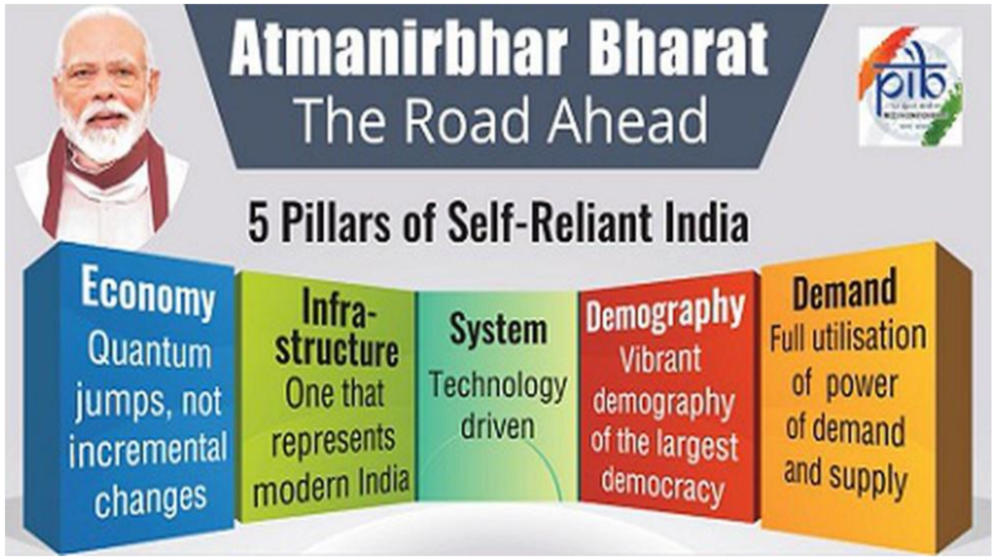
REPORT H1, 2021



Source: utkaltoday.com

The term Atmanirbhar Bharat translates to a self-reliant India and was used by PM Narendra Modi during the COVID-19 pandemic as an umbrella concept in relation to making India a more significant part of the global economy – not by isolating itself or becoming protectionist, but by pursuing policies to make itself more efficient, competitive, resilient, self-sustaining, and self-generating.

INSIDE THIS ISSUE

GRASSROOTS INDIA

INTRODUCTION

Our *Grassroots* publication (half-yearly in frequency) focuses on providing readers with the necessary insights when contemplating, assessing or understanding an investment into India's fast-growing economy. Whilst many investors are aware of the high GDP growth, driven by the strong fundamentals of a youthful, aspirational, and entrepreneurial society, it is the insights into what makes the economy tick, at a grassroots level, that helps to navigate a more successful path.

Indian equity markets are comprised of a plethora of companies which are thriving due to the pace of the country's growth in consumption, banking, infrastructure amongst many other industries. Understanding the ecosystem in greater depth is more likely to lead to a successful investment outcome for Australian and New Zealand based investors.

We would appreciate your feedback on the content and quality of this publication.
Please feel free to write to me at mugunthan.siva@indiaavenueinvest.com if you have any questions.

Thriving on Opportunity

The term Atmanirbhar Bharat[1] translates to self-reliant or self-sufficient India. The term was coined by Prime Minister, Narendra Modi and was announced during release of COVID-19 relief stimulus packages (in May 2020, US$260bn), aiming at making India a bigger and more important part of the global economy by pursuing policies which are efficient, competitive, and resilient.

The concept does not lend itself to isolation of being protectionist, but rather to being self-sustaining and self-generating, thus advancing India in the globally competitive landscape. The five pillars of Atmanirbhar Bharat include economy (quantum jumps not incremental), infrastructure (modernise India), technology-driven systems (improving efficiency in processes to build productivity), vibrant demography (utilise India's demographics to develop its productivity), and demand (maximise the power of demand and supply).

The initial focus during COVID-19 was to provide for the needy and maintain funding for when the economy was on the path to recovery. The Government initially sought to aid cottage industries which are supportive of India's MSME's. These businesses contribute close to 30% of India's GDP and are a significant employer of labour. The aim was also to support the middle class by providing improving infrastructure and efficiency through technology enabled systems and processes. Continuing reforms are also expected to drive the push towards self-reliance. In the last 6 months significant reforms have been announced in relation to standardising labour contracts and providing a free market in agriculture. Finally, there has been a significant push towards buying locally based products which is being referred to as "vocal for local".

