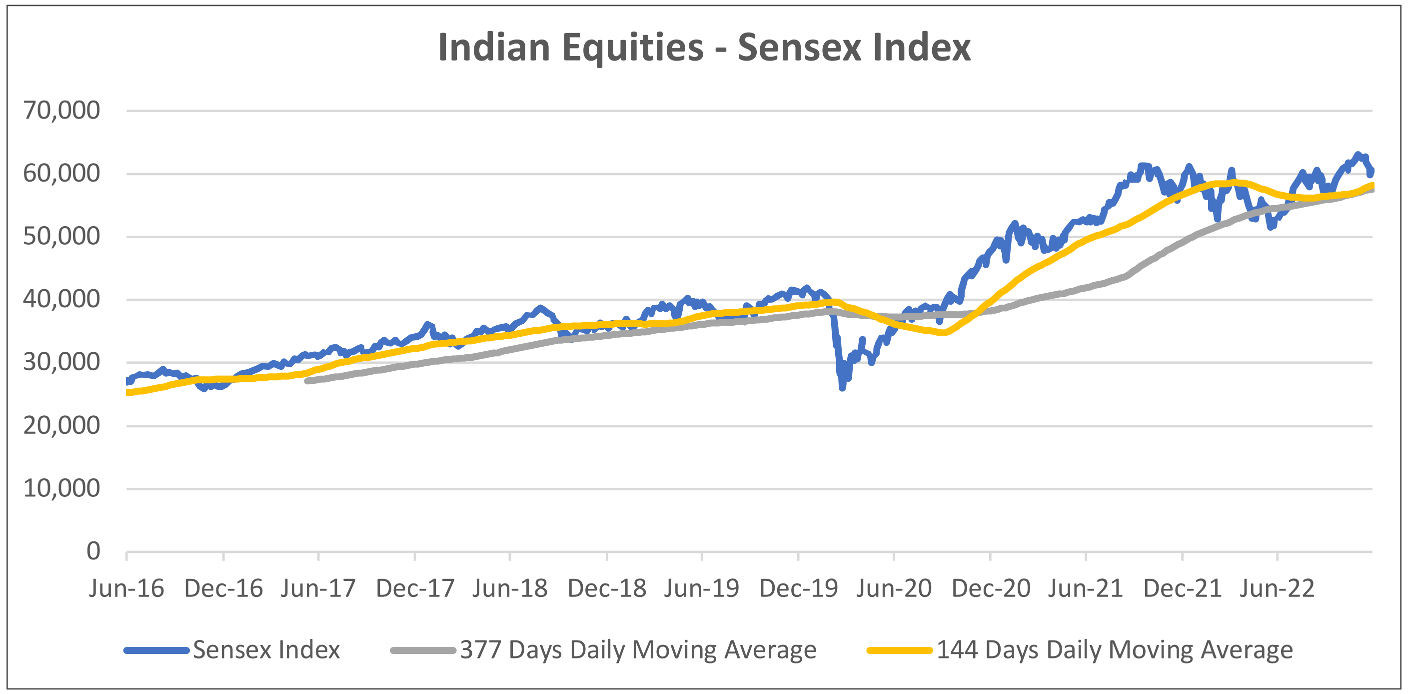
INDIAN EQUITIES - FURTHER UPSIDE POTENTIAL LIKELY IN THIS EXCELLENT LONG-TERM GROWTH STORY

