GRESHAM
Sustainable Wealth Management

India: Into the Daylight

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For decades, western analysts believed the economic potential of India, given its perceived advantages, such as a free market economy, democratically elected government and western-style legal system, would allow India to become a dominant global economic and political power. Political inefficiency, corruption and historical cultural influences have derailed India's progress, but reforms by the recently elected government have the potential to finally jump-start the economy and lift its citizens out of poverty.

What are the current challenges? What are the significant reforms? Will the political will for reform continue despite their significant short-term hardships? If so, can investors overcome the existing challenges to reap the potential rewards from the tailwinds that might be created? We provide our answers to these questions and share some insights into our current investment approach in India.

Background

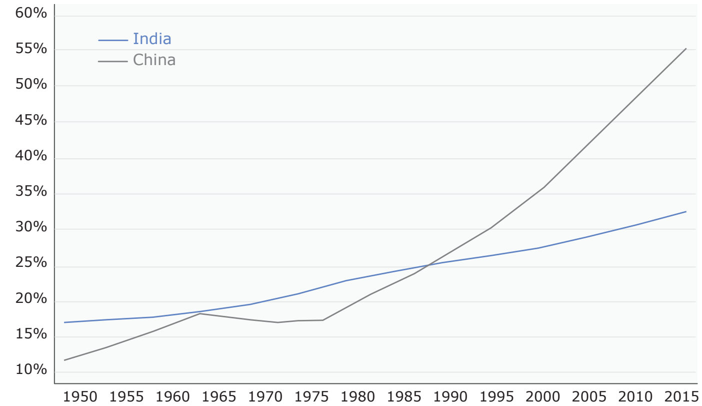
There is an old Indian expression "India grows at night, while the government sleeps" that refers to the country's economic progress despite the presence of a large, burdensome state. Recently however, Indian headlines have turned positive based on significant central government reforms and the acceleration of their economic growth rate, which now exceeds that of China, making India the world's fastest-growing large economy.

Much of the positive sentiment derives from recent structural reforms undertaken by Prime Minister Narendra Modi and his ruling Bharitiya Janata Party ("BJP"). These reforms are so extreme that many opponents and supporters alike deemed them political suicide. Instead, the BJP's subsequent landslide victory in the Uttar Pradesh, India's most populous and politically important state, has only strengthened their political standing and emboldened their pro-business reforms, creating the potential for India to become an economic growth leader for years to come.

However, it is important to remember that thirty years ago, many prognosticators predicted that India would emerge as the key driver of global economic growth over the coming decades. The thesis was that a country with a population that nearly rivaled China, with a western-based legal system and a functioning free market economy would provide the foundation for inexorable economic growth and prosperity. Instead it was China, a country without these perceived advantages, which lifted large portions of its citizens out of poverty by urbanizing and developing a robust industrial base to become the primary driver of global growth, as shown in Chart 1.

Chart 1. Despite a Head Start, India has Urbanized Much Slower than China

Population Living in Urban Areas



Source: Gavekal Data/Macrobond

What happened to India and why has it failed to realize its enormous potential? Will Prime Minister Modi's economic reforms finally be the catalyst for India's emergence? Or is this just another fleeting glimmer of potential that will go unrealized. These are foundational questions to understanding investment opportunities in the country going forward.

Until recently, we have largely avoided India as a dedicated and oversized investment opportunity due to its structural impediments to business formation and valuation creation. This is in stark contrast to our substantial and highly successful investment efforts in China, which have spanned both public and private markets. However, we believe India might now be in the early stages of an inflection point that may result in robust investment opportunities. Our reasons for that belief are described in this paper.

India vs. China

From the outside, India appears easy to understand for Westerners. India is a democracy with a free market economy and a legal system that, similar to the U.S., is modeled after the British system. Given the many similarities, there is a natural tendency for analysts to erroneously project a similar path to successful outcomes that many Western developed economies have enjoyed.

Some believe that India's muted development, particularly relative to China, is the quintessential illustration of the ineffectiveness of democracy. There is some truth to the idea that the large decisions required for transformational economic growth, particularly in a developing economy, are difficult to make within a democracy. However, India's challenges are more subtle and many are deeply rooted in the cultural differences between these two nations. In fact, aside from being quite large and located in Asia, India and China have very little in common.

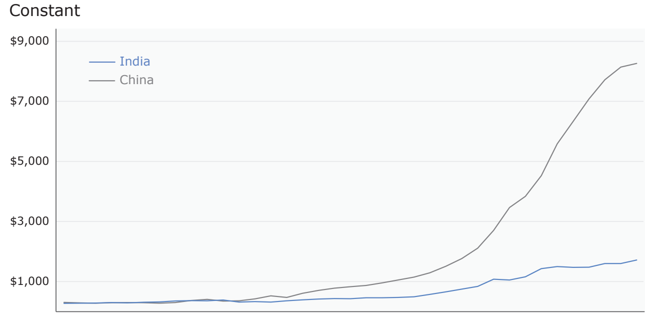
Cultural and Historical Influences

Many don't appreciate the important cultural differences that have contributed to these divergent growth paths. India's low growth emanates from its long-standing hierarchical culture, in which elitist tendencies never prioritized elevating its citizens culturally, educationally or economically. In contrast, China's non-stratified culture and egalitarian bias were centered on elevating the welfare of its people.

When China began its process of Reform and Opening back in 1978, its per capita GDP was similar to India's, as shown in Chart 2. Today, the average Chinese citizen is four times wealthier than the average Indian. Ironically, China has benefited from 100 years of war and political upheaval that resulted in the destruction of class structure and eventually the current Communist era. In contextualizing the economic explosion we have witnessed over the last 25 years, the China Economic Quarterly suggested that the proper analogy is the reconstruction of Germany or Japan after World War II. China's lack of a social strata, its common commitment to the betterment of its people resting upon its socialist philosophy, and its open market-oriented economic reforms have led to extraordinary economic growth, fostering the education, urbanization and enrichment of its citizens.

