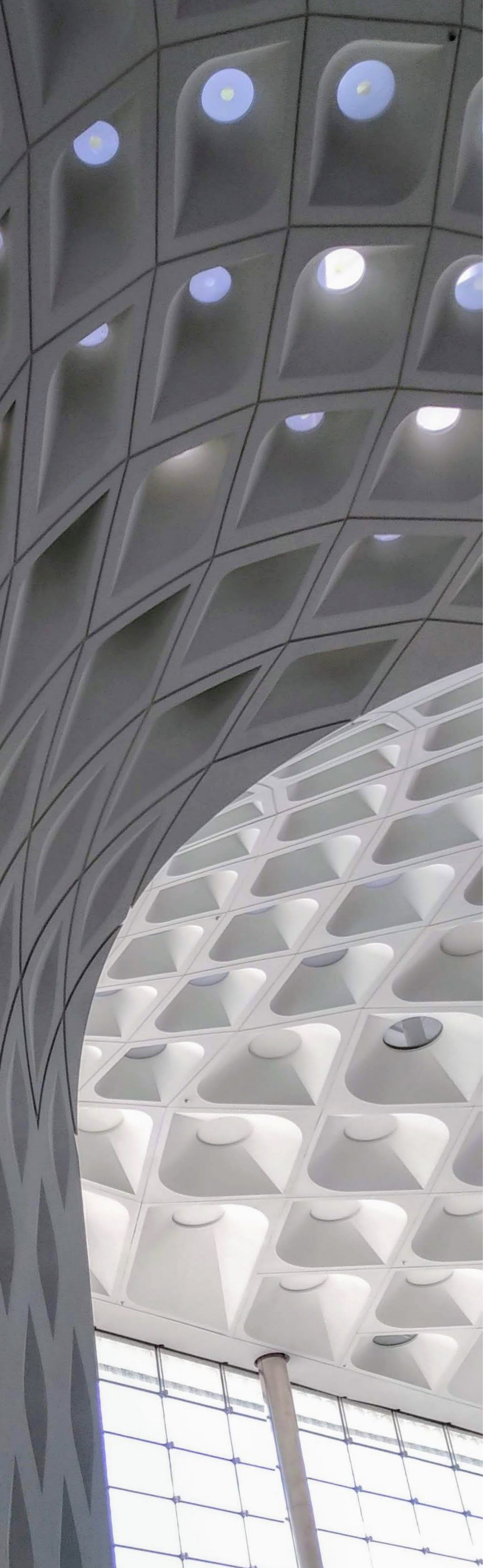

Manulife Investment Management

Transitioning to *India's* next stage of growth

September 2023

India has been one of the best-performing regional equity markets over the past three years. However, in the current uncertain environment, investors might wonder about the country's trajectory and the long-term growth drivers that could create investment opportunities. In this edition of Portfolio Insights, Rana Gupta, Senior Portfolio Manager, and Koushik Pal, Director India Equities Research, present how structural top-down reforms since 2014 gave rise to key growth drivers such as formalisation, digitalisation, and a manufacturing resurgence, which, in turn, bolstered the economy's resiliency. They will also introduce the emerging "Five Ds". Digitisation, Deglobalisation, Decarbonisation, Demography and Deficit Reduction – the new growth drivers causing a paradigm shift in the country's commercial environment.

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Introduction

Amidst a rapidly shifting global landscape dominated by growing geopolitical tensions and shifting supply chains, India is also changing.

The country's evolution since 2014 has already resulted in a paradigm shift driven by deliberate and targeted policies. The Indian economy embarked on a structurally transformative journey when a raft of critical policies laid the foundation for a new economic direction. Indeed, the government-led reforms have paved the way for a dynamic long-term growth trajectory driven by three key forces: formalisation, digitisation, and a manufacturing resurgence.

We believe that the interaction between these drivers is starting to structurally enhance India's macroeconomic resilience with a stronger fiscal account and better external-account dynamics. The possibility of structurally lower inflation should reinforce the virtuous growth cycle. Overall, these developments should transform the Indian economy, making it more formal, digital, efficient, capex-driven, and resilient. It should also raise productivity and India's ability to generate local capital and absorb more global capital.

And with these economic changes, the investment opportunity set has also evolved. This thought leadership piece will specifically look at the policies and reforms put in place and discuss the foundation built on the back of these programmes that had resulted in India's nascent stages of growth. We will also provide greater detail on future growth by providing a deep dive into the following areas:

- How India's improved digital and physical infrastructure amid a more formalised economy creates new commercial opportunities;
- How domestic manufacturing is becoming incentivised, and capex is improving in certain segments, leading to import substitution and the possibility of higher exports;
- Why industry consolidation and disruption in the economy are simultaneously at play;
- Where and why urbanisation is likely to deepen;
- Amid it all, how the right policies are helping India achieve the energy transition;
- A declining fiscal and current account deficit, along with range-bound inflation, provide a strong macro backdrop that makes India's growth drivers scalable and sustainable;
- Finally, we classify these drivers under Digitisation, Deglobalisation, Decarbonisation, Demography and Deficit Reduction (the Five Ds) and explain how they will reshape the country's commercial environment across diverse sectors.

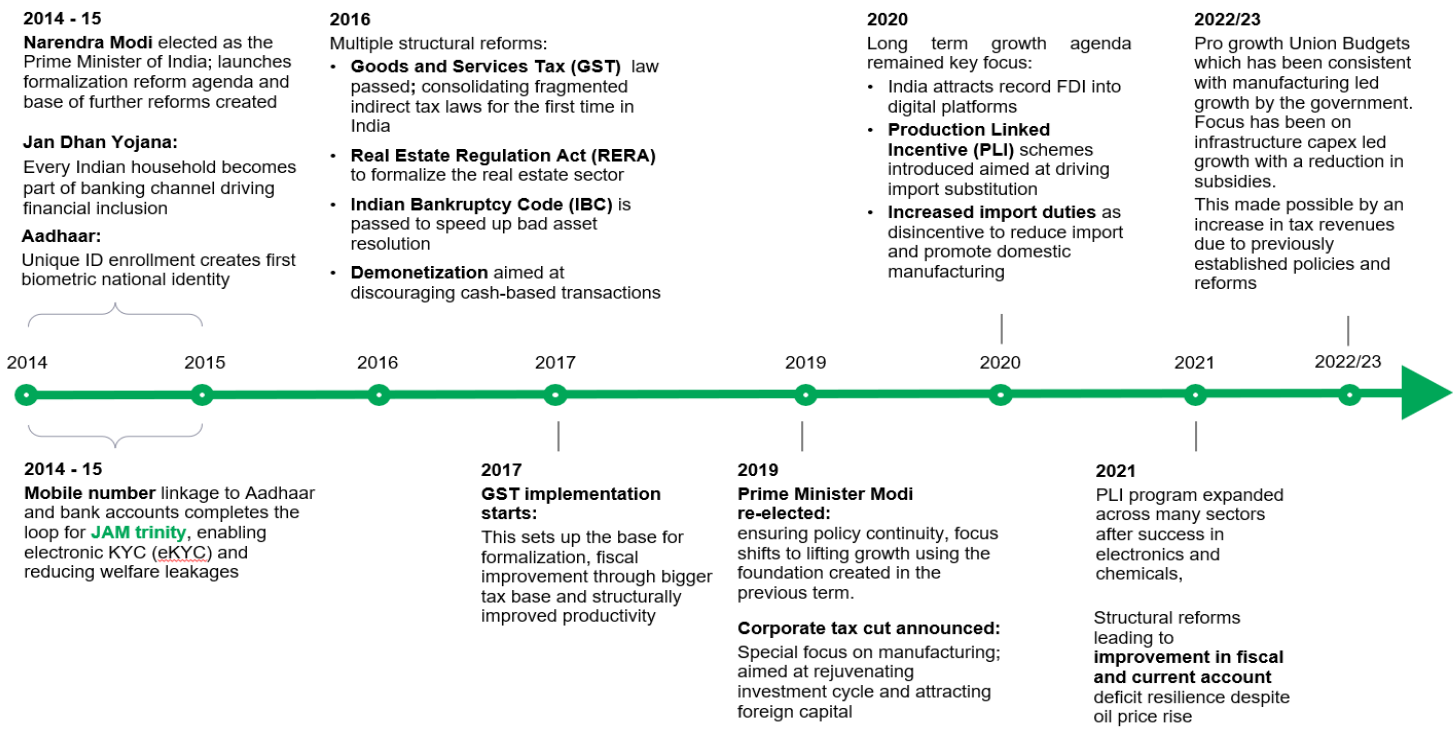
Given the current market and investment environment, this piece highlights why investors should consider Indian equities to participate in the country's long-term growth story amid policy continuity and a stable regulatory environment. Overall, we think the asset class presents sizeable and sustainable growth opportunities at an uncertain time when the global growth and corporate earnings environment remain volatile.

