EMERGING MARKETS: AN EVOLVING LANDSCAPE

MARTIN CURRIE
A Franklin Templeton Company

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For institutional investors in the US only

INDIA

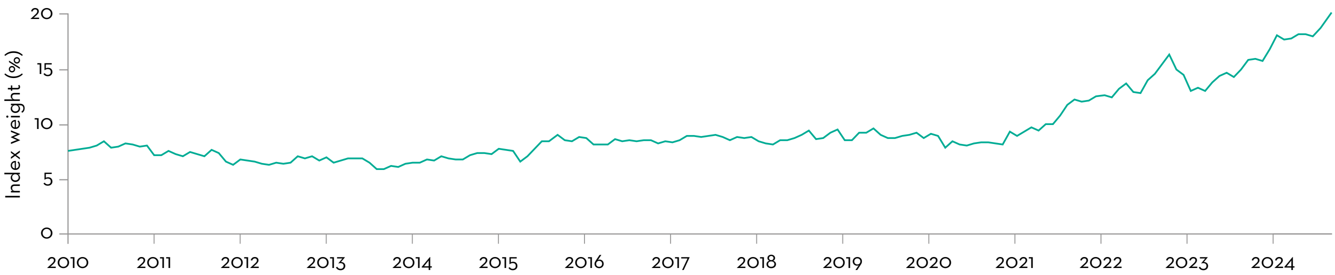
INDIA HAS THE POTENTIAL TO DRIVE EMERGING MARKET (EM) RETURNS OVER THE NEXT DECADE

- The world's fastest growing major economy, India remains a multi-decade structural opportunity
- It offers high returns, consistent earnings growth and strong governance
- India is now the second largest country in the MSCI EM, its highest weighting in the index[3]

India's role in EM has significantly increased in recent years

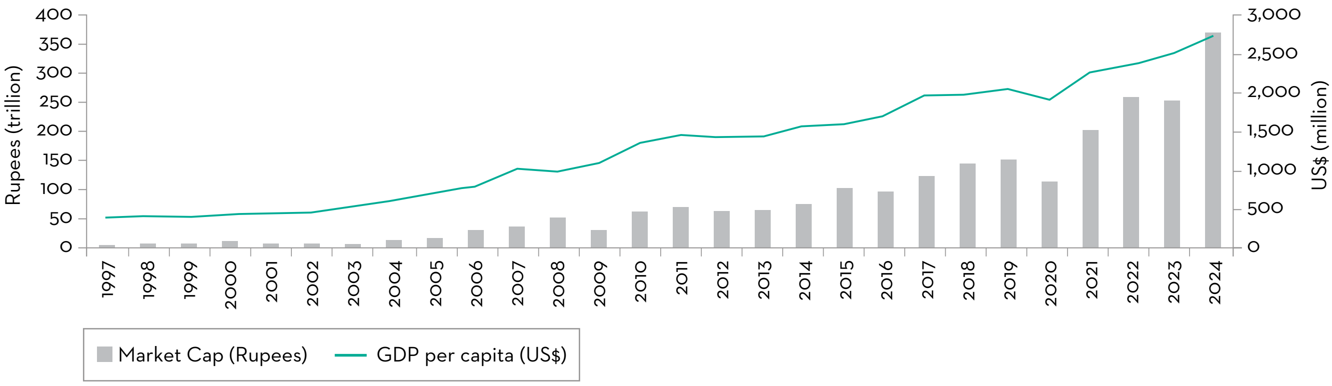
India's programme of structural reform is now enabling it to reach its potential. It has more than doubled its weight in the EM Index in just six years – from 8% to 20%[4]. Strong economic growth delivered in a period where global growth has been challenging has enabled the country to attract investors and power its market cap ascendancy. With tremendous growth in Gross Domestic Product (GDP) per capita as well – India has been able to deliver in-tandem stock market returns.

Weight of India in the MSCI Emerging Markets Index



Source: MSCI and FactSet, as of 30 June 2024.

Indian market capitalisation versus GDP per capita, 1997-2024



Source: Bloomberg, IMF, CEIC, Kotak Institutional Equities, June 2024. Data as of March fiscal year ends.

[1]Source: Factset as at 2 August 2024.

