Investing in Secular Mega-Trends: Indian Domestic Consumption and the Rising Middle-Class

Most developed markets are experiencing a low growth resulting in investors looking for higher growth opportunities in emerging and frontier markets. In the last few decades, investors seeking alpha have sought out Greater China. In the last few years, India's growth has been accelerating relative to China. Driven by the domestic consumption and a rising middle class, the Indian economy is on the verge of experiencing a multi-year growth cycle.

"India's economy is poised to leapfrog from its current seventh-place position to the third-largest economy by 2027 with $6 trillion gross domestic product." – Morgan Stanley Research Estimates

Source: http://databank.worldbank.org

How to Capture Alpha in India

In our view, investors who take advantage of the right opportunity set in India such as investing in companies which are direct beneficiaries of the domestic consumption theme will continue to generate good returns irrespective of the risk factors associated with investing in India such as politics, policy decisions, employment, weakening currency, etc.

The Indian consumer is relatively diverse given multiple languages and the number of ethnic sub-groups. When this is combined with the infrastructure challenges, it can be difficult to reach the consumer. As such, companies with strong brands and deep penetration will continue to reap benefits of this consumer spending upsurge. Identifying and investing in such companies can help generate substantial alpha on a sustainable basis.

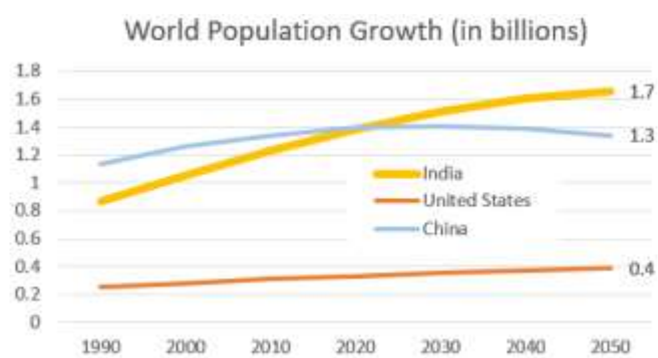
The aspirations of the Indian consumer are similar to consumers in other developed countries, and companies that target these aspirations have the ability to grow earnings strongly over a multi-year period.

Why Invest in India?

A Burgeoning Workforce

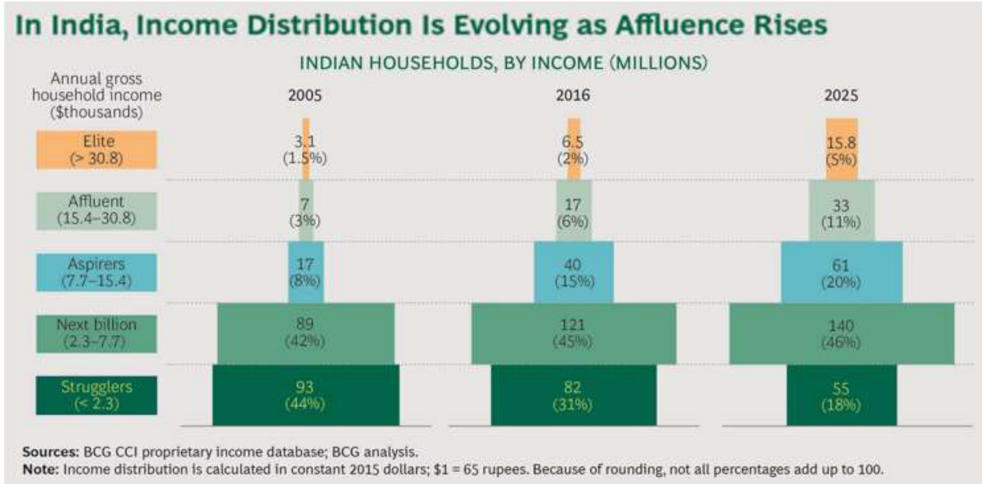
- 150 million Indians are expected to join the workforce in the next 10 years and the per capita income is expected to grow 2x by 2027.
- About 60% of the population is under the age of 29 and is about to join the workforce.
- Reasonably educated, skilled and quite enterprising population
- By 2027, 69% of the Indian workforce will consist of Millennials.

