Investment Insights

Invesco Emerging Markets Select Equity

India offers tremendous growth potential despite short-term challenges

Invesco

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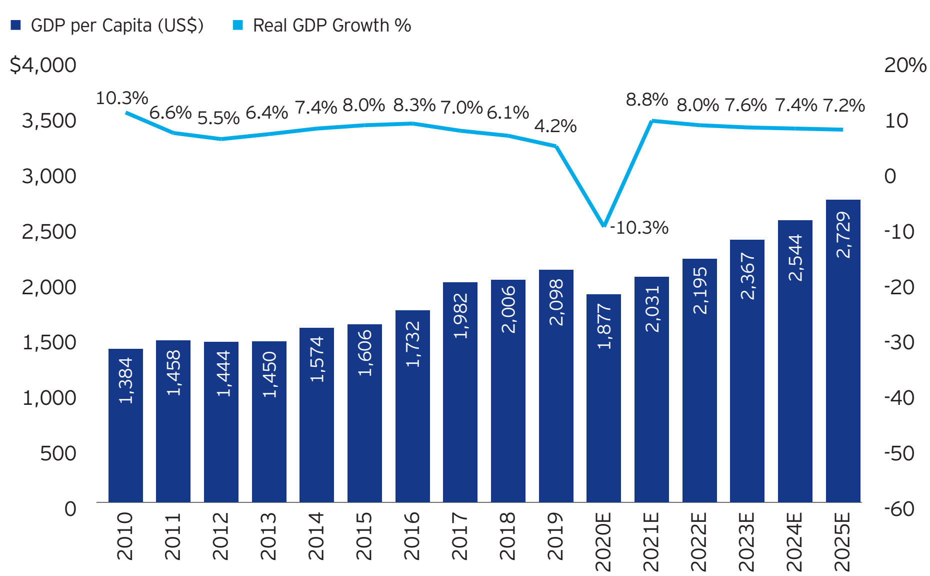
Executive summary

+ India offers opportunities in both the consumer and financial services sectors.
+ India's long-term growth potential has attracted many investments from global companies in traditional sectors such as consumer goods and in new economy sectors such as communication services and e-commerce.
+ Despite its growth potential, India has short-term challenges originating from the macroeconomic environment and COVID-19.
+ India is not a uniform market, and there are regional differences and infrastructure challenges that companies need to navigate.
+ We remain disciplined in our investment approach and will not "chase" companies in search of returns but rather wait for attractive opportunities to generate potential excess returns for our clients over the longer term.

India stands out among most emerging market countries because of its strong gross domestic product (GDP) growth, which remained consistently above 6.5% for most of the last decade until it dipped under 5.0% in 2019 (see Figure 1).

Figure 1: India's GDP per Capita (US$) and GDP growth (%)

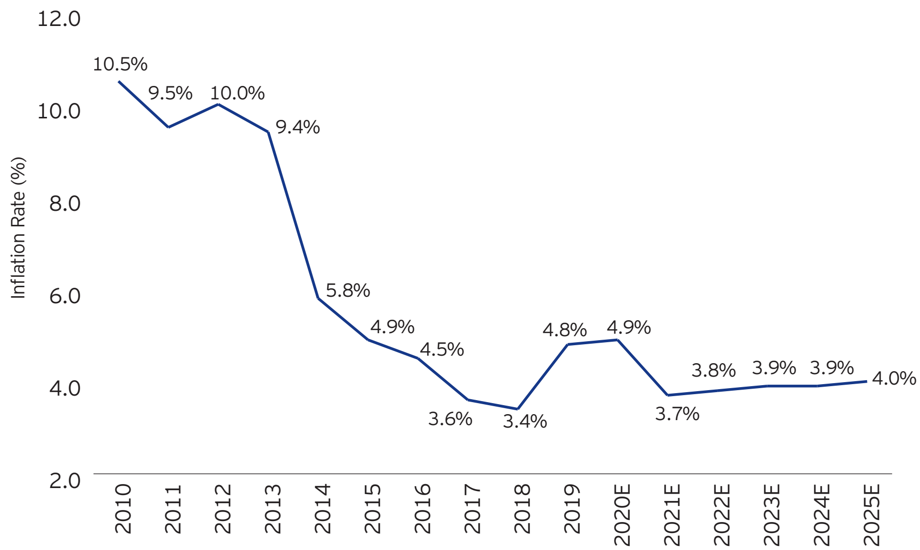


Source: IMF, as of October 2020.

In the past five years, India's macroeconomic situation has gradually improved, as the government took steps to correct its perennial problem of twin (current account and fiscal) deficits. India's current account deficit stems from large imports of gold and oil and low growth in exports. The government has passed various reforms to boost foreign direct investment (FDI), facilitate investments and improve ease of doing business. This has increased FDI flows into the country and has improved the current account deficit. Notably, since 2016, India's rank jumped from 130 to 63 on the World Bank's "ease of doing business index," resulting in strong FDI flows into India.

