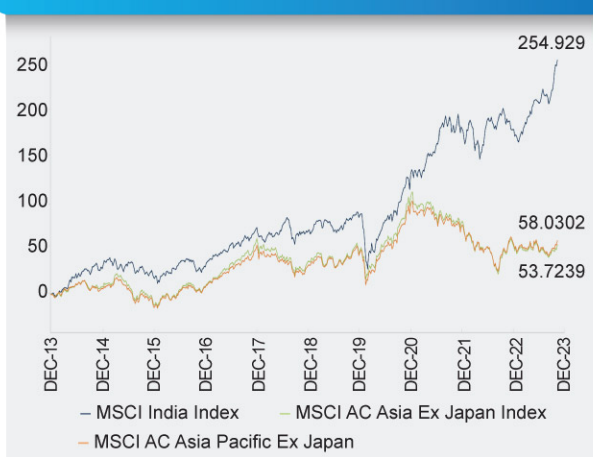


## Capture the upside with an Indian strategy

Investors have been arguing in favor of a standalone investment in India for many years.

Firstly, consider the numbers. Some of the Asia strategies in the market typically have a healthy weighting to Indian companies; and yet, if investors look at the MSCI index, there is a significant difference in the returns enjoyed by clients in an Asia strategy versus an India strategy.

Cumulative total returns (gross dividends) over 10 years



Source: Bloomberg, as of January 2024.

Past performance is not a guide to future performance. For illustrative purposes only; this does not constitute any advice or recommendation with regards to any investment products / services.

In addition, what one gets, with this exposure to India via regional funds, are usually large companies which are actively traded. Typically, these tend to be a bank, an IT services company, and maybe a consumer staples company. While they have kept up with the market they are not the “best” businesses to own in India, particularly when investors look ahead at the next 10 to 20 years. It’s believed that the really attractive businesses are still not yet on the radar of regional investors.

To illustrate the point, when investors look at the top contributors to performance of FSSA India strategy over the past decade, companies like Eicher Motors and Blue Star feature prominently. However, these Indian companies are not commonly owned by most regional strategies.

Taking a step back from the discussion, it is perhaps worth revisiting the reasons for the long-term enthusiasm on India.

### Large universe of high-quality listed companies

Of the 5,000 or so listed companies in India, about 1,400 have a market capitalization of more than USD 100 million (the minimum size and liquidity threshold). Over the years, the FSSA team has met with and analyzed close to 1,000 companies in India (in the last three years, FSSA conducted research on 350 of them). There are about 200 companies in India that meet standards of quality (in terms of ownership, management, alignment, and franchise strength). This number keeps increasing every year. In contrast, investors struggle in other large emerging markets like South Korea (which was, until recently, a bigger weight than India in regional indices) to list even five companies that investors deem investible. And this number keeps decreasing!

What is more, these quality Indian companies come from a wide variety of industries, unlike various commodity-driven emerging markets where certain sectors are simply absent from the stock market. According to S&P Global and Morgan Stanley, India is likely to become the world’s third largest economy by 2030,<sup>1</sup> which means that these companies have a large home-market to exploit and are not overly reliant on export demand. This makes investors more confident about the ability of these companies to remain relatively insulated from extraneous shocks.

### One of the oldest equity markets globally

India’s Bombay Stock Exchange was established in 1875, making it among the oldest in Asia. The culture of entrepreneurship, and the ability to deal with the opportunities and challenges that come with being a public listed company, has been in place for many decades. As a result, there is an abundance of family-owned business that are listed – it is not uncommon for a public company in India to have more than 50 years of listed history and is now being managed by the third or fourth generation of family members. On the other side of the equation, there is a large (and rapidly growing) domestic asset management industry and retail investor base (i.e., individual shareholders), who tend to be well informed and moderately sensitive to governance issues (albeit not as much as investors would like).

Anecdotally, good corporate citizens are typically more common in India. Investors find the situation markedly different in several Asian countries where the culture of stock ownership and public listing is not yet as ingrained. In some of these large emerging markets, the listed history is relatively short and many businesses are still run by first-generation managers, who might have only experienced a monotonous boom economy for the last two decades and thus lack the resilience that is built up by operating under tough conditions – something that Indian companies combat almost every day.



