The India Story: Impending Revival

Incoming Prime Minister Narendra Modi, hailed by his supporters as a strong leader in the mould of Margaret Thatcher and Ronald Reagan, has come to power on the promise of creating job opportunities for hundreds of millions of Indians by focusing on manufacturing, pro-industry regulation, world-class infrastructure development and private investment.

The elevation of Narendra Modi as India's prime minister in May 2014 marked a watershed moment in the history of the country. 66.4% of nearly 815 million eligible voters cast ballots in the world's largest democracy, with Modi's unabashedly pro-market, pro-business, BJP party emerging with a solid majority, marking the first time since 1984 that an Indian party will be able to govern without requiring a coalition. For a country where political discourse has long been dominated by left-leaning socialist policies, fragmented mandates, and identity-based politics, voters have given a clear mandate to Modi's agenda of growth, infrastructure and development. With a strong track record of economic success over 12 years as chief minister of Gujarat (a state of 60 million people on India's west coast), Modi seems capable of delivering on his promises. Over the last few years, India has been hampered by weak leadership, political gridlock, burdensome regulations and large-scale corruption, all of which drove away foreign investors. GDP growth dropped from nearly 10% in 2010 to less than 5% in 2013. In addition, due to rising deficits and deteriorating public finances, India was put on a negative credit watch by global fixed income rating agencies. With Modi at the helm, India is back on the radars of investors and analysts around the globe. India is expected to become world's fastest growing economy in 2015 replacing China. India is expected to grow at average rate of more than 7.5% over next 5 years as compared to number of near 6% and 5% for China and Broad EM grouping, respectively. With Modi already indicating infrastructure development, fast-track project clearance and leveraging the "demographic dividend" as his top priorities, India is looking very similar to China in the early 1990s and could represent a compelling investment in both the short and long term.

While China's demographic dividend will taper off after 2020, India's is expected to grow through 2040. In terms of the demographic dividend, the opportunity represented by India today is very similar to China 25 years ago.

Demographic Dividend

Fig 1: Working-Age Population (in Mn.)

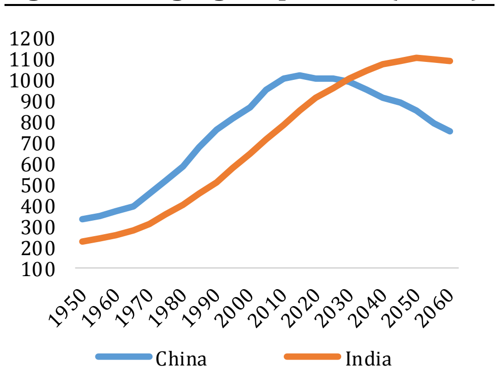
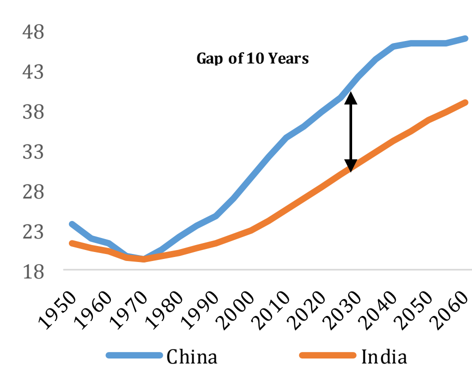


Fig 2: Median Age (in years)



India should cross China as the largest labor force in history sometime after 2025, and will keep adding to its workforce significantly until 2050.

India must create 10 million new jobs every year to simply keep up with population growth, which will require a focus on manufacturing and infrastructure.

India, similar to China over the past few decades, is expected to reap huge economic benefits over the coming years from its young and growing population. India's median age is approximately 10 years younger than China, with a working age population that is expected to continue to rise for decades, while China's has already peaked. A good measure for this is the age-dependency ratio (the ratio of dependents per working-age population). The lower the ratio, the fewer dependents there are per working age population, which is a good indicator for economic growth. For India, this ratio is expected to decline from 54 in 2010 to a minimum of 46 in 2040. In comparison, the age-dependency ratio of China is expected to rise from a low of 36 in 2010 to 58 in 2040. For a historical perspective, China experienced its main economic high-growth phase during a period marked by a decline of the ratio from 58 in 1990 to 36 in 2010.

India has the lowest wages among the top 30 emerging market economies but also has the worst ranked business environment among its Asian neighbors.