India's fiscal and monetary policies are more prudent now, focusing on raising the quality of growth rather than just the rate of growth. The central bank has adopted an inflation-targeting framework to manage the growth-inflation mix, while fiscal policy is growth-oriented (see Figure 2). The government is also gradually reducing the fiscal deficit by issuing bonds and selling stakes in state-owned enterprises. As a result, India's macroeconomic situation is a lot more stable than during the economic downturn of 2013.

Figure 2: Inflation Rate in India



Source: IMF, as of October 2020.

What is holding back growth right now?
India's economic growth has slowed in recent years because of government actions, including demonetization in 2016 and the introduction of a goods and services tax (GST) in 2017, which disrupted business activities.

Further exacerbating the situation was a liquidity crisis, followed by a credit crisis that started in September 2018 when a large non-bank financial company (NBFC) called Infrastructure Leasing & Financial Services Limited (IL&FS) defaulted on its loans. The liquidity crisis had an impact on rural growth in particular, as small businesses that depended on credit from NBFCs suddenly didn't have credit available. This hurt business and consumption growth.

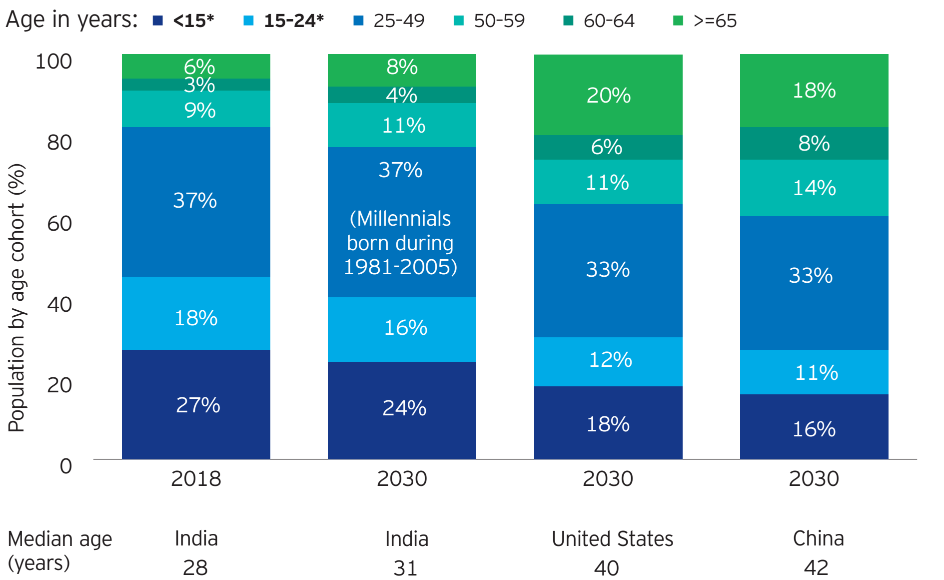
Another key issue in rural India is the lack of wage growth (currently less than the inflation rate), driven by a slowdown in government spending and stalled projects. At the same time, agriculture has not kept up with overall economic growth. While the government provides direct benefit subsidies to farmers and other rural sections (remitted directly into their bank accounts), this cash is not immediately available to spend because it sits in banks located 15 to 20 kilometers away from many rural communities. This affects the frequency of purchases, causing a slowdown in consumption growth.

The COVID-19 pandemic has compounded stresses in the system, led to a sharp decline in economic growth in 2020, and raised questions about the asset quality of NBFCs. The Reserve Bank of India has increased liquidity in the financial system by lowering rates and performing open market operations. However, there is no risk appetite in the system to ensure that NBFCs and microlenders receive funds to extend credit. Although India has avoided systemic financial distress due to the NBFC crisis, it is expected that weaker NBFCs and unscrupulous lenders will not survive and will be weeded out of the system, and this should improve the quality of growth going forward. While India's GDP growth is set to rebound in 2021 as businesses reopen after lockdowns, in the long term, India needs to solve the NBFC crisis and clean up the system to boost its GDP growth back over 7.0%.

What will propel growth into the future?

