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MARKETING DOCUMENT

India: A New Driver Emerges

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Key Points

- As China moves from a multi-year post-bubble economic restructuring, as outlined in our publication *Looking Beyond China* in November 2023, India stands out as a compelling alternative for investors seeking exposure to emerging market growth.
- Indian domestic policy offers tailwinds for its economic model as the nation enters an investment phase focused on physical and digital infrastructure, akin to China's in the 1990s.
- The rise of an era of de-globalisation, shifting away from centralised manufacturing in China, adds a new driver to India's domestic policy focus. This shift might echo China's 1990s foreign investment boom as industries moved from the West.
- Over the past decades, Indian corporates have delivered US-style earnings growth and returns on equity, creating a medium-term catalyst for increases in growth in earnings per share and return on equity.
- Compared to the broader emerging markets universe, Indian equities are trading close to their historic average valuations, owing to their premium earnings growth looking ahead.
- MSCI India is trading at premium valuations, mainly attributed to the re-rating of IT services post-pandemic.

India: A New Driver Emerges

Since the turn of the century, India has achieved an annual GDP growth rate exceeding 9%. Although this has been slower than China's 12% annual increase, accelerated by its accession to the World Trade Organisation (WTO) in 2001, the early advantages China gained from joining the WTO have started to fade.

Following the 2008-2009 Global Financial Crisis, however, changes in leadership within each country steered their economies in opposing directions.

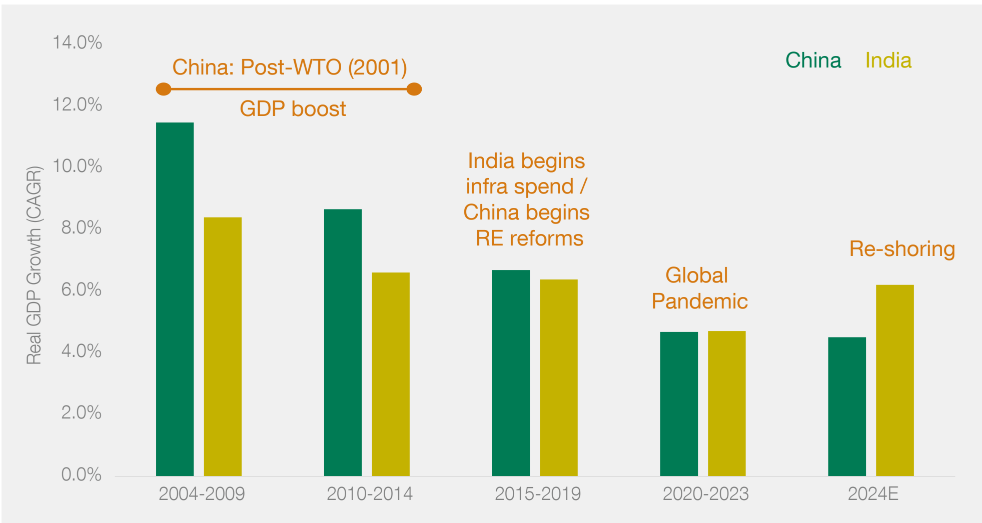
China, with Xi Jinping taking the helm in 2012, saw the nation pivot away from a growth model that was heavy on real estate, following his now famous December 2016 exhortation that, "*Houses are built to be lived in, not for speculation*", thus unofficially kicking off China's restructuring and reform of a sector that accounted for as much as 20-25% of GDP at the time.

RESHORING AND MODI'S REFORMS SET TO DRIVE THE NEXT FOREIGN INVESTMENT WAVE

Since taking office as Prime Minister in 2014, Narendra Modi has launched an economic agenda dedicated to enhancing productivity by investing in the nation's infrastructure.

This program includes not only physical and digital infrastructure, similar to China's approach since the 1990s, but also financial infrastructure to strengthen and deepen its domestic capital markets.

