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FUND INSIGHTS

INVESTING IN INDIA: ON THE PATH TO RECOVERY

EASTSPRING INVESTMENTS – INDIA EQUITY FUND
OCTOBER 2014

Economic recovery in India began almost simultaneously as the political guard was inevitably about to change. Some measures taken by the previous government since late 2012 coupled with the initiatives of the new government are slowly bearing fruit; early signs of recovery are visible.

The country's GDP accelerated to a two-year high of 5.7% in the June 2014 quarter from a year earlier, driven by growth in services and industry. Industrial production has been expanding at a healthy pace for a few months. Inflation has been moderating. Foreign reserves have increased by approximately USD 45 billion from the lows seen in August to September 2013 to around USD 316 billion. Consequently, the Indian Rupee too has been in a tight range and confidence has been restituted in the currency.

Against this backdrop, the new government's reform aspirations coupled with a decisive political mandate to smoothly execute them has triggered an overall sense of optimism for the country's future, visible in the buoyant asset markets.

But rooted in this optimism are high expectations for the new government to deliver on the promised reforms. Scepticism however remains in many quarters. This is not surprising given that the previous government failed to deliver on their set of reforms.

SO COULD IT BE DIFFERENT THIS TIME? WE THINK SO.

For one, Modi's party has won a majority mandate, effectively removing the policy paralysis created by coalition governments that have characterised Indian politics for long. Second, Modi's 12-year economic track record in the Indian state of Gujarat has been well appreciated with growth exceeding 10%[3] over most of his governing period. True, Gujarat's small size and homogeneous society cannot be compared to India's heterogeneous population. While different challenges will arise, these are definitely not insurmountable, in our view, given Modi's institutionalised, process-driven problem solving approach.

We are now confident that the worst is behind.

The new government seems extremely focused on mending the past inaction. It was never going to be an easy task and course correction could only happen gradually over time. However Modi's government has a few low hanging fruits and his cabinet is rightly focused on plucking those first; the single largest being clearing a pile of stalled projects to push growth. As per our meetings with the Project Management Group of Indian government, projects up to USD 100 billion have been cleared in the last few months.

[1]Source: Central Statistical Organisation, CLSA India as at January 2014.

Initiatives such as combining key ministries for smooth functioning and quick decision making will be key to make progress in the infrastructure segment. Furthermore they have been tactfully introducing numerous small initiatives rather than big – bang reforms which may face opposition in the upper house of the parliament.

Modi's maiden budget also revealed both near-term and medium-term priorities. It laid the foundation for a path to higher medium term growth, rather than an attempt to accelerate this year. The government's key thrusts are inflation moderation, infrastructure, manufacturing, job creation and fiscal consolidation. Fiscal consolidation is a key focus; financial year 2015 target is pegged at 4.1% of GDP and down to 3% by 2017, by reducing subsidies and increasing tax collections. Subsidy on diesel fuel has now successfully been abolished with monthly price increases effective since January 2013.

Fig.1. Some of the key initiatives by the new government since assuming office include:

Foreign Direct Investment	Increasing Foreign Direct Investment limit in Defence and Railways.
Inflation / Agriculture	Containing support price increase for Agricultural products and setting minimum export price to ensure domestic supply of staple vegetables.
Infrastructure	Empowering Project Management Group. Extending web-based project clearance to environment and mining.
Fiscal / Budget Management	Raised passenger and freight railway fares.
Labour / Manufacturing	Tweaking Labour laws, to increase efficiency and aid ease of doing business.

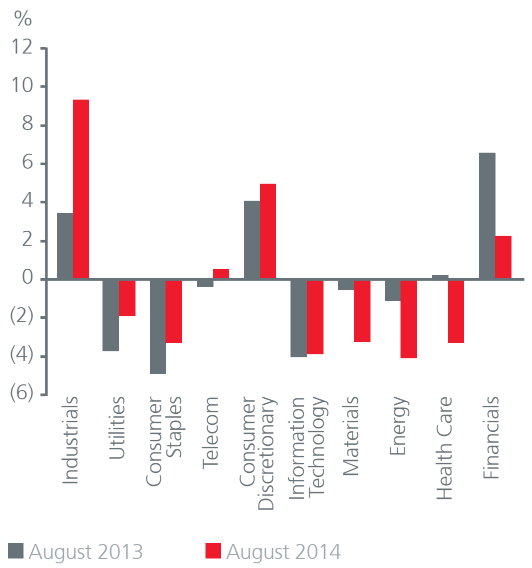
THE EASTSPRING INVESTMENTS – INDIA EQUITY FUND IS POSITIONED TO BENEFIT FROM THESE DEVELOPMENTS

