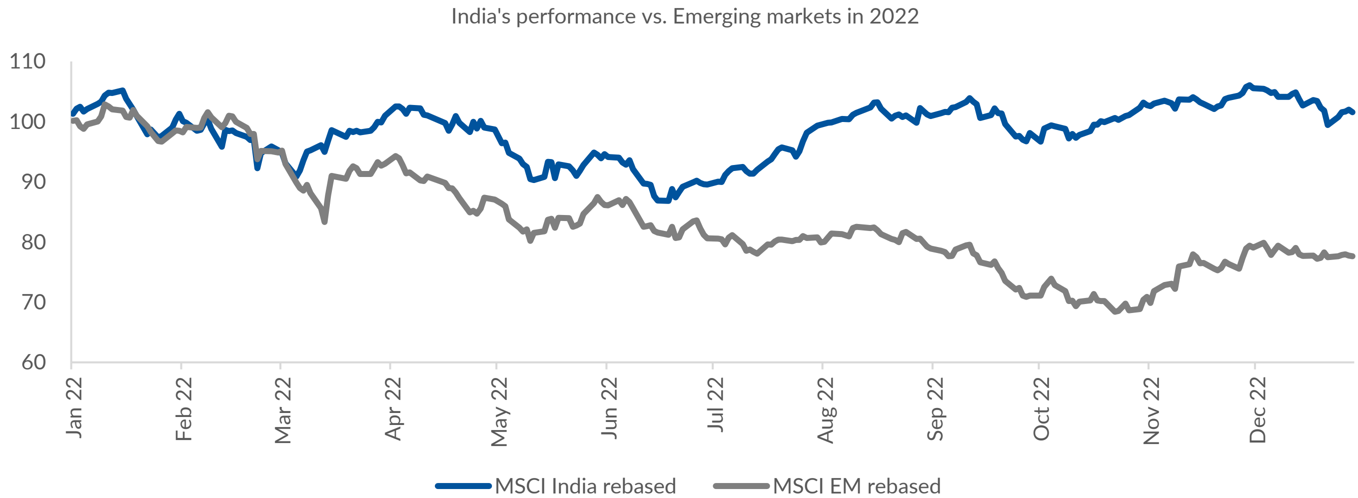
India Capital
GROWTH FUND

# HOODnote: India is an investment, not a trade.

2022 may not have been as good as 2021 in terms of absolute numbers but it was a great year for India especially against other emerging markets. India also stood out in terms of relative performance against global equities which had their worst year since 2008.

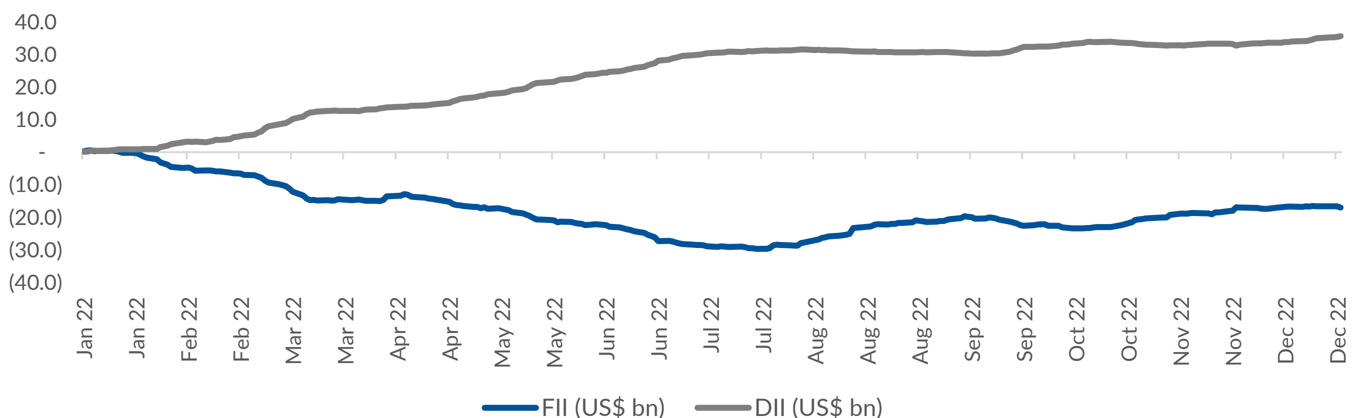



Source: Ocean Dial Asset Management, Bloomberg

The above performance is particularly gratifying as it comes on the back of a challenging global environment – the Russia Ukraine War; a spike in oil prices; rising interest rates; and a flight of capital out of emerging markets including India. In the past, the occurrence of any one of these factors would have led to a sell-off in the Indian equity markets.

