



Photo credit: QAD

India Outlook

May 2024



Emerging Markets Value

India Outlook

Introduction

India is on the brink of an evolution of their economic development led by infrastructure investments and favorable demographics. Currently, the world's fastest-growing major economy, India is expected to outpace Germany and Japan and become the world's third-largest economy by 2027, according to BlackRock. While comparison is a thief of joy, we highlight China's development in the 2000s as a proxy for the magnitude of the development opportunity that lies ahead of India. During the 2003-2016 era, Chinese infrastructure investment significantly outpaced the average GDP share of government investment in advanced or emerging economies. According to Dinlersoz and Fu's article in the Journal of Development Economics, as agriculture resources shifted to other areas, infrastructure expansion accounted for 14% of China's average annual growth rate in the same period. This supported a structural change in labor-augmenting productivity improvement. At that time, China was synonymous with global economic growth and one of the best examples that underscored the rise and opportunities of Emerging Markets. Looking ahead, India gives us the same level of excitement as it is poised to continue transforming its economy.

India's equity market has seen a rerating over the past decade, benefiting from multiple converging trends. We are optimistic about India's prospects over the long-term, however, we remain cautious in certain areas where valuations are elevated. We have identified select pockets of relative value, driven by bottom-up opportunities that we discuss in this paper.

The Backdrop: Equities Have Rerated

Indian equities have seen a rerating over the past decade. The Sensex Index has traded at an average forward P/E of 16.4x during the years from 2014 to 2019. Excluding 2020 which was impacted by the pandemic, the Sensex index has traded at an average forward P/E of 19.1x (since the beginning of 2021). The current forward P/E valuation of 18.2x only trails two markets – the US and Japan, according to SBI Securities.

Exhibit 1: SENSEX Index Fwd. P/E (Pre- and Post-2020 Averages in Orange)



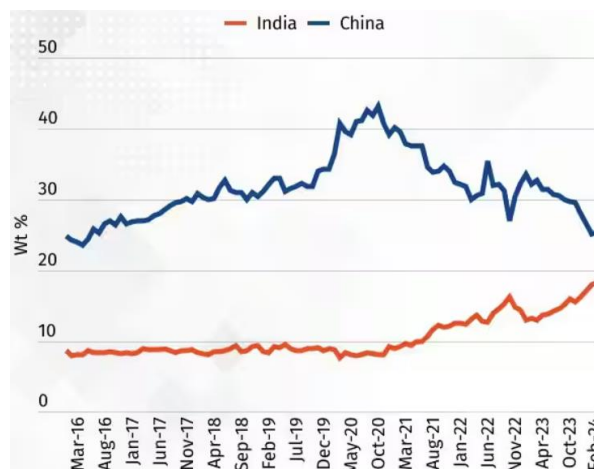
Source: Bloomberg

India's equity valuations are expensive on an absolute basis, however, its corporate return on equity (ROE) increased in contrast to China's ROE deteriorating. According to Bloomberg, MSCI India's ROE went from 11.1% in 2019 to 14.7% in 2023, while MSCI China's ROE went from 12.6% to 10.6% in the same period. China's weight in the MSCI EM Index changed from 41% in June 2020 to 25.4% as of February 2024. On the other hand, India's Index weight has increased from 8% to 17.9% during the

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same period, according to Nuvama and MSCI. To provide further context for the rerating of Indian equities, we highlight three important drivers for this backdrop: demographics, political reforms, and infrastructure development.

Exhibit 2: MSCI EM Index India and China Weights (%)



Source: Nuvama Alternative & Quantitative Research, MSCI Indices

Firstly, India is a country with the largest population in the world at 1.4 billion, after overtaking China in 2022, according to Statista Research. In the global context, its working-age population has also been increasing over the past half-century and is likely to continue given that the average median age is 29 years, compared to 37 years in China and 38 years in the USA, according to the IMF. The potential for further workforce productivity is likely to increase from the trend of urbanization. The urbanization level in India has grown from 18% in 1960 to 36% in 2022. This is still significantly below the peer group, with Thailand's urbanization rate at 53%, China at 64%, and Malaysia at 78%, according to the World Bank. With more people living in urban areas and pursuing better-paying opportunities, this has supported the rise of the middle-income class.

