

TRANSCRIPT: EPISODE 410

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. India's economy is booming, yet foreign investors have been heading for the exit. Today's guest shares why the current disconnect between investor sentiment and economic growth could prove an increasing opportunity for long-term investors.

Darius McDermott (DM): Hello, I'm Darius McDermott, today I'm delighted to be joined by Andy Draycott, who is manager of the Chikara Indian Subcontinent fund. Andy, good afternoon. How are you?

Andy Draycott (AD): Good afternoon. Very well thank you Darius. Looking forward to the podcast.

DM: Good. And I know because we chatted briefly that you've just come back from India, so your views are going to be super current and up to date. So we've caught you at a really good time.

AD: Yeah, it's an opportune moment.

[INTERVIEW]

DM: Good. Well, let's just get into a few areas and see where it takes us. Having been the darling of the emerging markets in Asia for a number of years, there appears to be a bit of a, certainly a disconnect between stock markets and maybe what's happening on the ground in India. Foreign investors who loved India two years ago who have sort of been selling and moving out. What do you think is going on and are investors potentially missing out on?

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AD: Yeah, so I think interestingly, India, as you said, is averaging very high growth rates. I think if you take the last three or four years, we've been close to 8% GDP growth. And there is domestically, there is a boom which is going on from everything from private bank lending to private CapEx.

Now I think that the dichotomy is occurring largely because emerging markets as an asset class tend to be all grouped together. So you have Taiwan and South Korea, which have obviously got GDP per capita, which is much higher than India. I mean, it's more like \$40,000, and India's at \$3,000. But they are very semiconductor heavy.

So if we go back to 2024 when India was the darling, as you say, India was around 23, 24% of emerging markets, the benchmark that is. And roll forward to today, India's fallen to around 11%, and the beneficiary of that has been Taiwan and South Korea, which have dramatically jumped up in the benchmark indices.

Now, the reason for that is clearly just because of semiconductor supply chains. So the American hyperscalers, the Amazons, the Microsofts, the Googles, they need to fund the data centre boom, and that obviously needs semiconductors. And so the earning cycle for South Korea and Taiwan has been exponential. And given it's a limited asset class and the money that goes into emerging markets has to be spread amongst various jurisdictions, India's largely been the funding source for that kind of CapEx and supply chain movement.

I think what I would say is if I look at the last year, what we are seeing is the domestic economy accelerating. And I think I've never really seen such a large dichotomy between the domestic economy, which is really doing very well, and the absence of interest from foreign investors. And I think that's something that is leading to an opportunity.

DM: Yeah. I mean, we're not going to do this today, but one might make the argument that those semiconductor... I mean, as you say, \$40,000 per GDP capital doesn't sound much like an emerging market, but maybe—

AD: Yeah, no, I think that's absolutely right. It's becoming a conundrum for asset allocators. Do you want to have traditional emerging market exposure? I mean, even China's sort of \$15,000 GDP per capita and India is three. Yeah. Are you getting the diversification that you're looking for as a global asset allocator?

But that funding source has definitely meant that, you know, if we take the last two years, around sort of 60 to 70 billion dollars of equity has left the Indian market.

The second element to it, which I think is a myth, and myth busting is something that I'm having to do quite a lot of at the moment, is the perception that India's a loser in the AI race. So not only has that money gone to South Korea and Taiwan, India is an embedded IT services sector jurisdiction.

And, you know, there are six million people that work in IT services in India. There is a hypothesis that those six million jobs are under threat as a direct consequence of the LLMs in America. And I think, again, that myth versus, well, that sort of narrative versus reality is that we're actually seeing services export revenue climbing in the mid-teens in India.

So there's something called global capability centres in India. That's multinational companies opening up in India, and they're hiring multiples of thousands of employees. So last year, they employed 200,000

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employees. So actually, what we're seeing is the opposite of the narrative, but you can never let something get in the way of a good story.

DM: No, absolutely. Absolutely. So I want to talk a little bit about currency, because currency affects any overseas region. You know, if you invest in US and the dollar is bad, your returns might be less good. What's happening with the rupee at the moment, and is that something that overseas investors should be worried about? Or is that a significant problem, do you think, today?

AD: Yeah, so one of the phenomenons with India, which is different to the other large emerging market in the region in China, is that it has traditionally run a current account deficit, which effectively means that it structurally imports more than it exports. And the two biggest line items within that import bill are oil and gold.

