Manulife Asset Management

Investment Note

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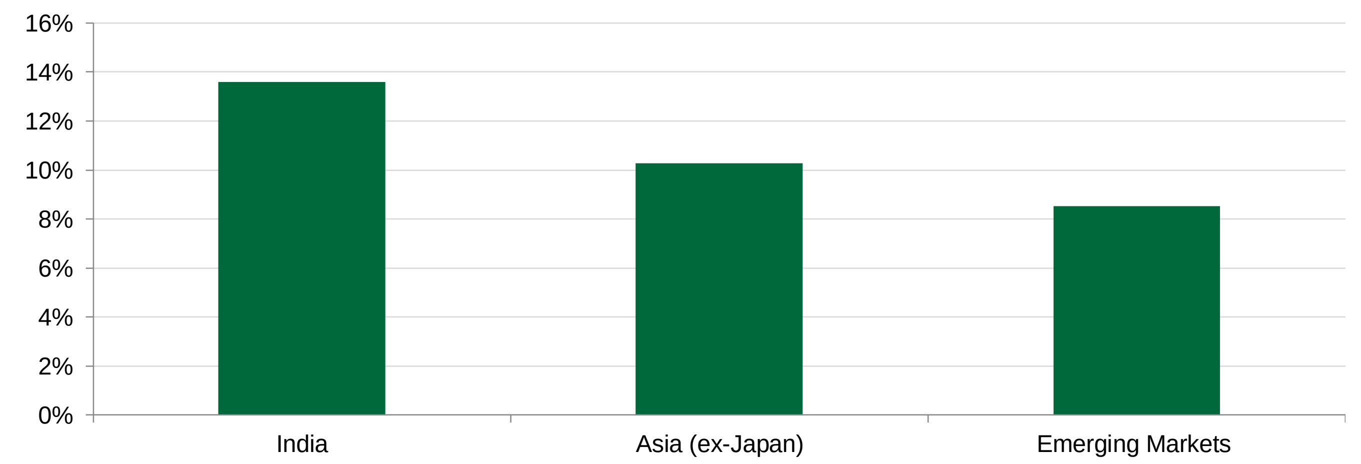
Four “F’s” are key positive drivers for Indian equities

Over the past two years, Indian equities have outperformed their Asia-Pacific and emerging market peers[1]. Structural reforms that laid the foundation of sustainable growth have been a key driver of this trend. This has strengthened the bottom-up domestic-demand driven story for Indian equities, particularly in the current uncertain global economic environment. In this investment note, Rana Gupta, Indian Equities Specialist, presents his investment thesis outlining how the Four “**F’s**”- **F**ormalisation, **F**iscal stability, **F**inancialisation, and (Re)**F**orms on banking asset quality-should serve as key drivers for sustainable growth. A transformational journey has begun; it should support growth, earnings, and, in turn, Indian equities over the medium-term.

Equity outperformance built on structural reforms strengthening a domestic bottom-up story

Indian equities have outperformed Asia (ex-Japan) and emerging-market (EM) stocks over the past two years (Chart 1). We expect this trend to continue in 2019, even against the current difficult macro backdrop of trade tensions and an uncertain global growth environment.

Chart 1: India’s equity market returns versus regional and EM peers[1]



[1] Source: Bloomberg. January 2019. Note: Return represents annualised returns from MSCI India (MXIN), MSCI Asia ex-Japan (MXASJ), and MSCI Emerging Markets (MXEF). Indices measured in USD terms from 30th December 2016 to 31st December 2018.

We believe India's outperformance among EM peers is driven by two long-term factors:

- India offers a unique bottom-up, domestic demand-driven story characterised by relatively low export dependency[2], favourable demographics[3], and a large services sector[4].
- The reforms undertaken to formalise the economy will have positive long-term implications in unlocking the potential of the Indian economy.

Of these two factors, we believe that reforms will be the most significant driver of sustainable growth and helping Indian equities to realise their promise of delivering solid returns. We suggest the Indian economy has the potential to grow 2.5 times over the next decade on the back of these policies. Over the past 18 months, for example, India has implemented several structural reforms promoting formalisation, such as indirect tax reform (e.g., the Goods and Service Tax, GST) and resolution of bad assets (e.g., Insolvency and Bankruptcy Code).