## Large businesses hiding in small market capitalizations

The sheer scale of India's population (1.4 billion people)<sup>2</sup> and the still nascent stage of several industries in the country means that the market leaders are quite small in comparison to regional and global peers. For example, per the International Energy Agency (IEA), it is estimated that China has 860 million air conditioners installed versus around 80 million in India (2023 figures).<sup>3</sup> The top three listed air-conditioner manufacturers in China have a combined market capitalization of USD 105 billion (as at January 2024), whereas the top listed companies in India are tiny in comparison – Blue Star, for example, a leading player with a 13% industry market share, has a market cap of just USD 2.6 billion.

Investors come across many such examples in India, across several industries; and more importantly, are often able to identify the ultimate winners early. This gives investors the conviction to hold on to their positions and perhaps add to them when market conditions permit.

## Engaged and accessible owners and management teams who are return-on-capital conscious

The most important difference between India and many other emerging markets is that India has always been capital starved (with relatively high interest rates in general) and the government has rarely been explicitly supportive of private entrepreneurs. This apparent headwind has become a tailwind under the current business-friendly regime.

Furthermore, Indian managers are keenly aware of the availability of capital and its cost. This means that the best-managed Indian companies operate with high returns on capital employed (ROCE) – and even middle-level managers might be able to dissect the drivers of ROCE in the business. Thus, it is possible to have meaningful conversations about capital allocation in India – something that is hard to do in places where the gravity has been switched off for years (i.e., either the cost of capital is negligible or is freely available via state diktat).

These constructive discussions are not restricted to the capital allocation process. The engagements on issues like board independence and effectiveness, remuneration policies, succession, quality of financials, related-party transactions, etc., tell investors a lot about the culture of a company. To become convinced about being a long-term shareholder, it is absolutely vital to feel aligned with the culture and be comfortable with the management quality. This allows investors to stay invested through thick and thin. In general, high-quality entrepreneurs in India are comfortable engaging with minority shareholders and cherish this constructive exchange of views from long-term-minded investors. This goes a long way in helping to develop conviction in holdings as compared to other markets where the conviction in a business is often directly correlated to its share price!

## Governance standards and minority shareholder protection have consistently improved

The experience of investing across emerging markets suggests that the Indian market is ahead of peers when it comes to the protections that are in place for minority shareholders. Whether it is privatization rules/tag-along rights, approvals for related-party transactions, mandatory independence rules for boards, mandatory disclosures of shareholdings and pledges, etc., investors are able to sleep well at night owning the average Indian company. Investors can say from some rather painful and frustrating experiences that that is not necessarily true for many other emerging markets.

## “How do you justify the valuations?”

Finally, this is a question often raised from clients and prospects. It is true that India has historically been an expensive market (some of it is justified as explained above). However, it's acknowledged that the past few years in particular have witnessed higher valuations.

Admittedly, there is a huge amount of froth in some pockets of the market, where investors could get hurt. But that is not true for the entire market. For instance, the weighted average 12-month forward price-to-earnings (P/E) ratio for the FSSA Indian Subcontinent strategy is 25x. When measured against its own history (5-year average of 22x P/E), this does not seem overly concerning. The portfolio's weighted-average return on equity (ROE) of 21% and anticipated earnings CAGR (compound annual growth rate) of 17% should also be supportive in the medium term.

Most investors like to be contrarian. Some exuberant signs indicate that it's the near-term peak of the market. The important question, however, is whether investors have confidence in the businesses to emerge as the respective winners in their industries – and therefore have a long runway of growth ahead of them. And that is why investors would happily add to their positions on market weakness rather than second-guess themselves.

FSSA has spent the past decades building relationships with high-quality owners and managers in India and have identified, in their view, some of the best compounding growth opportunities in the world. This conviction compels them to highlight the idea of a separate allocation to the India market on top of an Asia or regional strategy – so that clients can realize the maximal benefit from what they believe to be a great next few decades for businesses in India.

# 市場觀望

## EYE ON THE MARKET

Source:

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Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 23 January 2024 or otherwise noted.

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## Investing in a critical global resource: water

Rising living standards, demographics and the rise of water-intensive industrial processes are reinforcing long-term demand growth for water. However, in many parts of the world, water resources are strained by overconsumption, pollution, and the effects of climate change. Water supply problems do not just affect the emerging world – aging infrastructure compromises reliable supply and contributes to pollution across the developed world.

To address these challenges, investment in the industry must increase significantly. The UN estimated in 2020 that an extra USD 260 billion would be needed each year to realize its Sustainable Development Goals by 2030<sup>1</sup>.

