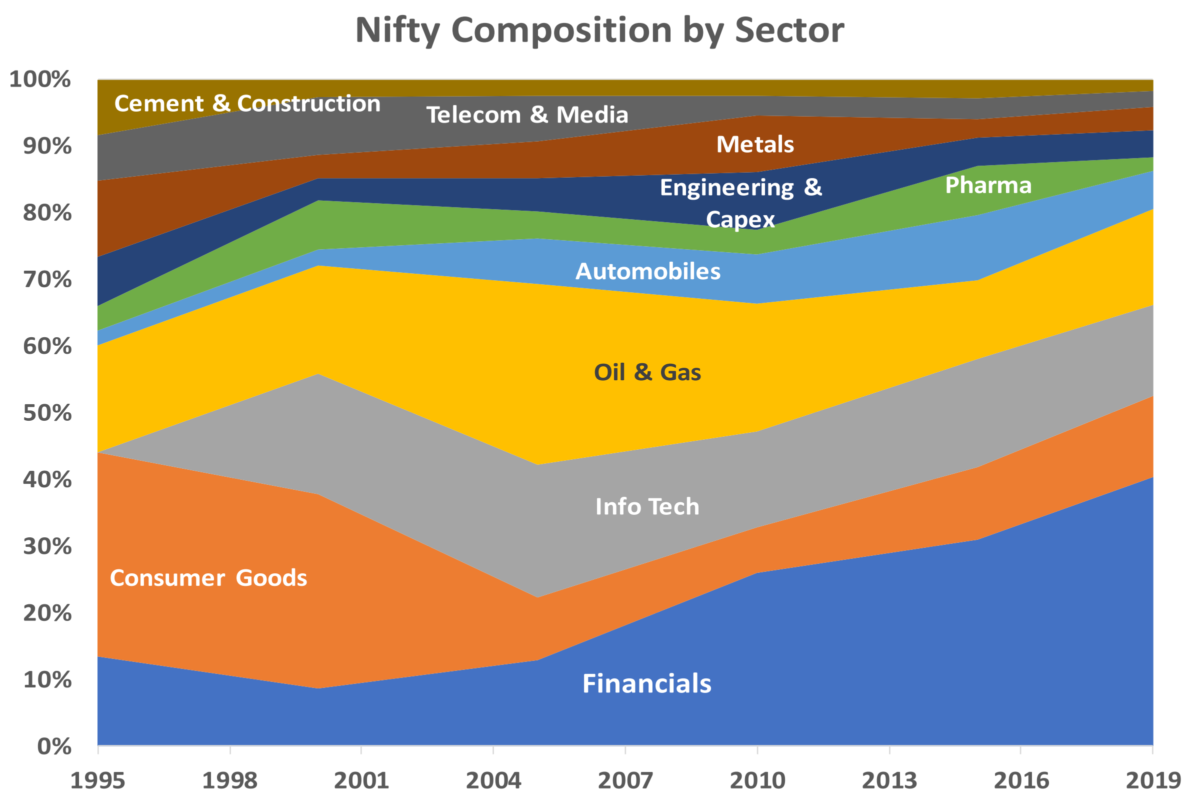
History doesn't repeat itself in India

India's equity markets are represented by numerous indices as a yardstick to measure generic investment returns from investing in the region. However, there are some observations into these indices that investors should consider, particularly if considering a long-term investment into the region.

Developing economies are more influenced by their Government and Central Bank policies and Government spending and initiatives. This more often has a direct impact on supply and demand economics, which maybe be quite different across various industries. It is also more likely to dictate the business cycle and its length, through its impact on savings rates, private investment and capex, product life cycles and level of disruption.

The Nifty, an Index of India's 50 largest capitalisation free-float companies, is a commonly used bellwether Index to measure equity market performance in the country. It is a free float Index which equates to approximately 60% of overall market capitalisation. India's market-cap-to-GDP has traditionally averaged around 0.7x. Therefore, you could say the Nifty captures about 50% of the GDP of India. Despite the Nifty consisting of only 50 of the largest stocks, there are 6,000 plus listed companies of which a 1,000 are liquid are tradeable – an active investors delight.

