Whilst your back was turned

As a single country investment destination, India has "come of age"

Foreign investors have abandoned India in 2022, so far. Foreign ownership of Indian equities (17.4%) is, according to CSLA, close to 10 year lows. This has created both a tactical, and a long term, buying opportunity in the world's fastest growing (large) economy.

We are confident that healthy absolute returns can be made by investing at these levels. Looking at why this opportunity has emerged, some reasons behind the sell-out are clear.

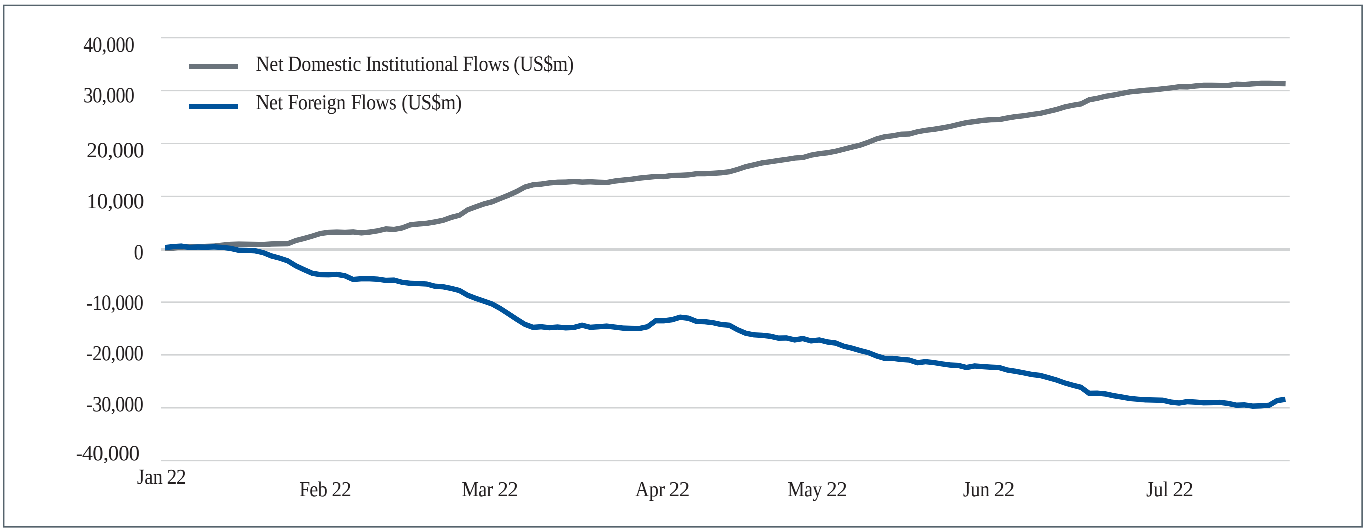
1. Oil price rise
2. Previous market performance in '20 and '21 enabled easy profit taking in '22
3. Expensive
4. Strong dollar; repatriation of flows to DM
5. Investor concerns in China causing broader EM outflows

Were it not for the offsetting strength of domestic mutual fund flows, the market would have performed far worse than it has. In fact, India has outperformed Emerging Markets year to date*, suggesting a resilience previously absent.

First takeaway; more buyers

Indian equities are less susceptible to global investor sentiment, as the on-going financial-"isation" of the economy drives incremental domestic savings into equities. There is a structural element to these flows if India follows the pattern of other countries' savings habits, giving us room for optimism. Imagine a scenario for Indian equity performance whereby both locals and foreigners were buying in these quantities at the same time.

