March 2021

Stewart Investors
Sustainable Funds Group

Indian Subcontinent: The Decade Ahead

Risk factors

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Investment terms

View our list of investment terms to help you understand the terminology within this document.

The Strategy did well in 2020, thanks in part to the generosity of central banks globally, while the real economy tried to shake off a pandemic. However, we believe that the real opportunity for investors in the subcontinent should be in the decade ahead[1]. We are optimistic for two reasons.

1 Many macro-economic factors are beginning to turn in India's favour

One may conclude from the past decade that India is likely to remain a low-growth economy. We disagree. Many ingredients are now in place for a revival in economic growth and sustainable development. Below are some of the macro-economic tailwinds that contribute to this view.

- A lower carbon future
- A potential revival in infrastructure investment
- A potential revival of the manufacturing sector
- A global health crisis that has further strengthened India's IT services and pharmaceutical companies
- A potential resurgence of the property cycle

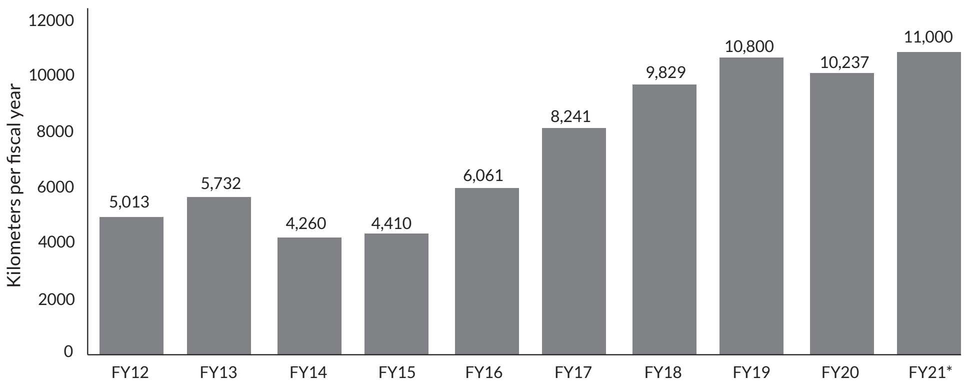
A lower carbon future

India has only produced 3% of total carbon dioxide emissions historically[2]. Surprised? We were too! The United States, Europe and China have together contributed 60%[2]. As a signatory to the Paris Agreement, India has committed to reduce carbon intensity by 33-35% by 2030[3]. As part of this journey, 175 gigawatts (GW) of renewable generation capacity is already commissioned or in construction by 2022, up from just 34 GW in 2014[4]. Falling solar prices could help India reach its target of 450–550 GW by 2030 or 60-65% of total generation capacity[4]. Changes in vehicle emission norms to European standards, rapid evolution of electric vehicle (EV) technology and introduction of scrappage vehicle policies should further reduce emissions intensity and improve the country's finances. These are sound reasons to believe India will not follow a similar carbon-intensive development path as the west or even China.

A potential revival in infrastructure investment

Infrastructure investment has been India's Achilles heel. It could well be its champion in the next decade. For instance, construction of new roads has continued behind the scenes at a good pace in the last five years. Private investments and participation have now begun to improve in areas such as airports, gas and power distribution, renewable energy and even parts of the railways. The government has embarked on many difficult but essential reforms in agriculture and labour markets. The pace of reforms is likely to be dictated by acceptance from various stakeholders. Such checks and balances are sometimes necessary to ensure the benefits of development are widespread and equitable.

