Source: www.entrepreneur.com

THE OUTLOOK FOR INDIAN EQUITIES

2022 AND BEYOND

INDIA AVENUE INVESTMENT MANAGEMENT www.indiaavenueinvest.com

India's future shaped by Smart Cities *Source: www.financialexpress.com*

POWERED BY FUNDAMENTALS

India has underachieved its enormous potential in the past, resulting in GDP per capita of approximately US$2000. However, the country it is fast approaching an era of rising productivity as its dependency ratio declines. In fact, by 2030, India will account for close to 23% of the world labour force.

India remains about 10-15 years behind China is terms of GDP per capita. Its pace of ascent will be more measured with different drivers.

Over the course of the current decade India's economy and stock markets are likely to rise in prominence from US$3 trillion to US$5 trillion. India's stock markets, however, will not just be driven by foreign investors, but also by rising local investment and acknowledgement of equity investment as a way to generate wealth.

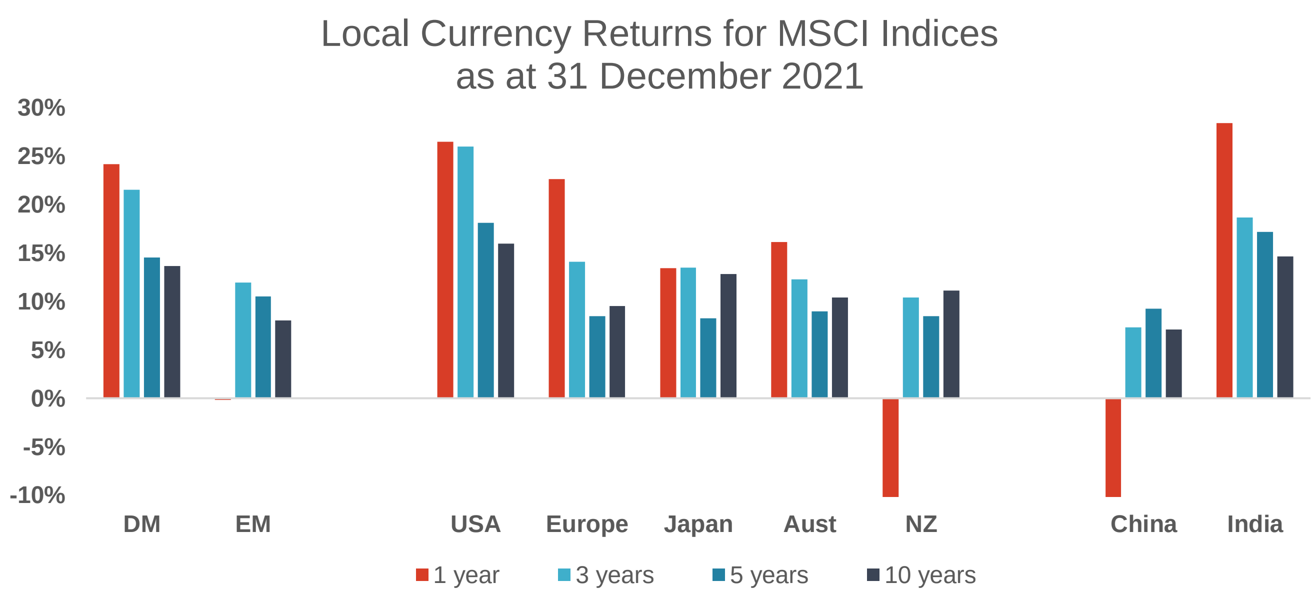
EQUITY MARKET RETURNS

Increasing Dispersion in the face of Deglobalisation

Equity market returns over the last 12 months validate increasing dispersion by country based on the impact and response to the pandemic and the speed of its economic recovery and leverage to the “new economy”. This inevitably results in a greater focus on technology, renewables/ commodities, healthcare and global supply chains.

Greatest Dispersion seen in Emerging Markets

Emerging Market returns have been poor particularly over the last 12 months as the dispersion between China and Brazil (-11.4%) and the rest of the countries making up the Emerging Markets Index has been significant. India, Taiwan (Technology), Russia and the Middle East (Oil/Energy) have all experienced strong 12-month returns.



Source: MSCI

Local Currency Returns

Whilst the general practice is to provide return comparisons in USD, it is our view that currency movements in future are less predictable. Hence, we have illustrated local equity market returns for this comparison. Over the last decade the USD has strengthened against most currencies (DXY is up 20%), however that may not be the case in the upcoming period.