Expanded fiscal support and investment by utilities and water users should trickle down to suppliers of products and services, creating investment opportunities across the water value chain.

### Interrelated trends support long-term investment in the water industry

#### 1. Water scarcity

Water may cover more than two-thirds of the Earth's surface, but only 0.5% of the world's water is useable and available fresh water<sup>2</sup>. The scale of the problem is clear: a recent report suggested that global demand for fresh water is likely to outstrip supply by 40% by 2030<sup>3</sup>.

This challenge emphasizes the need for better water management: to avoid waste and unsustainable consumption and improve the efficiency of water usage.

#### 2. Growing populations

Growing populations place the world's limited freshwater resources under further strain over the long term. According to the UN, the global population is expected to increase from eight billion in 2023 to close to 10 billion by 2050<sup>4</sup>, not only increasing demand for drinking water, but also for products and processes that rely on water such as agriculture and industry.

#### 3. Climate change

Rising temperatures pose profound challenges to secure, reliable water supplies around the world. For every 1°C increase in average global temperatures, the UN projects a 20% drop in renewable water resources<sup>5</sup>.

Rising sea levels are also expected to increase the dissolved salt content of groundwater supplies in vulnerable coastal areas.

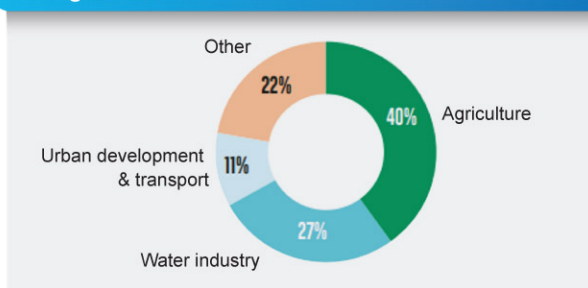
The UN also estimates that 400 million more people will be at risk of flooding by 2050 as climate change intensifies the water cycle<sup>6</sup>.

#### 4. Pollution

Over 80% of used water flows back into the environment untreated, often containing human waste and toxic industrial byproducts<sup>7</sup>. In some developing economies, it is as high as 95%. Agriculture is also a major source of water pollution, with rainfall washing fertilizers, pesticides, and animal waste from farms into the world's waterways<sup>8</sup>.

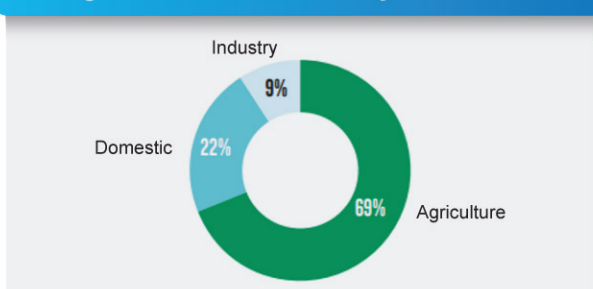
A tightening regulatory environment supports innovative approaches and technologies that address water quality issues, from water testing technologies to wastewater treatment.

#### Reasons for English rivers not achieving "Good Ecological Status"



Source: Environment Agency, August 2022

#### Global groundwater abstractions by use



Source: UNECSO, 2022: United Nations World Water Development Report 2022

## 5. Urbanization

The UN has forecast that 2.5 billion more people will live in cities in 2050 than in 2018, with most of this growth in the developing world<sup>9</sup>. Urbanization poses two major challenges:

- providing clean water and sanitation to more people in a concentrated area
- increased flooding risks due to water run-off from impermeable surfaces such as roads and roofs.

## 6. Infrastructure

UNESCO has calculated that between USD 0.9 trillion and USD 1.5 trillion of annual investment is needed in water and sanitation infrastructure, including upgrades in the developed world, by 2030<sup>10</sup>.

This creates opportunities across the value chain, from companies that supply products integral to moving water and detecting leaks, to companies engaged in developing and constructing utilities' systems.

**USD 0.9 trillion  
to USD 1.5 trillion**

Annual investment needed in global  
water-related infrastructure by 2030

## 7. New industries

The energy intensity of the digital economy has been relatively well documented, but perhaps less well known is its thirst for water; both data centers and semiconductor manufacturing are very water intensive.

**1.2 million  
megalitres of water**

will be used by the global  
semiconductor industry every year

In addition to the importance of water efficiency for a company's profitability, potential droughts and water scarcity pose operational risks given the water intensity of processes. Innovative water management solutions can play an important role in addressing such sustainability challenges.

