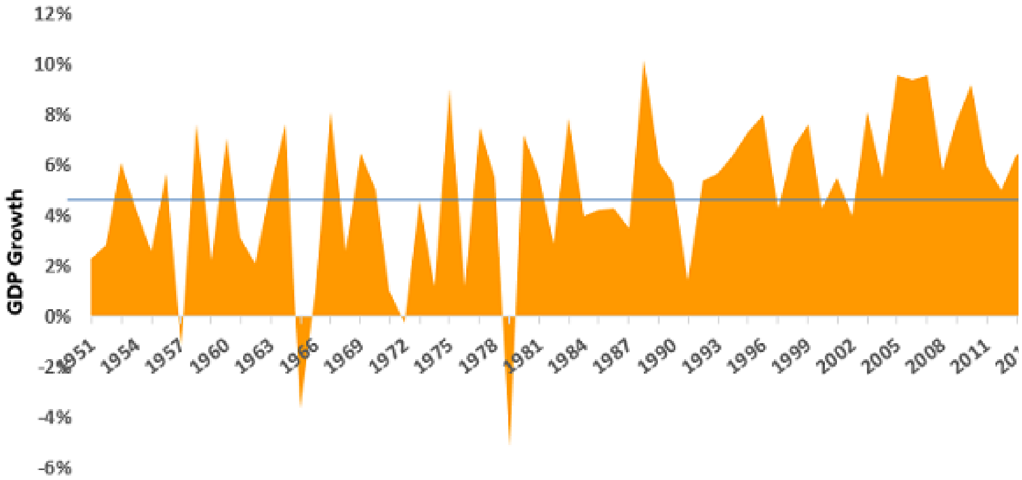
Harnessing India's growth by investing before the crowd

Mugunthan Siva | India Avenue Investment Management | 4 November 2015

The India growth story has been in progress for over three decades, effectively since the early 1980s.[1] Over the period, the services industry was the primary driver of growth in comparison to the agriculture and manufacturing sectors. This period followed a period of weak growth in the post-independence period from 1948 to 1980, where GDP growth averaged 3.5% per annum. Since 1980, GDP has averaged 6.2% per annum, a step up from the 5% per annum average over the entire period (Figure 1).

Figure 1: India's GDP growth
Year end:1950-2014



Source: Trading Economics, January 2015

A further step-up occurred at the turn of the century, particularly from 2003 to 2015 during which GPD growth averaged 7.7% per annum, largely driven by[2]:

- Growth in the services industry, driven by a large and increasing population[2];
- Strong growth of the workforce and the exporting of highly skilled outsourcing[3];
- Increasing openness to foreign trade; and,
- Rising foreign investment, following economic reforms commencing in 1991.

In 2014, India's political landscape underwent a significant change when newly elected leader, Narendra Modi, was sworn in on 26 May. Modi is the parliamentary leader of the Bharatiya Janata Party (BJP). The BJP won 282 seats and with their alliance partner, National

Democratic Alliance, together won a total of 336 seats in the 543 seat lower house. This was the strongest mandate for action given to a government in India since 1984.

The change in government has resulted in a pro-business-oriented approach and a shift in economic policy towards manufacturing. Through its "Make in India" campaign, the government aims to create jobs to employ a significant youthful population. This shift is required to facilitate increased investment, foster innovation, enhance skill development and protect intellectual property to promote economic growth.[5]

Both the World Bank and the IMF have re-rated their GDP growth forecasts for India upwards to 7.5% for 2015-2016. Moody's, IMF, World Bank and CRISIL (one of India's rating agencies) foresee growth rates of 7.5% to 8.5% per annum over the next few years, for the following reasons:[6]

- Falling interest rates as a result of lower inflation, which should promote private sector spending (Moody's Analytics);
- Business-oriented reforms which are likely to promote growth (IMF, World Bank);
- A shift from consumption-driven growth to investment-led growth (World Bank);
- Reducing red-tape and regulation to promote foreign investment (Moody's);
- Lower crude oil prices which should reduce inflation and raise real disposable income (IMF, World Bank); and,
- Lower external vulnerabilities from an improving Indian economy allowing it to cushion volatility in capital flows (CRISIL, IMF).

