Economic Update

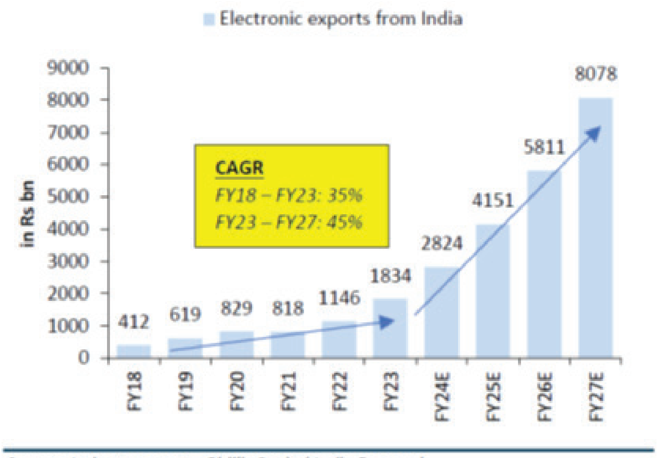
The Indian market was positive and substantially outperformed the MSCI Emerging Markets Index over the last quarter. India outperformed almost all other Emerging Markets including China, Korea and Taiwan. For China, the bounce back from the reopening of the economy following three years of ultra-stringent zero-COVID policies has faded, and elevated debt and weakness in its property sector are weighing on growth. China's exports and imports both fell in August from a year earlier, reflecting tepid global demand that is adding to pressures on its slowing economy. Also, August consumer prices rose 0.1% in China, pointing to weak demand. The US FOMC (Federal Open Market Committee) hiked the interest rate by 25 bps in July to 5.5%, however it did not conduct an increase in September and remains watchful currently. The Committee remains highly attentive to inflation risks and sees a 50% chance of a hike for the rest of the year. The Reserve Bank of India (RBI) continued to pause for the third time in August meeting, though RBI members continue to remain focussed on withdrawal of accommodation. Over the quarter, Foreign institutional investors recorded strong net inflows of USD 3.9bn, domestic institutions recorded net inflows of USD 410 mn, the G-sec yield went up to 7.2%, and the price of crude oil strengthened to around USD 94 per barrel driven by earlier than expected supply cuts by Saudi Arabia. The oil price has risen from lows of USD 75 few months ago and we are keeping a close watch on the price going forwards. INR weakened through the quarter and closed at USD/INR 83.23. This was mainly led by the strengthening Dollar Index due to rising yields in US.

For the quarter ending June 2023, India's GDP grew at a robust of 7.8% YoY vs. 6.1% in 1QFY23 (quarter ending March 2023), inline with consensus expectation. This was strong performance considering the slowdown in global growth. GDP growth was driven by services sector growth of 10.3%. CPI slowed to 6.8% YoY in August while core CPI moderated further to 4.8%. The consensus expectations are for a pause on policy rates in CY23 followed by a shallow rate cut cycle from 2QCY24. CPI had reduced to lower than 4.3% in May 2023, but picked up temporarily due to food inflation driven by uneven monsoon rains. The August trade deficit expanded to USD 24bn (from USD 18bn in July). This was predominantly due to increased oil and gold trade deficits, however some core product deficits also contributed. The RBI MPC (Monetary Policy Committee) voted unanimously to hold the repo rate at 6.5% in its August meeting also. The MPC retained its growth forecast at 6.5% for F2024, supported by strength in consumption and investment activity. On the inflation front, the RBI raised its headline CPI projection to 5.4% for F2024 from 5.1% on the back of higher food inflation. Rainfall over the country as a whole during monsoon season (June-September) 2023 was 94% of its long period average (LPA). Although the overall rainfall figure was fine, the capital distribution was uneven impacting some crops. Pulses sowing is down by 4.6% while cereals sowing has advanced. In terms of reservoir levels, the overall storage is lower than last year's levels.

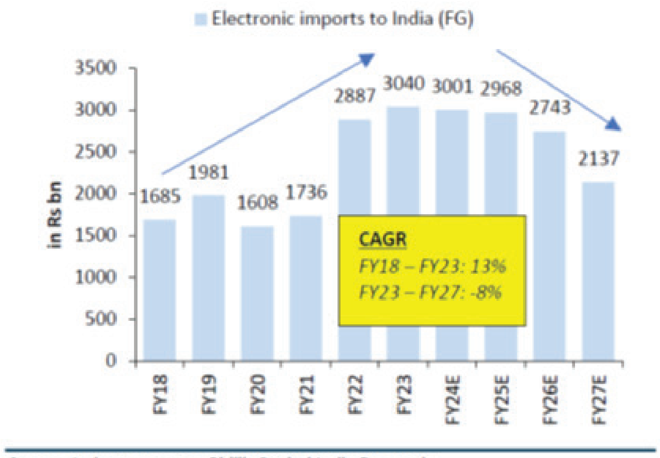
Electronics Manufacturing Services (EMS) in India – It's just the beginning