Secondly, political reforms the country undertook were supportive of the equities rerating. India has transformed from frequent government changes and fractured electoral periods in the 1990s to a more stable environment with Prime Minister Narendra Modi pursuing a third term with his right-wing Hindu nationalist Bharatiya Janata Party (BJP).

It is important to emphasize that the reforms that occurred between 2016 and 2017 are largely responsible for the economic formalization that benefited equity markets. In 2016, India demonetized 86% of its currency in circulation with the intent to formalize the economy by seizing undeclared income and counterfeit currency, according to the American Economic Association. Afterward, Goods and Services tax laws were implemented, replacing the complex structure of central and state taxes, to support the ease of doing business. The Insolvency and Bankruptcy Code followed, providing a time-bound process to resolve insolvencies of companies, and to address some of the concerns among the investor community. Additionally, the Real Estate Regulatory Authority Act (RERA) was passed, protecting buyers by improving transparency requirements for project developers. While these reforms initially led to a loss of jobs and economic output, the struggles proved to be only temporary. The economy has since rebounded and experienced a trend of formalization, as clearly seen in Exhibit 3.

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Exhibit 3: Market Share Trends Across Sectors

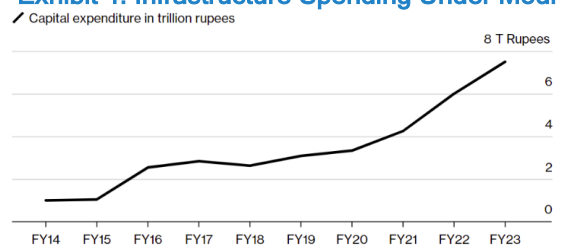
Sector	Parameter	Share	FY17	FY20	FY23
Bank Credit	Credit Market Share	Top 6	48.4%	55.8%	61.8%
Cement	Sales Volume	Top 5	46.6%	53.0%	58.0%
Steel	Sales Volume	Top 6	56.0%	63.0%	64.0%
Telecom	Revenue Market Share	Top 3	66.3%	83.4%	90.0%
Passenger Vehicles	Volume	Top 4	77.5%	83.3%	86.0%
Domestic Pharma	Revenue Market Share	Top 20	65.0%	65.8%	68.3%

Source: Avendus Spark Research

The formalization was achieved by increased volume growth and pricing power of the leading companies. With positive operating leverage, these companies were able to improve their cash flow profiles and ultimately improve their balance sheets through debt repayments. Debt to Equity levels of Indian corporates fell from 93% in FY14 to 63% in FY23, according to CMIE and Spark Research.

Thirdly, infrastructure development has provided a supportive backdrop for equities. Through initiatives such as the National Monetization Pipeline (NMP), the federal government's capital expenditure as a percentage of GDP has risen to 3.3% in FY2024 (vs. sub 2% pre-pandemic). The government is injecting capital into various sub-sectors, upgrading power grids, roads, railways, and urban development. This should likely result in job creation and further improve workforce productivity. Going forward, India's infrastructure is expected to grow on the back of planned investments of over \$1.4 trillion by 2025, according to EY.

Exhibit 4: Infrastructure Spending Under Modi



Source: Budget documents, Ministry of Finance, Bloomberg

Additional support for infrastructure development should continue with the Production-Linked Incentive (PLI) program. The PLI program was launched in 2020 and covers 14 industries, with half of the program's subsidies allocated to electronics and parallel semiconductor investments. The PLI-related investments increased five times from FY22 to FY23 reaching \$5.5 billion, and could, according to ICRA credit ratings, peak at \$20 billion in FY26.

Private capital expenditures are expected to pick up their pace as well. Several sectors are expected to boost their capacity additions in the next three years at a faster rate than in the last five years.