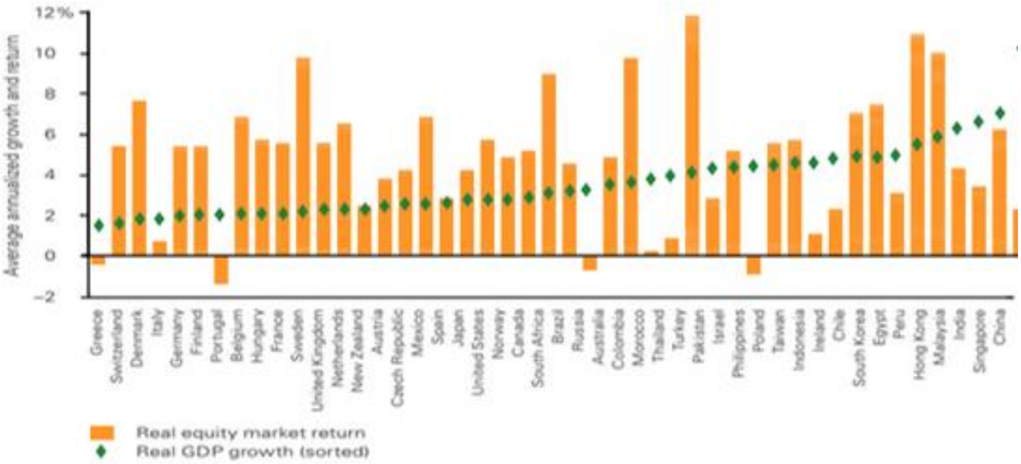
The renewed vigour in India's GDP growth which seems set to continue, in conjunction with a youthful and highly skilled population (58% below the age of 30[7]) is likely to result in a significant increase in household wealth, albeit from a low level. India's total personal disposable income has already risen 20% per annum over the past five years (2009-2014)[8], largely due to these facts.

Additionally, GDP growth will be driven by the significant need for increasing investment in infrastructure[9]. Decades of underinvestment have left India starving for capacity in roads, railways, ports, airports, telecommunication and electricity. In the World Economic Forum's Global Competitiveness Report 2014-15, India ranked 90th out of 144 countries for its overall infrastructure.[10] The need for infrastructure spending presents significant opportunities for growth. In its recent 2015-2016 budget, the Modi government clearly signalled its intention to kick-start infrastructure investment and un-block the pipeline of stalled projects. By increasing public spending, creating new infrastructure funds and creating a transparent investment path, the government seems focused on reducing the hurdles for foreign and local investors.[11]

DOES GDP GROWTH TRANSLATE TO EQUITY RETURNS?

While India's GDP growth has been strong for well over three decades, it hasn't necessarily led to strong participation in India's equity markets by foreign investors.[12] In general, returns have lagged relative to the country's contribution to global GDP (Figure 2).

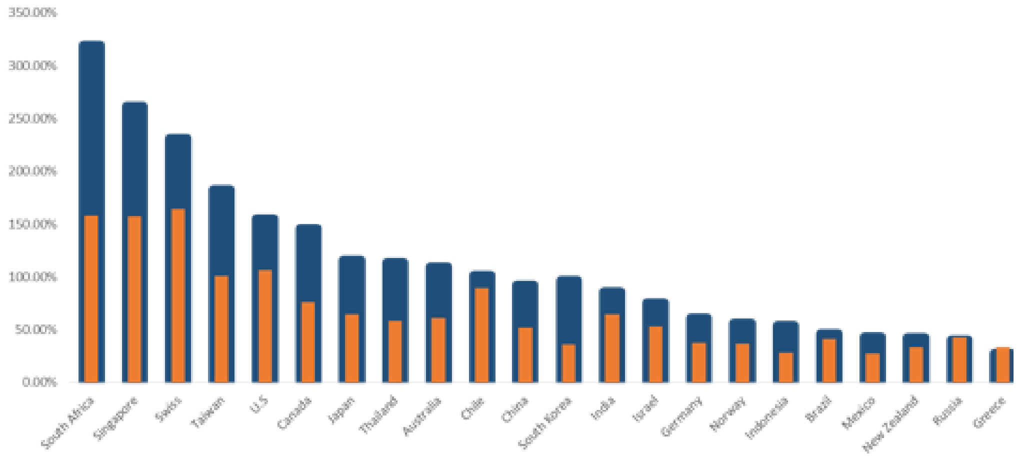
Figure 2: India's equity markets, not keeping pace with GDP



Source: Business Insider

Some of this can be attributed to the less developed nature of India's investment markets. The Market Cap-to-GDP ratio continues to be low relative to developed stock markets such as the US, UK, Japan and Australia (Figure 3). Over time, the average market-cap-to-GDP ratio for the 22 nations studied has been 112% (Figure 3).