Road construction in India



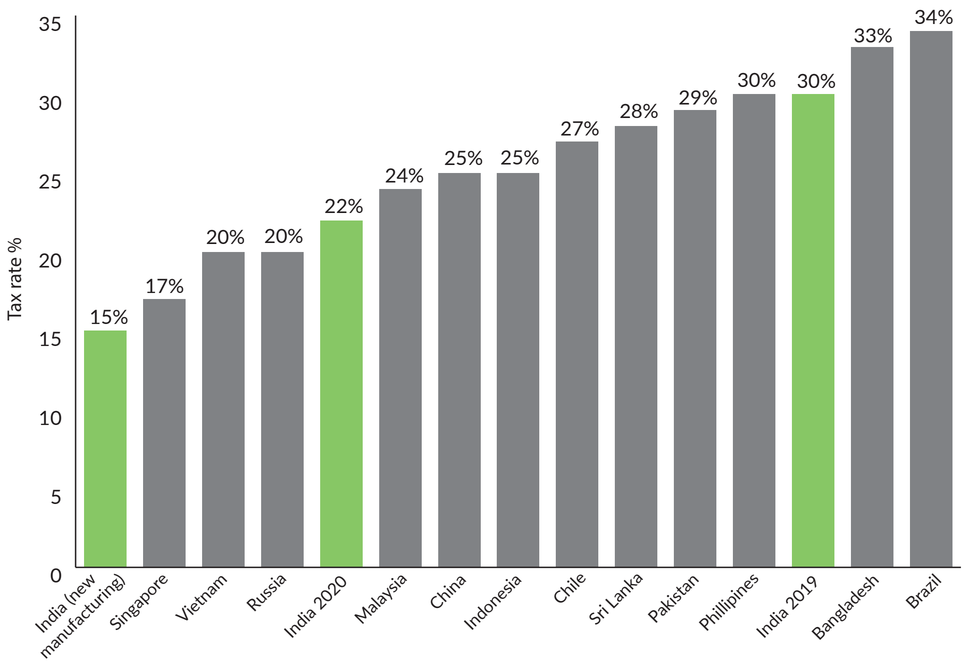
Source: Ministry of Road Transport and Highways, Indian government. *Target for 31 March 2021.

Funding availability and lower interest rates are necessary ingredients to fuel an investment cycle. The previous cycle was overly dependent on the state banking system as a funding source. Today, insurance companies, infrastructure investment trusts, corporate bond markets and large well-capitalised private banks can participate in financing infrastructure. Unlike what we see elsewhere, corporate and bank balance sheets have been slow to repair in the last decade. The insurance industry's assets have grown to USD600bn from just USD200bn a decade ago[5]. Approximately USD18trn in global debt earns negative returns[5]. If India keeps the inflation genie in the bottle, it could become an attractive destination for long-term debt capital. Interest rates today are at least 5%, which is 6% lower than the previous investment cycle[5].

A potential revival of the manufacturing sector

India's manufacturing sector is showing early signs of promise. While the government encourages investment in local manufacturing through attractive taxation and labour reforms, the case is becoming stronger from the bottom-up via productivity improvements. A large domestic market, improving infrastructure and the need to diversify global supply chains due to geopolitical tensions, add wind to India's manufacturing sails. Apple's* suppliers have invested close to a billion dollars to set up manufacturing units recently[6]. Many home appliance producers are localising manufacturing through companies such as Dixon Technologies and Amber Enterprises*. These are still early days but the conditions are far better today for Indian companies to become competitive at a global scale in this area.

Corporate tax rates



Source: Country government statistics and OECD, 2020.

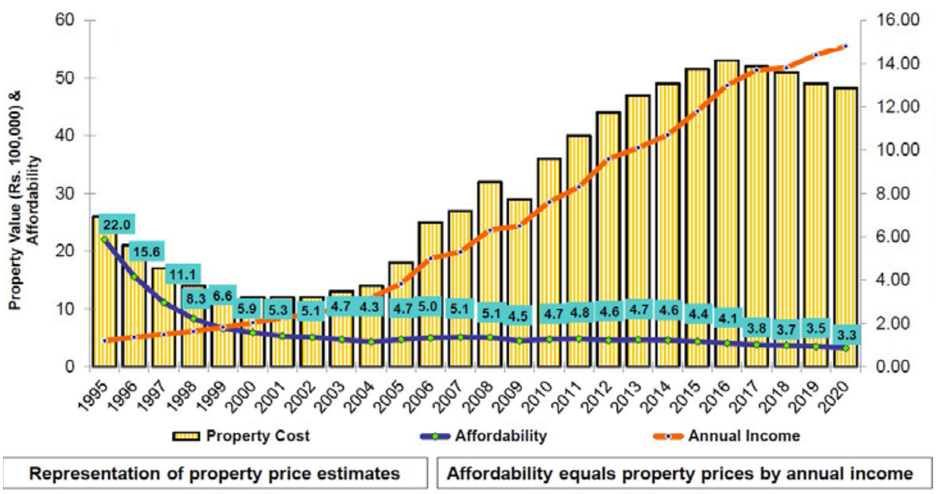
A global health crisis that has further strengthened India's IT services and pharmaceutical companies

