August 2022

A Letter from India - Emerging Markets Research Trip

Our EM specialist investment partner, Northcape Capital, recently undertook their first on-the-ground research trip since the COVID-related global travel lockdowns. Online communications represented a positive development amid the pandemic's fallout, but on-the-ground research remains a critical element of gathering fundamental research.

India represents the portfolio's largest country exposure by allocation at 21%, in addition to being the largest active overweight position relative to its 14% benchmark weighting.

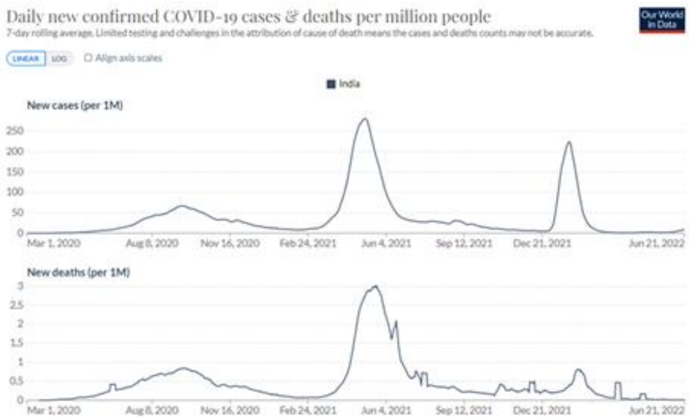
This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Indian economy normalising post-pandemic

Back in April 2021, when the country was gripped by a severe public health crisis, the rolling 7-day average of new Covid infections (Kappa & Delta variants) exceeded 350k/day, well above the 2020 mid-September peak, with India becoming the first country to report more than 400k/day new coronavirus cases. The government resisted a second lock down, due to the subsistence needs of India's informal economy and migrant workers, along with an absence of meaningful state-based financial support.

The government also relied on accelerating Covid-19 vaccinations to ease symptom severity and related fatalities. The vaccination program raised the percentage of population with at least one dose from approximately 10% at April 2021, to more than 70% currently. India recently experienced a third infection wave, the Omicron variant, around the start of 2022, however on this occasion **widespread vaccination and population virus exposure** resulted in a mercifully benign death rate attributed to the virus compared to a year earlier (refer Exhibit 1).

Exhibit 1: India moving on with COVID-19 (Source: Our World in Data)



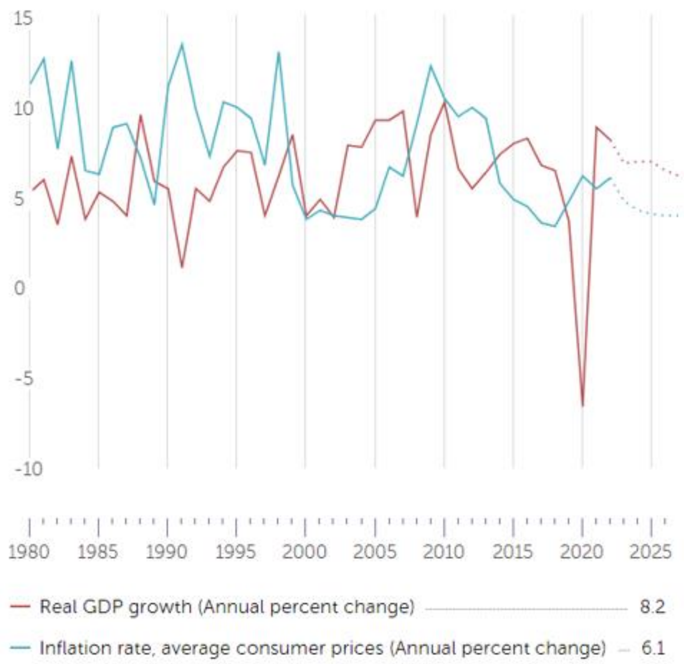
India's Covid -19 response has been well managed given challenges of existing population size and medical infrastructure, such that the economy is increasingly normalising to a post-COVID world, contributing to improved sentiment and investment certainty, **standing in stark contrast to China's** current highly disruptive and draconian Zero-Covid policy.

Supportive official policies

Meanwhile, India faces similar economic headwinds common elsewhere, namely elevated inflation and slower economic growth, due to a global economy beset by geopolitical tensions and sanctions, elevated energy and commodity prices, and disrupted supply chains. In this respect India compares favourably both in absolute and relative terms. While April growth was negatively impacted by macro headwinds, **real annual GDP managed +7%.**

The National Statistical Office estimated India's economic growth at more than +8% for the fiscal year to March 2022, coinciding with an annual inflation rate modestly above +7%. India has recorded a remarkably consistent range of annual historical nominal economic growth between +10% and +15% (refer Exhibit 2).