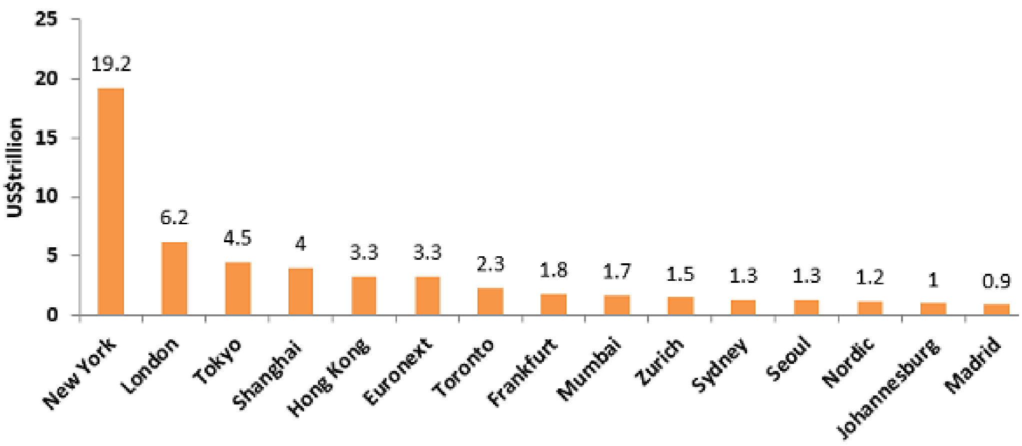
Figure 3: Current vs 1991-2015 Median Market-Cap-to-GDP ratios of 22 nations
June 2015



Source: National Inflation Association, "Market Cap to GDP Ratios of 22 Nations", June 2015

Despite this, India's market capitalisation is now larger than several developed markets including Australia and almost all other emerging markets excepting China (Figure 4).

Figure 4: Market Cap of Bombay Stock Exchange vs primary bourses of other countries
January 2015



Source: World Federation of Exchanges, Monthly Report. January 2015

Additionally, India's market-cap-to-GDP has been on the rise over the past 25 years (Figure 5).

Figure 5: Market Cap to GDP of India over time

Sources: World Bank, Jan 2015

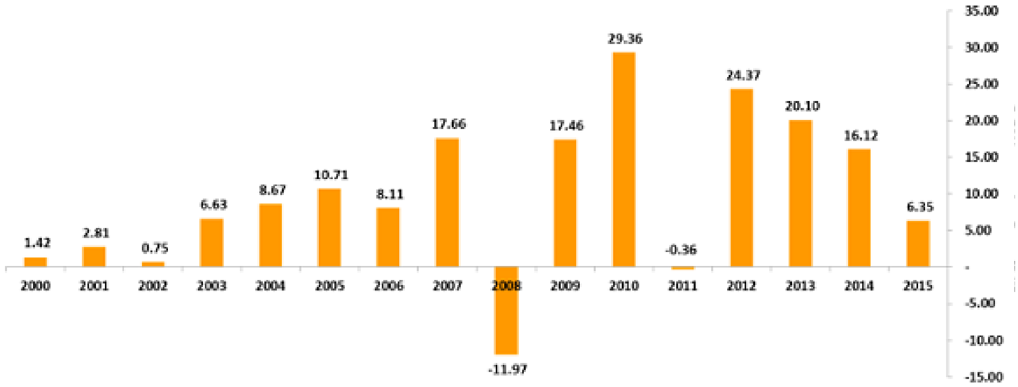
It is the authors' contention that India's market capitalisation should continue to increase, driven by some of the following factors:

1. Increasing foreign investment;
2. Increasing number of IPOs;
3. Rising local penetration; and,
4. Increasing market efficiency and transparency.