As a result of this initiative, we have seen significant advancement for India in certain industries like personal protective equipment (from zero to US$1.4bn and second to China), a 5G network announced which should lead to homegrown technologies and solutions, significant advancement to self-reliance in fertilisers (by 2023) and the strengthening of the STI ecosystem to achieve self-reliance through technology.

India has recognised that local manufacturing and FDI investment will be required to improve India's trade position, develop industries, and create employment. Given close to 1 million people per month are new entrants to the work force in India, it will require a local manufacturing and private investment thrust to benefit from the demographic dividend and create the 'wealth effect'.

Source: engmag.in

EXAMPLES OF INITIATIVES TOWARDS SELF-RELIANCE:

Sectors	Initiatives/Changes/Proposals
Defence	An embargo was placed on items to allow for a build-up of local industry. Foreign direct investment levels permissible have increased (from 49% to 79%). A deal was signed with Russia to manufacture rifles locally.
Semi-Conductors	The semiconductor industry is US$726bn according to Fortune Business insights with India being relatively non-existent due to its out-dated process and limited reach. China, as a hub for semi-conductor related products, has previously carried too much dependency from other countries. India does not have facilities nor the capability to manufacture with scale. There is opportunity to manufacture locally for its own consumption and build some scale/ economics to export. This can be achieved by welcoming global players with tax holidays and a drop in import duties to whet the appetite locally.
Manufacturing	Modi launched the Make in India campaign in 2014 which has only had mild success. Manufacturing has been a weak contributor to GDP. India relies too heavily on imports of key items like electronics, telecom, and medical equipment. The Government is considering hiking import duties on 50 items and cutting import duties on raw materials. India can become competitive globally at the finished product level.
Electric Vehicles	India lacks the manufacturing might of China and USA in building infrastructure to boost EV adoption. However, providing production and tax-based incentives to local and foreign EV manufacturers to set up in India as well as offering demand-based incentives to buyers can speed up the process of adoption in the country.

[1] https://aatmanirbharbharat.mygov.in/

Source: www.gbreports.com

Description	Opportunity
Divis Labs: Rev $0.7bn, Margin 36% A significant API manufacturer with two manufacturing units. The API's are noted high quality products with a high level of compliance/integrity. Exports go to over 95 countries.	Leader in 11 of 26 API's produced globally. Established long-term relationships with 6 of Top 10 pharma co's. Quality, versatility, customised. 350 scientists
Aurobindo, Rev $3.1bn, Margin 21% 29 manufacturing facilities in over 155 markets with over 300 products and 36 billion diverse dosage forms. Large R&D facility in India for formulations and active ingredients.	Vertical integration, regulatory expertise, technology and knowledge for specialty formulations. Dedicated R&D (1600 people).
Dr Reddy's, Rev $2.3bn, Margin 27% Manufactures and markets a wide range of drugs locally and overseas. The company has over 190 medications, 60 API's.	84% of revenue comes from offshore and significantly from global generics. 400+ high quality generic drugs
Aster DM, Rev $1.2bn, Margin 15% Operates hospitals, diagnostic and, medical centres and pharmacies in India and Middle East	7 countries, 26 hospitals, 115 clinics, 224 pharmacies and 19,000 employees
Strides, Rev $0.4bn, Margin 22% Focus on development and manufacture of IP-led finished dose formulations. Manufacturing facilities, R&D hubs, and platforms to sell globally.	8 manufacturing facilities across 4 continents. Footprint across 100 countries. One of the world's largest soft gelatin capsules.
Indoco Re, Rev $0.2bn, Margin 11% Research oriented pharma company engaged in manufacturing and marketing of formulations and API's	9 manufacturing facilities and R&D centre. Presence in India as well as 55 other countries. 300 scientists

*API = Active Pharmaceutical Ingredients

Source: India Avenue Research

INDIA AVENUE'S PHARMACEUTICAL EXPOSURE

ANOTHER INDIA MANUFACTURING STORY

The Healthcare sector was the strongest performing sector in India in 2020 given its linkages to COVID-19. India is the world's leading generic drug and vaccine manufacturer by volume and thus has attracted a lot of interest from global investors trying to identify which companies in India could benefit from COVID related drugs and vaccines. Apart from this, the fundamentals of a large population with increasing awareness and spend on health is a melting pot for success for local and global pharmaceutical companies operating in India.

