India Equities Look Interesting.

India is an interesting market. Modi’s election success boosted equity markets but lately delays in reform have stalled the market which is some 10% of its 2015 highs.

Growth:

- Near term the economy is slowing but long term potential remains strong.
- India has strong demographics with the working age population rising as a percentage of total and is expected to peak only some 20 years from now.
- The urban population in India is rising at an accelerating rate and per capital income is rising.
- Current GDP growth is 7.5% YOY. Inflation is 5%. With a 2 trillion USD nominal GDP economy, India has plenty of room to grow.
- India has for a long time had strong growth potential but was held back by excessive bureaucracy, corruption and inefficiency. A reformist government may unlock this potential.

Government:

- The Modi government has a strong mandate with 282 out of 543 seats in parliament making it the first simple majority government since the Congress government in 1984.
- Modi’s mandate is growth and development. He has been a good Chief Minister of Gujarat with 4 consecutive terms and has shown talent as a strong CEO.
- The government is addressing a number of areas for reform:
    - Ease of doing business, moving to on line licensing and rationalizing other administrative functions.
    - Improving the investment climate, for example increasing FDI limits in selected industries like insurance, defense and

    - railways, circumventing potential for corruption through more transparent processes, and more government co-investment in infrastructure.
    - Fiscal policy, to continue fiscal consolidation and removal of price distorting subsidies, for example in energy and transport, and to make government expenditure more efficient.
    - Taxation, simplifying the tax code, consolidating state and federal taxes into a single GST, expected to be circa 20% – 22%, also lowering corporate taxes from 30% to 25% over the next 4 years.
    - Banking and financial services, take for example the roll out of formal banking services to the general population (target circa 110 million new accounts), and the further augmenting of the bankruptcy law (last week creditors were granted rights to wrest control of management of defaulting companies.)

Corporate sector and Markets:

- RBI has made 3 rate cuts this year, most recently 2 weeks ago to take the repo rate from 7.50% to 7.25%.
- The Indian market is dominated by private sector business with SOE's conspicuously absent. Companies are entrepreneurial and therefore capital and asset efficient.
- Long run ROEs are 17% compared with 11% for the rest of the world and 12% in emerging markets.
- Current ROEs are circa 15% and EBIT margins are around 10% which are cyclical lows.
- Market PE is 16.3X which is at the long term average. The market is relatively cheap considering that corporate profitability is at cyclical lows.

Risks:

- Things always take longer than planned or expected in India. This is one of the consequences of India's democracy and bureaucracy. For example, the GST bill is facing opposition in Parliament and will only be reintroduced in July. It is expected to be passed during the monsoon season.

- While bureaucracy is being rolled back and even civil servants are optimistic about the progress legacy issues remain. Take for example the retroactive nature of the Minimum Alternate Tax which has caused much confusion and is still in resolution.
- Inflation may yet rise. The monsoon can affect near term inflation through food prices. India is energy dependent and affected by the oil price. We expect the oil price to remain capped and that long term the oil price will not appreciate significantly.
- Infrastructure remains poor despite the stated aims to increase infrastructure investment.
- INR exposure is difficult or costly to hedge. Interest rate differentials imply FX hedging costs between USD and INR to be circa 7%.