Source: http://databank.worldbank.org



Rising Middle Class

"By financial year 2024-25, Morgan Stanley expects per capita income to rise 125% to $3,650. The report said India's millennial population of 400 million is the largest in the world and is armed with around $180 billion in spending power, and with high smartphone adoption and widespread availability of mobile broadband infrastructure, it will become a disruptive force faster than most businesses expect." – LiveMint.com



Society Changes are Fueling Consumerism

- Growth of nuclear families: people move away from their parents'/family household and stay on their own.
- Dual-income earning families: women are earning a livelihood on their own even in interior towns and villages.
- Urbanization: increase in the proportion of people living in towns and cities.

The current generation--the young generation below age of 29 years--has grown in a liberalized/globalized India (where liberalization began in 1991). As such, it has been exposed to various consumer influences led by mass media/social media and accessibility/availability. This is feeding into the young consumer's aspiration levels.

Digitization and Tax Reforms

- Morgan Stanley estimates that the current 38% countrywide Internet penetration will increase to 60% by 2020, with 90% of them connected by smartphones. The increase in smartphone usage is set to drive the e-commerce and online retail market.
- Over 1.3 billion people have been digitally authenticated and over 305 million new bank accounts have been opened under the 'Aadhar' and 'Jan Dhan Yojana' implemented by the government.
- Along with digitization, demonetization has also played a part in increasing the digital transactions. From an archaic cash based economy, India is moving towards a formal digitized economy, set to support the growth expansion.
- In July 2017, the nationwide GST replaced the patchwork of value-added, sales, and excise taxes levied by 29 states and the federal government. A uniform tax structure and centralized registration process makes easier to start or expand the business. The government is providing tax breaks to SME with revenues less the 50 Cr INR.

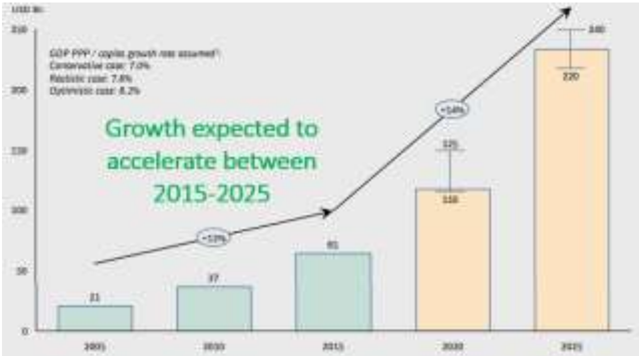
A Reform-Minded Government

- A single party stable government: reforms like demonetization and GST along with other factors are making the economy more formal and increasing the tax compliance.

A Diverse Investment Universe with Very Little Competition

- The total number of offshore single manager funds in India combined is ~60 and is small compared to the same in US (>1000).

Growth in the FMCG Sector (Fast-Moving Consumer Goods)



Along with rising income, the FMCG sector is expected to experience leapfrog growth.

"FMCG sector to grow at a CAGR of ~14%. This implies FMCG is expected to increase 1.8x by 2020 (~$110-$125 USD Billions) and 3.6x by 2025 (~$220-$240 USD Billions)."

Source: BCG, "Re-imagining FMCG in India"

Economic Growth

- India's real GDP growth is expected to remain over 7% in the coming years while the inflation is expected to remain stable around 4%. The nominal GDP growth of India over last 20 years has averaged about 11.7%. **If you extrapolate this growth to 2017 GDP, India will become a $5 trillion economy by 2022/2023 which will make it the world's third or fourth largest economy, thereby making it an important investment destination.** India was the 10th largest economy at beginning of 2014 and now is the 6th largest global economy.
- India's Inflation is under control at about 4% and is expected to remain stable.
- Indian IPO market is on the rise with 38 IPOs being introduced in 2017.
- Moody's upgraded India's sovereign rating after 14 years to Baa2 with a stable economic outlook.
- Fastest growing economy with a growth rate of 7.4% for 2018 which is expected to rise to 7.8% by 2019 – IMF.

What are the ways to invest in India?

ETF's

- Given the complexity of investing in India from offshore jurisdiction and given the need for ID and tax issues, the easiest way to invest in India is to invest in Indian ETFs which tracks the benchmark indices.
- However, most ETFs on India are benchmarked against the Nifty 50 Index (in USD terms) and this index may not truly represent overall growth stories in India or the domestic demand focus. One has to note that Nifty comprises of 50 stocks while there are > 5700 stocks listed on National Stock exchange (NSE). A number of nifty constituents are in government owned companies or companies focused on global growth like the IT sector.
- Most good quality single manager funds have significantly outperformed the Nifty index over a longer period of time.
- The Nifty index constituents are being changed far too often in recent years so the index has lost some significance and the volatility in this index is in the range of 18-20%.
- Most India ETFs are not very liquid so may not be an option for institutional investors.