A crisis is an opportune time to build trust. Companies with time horizons spanning decades understand this well. Despite unexpectedly extreme conditions, companies such as Tata Consultancy Services and Infosys* ensured uninterrupted services to their clients by swiftly enabling hundreds of thousands of employees to work remotely. A monumental task given their scale. Clients rewarded them with USD40bn in new business during a pandemic[7]. A sign of trust! Indian pharmaceutical companies have long provided affordable drugs to the world. Companies like Serum Institute and Dr. Reddys* are preparing to produce billions of doses of affordable vaccines. The trust earned by supplying these at a reasonable cost should help cement their role as providers of quality affordable healthcare globally for decades to come. We believe that trust is one of the best barriers to entry for any business.

A potential resurgence of the property cycle

"More than ever before, people will want to own their homes. People will go to any length to hold on to their homes" – says Deepak Parekh's (Chairman of HDFC[8])*. Structural changes are afoot in how people view homes and the need for work spaces within homes. And property is more affordable today than at any time in the last 25 years[9]. Tax incentives for affordable housing materially reduce the cost of servicing mortgages. India remains one of the most attractive mortgage markets in the world due to low home ownership, low mortgage penetration and a young population. Mortgages would have to grow at twice the rate of GDP in the next 10 years just to catch up with China. This presents favourable conditions for the start of a multi-year property cycle.

Improved affordability
Best affordability in 2.5 decades, Government support towards housing has helped improved affordability



Source: HDFC. Data reflective of HDFC's customer base.

2 Quality companies should benefit disproportionately from macro-economic tailwinds

India is home to many high-quality companies. We have been saying this for many years. We are particularly excited by the resurgence of good old-fashioned Indian conglomerates - the Tatas, Murugappas and Mahindras*. The Strategy has around one-third of its assets invested across many companies stewarded by these groups. These companies engage in diverse businesses which are well positioned for sustainable development in the region.

It is difficult to reconcile with the unceremonious removal of Tata Sons' previous Chairman Cyrus Mistry. But it is equally difficult to disagree with the choice of his successor – **Natarajan Chandrasekharan**, the former CEO of Tata Consultancy Services. Over the last four years, Chandra has been resolute in rekindling a culture of focus and performance, while holding on to the group's cherished ethos and long termism. The group now desires less risky balance sheets while tilting its emphasis back to India after a decade of outward investments. Microsoft, under the leadership of Satya Nadella, is a good example of the potential returns investors can reap when good groups find quality managers to steer them ahead.

Companies[8]	Group	Nature of business	Strategy weight
Tata Consumer Products	Tata Group	Food and beverages	3.1%
Tata Consultancy Services	Tata Group	IT services and platforms	3.7%
Tata Chemicals	Tata Group	Basic and specialty chemicals	2.0%
Voltas	Tata Group	Air conditioners and home appliances	1.8%
Tata Communications	Tata Group	IT infrastructure services	2.5%
Mahindra & Mahindra	Mahindra Group	Farm equipment and holding company	5.4%
Tech Mahindra	Mahindra Group	IT services and platforms	3.1%
Mahindra Logistics	Mahindra Group	Third party logistics provider	2.4%
Tube Investments	Murugappa Group	Engineering conglomerate	6.0%
Carborundum Universal	Murugappa Group	Industrial consumables	2.7%
CG Power & Shanthi Gears	Murugappa Group	Industrial equipment and gears	1.9%

Source: Stewart Investors as at 28 February 2021.