Abhishek Shukla, Head of Investment Research, FAB Asset Management



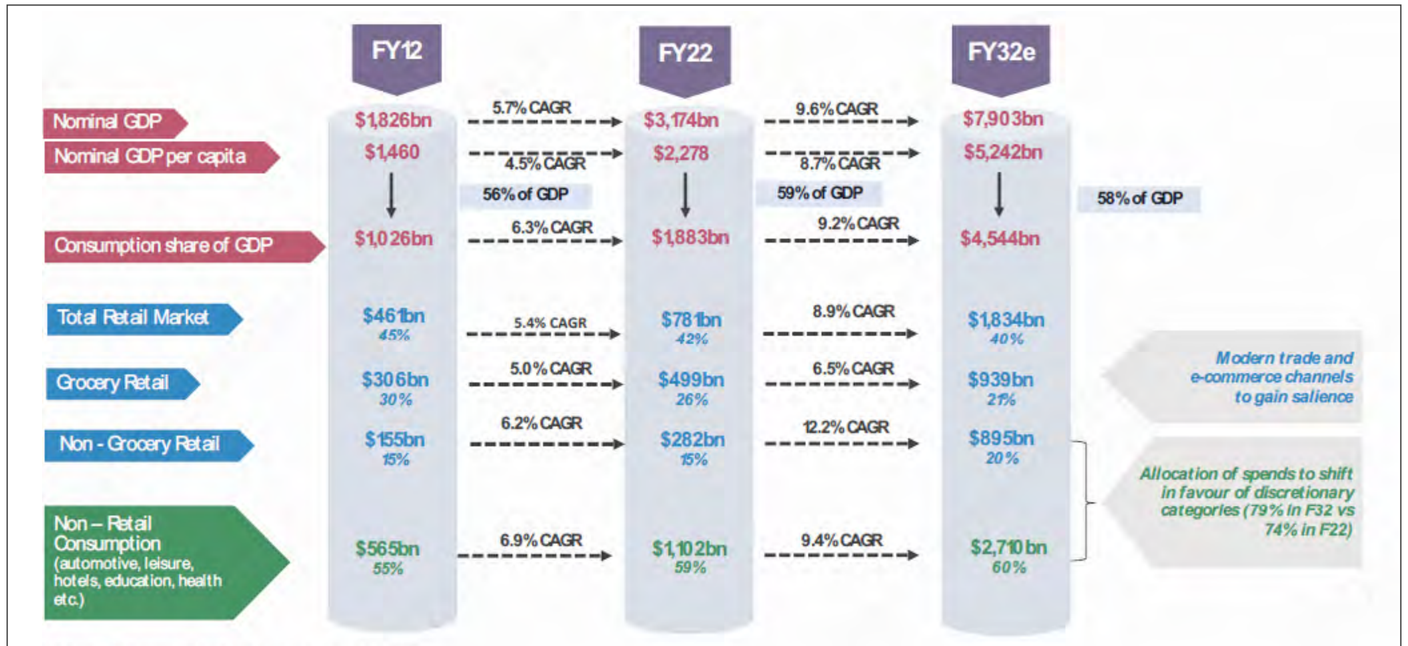
Source: Bloomberg/FAB

Introduction:

The Indian economy has rebounded strongly in the aftermath of Covid-19. In the fiscal year 2022-23 ending 31 March 2023, India's real GDP growth is forecast to be 6.8%, according to the International Monetary Fund (IMF). The country's economic growth momentum is continuing, after posting a huge recovery of 8.7% in the previous year. India stands out as one of the fastest-growing major economies globally. We believe India represents an excellent long-term, sustainable growth story, capable of generating compounded real economic growth of 5-7% per annum for the next few decades. It is estimated that, according to Morgan Stanley and S&P Global, by the end of this decade India could be the third-largest economy in the world, after the US and China. India recently surpassed the UK to become the world's fifth-largest economy.

Rising per capita income will drive discretionary spending by 10% CAGR over the next decade

The middle class is growing strongly, fueled by urbanization, and the economy is benefitting from rapid digitization and new technologies. The country should become a USD5 trillion economy by 2026-27, according to Mr. V. Anantha Nageswaran, Chief Economic Advisor to the government of India. India's per capita GDP in current prices is estimated to increase from the current level of USD2,200, to USD3,700 over the next five years, according to estimates from the Statista. The increase in per capita income will boost demand for the consumer discretionary goods and services, including non-grocery retail, autos, insurance, education, leisure, and luxury goods. According to Morgan Stanley projections, over the next ten years, the aggregate amount for non-discretionary spending in India should increase from the current level of USD1,384 billion, to USD3,605 billion, a compound annual growth rate (CAGR) of 10.0%.



Source: Morgan Stanley Research estimates

India vs. China growth trajectory: narrowing gap

India's expected growth trajectory is often compared to China's, in terms of forecast demand for consumption, investment, and exports. China's economy is currently nearly five times the size of India's, but in 2007 China's nominal GDP stood at USD3.6 trillion, the same as India's current size. China became a USD 7.5 trillion economy by 2011, and India's economy should be about that size by 2031. It is expected that India's private consumption, investment and exports will increase by the similar multiples seen in China during the latter's years of high growth. Assuming this is broadly possible, India will likely become a key player driving global growth during the next decade, similar to China's earlier contribution.

Indian demographics look more favourable compared to China's. India's median age is 28 (the same as China's in 2007), which is 11 years less than China; China's working population has been declining since 2015, according to the United Nations, India's young population should support good long-term growth, and given India's relative comparative advantage to China it is expected to grow relatively faster.