Exhibit 2: Real GDP growth & Consumer Price Inflation annual percent change (Source: IMF, World Bank)



Rising inflation reflects **broad-based price increases across food and energy, in addition to broader cost of living components,** such that inflation sits above the Reserve Bank of India's upper inflation band of +6%.

The RBI policy rate was raised to by 90bps 4.9% during the June quarter, 5.4% in August and with further increases expected to around 6% by end March 2023, in line with core inflation. Concerns over high-cost pressure, including mid-teen wholesale price inflation, have eased with Bloomberg's Commodity Index falling -12% in recent weeks, albeit some +19% higher over CYTD.

Government initiatives such as reducing excise duty on fuel helped alleviate input and supply disruption price pressures along with the negative fallout from India's recent heatwave, personally experienced during our visit, where daily temperatures consistently exceeding 42 degrees in the region across the length of our stay. Performance of India's current monsoon has therefore assumed increased importance, given 70% of the country's annual rainfall typically occurs in June to September. Positively, **current projections are for a normal weather pattern this year.**

Despite headwinds, the economy displayed a broadening of economic recovery over recent months evident in improving urban and rural demand. Merchandise exports and imports have increased by more than +20% annually on rolling monthly basis since early 2021. However, with India importing more than 80% of its oil requirements, a deteriorating trade deficit on sustained elevated oil prices continue to pose a risk to the country's current account deficit. A doubling to around 3% of GDP in FY23 from FY22, has exerted downward pressure on Indian capital markets, with the Rupee depreciating -6% relative to the USD CYTD, although the Indian market is down modestly YTD.

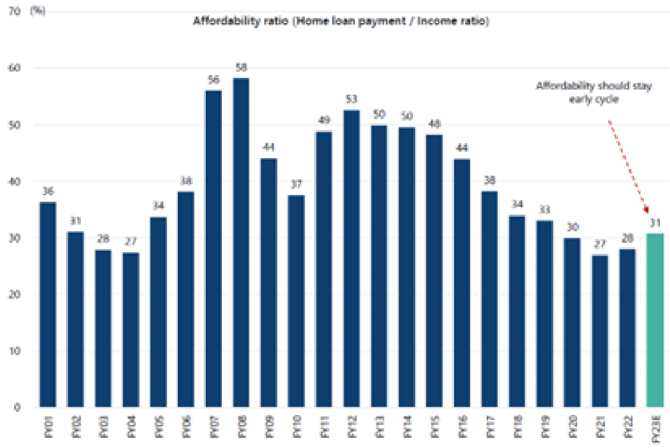
Despite these macro challenges India's underlying fundamental characteristics have improved markedly. Corporate gearing is at the lowest rate in fifteen years, and though household debt has increased, 25% of GDP consumer indebtedness remains modest, with minimal evidence of financial stress. An attractive consideration of India as an investment destination is the country's robust internal domestic demand, with several notable corporate growth drivers including the financial and IT services, consumer staple and consumer discretionary sectors.

India's development won't be a straight line, and as much as the 1.4 billion population offers opportunities, it also represents challenges, especially placing young adults entering the workforce each year in gainful employment. India's formal labour market accounts for a still modest 23% of total employment.

India's housing cycle turned decisively positive around a year ago, representing a material supportive growth tailwind, potentially adding around 100bps annually to domestic economic growth. Residential real estate is especially attractive.

Housing affordability is at a near twenty-year high (refer Exhibit 3), liquidity conditions are positive, and there is a burning desire for home ownership, especially among millennials. Residential property prices have been broadly flat over the past seven and half years, while domestic incomes have compounded at +6% annually, representing a powerful impetus for a property cycle upturn. **A substantial contrast to China,** where its housing sector is caught in horrible, seemingly irreversible downtrend.

Exhibit 3: Indian home loan payment to income ratio (Source: Jefferies)



Meanwhile central and state governments have provided the economy fiscal support, resulting in a combined deficit close to 10% for both FY23 and FY24. Support has been targeted at the Indian consumer, specifically subsidies of food, fertiliser, and cooking gas, along with lowering excise duty on gasoline and diesel fuels. India's public debt to GDP ratio sits around 80%, however as noted earlier, with nominal GDP growth typically around mid-teens, this is unlikely to represent a near-term concern.

Continued economic reform

Reforms have been a feature of PM Modi's administrations since taking office in 2014, typically concentrated on reducing bureaucratic impediments, improving commercial efficiencies, and raising formal worker participation.