Chart 1
INDIA LISTED EQUITY TOTAL FLOWS YTD



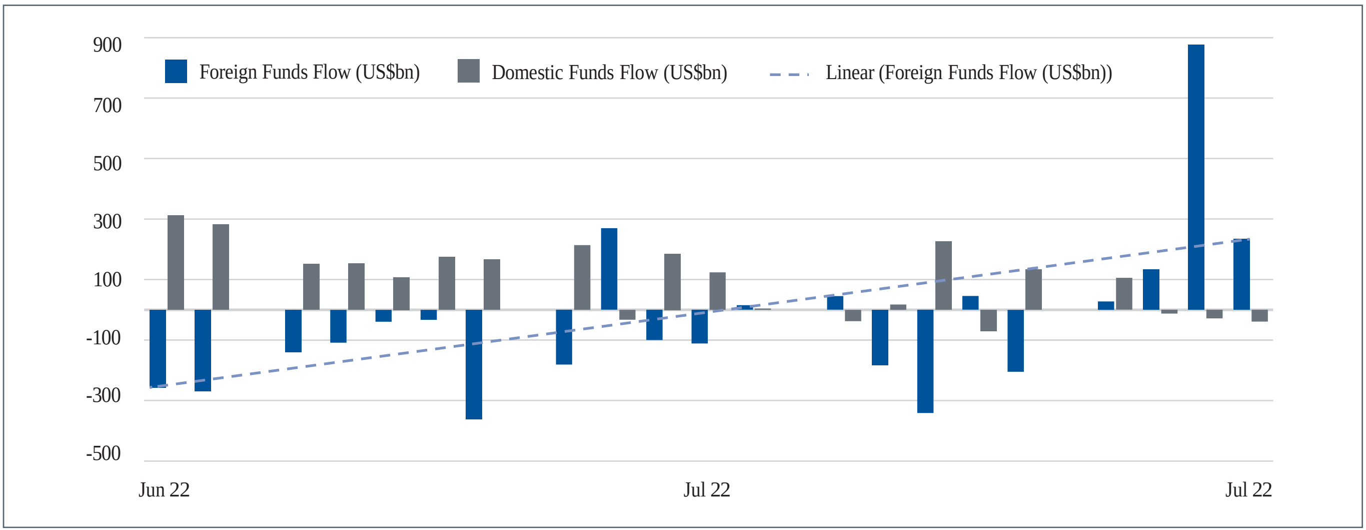
Source; Bloomberg

* In GBP terms (as July 31st), MSCI India is up 2.4%, whereas MSCI Emerging Markets is down 10.3%. Source Bloomberg

Where possible, we recommend that investors increase equity exposure to India; Points to note;

1. As a single country India specialist, there is palpable fresh attention to the market
2. Easing commodity price pressure removes negative sentiment and supports earnings
3. Risk assets are oversold; bond yields have fallen back
4. Corporate earnings (in general) are not as worst feared (both domestic & globally)
5. Foreign selling pressure in India has eased

Chart 2
INDIA LISTED EQUITY INCREMENTAL FLOWS. JUNE/JULY 2022



Source; Bloomberg

The question as to whether it makes sense to buy India tactically (as a short term trade) or structurally (as a longer term investment) is debatable. Over longer periods (10, 15 or 20 years), hard currency returns (USD or GBP) from Indian equities have been greater than most (if not all) major stock markets. This is in spite of higher political risk, greater currency volatility, weaker macroeconomics or any globally induced stock market wobbles, and is because corporate profits in aggregate compound in line with (or higher than) already impressively high nominal GDP growth. As such, it is a wonderful investment opportunity, particularly for competent stock pickers. This argues well for the "buy and hold" investors who believe in a long term approach. This is easier said than done however, as the outflows this year demonstrate. And hence the argument that India remains a tactical buy, historically performing in lockstep with oil prices has held, up to this point.

Chart 3 highlights this.

Chart 3
BSE 500 - 18 MONTH ROLLING RETURNS (US$)

Source; Bloomberg

Had you invested in March 2012 (18 months before the start of the period), by September 2013 you would be wearing a 26% loss. The subsequent rally that ensued occurred over 359 trading days, generating a 90% return. Interestingly, only 203 of those trading days were positive, and of those, over 111% of the 90% return was generated in just 50 days. By January 2016 however, 18-month returns had fallen to zero. The 2020 “Covid rally” produces a similar outcome. In this case the returns were 146% over 221 trading days, of which 103% of the total return came from 50 trading days. By end June of this year, 18 month rolling returns are back to a meagre 7.8%. We haven’t shown the data here, but three-year rolling returns look equally cyclical. India’s better economic management - leading to less sensitivity to rising price of oil has not yet been acknowledged by the markets, and thus presents an opportunity.

Second takeaway; impossible to chase

When India moves, it moves fast, making makes it near impossible to chase. Hence it is wise to own it before it starts to race away. From an 18 month (and 3 year) rolling returns basis, now is as good a time as any that will present itself. If proved right, the decision to hold it for the longer term is more straightforward.

For us the question “do you buy India for the short term or invest for the long term” is best answered in the following way.

For as long as India remains structurally under owned* by foreign investors, volatility of this nature will continue. But since the successful implementation of hard earned reform, the time is approaching when investors will see greater risk in not owning India than in owning it, and in the way that China has become de rigueur, so will India.

With the exception of Modi’s reform agenda (2014 – 2019), each stage of India’s economic reform (since 1991) has brought the stock market one step closer to mainstream investors. Recent reform over the last three years has been over shadowed by global events however. Economic growth (and corporate earnings) were negatively affected by the impact of the reforms culminating in the banking crisis which lasted to 2019. Foreign investors, barring “hot” money, stayed away. And as India emerged from its earnings recession, Covid-19 struck, delaying the “harvest” and from there the Covid “fallout”. Finally the war in Ukraine sapped any lasting appetite. India does not stand in isolation in this regard, but it still remains deep in the back of many investors’ minds currently, in spite of the progress that has been made.

