EDMOND DE ROTHSCHILD

EDR INDIA: CAPEX IS INDIA NEXT GROWTH DRIVER

The Indian equity market has continued to defy gravity. After a strong performance in 2021, Indian stocks continue to outperform in 2022 (in EUR the MSCI India is up +4.6% vs -11.0% for the MSCI World and -15.6% for the MSCI Emerging Markets YTD as at October 18th 2022[1]). This, in a context of several headwinds such as high oil prices, a falling rupee and near all-time high valuation. We recently had the opportunity to do a field trip to India and conducted 22 companies' on-site visits. This was our first field trip after the pandemic, and we were able to see that many Indian companies were well adjusting to a post COVID world with accelerating inflation, rising commodity prices and geopolitical uncertainties.

Our conversations with the management teams of some of our core holdings have enabled us to take stock on some of the Fund's long-term investment themes, such as India's rising middle class, financial inclusion and the digital economy. The conclusion is that these themes remain vibrant and strong engines of India's domestic growth.

What caught our attention this time around is the unfolding of an unprecedented capex[2] story: India is about to experience a massive uptick in its capex cycle (both from private and public operators). This can be a pivotal growth tailwind in many parts of the Indian economy and an important theme of the EdR India portfolio. The magnitude and scale of this capex cycle, we think, is not entirely grasped by the market and is therefore a source of opportunity.

A RESILIENT MACRO BACKDROP

Whilst the rest of the world continues to come to terms with economic woes, end of monetary stimulus and geopolitical uncertainty, India's macroeconomic backdrop, in contrast remains very solid: inflation is stable (although still above the Reserve Bank of India's threshold) Gross Domestic Product (GDP) growth (expected around 7% for 2022 – Source Bloomberg as at October 2022) is twice as high at the Emerging Markets average and above many developed economies' growth rates (which translates into a corporate earnings growth of almost 20% (source Refinitiv Datasream as at October 2022). Besides, the country benefits from an alignment of stars:

- **Political stability** Modi's BJP won important state elections this year, which bodes well for its chance of reelection in 2024. Modi, according to many companies we met, has been instrumental in bringing structural reforms to India, and his reelection is key to India reaching its full economic potential.

[1] Source: Bloomberg as of October 18th 2022. MSCI India 10 Years cumulated performance as of October 18Th 2022: +172% and MSCI Emerging Markets 10 Years cumulated performance as at October 18th: +46%. MSCI India 10 Years annualized performance as of October 18Th 2022: +10.53% and MSCI Emerging Markets 10 Years annualized performance as at October 18th: +3.88%.

[2] Capital expenditure.

- **An essential piece of the geopolitical chessboard**. India is also emerging as a serious alternative in the "China+1" strategy[3]. India has a large labour market and an improving infrastructure. The country is also a long-term ally of western democracies and the Modi administration has developed several policies to attract Foreign Direct Investments.
  - ⇨ At the same time, it was able to secure its energy access buying Russian oil at a discounted price without encountering much pushback from Washington.
- **Strong domestic inflows**: While foreign investors have been net sellers last year (36bn$ of outflows between October 2021 and June 2022, source: CLSA) and became net buyers again only recently, domestic inflows remain strong, driven in part by Indians increasing their exposure to equity (still only around 5% of their financial assets).
- **Persistence of secular growth themes:** Finally, the long-term investment case for India remains solid: strong demographics with rising middle class, financial inclusion and digitization has led to the emergence of a "Digital Billion". The boom in capex is another leg of India' growth story and a foundation theme, which have arisen in many of the conversations we have had with corporates.

PUBLIC CAPEX

As a direct result of Modi's focus on fiscal consolidation, India's fiscal balance sheet has dramatically improved in recent years. This has allowed India's government to come out post-Covid with an increased focus on capex. This new policy orientation surprised the market first, in February 2021, as Modi's government emphasized a pro-growth budget with a 25% year-on-year capex growth, and this year, as the announced increase in capex came out even higher (+34% yoy).