Recently, economic growth in India has moderated due to global financial tightening and implementation of structural reforms, which has created near-term volatility. That said, we believe the foundation for sustainable growth has been laid. We see four key investment themes supporting India's sustainable growth story: **F**ormalisation, **F**iscal stability, **F**inancialisation, and (Re)**F**orms on banking asset quality.

The Four "F's" drive sustainable economic growth prospects

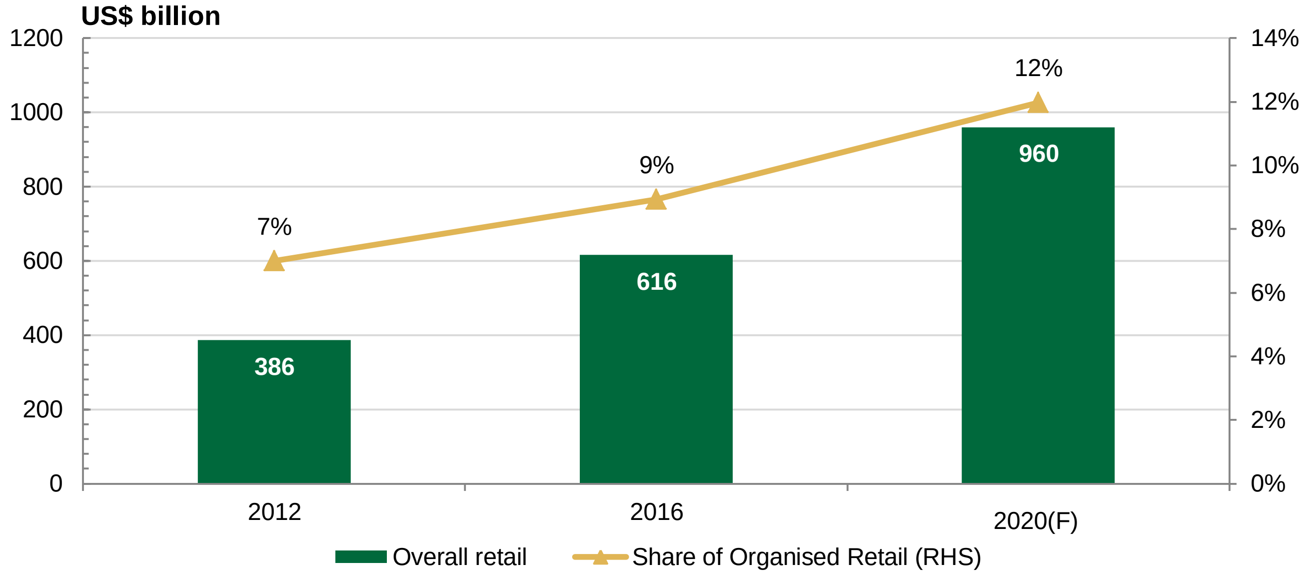
1. **Formalisation - Value migration to organised sector**

As a result of the GST, a value-added tax with input credits replacing most other indirect taxes, companies in India are now operating on an almost-level regulatory playing field. Indeed, the organised corporate sector now has a great opportunity to capture market share as many smaller and informal businesses restructure to comply with government regulations and taxes. This transformation is causing value to migrate from the informal sector to the formal sector- a process that we believe has just begun.

For the next several years, formal companies should find opportunities to grow market share in fragmented sectors, particularly with a large number of informal players. We believe the retail sector will be a prime beneficiary. We see structural long-term growth opportunities for organised retail players, which had a market share of just 9% in 2016. This has already started to play out over the past two years.

[2] Source: World Bank, July 2018. In India, merchandise exports to GDP ratio is 11.6%, compared to China's 15.5% and Indonesia's 18.7%.
[3] Source: CLSA, US Census Bureau, 2013.
[4] Source: World Bank, Kotak Institutional Equities, August 2017.