The foundation

Historically, the Indian economy comprised of less formal and mostly informal segments, with the latter being primarily cash driven with minimal government regulation. Due to the structure of the informal economy, we believe inefficiencies were high, and productivity was low. In our view, this was a key bottleneck in India's economic development.

The initial policies and reforms established in 2014 when the current government was first elected to office have defined the shift from the informal economy to a formalised one. Chart 1 provides a summary of the steps taken over the past nine years to position India for its next stage of growth.

Chart 1: Key government reforms, 2014-2023



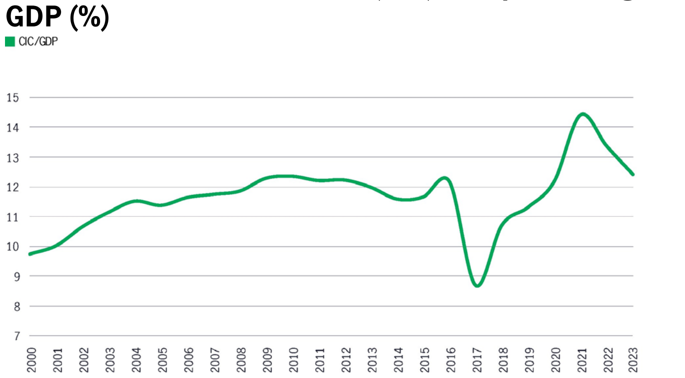
Source: Manulife Investment Management analysis, August 2023.

It is crucial to recognise that India's current growth drivers stem from deliberate and targeted policies implemented since 2014. The first step in the transformative journey began with the JAM Trinity (please see the Appendix for a brief description of the key reforms), which set up a system that provided every Indian citizen with a national identity number and a linked bank account. This process eliminated leakages in government welfare payments, ensuring the money went where it was supposed to.

This was followed by several reforms and policies, including the introduction of a Goods and Services Tax (GST). The government did not have sufficient information on transactions to collect taxes from unregistered businesses and companies. GST unified India's tax system, and businesses had to register and report all transactions to the government, increasing transparency.

As informal businesses entered the formal economy, they were required to register and pay taxes. This also allowed them to show banks and other financial institutions proof of business results, making it easier to apply for loans. This facilitated businesses operating in the cash-based economy to participate in India's growth. It also increased efficiency over time; cash usage did not maintain a consistent reduction after demonetisation; however, it has declined in recent years (Chart 2).

Chart 2: Cash in circulation (CIC) as a percentage of GDP (%)

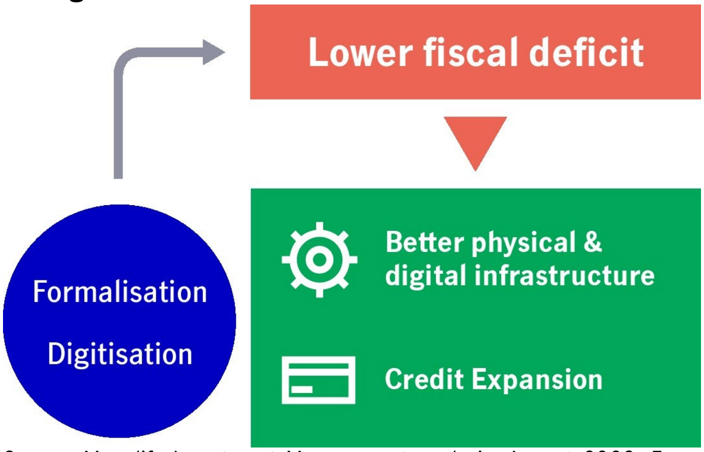


Source: CEIC, RBI, Kotak Economics Research estimates, July 2023. The above information may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

As a result, the government was able to increase tax revenue despite offering tax incentives for domestic manufacturing. This improved the country's fiscal position and allowed for critical investment in physical infrastructure.

Formalisation laid the foundation for the growth of the digital economy, leading to better productivity and robust growth in tax collection, enabling the government to gradually increase spending without risking a more significant fiscal deficit (Chart 3).

Chart 3: Formalisation and digitisation driving change



Source: Manulife Investment Management analysis, August 2023. For illustrative purposes only.

