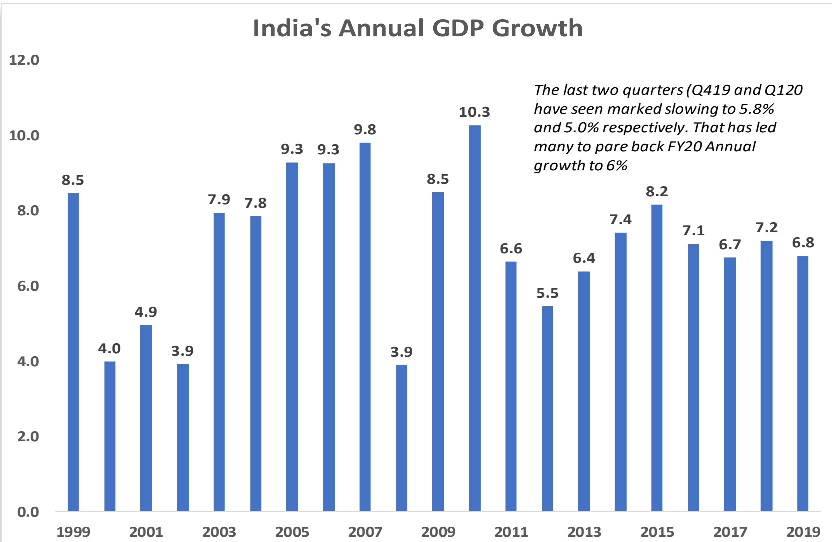
India Avenue
Investment Management

Explaining current economic weakness in India

Indian equity markets have lost 11.3% over the past three months in local currency terms. Add a slight weakening of 1.2% of the Rupee against the AUD and you have a fall of approximately 12.5% for unhedged Australian investors.

This has largely been driven but weakening economic growth, which appears to be impacting corporate profit growth. Brokers who had forecast earnings recovery, driven by the Banking Sector turning non-performing loan provisioning losses into profits, are now pulling back their forecasts for a general slowdown, which has been led by sectors like automobiles. Auto's have been a yardstick for consumption and sentiment.



1QFY20 GDP growth (June 2019 Quarter) printed at 5% year-on-year growth. This is a 6-year low and has been led by weak agriculture and manufacturing output.

However, its not the first time India's growth has stalled. In fact, we only need to go back to 2012-2013, where India was part of the Fragile 5 of high inflation, slowing growth, weakening currency economies.

Corporate profits ex-Banks and Oil also reported a decline of more than 6% - a far cry less than expectations as weaker growth has led to an impact on sectors like Automobiles, Infrastructure, Domestic Travel, Consumer Products.

The factors that be attributed to this economic slowdown are a liquidity crisis brought on by a high-profile default in September 2018 (IL&FS), weak government expenditure due to fiscal tightness and poor GST collections and a slowdown in manufacturing (partly induced by a weakening global environment). This was already in an environment of a high level of non-performing loans at state-owned banks (which are 70% of the lending to the economy).

There has been a significant response to consider as a result of this:

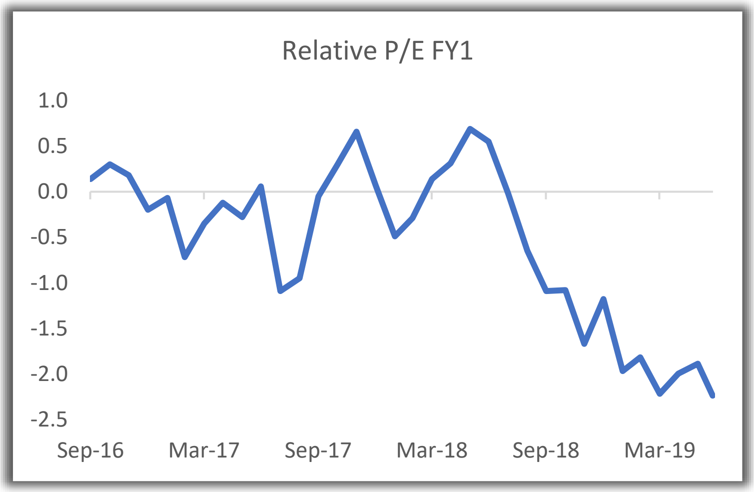
1. Firstly, **monetary policy (110bps of rate cuts**) takes 6-9 months to filter into the economy. The transmission of that into the system is also improving as the Government is recapitalising banks and improving liquidity of non-bank financials
2. **Tax surcharges levied** in the Budget (June 2019) on foreign investors have **now been reversed** given foreign investor outflows.
3. **GST refunds** to MSME's have **speeded up** to enhance working capital for these businesses
4. **Additional depreciation** allowances for automobiles and significant incentives for EV
5. A Central Bank **transfer of A$36bn provides additional fiscal stimulus** for the economy, given the RBI was over-capitalised relative to their requirements of managing a developing market economy.
6. An Insolvency and Bankruptcy Act (2016) which is slowly leading to an **improvement of NPL's** (e.g. 11.5% in FY18, 9.3% in FY19 and forecast 8% by end of FY20).

Our simple analysis of the market shows that consensus expectations for earnings have been peeled back towards 550 for FY20 (Nifty 50) and 670 for FY21. This places the market around 17.8x one year forward. Most of this earnings growth is likely to come from a recovery of banking profits from a loss-making position.

If we assume earnings growth are purely driven by Banks and imply a discount to the extent of this recovery and imply that the market at worst case is trading at 19.3x one year forward. This would imply a more structural slowdown. It is our view that a global economic slowdown will have an impact and we are in a cyclical slowdown in India. With the potential for further monetary stimulus and some incentives in needed areas, we are likely to see growth pick-up towards 7% in FY21.

We will continue to update you on the impact of stimulus and leading indicators in India. This will provide a strong signal for the potency of any economic recovery. Right now, there is significant pessimism built into India's equity markets.

The India Avenue Portfolio Positioning



Our current bias towards value has had a negative impact on our relative returns in an environment where momentum and quality have worked best, with the Top 10 stocks by market cap attracting most of the investment as investors focus on safety and earnings visibility during the downturn. However, our portfolio now has a significant margin of safety in its valuation relative to the Nifty 50 Index (trading over 18x vs our portfolio trading closer to 15.5x).

Our analysis indicates the value style is likely to outperform from either very low valuations or very high valuations at a starting point. Whilst the Index is still trading at a slight premium, our portfolio is trading at what we perceive is an attractive entry point, with some margin of safety for weakness built in.