INDIA ECONOMIC GROWTH DRIVERS REMAIN AMIDST CHINA'S WANING TAILWINDS



Sources: IMF, Bloomberg Financial L.P. and UBP

The effort to boost India's domestic economy through investments led to a noticeable increase in fixed investment from about 30% of GDP at the beginning of his tenure, to 35% by the end of 2023.

Of equal importance, this investment has coincided with an increased share of global Foreign Direct Investment (FDI), from 1-2% before Modi took office, to 3% on average between 2016 to 2022. That equates to an additional 15 billion US dollars in FDI per annum under his government.

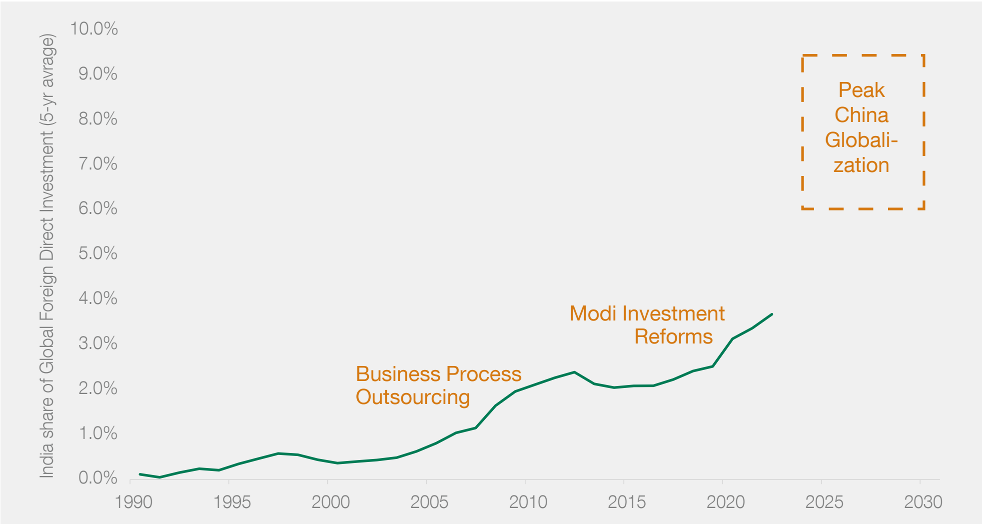
This rise is similar to China's increase in FDI share beginning in the 1990s. Whereas China began with the movement of global light manufacturing across the Pacific in the 1980s at a similar pace of around 2% of global FDI, India began with the migration of services – via business process outsourcing – at the turn of the century.

China's next stage saw the combination of investments in medium and heavy industries by global and local firms in the late 1990s, catalyzed by China's 2001 ascension to the WTO, matched by broadening investment in domestic infrastructure, seeing its share of FDI rise to 6-10% through the 2000s.

Looking ahead, India may similarly benefit from domestic reforms attracting increased domestic and foreign investment. Like China post-2001, India will also benefit from changes in global supply chains, as there is a shift towards diversifying and partially reshoring supply chains concentrated in China since the turn of the century.

Even though India is unlikely to reach the peak share of global FDI that China achieved when globalisation was at its zenith, we expect that reshoring will still serve as a similar driver for the upcoming investment cycle in India's economic growth.

PM MODI INVESTMENT REFORMS COMBINED WITH RESHORING MAY DRIVE INDIA'S NEXT FDI WAVE



Sources: United Nations Conference on Trade and Development and UBP

While supply chains are relocating to take advantage of India's vast domestic market and bourgeoning middle class, again similar to China at the turn of the century, India is also benefitting from growing bilateral trade with the world's largest economic regions, the United States and the European Union. Indeed, over the past decade, the US's share of imports from India has increased by almost 50 billion US dollars per annum while the EU's share of imports from India has nearly doubled over the same period.