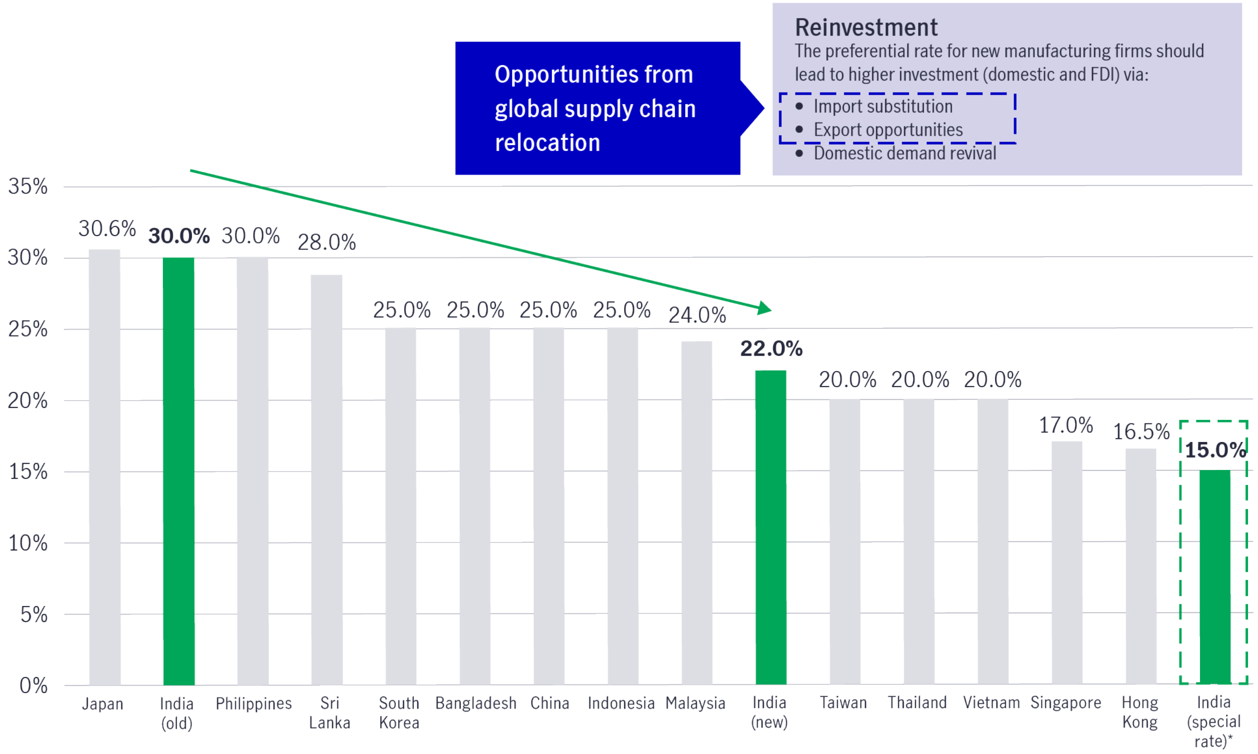
More importantly, resources available from these actions allowed the government to increase its capital expenditure on developing physical infrastructure, providing incentives for domestic production – imperative for improving India's manufacturing share of GDP. Indeed, the focus has been on creating infrastructure, boosting investments, and incentivising production over consumption. We believe such steps will structurally moderate inflation.

A growing digital economy gradually turned the informal sector to a formal one. In turn, a more formal economy depended on formal credit rather than cash for expansion.

Other key reforms, such as the Real Estate Regulatory Authority (RERA) and the Insolvency and Bankruptcy Code, also built a strong foundation for enhancing India's potential growth.

Building on these reforms, the government announced policies to boost manufacturing's share of GDP. In 2019, the corporate tax was reduced from 30% to 22%, with a preferential lower rate (15%) for newly established manufacturing companies (Chart 4). The aim was two-fold: driving domestic investment in manufacturing while attracting foreign direct investment to help diversify the production bases of multinational corporations looking to participate in the "China +1" strategy.

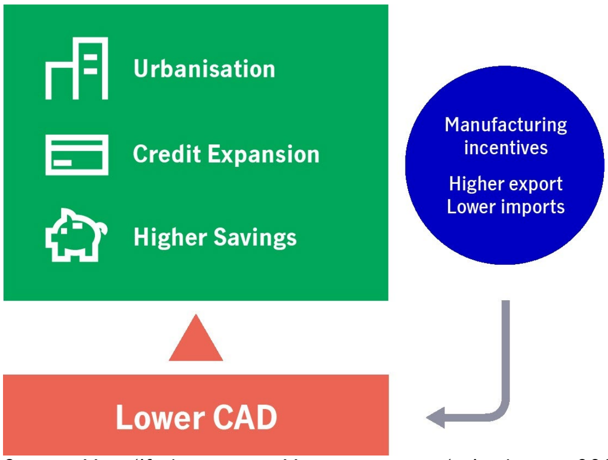
Chart 4: Lower tax rates boosted India's competitiveness



*Note: Special rate refers to the preferential tax rate for manufacturing companies incorporated after 1 October 2019 and starting production before 31 March 2023. Source: Bloomberg, KPMG, as of 24 September 2019.

Another critical policy push was the production-linked incentive (PLI) scheme, designed to increase onshore manufacturing capacity and drive import substitution (Chart 5). Targeted segments included mobile phones and white goods, such as air conditioners.

Chart 5: Manufacturing incentives changing the commercial and economic landscape



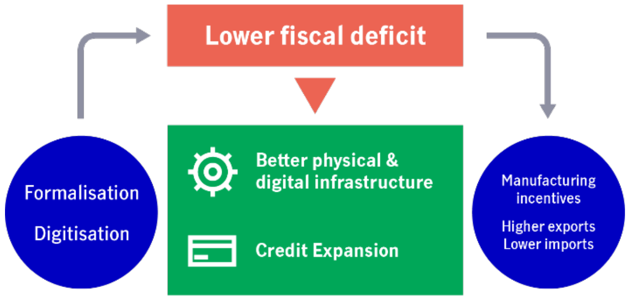
Source: Manulife Investment Management analysis, August 2023. For illustrative purposes only.

In segments where Indian exports were traditionally strong, the PLI scheme would help drive export growth in automobiles, pharmaceuticals, textiles, and chemicals. Emerging sectors in which the PLI scheme would help drive new investment included high-efficiency solar photo voltaic modules and advanced chemistry cells battery storage. Additionally, import disincentives were enacted to promote new domestic manufacturing investments.

The transition

The fusion of the structural reforms since 2014 in the Indian economy have created the two powerful themes we highlighted in the previous section: formalisation and reinvestment in manufacturing (Chart 6). They have featured consistently in our investment analysis since 2020 (See Appendix for a list of relevant investment notes).

Chart 6: India's virtuous growth cycle

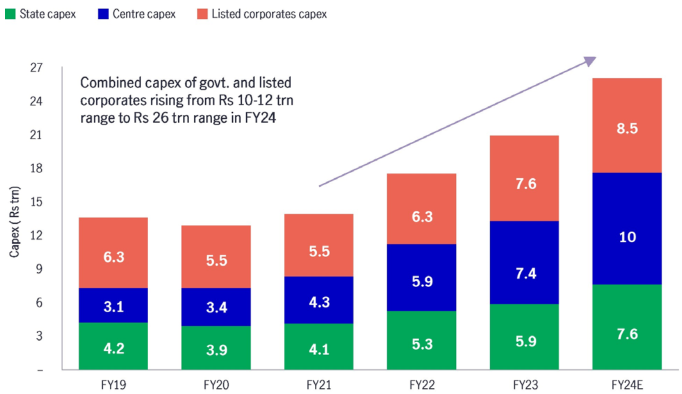


Source: Manulife Investment Management analysis, August 2023. For illustrative purposes only.

These primary growth drivers have started to perform strongly over the past few years. In this section, we will look at the tangible results of these two drivers.

We already see a substantial uptick in private and government capital expenditure as reinvestment-led policies drive more investment in India (Chart 7). The investment in physical infrastructure creates an environment conducive to manufacturing in India, leading to fewer imports and more export-led growth.