With Modi making fast-tracking of projects a key point in his election manifesto, a large workforce and competitive wages could attract significant investment into India at a time when military tensions and rising wages is making China a less attractive option.

Fig 3: Minimum Wages

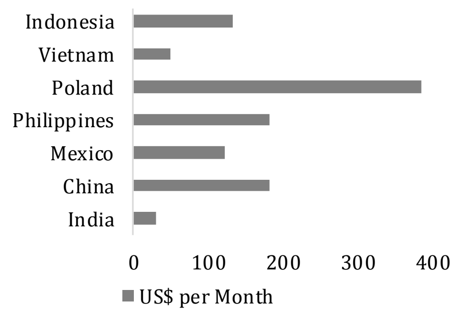
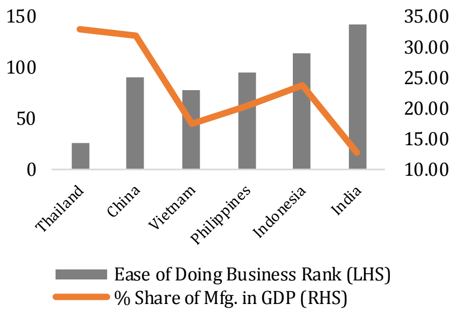


Fig 4: Cross-Country comparison



Wages are another area where India has a major advantage, with the lowest wages among the top 30 emerging market economies. Yet despite this, India has not been able to generate productive manufacturing jobs over the last few years due to red-tape and burdensome regulation, indicated by the low share of manufacturing in the country's GDP (just 13%) & the fact that projects worth US$ 52 Billion are stalled due to bureaucratic delays. Mr. Modi has made fast-tracking these projects (and others) one of his key priorities, which should lead to large and fast gains.

A Sleeping Consumer Giant

India's demographic dividend should lead to a nearly 10-fold increase in productivity, as experienced by China over the last 20 years. The shifting of agricultural labor to manufacturing will lead to further improvements in productivity.

Sharp productivity improvements and increasing urbanization will lead to a sharp rise in incomes, fueling the rapid growth of India's middle class (the world's largest by 2050), expanded consumer demand and higher savings (thereby growing financial services).

Fig 5: Size of Middle Class (Millions)

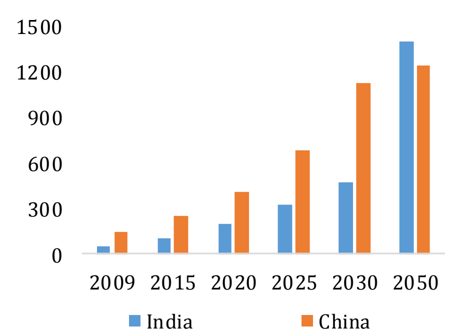


Fig 6: Labor Productivity Levels

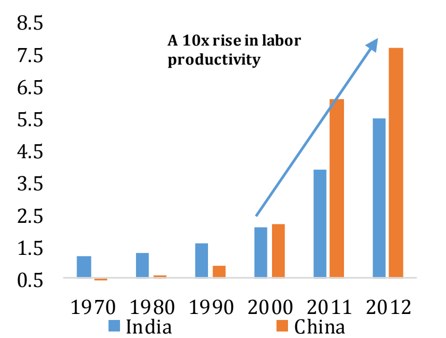


Fig 7: Urban Population in India

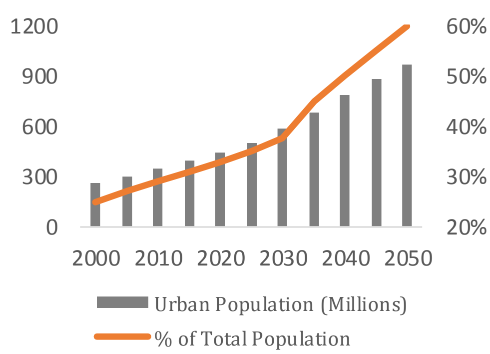


Table 1: Urban Population in India

	India	China	South Korea
Electricity Consumption*	684	3298	10162
Telephone Mainlines**	3	61	62
Mobile Phones**	71	89	111
Household with TV	47%	95%	99%
Personal Computers**	12%	44%	81%

*KwH Per Capita **Per 100 People

According to estimates, India will be among the top 3 consumer markets in the world by 2025 and the largest market by 2050.

Consumption penetration in India is significantly lower than China, which indicates that rising incomes will directly translate to a rise in consumption expenditure.