Chart 2: Organised retail's increasing market share[5]



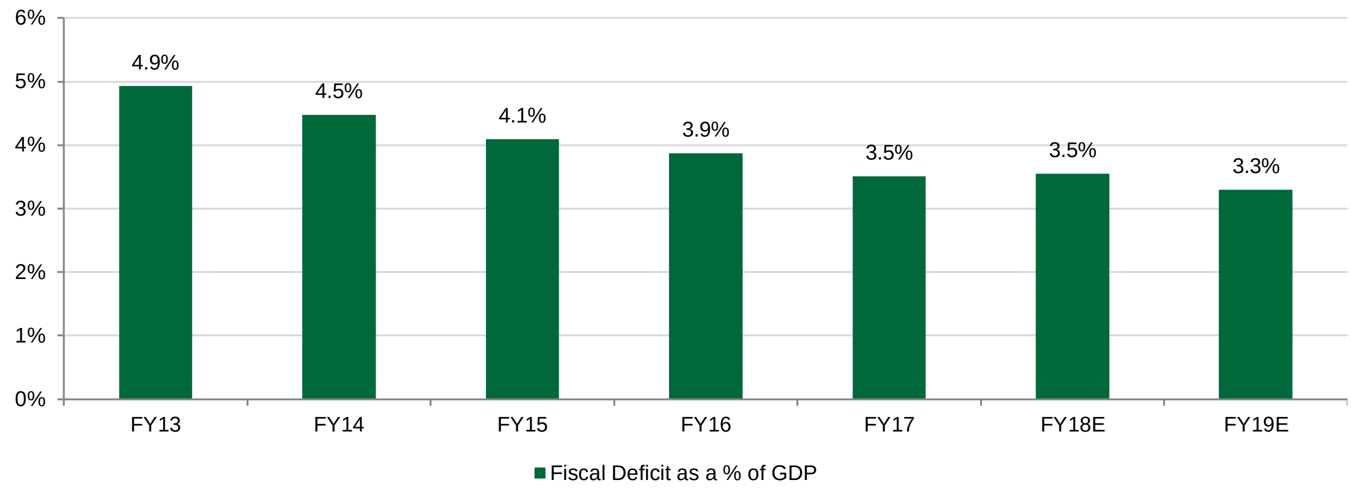
2. Fiscal Stability – Higher revenue and better quality government spending

As a result of the formalisation reforms, we expect the government's tax collection revenue to grow with a lag along with an expanding tax base. This will enable the government to gradually increase spending without risking a larger fiscal deficit. Indeed, in the past three years, we have already seen significant building of assets, which will increase long-term productivity. Areas such as rural electrification, road connectivity, and better sanitation have seen substantial investments against the backdrop of a declining fiscal deficit (Chart 3).

These government investments have had knock-on effects, such as the accelerating sales of electrical consumer durables. We believe this represents a structural opportunity and companies with the right manufacturing and distribution footprint will be able to capitalise on this trend.

[5] Source: Avenue Supermarts DRHP, Credit-Suisse estimates, August 2018.

Chart 3: A lower fiscal deficit amid rising government spending[6]



3. Financialisation – Higher financial savings, higher consumption growth

As economic formalisation deepens and transactions migrate from cash to formal financial channels, the level of financial savings should grow. Financial savings increased from 52% of total household savings in FY 2014-2015 to 62% in FY 2016, before marginally decreasing in FY2017[7]. Some of those financial savings are flowing into the banking system, which has seen many "new to banking" customers. This, in turn, is expanding the deposit market. Meanwhile, this trend of higher financial savings will also democratise credit availability and lead to greater aspirational consumption.