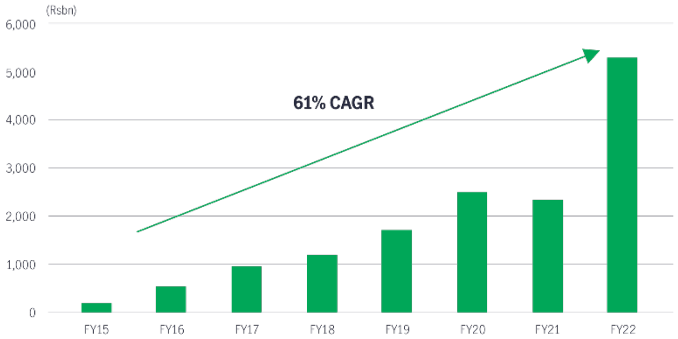
Chart 7: Capex has experienced significant growth on the back of reforms



Source: CEIC, Capitaline, I-SEC Research, June 2023. The above information may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

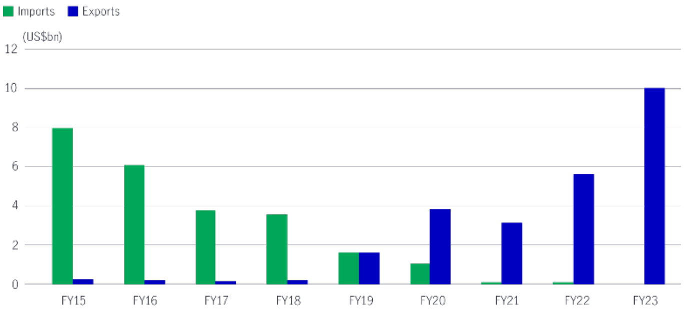
As an example, policy-led initiatives have underpinned the solid growth of the electronics sector, particularly in mobile phone production, which has grown at a 61% (value) CAGR since FY 2015 (Chart 8). Indeed, India has transitioned from being a net Importer of mobile phones to a net exporter: Mobile phone exports exceeded US$10 billion in FY2023, compared to peak imports of around US$8 billion in FY2015 (Chart 9).

Chart 8: Strong increase in the value of mobile phone manufacturing in India



Source: MeitY, Investec Securities Research, July 2023.

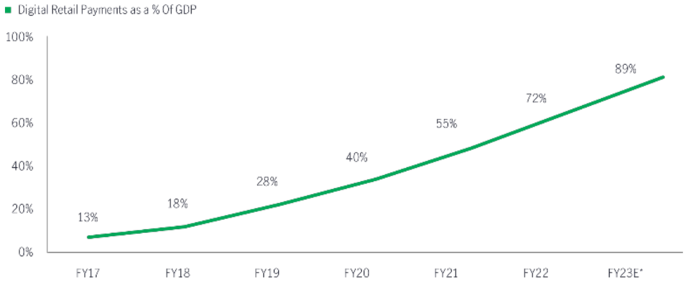
Chart 9: India has transitioned to a net mobile phone exporter



Source: MeitY, Investec Securities Research, July 2023. The above information may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

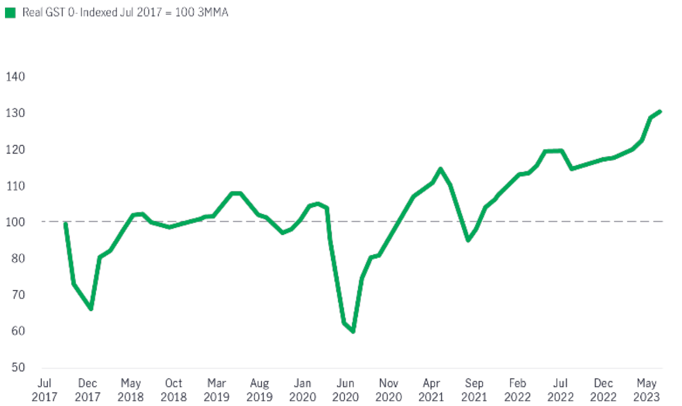
Similarly, digitisation and formalisation have reinforced each other, with robust growth in digital payments (Chart 10), an increasing digital footprint, and improved tax compliance. This has translated into strong tax collection, with GST growing at a 26% CAGR over the past two years (Chart 11).

Chart 10: Digital retail payments (as a percentage of GDP) have experienced strong growth since FY 2017



Source: RBI, NPCI, Government, Companies, Jefferies, March 2023. *Annualised figure

Chart 11: Higher tax compliance driving strong growth in government revenues



Source: Ministry of Finance, Morgan Stanley Research, as of May 2023.

Primary growth drivers should gradually improve India's macroeconomic resilience

Overall, we believe these drivers have started to structurally improve India's macroeconomic resilience with a better fiscal position (from improved tax collection) and external account dynamics (higher net exports). Structurally lower inflation should reinforce the virtuous growth cycle.

These developments should transform the Indian economy, making it more formal, digital, efficient, capex oriented and resilient. It will likely also raise productivity and India's ability to generate local capital and absorb more global capital.

Furthermore, these drivers' interaction with current macro and global forces is creating new themes and opportunities that should improve India's productivity and growth in the coming years:

- Improved physical and digital infrastructure creates new market-access channels, expands the total addressable market (TAM), and improves efficiencies. These developments are lowering customer acquisition and servicing costs. The Indian corporate sector's intentions to build on those efficiencies through further investments are surging due to market expansion and lower costs in accessing the same.

- A more formal and digital economy results in a stronger digital footprint across financial transactions. This expands financial inclusion and credit access along with strong asset quality. Easier credit access is changing investment and consumption patterns.
- As India formalises and transforms, we will likely see market share consolidate towards larger, better-managed companies, especially for asset-intensive businesses. We should also witness market disruption by innovative companies leveraging these gains, especially in consumer and financial services.
- Better infrastructure, capital expenditure, and industrialisation will likely promote more urbanisation, driving growth in real estate and allied industries.
- With urbanisation, consumers are opting for feature-rich products in various industries: auto, home, white goods, or electronics. With corporate and government capex, they also opt for feature-rich products that connect their physical and digital worlds. In short, the level of domestically produced content is increasing. Previously, India would import most of it, but thanks to PLI, a part of such spending is now captured by companies setting up plants to cater to the burgeoning demand.

Overall, the Indian economy is undergoing a paradigm shift: From informal to formal, from cash to digital, and from import-based to domestic manufacturing.

Meanwhile, India is upgrading its physical and digital infrastructure and focusing on the energy transition to reduce fossil-fuel dependency. We believe reducing fossil fuel dependency should unleash opportunities in energy transition, lowering the oil import bill and further boosting the country's macro stability.

We will now take a closer look at how these developments create new opportunities for investors.

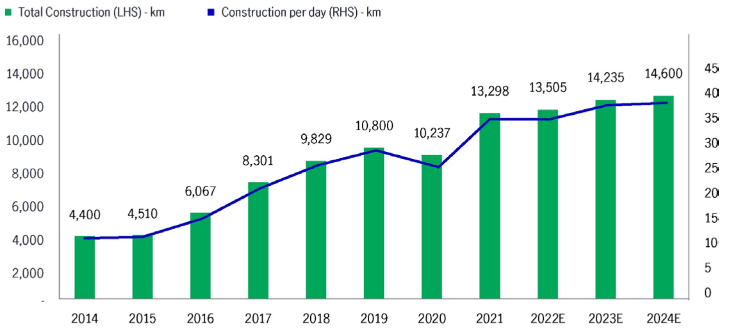
The opportunity set

Over the past decade, we have seen a remarkable improvement in India's digital and physical infrastructure.