Exhibit 5: Capacity Additions Are Expected to be Elevated

Sector	FY20-24	FY25-27E
Cement	144 MT	165 MT
Steel - Flat	7 MT	24 MT
Steel - Long	4 MT	7 MT
Hospitals (Listed Universe)	4,000 beds	15,000 beds
Aviation (Gross Fleet Addition)	50	400

Source: Avendus Spark Research

The Outlook: Value Opportunities

Reforms improving corporate balance sheets have also boosted the financial health of banks, that are more adequately capitalized with Tier 1 ratios above historic levels, according to Goldman Sachs. This dynamic is supportive of credit expansion, while Indian Banks trade at cheaper valuations than the broader equity market (BANKEX Index P/B of 2.1x vs. SENSEX Index P/B of 3.3x). A case in point is Federal Bank, a banking business growing in urban and rural India. Federal Bank underwent an equity raise in 2023, and the de-risking of its book. The bank is focused on growing higher-yielding loan segments while maintaining high asset quality. As competition for deposits remains elevated due to RBI's attempt to further lower systemic leverage, its high market share in remittances at over 19% of total NRI (non-resident Indians) remittances in India should be positive for performance as well.

An additional example is HDFC Bank, one of India's largest and most well-known private sector banks. The bank has commanded a premium valuation throughout its trading history up until 2022 when it merged with its sister company, the country's largest mortgage lender, to form an even larger financial institution. The combined company's valuation has since derated to the lowest level in the past decade due to antitrust and integration uncertainties. We expect the bank to benefit from the merger synergies which should reduce funding costs and lead to a recovery in net interest margin. Moreover, the core business should continue to grow through cross-selling of financial products.

The urbanization trend will likely support the growth of many segments that are currently underpenetrated. A case in point is two-wheelers. Motorbikes or scooters are only owned by 47% of the Indian population, whereas for some regional peers, such as Vietnam, Indonesia, and Malaysia, the penetration is above 80%. The two-wheeler segment is also likely to benefit from the real wage growth trend among the Indian population, which according to the Economic Times is expected to increase by 4.9% in 2024. One of the beneficiaries of the two-wheeler penetration potential is Shriram Finance, one of India's largest non-banking financial companies. The company offers loans in various segments including commercial vehicles and two-wheelers. After merging with Shriram Transport Finance Company, we believe the merged entity should benefit from improved overhead efficiency, lower cost of credit, and opportunities to expand the product suite.

Real estate is also an exciting area of opportunity. The current real estate contribution to GDP in India is only 7%. In comparison, China's real estate accounts for approximately 30% of GDP, while in the US it accounts for 15%, according to Goldman Sachs and Asia Fund Managers. India's real estate sector is currently valued at \$477 billion, with projections foreseeing an expansion to \$5.8 trillion by 2047. This would imply the sector contributing to 15.5% of the total economic output, according to Avendus Spark Research. Post-pandemic, the real estate market in India saw a recovery and started an upcycle, after a prolonged 8-year downturn. We identified Oberoi Realty as one of the leading luxury real estate development companies in Mumbai. Oberoi should be one of the beneficiaries of the real estate upcycle as the company has multiple upcoming launches, for which the majority of the construction costs have already been incurred. This should be supportive of their cash flow generation capabilities.

DRZ Emerging Markets Value Fund Portfolio Manager, Marc Miller was able to get first-hand insights as he visited India in 1Q24, where he met with the top management and investor relations teams of multiple companies.

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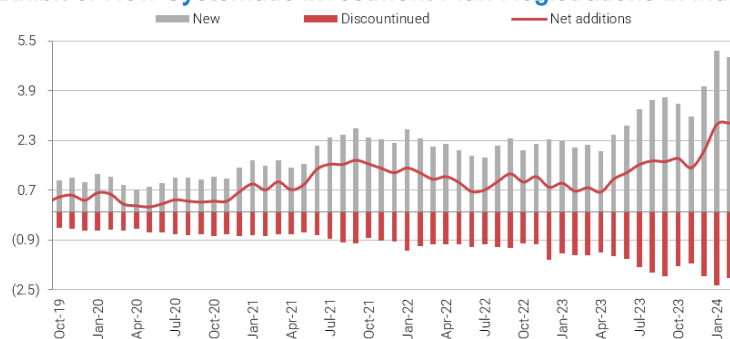


Marc Miller (left) met with Mr. Vikas Oberoi, CEO of Oberoi Realty (right)

Concluding Remarks: What Else Is There to Consider?