Chart 2. GDP Per Capita for India Trails China Substantially

Constant



Source: The World Bank

In contrast, India's political history over the last few hundred years has been dominated by their struggle to remove a British colonial elitist power only to replace it with an indigenous elite. Neither of these ruling powers embraced a philosophy of broad economic progress, but rather focused on self-preservation and enrichment. India just celebrated the 70th anniversary of the British departure and, in many ways, India's political journey, on its way to becoming the world's largest democracy, has been quite remarkable and even unlikely from many perspectives.

From the outside, India appears as a single country, but in reality it remains a collection of disparate groups of people with different languages, customs and traditions. The trade-off required to create a central government was ceding significant power to local states and their officials. While this balance allowed democracy to take root, it also sowed the seeds of corruption and bureaucracy among local officials who were empowered to distribute and withhold business licenses and collect taxes. Despite all of this, India has persevered to create a national Indian identity.

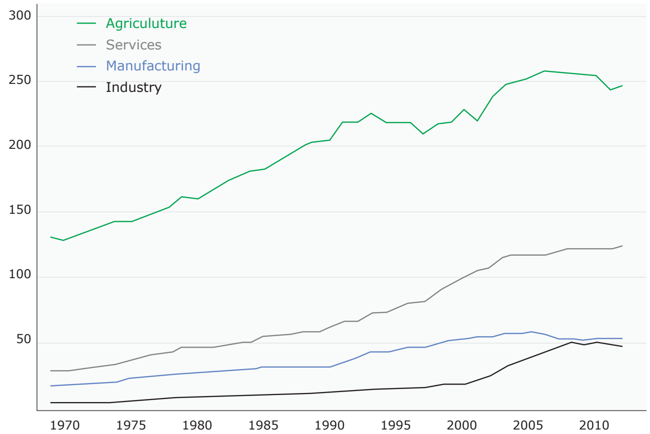
Made In India

While comparisons with China's industrial transformation are not entirely appropriate, India's inability to create a global manufacturing powerhouse, given its abundance of cheap labor, is still at the core of its economic disappointment. While China became the world's manufacturing superpower, employing hundreds of millions of former farmers, most Indians still depend on agricultural for their livelihoods, as shown in Chart 3.

According to Gavekal, a premier Asian-centric research organization, Indian manufacturing employs a meager 12% of the population and contributes just 16% of GDP, well below the 25% to 40% achieved in many other East Asian nations. India's manufacturing exports

Chart 3. Agriculture Dominates Employment in India

People Employed by Sector (million)



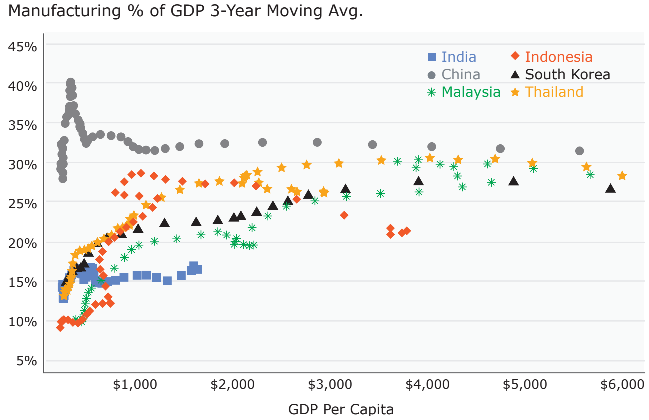
Source: Asian Productivity Organization, Gavekal Data/Macrobond

account for a paltry 1.7% share of total global exports, which is roughly on par with Taiwan, whose entire population is smaller than the Indian city of Delhi.

Further, many analysts believe that the manufacturing renaissance China exploited to urbanize and raise the standard of living for its enormous population is no longer available to India in the same way. Now, in pursuit of lower-cost labor, manufacturing activity is shifting to countries such as Indonesia, Vietnam and Malaysia, further bypassing India as shown in Chart 4.

Chart 4. Manufacturing in India has Underperformed Asian Peers

Manufacturing % of GDP 3-Year Moving Avg.

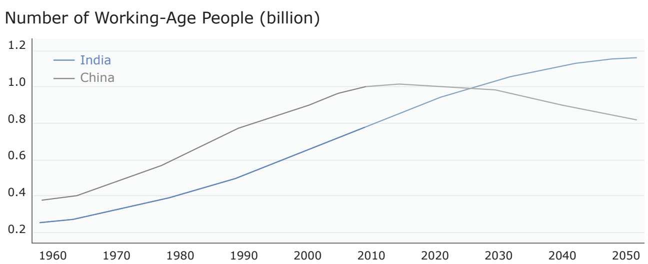


Source: Gavekal Data/Macrobond

The Greatest Demographic Dividend in History

The importance of an urbanization and industrial transformation cannot be overstated. Perhaps India's largest structural asset lies in its demographic profile, as the share of its working-age population will continue to increase and its dependency ratio falls. Already on schedule to become the world's most populous country in 2022, India's population is also uniquely youthful. More than half of Indians are under age 25, nearly two-thirds are working age (15-64), and less than 3% are over the age of 70. This youthful surge will peak in 2030 as shown in Chart 5, by which time an additional 200 million people will have entered the workforce and 485 million people, or one-third of the population, will be aged 15-34. The magnitude of these numbers is staggering.

Chart 5. India's Working-Age Population will Soon Surpass China's



Source: Gavekal Data/Macrobond

If India fails to exploit the potential of its youthful populace, it will squander the biggest demographic dividend in history. However, this is a double-edged sword that creates a political imperative: If hundreds of millions of young men and women cannot find work over the next two decades, India's slums will fill with resentment and anger that will likely morph into a social nightmare. Job creation is the highest priority and India will need to create roughly eight million jobs every year to absorb new entrants into the labor force.