* Structurally under owned is loosely defined as India’s under representation in global benchmarks relative to the size of the economy and its incremental contribution to global GDP. To illustrate this, in Dec 2000, India represented 8% MSCI Emerging Market Index, whilst China represented 7.5%; today India represents 13.8%, whilst China represents29.6% (source MSCI I Shares)

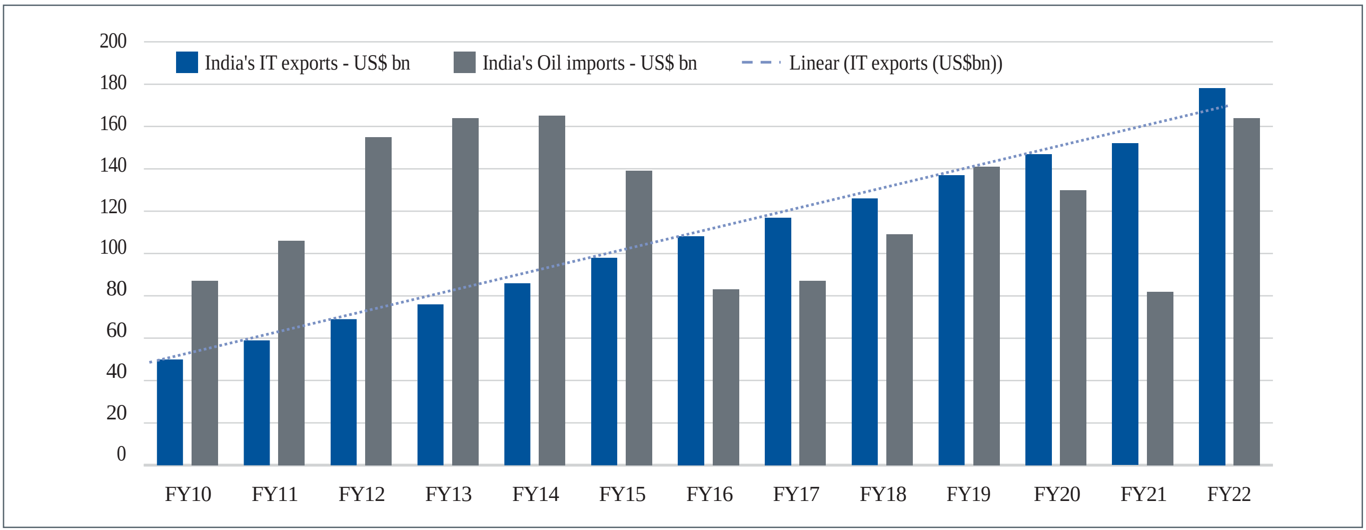
So, whilst investors' backs have been turned, the structural process of reform has set the country up for a period of eye catching growth, with lower risk of an inflationary response. The key elements of these reforms don't need regurgitating, but the remaining charts demonstrate the positive impact. Since oil prices are front of mind, it's a reasonable place to start.

Third key takeaway; oil

Although India's dependency on imported oil remains, the overall economic impact has been suppressed. This has reduced Rupee currency volatility, arguably the biggest deterrent to long term investors

1. Imported oil costs are now offset by the increasing value of India's IT exports (chart 4)
2. The government no longer directly absorbs the cost of rising oil.
3. Record foreign direct investment flows have improved the quality of the capital account.
4. India's balance of payments is forecast to be near neutral
5. India now has 4th largest FX reserves globally, behind China, Japan and Switzerland