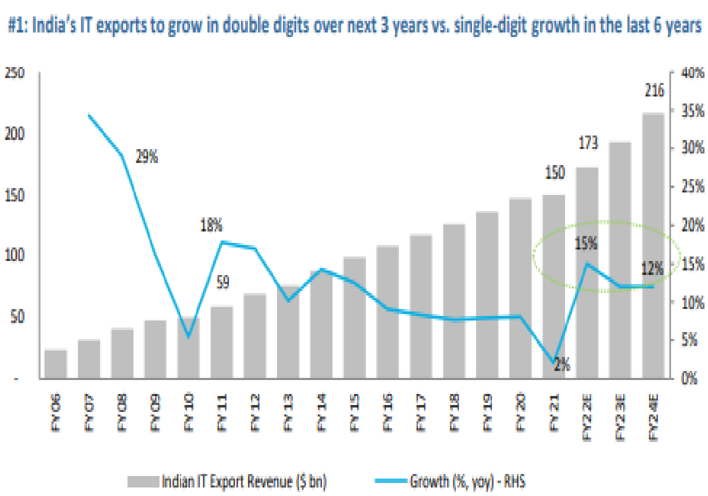
US Dominance (2011-2021)

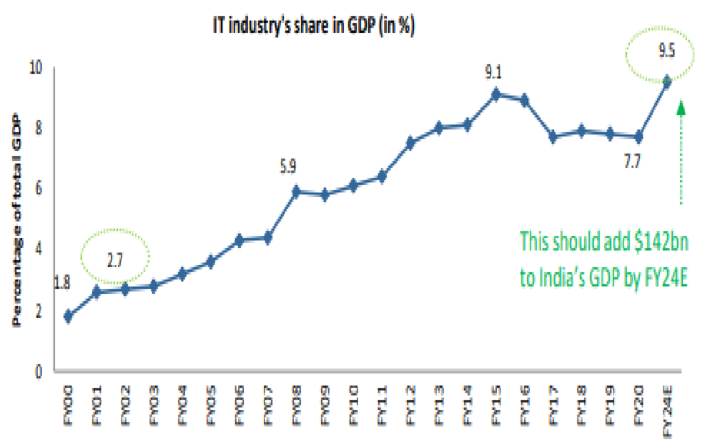
The US markets have been extremely dominant post GFC as capital has continued to flow towards US companies which have benefitted from larger addressable markets, growth and innovation, within a supportive liquidity and interest rate regime.

THEMATICS IN PLAY

Technology – Multi Year Growth Tailwinds

- India is the leading sourcing destination across the world, accounting for approximately 55% market share of the US$200-250bn global services sourcing business in 2019-20.
- The export revenue of the IT industry is estimated at US$150bn in FY21. The industry is above 8% of India's GDP and employees over 4.5m people.
- India-headquartered IT services companies doubled revenue market share from 13.9% in 2010-2011 to 28% in 2021 fiscal, while share of foreign-headquartered companies (Accenture, IBM, DXC, Atos, Capgemini, and Cognizant) shrunk from 86% to 72% during the period. The revenue of India-headquartered firms rose to $59bn from $24bn over the last decade.
- Indian IT firms have shifted their role over this period from pure service provider to a consultant/enabler to global firms in cloud migration, data analytics/AI and enabling businesses to benefit from an enhanced digital platform.
- India's digital architecture has now accelerated given access to lowest cost data and far more significant local smartphone and internet penetration.
- Revenue growth, which has averaged 5-10% p.a. for the IT services industry over the last decade, is likely to accelerate to 10-20% p.a. (in USD terms) over the next 2-3 years as firms increase IT capex. Companies are exhibiting strong deal wins, outpacing increases in employment cost and attrition
- India's IT Industry will move to the dominate exposure in India's equity indices akin to China





Source: Spark Capital, Nasscom

Our Portfolio

The India Avenue Equity Fund currently has 24.0% allocated to Information Technology relative to its benchmark, MSCI India's 19.8%. However, part of this overweight position also reflects digitisation plays and not purely IT outsourcing companies. We envisage remaining overweight to this sector as the market catches up to rising earnings, improving margins and easing supply chain issues.