1. Increasing foreign investment

Foreign investment into India's markets has been volatile over time, but continues to increase (Figure 6). As India's GDP growth appears set to remain robust according to the IMF, investors who are seeking growth appear to be taking further notice.

Figure 6: Foreign institutional investment into India

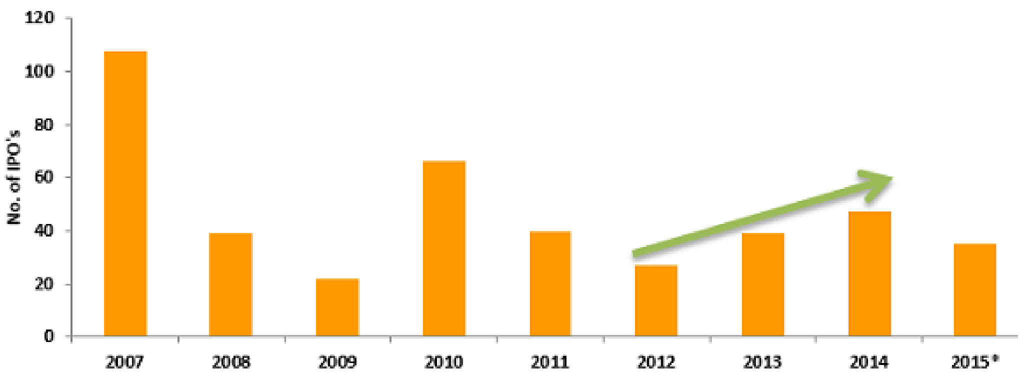


Sources: Moneycontrol.com

2. Increasing number of IPOs

Another way by which market capitalisation can increase is through new listings on the stock exchange. While GDP represents the growth of the broader economy, the stock market does not fully represent this growth, as several major companies are not yet public. India, being a less mature equity market, also contains several "young" companies which are yet to go public. However, IPOs are continuing to increase. A report by Ernst & Young found that the IPO market in India is set to rebound on economic growth, businesses being in need of capital, pent-up demand, favourable secondary markets and a backlog of financial sponsors waiting to exit.[13]

Figure 7: Number of IPOs in India
2007-2015



Source: Ernst & Young, Global IPO Trends 2014, Q4 2014

3. Opportunity in low local penetration

India's household savings rate is high, at 29% of GDP[14] however only a small proportion of savings is invested in local equity markets. Less than 1.5% of the population invests in securities, compared with 10% in China and 18% in the US.[15] Furthermore, just 2% of household savings are exposed to equities, whereas in the US the long-term average is 45%. Additionally, approximately 80% of those investing in India's equities markets reside in the top 10 cities by population.[16]

4. Increasing market efficiency and transparency

India's equity markets appear to have underperformed relative to potential. According to the US Department of State, "This has been driven by corruption, taxes, caps for foreign investment, inadequate financing, complex and lengthy investment approval and land acquisition processes, antiquated laws and poor contract sanctity and enforcement of arbitration judgements"[17]. The change in government in 2014 has led to expectations for a more decisive policy, increased transparency and a pro-business environment.

GLOBAL INVESTING

With India's equity market being less than 1% of the MSCI All Countries World Index,[18] the need for global equity investors who are benchmarked to this Index to undertake an investment via country-focused exposure to India has been minimal. Although Foreign Institutional Investor (FII) flows are increasing as seen above, they haven't been significant relative to India's share of global GDP.

Many investors are conscious of volatility when investing, with volatility generally deemed a measure of investment risk. The volatility of India's equity market has reduced its attractiveness as an investment proposition for foreign investors (Figure 8).

Figure 8: Volatilty of India's equity market vs global equity markets
(Local Currency terms, 10 years to 31 July 2015

	MSCI All Countries World Index (Local Currency)	MSCI India (Local Currency)
Volatility	14.2% pa	25.1% pa

Source: MSCI, India Avenue Research

This is not to say that foreign institutional investors have not thus far invested in India, as currently about 70% of the market is dominated by foreign institutional investors.[19] Indian equity markets and India's currency have been impacted by "the billions of dollars flowing, producing upward pressure on the rupee and a decline in India's competitiveness. When they flow out, usually at short notice, markets collapse and the exchange rate increases in volatiity".[18]

Figure 9: Assets under custody of Foreign Portfolio Investors in India
(USD$Bn) – as at Feb 2015