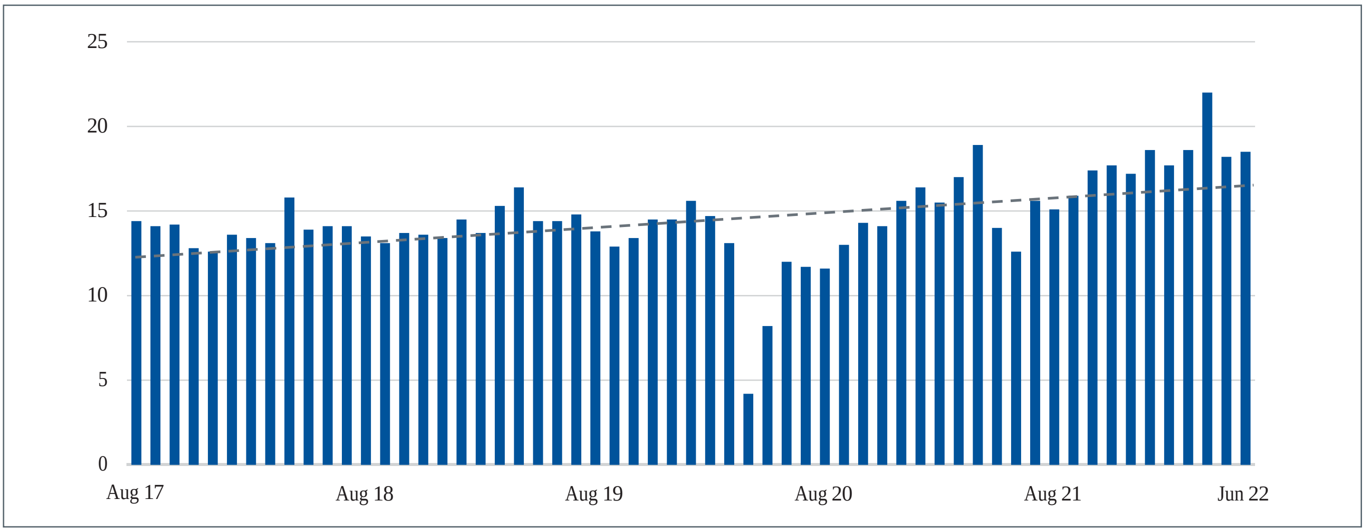
Chart 4
INDIA'S INCREASED RESILIENCE TO CRUDE IMPORTS



Source: NASSCOM and Ministry of Petroleum and Natural Gas

Chart 5 highlights the extent to which indirect tax collections are improving, both in terms of the breadth and efficiency of collection. This is a useful barometer for economic activity as well as confirmation of the shrinkage of the informal sector. As mid and small cap specialists, the ongoing squeeze on tax dodgers is an important theme in our investment process. The steady breakup of the black economy supports higher corporate productivity. It forces consolidation, thereby improving opportunities for industry leaders to gain market share. Informal players are finding it harder to compete. This is best reflected across the consumer sector where the "unorganised players" are struggling to operate under a legalised framework.

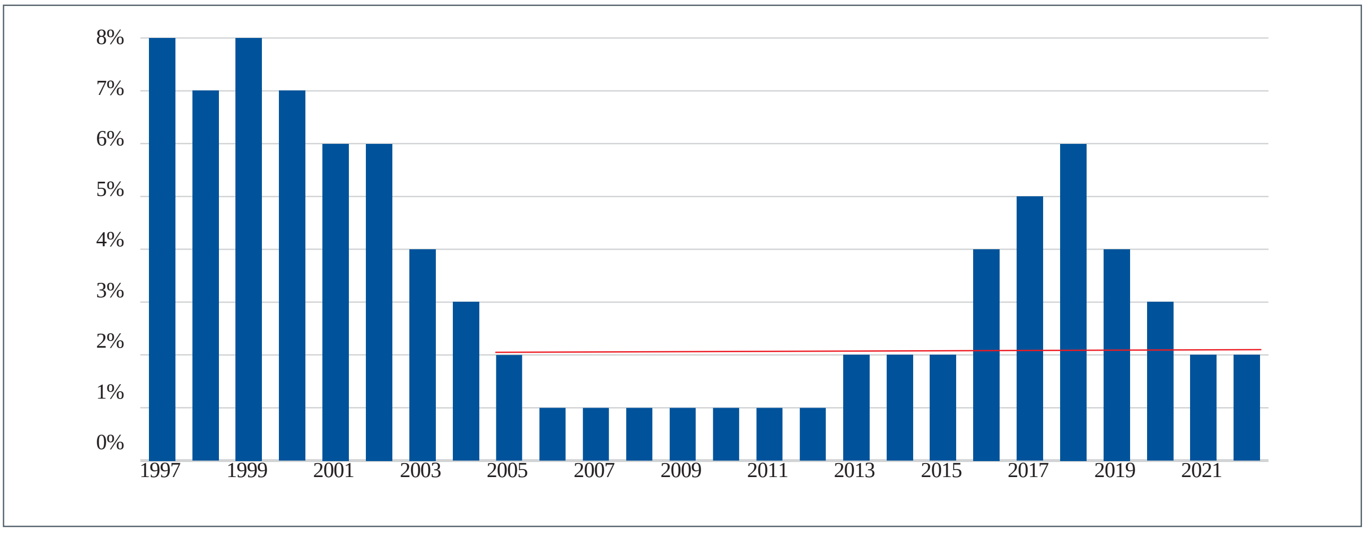
Chart 5
GOODS & SERVICES TAX MONTHLY COLLECTIONS US$BN



Source; GST Council, India

Chart 6 highlights the positive benefits of banking reform. This issue was first addressed back in 2015 by the then RBI Chairman Raghuram Rajan. It has been a laborious process to fix, but the worst of the provisioning process in this cycle is behind us. The banks survived Covid without any undue additional stress, suggesting there were no longer poorly performing assets to "kitchen sink". Whilst credit growth has been sub-par over the long period of cleaning up banks' asset quality which has restrained economic activity, the worm has finally turned. Banks are starting to compete for clients once again, and demand for credit is recovering.