The Murugappa Group felt the overhang of an inter-generational leadership transition within the family. The succession is now firmly in place and the group is becoming bolder in its aspirations. Tube Investments, is headed by **Vellayan Subbiah**. The recent acquisition of CG Power, a maker of industrial motors, is a clear sign that Tube Investments has set its sights on becoming a leading engineering conglomerate. We believe that the group's multi-decadal time horizons, competent leadership and conservative approach to financials make them well positioned to succeed.

The Mahindra Group had two wonderful decades under the stewardship of **Anand Mahindra**. However, a global expansion in automobiles and some investment choices away from their core strengths set them back recently. Incoming CEO **Anish Shah** has spent the last six years understanding the group's history, culture and evolution. He has sought inspiration from how the Mahindras responded to the oil crisis in the 1970s and to the dotcom bubble in the late 1990s. A raging pandemic did not stop the group from admitting to some of their recent strategic mistakes. Much of the repair is now well underway, paving the way for an exciting decade ahead.

In each of these groups, a generational transfer of leadership is leading to an exciting future. These institutions have survived and thrived over generations, partly because of their ability to admit to mistakes and correct the course when necessary. A rare and exceptional quality. This combination of internal improvements under highly competent leaders, in addition to macro tailwinds, could prove to be powerful for investment returns.

Risks are often misunderstood

It is rare to see tens of thousands of people protest peacefully outside a nation's capital for months. It is more rare in the polarised times we live in. The ongoing farmer protests in India are a sign that society can challenge the prevailing government of the day. It is not the first time. Back in 2012, there were peaceful anti-corruption protests across the nation, which eventually led to the fall of the previous government. India's vibrant and often loud democracy is misunderstood as chaotic and risky. We believe the opposite is true. The ability of companies and society to engage with governments and hold them accountable where necessary is key for the sustainable development of economies. We struggle far more with the opacity and the binary risks that come alongside investing in authoritarian regimes. Investing in the subcontinent is not without risks and potential market volatility. Fragile borders, water shortages, rising social divisions and climate change are key challenges. Moreover, society still has a pandemic to deal with. Quality private companies operating in unfavourable macro-economic conditions drove the Strategy's performance in the last decade. We believe that many conditions should turn favourable and with good reason. We are optimistic that the subcontinent should reward patient investors with sound absolute returns in this decade.

Sashi Reddy
March 2021

*Source for company information: Stewart Investors and company data. For illustrative purposes only. Reference to the names of each company in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies. Companies mentioned herein may or may not form part of the holdings of Stewart Investors.

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[2] Source: Our World in Data based on the Global Carbon Project. Share of global cumulative carbon dioxide emissions, 2019. Hannah Ritchie and Max Roser (2017) - "CO_2 and Greenhouse Gas Emissions". Published online at OurWorldInData.org. Retrieved from: 'https://ourworldindata.org/co2-and-other-greenhouse-gas-emissions'.

[3] Source: United Nations Climate Change. Pledge is to reduce carbon emissions intensity of its GDP by 33 to 35 percent by 2030 from 2005 level.
https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/India%20First/INDIA%20INDC%20TO%20UNFCCC.pdf

[4] Source: United Nations Climate Action Summit 23 September 2019. Prime Minister Modi address.
https://www.pmindia.gov.in/en/news_updates/pm-modi-addresses-climate-action-summit/

[5] Source: Motilal Oswal Financial Services Limited.

[6] Source: Reuters, 28 September 2020.

[7] Source: Company data.

[8] Source: Company data. 2020 Chairman letter.

[9] Source: Stewart Investors and company data.

[10] Source: Stewart Investors as at 28 February 2021. Data shown is for a representative Stewart Investors Indian Subcontinent Sustainability account. Data shown for all Indian conglomerates held in the strategy. It is not a recommendation or solicitation to purchase or invest in any fund. Differences between the representative account-specific constraints, currency or fees and those of a similarly managed fund or mandate would affect results. This stock information does not constitute any offer or inducement to enter into any investment activity nor is it a recommendation to purchase or sell any security.

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