Country	Dec-14	Jun-14	Dec-13
USA	102.5	92.8	70.1
Mauritius	68.9	66	49.7
Singapore	26.5	23.1	15.2
Luxembourg	26.6	23.1	19.3
UK	16	14.5	12.6
UAE	9.9	9.5	7.8
Norway	6.2	6.2	4.6
Netherlands	6.3	6.1	4.7
Canada	7	6.2	4.6
Ireland*	6.4	BT10	BT10
Australia*	BT10	5.8	4.1
Others	36.7	32.6	23.1
Total	312.8	285.9	215.8

Source: SEBI/NSD, BT10 = Below Top 10

As Figure 9 shows, US-based investors have been the most significant investors in India, not surprisingly given the size of the US investor market. Mauritius is also a significant investor – its double tax treaty with India makes it a more attractive way to access India. Tax havens (Singapore, Luxembourg and Ireland) disguise some of the true locations from where investment into India is sourced. The US, Europe and the Middle East appear to be at the forefront of investing in India rather than Asia-Pacific countries. Australia has been a laggard, particularly given it now holds the fourth largest pool of pension assets in the world.[20]

INVESTMENT ACCESS VEHICLES

Investment options for accessing India's capital markets are relatively limited. Figure 10 highlights the issues to consider when seeking exposure to India's equity market. Generally, to best capture the growth story of an economy via investing in its equity market, the bias of investment must be directed towards companies which are benefiting from local business dynamics, rather than those companies overly exposed to foreign revenue sources.[21] Naturally, investing in only liquid stocks can create a significant bias towards the largest companies.

Figure 10: Investment vehicles for accessing India's capital markets

Format	Global Equity Fund	Emerging Market Fund	Asia-ex Japan Fund	Indian ETF	India Dedicated Fund
% of funds allocated to India	1%	5-10%	5-15%	100%	90-100%
Bias in market segment by capitalisation	Focus on Top 10 companies	Focus on the Top 20 companies	Focus on the Top 20 companies	Index replication	Combination of large and mid cap companies
Focus on liquid investments only?	Yes	Yes	Yes	Yes	No
Focus on stock picking within India vs allocation to India	Allocation to India	Predominantly allocation to India	Mix of stock picking and allocation to India	Index replication and fixed allocation to India	Fixed allocation to India and active stock picking

Source: India Avenue Research

ACCESSING INDIA'S GROWTH DRIVERS

While India's GDP growth has averaged between 6% to 8% per annum in recent history (Figure 1 above), there are industries growing at a rate which is faster than the broader economy, as shown in Figure 11. Industries mature at different times based on the competitive forces at play, driven by cyclical, structural and secular changes within an economy.

Figure 11: Examples of growth industries in India growing faster than GDP

Sector	Key drivers	Market Size by 2018-2020 USD $bn	Growth Rat 2012-202(CAGR %
Construction Equipment	Infrastructure, Exports, Global growth	23	29
Pharmaceuticals	Generics growth, Patent expiry, R&D, Global expansion	55	24
Retailing	Rising wealth, Aspiring culture, Increasingly organised, E-commerce	1,000	12
Real Estate	Foreign demand, Industry growth, Infrastructure	180	12
Media & Entertainment	Rising wealth, Consumers, Advertising	37	15

Source: IBEF: India Brand Equity, India Avenue Research. 2015

Banking is another sector participating in the growth of all sectors in India, given its role as financier. Total Indian banking sector assets have grown strongly, reaching USD$1.8 trillion (by March 2014), with both total asset and deposit base growing by 15% per annum over the two years to March 2014.[22] The banking sector is poised for further growth, driven by demand for business, housing and personal finance.[23]

BENCHMARK REPRESENTATION

A commonly used global equity market benchmark is the MSCI All Country Weighted Index (ACWI). This benchmark is composed on 10 different sectors developed by MSCI and Standard & Poor's as a Global Industry Classification Standard (GICS). While stocks which comprise the MSCI India are also aggregated into 10 sectors, there are several categories or sub-sectors within these sectors that have their own unique growth trajectory due to opportunities in the Indian economy. For example, one of the 10 sectors aggregates the exposure to all companies falling within Consumer Discretionary. In the context of Indian markets this includes Automobile, Media and Retail companies which have their own unique drivers.