## Regulation in three main areas

In the face of water shortages, pollution and leakages, governments around the world are imposing stricter regulations to safeguard water quality, improve infrastructure, ensure water is correctly priced, and address drivers of biodiversity loss.

### 1. Water scarcity

The two most important laws regulating water quality in the US are the Clean Water Act, which regulates the discharge of pollutants into waterways, and the Safe Drinking Water Act, which ensures the quality of drinking water. More recently, the 2021 Bipartisan Infrastructure Law included USD 55 billion for water-related infrastructure, with most funds allocated to improving drinking water and replacing the millions of lead pipes across the US<sup>11</sup>. In the EU, the recast Drinking Water Directive tackles emerging pollutants such as endocrine disruptors and microplastics, and favors actions to reduce pollution at source<sup>12</sup>.

### 2. "Forever chemicals"

Awareness of one specific water quality issue has been rising in particular: the presence of perfluoroalkyl and polyfluoroalkyl substances (PFAS) in drinking water and water courses. In both the EU and the US, regulators have proposed or enforced limits for PFAS levels in drinking water.

### 3. Biodiversity

Regulators are turning their attention to water, since water quality and the state of biodiversity are interconnected. The European Water Framework proposes heavier restrictions on sewage and limits on agricultural run-off to deal with eutrophication. Meanwhile, the UK government has proposed a plan that would require water companies to invest an estimated GBP 60 billion in infrastructure over 25 years to reduce the use of storm overflows for sewage<sup>13</sup>.



## Investment opportunities across the water value chain

### 1. Water utilities

There are selective opportunities for investors in the companies that operate water treatment and supply infrastructure, providing clean water, wastewater, and sewerage services. Utilities that demonstrate progressive water stewardship processes face lower regulatory risks in the form of potential fines or the loss of their social license to operate.

### 2. Water infrastructure

There are three overarching categories:

- Network equipment products such as specialized pipes, pumps, and valves that assist in the transmission of water.
- Parts and systems that distribute water around buildings and within industrial processes.
- Companies helping with the design and construction of water infrastructure projects.

### 3. Water treatment, efficiency, and testing

Companies in this field tend to have relatively high margins, specialized technologies, and strong pricing power.

- Services or products that enable the chemical or non-chemical treatment of water.
- Products and services improve the water efficiency or reduce demand.
- Products and services enable the testing of water quality.

## Evolving technologies and solutions

Innovative technologies promise to play a critical role in helping address water-related challenges, creating new markets and tapping into structural demand growth.

### 1. Advanced treatment

Innovative treatments have been developed to remove newly identified contaminants from drinking water and to produce ultra-pure water for processes such as semiconductor production. For example, membrane filtration has transformed water treatment processes by mitigating the need for certain chemicals to separate out impurities.

### 2. Advanced measurement

Advanced flowmeters and smart meters provide reliable, real-time insights that help operators respond quickly to changing conditions and play an important role in leak detection. Advanced measurement systems can provide data that can inform agricultural irrigation decisions, helping to conserve water and maximize crop yields.

### 3. Detecting new contaminants

Detection technologies range from mass spectrometry solutions that can measure and detect PFAS compounds in water to next-generation sequencing techniques to detect waterborne viruses – and so trigger effective policy responses.

### 4. Data and software

There are promising applications that are delivering efficiencies and improving regulatory compliance including:

- hydrological modelling software
- Geospatial data solutions to create up-to-date databases of water pipe networks and improve modelling
- Compliance management software to support adherence to evolving regulations governing water quality and environmental standards.

### 5. Smart irrigation

Innovative “smart irrigation” approaches integrate technology to optimize water usage and crop yields. They can also be applied in major end-markets beyond farming, including gardening and the management of urban green spaces and golf courses.

### 6. Water reuse

Water recycling systems offer both environmental and financial advantages and are now being embedded to optimize and mitigate water consumption, and alleviate local water scarcity issues.

## Outlook

Water represents an exciting opportunity set for investors in listed equities. By carefully choosing from the universe of listed companies that have exposure to the water theme, investors can aim to build a high-quality portfolio of stocks that is well balanced between economically resilient businesses and firms that are more growth oriented. The tightening ratchet of regulation, combined with structural drivers of global water industry growth, will support opportunities for expertise-led active investors to outperform over the years and decades ahead.

# 市場觀望

## EYE ON THE MARKET

### Source:

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