Chart 6
BANKING INDUSTRY- NON-PERFORMING ASSETS (as percentage of total assets)

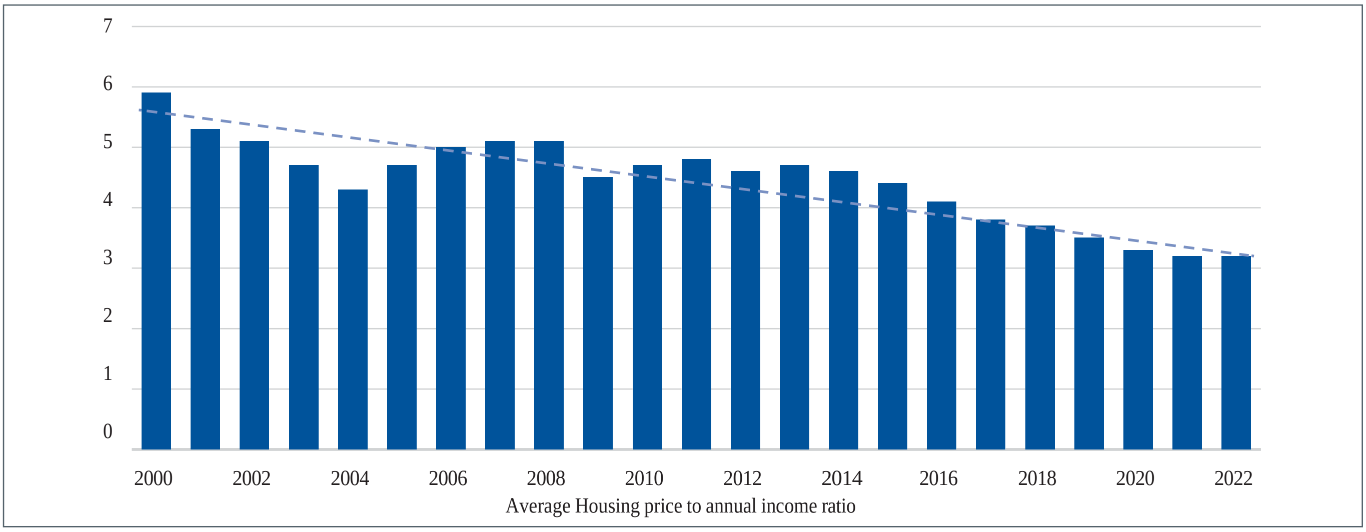


Source; Reserve Bank of India, Ocean Dial Asset Management

Another consequence of the reform process has been the collapse in real estate activity and property prices. Tighter regulation combined with reduced credit has forced disreputable players out of the market, leaving unsold inventory and poor returns. Similarly, to the banks, it has taken the real estate sector many years to root out the corruption and poor governance that pervaded. Recent signs indicate this floor has been reached and housing construction and property prices are on the up again. If momentum builds it will generate a boost to economic growth (1-1.5% addition to GDP forecast), with a range of sectors (alongside employment) seeing job growth. The on-going urbanisation of India is an investment theme that should support corporate profitability indefinitely particularly now key structural impediments have been removed.

On the demand side, the picture looks bright. Mortgage credit as a percentage of GDP is just 11%, implying consistent growth now that regulatory and monetary conditions are in place. Chart 7 below demonstrates that India's affordability ratio is back to the lows, as the combination of lower interest rates and rising incomes improve purchasing power. The cost of money is rising in India (in hock with developed markets), but it will peak well below previous highs, and is not expected to dent demand for housing.