India cannot create its desired economic boom without broadly raising household incomes throughout its population. Higher incomes create a virtuous cycle, as wealthier households spend more on goods and services, in turn creating more jobs. But household incomes will not rise unless more people are productively employed. Currently, half of Indian workers toil on the land, often barely above a subsistence level, while many others are employed informally with few labor protections and measly pay.

As evidence of the magnitude of this challenge, *The Times of India* reported that last year in the West Bengal state an estimated 2.5 million candidates – including college graduates, postgraduates and even PhDs – responded to an advertisement seeking applications for 6,000 entry-level positions in the government secretariat. In 2015, it was reported that 2.3 million candidates applied for 368 low-level positions in Uttar Pradesh, equating to 6,250 candidates, including 250 candidates with doctorate degrees, for every post.

Current Economic Challenges

Before analyzing the potential impact of Modi reforms, it is helpful to provide some background on the current economic and business environment.

"Informal" Economy

In 1973, India's highest personal tax rate, after adding a surcharge, reached 97.75%. Tax rates subsequently dropped, but the Indian government had created a long-lasting incentive to avoid paying taxes. Partially as a result of oppressive tax regimes, the Indian economy came to be dominated by cash transactions. This so-called "informal" segment of the economy allowed citizens to easily conceal their true income and avoid numerous taxes and the stifling government regulation associated with the "organized" segments of the economy. Further, there was little incentive to change as working outside the system lowered the cost of doing business and created a systematic advantage against "organized" competitors.

In 2015, PriceWaterhouseCoopers estimated that cash transactions in India constituted 68% of total transactions by value and 98% by volume. Further, analysts estimate that as much as half of India's output is produced by companies outside the formal economy. If accurate, this would imply over $2 trillion of economic activity remains outside the system. Central to any reform effort is bringing these informal businesses into the daylight of the organized economy, broadening the tax base and leveling the playing field for all.

Business Environment

Historically, India's governance structure has been ineffective from almost every perspective. On one side, the red tape of massive bureaucratic regulation strangles new business formation and makes existing firms uncompetitive. On the other, the governance structure has proved ineffective in building infrastructure and delivering public services. Whether too big or too small, the state has failed in every direction.

To better understand the stifling business environment, *Gavekal* provides several examples:

- It takes 26 days to start a business and 190 days to gain a construction permit.
- In Mumbai, it takes nearly 13 days for imports to clear customs compared to a brisk nine hours in developed economies.
- Road delays alone are estimated to increase manufacturing costs to levels two or three times higher than international benchmarks. Simply cutting wait times in half would decrease logistics costs by up to 40%
- Enforcing a contract following a payment dispute takes nearly four years.
- Factories with more than 100 employees must receive government approval to fire workers or risk heavy fines and even prison sentences for managers.
- Companies currently spend 241 hours a year paying taxes, some filing over 100 returns per year.

Prime Minister Modi has promised to sweep away the paralysis and corruption of the previous governments and build a "strong, efficient and enabling state" so that India can "grow by day." As one measure of success, Modi is targeting a Top 50 ranking in the World Bank's Doing Business Report by 2018. By demanding a higher ranking, Modi is paralleling his formal reform efforts with informal pressure on government ministers and administrators to implement policies that support private enterprise. Unfortunately, in the World Bank's 2017 report, India still ranked a disappointing 130th out of 190 countries. To put this ranking in perspective, Russia ranked 40th, China 78th and Indonesia 91st.

However, there are signs of progress. It now takes 45 days to get connected to the power grid, down from 138 days two years ago, which is almost twice as fast as the average for OECD countries. Additionally, reliability of power ranks 26th in the world, which suggests that a bailout and reform of state power distributors is beginning to work. Further, only 12 countries do a better job than India of protecting shareholders after it implemented its Companies Act of 2013. Productive reforms in India are possible when the right motivations are supported by sufficient political capital.

Modi Reforms

Prime Minister Modi rode to election victory on the promise of reforms, but the early days of his administration lacked real progress, proving how difficult it is to unseat entrenched interests. However, over the past year, he has been successful in implementing significant and transformative reforms, several of which are worth discussing in greater detail given their potential impact.

GST Reform

The Goods and Services Tax ("GST") is the first large-scale reform Modi was able to implement after more than two years of failed attempts. The GST replaces a wide range of central, state and local taxes with a system that will unify and simplify tax payment regimes for much of the economy leading to improved tax compliance throughout the economy.

While implementation has only just begun, most envision several clear benefits of the GST:

- The GST will level the playing field by eliminating many of the subsidies that historically favored certain industries and businesses.
- State and regional governments are now quite limited in their ability to charge and collect taxes so that goods should move more freely across state borders, improving the competitiveness of local goods compared to imports.
- The GST will broaden the tax base – the current income tax regime only captures taxes from 5% of the population – and increase governmental receipts, improving the government's ability to invest in infrastructure.
- The simplification of tax compliance is expected to improve participation in the formal economy by reducing the enormous tax-compliance burdens and costs currently embedded in most areas of the economy.

Gavekal estimates that the enactment of the GST alone will boost India's economic growth by 1% to 2% per year.