The expansion of digital infrastructure was central to the formalisation process that empowered the JAM Trinity initiative and India's digital payment revolution. Since India's 4G rollout started in 2016, it has gone from being a poorly covered country in high-speed wireless broadband to being fully covered with 4G and a billion smartphone users. India now has one of the highest per-subscriber data-consumption levels in the world at 17GB per subscriber per month[1]. Moreover, 5G network rollouts started in 2023 and will likely be completed by 2025 in major cities.

Similarly, as part of supply-side policy initiatives, we have seen a substantial improvement in physical infrastructure. The country has increased the pace of road construction and improved port capacity in India (Charts 12 and 13), and these have eased logistical bottlenecks and reduced logistical costs.

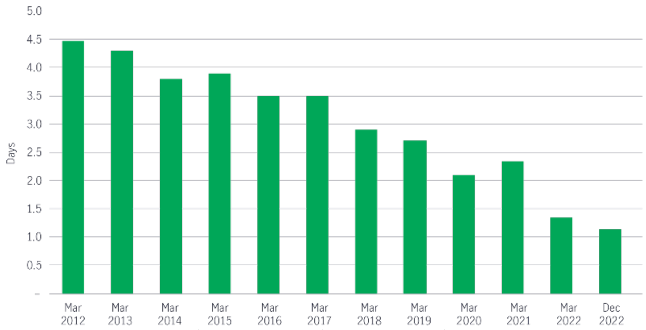
Chart 12: Pace of road construction and total construction have increased



Source: PIB, MoRTH, NHAI, Kotak Institutional Equities estimates, as of July 2023. The above information may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

[1]Source: CEIC, Telecom Regulatory Authority of India, as of July 2023.

Chart 13: Significantly lower average container ship turnaround time (days) since 2012

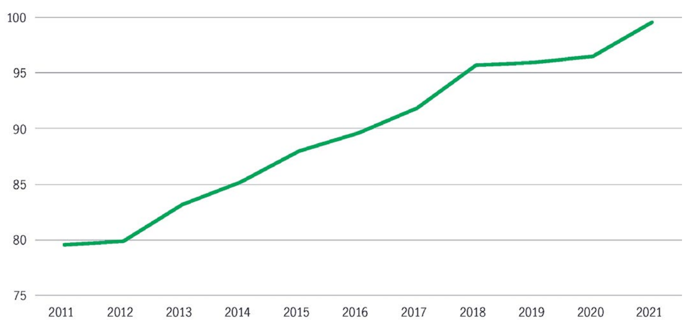


Source: Ministry of Shipping, Kotak Institutional Equities, as of December 2022.

The start of the dedicated freight corridor in 2024 will be another landmark event that will add 7,000 kilometres of dedicated freight tracks with double stacking technology, potentially reducing transportation costs by another 200 basis points of GDP.

Power availability for residential and industrial purposes has also significantly improved due to investments in generation, transmission and distribution (Chart 14).

Chart 14: Power availability has significantly improved (Percent of population with access to electricity)



Source: World Bank, as of 2021.

New infrastructure gives rise to novel business models and investing opportunities

Blending better physical and digital infrastructure with formalisation reforms like GST and JAM Trinity has drastically improved India's economy's productivity and growth potential. Additionally, government initiatives, like the unified payment interface (UPI), have triggered a rise in digital transactions and reduced hard-currency usage.

Furthermore, this has increased the digital footprint of transactions, making lower-cost credit underwriting possible. This is generating new opportunities and digital-led business models in services across food, logistics, e-commerce and financial services, just to name a few.

This also negates the network advantage of many established incumbents, as an extensive digital reach, along with interoperable platforms, gives newer entrants access to many customers and an opportunity to gain market share with reduced transactional friction and costs. We envisage:

- Hyperlocal businesses, like food delivery platforms and quick commerce, can now create highly adaptive business models that transform inventory, delivery radius, and delivery partner availability at a high frequency. By harnessing data analytics from customer smartphones, these companies can react to peaks and troughs in demand.
- New logistics players are emerging, operating at around three times the productivity of current standards using big-data analytics and large-scale warehouses. This has further implications, as lower logistical costs can deepen reach and increase addressable market size for e-commerce platforms.
- Traditional lenders and fintech platforms are expanding the credit market by offering new loans to individuals and small businesses, as well as utilising the power of high-frequency payment data and GST records, gaining market share and acquiring customers at a low cost without sacrificing credit quality.
- Unsecured credit has grown at around 29% CAGR over FY2019 to FY2022, and despite this, we are seeing improving asset quality reported in the system. Better credit availability and India's young demographics will likely support consumer demand, especially in more premium, discretionary consumption.
- Digital insurance platforms are launching innovative products with new-age insurance companies, lowering customer costs and improving insurance penetration.

Digital disruption in services; consolidation in asset-backed businesses.

India's economy has experienced multiple disruptions since 2017. However, as it has formalised (demonetisation, GST, RERA, and Covid-19), we have seen the first phase of industry consolidation where larger players in multiple sectors have gained market share as smaller/unorganised players have been unable to keep up. This trend has been witnessed across real estate, building materials, passenger cars, aviation, and telecoms – sectors that typically require significant investment in fixed assets.

At the same time, disruptors, led by new business models, are employing the efficiencies of a transforming India to take market share from incumbents in many sectors, which has been asset light. They are leveraging digitally led distribution, as well as new manufacturing investments, by harnessing manufacturing incentives.

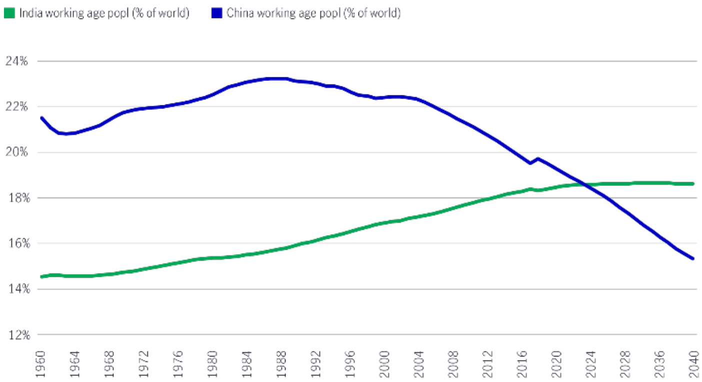
We see categories such as air conditioners, consumer staples and discretionary (ex-auto), decorative paints, and home improvement being disrupted by platforms and direct-to-consumer brands. Incumbents have been slow to invest and have instead chosen to maximise return ratios. As a result, they have become the targets of new-age companies that are more innovative, efficient, and well-capitalised.

Urbanisation is likely to continue

We expect the urbanisation trend to continue and accelerate via primary growth drivers. As infrastructure improves amid higher capital expenditure and manufacturing investment, it will support more cities.

A young aspirational India seeking prosperity will likely be rewarded with higher-paying jobs as more global capital invests in the country. Over the past two years, we have seen services exports substantially grow as an increasing number of international companies have set up knowledge outsourcing centres in India. By 2027, India is expected to surpass China as the country with the highest share of working-age population globally (Chart 15). According to NSSO, CEIC and UN estimates, 10% of Indians will urbanise over the next 15 years.

