The magic of India

Notes from the road

Guido Giammattei
EM Equity Portfolio Manager

Published December 2024

> **"GDP growth has averaged 8% in the last 10 years and, over the last two decades, India's share of global GDP has doubled to 10%."**

Upon landing in Mumbai, I noticed the word 'magic' curiously often: the 'Magic of Abilities' juice bar just outside Mumbai airport, the 'Magic Carpet' restaurant, 'Magic Pharmacy', and even a 'Magic Carpet' newspaper. Indeed, the word seems fitting for a country whose economic journey in just over a decade has been nothing short of magic. Gross Domestic Product (GDP) growth has averaged 8% in the last 10 years and, over the last two decades, India's share of global GDP has doubled to 10%[1]. But what about the next decade? Will it be possible to recreate the same success and achievements? The International Monetary Fund (IMF) expects India to become the third largest economy in the world by 2030.

Juice bar in Mumbai airport.

Site visit to a private healthcare operator in Chennai.

[1] Bloomberg, November 2024.

Exhibit 1: Median population age by country

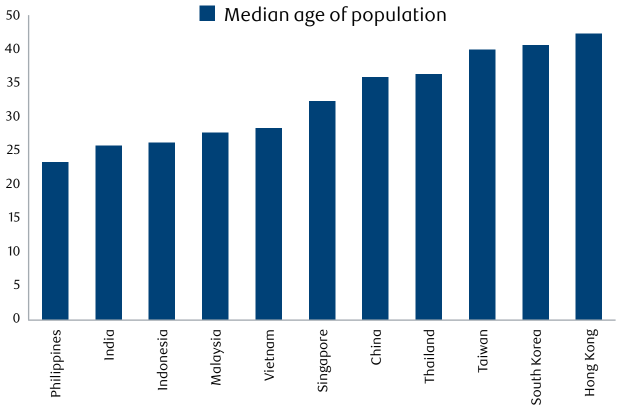
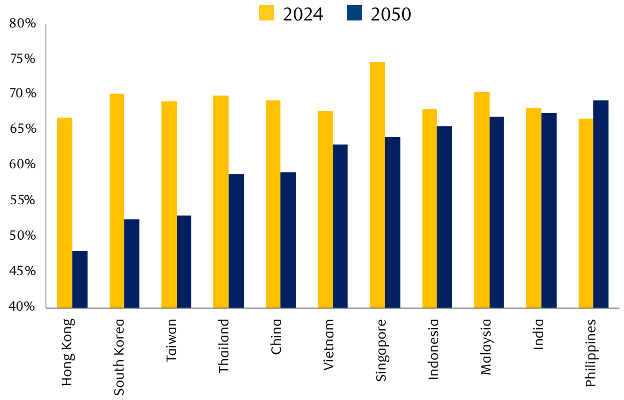


Exhibit 2: Current versus expected working age population by country



Source: World Population prospects, as at November 2024.

India's relatively high equity valuations could potentially be justified if one can gain confidence in the durability and quality of growth from the country and its corporates. After observing the degree of transformation that the nation is undergoing, and meeting with many corporates, government officials and financial agencies (including the IMF), I have returned with a stronger sense of conviction. If political stability and reforms continue, India's economic growth is underpinned by several structural factors.

> **"India offers a fertile ground for stock picking, with many high return and quality companies."**

The first and most important is India's demographic dividend. With a median age of 27.6 years (Exhibit 1), India is one of the youngest countries globally and has the world's largest youth population. The country's working age population (15-64 years) stands at over 920 million[2], and the UN expects this number to surpass 1 billion in the next 10 years. This would be largest globally in absolute terms and second largest as a percentage of the total population (Exhibit 2).