[2]Source: BBC News as at 1 March 2024.

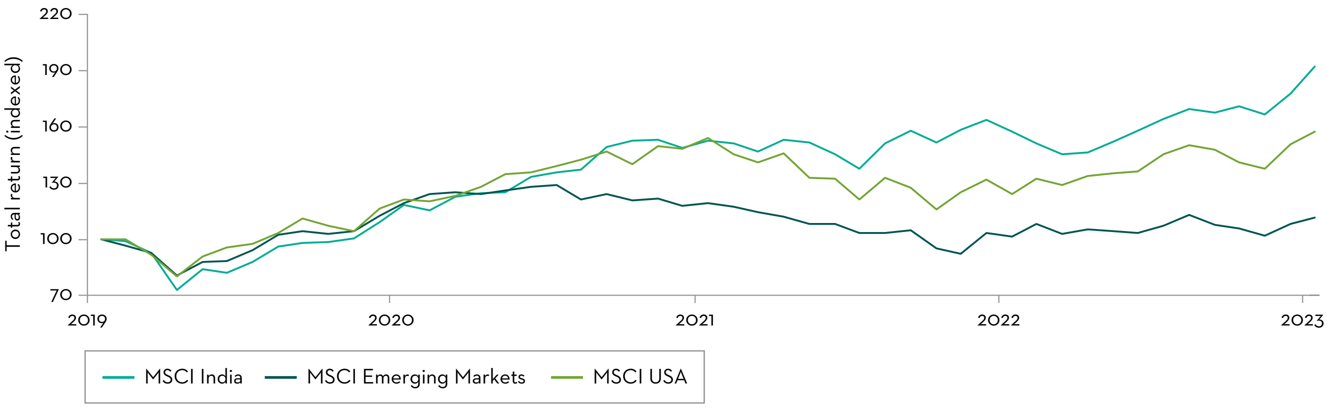
[3]Source: MSCI as at 29 March 2024.

[4]Source: FactSet, as at 31 May 2024.

Indian companies have delivered

Between 31 December 2019 and 31 December 2023, India outperformed EM by 72% and the US by 22%. It achieved this by delivering strong earnings growth.

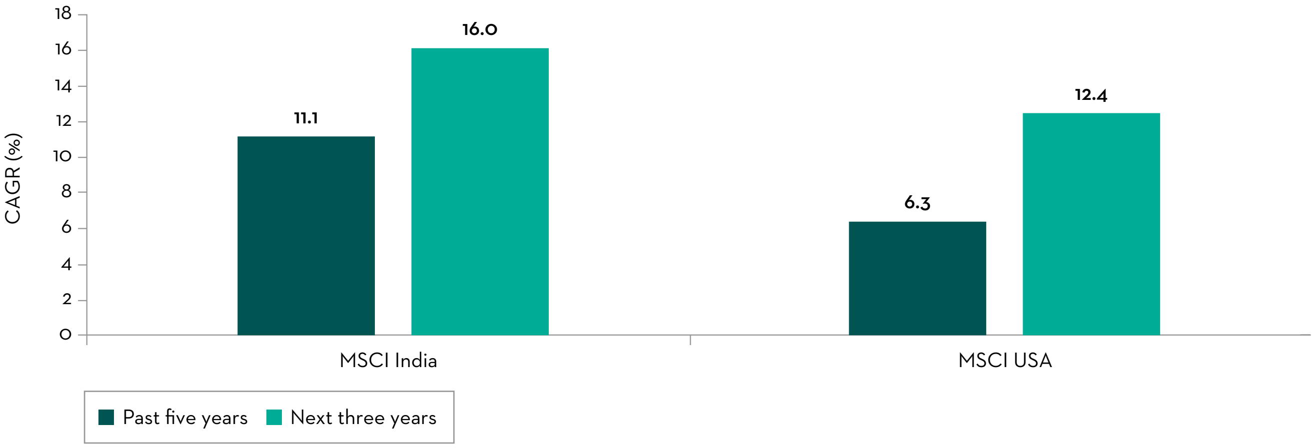
Total return of India, EM and the US over four years



Source: FactSet. Data shown is between 31 December 2019 to 31 December 2023.