Transition to Renewables

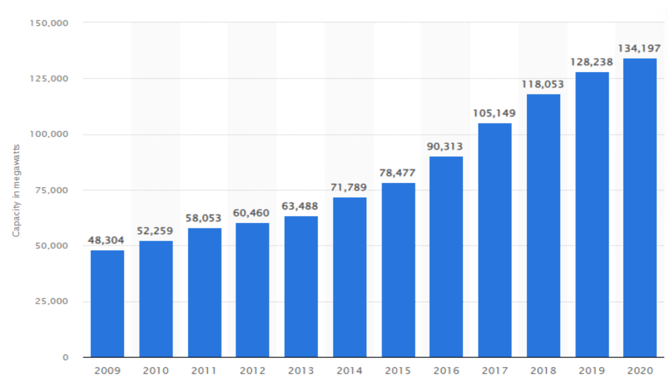
India is the worlds third largest consumer of electricity and the third largest renewable energy producer with 38% of total installed energy capacity in 2020 coming from non-fossil fuel sources. India has a target of producing 50% by 2030 (500 GW) from renewable energy. The source of this energy is predominantly from Hydroelectricity, but also increasingly from Solar and Wind. Currently most of India's energy needs are met by Coal (approximately 55%).

India will achieve net-zero emissions by 2070

Prime Minister Narendra Modi at the Glasgow, COP26 conference

Source: www.thenewztub.com

The transition of energy from fossil fuels to non-fossil fuels presents India with significant opportunity both from a reducing influence from the need for oil and coal imports to an opportunity to build significant capacity for renewable energy. This will have a profound impact on the current account and the country's macroeconomic fortunes. At the COP26 conference the Indian Prime Minister emphasized the need for advanced nations to support the efforts of developing nations by providing finance and technology. Without such support, the developing countries are unlikely to meet the key targets.[1]



Given low interest rates, the potential for assistance/funding and rising demand, it is likely that a capex boom will prevail in investing in renewable energy and meeting the rising energy intensity. This typically accompanies an economy moving from low GDP-per-capita (India is only 14% of the global average at US$1,800) to US$5,000-$10,000 (China is just over US$10,000).

Source: Statista

Our Portfolio

The India Avenue Equity Fund holds some exposure to companies which are likely to benefit from the thematic of rising investment in energy intensity through renewables such as Indian Energy Exchange, Hitachi Energy and Torrent Power. None of these companies are constituents of the MSCI India at this stage. It is expected that our allocation to this area will increase through indirect beneficiaries until the commercial aspects of investments in the space are better understood.

Additionally, our ESG overlay on the portfolio screens out companies which are deemed "harmful" to the environment, as part of our process.

[1] *The Diplomat, India Commits to Net-Zero Emissions by 2070, Santosh Sharma Poudel*

Supply Chain Diversity

Several businesses have sought to diversify their supply chain post the impact of COVID-19. Whilst China will remain as the most significant player when it comes to global supply chains, we are likely to be at an inflexion point in terms of other scalable economies being considered as alternatives for manufacturing, even if on an incremental basis.

Economic policy in India has sought to accelerate this shift through the introduction of Production Linked Incentive (PLI) schemes. Whilst this was originally introduced in April 2020 for mobile phones, pharma products and medical equipment, in November 2020 it was extended to 10 further industries including electronics, telecom, food, white-goods, solar, auto and ancillaries, batteries, textiles and steel. This seeks to create local manufacturing "champions", introduce foreign capital and expertise, and generate opportunities for India's employable population.

The Government of India announced a philosophy upon the onset of the pandemic to be more self-reliant. However, the focus was not to close the doors to global engagement, but to rather open them wider, and become a part of global interactions and businesses as an equal, trusted partner.

In fact, India has emerged as a global manufacturing hub and effectively surpassed the United States to become the world's second most desired manufacturing destination[2]. India provides various advantages for companies worldwide through relatively cheap land and labor, ever-improving infrastructure, and policies in favor of a thriving business partnerships. Further, there is ample government support and corporate tax rates have been reduced (30% to 25%).

	1980	**1990**	**2000**	**2010**	**2020**	**2021**
Global Manufacturing Rk						
India	15th	14th	14th	10th	3rd	2nd
China	7th	7th	4th	2nd	1st	1st
USA	1st	1st	1st	1st	2nd	3rd

Our Portfolio

The India Avenue Equity Fund holds exposure to several companies which are benefitting from India's improving manufacturing prowess across several industries. We expect several industries to continue to emerge as potential competitive advantages for India as global business continue to seek diversity in their supply chains.