STRENGTHEN THE DOMESTIC FINANCIAL SYSTEM

Another aspect of the Modi government's economic restructuring was the introduction of new bankruptcy laws and the enhancement of the financial system's digitisation.

Prior to the Modi-led effort to reform the Indian bankruptcy code nationally, the framework for resolving and restructuring corporate insolvencies was governed by various pieces of legislation across multiple jurisdictions, making it challenging for creditors to realise adequate recovery values over time.

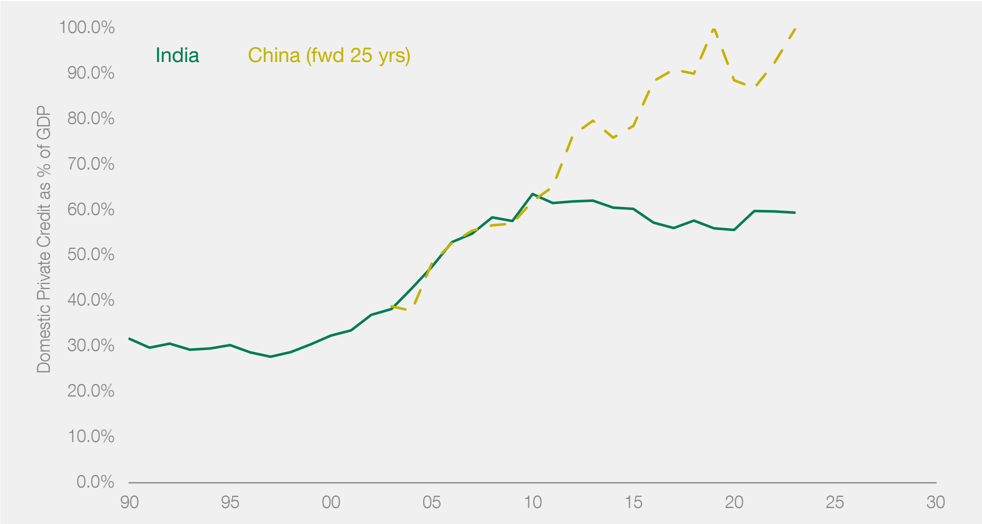
When these new laws came into force in 2016, non-performing loans (NPLs) accounted for over 9% of total loans in the Indian banking system, equivalent to 160 billion US dollars or nearly 2% of Indian GDP at the time. Following the implementation of the reformed bankruptcy code, banks were able to use the new provisions to lower NPLs to less than 1% of total loans across the system by 2022.

However, the bulk of this decline appears to have come via liquidations rather than restructurings/workouts, resulting in a decline in recovery values since implementation. Indeed, the stagnation of credit penetration suggests that credit risk appetite did not change meaningfully following the reform of the bankruptcy code, limiting the benefit to the wider economy. Even with that, cleaning bank balance sheets from NPL burdens raises the prospect of a credit-led cycle, much like China experienced in the late 1980s / early 1990s.

Admittedly, absent a subsequent phase of reforms of the bankruptcy code, a renewed 'boom-bust' cycle in credit could emerge in India once again. However, with credit penetration at only 60% of GDP, as China saw through the 1990s, the 'boom' stage may be beneficial for shareholders, leaving a potential 'bust' stage as only a medium-term risk on the horizon.

To avoid this, a subsequent phase of reforms should not only maintain a speedy bankruptcy process, but also improve the prospect of restructuring or workout regimes, enhancing recovery values and allowing for smoother credit cycles when they eventually arise.

