January 2015

Matthews Asia

Matthews Asia Perspective:
India: What Lies Ahead

Q&A with Sunil Asnani, Portfolio Manager of the Matthews India Fund

Q **The Indian equity market has been one of the strongest performing markets in Asia in 2014. Can you explain what the main drivers were?**

A The equity market rally during 2014 was based less on the improvement of fundamentals and more on sentiment, which was largely driven by a renewed sense of hope for the country. Prime Minister Narendra Modi's election campaign evoked the belief that reforms could spark change in governance and growth, particularly by improving on executive efficiency and the ease of doing business. Important reforms are also anticipated in the usage of land, labor and other natural resources.

Q **How significant do you believe the reform process initiated by Modi has been so far? Do you believe the reaction over the possibility of reforms has been over-done?**

A So far, the government has made incremental changes to improve functional efficiencies, more so than structural reforms. To assess the government's ability to make reforms, one has to understand how reforms can be implemented at various levels of government.

The easiest changes to make could relate to improved efficiency and fair dealings with the corporate sector. Clarity around necessary approvals to conduct business in the country should be helpful for companies. In order to do this, the government needs effective leadership and a sense of urgency. Fortunately, the government does seem intent to make the necessary changes.

More difficult is implementation of legislative reforms, which requires varying degrees of political support, depending upon the nature of legislation. The ruling Bharatiya Janata Party (BJP) has a majority coaltion in the Lower House of Parliament but not in the Upper House—and it only has a narrow majority coalition in the combined houses. Some matters require a simple parliamentary majority. But others require a two-thirds parliamentary majority, and/or the additional support of 50% of the states. Currently, the BJP struggles to gain this level of legislative support.

We believe this is why Modi's government seeks to temporarily affect reforms into law through promulgating ordinances, in spite of the fact that these reforms will eventually need parliamentary approval. Clearly, this is a short-term solution.

While concrete progress has yet to be made, the focus is on land, labor, insurance, as well as goods and services tax reforms.

Q What are the keys for successful implementation of reforms?

A In the short run, legislative majorities at both the national and state levels could definitely help. Improving transparency and efficiency within the government, with the aid of technology and support from the top leadership, could go a long way toward boosting business confidence. The recent elections provided a mandate for change—but timing is critical.

Over the medium to long term, the government needs to use its support to make investments in social (e.g., education, health care) and physical infrastructure (roads, rail, housing, ports, etc.). It also needs to improve upon the hurdles for doing business within the corporate sector. Simplifying the tax code, for instance, is vital for corporations.

Q How do you see 2015 in terms of the Indian economy? Will reforms remain the focal point for investors?

A The most important drivers of the Indian economy over the coming year will be:

- Legislative reforms that would enable the fair and efficient use of resources and make India more business friendly
- Monetary policy as lower inflation would reduce the cost of private investment
- Executive efficiency which includes bureaucratic efficiency to approve projects faster and not stunt development

There are also global or exogenous factors such as geopolitical risk, further moves in oil prices or U.S. Federal Reserve policy that could have a significant impact on India.

Q Looking ahead to 2015, why might there be a reduction in interest rates in India and how might that impact economic growth?

A Declining interest rates do not automatically translate into an improved investment environment. We have already highlighted a number of challenges facing the business environment. Implementation of reforms will be required to propel investments into physical and social infrastructure and put India on a faster growth trajectory.

Q Global investors' attention has recently focused on the declining price of oil and commodities. What impact do falling commodity prices have on India's economy?

A Because India imports almost 80% of its crude oil needs, declining oil prices should reduce India's current account deficit and contribute to the stability of its currency. India's inflation is significantly affected by oil prices and lower inflation could eventually translate into a lower cost of capital. Consumers also stand to gain with more discretionary income in their pockets, which can help fuel domestic demand.

On the corporate side, companies with pricing power can maintain higher margins in this environment. And companies with commodity-like products or services might have to pass on the benefit to consumers. At Matthews Asia, we tend to focus more on businesses with pricing power; so a correction in commodity prices may actually benefit a number of our holdings.

While the initial impact appears positive for India, there could be geopolitical consequences arising out of low oil prices that could adversely affect the country. Also, in an increasingly connected world, many oil-producing nations—sources of capital and trade partners for India—may be adversely impacted by cheap oil.

Q Is India's equity market now trading at reasonable valuations? What upside remains for investors who are still thinking about investing?

A India equity markets are trading between 18 and 19 times (trailing) price-to-earnings, slightly higher than the five- to ten-year averages. Companies that are seeing sustainable and profitable earnings growth are likely to do well over the next few years and we believe that this fundamental strength should eventually translate into solid market performance over the long term.

Q In terms of portfolio positioning, is the Matthews India Fund dependent on successful policy reform?

A The Matthews India Fund tends to favor companies that control their own destinies, where management is able to steer through macro headwinds via strong fundamentals and solid business models. Such companies do tend to benefit from growth sparked by reforms. But these companies are not necessarily uprooted if reforms do not take place. Companies that are dependent upon successful policy reforms could face disappointment, as the reform process in India is neither fast, nor institutionalized.

Q **The Matthews India Fund has a substantial allocation to small-cap companies. What makes them attractive investment opportunities?**

A Small- and mid-capitalization stocks generally trade at a discount to their larger peers—and often for good reason. These stocks can offer less transparency than large cap stocks. So there are additional elements around information discovery and evaluating the impact of market, economic, regulatory and other factors may be more challenging. Smaller companies can also have untested business models and greater corporate governance risk, which require additional stock selection effort, compared to large caps. That said our allocation is higher in small caps because we feel there are many long-term growth opportunities available at fair prices that are sometimes overlooked in this universe.

While the discount to large-caps has narrowed in the last 12 months—and a reversion to mean could very well happen in the short run—we believe these stocks stand to outperform over the long term. Small companies are often at the forefront of change as economies become more oriented towards consumption and services, and less reliant upon fixed investment and manufacturing.

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