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Why India has much to offer

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India is one of the most diversified equity markets in Asia, potentially offering skilled investors significant room to add alpha. With numerous exogenous events weighing on corporate earnings in the last five years, the stage may be set for a recovery in earnings as the economy rebounds and reforms gradually bear fruit.

The Covid-19 pandemic may have affected India's economy more severely than many others, yet the MSCI India Index rallied 16% in 2020 and is up another 7.8% in 2021[1]. While Indian equities have garnered less investor attention in recent years compared to some of its emerging market peers, we believe that the less crowded Indian equity market has much to offer investors.

SIGNIFICANT DIVERSIFICATION A POTENTIAL SOURCE OF ALPHA?

For one, the MSCI India Index, which measures the performance of the large and mid-cap segments of the Indian market, is one of the most diverse in Asia, and among emerging markets. By having diverse sizable sectors that derive revenues from both within and outside of India, there are many opportunities for skilled stock pickers to buy into companies that can beat the broader market.

To illustrate, India's Information Technology (IT) sector accounts for 17% of the index and derives most of its income from North America as well as Europe. Healthcare and pharmaceutical companies, which makes up about 6% of the index, also earn a substantial portion of their income from overseas investments. Afterall, India manufactures 50% of the world's vaccines, 40% of the generics sold in America and a quarter of all medicine bought in Britain.

On the other hand, the Industrial and Financial sectors, which make up roughly a third of the index, are almost entirely domestically oriented, and tend to fare better when the Indian economy is in good shape.

Source: [1]Bloomberg. In USD terms. 2021 as of 10 March 2021.

Fig. 1 shows that in terms of variance, which compares the weight of the different sectors against the average sector weight, the MSCI India Index has a much lower variance versus many of its emerging market peers, implying that it is much more diversified.

As such, active managers can adjust sector weights according to their outlook of the domestic economy. This unique feature helps the Indian equity market outperform other emerging markets over the long term[2].

INDIA'S LOW CORPORATE EARNINGS PROVIDES UPSIDE

Meanwhile, Indian corporates have experienced multiple exogenous shocks over the last five years. These include:

Asset Quality Review (2016)

In the second half of 2016, the Reserve Bank of India conducted an Asset Quality Review, forcing the country's banks to deal properly with bad loans. Declared bad loans increased dramatically, and loan losses weighed on many lenders' earnings.

Banks were also asked to set aside more capital and make more loan provisions on a retrospective basis. This hit the broader economy as credit costs rose by ~300bps per annum.

Demonetisation (2016)

India banned lower currency denomination overnight on 8 November 2016 with the aim to combat "black money", fake notes and promote a cashless economy. The move effectively withdrew 86% of the notes in circulation and caused massive disruption, dealing a big blow to India's large informal economy,

Fig 1: Index: Sector breakdown and variance

MSCI Sector Weight (%)	India	Thailand	Malaysia	Philippines	China	Indonesia	Korea
Consumer Discretionary	8.57	5.90	3.65	3.09	35.18	9.03	9.29
Communication Services	2.34	9.31	8.58	6.56	20.07	12.55	7.92
Consumer Staples	10.41	12.92	13.94	6.28	4.49	11.90	4.03
Energy	12.80	15.86	4.17	-	1.57	4.40	1.35
Financials	27.05	13.07	31.65	18.09	13.53	49.24	6.57
Health Care	5.96	6.60	16.15	-	6.46	2.11	7.18
Industrials	3.23	9.41	7.87	34.85	4.50	-	5.77
Information Technology	17.33	3.53	-	-	6.70	-	49.76
Materials	9.03	11.40	6.19	-	2.08	9.55	7.44
Real Estate	0.27	4.05	-	27.37	3.62	-	-
Utilities	3.01	7.96	7.79	3.75	1.80	1.22	0.68
Variance	**61.1**	**15.6**	**76.4**	**161.4**	**106.5**	**238.8**	**203.0**

*Variance is the sum of square of the difference between each value and mean. In this context, the lower the variance, the more diversified the index.

Source: Eastspring Investments, MSCI. Data as at 31 December 2020.

Source: [2]10 years versus MSCI Emerging Markets as of end January 2021.

which is reliant on cash transactions. The Central Statistics Office attributed the demonetisation exercise as a key factor that reduced India's economic growth rate in the subsequent years[3].

Goods and Services Tax (2017)

India announced a nationwide Goods and Services Tax (GST) in July 2017, which replaced a complex patchwork of taxes that were imposed at the state level. However, the new tax initially hampered growth, as it led to widespread confusion among many small businesses and disruption of supply chains due to the multiple rates.

