 16 months has seen almost continual outflows from institutional funds dedicated to Indian equities. Instead, investors choose to "rent" Indian equities rather than a "buy & hold" strategy, hoping to time both the entry and exit points, knowing this is harder than it sounds. As such, without the conviction to ride out the volatility through the cycles, not many will have enjoyed such a healthy CAGR that is on offer. Indeed the BSE-500 has compounded at 20% per annum over 20 years in US Dollars, despite the ups and downs and significant currency depreciation.

So, what has changed to make us believe that *this time is different*? Why now do we believe that the fasting period is over as India looks set to join the long-term investors' menu of choice? More importantly perhaps, what does this mean for the market, since much of this positive perception change may already be priced in?

A push for growth

First has been a critical shift in the Government's focus. Since early in Modi's first term, the PM's focus has been to restore macro-economic stability and move India away from a patronage-based system of doing business to a rules-based system. This has been an arduous process, problematic to implement and highly disruptive to businesses used to "getting things done" through the informal channels. Nowadays, "*picking up the phone to Delhi*" is no longer an option for Corporate India and although this sea change is encouraging for "ease of doing business", it has had a damaging impact on growth and profitability, particularly on the back of haphazard policy implementation.

Whilst there is always more reform to accomplish, (for instance the recent news that the Government has rescinded the laws around retrospective taxation which devastated Cairn Energy and Vodafone, causing limitless PR damage, is an example), the overriding Government agenda has altered, now the heavy lifting has been done. Today policy is about restoring growth through investment, particularly considering recent Covid induced disruption.

The Budget in February set this tone, with an increase in infrastructure spending of 35% year over year, the intended privatisation of several public sector entities, an infrastructure monetisation programme, and the creation of a bad bank to ease banks' balance sheet constraints. Covid's second wave (March to July) delayed these initiatives (a senior Government Minister closely involved died of Covid), but as life returns to normal, the growth agenda is uppermost once again. Production Linked Incentive Schemes (PLISs) have been introduced across several sectors to encourage, or subsidise, the private sector to invest in capacity to manufacture products onshore that have been historically imported from China. Foreign Direct Investment (FDI) is reaching all-time highs, as is the value of exports, buoyed by a global economic recovery. There are significant improvements in India's competitive positioning vis a vis other emerging economies, and as such multinational corporations are adjusting long term strategic planning on China, if only at the margin.

Technology

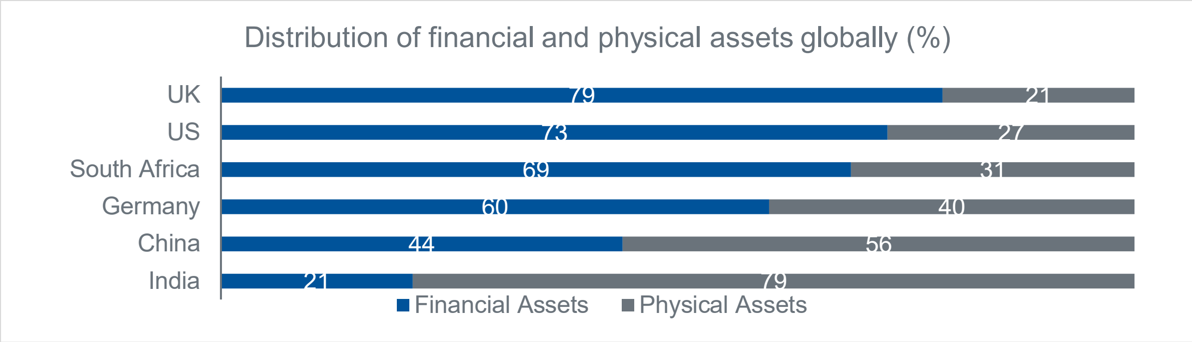
Second is the fast tracking of digitalisation across all levels of Indian society. We can all identify with this phenomenon, but the timing of this mainstreaming for India was particularly significant, coinciding as it did with the completion of India's technology ecosystem, or "stack". The combination of the completion of the biometric identity scheme enabling direct KYC, the opening of one bank account per household, sufficient fibre optic capacity nationwide, smartphone handsets at $50, the cheapest mobile data globally and the United Payments Interface (in total, the "stack") have blended to enable a rapid shift to digital adoption across multiple industries, sectors and subsectors, fast-tracked as it has been by the pandemic.

