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"India is already a very big economic power"

Emerging markets expert sees bright prospects for India - China remains a difficult place for investors - Brazil surprised under Lula

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18 November 2023

In an interview with Börsen-Zeitung, emerging markets expert Ashish Chugh talks about why many things are changing for the better in India and why he advises against investing in China.

Mr Chugh, do you think it makes sense to focus on specific regions or countries in emerging markets, or is it better to spread the risks broadly?
Emerging markets are a very broad field; the MSCI benchmark index comprises 24 countries. You can find good companies and great investment opportunities in all of them. However, there are certainly some countries that are much, much riskier than others for political and macroeconomic reasons. We manage the country risk by limiting our exposure there to a maximum of 10%. For example, with Russia before the invasion of Ukraine. In other countries such as India, Brazil or Indonesia, where the macroeconomic situation is very good, which are politically very strong and which structurally offer very good long-term opportunities, we are more involved. So you have to look from country to country.

You limit your fund to very few stocks. What criteria do you use to select them?
We have between 35 and 45 positions and therefore a very concentrated portfolio. We focus on companies that we consider to be high quality or that are on their way to becoming high quality. Our most important quality criterion is the question: What significant competitive advantage does the company have that enables it to generate a significant return on invested capital that is well above the cost of capital and above the returns of its competitors? And is this return on invested capital sustainable in the long term?

What else do you look for?
We look at the track record of the management team, how they have achieved returns over different economic cycles. We also look at the corporate governance of the company. How have they treated minority shareholders? Has excess capital been utilised to generate additional returns? Was it returned to shareholders? Because often companies invest just to grow their empire without really focusing on how that capital is best utilised. And then we also look at the quality of the returns, i.e. how sustainable they are and where the returns come from. Do they come from the core business itself or from related business areas? We also look at very objective criteria such as the capital structure and the way it "breathes". High quality companies do well even in bad credit cycles.

You mentioned the best possible utilisation of capital. Are you in favour of share buybacks or are you generally against them?
It depends on whether a significant return can still be generated with the surplus capital. If this is not the case, a company should return the excess liquidity through share buybacks and dividends and let the shareholders decide where they want to invest this capital elsewhere. However, companies in emerging markets tend to have very high growth rates and good management teams are able to deploy this capital in attractive investment opportunities. Share buybacks are therefore not very common in emerging markets. What you do see more often, however, is that excess capital is invested in areas where it does not generate a good return. This happens, for example, when companies go into global expansion just because they want to get big and build an empire. We see such "trophy profits" from time to time in India. Many companies there are run by families, and they are sometimes driven more by their ego than by the question of how best to utilise the company's capital.

India is a good keyword. The Indian stock market is the best performing index post Covid-19, even outperforming the Nasdaq with a 145% increase since April 2020. You have Indian roots. Is India going to be the next big thing or is it already?
In fact, India is already a very big economic power. It is already the fifth largest economy in the world and will be the third largest economy in the world after the US and China within the next three years. In terms of sheer size of GDP, it could well be described as an economic superpower and the fastest growing major country. If you look at what makes India so attractive, it is its structural, long-term growth story. In the last ten years, the Modi government has taken a number of measures to boost growth. For example, it has invested heavily in physical and digital infrastructure. You can see that in the number of airports, kilometres of roads and ports. However, I believe that digital infrastructure has made an even greater contribution to growth and productivity. For example, the UPI framework has introduced a standardised payment interface, which has led to a boom in financial technology. India is fast becoming a cashless society. Every Indian now has a unique identifier, similar to the national insurance number in the US. This has led to more and more people gaining access to the banking system. Hundreds of millions of Indians have opened a bank account in the last ten years - people who previously had no bank accounts. This has also given them access to credit, which is always necessary in a growing economy.