Pharmaceuticals	Divis Laboratories, Dr Reddy's, Aurobindo Pharma
Auto Ancillaries	Endurance Technologies, Motherson Sumi
Automobile	Tata Motors, Maruti Suzuki, Ashok Leyland
Steel	Tata Steel
Specialty Chemicals	Clean Science & Technology
Engineering	AIA Engineering, Larsen & Toubro
Air Coolers	Symphony
Textiles	Welspun India

[2] *Cushman & Wakefield's 2021 Global Manufacturing Risk Index*

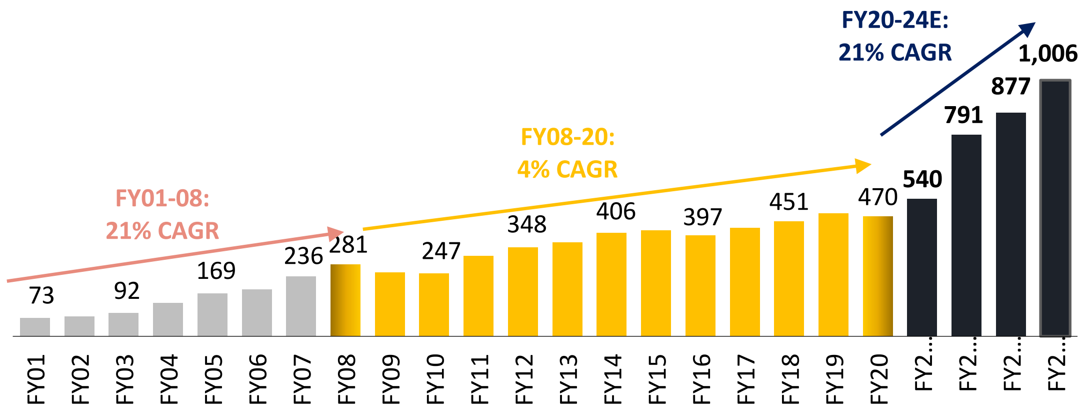
OUTLOOK

It is our view that the upcoming period should see the beginning of a capex boom as capacity utilization levels rise and businesses respond to rising demand by adding capacity. Despite the global threat of rising interest rates to keep inflation under control, global liquidity pools will remain broadly conducive to investing for growth.

India is likely to have incremental competitive advantages which exceed those of their developed and emerging market peers if it can successfully navigate between increasing trade whilst becoming more self-reliant. Rising exports and a significant level of foreign reserves place the economy in a strong position to deal with adversity i.e. rising energy costs/inflation, threat of wave 3 and the potential of disappointing earnings.

Whilst economies and stock markets around the world have thrived on the "recovery trade", we are more likely to see greater dispersion between industries and companies within these industries in future. Broad based theme/trend investing has helped all players within industries to be "tagged" in the same trade. Selection will become more important as winners emerge intra-theme/trend.

Nifty-50 EPS Growth Over Time + Consensus Expectations



Phase 1 2001-2008	Phase 2 2008-2020	Phase 3 2020-2024
Capacity addition, rising fixed capital formation, synchronised global growth	Slower global growth, bank asset quality, policy paralysis and reform indigestion, lack of private investment	Digitisation, financialisation and reform penetration. Switch from informal to formal. Rising exports and global growth. Low rates

India's equity markets by price have been cyclical, distinct to its earnings volatility. The Nifty-50's earnings growth exhibit low volatility (relative to other equity markets), which is typical of India's compounding earnings story of companies operating in significantly growing addressable markets.

It is our view that India's equity markets offer investors the opportunity to add on weakness, induced generally by global events. It is typical for the Indian economy and equity markets to thrive post global economic weakness or a recession.

In summary, we believe the following are supportive to long-term strategic investment in India over the course of the current decade:

1. **Greater productivity** from the Insolvency and Bankruptcy Code (2016), Inflation Targeting and Monetary Policy Committee (2016), GST (2017) and lowering Corporate Taxes (2019), introducing Land and Labour reforms (2020) to increase productivity and growth, direct benefit transfers to reduce leakage and production linked incentives (PLI schemes) (2020).
2. An upcoming **Capex Cycle** will be supported by low interest rates (resulting abundant liquidity), rising demand/higher capacity utilisation and resurgent business confidence which should lead to significant gross capital formation.
3. A focus on **ESG/Renewables** will lead to significant investment as India's energy intensity rises both from foreign direct investment, local private investment as well as the Government of India.
4. **Strong Momentum for IT Services** given significant focus on IT Capex by businesses around the world to provide a digital uplift to their business capabilities. This should play out over the next 3 years.
5. **E-Commerce / Internet** will continue to create opportunities as businesses seek to reach India's lucrative young population as a target market. This is creating substantial opportunities for unicorns to grow their business aggressively.
6. **Emphasis on Growing Companies** will continue with greater scrutiny in selecting winners. The economic recovery bodes well for companies who are building strength in a fast-growing addressable market as their valuations don't fully reflect their opportunity yet. These companies are the greatest wealth creators for investors in Indian equity markets, rather than the market heavyweights whose opportunity set maybe more recognised.