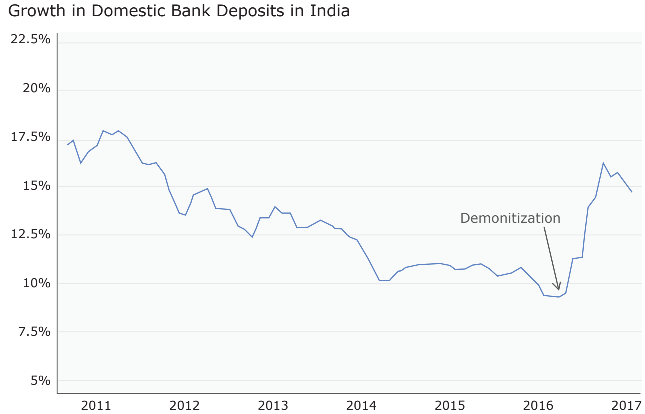
Demonetization

In an effort to curb the use of "black money" and bring the cash-based informal economy into the organized economy, the Modi government implemented a surprise demonetization program. On the evening of the U.S. election in the fall of 2016, Prime Minister Modi announced that all of the 500 rupee and 1000 rupee notes would stop being legal tender as of midnight that day. At the time of the announcement, India had roughly $240 billion of local currency in circulation, of which about $205 billion was in 500 rupee and 1000 rupee notes, the combination of which equated to 86% of all currency in circulation by value!

Given that the vast majority of transactions in India occur in cash, it would be a great understatement to describe this reform as "disruptive." The cash crunch severely curtailed transactions in the economy, stunting economic growth. As a result, the IMF trimmed its estimate of India's GDP growth by one percentage point for 2016 and 0.4 percentage point for 2017.

Chart 6. Bank Deposits in India Spurred by Demonetization

Growth in Domestic Bank Deposits in India



Source: Gavekal Data/Macrobond

While it is still early, we see signs that demonetization is having a positive impact on the economy. Digital transactions in the last few months have accelerated as a result of massive customer adoption of debit cards, credit cards and digital wallets for daily transactions. This impact is reflected in the dramatic growth in bank deposits since demonetization, as shown in Chart 6. Despite India's many challenges, smartphone penetration is over 80%, providing a powerful tool for the government to encourage migration to digital platforms and transactions. The government recently launched a new platform called the Unified Payments Interface (UPI), which allows customers to transfer money across bank accounts at any time of the day using the UPI smartphone app. According to Bloomberg, Paytm – the country's largest digital-payments provider – noted a 1,000% surge in money added to customers' digital wallets the day after demonetization was announced.

Expected Long-Term Benefits of GST and Demonetization

While short-term disruptions resulting from both GST and demonetization have been significant, the longer-term effects are expected to be quite positive. Beyond simple headline growth estimates mentioned earlier, these reforms should also accelerate the shift towards the organized segment of the economy by reducing tax complexity and increasing adoption of electronic payments and tracking.

As businesses transition "into the light," we expect to see the tax base widen and improve India's tax-to-GDP ratio, which at 16.6% is less than half of the OECD average of 34%. With more tax revenue in the hands of the government, we should see either higher spending by the government or reductions in tax rates, both of which can result in a revival of a long-overdue capital expenditure cycle.

Agriculture Reforms

The government launched a new crop insurance program in early 2016 to help stabilize farmers' income, especially in disaster years. A farmer can now protect his crop from any kind of non-preventable risks by paying a low premium (1.5% – 5%). More than 31 million farmers enrolled in just the first few months of the program.

A second and equally important reform was the formation of a single national agricultural market (eNAM) to facilitate the sale and purchase of produce by connecting these fragmented markets through an online trading portal. Analysts estimate that eNAM will become the largest digital agriculture exchange market in the world, which could deliver a 20%-30% reduction in intermediation costs to be shared by consumers and farmers.

Importantly, with the agriculture sector comprising nearly 50% of India's labor force, these reforms will be popular with large portions of the population, providing additional political capital and election victories for the BJP and Modi.

Modi's Agenda Requires Sustained Political Success

Skeptics point out that we have been here before and India's history has been filled with false promises. Without a commitment to continued reforms, India risks sliding back into its old ways. Therefore, it is critically important that the population appears to have taken even the most drastic reforms and related disruptions somewhat in stride in hopes of better long-term job and growth prospects.

Early signs are positive, as the BJP has secured several important political victories in state elections in the disruptive aftermath of these reforms. Equally important is the opportunity the BJP appears to have to gain a majority of seats in the upper house of Parliament. India's rolling state elections smooth (or slow, if you are a skeptic) the process of political change. In the five state elections just after enactment of the demonetization reform, which disproportionately affects the poor, lower caste voters, the BJP won by a landslide, including 80% of the seats in Uttar Pradesh, a state with over 200 million people, marking the BJP's first victory in that state in 15 years.

If the momentum continues with Modi winning reelection in 2019 and the BJP gaining control of the upper house, Modi will be in a strong position to push through even more substantive reforms and make additional progress in unleashing the potential of the Indian economy.

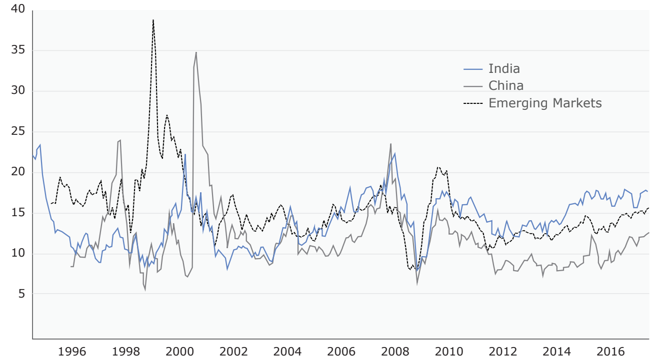
Investment Challenges

Accelerating economic growth and discretionary spending by hundreds of millions of Indian consumers has the potential to drive significant investment returns. As it was with China over the last few decades, the tailwinds created by an upward inflection of discretionary consumer spending can be very powerful drivers of investment returns. Despite a similarly-sized population, India's current online retail sales of $16 billion is just 2% of the value of similar sales in China, according to Forrester Research. This data makes it clear that India has a long way to go.

Modi's continuing economic reforms are a necessary, but not sufficient, condition to create sustained capital market returns for investors. India has some unique structural challenges that make investing more difficult than some investors might assume given its free market reputation.