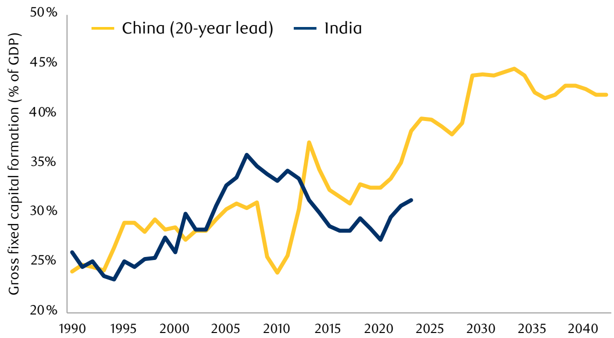
That means that more people are joining the workforce in India every year, while the working age population in most countries globally is shrinking significantly. Reforms and growing investments to build a digital, financial, and physical infrastructure pave the way to capitalise on this demographic dividend.

From an equity investor's standpoint, India offers a fertile ground for stock picking, with many high return and quality companies. One of the main conclusions from my meetings is that these companies are managed with a focus on efficient use of capital and long-term shareholder returns. This is probably helped by the fact that founders – called 'promoters' in India – own fairly large stakes in listed companies. Promoter ownership in the top 70 Indian companies is 45%[3].

The three areas I identified as most compelling in terms of potential equity exposure are infrastructure, manufacturing, and financials. Consumers stocks also offer exposure to India's attractive demographics and growth, but valuations are quite elevated at this point and competition is intensifying.

Infrastructure investments have been the primary driver of growth in India, overtaking consumption for the past three years. Driving through Chennai and Mumbai makes it clear that even while significant infrastructure investments have been made, there is still much work to be done. India is where China was more than two decades ago in terms of infrastructure (Exhibit 3), hence the economic benefits and productivity gains from such expenditures are likely to remain high for many years ahead. While driving through Andheri, the most prominent business and industrial hub in Mumbai, many roadways are still unconnected, and this causes considerable traffic congestion and delays. Many projects are already in progress to address these issues, and more will follow, including in subterranean infrastructure, bridges, renewable energy, and hospitals. These projects will likely play a significant role in promoting growth, just as they did in China two decades ago.

Exhibit 3: India versus China infrastructure investments as a % of GDP



Source: OECD, World Bank, as at November 2024.

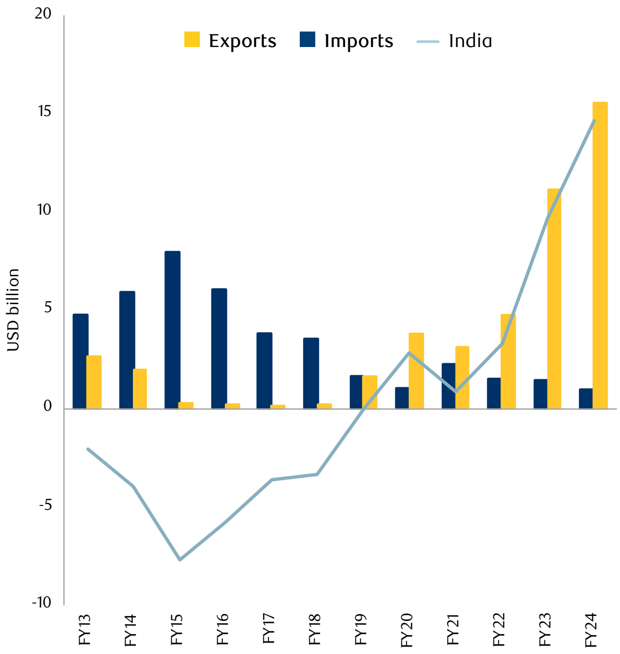
[2] https://www.indexmundi.com/facts/india/indicator/SP.POP.1564.TO
[3] Morgan Stanley, The Indian Opportunity, January 2024.

India also offers significant potential in the manufacturing sector. The country is a major player in the services sector; Business Process Outsourcing ("BPO") and IT Services are two areas where India has excelled. With geopolitics acting as a tailwind, and the sheer size of India's workforce as a significant competitive advantage, the country is currently on the cusp of shifting from a service economy to a design and manufacturing one. Particularly in the electronics manufacturing services ("EMS") sector, India is benefiting from global supply shifts.