Chart 7
AFFORDABILITY INDEX: HOUSING PRICE TO ANNUAL INCOME



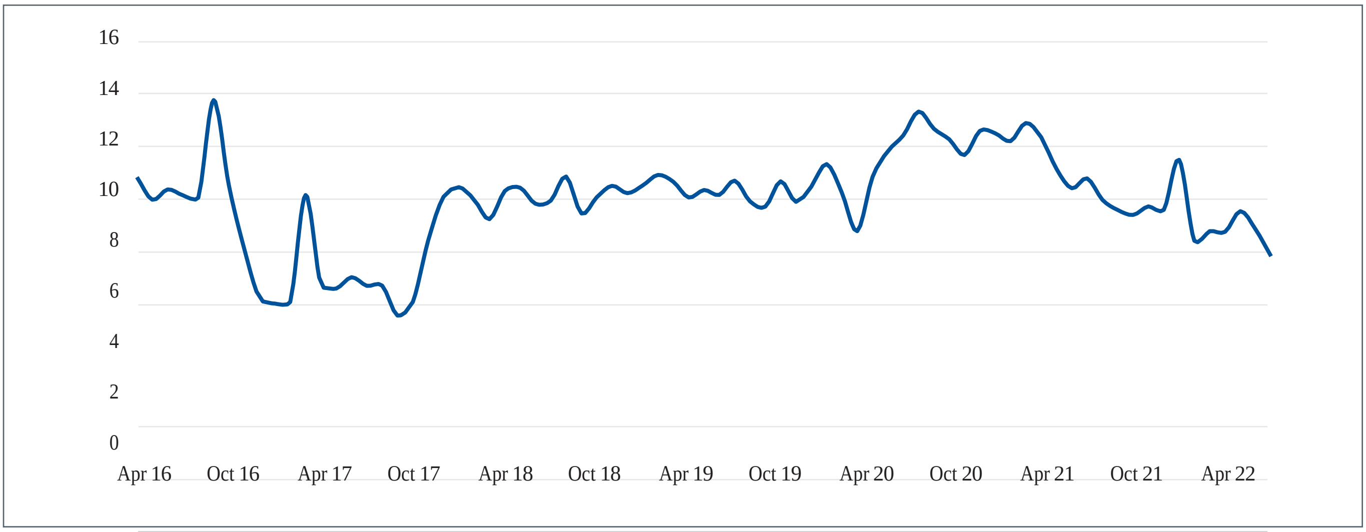
Source; HDFC Limited

Fourth key takeaway; inflation

India is experiencing high inflation with CPI at 7% (as at end June) but which is expected to fall to 6.4% by year end. It is rare for India's inflation to be lower that developed market inflation, and with important distinctions;

1. India's inflation is not driven by monetary policy (see Chart 8)
2. India's inflation is not driven by wage pressure, or the expectation of wage increases
3. India's inflation has been due to the rising cost of imported commodities and second round effects
4. Food costs are rising, but India is self-sufficient in food, and the monsoon is forecast to offset these

Chart 8
INDIA - M3 (%)



Source; Kotak Mahindra Bank Limited

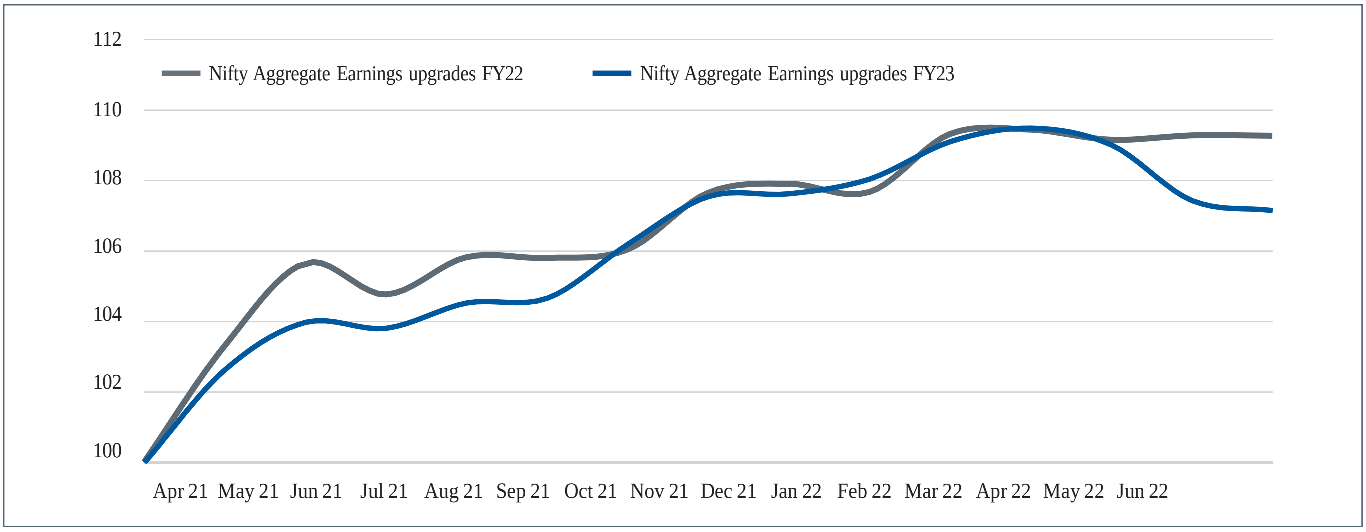
Although the Reserve Bank of India has been raising interest rates (to support the currency as US rates rise), the embedded risks of excessive money supply and labour cost pressures (combined with energy price escalation that grips Western economies today), are not contributing factors. Also, neither India's interest rates (base rate 5.75%), nor its inflation (7%) are close to historic highs, and as such are not expected to derail economic growth.