What else is in India's favour?
Reforms such as the GST reform (Goods and Services Tax, editor's note), which standardised the tax system in all states, have led to less corruption. Less tax evasion, more revenue for the government, which it can then reinvest. And it has also made it easier to do business. If you look at rankings on this, ten years ago India was mostly in the bottom quarter, today it is in the top 50 per cent, if not the top quarter. A significant improvement that makes it much easier to start a business. It is also much easier for foreigners to invest here. The approvals are now much faster than before. India also has a kind of structural growth that is simply a result of demographics. It is the youngest country in the world. The population speaks English, there is a skilled labour force and a growing middle class. Also, with the problems with China, more and more American companies and investors are looking for alternatives. So there are a number of things that are changing for the better for India. This is also changing its position on the political map. India is becoming a global leader. Modi has become not just an Indian leader but a global leader. The country is sort of claiming to be the leader of the global South, which I think is a very skilful positioning. I think that in view of the geopolitical tensions that the West has with China and Europe and the USA has with Russia, India is a very good regional, economic and political counterweight.

Which sectors, which companies from India do you think are particularly promising for the future?
Anything to do with consumption is certainly very, very attractive and, frankly, always has been. This is due to the growing middle class, the increase in GDP per capita, demographic trends and market penetration. And there are many great, high-quality companies in this sector. The second attractive sector is the financial sector. Two thirds of banks are still in the public sector; only one third are private banks. Over time, their share will increase. Despite all efforts, there is still a considerable undersupply in the banking sector in India. At the same time, there is considerable demand for credit for the growth forecast by many. What makes India attractive here is the regulatory framework for financial service providers. During the global financial crisis, there was not a single bank that collapsed in India or in many other emerging markets because the banking system is strong and the supervisory authorities are very independent.

HDFC Bank is a great example of a very prudent bank with high quality. You see high credit quality and strong growth that carries it through different cycles. I think it is one of the best banks in the world, not just in emerging markets.

What about technology?
The technology sector is booming because entrepreneurship is booming. India has long been known as the country where technology services are outsourced. Now we are seeing a new generation of technology companies springing up. Fintechs are just one part of it. In India, a whole culture of entrepreneurship and risk-taking has developed in many industries in recent years, which is being celebrated today. Earlier, people did not want to be entrepreneurs for cultural reasons. They preferred to work in established companies and stay there for many, many years. But more and more people, just like in the West, are choosing to work in start-ups. They are choosing to take risks because it is exciting, because they have great role models, because they have seen the enormous success of other companies that have become leaders in their country. Similar to the US, there are online e-commerce companies or software-as-a-service companies or cloud infrastructure companies or companies that deliver food or groceries. An ecosystem is emerging in India into which a huge amount of venture capital is flowing. Capital that is being withdrawn from China, for example. India is much more attractive because it is democratic, because there is not the regulatory overhang like in China, where the state intervenes in companies. In India, the exact opposite is the case: the state supports the growth of these

companies. After the USA and China, India is already the country with the most so-called "unicorns", i.e. start-ups worth over one billion dollars. In a few years, the number of Indian unicorns will exceed that of China.

China has recently disappointed many investors with its property crisis, lack of recovery after the coronavirus crisis and problematic demographics. Should we get in there now at a good price or do you think it would be better to stay away from China?
I think it would be better to stay away from China because we think it is a very risky country at the moment. If you take a step back and look at what made China so successful, it was really the one-party system, the goal of which was strong economic growth. Because with strong economic growth, the party was able to maintain control while providing stability and security. It dealt very wisely with the US in joining the WTO and basically did a great job of putting China on the world stage and making it an economic miracle, lifting hundreds of millions out of poverty. But in recent years, this one-party system has turned into a one-man system. Xi Jinping is not only the party leader, but de facto the only person running the country. He has appointed his loyalists to the top ranks of the Politburo, whereby it is basically not a question of who is the most competent, but who is the most loyal to the leader. And so decisions are made based on the leader's desire for control rather than what is best for the country. This is why China is in the position it is in now.

The best example of this is Zero Covid. No country in the world, especially a country with such a large economy, has been shut down for two years. The only reason was that the leader wanted it, even if it was unattainable. How are you supposed to fight a virus without effective vaccines? It's really not feasible. China did things that were basically irrational by shutting down the economy and not importing vaccines from the West, even though that would have been necessary to cure everyone and prevent the spread. Without the mass protests, it would have gone on for even longer than two years. This kind of decision making, which is not for the greater good, usually leads to people taking to the streets. If you think back to before Covid, when was the last time you heard of protests on the streets of China? There was nothing like that.