Actively Managed Funds

While investing in ETFs is a simpler option for individual investors, generally most institutional investors including endowments/foundations prefer to invest with managers who give them exposure to broader variety of Indian companies. However, before investing into India focused funds, one needs to understand their investment style and philosophy and be comfortable with the same. There are about 60 such India focused single manager funds. Most India focused funds tend to invest in small-cap / illiquid stocks or in so called value stocks, such as cheap stocks, which generally results in investing in value traps more often than not. Also, small-cap / illiquid stocks tend to be a lot more volatile and such funds' performance get affected if there is redemption pressure In difficult market conditions.

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Challenges India faces/Risks to Investing

1. **India has been a land of hopes and promises** and has always looked good from a longer term point of view; however, investors have been disappointed in the past. The disappointment is mainly driven by the nature and vibrancy of Indian democracy and bureaucracy, policy reforms and measures being delayed or simply blocked in implementation. This also causes a lot of volatility and cyclicity to the Indian growth story.

   Mitigants: One should focus only on where the true secular story of India lies and which is devoid of any policy related benefits.

2. **Fiscal deficit:** Indian policy makers in the current and even the previous administration have been quite prudent in the path to fiscal consolidation. Current Fiscal deficit stands at 3.3% of GDP and the aim is to bring it to 3% of GDP. Increasing tax compliance and measures towards formalization of the economy in recent years are helping to improve Government revenues.

   Mitigants: Government has shown significant resolve in keeping fiscal deficit levels to targets spelt out in Union Budget and has so far not resorted to populist measures of reducing taxes on crude oil which will impact fiscal deficit targets.

3. **Currency risk and Current account deficit:** Current account deficit for 2017 was at 1.5% of GDP and it's expected to be around 2.6% of GDP on account of rise in oil prices. It is important to note that over a longer period, Indian currency has depreciated about 3.6% on annualized basis, though the depreciation is not linear but in steps. Investors should factor in this INR depreciation in their return expectations.

   Mitigants: Indian rupee has been one of the weakest currencies in Asia, depreciating about 12% for 2018. However, effect of rising Oil prices around USD 80-90 per barrel has now been factored in, in terms of effect on both current account and fiscal deficit and current levels of Rs 71-72 should be attractive for investors to look into entering India. Yes, definitely any strength in Oil above $90 /barrel would lead to further weakness in INR in the short term.

4. **Political risk:** General Elections are due May 2019. Investors are concerned whether the current regime led by PM Modi will return to power. PM Modi's regime is widely seen as being much less corrupt, having implemented some strong policy measures which are meant to help the economy. It is widely expected that PM Modi will return to power albeit with a reduced majority. Indian electorate is quite unpredictable and it is anybody's guess at this stage.

   Mitigants: India has been a story of two steps forward, one step back but the private sector's especially good quality companies continue to generate strong growth and returns for their shareholders and that will continue. **Over the years, good quality Indian corporates have learnt to continue to thrive, not because of the government but despite the government**.

5. **Valuations:** Given the growth environment, strong domestic equities culture and limited availability of good quality companies, the Indian Equity market always looks expensive generally relative to other emerging markets.

   Mitigants: The market corrects in a straight line on account of various extraneous events like politics, currency, corporate scams/bankruptcies, global sell-offs, geopolitical concerns etc. These are the times when opportunity presents to an investor to buy good quality stocks at reasonable valuations. Most of the times these stocks recover pretty quickly because the domestic institutional investors also tend to then migrate to such good quality stocks. As such, it is either prudent to buy and hold good quality stocks for the long term or enter the Indian market when there is a sense of crisis to build a portfolio of good quality stocks at reasonable valuations.

Special Thanks to:	Vikas Gattani , Chief Investment Officer Progress India Opportunities Fund (PIOF) P: +65 6820 8701 M : +65 9109 4085 E: vikas@progress-capital.com	Progress India is an absolute return focused Hedge fund with a differentiated strategy, focused on the most secular part of India's story - the rise of consumer spending, given the young Indian demographics. www.piof-india.com