The government's emphasis on 'Make in India, Make for the World' complements this labour advantage, by incentivising marquess global companies to invest in Indian manufacturing. Unlike Asian peers, India has a large trade deficit in electronics, with this sector being the second largest contributor to the country's overall merchandise trade deficit. Many government policies have therefore been focused on supporting the EMS sector for both domestic use and exports. As a result, India's electronics trade has grown at a CAGR of 15% over the past five years and the electronics import/export ratio has reduced sharply over this period, from 8.3x in FY18 to 3.2x[4]. Notably, mobile phones have been a success story within the industry. Mobile exports have significantly increased over the past five years, and net exports are now positive after several years of deficit, buoyed recently by a sharp rise in exports from companies such as Apple and Samsung (Exhibit 4).

The Indian financials sector is another area which stands out in terms of the structural growth opportunity and quality of companies. India suffers from underpenetration across all financial segments. The country's credit-to-GDP ratio (at 53%) is still lower than other developed and developing economies (40-220%) (Exhibit 5). Similarly, a life insurance premium-to-GDP of approximately 3% for India is low relative to other economies. As per capita income and financial literacy improves, demand for financial products across savings and investments will also increase.

Exhibit 4: India mobile phones trade balance

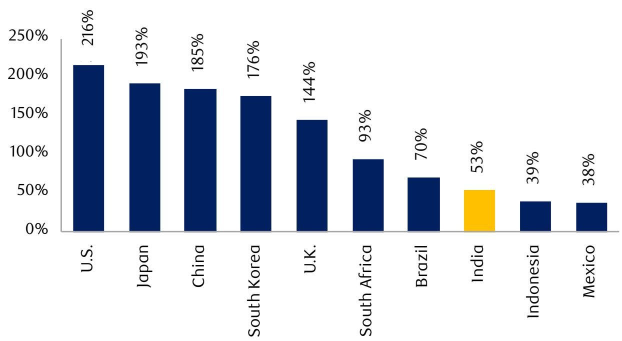


Source: India Ministry of Commerce, HSBC, as at November 2024.

"India's electronics trade has grown at a CAGR of 15% over the past five years and the electronics import/export ratio has reduced sharply over this period, from 8.3x in FY18 to 3.2x."

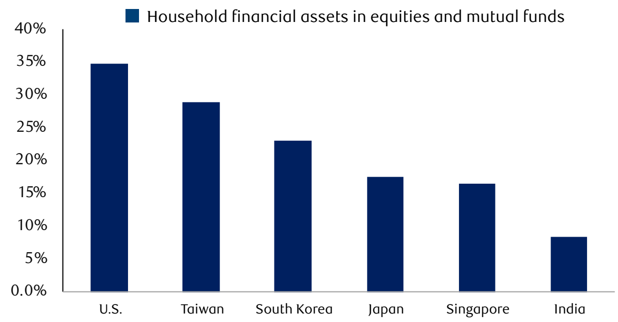
The mutual fund industry in India has witnessed an 18% CAGR in assets under management from 2015 to 2023[5]. Growth in Systematic Investment Plans ("SIPs") in recent years has meant that retail investors have become bigger participants in the equity market. We expect domestic participation to continue to grow, given less than 10% of households' financial assets are currently in the form of equity and fund products, compared to circa 30% in, for example, Taiwan (Exhibit 6).

Exhibit 5: Domestic credit as a % of GDP



Source: India Ministry of Commerce, HSBC, as at November 2024.