Despite its challenges, India is expected to remain one of the fastest-growing major economies of the world in the years to come. Our optimism stems from India's large population base (more than 1.3 billion people) and very attractive demographics (as much as 90% of the population is younger than 60, and 64% of the population is of working age – 15 to 59 years old) (see Figure 3).[1]

Figure 3: In 2030, 77% of India's population will comprise millennials and Generation Z

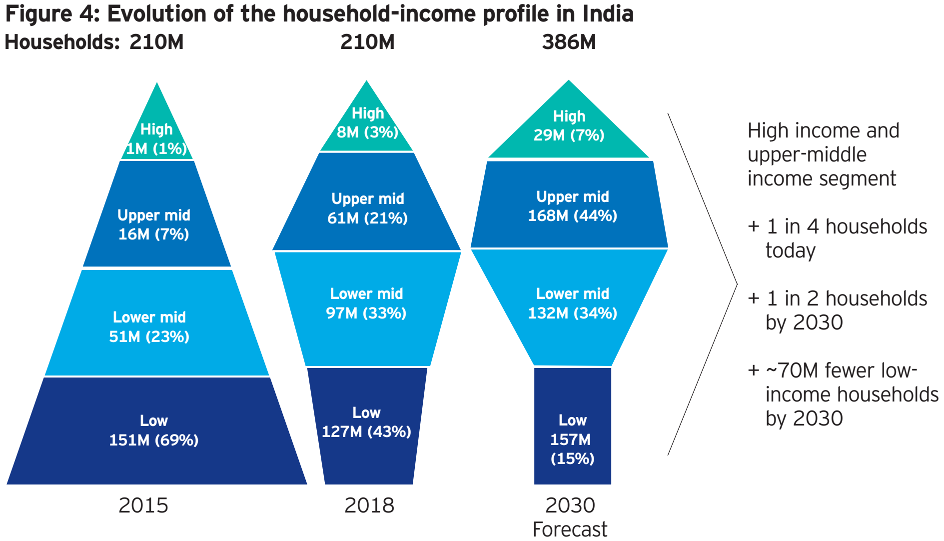


* Generation Z (born post 2005)
Source: Bain & Company, as of October 2020.

Urbanization is another key driver of economic growth, with the share of the urban population in India expected to grow from 34% in 2019 to more than 40% in 2030. Rapid urbanization is expected to lead to substantial investments in infrastructure, creating more jobs, modernizing consumer services and mobilizing savings.

India boasts one of the largest middle-class populations (about 300 to 350 million people), a segment expected to grow by an additional 500 million people by 2030,[1] driven by strong economic growth over the next decade (see Figure 4).

Figure 4: Evolution of the household-income profile in India



Source: Bain & Company, as of October 2020.

1 According to Bain & Company.

Also, the government has passed key structural reforms to improve the livelihoods of farmers and increase financial inclusion in the country while also reducing corporate taxes to spur private investments.

All of these factors bode well for long-term economic growth, which will drive the consumption of goods and services and grow household savings. Together with improving financial literacy, this could increase the flow of savings into products such as bank deposits, mutual funds and insurance. Given the secular drivers of growth and rising consumer power, it is no surprise that the consumer and financial services sectors account for almost 50% of the total Indian equity market.[2]

Fast-moving consumer goods making rural inroads

Within the consumer sector, fast-moving consumer goods (FMCG) is a large and growing market in India, given the under penetration of branded consumer goods and large market share in the hands of unorganized and informal players. Many multinational consumer companies have invested in India to capitalize on the growth opportunity and have established market leadership in their respective categories over the decades.

Established consumer companies must navigate the regional differences and infrastructure challenges to succeed in India. The penetration of informal and local players remains high due to a large rural population (66% of the total population) and distribution challenges faced by national branded goods companies. While it was widely believed that large consumer companies would rapidly gain market share following demonetization and the introduction of the GST, market share loss for small/informal competitors has been very slow. Small and local/regional competitors are doing well in rural India as their products are cheaper than those of the national players, particularly following the slowdown in rural economic growth.

Some of these local/regional players are deeply entrenched in their local markets and have no ambition to compete on a national scale. These companies also customize their products to suit the tastes and preferences of consumers in rural markets, while national players have limited flexibility to do this. For example, in parts of India where the water is very hard, local detergent manufacturers add more froth to their products, which consumers prefer as they perceive these detergents to be of better quality.

Another challenge for FMCG companies is distribution. National major players have only been able to penetrate the top rural areas. The key challenge is the higher cost of distribution in remote areas because of poor road connectivity, while volumes are not big enough to justify distribution economics. As a result, most FMCG companies rely on wholesalers to reach into these areas. Hindustan Unilever has the best distribution network in India because it recruits women in rural areas to be its agents, and they carry stock from stockists/wholesalers/distributors to retail outlets and/or sell by going to individual homes.

Another significant consumption trend in India is an increase in brand-savviness among consumers in both urban and rural areas, driven by rising aspirations and incomes. A common rural strategy across all FMCG companies has been to introduce brands/products in smaller, more affordable package sizes. Premiumization is happening across both urban and rural areas facilitated by smaller package formats.