The EMS industry in India was worth INR 1,469bn (USD 18bn) in FY22 and is expected to see a significant CAGR of 33% to reach INR 5,995bn (USD 73bn) by FY27e. EMS companies can offer end-to-end services, from design, assembly, production, and testing to after-sales. There are more than 700 companies in EMS industry of which 30 are organised. Factors driving growth in the Indian EMS market are as follows; 1) Import substitution 2) Supportive government policy 3) Ease of doing business 4) Enhancing local value addition 5) China +1 strategy 6) Exports focus on USD 5tn GDP 7) Increase in investments by local and global players 8) A huge workforce with relatively very low wages compared to the global average. There are various policy initiatives taken by the Government of India like Performance Linked Incentives (PLI), and Phased Manufacturing Programme (PMP) aimed at incentivising local manufacturing. Low level of electronics penetration in India, and significant manufacturing opportunities in segments such as railways, EVs, automotive, industrial, telecom, medical, A&D, mobile phones, and IT hardware will drive the EMS industry.

Mobile phones, consumer electronics, and industrial electronics contribute to 75% of the market. Original Equipment Manufacturers (OEMs)/brands are increasingly embracing the Original Design Manufacturing (ODM) model of partnership and venturing into new product segments. Under ODM, EMS companies design products as per the specifications provided by OEMs. They source components, carry out fabrication and assembly, test the final product and undertake logistics and after-sales services. This is a high-margin business and comes at a premium for good designs.

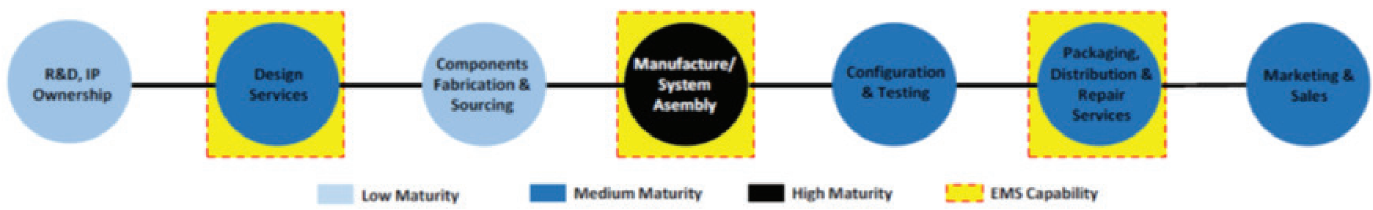


Source: Industry reports, PhillipCapital India Research



Source: Industry reports, PhillipCapital India Research

As seen in the chart above, with increasing domestic production + value addition the Industry expects imports to come down and exports to go up substantially. The top-three imported products in India were laptops and desktops, FPD (flat panel display) televisions, and storage devices. Most components used in building notebooks and laptops were imported as SKD (semi-knocked down) units from China and Thailand. Globally, India ranks second in mobile phones manufacturing, which involves design, assembly, and manufacturing processes.



Source: Philip Capital

To develop India as an electronics manufacturing hub, it is imperative to bring in as many manufacturing operations as possible, and PCBA (Printed Circuit Board Assembly) is a key manufacturing activity. It is the process of placing electronic components such as resistors, capacitors, integrated circuits, connectors, and other devices on their designated locations on the Printed Circuit Board, and then soldering them in place to create a functional electronic circuit. PCBA is a crucial step in the manufacturing of electronic devices as it transforms the bare PCB into a fully operational electronic product. At the start of PCBA operations, value addition is about 3-5%, which can climb to 15-20% within two years.

Backward integration involves going into the semiconductor business. The semiconductor value chain starts with chip design and manufacturing, followed by wafer testing, chip packaging, and OSAT (Outsourced Semiconductor Assembly and Test) services to ensure chip functionality. The packaged chips are then assembled onto a PCB in the PCBA phase, leading to system integration and the creation of end-use electronic products. EMS companies are now focusing on backward integration and bringing OSAT services (Stage-3 backend manufacturing) under their preview. OSAT services involve testing packaged chips to ensure their functionality and reliability under various electrical and temperature conditions. OSAT makes higher margin than PCBA.