The economy has shown remarkable **`resilience'** in 2022 aided by:

- healthy growth in government tax collection
- a revival of private sector capex cycle and in the real estate sector
- consumption demand holding up despite high inflation
- stable currency buoyed by foreign currency reserves of US$ 560bn+ and rising inward remittances
- exports of IT services surpassing the oil import bill taking the pressure off the current account deficit
- domestic Institutional Investors (DIIs) including local mutual funds, emerging as a strong & steady buyer.




Source: Ocean Dial Asset Management, Bloomberg

## 2023 – Can India deliver on expectations?

As we enter 2023, we are confronted with divergent commentaries:

a) Western economies where discussions are centred around probability of a recession; and

b) A positive outlook for India's economy, where sustaining 6%-8% GDP growth for the next decade is the focal point of discussion.

The positive outlook is reinforced by IMF's / World Bank forecasts which list India as being among the fastest growing large economies in the world in the next 3 years, and over the next decade emerging as the 3rd largest economy globally (India's GDP surpassed UK in Q4 2022 to make it the 5th largest economy in the world). India is on track to becoming a US$ 10tr economy in the next decade (compared with US$ 3.5tr at present). This optimism is also reflected in the management commentary of most corporates.

So, as we enter 2023, two questions dominate the thought process:

(i) Will India be able to deliver on earnings expectations – running at 14-15% p.a. earnings growth for the market over the next two years (FY24/FY25*)?
(ii) Can the elevated valuations (both absolute and relative) be justified?

*FY24 is the fiscal year ending in March 2024, FY25 is the fiscal year ending in March 2025

### Earnings Growth

To answer the first question, there are several enabling factors at play, namely:

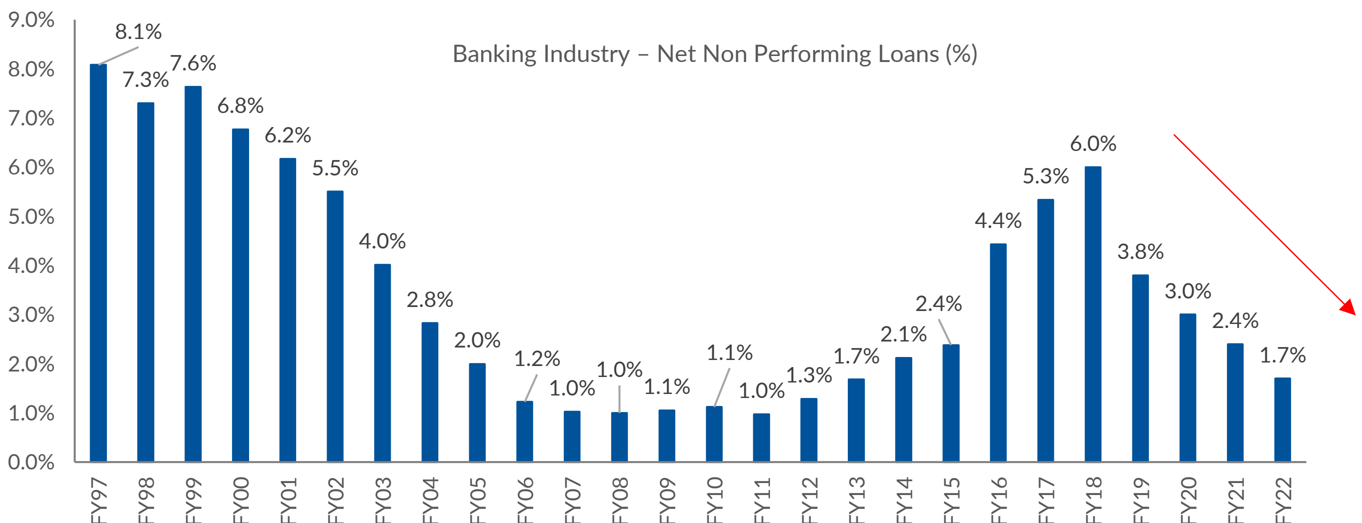
1. India's traditional bottlenecks such as poor infrastructure; the long lead time in getting regulatory approvals; the difficulty in purchasing land; and the high costs and availability of capital are no longer topics of conversation. In fact, states are competing with each other to attract investments. Even state elections are now being fought on development and growth rather than just caste and religion.