Our exposure to this sector currently sits at about 7-8% and is spread amongst six companies. Obviously, large moves in prices have led to some turnover of companies, but the exposure levels have remained well above passive or large-cap oriented India focused Fund's and ETF's.

The story here is not necessarily about COVID-19 and rolling out vaccines and solving the immediate issues, rather it is more about the fact that India is significantly integrated in the global supply chain for pharmaceuticals and will become an increasingly significant player as diversification continues away from China. Whilst thus far the focus has been towards volume driven business, the shift towards increased R&D to sales (5% to over 10% over the last decade) is pushing India up the value chain in this industry. With significant investment being made towards building a pharmaceutical hub in India (e.g., pharma technology parks), a substantial amount of educated scientists and a large population with an increasing demand for healthcare and nutrition needs, India is well poised to develop competitive advantages in this industry. COVID-19 will only accelerate the importance India has globally and increased awareness amongst global peers.

Source: thelogicalindian.com

AGRICULTURAL REFORMS IN INDIA

India's Agricultural sector employs around half of its 1.3 billion people and contributes nearly 15% of the output of India's $2.9 trillion economy. Around 85% of India's farmers are considerably small, owning less than 2 hectares of land and lack the means to sell beyond local markets, even if that means forgoing better prices.

This is despite India's agricultural market being heavily regulated, originally planned to help farmers to sell to the market but at the same time to protect the small, less fortunate farmers from the whims of the open market. Historically, such regulation has been a responsibility of the state where each state had their own system on how wholesale markets called 'mandis' operated. Mandis had licensed middlemen who were regulated by the Government to ensure that farmers were not exploited.

However, despite the idea of monitoring, middlemen were often found to collude to take advantage of the farmer. Furthermore, variations in regulations across states hindered interstate trade opportunities. As markets liberalised, agribusiness was growing, but the red tape created by the regulatory framework, meant that many inefficiencies remained.

Given this, the need for reform was heavily warranted and in September 2020, a set of three complementary bills by the Modi government was passed.

- Reduce the role of the regulated mandis in marketing farm produce by allowing trade outside of mandis that included electronic trading within and across states.
- Allowing restrictions on stock produce only in the case of strong price spikes when hoarding becomes a concern.
- Set up a framework for direct formal contracting between farmers and the agribusinesses that buy from them.

The reforms provide a significant fillip for the private sector, especially large agribusiness in India. The expectation of the Government is that the strengthening of these parallel market channels will create competition for the farmers' produce from both within and across states, leading to improved remuneration for farmers.

Concerns

Although agricultural reforms have been a long time coming, the direction of travel of the bills seem to imply a slippery slope of moving towards private sector control and has left farmers worrying about the future of other government policies such as minimum support prices (MSPs) for produce which help provide a measure of stability and certainty to prices received by farmers, Furthermore, the new system may completely disrupt the longstanding regulated mandi system that farmers understand, despite its numerous flaws.

India Avenue's views

We personally feel that this is potentially the biggest reform made to India's massive farm economy and brings it closer to developed market practices. Research on agricultural markets in India has typically concluded that they are inefficient, characterised by a high level of wastage with some evidence suggesting that it goes through as many as five-six times different hands before it reaches the end-consumer. This rate of wastage from ineffective supply chains is four to five times that of most large economies. With these new reforms, effectively creating a unified national market and removing inter-state barriers to trade, it is expected will increase farmer prices by 11%.

However, experience from India and globally shows that large buyers often prefer to deal with larger farmers with large volumes. Small farmers from less developed areas with poor infrastructure may find themselves disadvantaged.

Nonetheless, collectively, the reforms are bold, revolutionary and will reduce barriers in the agri-food supply chain between the end-user and farmers. The Agri-tech market is also an exciting space as India's entrepreneurs are selling farmers apps to connect them to big buyers. With real-time prices available on affordable mobile phones and ultra-cheap data, the process of price discovery and selling goods should increasingly become more transparent.