There are few reasons why electronics supply chains are diversifying out of China:

I. The new PCB Act 2019 in China led to the closure of c.30% of its existing PCB shops in FY22
II. The China US trade war has resulted in American players thinking about moving out of mainland China
III. China now has strict environmental laws
IV. Rising labour costs in China

We have added a few companies into our portfolio giving exposure to this high growth industry. We visited a factory of one portfolio company in Delhi in September (Please see picture below).

This company is growing at a very fast pace. They have two SMT (Surface Mount Technology) lines in their old plant at the visited location, while the new plant can accommodate up to 10 lines. They expect the new plant to be fully utilised by the end of next year. They are also building a large complex (17 acres) in Southern India for the manufacturing of PCBs and OSAT to perform IC packaging and testing. This will open a new and larger market for this company to aid stronger growth for the long term. Overall, the company can grow at 50% CAGR for the next 3 years.

Nifty Q1 FY24 Earnings Review

Sales/EBITDA/PBT/PAT growth for Nifty constituents was +5%/+22%/+29%/+32% YoY in 1QFY24, slightly better than the consensus estimates. The banking sector reported a mixed performance in 1QFY24, driven by healthy loan growth and sustained improvement in asset quality. However, the margin trajectory reversed, led by a sharp rise in funding costs. Several factors supported the credit expansion, with the Retail and MSME sectors exhibiting robust growth, along with a recovery in the corporate book. Deposit growth was muted due to sluggish CASA (current and savings accounts) trends across the industry, contributing to a sharp sequential rise in funding costs across the sector. Even the NBFCs experienced a margins contraction driven by rising costs of funds. Private life insurers witnessed a muted quarter as growth in premiums was affected by the new taxation rules for INR 0.5m+ ticket size policies. This led to a drop in the share of the non-par segment sequentially for the listed private life insurers. Auto volumes growth was good driven by better demand for SUVs and initial recovery in two wheelers. Gross margins improved due to moderating raw material costs. FMCG volume growth has exhibited a partial recovery during the quarter; however, it continues to hover at subdued levels due to the ongoing weakness in rural India. The weakness in retail demand continues as revenue growth across the retail segment remained moderate for 1QFY24. The growth in topline was primarily driven by new store additions. The IT Services companies reported weak performance in Q1. Surprisingly Tier 2 companies outpaced the Tier 1 companies. Chemicals results have been weak as demand has not picked up as expected, with Chinese players offloading stock at heavily reduced prices, thus hurting domestic players who are unable to compete. Pharma companies experienced strong sales growth driven by the abatement of price erosion and niche launches in US market. In infrastructure, the order book of several road construction companies picked up as NHAI's (The National Highways Authority of India) awarding contracts increased in the last quarter of FY23.

Portfolio Review

We continue to be cautious on global growth but added some exposure back to unperforming information technology stocks where the valuations are comfortable. We added exposure to two large IT services company and a small corporate training company. In financials we slightly increased the overall exposure but booked some profit in large banks and added that to a mid size life insurance company and a power financing company. We are very positive on the power sector due to the ongoing peak power shortage. As a result, we also increased our exposure in the largest power utility company in the country. Additionally, we exited the largest power transmission company as it reached our target price. In consumer discretionary, we booked partial profit in the largest passenger vehicles company as it reached our target price and added another large global auto company due to its improving balance sheet and growth. We also booked partial profit in an auto ancillary company and fully exited a large commercial vehicles company as they reached our target price. We also added more exposure to a small pharma retail company. In healthcare, we fully exited the largest CRAMS (contract research and manufacturing services) company as the valuations reached our target multiples. In chemicals, we booked partial profit in a chemical company as the sectors global cycle is still unfavourable. We booked partial profit in the largest plastics company as its large rally left limited upside in the stock price. India has a large opportunity on both infrastructure and capex, hence we added more exposure to the largest engineering and infra company in the portfolio.

We invested in a managed training services company which is the leading player in this space across 30 countries. Its comprehensive suite of managed training services includes custom content and curriculum design, learning delivery, learning administration, strategic sourcing, learning technology, and learning & development consulting services. Despite near-term headwinds arising from the uncertain macro environment (impact likely to show in the next few quarters), the management remains upbeat on the training outsourcing activities in medium term and company's ability to capitalize on this. History suggests that every recession has resulted in an increased in propensity to outsource training as training is non-core to any organization and they are better off outsourcing it to a specialized player at a lesser cost. The company has a very strong net cash balance sheet with mid-teens growth prospects on annual basis. In Q1FY24 its sales figure was up 22% YoY.