Chart 7. Indian Equities are Trading at a Premium

12-Month Forward Equity P/E Ratio



Source: IBES/Thomson Reuters

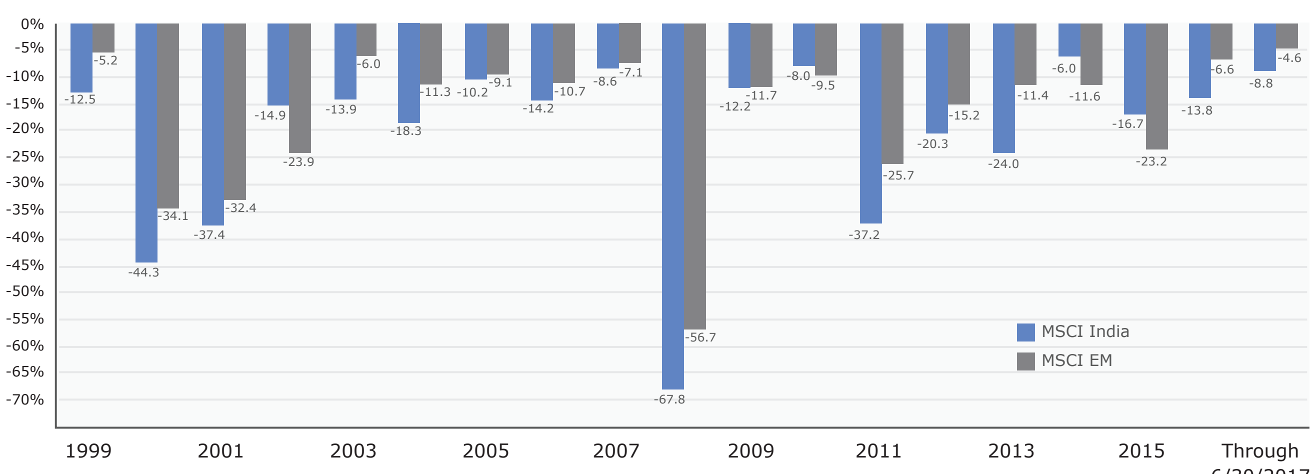
Public Market Performance and Valuation

Recently, Indian equity market performance has been quite strong, as westerners have been eager to participate in its potential. Over the last five years, India has returned just over 9% per year, keeping pace with China (+9%) and far outpacing broader emerging market equities (+4%).

One of the negative consequences of this outperformance with little corresponding earnings growth is that the Indian equity markets are trading at a premium valuation compared to other emerging market countries, as shown in Chart 7. For investors,

Chart 8. Significant Drops in Indian Stock Prices Occur in Most Years

Maximum Price Decline



Source: Morgan Stanley

elevated valuations create significant risk by reducing the margin of safety if earnings growth doesn't live up to expectations

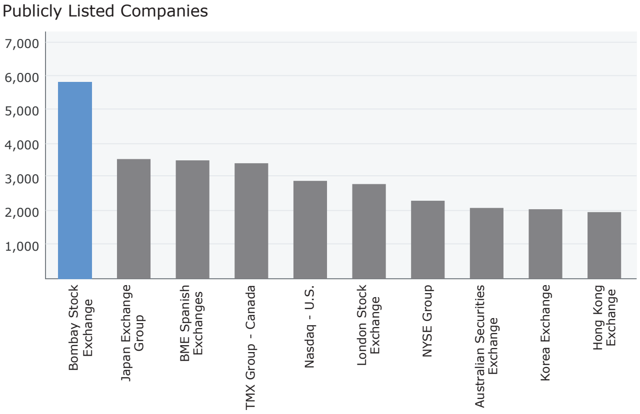
Volatility

The good news for long-term investors is that the Indian equity market provides numerous attractive entry opportunities given its high volatility and frequent drawdowns. Generally, emerging market equities are more volatile than developed markets and the Indian market is particularly so. Chart 8 shows the largest decline that occurred within every calendar year for the last twenty years for both the Indian market and broader emerging market equities.

- In 16 of the last 20 years, Indian equity market experienced a decline of over 10% during the calendar year.
- In three of the four remaining "good" years, investors experienced an 8% or larger decline.
- In 17 of the last 20 years, Indian equity market experienced a larger decline than broad emerging market equities.

These declines can provide long-term investors very attractive entry points to deploy capital.

Chart 9. Indian Stock Exchanges have More Listed Companies than any Other Exchanges



Source: Bloomberg

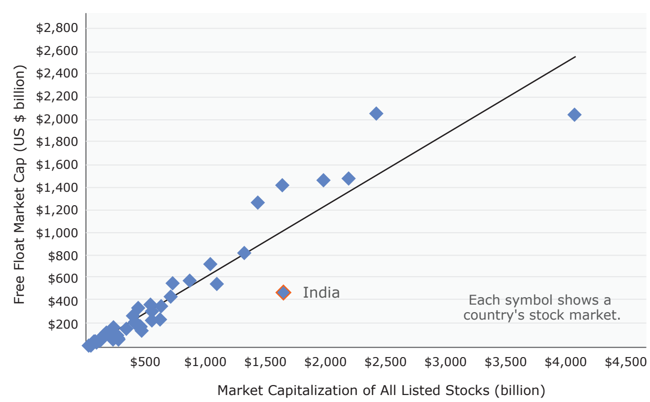
Market Liquidity

At first glance, the Indian market appears deep. Even the Bombay Stock Exchange ("BSE"), which is generally regarded as the nation's second exchange behind India's National Stock Exchange ("NSE"), has over 5,500 listed stocks, more than any other national exchange in the world, as shown in Chart 9.

However, many of these stocks are small and illiquid. Over 4,000 Indian companies are less than $1 billion in market capitalization. Further, the number of liquid stocks is quite small compared to many of India's emerging market peers. India has just over 150 stocks with an average daily trading volume exceeding $5 million per day versus nearly 3,000 listed companies with this trading volume in China. Even Korea, a much smaller country and stock market, has nearly 300 such stocks.