Of the 10 GICS sectors in India, the largest weightings by market capitalisation are the IT, Financials and Consumer Staples sectors. These sectors have participated in the growth of India's economy over the past three decades, given their significant market capitalisation. However, some sectors such as Consumer Discretionary, Industrials and Materials are not highly represented in terms of market capitalisation (in MSCI India), but yet there are several emerging companies with future growth potential. These sectors are more likely to be nascent in their development and are thus highly conducive to opportunities for significant wealth creation for investors.

For example, retailing, which has a significant market size (Figure 10 above), has minimal representation as a sub-sector of the GICS classified Consumer Discretionary sector and a weight of below 1% in MSCI India.[24] This is driven by the fact that the development of the retail sector in India has largely been disaggregated with several small businesses, rather than in an organised, publicly listed format. Several e-commerce companies are now emerging but are still in the nascent stage and thus not yet listed.

The number of listed companies in each MSCI sector is not necessarily correlated to the size of the market capitalisation (Figure 12). For example, there are over 1400 listed companies within Consumer Discretionary, which is significant relative to its representation in MSCI India. However, other sectors such as IT are more consolidated into significantly large outsourcing businesses, where scale and economics are the keys to growth.

Figure 12: Market capitalisation of MSCI India in comparison to publicly listed companies in sector

Sources: India Avenue research, ACE Equity, MSCI India. May 2015

WHY INVEST EARLY?

Stock markets generally reward patient, long-term investors. The identification of an idea before the investment herd arrives allows for more significant investment returns to be made. Conversely, investing with the crowd can sometimes be a volatile and harrowing experience.

Larger capitalisation stocks tend to be mature, well-established companies with a significant brand or market presence and are therefore considered "safer" given they are well researched, their brands are well known and there is greater liquidity. Most large cap companies generally have a greater level of market efficiency in their pricing, arising from significant disclosure practice and high level of broker coverage. In India, these companies generally have a market cap of USD$5bn or more of which there are currently over 60 stocks.[25]

On the other hand, mid cap stocks in India are those that have a market capitalisation of between US$1bn to US$5bn. Currently, there are over 150 companies in India within this range.[26] Mid cap companies are generally more volatile than large cap companies, but less volatile than small cap companies (below US$1bn in cap).

Figure 13: India's market indices for Large, Mid and Small Cap Stocks
(31 July 2015)

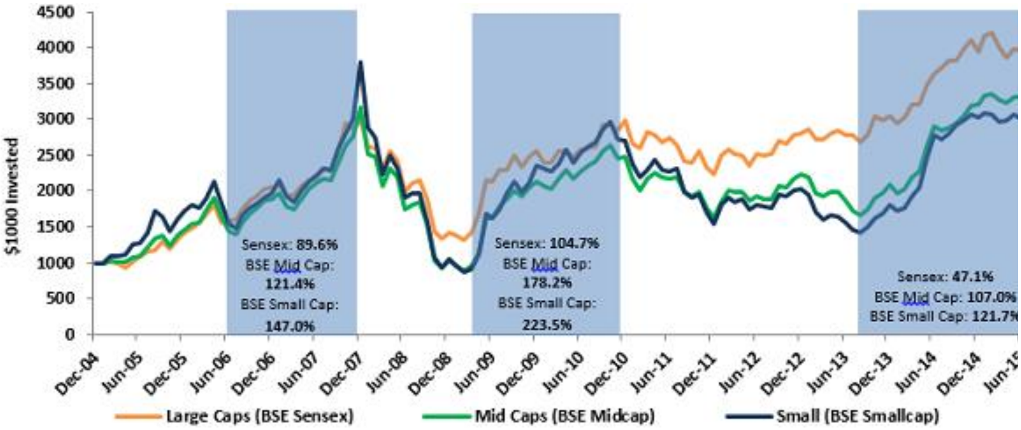
Capitalisation	Index*	Description	Constituents	Market Cap covered	Volatilit
Large Caps	BSE Sensex	30 largest and liquid stocks traded on the Bombay Stock Exchange (Free-float)	30	Approx 80%	24.4%
Mid Caps	BSE Midcaps	Next Tier of stocks which included with the Sensex covers 95% of the market (Free-float)	77	Approx 15%	
Small Caps	BSE Small Caps	Last Tier of 5% of stocks (Free-float)	583	Approx 5%	36.1%

Source: Ace India, BSE, Moneycontrol.com * These three indices cover approximately 93% of India's overall market cap.