The Fund has been benefiting from the above developments in the Indian economy and also at the corporate level. Our portfolio manager has been positioning the Fund for an economic recovery since early 2013. Using our unique investment approach, we identified and invested in valuations outliers which were out of favour and beaten down; examples include select banks and beaten down companies active in the Indian industrials space. These have since recovered smartly, aiding the Fund's relative performance.

Over a one-year period, from August 2013, the Fund has posted 58.2% (bid to bid basis), outperforming the benchmark by 5.8%.

The portfolio manager continues to maintain an adequate tilt towards fundamentally strong and attractively valued companies from cyclical sectors such as financials, industrials and consumer discretionary which are likely to benefit the most from the growth recovery phase.

Fig.2. Change in fund positioning (August 2013 versus August 2014).



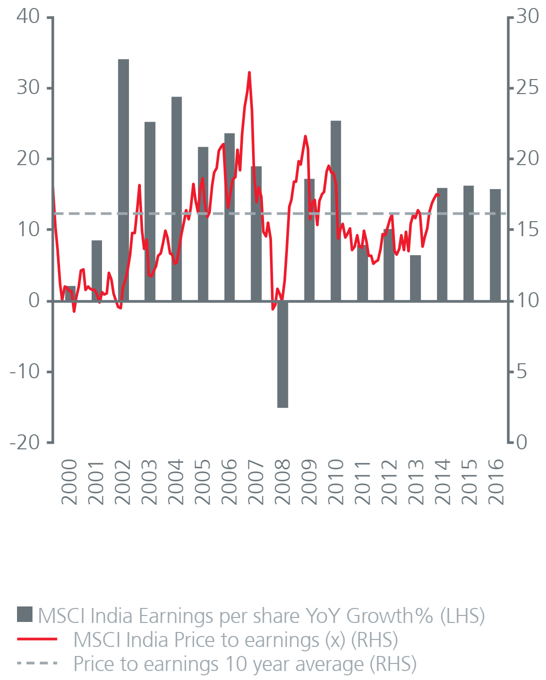
Source: Eastspring Investments, 29 August 2014.

VALUATIONS ARE NOT DEMANDING IN OUR VIEW

Valuations are looking stretched has been the common refrain given the run up in the market. But we think that valuations may not be reflecting entirely the benefits of a range of reforms and measures that may be underway. While they are no longer at distressed levels seen in the 3Q 2013 and have normalised to historic mean levels, they are only at fair levels in our view.

Consensus estimates suggest that earnings growth is expected to be around 16% for the current and next two calendar years, from the single digit growth in the last three calendar years. While this is an improvement, the current estimates have yet to reflect any meaningful earnings upgrades. History suggests that the analysts' revisions usually lag the market. Hence further upside is likely in our view.

Fig.3. Earnings outlook (%) and valuation (x)



Source: IBES, MSCI India, from Thomson Reuters Datastream September 2014.

With the expected expansion in economic activity, companies with operating leverage particularly can witness significant upside to their earnings' estimates.

On a forward looking view, valuations appear fair to attractive.

Finally, as Fig.3. suggests, India traded above average historic valuations during phases of high earnings growth. The same is likely as corporate earnings trend up.

OUTLOOK AND STRATEGY

India is a long term story and our portfolio manager remains positive about the country's long-term outlook. Under the leadership of Prime Minister Modi, the new government's strong mandate is widely expected to set the country back in motion. The government's key focus areas such as inflation, infrastructure and policy reforms are likely to yield structural benefits.

Improved macroeconomic factors coupled with fast track clearance to stalled projects may accelerate growth recovery. Improved business and consumer sentiment post election is likely to bolster investments and demand.

The Fund is positioned to benefit from a pickup of domestic economic activity. The portfolio manager maintains exposure to companies with strong cash flows, which are levered to perform better during a growth recovery phase.

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