2. India is now competitive with other emerging markets on the cost front. Labour cost is one third that of China and tax rates are amongst the lowest in Asia, while specific incentives through Production Linked Incentive (PLI) schemes are offsetting other disadvantages. There is a recognition that India needs to be a manufacturing hub as it needs to employ its growing young population.

3. A public owned, low-cost, high volume digital infrastructure backbone has also helped India jump ahead several years in not just improving the ease of doing business, but also in the mainstreaming of the masses and small-town India with the rest of the economy.

4. As highlighted earlier, the private sector capex cycle (and real estate) appears to be gaining momentum. Capacity utilisation levels have crossed 75% and companies have announced increased capex plans. With the general elections in 2024 (and 9 States going for election in 2023), it is critical for, and expected from, the Government to sustain and encourage growth.

5. There is no stress in the banking system. Non-Performing Loans are at near record lows, banks are well capitalised and are ready to invest. The same goes for corporate India which has low leverage.




Source: Ocean Dial Asset Management, RBI

Simultaneously, there are areas of uncertainty:

1. At the consumption level, it is difficult to estimate the potential impact on demand due to high inflation. As highlighted earlier, urban demand has been strong, though there are pockets of weakness emerging especially in the discretionary space such as consumer durables and building materials, etc. This is however, not reflected in retail credit growth and with inflation peaking, it is likely to be temporary and is expected to be offset by improvements in rural demand. Hence consumption demand should broadly hold up.

2. The possible impact of a weakening global economy on India's exports which in turn could hamper growth. There are mitigating factors to argue that India should be less impacted than other markets though with India being the 5th largest economy, the global linkages cannot be discounted. These factors include:

   - A smaller share of India in global manufacturing exports (1.8% only)
   - GDP forecasts already being revised downwards to reflect a possible slowdown (6.1% from the earlier 8.4%, per IMF forecasts)
   - India gaining from the reallocation of global supply chains.

In summary, given the positive domestic levers, India should remain amongst the faster growing large economies. Also, unlike 2022, when revenue growth (led by price increases) was the driver of earnings, FY24 would likely be the opposite. We expect modest revenue growth (driven more by increase in volumes) and are confident that the corporates will be broadly able to achieve earnings growth of 14-15%, largely driven by rising margins as the costs normalise.

## Valuations

To answer the second question on elevated valuations, it is imperative to highlight that;

- the Indian market is trading above its historical average; and
- the valuation premium to emerging markets has increased, possibly making the rest of emerging markets look more attractive than India on a risk reward basis.

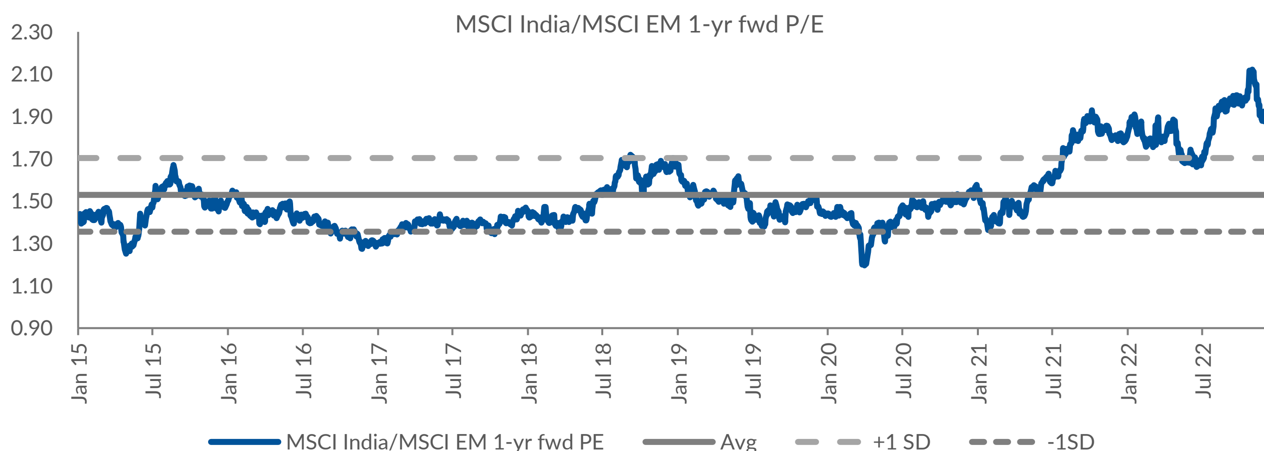
It is equally important to note that India has historically traded at a premium to emerging markets for the following reasons:

- Higher growth – this will remain, and the growth differential is likely to increase; and
- higher ROE – this is structural in nature due to a more diversified market, the nature of listed companies and higher cost of capital, which collectively force companies to be more capital efficient.