India's earnings growth in the past five years has surpassed that of the US by 76%, as shown by the chart below. This has supported its index outperformance. Consensus estimates point towards a continuation of this trend in higher earnings growth – with the three year compound annual growth rate (CAGR) for India approximately 30% higher for India than the US[5]. We believe India's strong earnings growth and will drive the outperformance of EM.

Earnings-per-share growth for India versus the US



Source: FactSet, as at 27 June 2024. Past five years measured from 31 December 2018 to 31 December 2023, using reported earnings. Next three years measured using consensus estimates for the period 31 December 2023 to 31 December 2026. There can be no assurance that estimates will be realised.

[5]Source: FactSet, as at 27 June 2024. Growth over multiple years calculated using the compound annual growth rate (CAGR).

"India's earnings growth in the past five years has surpassed that of the US by 76%."

Indian reforms provide structural support

What are some of the reforms being implemented in India?

Demonetisation and GST

The Indian government has decreased the notes in issue in India which effectively forced people to declare their cash (by banking it), driving a formalisation of the economy. On top of this, they introduced GST – a Goods and Services Tax – whose implications were that companies providing goods and services were incentivised to be more transparent in declaring their chain (of sales and purchases) to minimise the amount of tax they are required to pay. For example, a retailer would be liable to pay GST on the incremental difference between the item's sold price and the price they paid their supplier. Without declaring both sides, they'd be liable for the whole amount.

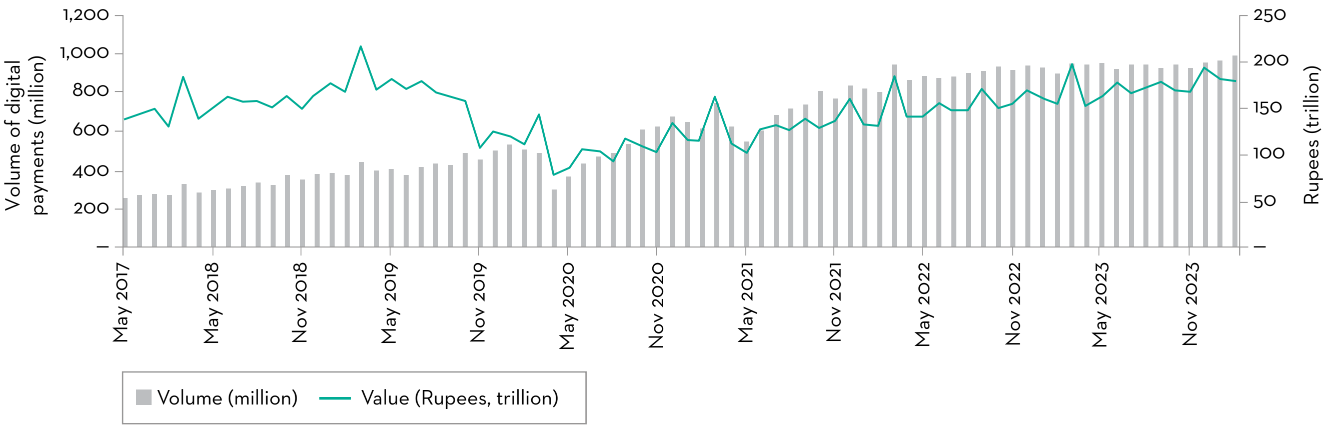
These two reforms have driven a broader move towards the formal sector, where historically much of India's market has been informal. Risks inherent in the informal market are the existence of local sellers with less professional business practices – less tax paying, customer due diligence. The reforms are broad-based but one area which has particularly benefitted is the jewellery market, which has historically been roughly two-thirds in the informal market. Further reforms in this market specifically, include the requirement of identification for purchases over a certain threshold (i.e. increased customer due diligence), and the introduction of hallmarking*. By channelling consumers towards the formal market, these reforms provide companies already operating in this segment with a huge structural opportunity. The bigger the historic tendency to the informal market, the bigger the potential opportunity.