The political situation will not be good for the country's future and economic growth. Also, as you mentioned, they have a distressed property sector that accounts for 40% of GDP and has huge mountains of debt - companies like Evergrande and Country Garden are among the most indebted companies in the world. And the banking system, which is heavily involved in the property sector, is no longer able to stimulate the economy as it used to. And then there are the tensions with the United States. China is becoming increasingly isolated and is therefore allying itself more and more with "bad" actors - Russia, North Korea and Iran. I don't think this will end well for China in the long term.

You also invest in Brazil. As an investor, have you noticed any changes since the left-wing President Lula replaced the right-wing populist Bolsonaro? Or has this had no impact on the markets?
Lula is a surprise. There were fears that he would be more left-wing, more socialist, but governing is very different from campaigning, and if you look at his policies, they are more centrist than left-wing. They are not implementing as many social programmes as investors had feared, while they are introducing reforms in the country that are certainly good for economic growth. Also, the Brazilian central bank has done a great job of raising interest rates much, much earlier than the Fed - they were actually a year ahead of the Fed. And now we have a great situation in Brazil because inflation has come down and interest rates have come down again. So from a cyclical point of view, Brazil is in a good situation.

And then there is the fact that the Lula government does not have a strong mandate in Congress. So he is almost forced to be centrist rather than leftist. We are of course looking at the macroeconomic situation in Brazil, which we believe has good potential in the medium to long term.

In recent years, the BRICS countries have lost their former outperformance compared to the broad emerging market index. What do you expect for the future? What of the new members?
You have to differentiate here. The Russian index, the Russian shares, have been driven down to zero by most foreign investors. Nobody invests or can invest in Russia, except Russians. This has certainly had a major impact on the performance of emerging markets. And then China is the other big country, in fact the biggest stock in the emerging markets index. It makes up a third of the benchmark and has significantly underperformed the other countries such as Brazil or India.

The BRICS club certainly has a certain significance and continues to grow in importance because these countries are among the largest economies in the world, which have their own interests vis-à-vis the West and are building their own institutions. So this organisation will certainly continue to exist, even if they have differences among themselves, especially India and China.

Nevertheless, these countries should be considered individually. India is very different from China. South Africa, despite its problems, is also attractive. And there are other emerging markets such as Indonesia, which are very large and growing fast. The Middle East has also experienced a very strong upswing despite the recent unrest. If you look at developments over the last two or three years, more and more companies that were previously state-owned are now being floated on the stock market. These are family jewels. Gems that used to belong to the governments of Saudi Arabia, Qatar or the United Arab Emirates and which they are now privatising or selling a stake to the West or to shareholders in general. These are very, very high quality companies that are helping to diversify investment opportunities for investors in the Middle East. In the past, the companies you could invest in were primarily oil and gas or financial companies. Now there are consumer goods companies, technology companies and also state-owned companies which, even if they are in the oil and gas sector, are also very high quality. So it's an area that people didn't really pay attention to before, but now it's gaining traction and it's one of the areas where there are a lot of IPOs.

You are also involved in frontier markets. What is your experience in this area?
Over 100 countries are considered frontier markets, and you certainly can't lump them all together. Many of them have macroeconomic challenges and political problems, problems in connection with the capital account, in connection with the current account deficit. But there are also countries where the macroeconomic and political conditions are good and where they are benefiting from the changes that we have seen in recent years in the context of globalisation. We are involved in Kenya, for example, and also in other countries such as Nigeria, a major oil exporter.

There are some frontier markets that are actually doing just as well as the emerging markets. Countries that will increase their GDP per capita and are developing. Vietnam, for example, is becoming a hub for the outsourcing of manufacturing processes. The country is benefiting from the migration from China. Vietnam is certainly also becoming more interesting when it comes to apparel, when it comes to outsourcing low-skilled labour and manufacturing.

India has a kind of structural growth that is simply a result of demographics. It is the youngest country in the world. The population speaks English, there is a skilled labour force and a growing middle class.