However, what has changed is the broad-based participation of the domestic retail investor, highlighted earlier as a trend which is most likely to sustain. This absorbed circa US$ 17bn of FII selling in 2022. The relative valuation gap can thus largely be attributed to India's resilience in absorbing such substantial selling pressure, which perhaps other emerging markets may not have been able to withstand.

The key issue is whether India would be able to trade at higher valuations than its historical average (approximately 10% premium to historical average). It should be noted that over the past 12 months, valuations have been trending downwards as earnings have played catch up. This is a trend that may continue in the future, which implies that:

1) 2023 could be a year of modest returns, driven by earnings growth, but a possible correction in valuations.
2) With China opening up, the valuation premium over emerging markets could narrow. We have already seen some of this play out over the last 2 months.
3) With India's share in the MSCI emerging market index increasing, India could benefit from higher allocations from passive funds should emerging market funds get inflows. This could be the joker in the pack.
4) In either case, the markets should be less volatile going forward with domestic flows providing the cushion. The risk of further FII outflows is mitigated.




Source: Ocean Dial Asset Management, Bloomberg

We believe India's valuation premium can sustain as highlighted by the above factors. India has enough tailwinds for growth, and we expect profitability of companies to improve as raw material pressures ease over the course of the year.

It is one of the few large economies with favourable demographics (set to overtake China on population in 2023, current median age of population is only 29 years) and an improving investment climate. This portends well for long term structural growth. India needs to be viewed from a longer term perspective i.e. India is an investment not a trade.

### India Capital Growth Fund - Current positioning and expectations thereof

From Ocean Dial's perspective, the focus remains on the individual stock valuations at a portfolio level, rather than concerns on the global macro front or on market valuations. Companies delivering on earnings expectations and our own estimate of fair value remains the key focus. In this aspect, we find over 55% of the portfolio trading below their fair value on FY24 earnings. However, absolute returns on FY24 earnings appear moderate. The big returns will come as we move towards FY25 earnings, with high earnings growth likely to drive returns.

Our largest sector exposure is in the financial space which has a long runway on growth, low risk on credit quality for the next 2 years (at the very least), and yet valuations are reasonable. Credit growth is trending in double digits and banks are well capitalised.

Our second largest exposure is in consumer companies which are our "earnings compounders". We have a wide range of consumer businesses from staples, building materials, quick service restaurants, garments and even electronic manufacturing services. The consumer portfolio has seen a decisive tilt towards more discretionary plays over staples. We are playing the pick-up in domestic growth and real estate revival through exposure in cement (11%) and industrial (5%) stocks. At the same time we are also well positioned to capitalise on the gains India is likely to make as economies rebalance supply chains out of China. There are several stocks across sectors which are already seeing a positive impact including Dixon & Kajaria (consumer), Welspun (textiles), Skipper (industrial). Others like PI Industries & Aarti (specialty chemicals) are also potential gainers.

With respect to our benchmark, the portfolio's overweight positions are in financials, materials, consumer staples and IT services. The portfolio's metals exposure is not through global commodities but instead through cement and speciality chemicals companies. We are underweight healthcare, having exited Divis Laboratories. One of our biggest underweights remains utilities and industrials.

| As at 31st December 2022 | P/E FY23 | P/E FY24 | Earnings Growth FY23 | Earnings Growth FY24 |
|---|---|---|---|---|
| ICGF Portfolio | 23.1 | 16.9 | 23.0% | 36.5% |
| Nifty 50 | 22.2 | 18.9 | 15.1% | 17.8% |

Source: Ocean Dial Asset Management, IIFL

So we enter FY24 with one of the highest aggregate earnings growths for our portfolio, India Capital Growth Fund. While a low base effect for some sectors like banks and cement have contributed to these high earnings numbers, broadly most sectors are expected to see healthy earnings growth.

We remain confident with our positioning as we enter the year with a portfolio having higher growth and lower valuation than the broader market.

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