The Indices quite often create significant concentration at points where the business cycle has already been favourable, with valuations reflecting success via a high market capitalisation relative to the fundamental business, given we often extrapolate success or suffer from last period bias.



The underlying sector composition of the Nifty provides significant insight into India's business cycles and how quickly things change.

- In 1995, Consumer, Financial, Metals and Energy companies dominated the Index (74%).

- However, as the rupee depreciated significantly in the 1990's after economic reform undertaken in 1991 liberalised the economy, the IT industry and particularly outsourcing was born in India. This sector grew to 19% of the Nifty by 2005, just 10 years later.
- By 2005 the Index's structure had completely changed to be dominated by Oil & Gas (27%) and IT (19%) with valuations in businesses like Capital Goods, Energy, Power, Infrastructure starting to rise, reflecting private investment and a business cycle led by cyclicals.
- Fast forward to 2010, post the GFC, again the Index's shape had started to change as valuations in cyclical sectors like Energy, Metals, Power and Infrastructure had collapsed and savings rates started falling as credit culture and consumption were rising from a low base.
- Banking, Consumption and Pharmaceuticals were set to have their day as the Government policy shifted towards favouring consumption. Consumption spending supported the economy as Infrastructure, Construction, Power and Real Estate all hit a brick wall after high valuations in 2007-08.
- Fast forwarding to today, the Nifty is dominated by Financials and Consumption stocks as the economy has been directed towards financialisation, credit culture and consumption. In fact, Consumption and Government spending have held up GDP (until the last two quarters) and household savings rates are reflective, falling from 25% to the current 17%. Valuations in the Banking Sector today average 2.8x Book Value (Non-bank financials are closer to 4-6x BV) compared to 1.5x in 2005 and Consumer companies have an average P/E of 34x, compared to 17x in 2005. The last company to enter the Nifty (in August 2019) is Nestle India – with a P/E of 60x.

The aggregation of 50 Nifty stocks tend to reflect what has worked successfully in India over the last 5-7 years (business cycle. Today the Government rhetoric is spending of US$1.5 trillion over the next 10 years on Infrastructure requirements which are needed to take India upwards from a currently low GDP per capita of USD$2,100. Job creation is essential to achieve the goal of GDP US$5trillion – also a stated goal of the Modi Government by 2025 as is "Housing for All by 2022" – another huge requirement infrastructure build along with the 25 metros being built around India's cities, the 100 smart cities project and road building of 35km a day .

All these things point to infrastructure being the forefront of the next business cycle in India. Private investment will be a key requirement to drive this and we are likely to see foreign public-private partnerships increase given low cost of debt overseas and local investment rise given lowering cost of capital (India's monetary policy has lowered rates by 110bp in the last year, with more rate cuts to come). This should result in a benefit to Construction, Engineering and Capex, Industrial manufacturing and Real Estate as well as to the Rural/Farm sector which should thrive from rising wealth. However, companies operating within these sectors are trading closer to 8-14x P/E and in several cases close to the replacement cost of assets. However, their representation in an Index like Nifty is miniscule as they reflect forgotten companies of the previous business cycle rather than those who have thrived from the current stretched cycle which has rewarded Consumption, Banking and more recently the IT sector given risk aversion globally and poor sentiment towards India's recently faltering growth story. <u>This has led to a focus on a narrow group of "Quality" businesses, which are essentially large to mega caps with high historical earnings growth and less dependent on the economic cycle. These success stories are fully reflected in the Nifty's valuation and so called "Quality" companies today.</u>

Accessing India's growth story today is not simply a matter of having passive exposure to India and hoping what's worked continues to work. That works sometimes like it has in the last 18 months, but it's also understanding <u>where we are in the business cycle, the cost of funding, business valuations</u>

and the direction of Government spending and initiatives, particularly in a developing and highly dynamic economy like India's.

One of India Avenue's three on the ground investment advisers, with a stellar track record of identifying companies in India, at an early stage of their involvement in the business cycle and whilst valuation is supportive to generating substantial capital appreciation – is Old Bridge Capital Management. Kenneth Andrade, founder of Old Bridge was in Australia recently and you can read about their investment process in the AFR article link below:

https://www.afr.com/markets/equity-markets/old-bridge-goes-against-grain-in-indian-stocks-20190926-p52v3i