Several factors contribute to this lack of liquidity, including the limited free float (i.e., the amount of stock listed and freely traded) of listed equities. India's free float is among the worst in the world, relative to the size at its market, as shown in Chart 10.

Chart 10. The Amount of Stock Freely Traded in India is Very Limited



Source: MSCI, RIMES, Morgan Stanley Research

As one might expect, India has a history of family business ownership. However, unlike other countries where family equity or so-called "promoter" holdings are broadly available for the public to trade, promoter ownership in India is typically 50% or higher.

Relatedly, the Indian government has historically imposed a 49% limit on foreign ownership of some companies' stock. With these limitations, stock price movements are often driven more by who is trading or owns a stock than by underlying company fundamentals. Additionally, limited free float creates some reluctance by investors to sell existing holdings for fear of difficulty in reacquiring the stock, which can cause valuations to become stretched. While this is a structural problem, it also creates opportunities for astute local investors who understand these dynamics.

However, it is important to recognize that some progress is being made in lessening these restrictions. For example, the average promoter owned 49.1% of BSE 500 companies at the end of June, which was down 10 percentage points from 59.1% ten years ago.

Shorting Limitations

Given the large investment universe, sparse research coverage and higher volatility, India would seem to be an ideal market for long/short hedge fund strategies. Unfortunately, an insider trading scandal by a former president of the BSE caused the Securities and Exchange Board of India (SEBI) to ban short selling during the 2000-2002 bear market, eliminating all true hedge fund participation.

More recently, SEBI began permitting institutional funds to engage in short selling and it is slowly allowing other investors to do so also. However, the reforms altered the way short selling is accomplished in India. Creating short exposure is now primarily executed through single-stock futures rather than borrowing shares and selling in the cash market. Unfortunately, futures are currently available on fewer than 250 companies and sufficient liquidity is typically available in only about 100 of them, which is a significant deterrent to long/short strategies.

Manager Selection in India

Given the traditional benchmark-oriented investment approach of most western investment managers, the vast majority of foreign capital invests in the Indian market through ETFs or other benchmark-centric investment strategies. Most India indices have sizable allocations to large-cap IT services, energy and pharmaceuticals. While these companies are important to the Indian business community, they are heavily influenced by the global economic cycle and their outlook is largely determined by external factors rather than Indian dynamics.

Investors looking for true exposure to domestic consumption and other impacts of local economic acceleration are better served in the small- and mid-cap segments of the market. These smaller companies are rarely followed by major research firms, creating significant inefficiencies. It is estimated that over 70% of companies with market caps of $100 million or less have no institutional research coverage. In addition to the information challenge, the restricted liquidity of these smaller companies keeps most global managers with large asset bases away from them.

To access these opportunities, local managers with local information networks and significant history working on these companies are required. While there are relatively few such firms that meet western institutional investment standards, the handful that exist enjoy the benefits of investing in a highly inefficient market.

To identify and access these managers, consultants and allocators face several challenges. First, the investment firms with great local knowledge and access are located in various cities across India. While travel to India is a surmountable challenge, other factors create additional disincentives.

Many of these investment firms do not report their results to traditional databases that form the basis of commonly accepted manager search practices. This makes simply identifying these managers a challenge. Further, given the limited liquidity of the underlying stocks, most of these managers are capacity constrained and many of them are closed to new investments. Even if these managers could take additional capital, the amount would be relatively small and not commercially viable for the massive asset bases of large consultants, private banks and trust companies.

Presently, Gresham has invested modest amounts of capital with several marketable managers within India. These strategies range from a traditional equity portfolio to a more eclectic small-cap manager, and even to a long-short manager. Early returns produced by these investments have been positively accretive for our clients, but it is still too early to evaluate the success of this initiative. However, if Indian reforms continue under the Modi administration, we expect investment opportunities will become more prevalent and compelling, causing us to increase our clients' exposure to levels that could be significant.

To illustrate the potential attractiveness of some Indian small- and mid-cap companies, we highlight in the Appendix two such companies, one from each of Gresham's two dedicated Indian managers. These examples are not intended to be an endorsement of these specific stocks or Gresham's Indian managers, but rather an illustration of the enormous growth potential found within the tailwinds of India's emerging middle-class consumer. They also illustrate the high prices that investors must periodically face to own these fantastic franchises.

Conclusion

India currently constitutes a small portion of most investment portfolios and Gresham has historically been reluctant to commit significant capital to the country given the business challenges described earlier. Further, there is always a healthy competition for capital amongst competing investment ideas around the world. To date, we have found more compelling investment opportunities in other emerging economies, most notably China. Although the promise of India's emergence has both tantalized and disappointed investors for decades, the political will and economic reforms needed to catalyze the emergence of India as a global economic power are beginning to appear under the Modi administration.

Appendix

HDFC Bank

Since going public in 1995, HDFC has grown to become India's largest private sector bank by assets and market capitalization. The bank has established over 4,700 branches and 12,000 ATM terminals across more than 2,600 cities and towns in the country. In total, the bank serves over 40 million customers.