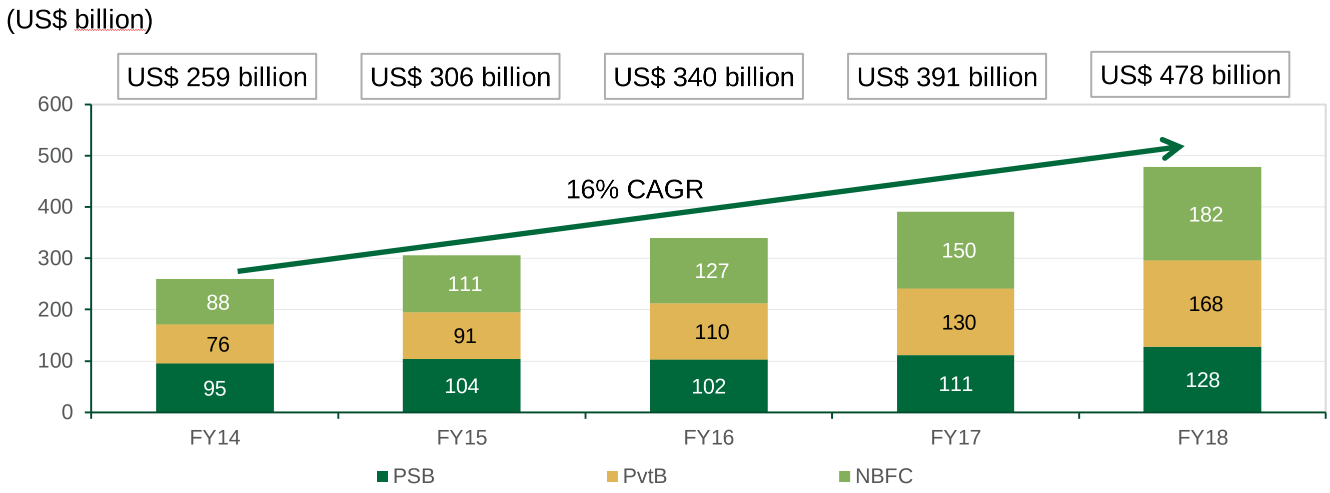
- **Democratisation of credit availability**

The transition towards a formal economy has led to profound changes in the availability of credit. As households and small businesses conduct more transactions on digital platforms, they are leaving a sizable digital footprint. For existing customers, lenders can use these data to cross sell and cut down origination, monitoring, and collection costs. At the same time, these data can drive financial inclusion by making credit available to "new to credit" customers, substantially expanding the loan market. We estimate outstanding retail credit was US$478 billion as of March 2018, and could grow to roughly US$1 trillion over the next five years.

We see this trend has already started to play out. Despite loan growth of 8% CAGR during FY14-FY18, retail credit grew at 16% CAGR during the time period. Within that segment, private banks (PvtB)[8], non-banking financial companies (NBFCs) and/ small finance banks (SFBs) grew their loan book at 20% CAGR during same time period (Chart 4). We see these trends strengthening further for private banks and SFBs.

[6] Source: Budget, Kotak Institutional Equities, March 2018.
[7] Source: CSO, Ambit Capital, December 2018.
[8] Private banks refer to banks where private investors own 51% or more of total shares.

Chart 4: Retail lending is poised to continue strong growth[9]



We like private banks with strong liability-gathering franchises and innovative SFBs that have adapted their business model to serve customers faster and cheaper with less friction, thus utilising the promise of the new digital footprint to expand their market share.