Digitisation

One crucial area of structural change in India is digitisation. One of the most impactful changes in the past 15 years is the introduction of Aadhaar, a biometric identification system. This was launched in 2009 and has over 1.38 billion registered card holders – roughly 97% of the population[6]. Although it is not mandatory, it has several benefits, such as its use as proof of residence. We think the key area of opportunity born out of this is for India's banking sector. A core requirement for opening a bank account is proof of residence – Aadhaar increases financial inclusion by giving people the means to open an account, essential for many jobs, businesses, or state benefits. Since introducing Aadhaar, the percentage of the population with bank accounts has increased from 35% in 2011 to 78% in 2021[7].

Related to this is the increase in digital payments. As the world becomes increasingly digitised, companies and people need to be able to transact digitally too. Obviously, one needs a bank account to do this. The government regularly publishes data on the number of digital payments in India and there is a clear upward trend, as shown below. In March 2024, the volume of digital payments made in India has more than doubled to almost 1 billion, compared to ~400 million five years earlier. With the Indian market becoming increasingly formalised and companies operating in India with a global footprint, we think this trend creates significant opportunity for investors, especially for the financial and fintech industry.

Digital payment adoption in India, 2017-2024



Source: RFI, Kotak Institutional Equities, June 2024. Data as of March fiscal year ends. Data shows Real-time Gross Settlement + National Electronics Fund Transfer + Immediate Payment Services.

*Hallmarking is a centuries-old practice that certifies the metal purity of precious metals

[6]Source: Unique Identification Authority of India (UDAI), as of 29 September 2023, and Statista and IMF, April 2024.

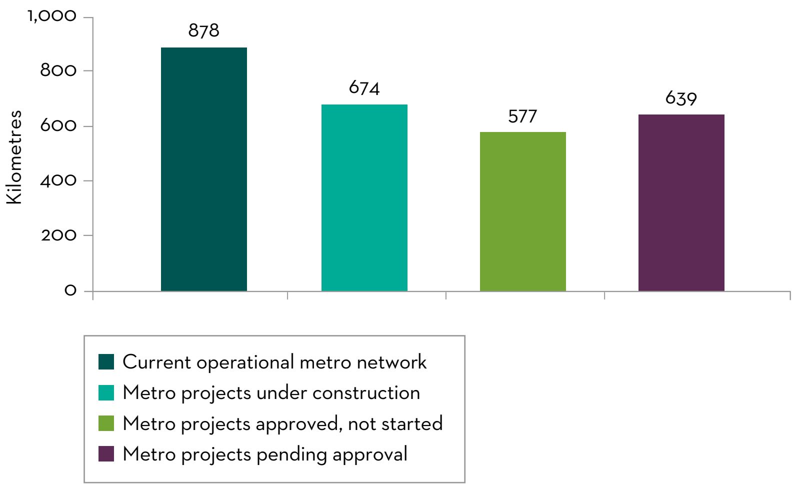
[7]Source: World Bank, June 2024. Account ownership at a financial institution or mobile-money service provider as a percentage of the population aged 15 and above. Data published every three years.

Infrastructure investment

India has implemented a huge infrastructure development project, building roads, affordable housing, airports, and metro systems. These projects have made travel within India significantly more accessible and have also helped to broadly increase standards of living. This higher accessibility and improved living standards have several implications: increased jobs, more efficient commutes, increased leisure travel (internal and international tourism), and more.

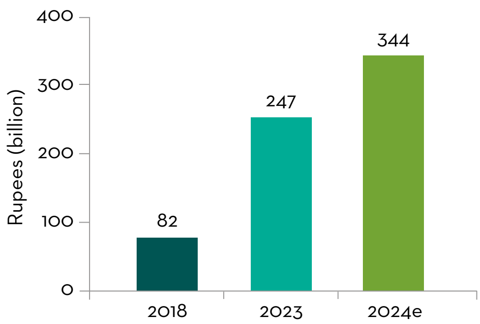
The opportunity for investors is both specific and broad-based. Any increased investment in these areas has the potential to significantly boost productivity in India – the level of which is typically quite low, so any incremental increase can have a large impact on the economy as a whole. Furthermore, infrastructure and related sectors stand to benefit from government investment and projects in motion. This includes, for example, cement, which not only is used in many large infrastructure projects but also, surprisingly, has a meaningful retail market in India.