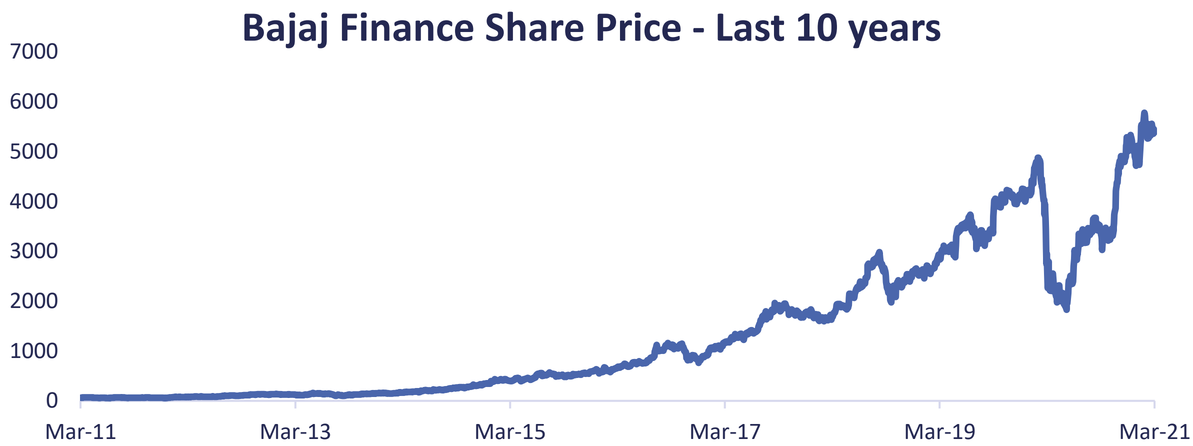
BAJAJ FINANCE – INDIA'S KING OF THE FINANCIALS

Bajaj Finance in a deposit taking, non-bank financial company, registered with the Reserve Bank of India, which deals in consumer finance, lending to SME's, commercial lending, and wealth management. The background of the company is that it was originated in 1987, providing 2 and 3-wheeler financing. The company was listed in 1998. It subsequently ventured into durables financing and business and property loans. The largest shareholders of the company are its listed parent, Bajaj Finserv (57%), Government of Singapore and Axis Mutual Fund (one of India Avenue's advisers).

In India, NBFC's have been growing at a faster pace than the commercial banks and do not have the legacy of bad lending practices of the government owned banks from 2007-2015. Private Banks and NBFC's like Bajaj have been mopping up a significant share of credit growth. Bajaj's net non-performing assets today stand at 0.7%, which is well below the NPA's of the public-sector banks. Additionally, the company's liquidity position remains strong, with a capital adequacy ratio of 28% as at 31 Dec 2020.

Bajaj Finance has grown its asset book by 232% over four years from 2016-2020 to A$26.3bn. FY21 has been far more challenging given COVID-19. However, the book of assets has remained relatively stable at A$25.7bn as at 31 Dec 2020. It is expected by Bajaj's management that growth rates will resume levels pre-COVID by 4Q21 (March 2021 ending). Profits dropped by 36% y-o-y, driven by lower fee income, whilst interest income remained stable during the COVID impacted period.

Three key categories of business for the company comes from Consumer B2C (26%), SME business (17%) and Mortgages (14%). The customer franchise of the company stood at above 46m, with a presence in 2,392 locations across India (with over 50% being in small towns/rural areas).



Source: Refinitiv

Over the last 5 years (including COVID-19, where all financial stocks in India lost significant value – Bajaj Finance itself fell 62% from peak to trough), the company has generated a return to shareholders of 52.5% annualised or 8.2x. Over the last 8 years it has generated 44x and a whopping 60% annualised.

One of Bajaj Finance's core strengths has been understanding the needs of their customers and having invested significantly to determine the consumption and investment patterns of their customer franchise. At some stage in the future the business is likely to shed its P/BV valuation measure (currently trades at 10x BV) and attract a P/E multiple assigned (trades at 62x P/E) to a fintech growth company given its deep knowledge of its customer franchise through analytics, its low NPA's and high liquidity as well as benefitting from the fundamental tailwinds of population, scale, financial inclusion, and digital infrastructure. Bajaj Finance is currently the largest holding in the India Avenue Equity Fund.