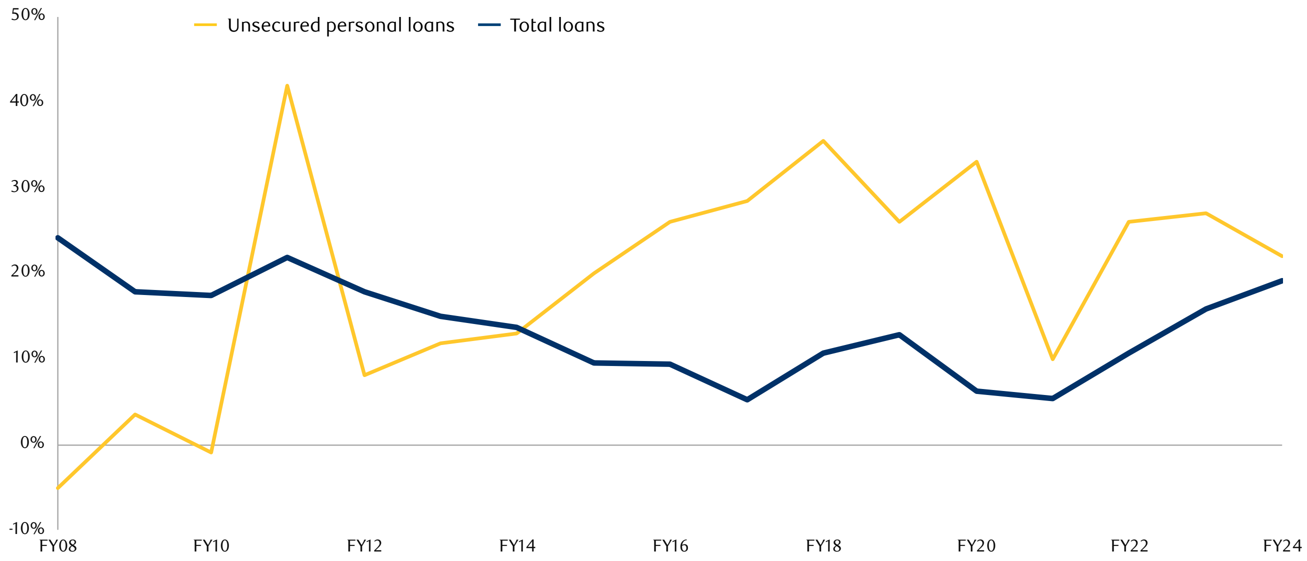
Exhibit 6: Household average financial assets by country



Source: AMFI India, as at November 2024.

4 India Ministry of Commerce data, November 2024.
5 Central banks, HSBC.

Exhibit 7: Growth in unsecured personal loans



Source: Company data, RBI, as at November 2024.

Despite this attractive backdrop, there are undoubtedly some potential short-term headwinds and long-term risks to be mindful of. Cyclically, the strong growth in unsecured lending and the resulting possible overleverage of low-income households is a potential risk to monitor (Exhibit 7). Some of these unsecured loans have been used to finance stock investments, and NPLs are increasing. An extended decline in Indian stocks could make the cycle of non-performing loans worse. Equity supply has also ramped up materially, 40% higher in 2024 than in 2023, and the IPO pipeline remains strong with 155 IPO prospectuses filed and another 30 IPOs pending approval[6].

From a long-term standpoint, there are three key areas to monitor: reforms, education, and female work participation. The nation structurally requires more private infrastructure investments. While government spending has been driving these initiatives, the private sector has been pushed out. Despite significant progress, India's labour rules and bureaucracy need to be further simplified.

The country also requires a much higher rate of female workforce involvement. Anecdotally, from the 25 Indian corporates I met during my visit, only two of the meetings had some female executive participation. Among emerging markets countries, India has one of the lowest rates of female workforce participation, which is burdening the dependency ratio and could become problematic in the future if it doesn't improve. If the nation wants to continue drawing in investments, it must also keep investing in education in terms of both access and quality.

A study conducted by the IMF found that only 5% of the population drive India's growth and gains within the value-added curve. India must expand this 5% to promote growth at all levels.

"If the nation wants to continue drawing in investments, it must also keep investing in education in terms of both access and quality."

[6] NSE, BSE, Bloomberg, Prime database, Jefferies.

Author

Guido Giammattei

Portfolio Manager

Guido is a portfolio manager and head of research for the RBC Emerging Markets Equity team at RBC GAM. Guido is currently responsible for research in Taiwan and Central and Eastern Europe. Prior to joining the organization in 2010, Guido worked as an emerging markets portfolio manager and also as an equities analyst at a U.K.-based asset management firm, specializing in global emerging market strategies. He had previously worked at a global asset management firm as a securities analyst, where he progressed to become a junior portfolio manager. Guido began his career in the investment industry in 1998 as an equity and derivatives trader in Italy.

Published December 2024

RE/0169/12/24

Global Asset Management