India is seven to eight years behind China in terms of internet users, e-commerce, and digital adoption, but expects to catch up at a higher growth rate, but there is little representation in the listed equity markets currently. Whilst the US Digital and Tech sector represents circa 30% of S&P500 market capitalisation, in India it is barely 1%, but we are now at the critical inflection point. In July, Zomato, India's equivalent of Deliveroo or GrubHub, was the first major tech company to list, with a market value of $14bn, 35x subscribed with a share price rising 50% on day one. This successful listing is expected to trigger a long pipeline of private equity and venture capital investors looking to raise both primary and secondary capital on India's exchanges through the sale of digital and tech companies, giving listed investors the opportunity to benefit from this tectonic shift in consumer and commercial behaviour.

India has the right demand and supply dynamics to enjoy multi decadal growth in the new economy given the large addressable market, the successful role models that exists within the India diaspora, the entrepreneurial and talent availability on the ground (25% of the world's tech engineers are India based), and now the funding. Since January, the digital start up eco system has raised $27bn confirming a sweet spot in the capital raising cycle has been reached. Of the circa 800 Unicorns (private companies with a business valuation of > US1bn) in the World, around 53 are in India with an aggregate business value of ~$190bn. Of these, 26 of them have become Unicorns just in the last 18 months. Furthermore, there are already 25-30 "soonicorns" (expected to become Unicorns). How these companies are valued and how the portfolio gains exposure to these themes are issues to be wrestled with, but these trends have a positive network effect across the economic spectrum. Equally it also shifts India's investment narrative away from disappointing growth, disruptive reform and Covid, and towards the opportunities to invest in the new economy with a young and vibrant population. This a major step change to which investors are only just beginning to wake up, as India becomes a realistic alternative to China and a meaningful investment opportunity.

Financial intermediation

Third is the rapid and ongoing formalisation of India's savings is providing incremental capital to fund this growth as well as reducing volatility in the stock market. Equities are benefitting from increasing participation by the mutual fund industry that is contributing over $1bn a month of flows coming from systematic investment plans (SIPs), many emanating from second and third tier towns. The distribution of savings assets in India between physical and financial is approximately 80% to 20%, where in the UK it is the inverse at 20% to 80%. China sits at 56% in physical, implying that Indian equities can expect to see ongoing inflows for many years before a parity is reached.



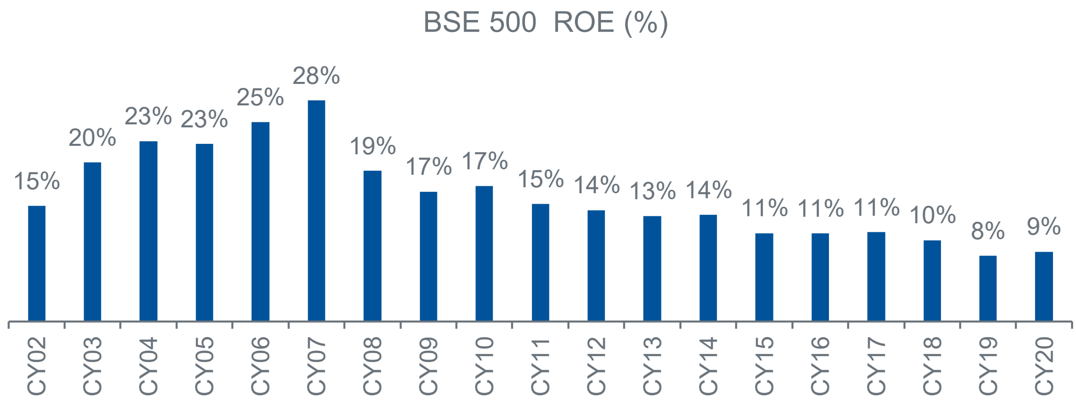
Source; www.clientassociates.com

In addition, we anticipate that India will be included in global bond indices creating demand for India sovereign paper overseas (currently India has no credit trading offshore) and incrementally reducing the crowding out impact of government borrowing. This is a multiyear process that will impact only over time, but it is being accelerated by the adoption of technology by India's best run financial services companies, as well as well funded Fintech disruptors. The direction of travel is clear and irreversible.