INDIA'S SHIFT TO ORGANISED BUSINESS

India is a country where a significant movement is occurring from unorganised to organised business. This effectively means a shift from fragmented industries with low levels of regulation and informal methods to business where applying a set of rules, regulations, and processes are followed. Over the last five years the shift towards the organised economy has accelerated due to the changing ecosystem.

Unorganised business tends to be the domain of underdeveloped economy and thrives due to lack of a strong network and a low level of inclusiveness. Where simple requirements we take for granted in developed economies are not available such as electricity, roads, communication, and credit, then businesses are more likely to operate with smaller scale and in their locality.

The reform of demonetisation was introduced in 2016, shifting the emphasis from a cash-based society towards a more credit oriented, digitised economy. Cutting the "black economy" to its knees had an initial impact of weakening India's growth rate from 2017-2020 to 3-5% GDP growth (compared to 6-7% for the 20 years previous). However, the shift away from the cash economy led to a surge in the following:

- UPI Payments (rising from zero in 2016 to 134bn transactions daily by December 2020)
- Mobile Phones (now close to 1.2bn mobile phone and over 600m smart phones)
- Broadband connections (over 700m connections i.e., 50% internet penetration)

Secondly, came the reform of GST in 2017, which had the impact of removing state duties and taxes and therefore the differential taxes across India's states and reduced logistical costs of transporting goods. This removes the comparative economic advantage localised businesses held relative to regional or Pan-India businesses. The scale benefits of having Pan-India business, lower taxes and logistical costs shift the balance towards large, organised players in every segment. Logistical costs are also dropping because of India's slowly but surely improving infrastructure i.e., better roads, greater road coverage, improving railways, more flights and greater accessibility of flights and improving efficiency at ports.

This shift is seen across economies as they develop, industrialise and their 'networking' improves. In the context of India today networking includes better roads, mobile phone connectivity, broadband access, are more affordable access to flights and financial inclusion through a greater percentage of the population being banked (close to 80% now).

This network will create a substantial expansion in consumerism. Consumption in India has already grown from US$550bn in 2010 to US$1.6tn in 2019 and is likely to reach US$5tn by 2030 (growing at 10-12% p.a. over the period). This rising consumption patterns will be driven by an increasing share of affluent/elite households, urbanisation, nuclearization of households and increasing component of Gen-I (who are more prone to spending).

Businesses are likely to shift from local to regional and from regional to national as the connectivity improves. This is likely to result in a shift from informal workers to finding formal work in retail outlets and chains. The growth of larger formats will make localised stores redundant given higher productivity and scale passing through to lower prices aka Walmart, Woolworths, Coles etc.

Opportunities for Organised Players

Industry	Market Size AUD	Unorganised Share	Industry	Market Size INR	Unorganised Share
Plywood	4.5bn	65%	**Watches**	1.6bn	50%
Tiles	4.0bn	49%	**Beverages**	9.4bn	50%
Jewellery	53.6bn	75%	**Dairy**	95.9bn	80%
Alcohol	7.3bn	50%	**Tea & Coffee**	1.8bn	50%
Footwear	6.0bn	60%	**Luggage**	0.7bn	67%
Apparel	63.4bn	73%	**Air Coolers**	0.5bn	80%
Diagnostic	7.8bn	85%	**Hair Oil**	1.4bn	50%
Hospitals	71.6bn	90%	**Innerwear**	3.6bn	48%

Source: Motilal Oswal, India Avenue

India Avenue's View: Dominant players across industries will thrive as the shift to organised formats and business occurs. An example is the Retail industry experiencing a significant move towards organised retail from India's "kirana stores' (single stores, convenience, localised). Yet while the growth in organised formats has been significant of late, it still only has 10% market share. Therefore, the shift to organised still has a long way to run and is more structural than cyclical over the next few decades. Better and more stable employment opportunities (in organised), lower prices and less tax arbitrage is likely to drive a greater share of the profit pie for largest players in each segment. This should be good outcome for listed players with dominant market share across industries.