Also it is important to highlight the extent to which India corporate management teams are capital efficient. Having experienced periods of higher inflation (and higher cost of capital) far greater than the situation faced today, Corporate India is "hard- wired" to operate in high interest rate environments, and the economy is therefore well equipped to manage the current inflationary climate.

Fifth key takeaway; earnings

We have confidence in the earnings outlook. Portfolio earnings (in aggregate) are expected to grow at 30% (FY23) and 28% for the next, (FY24). As Chart 9 depicts, there has been some minor adjustments overall, but earnings downgrades in Autos, Consumer, Cement and Healthcare have been offset by upgrades in Energy and Commodities, Financials and Chemicals. The banking sector plays a key role here since it is a large component of the index with little earnings risk and hence aggregate earnings are well supported. Brokers are bearish on the IT sector given recessionary warnings in the US, but our portfolio companies are not seeing this translate. On the contrary, IT budgets (cloud migration, digital rollout) are well protected given how central a role IT has become to overall operational efficiency and customer habits. Top line growth in consumer staples (small ticket) remains robust, and companies have been adept at offsetting gross margin weakness with lower ad spends thereby protecting profits. Looking forward, recent falls in input prices (commodities and oil) are supportive.

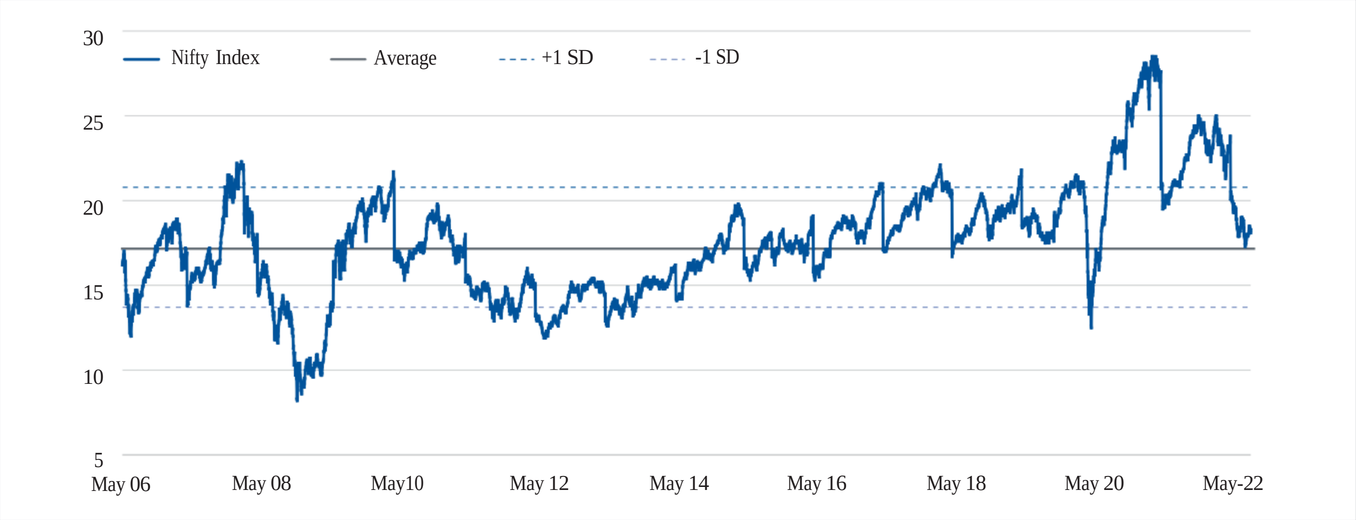
Chart 9
MONTHLY CHANGE IN NSE 50 EARNINGS UPGRADES APRIL '21 TO JUNE '22



Source; Jeffries International Limited

If earnings hold up then the market is trading in line with the long term average. Not cheap, but when is India ever cheap? There have been occasions of course, but normally these occur when extreme risk aversion deters even the most contrarian investors. On that basis "in line with long term averages" is a good entry point (Chart 10), particularly so given the quality of the investment has improved significantly.