In our experience improvement in balance sheet seldom happens in debt ridden companies. However, an auto major is going against this trend and cleaning up its balance sheet, alongside showing strong growth. Hence, we invested in the company recently. It owns a large global passenger vehicle premium luxury brand where the order book is 200k vehicles with 3-8 months wait on key models. Here the focus is on profitability which can be seen from EBIT level losses last year turning into 8.6% margin in Q1FY24. Electrification is also another theme which is going to play out in its global business. The company sells both passenger vehicles (PV) and commercial vehicles (CV) in the domestic market. The CV part of the business has reduced discounts to improve realizations and margins. This business has the potential to generate significant FCF with EBITDA an margin of 10-11%. We expect the CV upcycle still has some quarters left ahead, driven by strong freight rates. In domestic PVs, they have been the market leaders in introducing electric vehicles (EVs) in India. Before competition intensifies from CY25-26 (meaningful EV launches from mainstream OEMs), they will have around 10 EV models. The company can grow its EBITDA by 30% CAGR over next two years and become profitable from loss making currently.

Outlook

We expect domestic demand strength to be the key driver of India's growth trajectory amid global headwinds. Indeed, domestic demand indicators continue to exhibit the broad-based recovery as the economy benefits from fundamentally stronger balance sheet positions stemming from the private sector, which have improved risk appetite. Moreover, the government's supply-side focused policy measures are filtering through to reinvigorate capex. We expect relatively strong growth both in F2024 and F2025 of 6.2% and 6.5%, respectively. The Reserve Bank of India has upwardly revised the country's retail inflation projections for 2023-24 at 5.4% assuming normal monsoon rainfall. We expect the trade deficit to stay elevated over the coming months. Slower external demand may keep exports sluggish while incremental terms-of-trade benefits might fade owing to a higher import bill going forward (due to the rise in oil, gold and other commodity prices). The current account deficit is expected to track sub-2% of GDP in F2024e. Risks of a deep recession in US will weigh on the export and capex outlook, thus delaying the virtuous growth cycle. On the domestic front, risks emanate from weather-related events such as El Niño and uneven rainfall distribution, affecting crop yield and thus food inflation/crop output. The General Election in May 2024 also remains a key event risk to track. Growth enablers like offshoring, investment in manufacturing, the energy transition and the country's advanced digital infrastructure can help India grow at 6.5% for next 10 years.

The World Bank has maintained its forecast for China's 2023 economic growth at 5.1 per cent, in line with its previous estimate in April, but trimmed its prediction for 2024 to 4.4 per cent from 4.8 per cent, citing the persistent weakness of its property sector. They also maintain that further strong structural reforms including further liberalisation of the "hukou" residence permit system, stronger social safety nets and greater regulatory predictability for investments in innovative and green products could help revive consumption and investment, creating the basis for sustainable growth in China.

From a sectoral perspective, given the continued strong domestic growth we are positive on domestic themes such as banks, NBFCs, insurance, manufacturing, power and consumer discretionary. We expect financials earnings growth to remain resilient, guided by robust traction in loan growth and a benign credit cost, even though quarterly earnings growth is expected to decline sharply. As the credit-deposit ratio remains elevated, healthy growth in liabilities will be critical to sustaining loan growth. We expect competition for deposits to intensify further, resulting in a significant rise in funding costs in the coming quarters for most banks. The third consequent pause in policy rates by the RBI suggests that interest rates are near peak levels. As rates stabilize, the impact of margin compression on the NBFC earnings should abate, supporting better valuations. In the auto sector, sustained demand recovery, especially in the domestic market, improving chip supplies, and stable commodity prices are expected to drive performance going forward. The whole sector is also a beneficiary of EV conversion offering a big opportunity for first movers. In cement most managements remain positive about cement demand, led by sustained demand from the government's infrastructure projects, a pick-up in real estate, private capex and housing demand from tier-II/III/IV cities. In the retail business sector, there is an industry wide commentary on the demand situation, indicating that while there has been a MoM improvement in demand in 2QFY24, a healthy recovery is expected from 2HFY24 with the onset of the festive period.

Overall, the Indian market has corrected 2% from its high in middle of September and on a broader level, the Nifty is trading at a 1-year forward P/E of 18.6x compared to the 10-year average of 20x, and at a P/B of 2.9x compared to the average over this period of 2.7x (Source: Motilal Oswal). The market-cap to GDP ratio for FY24e is at 109%, higher than its 10-year average of 79%. The earnings growth expectations continue to be attractive with FY23-25e earnings CAGR forecast around 18% (Source: Motilal Oswal). The geopolitical uncertainty and recession fears in USA and Europe will need to be tracked in 2023. We will also track the Federal Reserve's actions after its continued pause at the September meeting, especially with the inflation increasing tailwind of rising commodity prices such as crude oil, which also impact India and will be closely tracked at versus current levels.