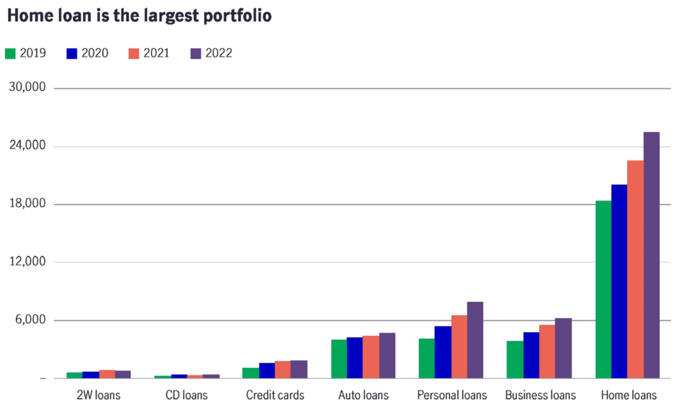
Chart 15: India versus China: percentage of working age population



Source: United Nations, Axis Capital, November 2021, data beyond 2021 are estimates. The above information may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

As housing demand increases (Chart 16), this will have positive implications for discretionary consumption, automobiles, and real estate. This should also benefit financials as more nuclear families drive credit demand.

Chart 16: Home loans are the largest credit segment



Source: CRIF, retail loan portfolio outstanding across banks and non-banking financial company, as of March 2023 fiscal year-ends (Rs billion).

Reducing India's dependence on fossil fuels through energy transition

Growth is energy intensive. India has traditionally relied on fossil fuels, most of which are imported. Therefore, a pivot to renewable energy is required to make growth sustainable.

To expand the country's green-energy capacity, the government has set an ambitious target of installing 596 gigawatts (GW) of renewable energy by 2032 – more than three times the current installed capacity of 176 GW[2] (Chart 17). Thus, the share of green-energy generation is expected to almost double from approximately 23% at present to 44%[3].

Chart 17: India has ambitious renewable energy generation targets

Year	Renewable energy generation
2017	16.5%
2018	17.5%
2019	19.1%
2020	21.2%
2021	21.7%
2022	21.7%
2023	22.6%
2032	44.3%

Source: Central Electricity Authority, India, National Electricity Plan, May 2023. Renewable energy generation is expressed as a percentage of total power generation. The above information may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

[2]Source: https://cea.nic.in/wp-content/uploads/resd/2023/07/Broad_overview_of_RE_Generation_June_2023.pdf

[3]Source: https://cea.nic.in/wp-content/uploads/notification/2023/06/NEP_2022_32_FINAL_GAZETTE_English.pdf

To address a growing need for the power required for growth and rising concerns about climate-change issues, an escalation in the manufacturing and installation of renewable energy sources has become imperative. We see an investment opportunity more than US $200 billion[4]. Therefore, there is an evolving and significant opportunity set here for asset owners (utilities) and equipment suppliers.

This relates to setting up and manufacturing renewable-energy equipment – for instance, the Indian government has recently introduced a US $30 billion transmission plan[5]. This move should be considered a crucial step towards achieving India's production target of 596 GW in non-fossil fuel-based energy by 2032.

The new transmission system should be a major catalyst ensuring a cleaner energy supply, representing 66% of the country's overall installed power capacity by 2032. It also underlines India's determination to meet its energy-security needs while recognising the demands of climate-change goals, thereby maintaining sustainable economic growth.

We also see evolving and large opportunities in India's power transmission and distribution sector. As renewable power generation centres are based on the availability of solar, wind and water resources, high-voltage transmission lines will be required to transmit power over longer distances.

A robust fiscal position enables the government to provide subsidies for the electric vehicle (EV) industry, which is becoming more rationalised. That said, EV developments are already altering the two-wheeler industry landscape. We expect profound changes across passenger vehicles, smaller commercial vehicles, and bus segments. This gives rise to several opportunities in the auto and auto ancillaries sectors as companies become willing to embrace technological tie ups and invest accordingly.

Emerging 5Ds should reshape the operating environment across sectors – creating winners and losers

The underlying themes emerging from these primary growth drivers should likely create potential investor opportunities. At the same point, investing amid these transformative changes requires a different mindset.

These themes emerge from underlying forces that create opportunities and challenges for potential investee companies. We classify these forces under the 5Ds framework- **D**igitisation, **D**eglobalisation, **D**ecarbonisation, **D**emography and **D**eficit Reduction. While in the past decades, many of India's prominent wealth creators capitalised on the trends emerging from the inefficiencies in the economy, we believe that future wealth creators should emerge from a crop of companies that are leveraging on the emerging efficiencies of India with innovation, investments, and market positioning.

This is a paradigm shift.

We explain below how we believe the 5Ds should drive change across a broad range of industries. We also look at the key opportunity sources for investors and highlight potential risks.

Digital: *Let the Cash Flow*

In the previous section, we explained how digital models are disrupting large markets like food, logistics, small loans, and insurance by reducing the cost of access for customers. In turn, this is increasing engagement and cross selling.

While the disruption is visible, what is less appreciated is the types of investments these companies have made and the scale they can cater to with relatively smaller incremental investments. We see limited merit in the market concerns about lower profits or cash flow (in some cases, this could be a loss). With a two-to-three-year view, operating leverage plays out, delivering a significant rise in profits and cash flow. Moreover, due to higher rates, the ability of new entrants to further disrupt the market has been reduced.

In fact, we see risk in capital allocation. As these companies' cash flows move from famine to feast, their respective management must articulate their policies, as we expect operating cash flows to be more than capex in 2-3 years.

Deglobalisation – *Reimagining Supply Chains*

The current geopolitical environment creates opportunities for different manufacturing destinations to fill the gap as countries worldwide attempt to shore up domestic manufacturing, and Western countries try to "de-risk" and "diversify" their supply chains away from China.

Thanks to the government's robust tax collection, India has provided tax breaks and incentives for domestic manufacturing at a time when the authorities are looking to reduce import dependency on critical infrastructure like railways, defence, and power. At the same time, global companies are looking to substitute imports into India by domestic

[4]Source: Manulife Investment Management analysis, August 2023.
[5]Source: https://www.bloomberg.com/news/articles/2022-12-08/india-unveils-30-billion-plan-to-upgrade-grid-for-clean-power.

production and use the country as an export base to diversify their supply chains.

Both global and local trends are supportive of domestic manufacturing, and its share of value continues to grow.

We have detected some investor scepticism about whether India can achieve China's scale or efficiency. We posit that Indian infrastructure has significantly improved, and the goal of producing more in India, whether driven by the government, global companies, or domestic firms, is strategic.

Over time, India has become competitive in terms of both labour availability and cost. Given tight labour markets in the West, we think the manufacture of auto ancillaries, chemicals, electrical and electronics and non-IT services in India has a long runway.

We see exogenous risks to this theme. Other countries seeking to gain market share may let their currencies depreciate, thus making it cheaper to produce in their markets. While it's a risk, we see a growing eco-system in India that should support domestic manufacturing, which might make it stickier.

Decarbonisation – *Grow with Green*

It is imperative that India diversifies its energy mix away from imported fossil fuels, which exhibit significant price volatility, to make growth sustainable. To this end, we expect substantial investment in renewable and green energy by the government, state-owned utilities and the corporate sector.

We also see significant investment opportunities in the utilities space, where the companies are redirecting cash from existing operations towards solar, wind, hydro power, and green hydrogen projects. There are other opportunities in component and equipment suppliers and transmission and distribution equipment.