COVID-19 (2020)

The Indian economy is forecasted to have contracted 8% in 2020 as a result of the COVID-19 outbreak[4]. India's travel and tourism sectors took a major hit, while many small businesses without a digital footprint suffered, as did industries relying on large pools of unskilled labour.

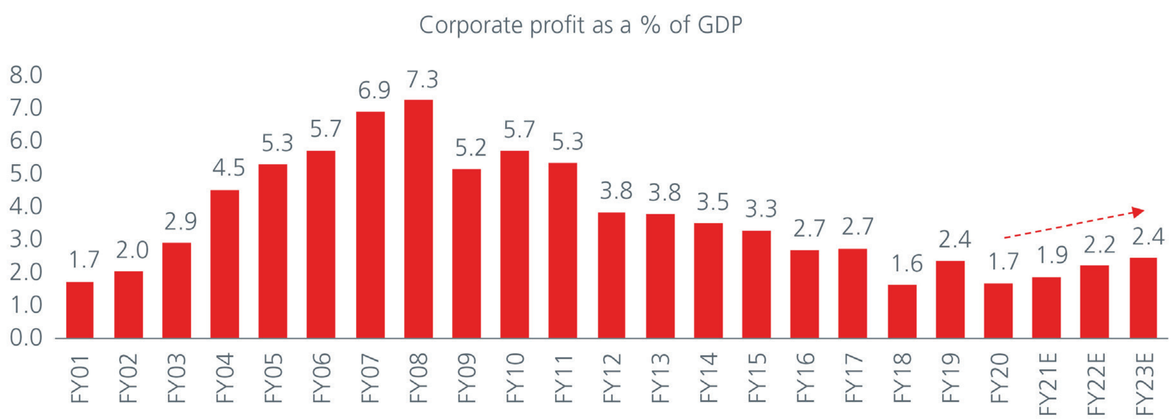
All the above events had led India's corporate earnings, as a percentage of GDP, to decline over the years. See Fig. 2.

This has in turn caused the price to earnings valuations of the Indian equity market to look expensive when compared to its peers. The good news is that as vaccines become more widely available and the worst of the pandemic effects start to fade, India's corporate earnings (as a percentage of GDP) can rebound from its low base, which will help temper valuations. The International Monetary Fund (IMF) forecasted that the Indian economy will grow 11.5% in 2021[5]. In addition, we also note that valuations on a price to book basis appear more reasonable versus the MSCI World and the MSCI Emerging Markets Indexes. See Fig. 3.

KEEPING THE FAITH IN INDIA'S LONGER-TERM REFORMS

India is no stranger to reforms – some of exogenous shocks mentioned earlier were precipitated by economic reforms. At the point of writing, the Indian government is facing protests from farmers in response to its proposed agricultural reforms. The Indian government also broke a decades-long taboo by unveiling plans to privatise two state-owned lenders in the FY22 budget announcement. These

Fig 2: MSCI India – corporate profits as a percentage of GDP (%)



Source: (LHS) Eastspring Investments, Bloomberg, as at 31 December 2020. (RHS) Morgan Stanley Research. As at January 2021. Please note that there are limiations to the use of such indices as proxies for the past performance in the respective asset classes/sectors.

Source: [3]https://www.indiatoday.in/education-today/gk-current-affairs/story/demonetization-gst-slowed-down-gdp-growth-of-india-1123939-2018-01-06 [4]IMF. World Economic Outlook. January 2021. [5]IMF. World Economic Outlook. January 2021.

add to the long list of reforms which the government has undertaken in the last three years to improve the labour market, change insolvency and bankruptcy codes and to make real estate transactions easier. See Fig. 4. Admittedly, implementation will always be a challenge, particularly for the reforms that require the alignment of the country's 29 states. For reforms that only need to be executed at the federal level, implementation should be easier.