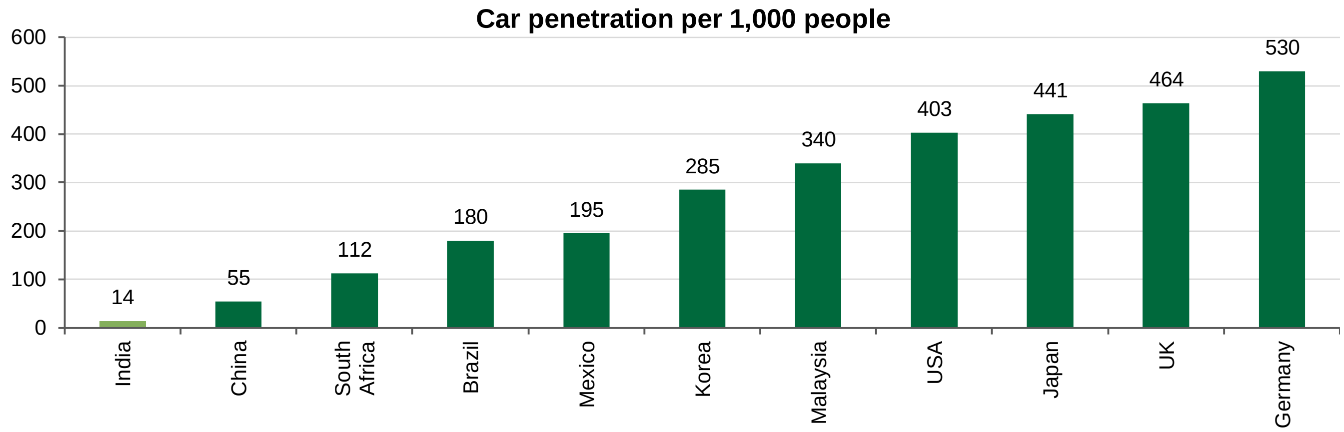
- **Aspirational consumption**

In India, millions of people are gaining access to better infrastructure and assets like power, roads, water, and sanitation facilities; improved infrastructure is deepening the process of economic formalisation. Over time, "sweating" of these assets should increase productivity and income. Simultaneously, formalisation and digitalisation are widening the availability of credit. As credit penetration of both credit and aspirational consumption categories is still quite low in India, we envisage multi-year consumer driven-demand growth in this area.

In particular, we see substantial opportunities in the passenger-cars segment, which has a very low comparative penetration level (Chart 5). We like companies with wide distribution networks that will help them capturing rising demand from lower-tier cities, as well as suburban and rural India.

[9] Source: Company Filings, RBI, MFIN, IIFL Research, July 2018.

Chart 5: India still has low penetration of car ownership[10]



4. (Re)Forms on banking asset quality– Improved asset quality and higher loan growth

The Insolvency and Bankruptcy Code (IBC) became law in 2016. This has led to notable changes in the banking system, catalysing the recognition, recovery and resolution of bad assets. Before the IBC was implemented, the Indian banking system lacked the legal framework to deal with corporate insolvency quickly, resulting in capital being locked in non-performing assets for years as costly and lengthy legal processes unfolded. The implementation of IBC has changed that; this is evident from the large recoveries made by the banking system in the last two years. We expect that credit costs for large banks will fall in the future, and loan growth should pick up as balance sheets are repaired. Based on this trend, we like large private banks with corporate exposure.

2019 Indian market outlook

Moving beyond the "Four F's", we now turn to a brief 2019 market outlook. From a fundamentals perspective, the current headline valuation of the Indian market is at 16.6 times earnings, about 15% higher than the 10-year median[11]. However, we believe this valuation level needs to be understood in the context of two factors:

1) An expected pickup in earnings growth, signs of which are visible in the latest quarterly results. Adjusted operating profit growth for MSCI India companies over each of the last three quarters has been greater than 15%[12].

2) Rising share of domestic inflows in the market insulating it against volatile foreign flows.

From an economic perspective, we see potential for monetary accommodation and perhaps a targeted fiscal stimulus. Lower oil and food prices should feed through to declining inflation, leading to monetary easing by the Reserve Bank of India (RBI). Indeed, the RBI has already started to provide liquidity; room

[10] Source: Credit Suisse Research, August 2017.
[11] Source: Bloomberg, January 2019, updated as of 31 December 2018.
[12] Source: Bloomberg, January 2019, updated as of 31 December 2018.

for a potential rate cut in 2019 has opened up. Lower food prices for farmers could also trigger a small but targeted fiscal stimulus this year.

There are two potential risks to our investment thesis in 2019. The first is a rise in oil prices. India is a large net importer of crude, and sustained higher crude prices (above US$75/ barrel) could put pressure on the country's external position and corporate bottom lines. The second is political. India will hold central government elections in the second quarter of the year. Around election time, rising political rhetoric could lead to volatility. However, we do note that India has experienced policy continuity during past changes in government.