

Gateway to India Fund

2022 Outlook and Portfolio Strategy - January 2022

2021 was quite the test for India but one that was passed successfully. The economy has recovered to pre-Covid levels and the BSE500 Index has risen 28% in US Dollar terms since the beginning of the year, making it one of the best-performing markets in the World. Such resilience looks set to continue this year but another observation of note is the acceleration of digital adoption both by companies and consumers.

A second wave of Covid infections hit India in March 2021. It was a brutal one that had every chance of derailing the economy. Unlike the first wave, though the Government chose not to have a blanket shutdown of the country. This time around lockdown was more local allowing the continuation of economic activity albeit at a curtailed level. Vaccinations were undertaken at a furious pace. As we write, India has achieved 1.5bn vaccinations, a level which was expected to be achieved only later in 2022. With this, the recovery of economic activity has been quite sharp. All through this, Indian markets have been steadily rising, helped mainly by consistent forecast earnings upgrades for the next three years. Domestic investor inflows have also been resilient and growing, more than offsetting secondary market outflows from Foreign Portfolio Investors (FPIs). Mutual Fund Systematic Investment Plans (SIPs) (mainly equities) have now reached a record high of US\$1.5bn per month.

The second highlight of 2021 is the 'mainstreaming of digitalisation' and its impact on the economy and investment opportunities. While ~57% of India's population uses the internet, only 12% of the population are online shoppers. Both internet users and online shoppers are rising rapidly following China's trajectory in the past few years. The only difference is that the pace is faster. A per capita GDP of ~US\$ 2,100, surpasses the threshold required for more discretionary consumption and India is at a digital break-out level. Also, for traditional businesses, digital adoption has turned from 'nice to have' to 'must-have'.

2021 saw India's start-up economy come of age, with a record 44 new Unicorns, a more than doubling from ~30 Unicorns at the beginning of 2021. Many of them are maturing enough to come up for public listing. Already, in 2021 ~US\$50bn of market capitalization has been added to public markets by these tech-first company IPOs. We expect another ~US\$250-300bn of market cap (at current business value) to be added by way of IPOs of these digital/e-commerce companies. This will dramatically expand the set of investible opportunities, of course, subject to valuations.

In 2022, we look forward to the continued resilience of the Indian economy and markets in the light of persistent risks related to Covid, especially Omicron. As we write, the ability of Omicron to disrupt economic activity appears quite low.

However, after two years of strong stock market performance, concerns are building up on valuations. Although market valuations appear high in comparison to historic averages, we think market valuations are reflecting the following:

1. Rebound in overall economic growth with normalisation of economic activity post-Covid. As the benefit from many 'disruptive' economic reforms now starts flowing in, we think GDP growth in the next few years should be much stronger now.
2. Strong corporate earnings growth cycle in the next few years. BSE 500 Corporate Profit to GDP ratio fell to 2.4% in 2020 from 4% in 2011. With higher top-line growth and thus operating leverage, cost rationalisations, and lower interest rates, corporate profit to GDP will rebound

smartly from here. We expect Nifty 50 companies to average a PAT growth of around 27% p.a. over FY22-FY23.

3. Corporate profitability is also improving. The average Return on Equity (RoE) of BSE500 companies fell from 15% in 2011 to around 9% in 2020. This has bottomed out now with higher profit growth and asset utilisation.
4. Corporate India has deleveraged substantially in the last few years and Balance Sheets have improved in quality comparatively. We appear to be at the bottom of the business cycle from a debt perspective which should also boost ROEs.

While the beginning of Quantitative Tightening (QT) in 2022 is a risk to markets, India is better placed to navigate it this time around. Unlike the 'Taper-tantrum' phase of 2013, India's macro-economic stability has vastly improved as fiscal deficit, current account deficit and inflation are at much lower levels and are broadly under control. Inflation has remained under control in India in 2021. Nevertheless, as economic activity picks up more, inflation will rise and along with it the need for rate hikes. This will be a good sign about reaffirmation of growth. Overall, we believe, the monetary policy stance in 2022 will continue to prioritise growth.

The Union Budget, to be announced on February 1, 2022, will continue to build on the earlier change in stance last year in favour of fiscal accommodation and investments to reinvigorate growth. The Government has successfully avoided populist measures in the past, which we think will be so in the future as well.

From a portfolio strategy perspective, there is a diverse set of opportunities available in the market. We continue to be bottom-up stock selectors and are well entrenched with our portfolio stocks from a long-term view. Our focus remains on identifying quality businesses which we believe have capital efficiency with sustainable growth and are available at attractive valuations considering the underlying business. Our portfolio is well-positioned in the consumption, financials, and IT services space. Within consumption, we prefer consumer discretionary especially 'Food Tech' companies. Within financials, we prefer large private banks, such as **ICICI Bank**, **HDFC Bank**, and **Indusind Bank**, and **Can Fin Homes**, an affordable mortgage financier. Here, we see higher credit growth and peaking of the NPA cycle at a time when they are over-provisioned. We also prefer large-cap IT services companies.

We have pivoted towards identifying businesses that benefit from megatrends such as the 'mainstreaming of digitalisation' and 'China plus 1'. For instance, we are positive on the 'Food Tech' sector where we see an acceleration of market share gains from the informal sector, thanks to smart phone adoption. Of particular mention, here are **Jubilant Foodworks** (Dominos franchise), **Westlife Development** (McDonald's franchise), and **Zomato** (India's largest food delivery company). This is over and above, our exposures to **Affle India** (an ad-tech company involved in 'targeted' digital marketing), IT services companies such as **Wipro** and **HCL Tech** (enablers for digital transformation globally), and **Reliance Industries** (upcoming e-commerce 'horizontal' with an omnichannel experience). 'China plus 1' or supply chain de-risking is captured in our portfolio through ownership of **Dixon Technologies** (outsourced electrical equipment manufacturing), **KPR Mills** (textile manufacturing), and **Neuland Laboratories** (API manufacturing and Custom manufacturing).

We continue with the '**All Cap**' character of our strategy with an exposure of ~50-60% to large caps and the rest being mid and small-cap companies. 2022 will prove to be a stock selectors market and we believe our Portfolio is positioned well enough to be a '**Core India Portfolio**'.

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