Indian metro rail length



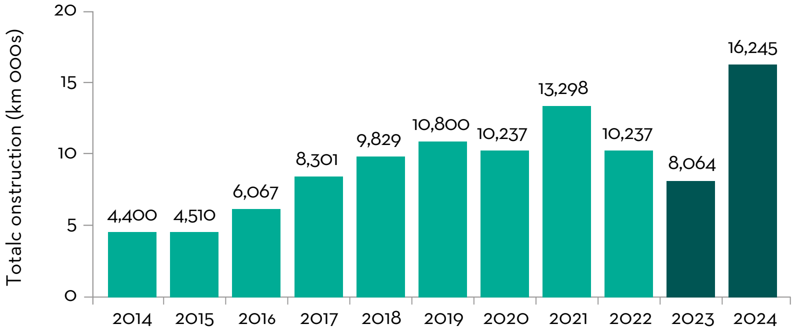
Source: PIB, Kotak International Equities, June 2024.

Investment spend on railways



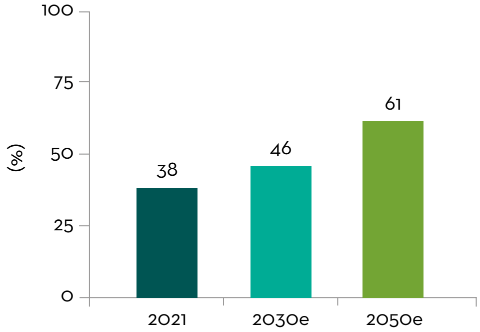
Source: Indian Railways, Kotak Institutional Equities, June 2024. Data as of March fiscal year end.

Road construction



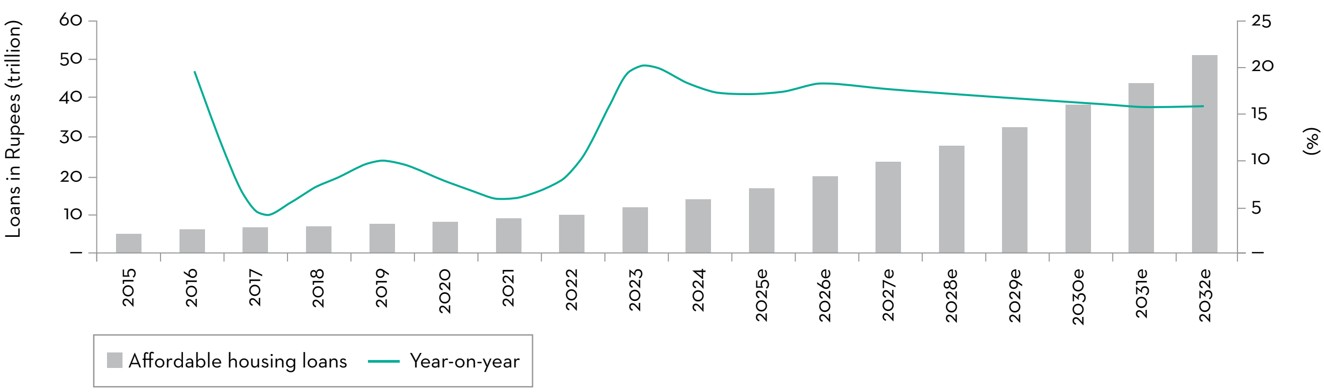
Source: NHAI, Kotak Institutional Equities, June 2024. Data for 2023 and 2024 based on estimates. Data as of March fiscal year end.

Significant increases to urbanisation (% of households living in urban areas)



Source: NSSO – 66th round, CEIC, UN, Kotak Institutional Equities estimates June 2024. Data as of March fiscal year end.

Affordable housing loans growing (outstanding credit)



Source: Crisil, Kotak Institutional Equities estimates, June 2024. Data as of March fiscal year end.

We believe India's time has come

But what does all this mean for equity markets? India is early in its journey of significant reforms which have created a structural growth opportunity for investors. The country has already demonstrated the positive impact of this through its increased relevance in the EM asset class. Although the structural reforms have been supportive, it is the companies themselves which have delivered on earnings and are expected to continue delivering in the years to come. We believe that India has the potential to drive returns in EM over the next decade as the structural growth opportunities come to fruition and companies rise to the challenges presented to them.

"We believe that India has the potential to drive returns in EM over the next decade"

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