So traditionally, India imports around 90% of its oil needs, and imports around, at today's price is around \$60 billion of gold as well. Now, typically, that current account deficit was shrinking over the last sort of decade, and it had actually fallen to record low levels of 25 basis points. The extrapolation of the oil price going up from sort of \$75 to north of \$100 in Brent led to an extrapolation that India was a significant loser, and that that current account deficit was about to blow out.

It did blow out, but actually the most significant factor was it was more a capital account problem. So what we had at the same time as the oil price spiking was we had quite significant exits from big multinational corporates IPOing in the Indian market. So we had the likes of Hyundai, British American Tobacco, LG Electronics, and Whirlpool, all basically taking money off the table.

So typically, if we'd just had the spike in the oil price, it was highly manageable. The problem that we had was that the capital account, which is typically around 3% of GDP, fell to zero. And so we had an extrapolation that the RBI was gonna have to defend the rupee. The consequence of that is that we have had significant depreciation in the rupee for the last sort of, well, since the fund existed, actually eight years, and we've averaged around 4% currency depreciation.

In spite of that, we have sort of delivered 10% compound annual growth in dollar revenues. And what I would say is that the depreciation, to my mind, looks to be largely done because back in March when the oil price was spiking, the government responded and they implemented a foreign currency deposit raising scheme where they raised effectively \$130 billion by offering Indian interest rates on US dollar deposits. And so that \$130 billion has effectively plugged the gap of that capital account, and the capital account is now back into surplus by a quantum of around 3% of GDP.

DM: So that you think should be positive for the rupee?

AD: I think that puts a floor under the rupee and it gives the Indian government time to start to address the structural imbalances of the current account. So if we do see any kind of decline in the oil price, then that will obviously have an alleviation on the pressures of the current account deficit.

But actually, the other point to this, which is heavily underappreciated by the market, is that that \$60 billion of gold, the gold that comes into the Indian economy isn't subsumed into the economy in the same way that the oil is. Effectively, that gold has gone into household wealth, and it's largely underappreciated. So if you look at the wealth effect of that gold, the gold at household level in India has gone from sort of \$1 trillion back in 2021 up to \$4 trillion. And household wealth in India's jumped from \$11 trillion in 2023 to \$16 trillion today. It's got higher household wealth than the UK.

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My view is that the Indian government are now focused on the rupee, and we will see measures coming through which will help the currency stabilise over the next decade. And it's one of my sort of anti-consensus beliefs is that the currency in the next sort of medium term should actually start to strengthen rather than depreciate.

DM: So we talked a little bit about the macro effects and growth and currency. Let's have a look at your portfolio. I know your fund quite well. We've met numbers of times. But maybe just for the benefit of the listeners, if they're interested in the Chikara Indian Subcontinent fund, what exposure are they going to get? What does this Indian fund target?

AD: Yeah. So I think what is unique to India at the current moment in time is that it is going through an economic evolution that you only go through once in your company's, in your country's history. Within that economic story lies a country with 800 cities and the largest consumer base of any market in the world. And as that consumer moves away from basic subsistence living and the sort of goods that it uses on a day-to-day basis to stay alive, it moves into things that are more aspirational in nature and more discretionary in nature.

And so what we do is we address that through sort of looking for any company that can aggregate that consumer base of what is known in the market as a TAM, total addressable market. So we're looking to get companies that can grow into the 1.4 billion people that is very unique to India.

And the second element to it, which is unique to us, is that we look for very under-penetrated levels within the categories that are operating in the country that can grow for multi-years without really sort of ever coming to a sort of pause.

And if I put that into a picture for your listeners, probably the simplest one that I would be able to pull out is McDonald's. So if you take something like McDonald's, it's affordable, it's very much for the middle classes. And in India, that story is exactly the same as any other country in the world as you sort of take your family out for their first experiences, then McDonald's would probably be the first cab off the rank.

And if you look at the penetration levels of McDonald's in India, it is incredibly low. So they've only got close to 800 stores across the whole of the country. And that equates to around one store for every nearly 1.8 million people. Now, if I juxtapose that against somewhere like the UK where we are, the UK's got 1,500 stores, or one for every 45,000 people. So the runway for growth for McDonald's in India is just enormous. I think the sort of steady state that we'd be looking for once it's completed, it's built out, would be circa 20,000 restaurants. And it just plays into that theme of Indians that want to go out and experience new things. Instead of eating from a sort of homogenous bag of rice, you know, you're eating your first Happy Meal with your kids, enjoyment of having your first paycheque.

And so that's kind of where we position the portfolio. What we're not trying to do is be sort of everything to everyone. We're trying to aggregate the growth in those very under-penetrated categories that offer you a degree of predictability that you perhaps could see have having occurred in every other developed market in the world from the UK to China to the US.

