

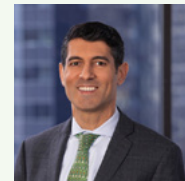
TECHNOLOGY AND POLICY IMPROVEMENTS ARE CREATING A BRIGHT FUTURE: RESEARCH NOTES FROM INDIA

- ▶ Equity Portfolio Manager Nuno Fernandes and Senior Research Analyst Siva Natarajan recently returned from an investment research trip to India. What they learned reinforced their belief that the future is bright for this country. From technological improvements like the India Stack implementation to important reforms like the single nation-wide Goods and Services Tax, the efficiencies gained from recent advances are creating a strong foundation for businesses and consumers.

Q: What were some of the differences between your visit to India this year compared to last year?

Nuno Fernandes: A year ago, we got a clear sense that business and consumer sentiment were improving, but activity levels were still below pre-Covid levels. This time around, activity has clearly surpassed pre-Covid levels and confidence is very high. Many companies are accelerating investment plans. Even rural consumers, who were the hardest hit from the rise in inflation, have clearly turned the corner now that inflation is dropping in a meaningful way.

Another major change from previous visits with corporates and banks is their focus on increasing penetration into lower-tier cities. We believe a confluence of events has helped make penetration into previously unviable segments and areas possible. These enabling factors include the “India Stack,” which comprises the Aadhar digital identification system and unified payments interface, reforms such as the Goods and Services Tax, and production-linked initiatives to attract manufacturing investments. As an example, the combination of improved payment systems, the nationwide biometric identity system, and other strong IT investments has allowed fintech companies in India to profitably extend unsecured loans to consumers for as little as R\$200 (US\$2.50). Traditional banks with branch networks have not been able to serve this segment of the market because of heavy transaction costs, which are now materially lower.



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Q: What are the main drivers behind the optimism you encountered in India this year?

Nuno: India, with a young population of 1.4 billion people, is experiencing a strong rebound in consumption post-Covid. Consumer confidence is high, and one CEO we met with put it bluntly: “They can take (Covid) on the chin, and just move on!” Such is the extent of the optimism of the Indian consumer, who is borrowing at increasing levels to travel, spend on their children’s education, and purchase homes, cars, and two wheelers.

Q: What are Indian corporates saying about the business environment for the rest of the year and for their 2024 investment plans?

Nuno: We met with government officials, more than 25 company management teams, and toured logistics facilities. The mood in India is clearly buoyant — one CEO shared: “Even we locals are surprised!” While most companies have maintained their investment plans, a smaller group of companies have accelerated them. We met with management from a quick-service restaurant chain that further increased the number of store openings for 2023, for example.

Q: How are Indian consumers behaving differently post-Covid?

Nuno: India’s consumer confidence is back to pre-Covid levels and consumers are borrowing more, in both unsecured and secured lending. Home affordability is still at attractive levels despite the interest rate hikes over the past 14 months, and Indian consumers are buying homes at an unprecedented level: Home sales in India reached a new record in 2022. Consumers’ interest in travel has also increased. Data on the hotel industry shows both occupancy and revenue per available room are above the previous pre-Covid peak.

Q: What are the impacts you witnessed on the ground from the multiple government policies in place, from digital to logistics and infrastructure?

Siva Natarajan: The Indian government has made, and continues to make, important strides in developing programs to support increases in productivity and higher levels of economic activity. Important programs the government has implemented to date include:

1. Aadhaar Biometric Database

This is the largest biometric identity system in the world, and includes more than 1.3 billion people. The system was implemented more than 10 years ago and has allowed more than 81% of adults in India to have bank accounts. Additionally, it has allowed the Indian government to save up to US\$27 billion in yearly transfers in social programs according to officials that in the past were lost due to corruption at the local level.

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2. Unified Payments Interface (UPI) System for Real-Time Payments

This system has allowed for more than 50% of digital payment transactions in India — both peer-to-peer and person-to-merchant — to be done in the free government network. It is the backbone to support digital transactions between Indian citizens who do not have debit or credit cards and businesses.

3. Goods and Services Tax (GST) Reform

The Modi government has successfully converted 34 different tax systems into a single GST tax system for the country, reducing the levels of bureaucracy for businesses and consumers. This single tax system has brought down logistics costs in India by 2% of GDP, according to officials.

4. Open Network for Digital Commerce (ONDC)

This most recent initiative is focused on unbundling e-commerce and offers interoperability across e-commerce platforms. ONDC aims to become the gateway between consumers and businesses, breaking the barriers of otherwise walled e-commerce networks and thus lowering transaction costs.

Q: How has the value of distribution evolved in India with the increased digitalization of the economy?

Siva: With only 6% of the country's transactions being done digitally, the value of distribution remains front and center in the minds of corporates investing in India. As digitalization increases and logistics improve there, distribution will become increasingly virtual and democratized. As a result, we expect an increase in the number of new brands reaching Indian consumers.

Q: How have valuation concerns evolved for Indian equities during the last year, and what kinds of new investment opportunities have you encountered?

Nuno: Indian market price-to-earnings figures looking forward 12-months have de-rated from 23 times at the end of 2021 to 19 times as of June 30, 2023. This has given us an opportunity to invest in a handful of new companies in India in the past 12 months, including HDFC Asset Management, Tube Holdings, and Cholamandalam.

Q: What is the outlook for Prime Minister Modi's government in the 2024 general election?

Siva: The recent defeat of Modi's Bharatiya Janata Party (BJP) ruling party by the opposing Indian National Congress Party in the state of Karnataka has brought concerns that Modi may not secure his current majority in the 2024 general elections. The consensus view among corporates and analysts we met during this trip is that Modi will likely win the 2024 election. We will be monitoring upcoming regional elections to try and better understand if local politics played the deciding role in the electoral outcome in Karnataka, or whether the message of the Congress Party is successfully reaching the Indian electorate broadly.

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Q: What is the sentiment with respect to China/US tensions and what role do India's energy needs play in foreign policy?

Nuno: India's dependency on imports of oil and gas brings a geopolitical risk to investing in India. In addition to this, India finds itself competing for energy with its historical archrival China, which is also increasingly dependent on imports of oil and gas. The complexity is aggravated by the increasing tensions between the US and China and Russia's invasion of Ukraine. Still, India is more likely to remain inwardly focused and thus avoid the limelight of geopolitics by aligning its defense strategy with the West while benefiting from the economic windfall of lower oil prices by remaining neutral on the Ukraine war.

Q: What are the biggest challenges facing India now?

Nuno: India is a large, complex, and mostly rural economy with great potential for modernization and wealth creation in the next 20 years. As a democracy, it is still threatened with high levels of corruption, overall poor infrastructure, and an increasing dependency on imports of oil and gas for its energy needs.

Despite these challenges, we are convinced India will emerge as one of the most important manufacturing centers in the world over the next 30 years, as China did over the past 30 years. China's manufacturing output is currently around \$4 trillion, or about 10 times India's \$412 billion. India has a long runway for growth and the gap will narrow meaningfully over the next 10 years.

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