	China		India	
Figures in USD Billions	**2007**	**2011**	**2022**	**2031E**
Nominal GDP	3,551	7,549	3,358	7,771
GDP Per Capita (USD)	2,688	5,596	2,393	5,140
Private Consumption	1,292	2,636	1,987	4,468
Investment (GCF)	1,438	3,523	1,026	2,681
Exports	1,353	2,100	674	1,880

Source: CEIC, Morgan Stanley Research Forecasts

India is emerging as a new global manufacturing destination

India was and remains a beneficiary from the disruption in global supply-chains that began during the pandemic, particularly in manufacturing. Many large global players who had set up manufacturing facilities in China have and/or are looking to add India, as their 'China +1' policy. One such example is Apple iPhones now being manufactured in India. Indian chemicals and petrochemical manufacturers

are benefitting from the implementation of tighter environmental rules in China, higher funding costs, and the increasing competitiveness of India, partly due to increasing labour costs in China. In addition, post Covid-19, Indian government polices remain focused on the country being as self-reliant as possible, for instance by the promotion of domestic manufacturing in the defence and railways industries. Some 70% of the defense procurement budget (USD7.1 billion) for fiscal 2022-23 is allocated to domestic defense manufacturers.

Exports are driven by services

Among emerging and developing countries, India is the largest exporter of services, within a grouping mostly known for exports of manufactured goods or commodities. In 2021-22, service exports driven by software services stood at an all-time high of USD254 billion, 19% higher than in 2019-20. India is known as 'office to the world', and during Covid-19 offshoring picked up further. The Indian government has set a target of USD1 trillion of services exports by 2030.

Recently, India has successfully delivered on multiple fronts, and demonstrating the scale and speed with which the country is adapting to change. India's economy was quick to recover from the pandemic, with more than 2.2 billion vaccine doses administered; 74% of the population has received one doses, while 64% has received both doses. Over the two years of the pandemic, India successfully ran the world's largest free food program, for nearly 800 million people.

Successful and even faster digitalization of the economy

India has made substantial progress in the field of digital payments. The country's indigenous electronic payment platform, the Unified Payment Interface, is a real-time payment system regulated by the Reserve Bank of India. Currently 250 million daily transactions are being done through this platform, and in fiscal 2021-22 the value of transactions exceeded USD1 trillion, 55% above the previous year. According to Cisco, the total number of internet users in India is estimated at 840 million, up from 357 million at the end of 2017,

due to the rising penetration of smart phones and due to availability of affordably-priced data. The monthly consumption of data in India is among the highest in the world; mobile data consumption has increased from an average 3.5 Gigabyte (GB) per person per month in 2017, to 17.5 GB currently. This has helped India to digitalize its economy quickly in recent years.

Better infrastructure to drive growth

According to the World Bank, India needs USD840 billion in investment over the next fifteen years to sufficiently enhance its urban infrastructure to meet the growing demand from urbanization. Over the past two decades substantial improvements have already been made to improve the country's infrastructure; for instance the total length of national highway has increased from 58,000 kilometers in 2003, to 136,000 kilometers in 2021. Indeed the government continues to allocate higher amounts in annual budgets towards infrastructure spending, and the cumulative benefits of this - and good multiplier effects - should continue to help improve productivity and boost economic growth.

The next capex cycle is expected soon

The investment-led capital expenditure cycle in India is expected to pick up strongly during the next few years. Industrial capacity utilization is close to what could be a trigger point (at 73.4%, the highest in the past 12 quarters for the top five players in most of the core sectors - cement, metals, power, and refining, according to The Economic Times of India), and we would expect this to stimulate the next cycle. The last capex cycle peak in India took place in 2010-11. Many large capital goods companies in the country now have strong order books, yet may need extra capacity to deliver.

Another important factor expected to contribute to the next capex is the continued cleansing of the books at the large public sector banks. During previous capex cycles, high commodity prices, negative real interest rates, and 'crony capitalism' led to overspending and below-par capital allocation. However, Indian corporates are still quite cautious, having learned from previous mistakes, and their focus remains on profit and cashflow generation. Having said this, the government's policies are designed to boost capital formation. We remain positive on India's capital goods sector, and we expect its capex cycle to accelerate sometime in 2023.

Inflation is driven by higher commodity prices

In 2022, India suffered rising inflation just as many other countries globally, and particularly due to higher commodity prices. Annualized inflation rose to 7.8% in April 2022, before cooling to 5.9% in November. The Reserve Bank of India (RBI), in coordination with the central government, has an inflation target of 4%, with an upper tolerance of 6%. In order to help control inflation, the RBI raised the repo rate four times during 2022, to 6.25%. Inflation is expected to decline further, and given that commodity prices have corrected recently.