We notice investors' reluctance to participate in the utilities sector, as a significant part of these companies' profits come from coal-fired projects. We posit that these businesses and India's power-generation capacity mix will likely change from approximately 60:40 (fossil: renewable) to 34:66 in favour of renewables over the next 10 years. Thus, we chose to look at the road ahead and not in the rear-view mirror.

We also see the transition to EVs as a central theme. This is most apparent in the two-wheeler segment, but investors have doubts about four-wheelers and smaller commercial vehicles due to the current lack of charging infrastructure.

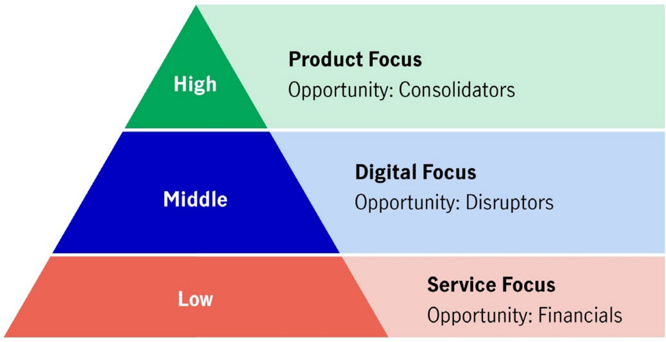
When we analyse the EV launch plans of major Indian automobile groups from 2025 onwards, as well as their investments and tie-ups from procuring batteries to investing in charging infrastructure, we think India's passenger car market is positioned for disruption, which will create new leaders in next 3-5 years. In short, the story played out in two wheelers whereby challenger companies invested in new technologies and chipped away at the market share of incumbents trying to protect profits and return ratios.

We see exogenous risks to this theme. Ultimately, the basic building block of solar power is polysilicon and that of battery is Lithium. India will be dependent on the imports of these raw materials from other geographies. That said, we believe India will continue to manage the geo-political risks in a balanced manner and facilitate de-carbonisation.

Demography – *Product for the top, digital for the middle, and services at the bottom*

Our title delineates the consumer segments where we are bullish (Chart 18).

Chart 18: Opportunities for different consumption ranges



Source: Manulife Investment Management analysis, August 2023.

For the **high-end consumer**, we like products they purchase, such as autos, jewellery, spirits, and real estate, to name a few examples. We note that these sectors have consolidated, and companies' competitive positioning has improved significantly.

Middle-end consumption in areas like consumer durables, apparel, and food services is being massively disrupted. Newer companies are chipping away at incumbents' market share through product innovation and digitally reaching the consumer, thereby increasing engagement and wallet share. We favour disruptor companies with a strong digital focus. Some examples are food-delivery services, quick commerce, payment processing, and online insurance.

India's low-end segment. This is mainly small businesses or those self-employed in the services business. Although these operations are small, they tend to have a healthy return on investment. A challenge for this segment has been the availability of capital to scale their businesses up. Large banks have steered clear of writing smaller loans (i.e., loans less than INR 1 million). However, thanks to increasing digital transactions, data availability, and better infrastructure, we have seen generation, assessment and collection costs reduce. This has prompted some smaller banks, non-bank lenders, and digital lenders to address this large market. We view this financial inclusion as a positive for small businesses and their lenders. Logistics as a proxy for growing ecommerce could be an option.

Deficit reduction – *Where will all the savings go?*

We have stated in earlier sections that fiscal and current-account deficits are reducing, leading to higher savings. Some of this can fuel growth in higher-end discretionary items, and the rest should be saved in institutions like banks and insurance companies or invested in real estate and capital markets. We believe structural upturn in higher-end discretionary consumption, savings institutions (banks, insurance), wealth management and real estate has begun.

Chart 19: Savings driving economic changes

Source: Manulife Investment Management analysis, August 2023.

We have previously discussed at length the consumption categories we like. Further, we believe the availability of domestic liquidity will be structurally positive for savings companies (e.g., banks and insurance), real estate, and capital markets. Local flows have indeed been a significant source of support for Indian equity markets, as we will see in the next section. Chart 20 summarises some of the key findings from this section.

Chart 20: Impact of Digitisation, Deglobalisation, Decarbonisation and Demography across industries

Sector	Digitisation	Deglobalisation	Decarbonisation	Demography
Consumers (ex-auto)	• E-commerce platforms negate traditional distribution advantages. D2C brands should disrupt incumbent brands using digital marketing in staples, durables, and retailing. • Low penetration is an opportunity for innovative consumer platforms in food delivery and e-commerce.	• Increasing domestic manufacturing driven by incentives in consumer durables, electricals, and building materials will increase competition. • High replacement costs benefit asset backed incumbent businesses, e.g., aviation, hospitals, telecoms, real estate.	• Opportunities will emerge in innovative, energy-efficient products in durables and electricals.	• Younger customer cohorts are more open to experimenting, dislodging brand loyalty, and favouring new D2C brands.
Automobiles		• Protectionist policies will likely benefit domestic OEMs in EVs. • Increased export opportunities for component suppliers in India.	• The drive for electrification will improve growth opportunities for many players with the right products.	• An aspirational young population will boost demand for feature-rich cars and will increase content per vehicle.
Financials	• Increasing digital payments and lower customer acquisition costs will expand the addressable credit market and improve financial inclusion. • Opportunities to improve the penetration of insurance and investment products using digital reach.			• Digitally native and aspirational young Indians will create opportunities in unsecured credit. • Small but growing businesses will boost demand for smaller ticket loans.
Industrials (domestic)	• Increased capex in data centres should generate new opportunities for engineering companies.	• More domestic manufacturing incentives; improving capex cycle and order books.	• A changing energy mix towards renewables will reduce the value of thermal assets. • The domestic capex cycle to improve is driven by renewable capex, energy-efficient infrastructure, and EV charging network.	
Exports (manufacturing)		• The increasing order book for local engineering and speciality chemical companies as global companies diversify away from China.	• Opportunities for auto component, engineering and speciality chemical companies from the global drive in EVs and renewables.	• The highest share of the working-age population with competitive manufacturing wages gives India the right to gain global export market share.
Exports (IT Services)	• Generative AI developments can deflate revenues and increase insourcing.			

Source: Manulife Investment Management Analysis, August 2023.

Market structure and setup

India has been one of Asia's best-performing markets over the past three years. This has been driven by numerous factors: strong GDP growth, a structurally improving macroeconomic backdrop, resilient earnings, and rising equity ownership among local investors. We believe the Indian equity market still presents a strong entry point to capitalise on the country's robust long-term wealth-creation potential.

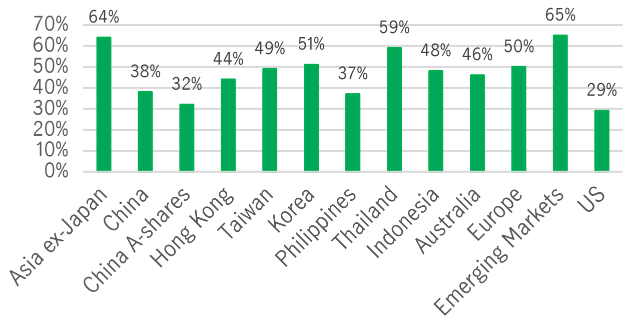
We also think that there should be significant and scalable opportunities in small and midcap segments, which could add both depth and breadth to the market.