Small cap companies have smaller revenue and client bases, and usually include the start-ups or companies in the early stage of development. Although there are 583 constituents in the BSE Small Caps index, there are over 5,000 listed companies in India[27] which, given that the economy is in a growth phase, continues to increase. Small cap stocks are potentially big gainers as they are yet to be discovered within the sector. However, care needs to be taken when researching these companies as they do not always have financial strength to survive bad times and can be mismanaged by their owner/managers. Hence thorough research regarding the promoters' credentials, management strength and track record and the growth plans of the company should be undertaken before investing.

To access the growth companies of India, it is important to consider early stage investing as returns can be significantly higher, particularly during periods where the economy is being driven by a cyclical growth spurt. Broadly, mid and small cap companies produce strong market returns during periods of market exuberance (as illustrated by the blue shaded bars in Figure 14 below) as they have greater leverage to strong GDP growth, economic upturn and domestic demand.

Figure 14: Performance of India's Large Cap vs Mid Cap stocks
BSE Sensex vs BSE Midcap vs BSE Smallcap as at 31 July 2015



Source: India Avenue Research

This point is best illustrated via a case study comparing the progress of two companies. Bharti-Airtel is a large cap stock, now India's leading telecommunication provider. Page Industries is a clothing company in India which has gone through a substantial price re-rating, but remains in mid cap territory, reflecting the potential investment opportunity.

Figure 15: Comparison of Bharti-Airtel vs Page Industries
31 July 2015

	Bharti-Airtel	Page Industries
IPO Date	Feb-02	Feb-07
Market Cap on IPO	USD$1.7bn	USD$80m
Current Market Cap	USD$26.1bn	USD$2.4bn
Stock Price - Last 5 years	6% p.a.	75% p.a.

Source: India Avenue Research

As figure 15 highlights, Bharti-Airtel has become more a mature company over the past five years, reflecting the lesser pace of growth of the Telecommunications Industry and Bharti-Airtel's existing leadership (it has 23% market share).[28] Although the opportunity remains significant given that Bharti-Airtel is well poised for expansion through acquisition of spectrum licenses and a large population, it is now a more mature company with more predictable revenue and profit. Bharti-Airtel's share price rose approximately 79% from 2002 to 2007, during a phase when the company was less researched by analysts and investors around the world.

Page Industries' revenue has been significantly driven by its Jockey brand of men's underwear, benefiting from a growing population of young consumers with access to increasing disposable income. However, from a global perspective, with a market capitalisation of US$2.4bn, Page Industries flies under the radar of large global or emerging market funds looking to invest in large and liquid companies in India. With companies like Page Industries, local investors are more likely to benefit from strong price appreciation before these stocks appear on the investible stock universe of global managers. Additionally, Page Industries is not a stock constituent of MSCI India and is therefore not part of the starting blueprint for global managers who use MSCI India as a benchmark for investing into India.

To discover these companies at an early stage it is important to have local market connectivity and network. This network is critical for identifying a good investment before the investment herd. A local network, usually a domain for local market investors, allows a deeper understanding through:

- Background checks on promoters;
- Discussions with bankers and trade partners;
- Inventory comparison at stores to competing brands;

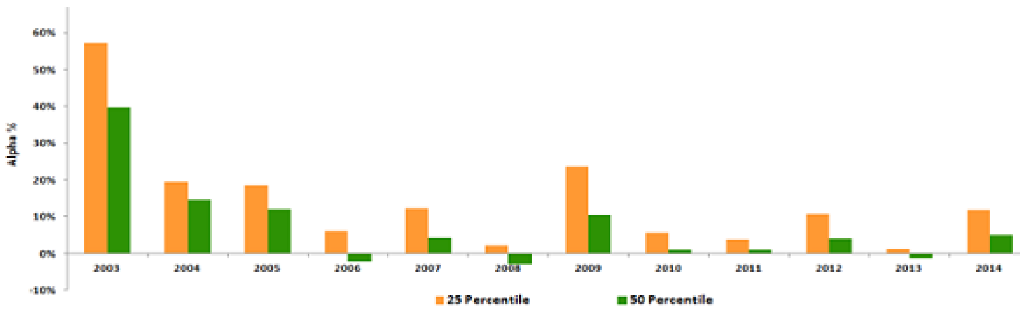
- Brand visibility and market pricing; and,
- Cash flow generation and velocity.