LOW CREDIT PENETRATION + AN INVESTMENT CYCLE = CREDIT-LED GROWTH LIKE IN 1990S CHINA



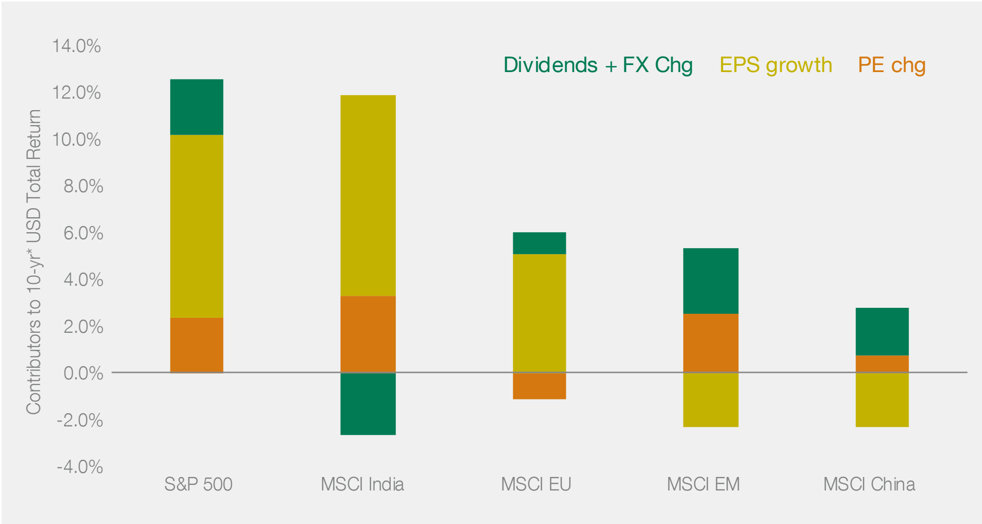
Sources: Bank of International Settlements, Bloomberg Financial L.P. and UBP

STRONG EARNINGS GROWTH FOUNDATION FOR INDIAN EQUITIES...

Operating under relatively constrained credit conditions for decades, India's listed corporate sector had to focus on efficiently using capital and effectively aligning management interests with shareholders.

Since 2010, large-cap corporates in MSCI India have been able to generate earnings growth of 9.2% at a compound annual rate. Even India's smaller-cap counterparts without comparable access to bank credit have generated 8.4% per annum earnings growth, both comparable to the 8.8% generated by the S&P 500 over the same period.

INDIA EARNINGS AND TOTAL RETURNS RESEMBLE US RATHER THAN EM EARNINGS TRENDS



Sources: Bank of International Settlements, Bloomberg Financial L.P. and UBP

Returns on equity for large Indian corporates have averaged nearly 16% per annum in India versus 17.6% for the benchmark US equity index, which has been boosted by the technology sector.

Thus, even if credit growth remains constrained amidst a domestic and FDI-driven investment cycle, stable shareholder returns on equity should allow India's high nominal GDP growth rates to flow through as continued high earnings growth for shareholders. Should the investment cycle coincide with expanding credit growth, the deleveraging cycle that has characterised many Indian corporates over the past decade may come to an end, allowing an upside surprise to return on equity and earnings looking ahead.