India's low equity market correlation relative to some of the key regional markets means that India offers overall portfolio diversification benefits with exposure to a structural growth story not only regionally but globally (Chart 21).

Valuations – a well-recognised growth story and strong domestic flows lend support

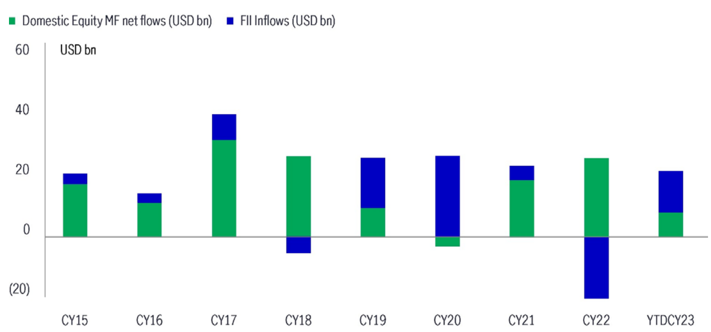
While Indian markets have seen some volatility in 2022, post-oil price shock and at the beginning of 2023, it is still one of the best-performing markets in the region on a three-year basis and currently trading near its five-year median valuations. With cyclicality, the macro factors in the Goldilocks situation (strong growth with falling inflation, strong CAD and balance of payments) have room to expand. We expect India to receive its fair share of emerging market flows to participate in the strong and recognized growth story. Despite some volatility in foreign flows with global markets, we have seen that with formalisation, rising income, and higher financial savings, domestic flows (Chart 22) have become a vital source of structural support in the markets, helping valuations (Chart 24).

Chart 21: MSCI India correlation with other markets



Source: Goldman Sachs Global Investment Research, August 2023.

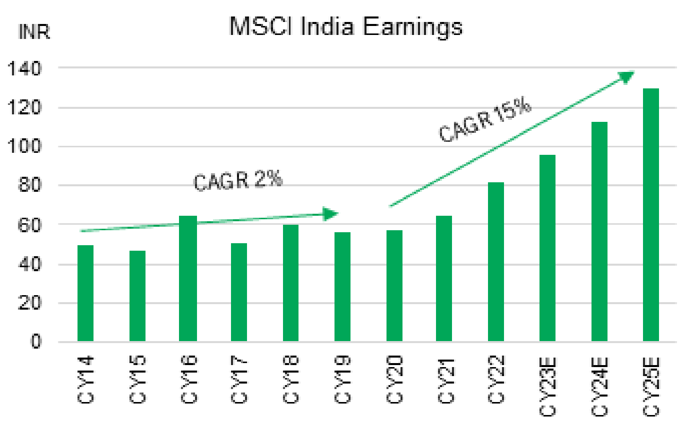
Chart 22: Equity inflows, 2015-2023 (YTD)



Source: AMFI, MOSPI, Bloomberg, Manulife Investment Management estimates, as of August 2023. Note: From 2018, arbitrage fund flow figures excluded from domestic fund flows.

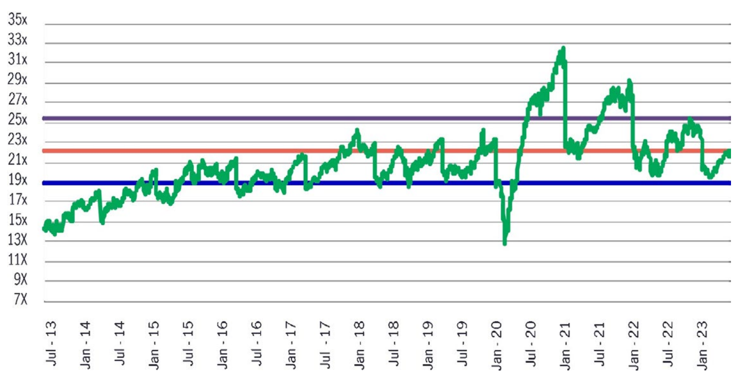
The information (Chart 22 & 23) may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations. There is no assurance that such events will occur, and the future course may be significantly different from that shown here.

Chart 23: India earnings growth pace slated to increase



Source: Bloomberg, as of 2023.

Chart 24: MSCI India P/E valuation, 2013-2023



Source: Bloomberg, as of July 2023. Note: 5-year median = 22.2 times. Below 1 SD= 19 times.

Conclusion

The primary driver of digitisation that supports the formalisation and reinvestment policies underpinning manufacturing expansion are well embedded in India's economic growth agenda.

This is starting to show results with visibly improved capital expenditure and industrial order books, as well as a narrowing current-account deficit and a healthier inflationary picture. We also believe that the structural reforms will make India a more efficient, productive, and resilient economy. The strong primary growth drivers create multiple new themes and investible opportunities that could be potent wealth creators for investors.

Indeed, through structural reforms and policy support, India has responded to various macro challenges over the past three years, including Covid-19 and the energy price shock in 2022. This resiliency has been helped by low external debt plus strong household, corporate, and government balance sheets, as well as a conservative central bank that is preventing the build-up of excess in the system. This has protected the currency outlook and kept foreign-exchange reserves strong. Macro resiliency has also underwritten the strength of foreign and domestic flows and valuations.

Cyclically, India's macro setup also looks robust with favourable growth, inflation, and external-account dynamics. We think the latest GDP print was ahead of expectations, driven by substantial investments and is in line with the economic agenda.

The current-account deficit has moved to near zero, and the balance of payments was positive in the last two quarters. Furthermore, a strong services trade surplus supports the current account as global companies increase their presence in knowledge-based outsourcing and consultancy services segments. Also, capital flows remain strong as overseas investors are keen to participate in the Indian growth story, which helps the country's overall balance of payments. We expect India to bolster its share of emerging-market flows as its medium- to long-term growth story remains strong.

We remain positive about India's long-term structural potential and believe these transformative changes require a modified approach. Also, we recognise that future wealth creators in many sectors will come from disruptors leveraging the transformed landscape and traditional incumbents. We have covered these in an earlier section and our aim is to capitalise on such opportunities through our bottom-up research process.

Appendix:

I. Key policy reform terminology:

- **Good and Sales Tax (GST)**: Introduced in 2017, the GST aimed to replace the fragmented tax structure between states with uniform tax rates nationwide. It improved tax compliance and increased the government's ability to collect revenue.
- **JAM Trinity:** "JAM" stands for a **J**an Dhan bank account, the **A**adhaar unique identity number, and a **M**obile phone. The JAM Trinity essentially allowed each Indian citizen to have a unique identity number that could be used to open a financial account. As a result, the government could make direct transfers, increase the number of individuals in the formal financial sector, and facilitate it all through mobile networks.
- **Production-linked incentives (PLI):** Introduced in March 2020 for three sectors, the PLI provides tax incentives for domestic and foreign companies to manufacture onshore. Since its inception, the incentives have been expanded to 14 industries.
- **Revised Insolvency and Bankruptcy Code:** The code was passed in 2016 to create uniform regulations across geographies.

II. Manulife IM publications on Indian equities since 2020

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India at the crossroads of disruption

5 Oct 2020
India's path to economic recovery

11 Feb 2021
2021 outlook series: Indian equities

25 Mar 2022
Strengths of the Indian economy

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