Marc came back from his trip to India very constructive on the government initiatives to transform the economy. We believe that infrastructure growth will be among the main drivers of the evolution. Additionally, the participation of retail investors in India has been increasing with the financialization of savings. With more people starting to have long-term investments allocated to Indian equities, this should incentivize the government to continue supporting the economy.

Exhibit 6: New Systematic Investment Plan Registrations in India



Source: AMFI, Kotak Institutional Equities

Ultimately, we remain nimble. For India, elevated oil prices could pose a risk as the country is among the largest global oil importers, while elevated interest rates could impede consumption trends. In the short term, as some investors reduce their underweight in China, this could also result in a tactical capital allocation shift to China from other Emerging Markets, such as India. As of 1Q24, we were underweight in India.

Despite current valuations, we still believe that pockets of relative value exist. Partially responsible is the relatively low concentration of the top 10 constituents in India's equity market. MSCI India's concentration of top 10 companies is only 38% compared to over 60% in many EM countries,

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according to Bloomberg. This suggests there is a more diverse set of opportunities across multiple sectors compared to other Emerging Markets countries.

Additionally, there are things to consider beyond absolute valuations. For example, despite Chinese equities trading at historically attractive valuations, the MSCI China Index ROE is expected to remain below historic values, at 10.7% and 11.0% in the next two years. This makes us more concerned about China's equity market performance over the medium term. On the other hand, improving ROEs in India should be supportive of equities. Bloomberg consensus estimates that the ROE of MSCI India should improve from 14.7% in 2023 to 15.6% in 2024 and 16.0% in 2025. With demographic tailwinds, healthy corporate balance sheets, continued infrastructure development, and evolution in consumption patterns, we remain optimistic about India's long-term prospects for equities and will continue to look for bottom-up opportunities with catalysts.

Disclosures

DePrince, Race & Zollo, Inc.
EMERGING MARKETS VALUE COMPOSITE
June 30, 2010 through March 31, 2024

Year	Gross Return(%)	Net Return(%)	Index Return(%)	Composite 3-Year Annualized Standard Deviation	Index 3-Year Annualized Standard Deviation	Number of Portfolios	Composite Dispersion(%)	Strategy Assets (\$Millions)	Total Composite Assets (\$Millions)	Total Firm Assets (\$Billions)
Q1-2024	5.25	5.06	2.38	16.46%	17.51%	≤5	N/A	442	442	5.079
2023	13.07	12.22	9.84	16.17%	17.14%	≤5	N/A	421	420	4.811
2022	(15.60)	(16.28)	(20.09)	22.49%	20.26%	≤5	N/A	327	327	4.756
2021	3.39	2.56	(2.54)	21.40%	18.34%	≤5	N/A	400	400	4.347
2020	16.70	15.77	18.31	22.54%	19.60%	≤5	N/A	289	289	3.447
2019	22.07	21.11	18.43	13.54%	14.17%	≤5	N/A	245	245	3.562
2018	(14.37)	(15.06)	(14.58)	14.33%	14.60%	≤5	N/A	462	432	3.916
2017	32.20	31.17	37.28	15.97%	15.35%	≤5	N/A	142	142	4.814
2016	16.67	15.75	11.19	17.06%	16.07%	≤5	N/A	92	92	5.565
2015	(12.73)	(13.44)	(14.92)	14.96%	14.06%	≤5	N/A	79	40	5.788
2014	(5.44)	(6.20)	(2.19)	15.01%	15.00%	≤5	N/A	89	46	7.901
2013	5.09	4.26	(2.60)	18.45%	19.04%	≤5	N/A	32	32	8.517
2012	17.96	17.03	18.22	N/A	N/A	≤5	N/A	16	16	6.770
2011	(21.77)	(22.40)	(18.42)	N/A	N/A	≤5	N/A	13	13	6.588
06/30/10										
12/31/10	29.85	29.35	26.69	N/A	N/A	≤5	N/A	17	17	5.832

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9. The composite creation date is July 1, 2010, and the composite inception date is June 30, 2010. DRZ's list of composite descriptions is available upon request.
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