Important developments include:

- Enacting the Bankruptcy Code changing the legislative model from "debtor in possession" to "creditor in control"
- The Real Estate Registration Act model resulting in greater investor protection and consolidating 22,000 developers in 2013 to just 800 by 2022
- The implementation of GST
- Technology investment raising welfare efficiency and broadening the tax base
- The recent Production Linked Incentive scheme
- Additional productivity reforms are expected in taxation, labour market, and education sectors.

India's economic potential looking forward, is somewhat reminiscent of the optimism portrayed by US President Reagan in 1984's "*Morning in America*" campaign slogan. Can India seize its own "morning" opportunity? (Refer Exhibit 4).

Exhibit 4: Morning in India? (Source: Northcape Capital)

Investors will need to monitor the developing trend of PM Modi and the ruling BJP political party towards increased consolidation of power and autocratic rule. India's next election in 2024 will likely be contested and led by Modi, considered a near certainty for him to win, given his consistently strong approval rating since taking office in 2014, and ineffective opposition parties. Modi's omnipresent profile and effectiveness in policy action offers a potentially problematic element of diluted governance standards, via a weakening of independent pillars, notably greater media alignment with the BJP, and judicial oversight of legislative policies to the detriment of India's minorities, primarily the more than 200mn Muslims.

Positive management feedback

The following is a summary of notes from our major holdings in India.

HDFC Bank's proposed merger with related mortgage originator HDFC Ltd offers significant revenue drivers to the enlarged group, led by underpenetrated home loans at 11% of GDP, mortgage growth around mid-teens, and housing inventory at a ten-year low. HDFC Bank continues to gain share, now 12% of system, but with room to grow at the expense of less competitive public sector banks' two-thirds share of system. HDFC Bank's extensive distribution and customer servicing is a core advantage, widening its addressable market to the wider deregulated public sector including education, healthcare, and religious institutions (refer Exhibit 5).

Exhibit 5: HDFC Bank digital processing facility (Source: Northcape Capital)

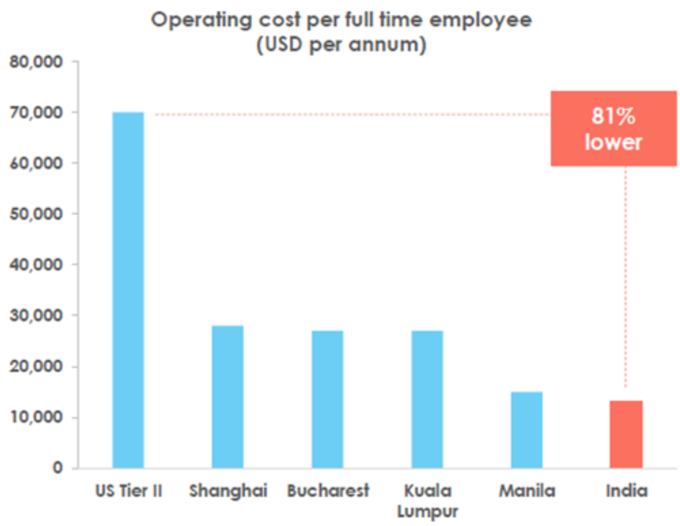
Bharti Airtel is well placed to benefit from the mobile telecommunications industry consolidation from fourteen players to effectively three. Consumer demand is represented by robust data consumption of 20GB per subscriber each month, providing industry players meaningful opportunities for network monetisation.

Maruti Suzuki & **Indraprastha Gas (IGL)** have both performed well in terms of underlying product volume (passenger vehicles and gas respectively), and despite higher raw material imposts, management were generally upbeat with respect market positioning and longer-term ability to pass-through costs and maintain margins.

Both companies are also facing government energy policy review as part of an **overall pivot towards cleaner energy,** including electric vehicles and natural gas to address India's dual concerns of pollution and its current account deficit.

Tata Consultancy Services (TCS) benefitted from strong demand over recently years, materially boosted by cloud migration, which accelerated during the pandemic and raised underlying revenue growth to the high-teens vs. high-single-digits just prior to Covid. India's competitive advantage in IT services is its low-cost (refer Exhibit 6), and abundant workforce – India produces around one million graduates suitable for the industry each year.

Exhibit 6: India (Bangalore) vs. international IT employee cost (Source: ANAROCK Research)



Conclusion

Our recent India research visit represented a much welcome opportunity to conduct face-to-face meetings with key company management and industry representatives.

India is an important capital destination for the Warakirri Global Emerging Markets Fund and we were again impressed by the country's energy and sense of optimism, and the opportunity available to investors in India's leading companies.

In sum, we were pleased to see that the outlook for India remains one of the healthiest in the Emerging Markets universe, and the updates from our portfolio holdings were also encouraging.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au