Perspective from
Templeton Emerging Markets Equity

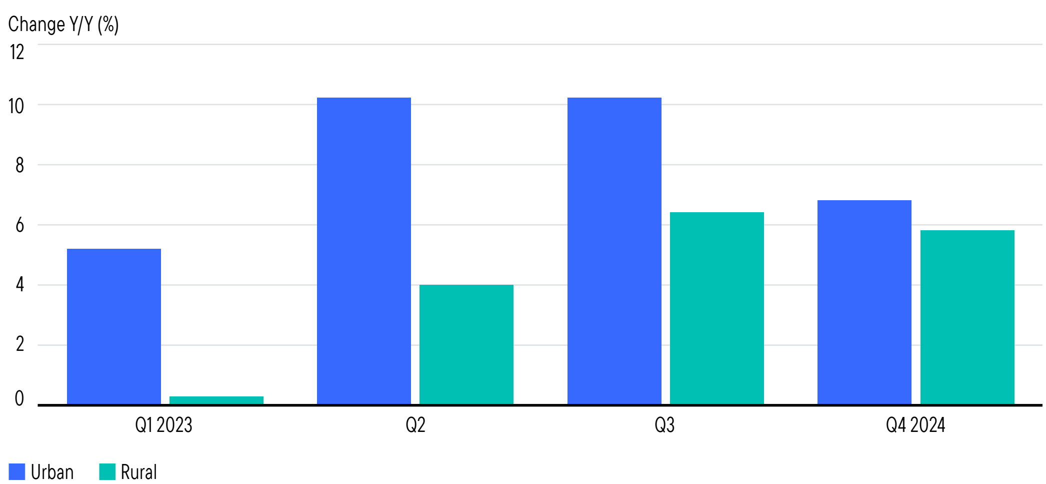
India: From K- to F-shaped consumption growth

September 2024

Recent consumption trends in India are characterized as “K-shaped”. Growth in upper income households has been surging, while growing at a slower pace in lower income households. Using urban and rural India consumption of fast-moving consumer goods (FMCG) as a proxy, urban spending increased 8.1% in 2023, while rural spending rose by 4.1%.[1] Differences in the pace of growth reflect erratic monsoons and high food inflation post COVID-19, which disproportionately impacts rural incomes.

Exhibit 1: Urban and Rural FMCG Spending Trends

As of March 6, 2024



Source: NielsenIQ. March 6, 2024. Data is in volume terms.

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The government is focused on supply side measures to boost rural and youth consumption by increasing employment and raising labor productivity. If successful, this would accelerate consumption growth among lower income households—creating an "F-shaped" consumption growth pattern.

Our portfolio managers see attractive investment opportunities in the banks, consumer discretionary and industrials sectors. This report includes individual case studies exploring the Indian consumption theme within these sectors.

