Thematic Opportunities Arising in India

COVID-19 has impacted lives, livelihoods, and economic growth in almost every country. India, given its significant and dense population, is deeply impacted as seen by its 500,000 recorded infections and 15,000 deaths. It is likely that economic recovery is likely to be slow and measured as most of the stimulus so far has been directed towards the supply-side rather than demand. Businesses are struggling to cope with where to cut costs to ensure survival and maintain margins i.e. capex related to capacity expansion, operational costs or selling and marketing expenses.

As an *active fund manager,* it is important to determine which businesses may be less impacted by changes in demand (inelastic to changes in aggregate demand) and supply chain shortages. Equity markets will allocate more capital to either less problematic industries or those with greater visibility on the other side of the COVID-19 valley.

The investment themes present in our fund are considerate of the challenges of managing a portfolio through this environment. We also recognise that typically when interest rates drop in India, it creates a more conducive environment for private investment to take place. Fortunately, this is occurring concurrently with lower oil prices. These factors which should start to benefit the economy once demand starts to respond.

We address five themes which are incorporated within our portfolio today:

1) High quality financials
2) Communication and internet penetration
3) Market leaders winning market share
4) Rural wealth rising
5) Pharma – India's comparative advantage industry

High quality financials (exposure 20%)

India's growth has been driven by its financials over the last decade. Household debt and credit growth has led to strong profitability growth by its Private Banks offering new bank accounts, increased level of services and a shift towards financialisation as the economy shifts from asset-based saving towards financial savings. Despite issues with non-performing loans in the industry, India's private banks grew given their lower level of exposure to problem corporate loans from the last decade.

Going forward we expect these trends to continue given the low starting point – a point quite distinct to developed economies where household debt levels are far higher. This is not to say that COVID-19 and the slowdown of the economy alongside loan and interest moratoriums will not bring challenges. However, the underlying trend of the economy still have a long way to go and high quality private banks like **HDFC Bank**, **Kotak Bank** and **ICICI Bank** are placed well to benefit from fragmentation of the Government owned banks and resulting rising market share.

We also hold exposure to **HDFC Limited** and **Bajaj Finance**, both leaders in their category of Housing Finance and Consumer Finance. Once again, it is not that these industries wont encounter problems, but more a function of rising market share for the market leaders in both areas as the industry consolidates.

Finally, India's banks will remain optically expensive on a P/B basis relative to their global peers. This is because of the growth opportunity they offer to investors. Their book values have been rising by double digit levels as the country increasingly moves towards penetration of financial products and continue a path of modest to high credit growth relative to global peers.

Communication and Internet Penetration (exposure 14%)

COVID-19 has taught us the importance of connectivity, data usage and the internet – that is if we did not know it already. In a landscape like India, these factors are going to drive a significant growth opportunity. India has close to 1bn mobile phone users and chews up more data consumption than most countries in the world (including developed economies).

As internet penetration continues to rise in the country, we can expect the demand for connectivity and data usage to rise significantly. Take the recent deal by Facebook (owns WhatsApp, which has 440m users in India, the largest in the world) to acquire a 10% stake in Reliance Jio platforms. Jio Platforms has founded in 2016. The company has onboarded 380m subscribers since then by offering data usage for free initially. Armed with deep pockets for investing into the future, the company (**Reliance Industries**) brought the industry to destruction with all players making losses. The survivors (**Bharti-Airtel, Reliance**) are now benefitting from rising ARPU and a rationalising industry. Companies like Facebook, Amazon, Walmart, Samsung and Apple are all seeking exposure to India's growing hub on consumers seeking to be connected.

Market Leaders Winning Market Share (exposure 20%)

When economic contraction occurs it usually leads to defragmentation of industries, with several smaller players not being able to cope with falling demand or supply chain issues. This has been occurring in India over the last few decades with the profit pool of the largest players in each industry increasingly concentrating. Imagine an economy which emerged from an agrarian background which was largely decentralised and unorganised in business. Given the reforms of demonetisation and GST as well as an economy driven by services and urbanisation, we have seen a shift which is pronounced and favouring organised business.