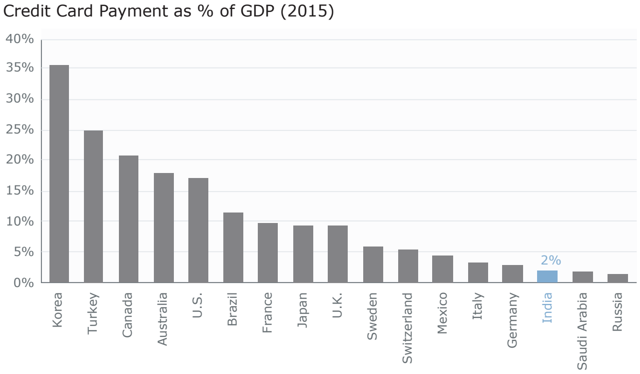
Secular trends are boosting HDFC's profitability

Rising retail lending penetration in India

- HDFC is poised to benefit as credit growth in India is accelerating from very low penetration levels. Indian consumers' share of retail, credit card and auto loans remains one of the lowest in the region, as shown in Chart 11.
- HDFC is the market leader in the issuance of credit and debit cards, with nearly 34 million cards issued. Approximately 75% of new cards are issued to existing depositors, further strengthening the Bank's customer retention and providing an additional level of credit data.
- In addition, HDFC Bank is among the top three players in auto loans, personal loans, commercial vehicles, cash management and supply chain management.

Chart 11. Retail Loan Penetration in India is Very Low

Credit Card Payment as % of GDP (2015)

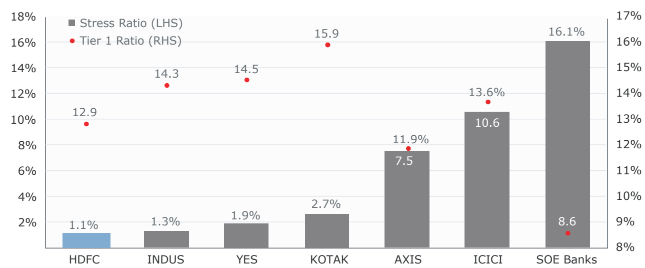


Source: World Bank, BIS, Goldman Sachs Global Investment Research

HDFC's strong asset quality is helping it gain market share against its private and public peers

- The bank's quality underwriting standards have protected its balance sheet, while many private sector banks are seeing an uptick in non-performing loans, as shown in Chart 12.
- HDFC has been using its expanded national branch network to gain market share from the struggling and undercapitalized public sector banks in the small-to-medium and mid-corporate segments.
- Because of its strong position in the growing retail loan market and its ability to selectively take market share in the non-retail segment, HDFC has the ability to grow substantially ahead of the banking system, even if the system is in a cyclically slow growth phase.

Chart 12. HDFC's Asset Quality is Superior to Public and Private Peers



Note: Impaired Loan Ratio Across Private Scholar Banks, Tier 1 Ratios

Source: World Bank, BIS, Goldman Sachs Global Investment Research

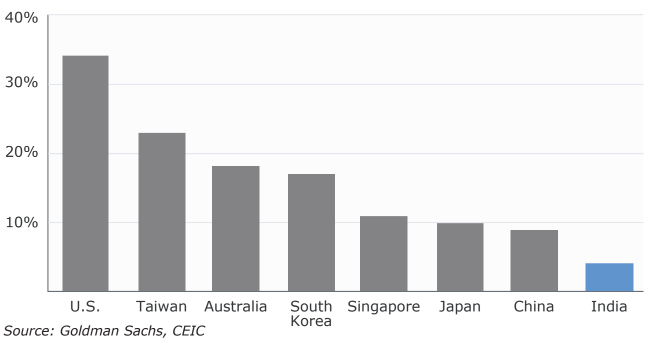
India is set to experience a shift of household savings from deposits to other financial products

- Historically, the country has one of the lowest household penetrations of insurance and equity investments compared to other countries in the region, as shown in Chart 13. The government's demonetization program has pushed deposits into the banking system, which is encouraging households to move assets into consumer financial products (e.g., equity mutual funds and insurance), aiding the bank's profitability in its brokerage business.

Financial Performance

- Despite the disruptions presented by demonetization and GST, HDFC has continued to show very strong earnings growth of 20%, led by loan growth of 23% and fee income growth of 30%, while containing operating cost increases to roughly 12%. Additionally, the bank reported 17% growth in commercial business lending, a space that showed almost no growth at a system-wide level.
- Since 2008, HDFC has grown earnings per share by fivefold and generated total shareholder returns of nearly eightfold, as shown in Charts 14 and 15.

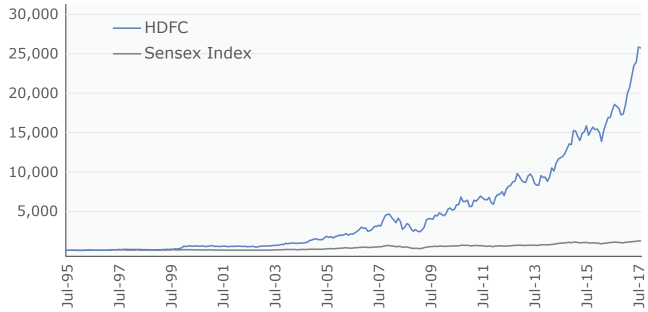
Chart 13. Household Allocations to Equities are Very Low in India



Source: Goldman Sachs, CEIC

Chart 14. HDFC's Stock has Substantially Outperformed

Cumulative Return in INR



Source: Bloomberg

Chart 15. HDFC has Produced Strong Growth and Current Financial Metrics

10 Year Compound Growth Rate		Financial Metrics and Valuation Estimates for FY 2018		
Deposits	18.6%		Return on Assets	2.0%
Profit After Tax	26.1%		Return on Equity	18.5%
Earnings Per Share	21.9%			
Dividend Per Share	22.3%		Price-to-Book	3.5x
			Price-to-Earnings (Fwd)	19.6
# Branches	21.8%		EPS Growth (consensus)	20.5%
# ATMs	21.8%			
Cities/Towns With Coverage	24.7%			

Source: HDFC Bank, Bloomberg

Avanti Feeds

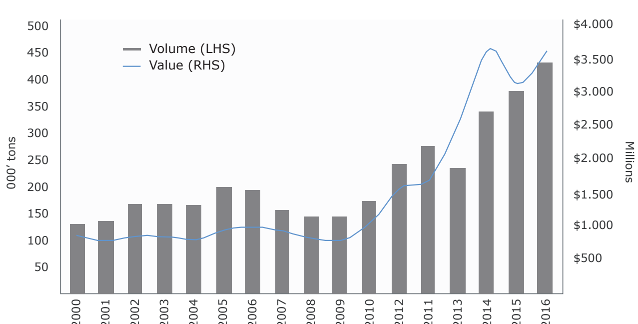
Avanti Feeds produces and distributes prawn and fish feeds to customers in the U.S., Europe, Japan, Australia and Middle East. The company operates five shrimp and fish feed manufacturing units with annual capacity of 400,000 metric tons. The company also operates a shrimp processing plant in Yerravaram. The company was founded in 1993 and is based in Hyderabad, India.