DM: So another thing with your fund is it's quite concentrated. You've got 6,000 stocks in India plus to pick from, yet you run a sort of a 25 to 40 stock portfolio. Why so concentrated with so many stocks to pick, or is that just a preferred investment style that you've grown up with?

AD: Yeah, so within that story about the emerging middle class, there is effectively a subset of sectors that can aggregate that growth. And they are very defined. They have been the same across multiple sort of countries across the world as they've gone through this evolution.

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So whether it's people going on their first flight or whether it's staying in their first hotel or whether it's drinking their first alcoholic beverage or going shopping, they are very distinct categories, but there is a finite number of them. There's not 6,000, as you say, there are only really sort of, as we identified it, around 20.

Now what we look for is a very specific growth from those different categories. And if we were to look at the overall Indian market, 60% of the Indian market actually is export related. So India's been very successful over the years with things like IT and with generic drug manufacturing.

We're not particularly interested in them because we believe that their growth rates are predisposed to what happens in the West. So they may have a boom if we go through COVID because India makes vaccines. They may do quite well if, you know, they're making GLP-1s, for example, you know, in a generic fashion and they take advantage of this boom in Ozempic and Mounjaro.

But we think that the better story for Indian investors or sort of foreign investors investing in India is to aggregate the growth of Indians getting richer and spending in predictable categories. And that's where the concentration comes from, because what we do as a second element to it is we look for the market leader within those 20-odd categories. And there is in most of those sectors, a very defined winner already, even though it's relatively nascent in the growth profile.

DM: Yeah. So definitely when you look at this fund, you are getting domestic exposure, not exporting exposure. It's the growth in that domestic economy. So let's just touch on a few sectors. Got around 24, 25% in banks. What's the growth story for the Indian consumer with financials?

AD: Yeah, so we think the Indian banking sector is an interesting one, largely because credit as a profile has been relatively low. So just again, putting some numbers to it for the audience, you would have mortgages to GDP at around 12%. In the UK, that would be around 60%. So there's a huge room for growth there in people buying their first property and putting their first mortgage on it.

The other element that we really like is that the Indian banking space is largely dominated by the government. So 60% of the banking space is dominated by government-owned entities. And we own the private sector operators. So we own the companies that are sort of bringing to an element of management expertise that you don't get within the government. And that transcends into the numbers. So you have relatively high profit growth within private sector banks in India, usually around 15 to 20%.

The point in time we're at at the moment, and we're not market timers, so we're not looking to just buy it because they're cheap, but it just so happens that at this moment in time, they are very cheap on a valuation basis. It's largely because of several factors, but one of the most significant factors is that we've gone through a rate cutting environment.

And so we are actually at sort of cyclically low net interest margins without getting too technical. Yeah. That effectively means that the bank's profitability is at cyclical lows whilst we're seeing this acceleration in lending credit growth.

So we think that you got a twofold factor here where you get higher profitability as interest rates go back up, and we benefit from the fact that they're lending more aggressively because they're seeing more opportunity to do lending. So typically, you know, we think that they're very good value at the moment.

They're good aggregators of the entire sort of macro story in India, and they can go and eat the lunch at the government because typically the government doesn't run businesses particularly well, whereas private sector operators tend to do a much better job.

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DM: Okay. There's a couple more sectors I want to touch on. And let me just sort of put it under that word digital economy, if you like. Yes. Obviously, you know, we've got iPhones, everything, you know, whether it's e-commerce or banking, but what is the sort of the state of play of India's digital economy? And I'm guessing that's another area with potential astronomical growth.

AD: Yeah. So we really like that element within the economy. We like companies that typically address a problem. And if I give you some examples of where that is the case, one of them would be in quick commerce. It's a sector that's just effectively evolved over the last three or four years in India.

India's always had problems with supply chain management, and it's always had problems with perishability of food going into the cities. One such company that we own, which was spawned by graduates from the Indian Institute of Technology, which is effectively like the MIT of India, these guys have built a business where they can deliver everything from a lipstick to an iPhone to your door within an average 11 and a half minutes. And they can do it profitably. I mean, the average order value of this company is less than five US dollars, and they make a 5% EBIT margin on it.

What that effectively does is, one, it brings down the overall inflation within the economy because they're sorting out supply chains that get into the cities in a much more sophisticated manner than the traditional mom and dad stores. But two, it's sort of democratising consumption, and it's allowing people exposure to new, what they call stock keeping units, SKUs, that they weren't previously being exposed to.