APPROPRIATE AVENUE FOR INVESTMENT

Global investors have many avenues to gain exposure to India's stock market and benefit from the strong growth dynamics of the economy driven by the demographic dividend, growth from infrastructure and rising household income. Of the many paths to choose from, long-term investors may want to consider exposure to growth segments of the economy and to companies which are not just large and liquid, but which are growing their earnings at a rapid pace. Global investors/funds require investments to be liquid as their view on India may change over time necessitating the need to trade their holdings. However, long-term strategic investors into the region do not have to be overly concerned about liquidity and thus may consider an exposure to large, medium or small cap growth companies.

Figure 16 illustrates the hypothesis that locally based managers in India tend to be highly skilled in selecting companies to outperform a relevant benchmark.[29] The data presented indicates that the median locally-based manager in India's mutual fund industry has outperformed the benchmark by 4% per annum on average over the last 10 years. However, selection of a local manager at the 25th percentile from a performance perspective reveals an average outperformance of 10% per annum over the period.

Figure 16: Alpha of locally-based managerd vs BSE 200
Calendar years



Sources: AMFI, www.tradingeconomics.com, BSE India, Bloomberg Consensus

Given that locally-based managers set themselves a broader benchmark (BSE 200 has 200 stocks, whereas the MSCI India has only 64 stocks) as a hurdle, they are likely to provide exposure to a wider range of opportunities by liquidity, market capitalisation and industry.

Local managers have been able to outperform offshore-based global managers with India dedicated funds. This is illustrated in Figure 1y showing the median locally-based fund outperforming the median off-shore fund by 2% per annum over the 10 years ended June

2014. The outperformance of local managers is particularly apparent during strong positive market environments (bull market) such as the years ending June 2005, 2007, 2010 and 2014.[30] As illustrated in Figure 14, these periods of strong market returns are also environments in which mid and small cap stocks outperform large cap stocks. Therefore there is correlation between local managers outperforming during periods of strong positive market returns, which is also linked to outperformance of mid to small cap companies.

Figure 17: India Dedicated Local Funds vs. Off-shore Funds

Year ending	Median offshore fund	Median local fund	BSE 200 Index
June 2005	47.6%	54.6%	47.7%
June 2006	45.8%	44.6%	37.7%
June 2007	60.0%	68.8%	71.3%
June 2008	-11.5%	-13.0%	-8.9%
June 2009	7.3%	7.6%	7.5%
June 2010	29.1%	34.3%	27.2%
June 2011	2.5%	4.4%	3.0%
June 2012	-6.2%	-6.0%	-7.6%
June 2013	11.6%	8.1%	8.7%
June 2014	35.1%	41.7%	34.5%

Sources: Bloomberg, AMFI, India Avenue Research

SUMMARY AND CONCLUSIONS

India is a growth market, which is being driven by population, demographics, need for infrastructure and strong export markets. The government is leading the way by improving the environment for conducting business and by focusing on enhancing businesses moving up the value-chain in terms of services provided, as well as facilitating the growth of manufacturing.

Several sectors are growing strongly in India, at rates well above GDP growth. These sectors are benefiting from secular, cyclical and structural changes occurring in India, but are at an early stage in their development compared to the larger, more mature industries. Companies within these sectors are now listing on India's stock exchange, seeking capital to grow their businesses and thus the investment opportunity for investors will increase.

Global investors often follow investment benchmarks, thus investing in mature large caps which have already experienced substantial growth. Such investors are not able to capture returns from local demand-driven growth stocks. Such returns can be best captured by skilled local investors who invest early, identifying opportunities through strong networks and intellectual property.

When investing in India, it is important to seek the ideal investment structure to capture the growth opportunities by investing before the crowd.

ENDNOTES

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28. Market Share of Wireless subscribers, Management Presentation, Bharti-Airtel April 2015

29. Benchmark is BSE 200

30. All returns in local currency (INR) terms.

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