Infrastructure is seeing the brunt of the increase. While earlier focus was mostly on roads, infrastructure investment has now a broader scope, with water, railways, underground transportation and power all seeing increase. Industry players expect a sustainable 15% compounded annual growth rate (CAGR) revenue growth over the next 4-5 years as India continues to build its infrastructure[4]. Next year could even see a bigger acceleration. India next general election will take place in 2024, and Modi's government could be inclined to pursue its investment policy, as a way to stimulate both the economy and job market. The construction sector is one of the largest employer, accounting for 12% of the total workforce, and the second largest employer in rural India behind the agriculture sector[5].

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[3] The China Plus One Strategy ("C+1") is a business strategy which encourages investors to diversify their investments by not only investing in China, but opting for a more diverse portfolio through investments in a variety of ASEAN countries.
[4] Source: Larsen & Toubro, September 2022.
[5] Source: Periodic Labour Force Survey, February 2022.

PRIVATE CAPEX

While public capex has been resilient, private capex has shrunk over the recent years, as companies faced several headwinds such as an economic slowdown, deteriorating balance sheets and excess-capacity. It bottomed out two years ago, representing as low as 9% of total capex[6], but has been recovering since then. Many elements now support a rebound of private capex:

- **Indian companies have deleveraged**, with corporate debt now representing less than 50% of GDP vs more than 60% In 2015 (source : CEIC, RBI at at october 2022)
- **Banks have also cleaned up their balance sheets** and have resumed their lending activity. Kotak Mahindra Bank, one of the most conservative private banks, has indicated its intention to pursue a growth strategy. Credit growth continues to accelerate; reaching 15% in the latest quarter (source : Kotak Mahindra as at October 2022), a number that most banks think is sustainable.
- **Capacity utilization is inching up after many years of under investment**, and has now reached 75% (source: Haver's management as at October 2022). Most companies met during our trip have stated that 75-80% is the threshold leading to new capacity increase, particularly in a context where demand is expected to grow
- **Property market recovery**: many real estate companies met during this trip have recognised that we are only at the beginning of an 8 year up cycle. Affordability remains very high, and consumers are much more sensitive to economic conditions than to a hike in interest rates
- **"Make in India"**: India has for many years tried to attract global companies FDI. Multinationals now look for alternatives to China. Recently, Apple started production of its latest smartphone in India almost as simultaneously as in China, and plans to make India one of its main manufacturing hub for its ex-China markets. Other sectors should also see significant opportunities, in particular auto parts, consumer durables and solar panels. While its domestic market is significant, India is also looking at the export market as an additional opportunity. India's share of world exports has improved but is only 1.9% as of October 2022 (source: Haver as at October 2022)

GREEN CAPEX

Finally, India also has deep ambitions in terms of energy transition. Concerned with both energy security (India is one of the largest oil importer), carbon and greenhouse gas (GHG) emissions, India has taken strong steps towards the rollout of renewable energy. We have already seen a sharp increase of clean energy within the nation's electricity mix. Now India is striving to build its own local supply chain.

Reliance, one of India's largest conglomerate with most of its legacy business in the oil and gas sector, has shifted its attention to the renewable energy with plans to invest more than $10bn in the next 3 years. It will set up five giga factories, dedicated to solar panels, energy storage, green hydrogen, fuel cells and power electronics.

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[6] Source: Bank of America, September 2022.

IMPLICATIONS FOR EDR INDIA

Economic reopening and pent up demand have been the largest contributors of India's economic and market recovery post-pandemic. With a new capex cycle about to jumpstart, we should continue to see higher earnings per share (EPS) growth for a large number of sectors (beyond the pure infrastructure plays). Whilst most non-domestic investors have stayed on the sidelines on concerns over inflationary pressures (which we think are transitory), **we remain very constructive on the Indian equity market outlook and on our portfolio holdings**. Infrastructure has been for a long time one of the Fund's core themes with companies in the cement industry (Ultratech Cement), industrials (Siemens) and water pipes (Supreme Industries). We also favor indirect plays such as Quess, one of the leading staffing companies in India, as well as the private sector banks (HDFC Bank, ICICI Bank, Axis Bank).

This is a marketing communication. Please refer to the UCITS prospectus and the Key Investor Information Document before making any final investment decision.

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The synthetic risk/return indicator rates this fund on a scale of 1 to 7. The risk and return category presented may change over time. Category 1 does not mean a risk-free investment. The UCITS is rated in category 6, in line with the nature of the securities and the geographical areas presented in the "Investment objectives and policy" section of the DICI as well as the unit's own currency.

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