An earnings recovery

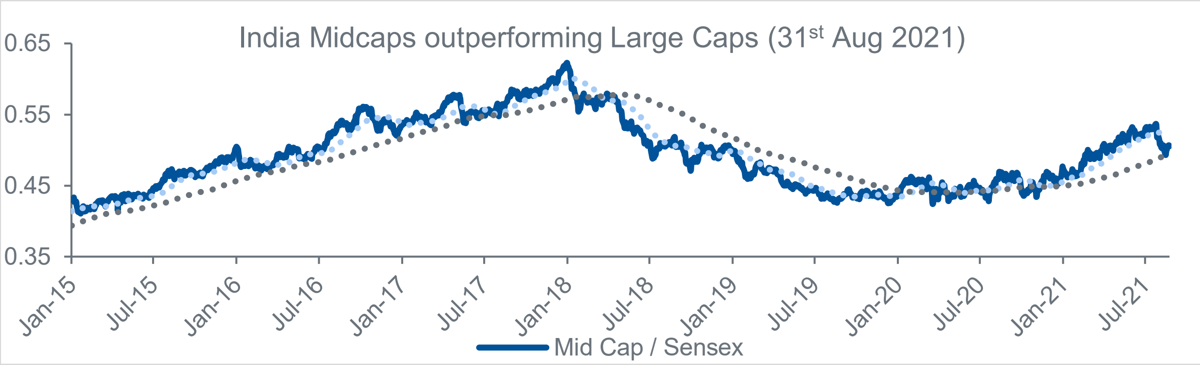
Interaction with our portfolio companies suggests that confidence is returning. Profits have held up relative to expectations despite the second lockdown, principally because business was able to continue as best as it could unlike the first "total" lockdown. Earnings forecasts for the portfolio have been upgraded over the last three quarters and we sense that a private sector investment cycle may be evolving after a long absence. This is not yet evident in corporate loan growth that remains below nominal GDP growth, but we anticipate this to recover in due course. The financial sector was severely affected by the liquidity crisis of 2018/19 in tandem with tighter reporting norms from the Reserve Bank's prompt corrective action plan. Covid generated a different set of provisioning requirements, equally affecting profitability and loan growth, and if or indeed when, a third wave strikes, the Banks will face further pressure on this front.

The BSE500 market has risen 24.9% in Sterling terms since the beginning of the year (having risen 9.6% in 2020) and valuations are above the long-term average. Hence, India's equity markets do not look cheap relative to either their peer group or indeed their own history.



Source; Bloomberg

However, debt to equity levels for the top 500 companies are at seven year lows and profitability (aggregate return on equity, ROE) is at its lowest level since 2002. Mid and Small cap companies lagged their Large cap peers from 2017 onwards, but this trend has reversed with the former outperforming by 16% year to date.



Source; Bloomberg

A shift in the Federal Reserve's commentary about the pace of monetary tightening would be expected to adversely impact Emerging Markets, including India, as would the Reserve Bank of India's expectations around domestic inflation which has been rising. Connected to these risks is ongoing upward pressure in international oil and commodity prices that impact inflation and will be passed through to consumers over time. India's handling of the Covid crisis highlighted the under investment in healthcare infrastructure which caused a devastating impact in all parts of the population both rural and urban, rich and poor. Today, India stresses its preparedness for a third wave but how this would play out and how the market reacts is uncertain. These short-term considerations should be put aside as attention would be better focused on the underlying dynamics that are driving the rapid development of India's economy and the consequences that will emerge for patient investors.

David Cornell
Managing Director
September 2021

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