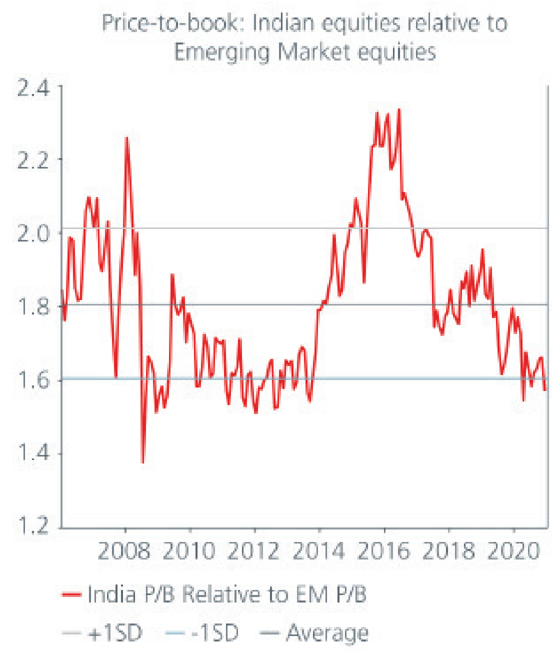
Meanwhile, the FY22 budget aims to shift expenditures away from less productive expenditures (e.g. salaries, pensions, subsidies) into more productive investments. Specifically, the budget for capital expenditures has been increased by 26% to INR 5.5 trillion, with a thrust towards infrastructure that can draw in fresh manufacturing capacity. The budget also promises higher spending for education, healthcare, nutrition and urban infrastructure. If executed effectively, this can help India get onto the path of sustainable growth which is needed to generate sufficient jobs and maintain its external balance.

MUCH TO OFFER

As one of the most diversified equity markets in Asia, India offers active investors significant stock picking opportunities and room to add alpha. Following years of lack luster earnings caused by idiosyncratic events, the stage may be set for a recovery in India's corporate earnings as the economy recovers from COVID-19 and as reforms gradually bear fruit.

While short term risks such as another wave of COVID-19, a botched vaccine rollout or sudden inflationary pressures bear monitoring, the diversity of India's equity market suggests that there are opportunities, regardless of whether there is a bull or bear market at home.

Fig 3: MSCI India Index – Price to book valuation



Source: Eastspring Investments, Refinitiv Datastream, as at 31 December 2020. Please note that there are limitations to the use of such indices as proxies for the past performance in the respective asset classes/sector. Dark grey horizontal lines represent average; light grey and blue lines represent +1/-1/ standard deviation/ P/B: Price-to-book.

Fig 4: India's structural reforms – last three years

Measure	Objective and Impact
Production Linked Incentive	Boost ***large scale domestic manufacturing*** of goods to bring about import substitution and increase global market penetration.
Phased Manufacturing Programme	Promote ***self reliance*** by strengthening indigenous manufacturing capabilities by providing ***infant industry protection***.
Labour Reforms	***Codification and rationalisation of labour laws*** to facilitate flexibility in implementation. Key states have taken the lead in tweaking state labour laws.
Land Reforms	Creation of ***land banks*** so as to make land easily identifiable for industrial projects and simultaneously also provide details about logistics.
Expanding Infrastructure	Provides a bulwark for sustained economic growth by encouraging the multiplier effect. Last few years have seen increased investment in road, rail, port sectors.
Agriculture	The 3 agriculture bills mark a landmark achievement for the Indian agriculture sector, as the reforms are critical structural steps to ***remove supply-side bottlenecks and improve productivity*** of the farm sector by attracting investments and boosting rural incomes.
Tax	The **corporate tax rate** was reduced from 30% to 22% (without exemptions), reducing the effective tax rate from 35% to 25% for existing companies and from 25% to 15% for new manufacturing firms, bringing the corporate tax for India broadly on par with the average tax rate of 23% for Asian countries. **Goods and Services Tax** was introduced in 2016, with the objective of simplifying the tax system by subsuming all indirect taxes, avoid cascading of taxes, minimising tax evasion by increasing compliance.
Revision of MSME definition	Encourage ***Micro, Small & Medium Enterprises to grow in size*** while creating an enabling environment to foster innovation, investment and inclusive growth.
Insolvency and Bankruptcy Code	Insolvency and Bankruptcy Code, 2016 was enacted for ***reorganisation and insolvency resolution*** of corporate persons, partnership firms and individuals in a fair and time bound manner for maximisation of the value of assets of such persons through its consolidated framework.
Inflation Targeting & Monetary Policy Committee	The Reserve Bank of India adopted the flexible inflation targeting framework in 2016 with the primary objective of ensuring ***price stability*** i.e keeping inflation at 4% with a tolerance of +/- 2% while also focusing on ***economic growth***.
Real Estate Regulatory Authority	The objective of RERA is to ***enhance transparency and eliminate corruption*** by disclosing full details to the buyers, setting up a grievance redressal mechanism and prevent delays in handing over projects to buyers.

Source: Eastspring Investments. 31 January 2021.

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