I mean, this company is highly innovative, but just to put it into perspective of they have two and a half thousand what they call dark stores across India, servicing up to around 300 cities, although it's typically in the top 200, in the top 20 cities. And they can effectively get something to your door very quickly for the lower price than you would if you were to go down to the corner shop and buy it from the corner store.

That's a company that has grown in the last five years by an average sale. So it looks like India is leaping from the traditional mom and dad shopping straight over the Tesco's and the Walmart format, directly to this model of dark stores across neighbourhoods that can deliver to your door through riders in a very, very rapid period of time.

Now, the consumption angle of this, just to put it into perspective, fridge sales in India are starting to drop because people are actually just buying just in time for everything that they need within their house. And Eternal, I was with them last week. They would talk about their super users ordering anything up from milk to butter, or ghee in India, up to nine times a day. And this is a company that's employing now 600,000 people in India, all the riders that they're employing. And it's just an aggregation of that capital. And it comes back to the foundation when you talk about digital.

So India has a network of universities called Indian Institutes of Technology, and these are modelled on MIT in America, and they started with four. There's now more than 20 of them. And they spawn these very intelligent people that are running the majority of these businesses. They're also running a lot of the companies in America, like Microsoft and Atabay, et cetera. And so when they come up with a new angle to solve a problem for business in India, we tend to take notice.

DM: Yeah. Can we just have a quick answer then on another interesting sector, which is leisure and sort of travel? Obviously there's a huge amount of people, hopefully moving up the sort of the wage and the economy scale. What does the travel boom look like in India?

AD: Yeah, so I think this is probably the one area that you'll start to see visibility. As an investor, you'll start to see more and more Indians holidaying overseas in Europe and the US. Again, put some numbers to it. So

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less than 8% of Indians have got passports. This is already the third largest aviation market in the world. In fact, the company that we own, Indigo, is the largest procurer of Airbus globally already. Willie Walsh is the CEO of that business, so he'd be familiar to a lot of your listeners. Yep. But the story is only really just getting started.

And the phenomenon behind that is if you look at in 2024, there are around nine million households in India that were earning \$35,000 or more. And that number of households jumps from nine million to 25 million by 2030. And there's gonna be north of 200 million households earning more than \$10,000 by 2030.

What do these people spend on? They spend on things like going on holiday. And so we own something, we own a company called India Hotels, which owns Taj. Taj is the most well-known brand within India. It's one accolade for being the most well-known brand. But that is something that can open everything from five-star to four-star to three-star as this growth starts to permeate across the country. And, you know, a good example of that would be there's 160-odd airports in India, but 100 are being opened.

And as you open an airport, you need an offering for people that are business travellers, high net worth people, but you also need stuff for just guys who are just, they want the premiere in equivalent in India. And this is what that caters to. So this step up in incomes effectively, this is a category that will aggregate that spend very easily, and it's one that we're particularly excited about.

DM: Right. Well, we started by talking about foreign investors exiting India in the last couple of years due to a bit of market disappointment, but because there were other sexy stories in emerging markets linked primarily to three or four companies in Korea and Taiwan, let's finish this on a positive. Why should people, UK investors, consider India as an allocation going forward? And what do you think people might be missing?

AD: Yeah, so I think if we roll forward five years, what does this look like? What I would say is that India's gonna be the third largest economy in the world, just on maths. So it will be the US and China, and then it will be India. The representation of people's money in India through global indices is minuscule. It's less than 2% of MSCI World. So nobody owns this as a thematic.

India is very much focused on becoming a manufacturing hub. So if you look at the success of the last 20 years, they've been highly successful in services exports. They're around 6% of global services exports, but they're less than 2% of manufacturing exports. So they don't make very much, despite the fact that they have a very low aggregate cost of labor. It's \$3,000 for an Indian labourer. It's 15,000 for a Chinese labourer.

And we're already starting to see tangible signs of manufacturing turn up in India. So iPhone now make 25% of their iPhones in India, and that used to be zero three years ago.

So what I think we will see is India starts to aggregate light manufacturing and high spec at manufacturing and move away from the sort of steel and cement story that we've seen over the last 10 years. And as they do that, I think they will become the secondary factory to China for the world.

And that will more than likely improve the economic model of India. It will firm up the currency at improved growth rates. And I think it will make it more relevant to global investors in terms of their asset allocation as well.

DM: Andy, thank you very much for your time.

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SW: The Chikara Indian Subcontinent fund is a high-conviction, concentrated, index-agnostic equity fund. The team are focused on high-quality, mid and large-cap companies which are benefitting from the domestic Indian growth story. To learn more about the Chikara Indian Subcontinent fund, please visit fundcalibre.com and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.