In the long term, we believe FMCG companies will continue to increase their presence and gain market share in rural India by improving their distribution footprint and launching more relevant products in packaging formats that make sense for rural markets. FMCG distribution in India is evolving rapidly with the introduction of new online business models, which are disintermediating traditional distributors by reaching mom-and-pop retailers and end consumers directly. Distribution is expected to get democratized to an extent so that companies that have relied mainly on their distribution strength, with no real product innovation and differentiation, will lose out. Private-label competition is also expected to increase as online models scale up. In our view, FMCG companies with strong brand equity and sales throughput in respective categories should continue to do well, as they will have bargaining power over online players looking to build traffic on their platforms.

Valuations for high-quality companies remain high

We have invested significant time researching and understanding companies in India's consumer goods and financial services sectors in India. Both sectors include a number of high-quality companies with strong free cash flow conversion, high returns on invested capital and good management teams. However, despite strong growth potential, India remains a modest weight in our Invesco Emerging Markets Select Equity strategy,[3] mainly because the companies we like have expensive valuations.

For valuation purposes, we typically link the discount rates (or hurdle rates) for a country to its current

2 Based on MSCI Domestic Equity Index.
3 Please read the investment risks on this strategy on p. 6.

10-year government bond yield to capture risks associated with economic and foreign exchange shocks. Given the macroeconomic challenges and high inflation in India, we use a higher discount rate to value Indian companies, which makes them expensive. Even during the market correction in March 2020 caused by the COVID-19 pandemic, valuations did not correct as much for high-quality companies.

The financial sector was the hardest hit, and we used this opportunity to increase our weight in one of our core holdings, the largest mortgage finance company in India. The company's strong balance sheet, high-quality assets and significant reserves should, in our view, cushion the impact from COVID-19, while it is expected to gain market share from weaker competitors. However, valuations of consumer companies did not correct much, and some stocks saw their prices rise because the sector is considered to be a safe haven.

One reason for premium valuations in India stems from these firms' very long runway of growth, strong competitive advantages and strong management teams. Corporate governance is important to consider when investing in India, and high-quality consumer companies have earned the trust of investors on that front over multiple decades.

Another reason for premium valuations in India is the dearth of investment opportunities, particularly in new economy sectors, such as communication services, which have attracted a lot of attention from investors in markets such as China and the United States. India has many home-grown consumer-focused technology companies in the e-commerce space, and they have attracted much of private capital from global companies; however, these companies are not publicly listed. These businesses are growing very rapidly as the adoption of smartphones in India rises, data costs decline, and consumer habits change.

It will be interesting to see if the valuation premium of consumer companies in India declines as some of these new economy companies list on stock exchanges over the next few years. We have already studied the business models of some of these online players through our investments in global technology companies, and we will continue to do more in-depth research on them in the future.

Finding attractive opportunities through disciplined investing

In conclusion, we are very optimistic about the India growth story over the next decade. With tremendous growth potential, global companies have been investing a lot of capital in India to capitalize on the growth opportunity. Despite some macroeconomic challenges exacerbated by the COVID-19 pandemic in the short term, the rising wave of consumerism, in our view, should continue to propel the economy forward and benefit companies with market leadership and strong moat qualities in their respective segments. We remain disciplined in our investment approach and will not "chase" these companies in search of returns but rather wait for attractive opportunities to generate potential excess returns for our clients over the long term.

Spotlight on Invesco Emerging Markets Select Equity

What differentiates the Invesco Emerging Markets Select Equity Team and investment approach?
It starts with our team of analysts and portfolio managers — either we were born in an emerging market or grew up there, or our families did, and we speak the local language. That deep-rooted familiarity contributes to our insights. There are eight professionals on our international team, with five of us specializing in emerging markets. Each of us on that team of five has more than 10 years of experience investing in emerging markets, as well as a direct personal connection to these markets.

In terms of our investment philosophy, we emphasize high-quality companies, meaning companies generating a high return on capital and have strong growth prospects and a capable and honest management team. Those traits are important everywhere but particularly critical in emerging markets, where there often are no strong corporate governance structures, and even the legal systems can be challenging to understand.

Perhaps our most distinguishing feature, though, is that we run a highly concentrated portfolio — typically owning just over 30 names — allowing us to do very thorough research. In a normal year, we visit dozens of countries and conduct at least 500 meetings with companies in which we hold a stake or are considering investing. While travel has been limited this year due to COVID-19, we're managing interactions through Zoom and Skype. Research doesn't stop because of the pandemic. Again, this is important for emerging markets because disclosure practices are not as strong there as they are in developed markets.

Investment Risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues. The dollar value of foreign investments will be affected by changes in the exchange rates between the dollar and the currencies in which those investments are traded.

This article is issued: In Canada by Invesco Canada Ltd., 5140 Yonge Street, Suite 800, Toronto, Ontario, M2N 6X7

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