Market leading companies (not necessarily large caps) are therefore becoming more dominant in their industry and are able to maintain and grow their pricing power through their financial stability, high return on equity and cash flow generation. Post COVID-19 we expect these companies to dominate further rather than see a cyclical shift towards the 3rd and 4th players. We expect the environment for companies benefitting from economic leverage is still 2-3 years away. By this stage market dominant companies will be in the best position to thrive.

Finally, it is also our view that foreign investors seeking exposure to Indian companies which are underpinned by fundamental growth. They are not really looking at India for dividend, value, or cyclical plays (utilities or commodities). Hence, they are more likely to pay up for growth given P/E's can drop away quickly in this economy if the story remains intact. Refer to some of our core holdings within this theme:

Company	Industry	Market Dominance
Maruti Suzuki	Automobiles	Over 50% of passenger vehicles
Symphony	Air Coolers	World's leading air-cooler manufacturer
Nestle India	Food & Beverage	Nestle's most profitable economy
Motherson Sumi	Auto Ancillary	Serving global car manufacturers for engine wiring
Larsen & Toubro	Infrastructure	India's largest infrastructure player

We also hold exposure to India's largest adhesives, CPVC pipe, biscuit, jewellery, paints and 2-wheeler manufacturers and retailers. These are all companies that dominate their industries.

Rural Wealth Rising (exposure 11%)

COVID-19 has largely presented a problem for India's metropolitan centres like Mumbai, Delhi and Chennai. The problem has not spread significantly to rural areas (which still holds close to 2/3 of India's population) given the lockdown put in place from mid-March to the end of the May. One of India's most populous and agrarian focused states in Uttar Pradesh (equivalent to the population of Brazil) has only 18,000 infections and 19 deaths (Brazil has 50,000 deaths).

Additionally, the South-West monsoon has arrived on time and is expected to deliver rainfall which is equivalent to the long-term average. This monsoon is important to rural India is terms of planting and harvesting crop. Rural wealth is driven by this harvest, which then leads to consumption across multiple areas.

For example, one area which has seen no real slowdown during COVID-19 expect for the month of April was tractor sales. In fact, the company was impacted more in supply chain and thus meeting demand rather. The year ahead should be positive for not only tractor and equipment moving companies in rural areas, but also fertiliser, seed and rural consumption focused companies.

India's Comparative Advantage Industry (exposure 7%)

India is the largest exporter of generic drugs to the rest of the world. However, whilst this might be more than 20% by volume, it is only 3% by value. This is largely because the history of Indian pharma has been a focus on high volumes in low margin products, leveraging its low-cost production base. However, some trends have emerged over the last decade which are more pleasing. Firstly, India's pharma companies have increased their R&D to sales, conforming towards global averages of 15%. Secondly, Indian pharma companies are increasingly lodging their own drugs at the US FDA for clearance. Finally, there is increased focus from regulators, industry bodies and the government on establishing India with its huge pool of scientists, lower cost of labour and growing local market to drive the sector harder as a potential comparative advantage for the country.

However, one of the negatives is the cost of compliance when submitting a drug to the US FDA. This can be significant and be met with significant issues and cost delays. It is more likely that the companies which will thrive will have a greater focus on local manufactured drugs for local consumption as well as research focused businesses which can leverage their IP, without the significant costs of compliance of manufacturing facilities. It is unlikely that the US FDA will accelerate clearances of foreign drugs at the detriment of their own industry.

Our focus in this segment is on companies that can grow from a focus on health and wellness (increased share of the wallet) in India, particularly as local GDP-per-capita rises from low levels. Drug research being outsourced to India also provides opportunity rather than housing manufacturing in India for export purposes.