India Equity Update

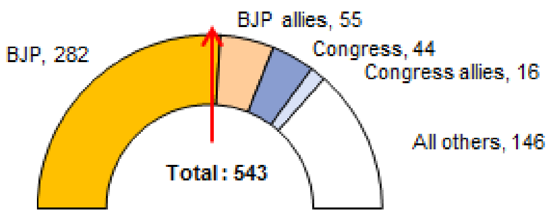
India Election Commentary, 23 May 2019

With the final results coming in, the Bharatiya Janata Party (BJP) led by Narendra Modi has performed better than expected in the general election, being re-elected with an increased majority.

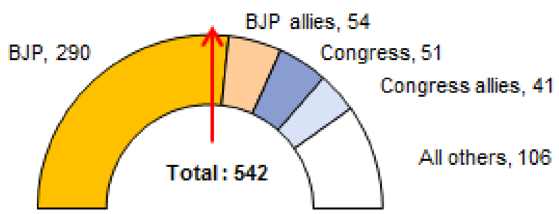
Markets went into India's longest ever election, spanning well over a month, with a heightened sense of anxiety given the number of possible permutations as to the outcome. With the nation grappling with major internal and external economic and geo-political challenges, the consensus focused on a new but messy 'third front' coalition led by the BJP, with the National Democratic Alliance (NDA). However, the picture began to brighten earlier this week following an exit poll which pointed to a large majority for the Modi government. Although exit polls in India are not usually terribly reliable, investors reacted very positively on the basis that the likelihood was that it will be 'business as usual'. The election results which followed confirmed the exit polls, giving the BJP a majority in its own right and not having to rely on NDA coalition partners, a strengthened mandate for Modi.

With only a few results to come the election results so far are as follows:

2014 Final Result



2019 <u>Tentative</u> Result



Implications

The re-election of the BJP with an increased share of the vote points towards greater political stability and a continuity of policy at the very least. This gives room for investors to refocus on economic and corporate fundamentals which are both positive and challenging at the same time.

The current investment environment presents external headwinds and a number of internal challenges that the new government will have to address promptly.

The two pressing external issues which require a response are:

- Rising oil prices - India is vulnerable by virtue of being a large net importer of oil
- Foreign exchange volatility – movements in the US dollar rupee rate has a big effect on fund flows

The internal economic issues are possibly more challenging and in this context the wish list of investors would probably start with the appointment of a competent and constructive finance minister and cabinet of ministers. Thereafter the wish list would likely include the following:

- Moves to eases the current tight liquidity scenario
- A significant interest rate cut
- An income tax cut in the first budget to stimulate consumption
- A corporate tax cut to stimulate investments – this has been promised in the first term
- A rationalisation of the current confusion of Goods & Services Tax (GST) rates
- Moves to speed up the of resolution of non-performing assets in the banking system
- Raising the future growth potential through a big push on infrastructure development - housing, highways, railways, metros as major areas of focus
- Measures to help rural areas - social schemes and transfers

The shorter-term initiatives need to be implemented as soon as possible to revive economic activity and followed up with longer-term measures, even at a cost of increasing the fiscal deficit by 50-100 basis points for the next year or two.

Even if only some the above measures are implemented, the current 15% corporate earnings growth forecasts for the current financial year and the next, would look more secure. This alone could provide the upside to the market albeit at a likely more measured rate than earnings progression given current valuations.

The Strategy
From a strategic perspective, when it came into power in 2014, we always believed that it would be very difficult for the Modi government to fulfil all the expectations of it at the time. This has certainly been the case, particularly as the challenges have proved greater than predicted at the time.

Our investment philosophy over this period of time has been quite simple:

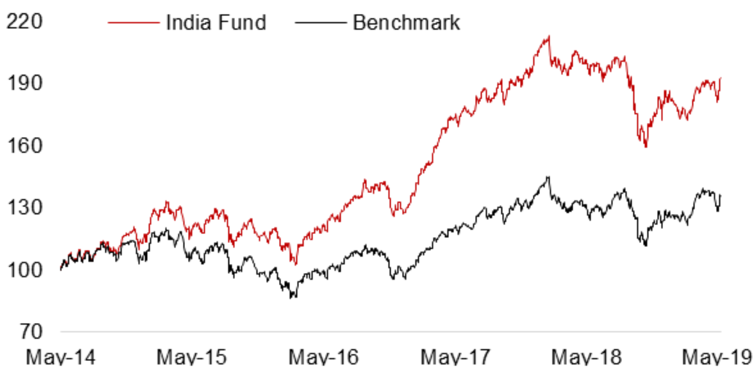
- Consumption will be the big driver for the Indian economy, not infrastructure or industry
- Bigger, fitter and strong companies will continue to raise market share at the expense of the weak
- Policy environment will be tough and it might be a case of one step forward and two steps back
- Broader market earnings growth would continue to disappoint

Things we missed:

- The length of time that activity was disrupted by Demonetization, the introduction of the GST
- Inability of even the stronger but smaller players to prosper in this environment

Despite the challenging environment, our stock selection proved particular successful, especially our steady growth choices like HDFC Bank, Hindustan Unilever and Bajaj Finance. This helped the fund to deliver a US dollar return of 92.7%, compared to the benchmark return of 35.7%.

Fund Performance vs benchmark



Source: Nomura Funds Ireland – India Equity Fund

Outlook
Going ahead, we expect the investment backdrop to improve gradually as the government sets about resolving the current set of challenges facing the economy. In this they will need to think laterally to bring and take onboard the lessons from the mistakes in the previous term. Until this change becomes apparent, we believe it will be more of the same for the equity market, the only discernable difference being greater certainty as to the earnings picture.

In the event of a further escalation in the trade war, India could be a relative outperformer amongst the emerging markets, but by the same token, could underperform in the event of a resolution in which export oriented nations were perceived to be the main beneficiaries.

Portfolio Positioning

In summary, at this stage we are not planning significant changes to our portfolio strategy and composition. We believe that earnings growth for our portfolio will be much stronger than for the wider market as will also be more visible and stable. The portfolio is biased towards larger capitalization names and until we see a perceptible increase in economic activity we will maintain that stance. Change could be sparked by the government bringing forward a rejuvenated reform agenda that would give economic growth an upward trajectory and, in that case we would adjust our positioning to take advantage of higher growth rates.
As for oil prices, if these remain under control 15% earnings growth scenario is very plausible and our portfolio is positioned in that framework.

Our main portfolio tilts are follows:

- Overweight private sector financials (40%) banks which will continue to grow faster than the state owned entities - any injection of liquidity into the system and a speedy resolution of the problems in the non-banking financial system should benefit our position.
- Strong positioning in both consumer discretionary and staples (25%), focusing on the best quality companies which can withstand any global uncertainties. While we did not anticipate the sharp slowdown in consumption, we think it is only transient in nature. Moves to revive consumption both in the urban and the rural economies through interest rate and income tax cuts or strengthen social schemes should be beneficial.
- Focus of infrastructure development. We have the largest infrastructure company in India and cement is an indirect play on both this and housing.