Emerging Leader in a Growth Industry

Scalable and fast growing market

- Since the introduction of Vannamei shrimp in 2009, the shrimp export industry in India has grown at an impressive annual rate of 38%. The Indian shrimp industry has annual production of over 434,000 metric tons and exports totaling over $3.5 billion globally, as shown in Charts 16 and 17. The worldwide shrimp market is approximately 3.2 million metric tons, providing significant headroom for Indian production to grow. Due to its vast untapped coastline, huge stretches of brackish water and one of the lowest costs of production, India is ideally suited for aquaculture.

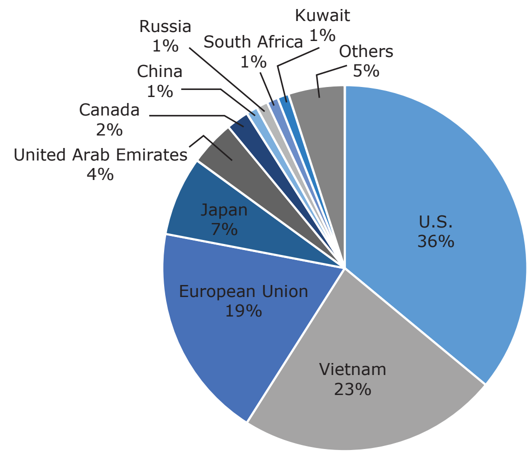
Chart 16. India Exports over $3.5 Billion of Shrimp Annually



Source: Avanti Feeds

Chart 17. India Exports Shrimp Globally

Allocation of Exports (2016)



Source: Avanti Feeds

- Despite increasing its feed capacity by 150% over the past four years, Avanti has faced stock-out situations at peak harvesting season in each of the last three years. Had it not been for capacity constraints, Avanti could have grown faster and gained further market share.

Strong brand, distribution and farmer relationships

- Avanti is the leading aquaculture feed company in India and has a strong brand known for the best feed conversion ratio, supported by a strong distribution reach and highly trained technical personnel of over 150 employees to assist shrimp farmers. This has resulted in very high retention rates of existing customers and a disproportionately high share of incremental growth.
- Avanti's technical expertise has allowed farmers to reduce feed expense to 45% of total cost from 55% eight years ago, further strengthening their competitive positioning and allowing the company to increase its market share to 50% from 25% in 2008.

Experienced and technically strong team

- Avanti has been in the aquaculture business in India for the past two decades and has shown superior execution capabilities compared to its competition. Avanti is further strengthened by a technical and marketing relationship with the Thai Union Group of Thailand, one of the largest sea food processors in the world, with a market cap of $3.7 billion.

Expansion into Food Processing

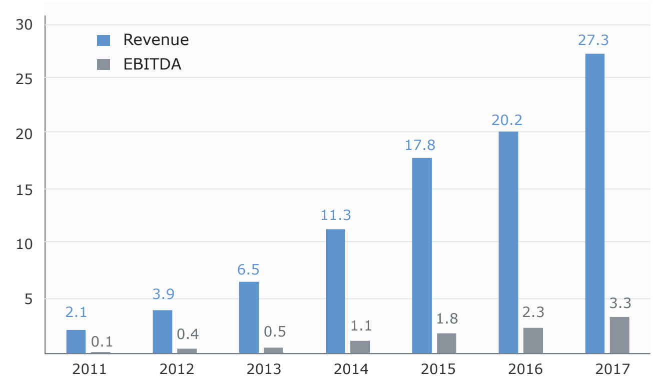
- Avanti derives 15% of its revenues from its shrimp processing business. It purchases shrimp from farmers, processes the harvest and distributes the cooked products to export markets. Avanti has created a dedicated new subsidiary for this processing business in which Avanti holds a 60% stake and Thai Union holds a 40% stake. Processing capacity has recently been increased from 7,500 metric tons to 22,500 metric tons. Avanti is expecting over 30% annual growth in its processing business revenues over the next three years.

Financial Performance

- The shrimp feeds industry is heavily concentrated and capital efficient. Avanti generated a return-on-capital-employed of 61.7% on a consolidated basis in FY 2017. The company has grown its revenues at an annual rate of 46% and EBITDA at an annual rate of 66% over the past seven years, as shown in Chart 18.

Chart 18. Avanti Financial Performance

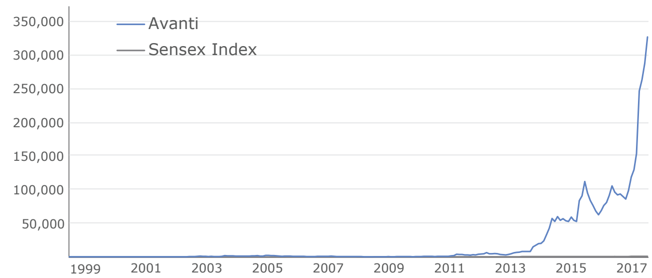
INR (billion)



Source: Avanti Feeds

Chart 19. Recent Innovation has Boosted Avanti Stock

Cumulative Return in INR



Source: Bloomberg

About Gresham

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