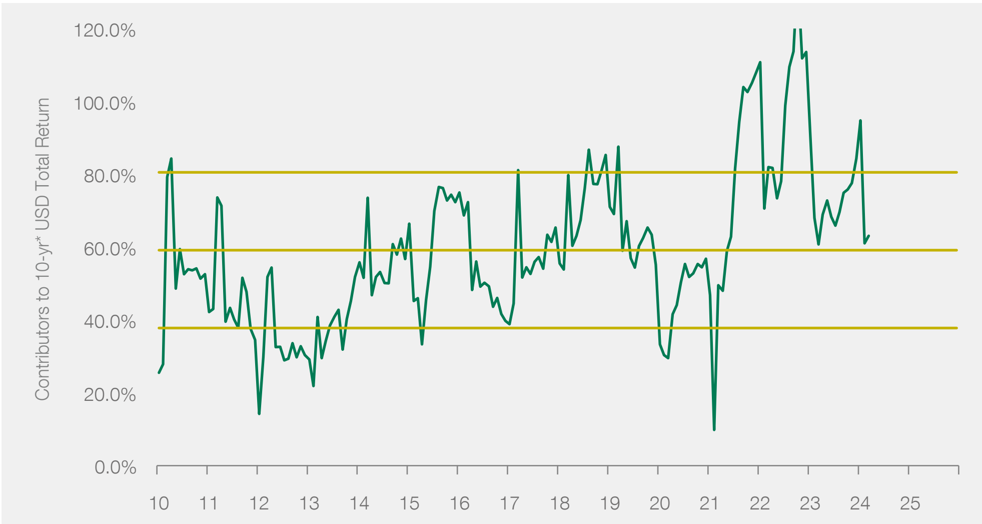
...THOUGH VALUATIONS ARE CHALLENGING

India's equity valuations remain elevated at nearly 23x earnings, driven by the re-rating of India's largest companies, including Reliance Industries, which re-rated from less than 14x earnings prior to the election of PM Modi to its current level of over 20x 2024 earnings. India's largest IT business services outsourcing firms have similarly seen an adjustment, following the global pandemic which increasingly realised expectations of the ongoing outsourcing of services across global economies.

We expect that the pace of growth in business services outsourcing may continue post-pandemic. Since the global pandemic, professional and technical services employment in the US has grown at nearly double the pace seen pre-pandemic, from 2.6% per annum from 2009-2019 to 4.9% per annum from 2020-2023, suggesting that outsourcing services offered by India's biggest providers may continue to grow at the same time.

In contrast, the secular re-rating of industrial conglomerate Reliance Industries may reflect optimism being priced in about the prospect of a domestic / FDI-driven investment cycle, from which Indian industrials might benefit. A similar re-rating has not moved through India's banking system, suggesting it underprices the prospect of deepening credit penetration alongside anticipated secular investment drivers looking ahead.

DESPITE PREMIUM ABSOLUTE VALUATIONS, MSCI INDIA TRADES NEAR AVERAGE VALUATIONS RELATIVE TO THE BROADER EMERGING MARKET



Sources: MSCI, Bloomberg Financial L.P. and UBP

For emerging market investors, the high absolute valuations of Indian equities are only at historical averages relative to broader emerging market equities. Indeed, the premium valuations of Indian equities compared to emerging markets in 2021-22 were addressed not by falling valuations and declines in Indian equities (they have risen 69% since early 2021), but CAGR earnings growth of nearly 25% compared to less than 4% CAGR for emerging markets as a whole.

Thus, with China having a weighting of nearly 23% in MSCI Emerging Markets, a pivot to the emerging world's second-largest market, India, with a weighting of almost 18%, offers investors the opportunity to participate in premium economic and earnings growth alongside the prospect of a secular investment cycle, not unlike what China experienced in the 1990s, as the global trade landscape continues to shift and especially as China moves through its reform and restructuring phase in the years ahead.

Investors should expand their search for emerging market growth with a focus on India as China moves through its own version of a multi-year, post-bubble economic restructuring as outlined in our November 2023 publication, *Looking Beyond China*.

STABLE INR EXCHANGE RATES WILL SUPPORT PERFORMANCE

Historically, the Indian rupee has weakened by nearly 4% annually against the US dollar. This has reflected slightly higher-trend Indian inflation prints – averaging around 5% annually since 2014.

Also serving as a drag on the currency has been India's current account deficit volatility during this period – with widening in the deficit tending to coincide with periods of increasing energy imports. The latest current account deficit was a modest 1% of GDP – which is more than manageable for the Indian authorities, suggesting that the rupee has little pent-up depreciation pressure.

Going forward, we expect that the Indian rupee will continue to illustrate a broadly stable profile especially if foreign direct investment flows towards India increase materially in the years ahead.

Overall, we think that investors do not need to hedge INR-denominated equity investments – as the generally stable INR profile will negate any need for aggressive hedging policies – saving investors hedging costs over time.

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