Chart 10
NIFTY 50 12 MONTH FWD ROLLING P/E MULTIPLE



Source; Bloomberg

Final takeaway; quality

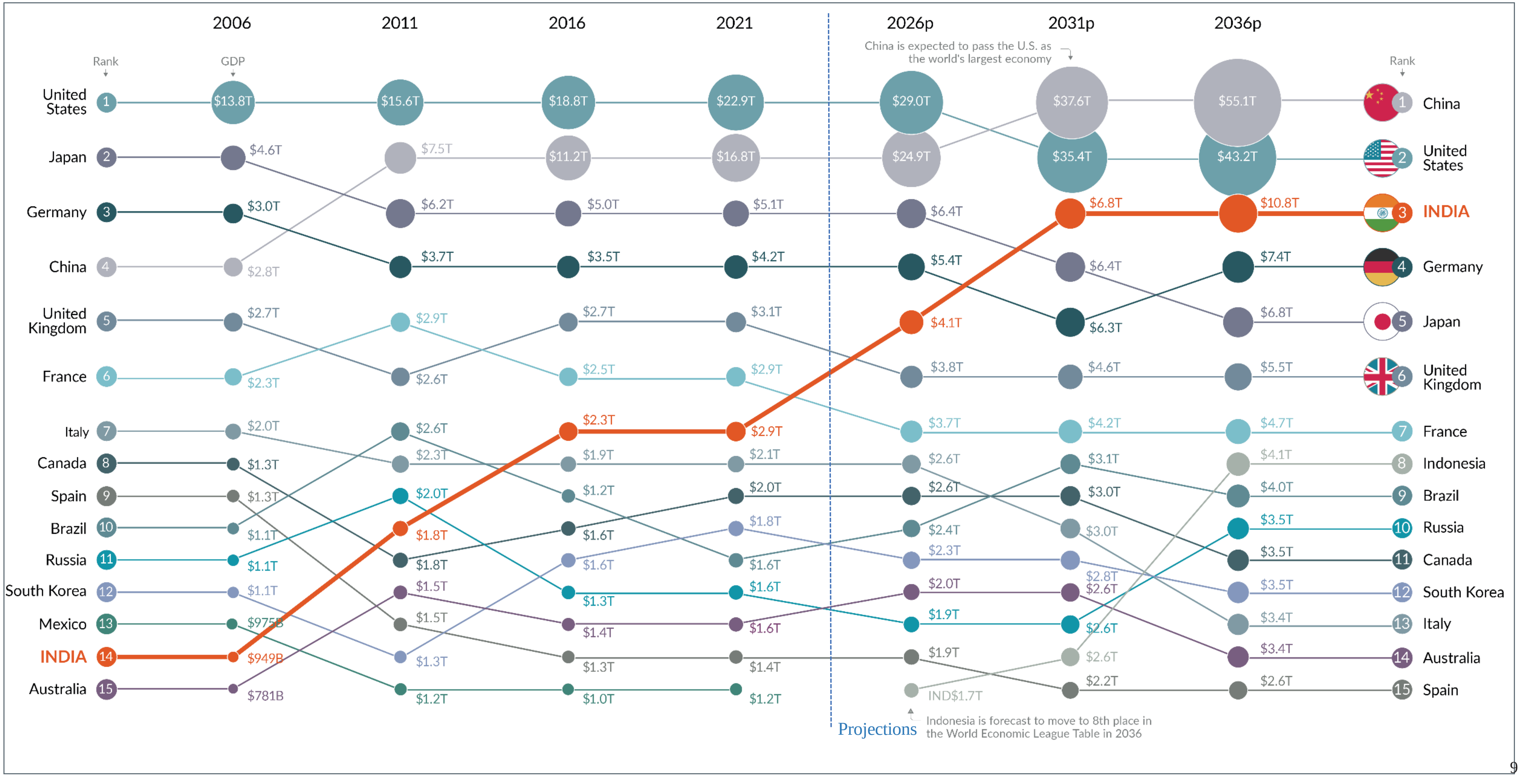
Headline valuation is in line with long term averages, but there are 10 reasons why buyers are accessing a superior quality investment;

1. Modi's government provides a stable political framework and clear policy direction
2. India is an easier place to do business and multi nationals are increasing commitment
3. Tech is central to economic progression, improving productivity and removing corruption
4. The black economy is shrinking, creating incremental opportunities in the formal sector (esp. Mid and Small Caps)
5. Geopolitically, India is benefitting from the US-Sino split. This is impacting business positively
6. Savings are flowing into the financial system, improving the availability of capital
7. India's renewable energy commitments at COP26 were practical and realistic
8. The housing recovery is supporting GDP growth, after a long pause
9. Corporate de-leveraging cycle is over. Balance sheets are healthy and can expand from here
10. Currently, India's inflation is a global, not a domestic, construct

The final chart (*see over, Chart 11*) aptly demonstrates the speed of India's rise from economic irrelevance to a seat at the top table. In the process of assuming its seat, foreign investors will cease to consider it a market best rented, and start to believe it to be a market best owned. Now is the time to take advantage.

Chart 11

GLOBAL ECONOMIC SHIFTS - ECONOMIES RANKED BY PROJECTED GDP



Source; Visual Capitalist, The Center for Economics and Business Research, The World Bank and Trading Economics

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