Based on the demographic dividend, urbanization and other factors, India's Middle Class (average daily household income of US$ 10-100) is expected to grow from just 50 million in 2010 to more than 1 billion in 2050. With private consumption already contributing nearly 60% of the country's GDP, forward estimates predict a growth of the Indian consumer market from nearly US$ 1 Billion in 2012 to around US$ 30 trillion by 2050 in real terms.

After 5 years of dropping FDI, India is projected to add 150 basis points annually in GDP growth from FDI going forward.

With a focus on its historically poor infrastructure, Modi's government is expected to set a target of roughly US$ 1 Trillion worth of private investments in Ports, Railways, Airports, Roads and Power.

FIIs have increased their stake in major Indian companies from 17% in Sept. 2013 to nearly 25% in Dec 2014. Over the last 3 months, US-based India ETFs have seen inflows of more than US$ 870 Million. Markets have risen by more than 30% since Dec. 2013 while the currency has remained more or less range bound.

Indian companies have maintained significantly higher profitability than EM peers on a consistent basis over last 5 years. For example, average Return on Equity for Nifty benchmark constituent ranges from 16%-17% vs 11%-13% for MSCI EM constituents.

Despite the strong rally at Indian stocks over last 6 months, valuations are still very attractive and company fundamentals are strong.

Rising Investor Interest

Fig. 8: Net FDI Flows as % of GDP

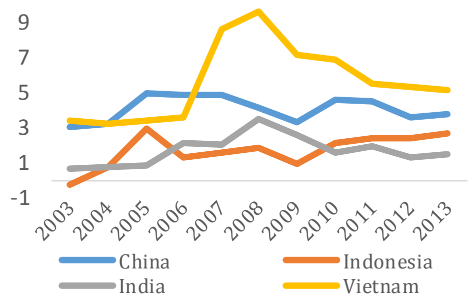


Fig. 9: FII Holdings

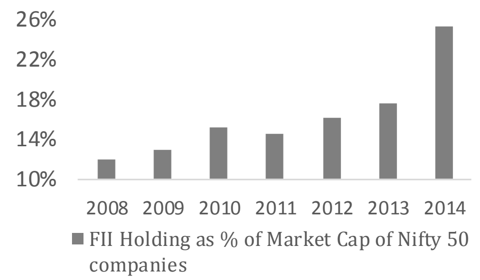
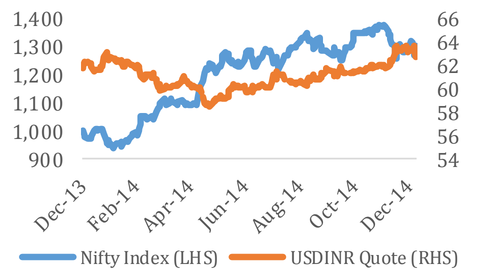


Table 2: Fund Flows in India ETFs

Month	Monthly Fund Flow (US$ Million)
Jun-14	835
Jul-14	241
Aug-14	293
Sep-14	37
Oct-14	129
Nov-14	492
Dec-14	248

Fig 10: Market Performance*



India has always represented a compelling long-term opportunity for global investors. With the recent election of a pro-business, pro-reform prime minister with a strong track record of success, India could finally be turning the corner, into a compelling allocation for investors today.

India in Emerging Markets Space

Table 3: Profitability Ratios - Nifty Index v/s MSCI EM

	Net Margin (%)		Operating Margin (%)		Return On Equity (%)		Return on Assets (%)	
	MSCI EM	Nifty	MSCI EM	Nifty	MSCI EM	Nifty	MSCI EM	Nifty
2007	12.71	15.95	15.06	17.14	18.99	29.36	5	7.35
2008	8.14	12.23	12.39	15.35	13.42	21.75	3.4	5.40
2009	9.37	11.17	11.9	13.68	13.27	17.19	3.13	3.35
2010	10.61	12.4	13.53	15.03	16.37	17.95	3.91	3.87
2011	9.62	11.28	12.94	13.63	15.12	17.66	3.41	3.59
2012	8.53	10.98	11.55	13.28	13.11	17.51	2.80	3.36
2013	8.41	10.98	11.64	13.76	12.54	16.62	2.62	3.16
2014	7.99	10.8	11.13	13.81	11.64	16.42	2.37	3.14

Fig. 11: P/E Ratio analysis for Nifty Index and MSCI EM Index