However, any rise in crude oil prices would be expected to boost inflation once again. India imports nearly 85% of its oil demand, so firmer oil prices put pressure on foreign exchange reserves and inflation. India's foreign reserves have declined from USD634 billion equivalent at the end of 2021, to USD525 billion as at October last year, before partially recovering to the current level of USD564 billion.

Indian Rupee depreciation was lower than most of the emerging market currencies

By late 2022, the Indian Rupee (INR) had depreciated by approximately 11% against the US dollar during the year (to USDINR 82.73). The INR has done relatively much better than most EM (and some developed market) currencies. India's current account deficit (CAD) is expected to jump to a 37-quarter high of 4.4% of GDP (i.e. USD36 billion, compared to USD9.7 billion, or 1.3% of GDP a year earlier), according to The Economic Times. This expectation of a rising CAD can be linked with possibly higher crude prices.

Higher fiscal deficit

India's fiscal deficit target set by the government is 6.4% for fiscal 2022-23, vs. 6.9% a year earlier. The government recently reiterated that it is on track to meet the current year fiscal deficit target, however for the past few years - due to increased government spending and lower tax collections linked to the pandemic - India's fiscal deficit has risen. The government is targeting a 4.5% fiscal deficit by 2025-26. However, with economic growth picking up, the central government's direct tax collection grew by 24.3% for the first seven months (April to November) of 2022-23.

Supply of skilled of manpower is a challenge

A key ongoing challenge faced by India is to continuously 'upskill' its labour force for ever-changing new job requirements. The attrition rate in the important software industries has gone up, due to stronger demand and a shortage of software engineers for certain jobs in high demand. Also, the level and quality of education and training needs to be enhanced, and to be more job-oriented, for India to remain competitive, and to make its labour force more employable given growing automation and digitalization across industries. In India, female participation in the labour force remains low at 31.4%.

New first-time equity investors are boosting monthly inflows into the market

An increasing number of first-time investors are entering the market, reflected in 30 million new domestic accounts being opened in fiscal 2021-22, taking the total number at the end of the period to 96.5 million. By the end of November last year the total number of accounts reached 106 million, more than twice the 49.8 million accounts at the end of December 2020. This is indeed quite explosive growth. During the last few months the number of new accounts has slowed, perhaps normal after such a period of account formation. Having said this, monthly inflows through systematic investment plans into mutual funds very recently rose to an all-time high of close to USD1.6 billion equivalent; this clearly reduced market volatility, and represents a powerful force in Indian equities. Previously, the market was overly-dependent on net foreign inflows.

Better managed companies and higher Return on Equities justifies premium valuation

Given the high Return on Equity (RoE) - often higher than 20% - achieved by many quoted companies, Indian equities have tended to trade at a premium to emerging markets generally, and forward P/E ratios of 20x or above for India have become the norm. Seasoned investors know this underlines investor confidence, sound regulation, transparency, and good corporate governance. Indian companies tend to be well-managed and borne out of a uniquely entrepreneurial mindset. India is a global leader in software, pharmaceuticals, and automotive ancillary industries.

India has achieved superior historical annualized returns of circa. 10% over the past decade in USD terms

India was one of the best-performing markets last year, with the S&P BSE SENSEX Index up by close to 7.7% just prior to the year-end. Over the past 10 years the Indian market has generated close to a 10% compound annual return in USD terms, compared to just 2% for the broad MSCI EM (Emerging Market) Index.

CONCLUSIONS: Bloomberg consensus earnings growth for the SENSEX stands at 19.16% for fiscal 2023/24, followed by 14.30% for 2024/25, resulting in prospective P/E ratios of 18.6x and 16.3x respectively. By the end of 2023 investors will begin to discount expectations for the 2024/25 year, and we believe a P/E of 16.3x for that year looks very good value in early 2023. We note that estimate revision has been positive, therefore medium to long term earnings growth could be in a range of 14-17% per annum, bringing the P/E ratio down. Lastly, at 14.3% of the MSCI EM Index, and just 1.6% of MSCI All Country World Index capitalization, Indian equities are distinctly under-owned. Given the growth story outlined above, we believe the investment opportunity in this asset class to be outstanding. For regular investors, using Dollar Cost-Averaging could be highly appropriate (please see the article on this elsewhere in the GIO).