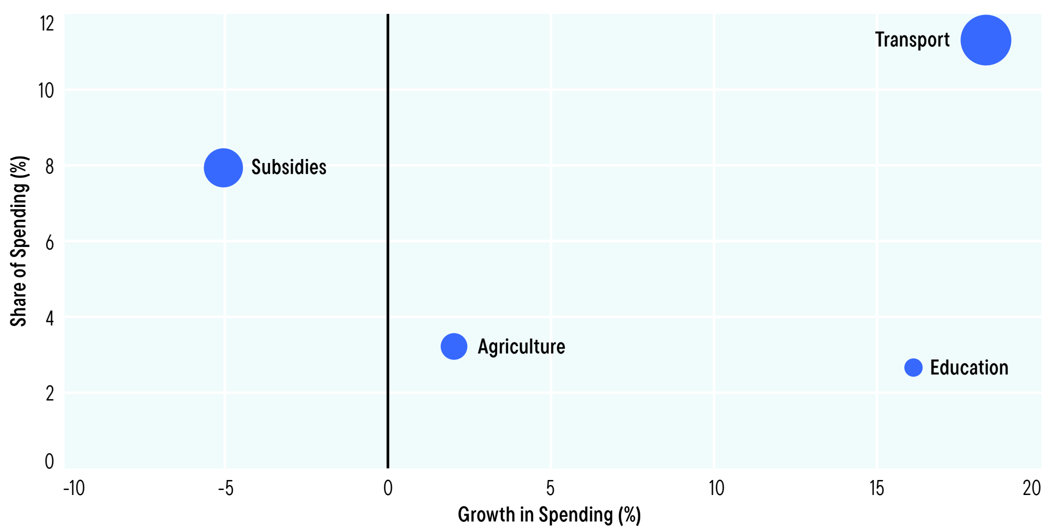
Supply-side measures

The government remains focused on supporting the rural poor, but it also recognizes that its ambitions in the manufacturing sector will need a significant increase in the availability of labor, with higher levels of education attainment and skills. There is clearly a gap between well-educated Indian university graduates, which grows—by 7.8 million every year—and the 250 million school-aged children, 75% of which leave school with only elementary education.[2]

The central government is ramping up spending on education, which will increase by 15% in fiscal year (FY) 2025.[3] This compares with an 8% increase in agriculture-related spending (excluding loan subsidies and forgiveness). Total government spending on agriculture remains slightly ahead of education, the change in focus is evident in their respective growth rates over the past four years. The former has increased 2%, while the latter has increased at 16%.[4] Nevertheless, at 2.9% of gross domestic product (GDP), India still has a distance to travel to raise spending on education (as a percentage of GDP) to levels seen in China or the developed world of 4% and 6% respectively.[5]

Exhibit 2: Growth and Share of Government Spending

As of March 6, 2024



Source: Government of India, World Bank.

To supply the rapidly expanding manufacturing sector with labor, Indian policymakers are targeting the youth population for upskilling. This is reflected in the FY25 budget, which launched four schemes to encourage companies to increase hiring with a focus on addressing supply-side shortages in education and skills. Taken together, the schemes are expected to benefit 31 million youths.

Targeting increase employability

The government announced in the budget an allocation of US$5 billion annually in loans and subsidies over five years, targeting 31 million youths for increased education attainment and a "skilling program." Most of the money will be allocated in subsidies and reimbursements to businesses for increasing employment. The schemes, which are divided between first-time employee support, job creation in manufacturing and support for employers, are highlighted in Exhibit 3.

Exhibit 3: Government Job Schemes

As of March 6, 2024

Scheme A First Timers	Scheme B Job Creation in Manufacturing	Scheme C Support to Employers
• One-month wage to new entrants in all formal sectors in three instalments up to US$180. • Expected to benefit 21 million.	• Linked to first time employees • Incentive to both employee and employer for EPFO contributions in the specified scales for the first four years. • Expected to benefit 5 million youth.	• Government will reimburse EPFO contributions of employers up to US$430 pa for two years for new hires. • Expected to generate 5 million jobs.

Source: Government of India. There is no assurance that any estimate, forecast or projection will be realized.

The alignment of course content and design relating to the needs of industry are of most significance, in our view. Prior studies[6] on Indian education highlighted weakness in course structure and design as a factor in low employability of graduates from vocational training schemes. Countries where educational institutions are willing to design courses that meet the needs of employers are successful in attracting foreign direct investment. Companies are often willing to subsidize the cost of these courses, given the benefits of a steady supply of labor with skills they are looking for.

Public and private partnerships

In the United States, Taiwan Semiconductor Manufacturing Company (TSMC) is building new semiconductor fabrication plants in Arizona with plans to hire 6,000 workers. Recognizing the skills gap, TSMC is collaborating with high schools, community colleges and universities to train students, provide apprenticeships, internships and to fund research projects.

Similar public and private education partnerships will be required in India as the government seeks to successfully attract new industries, both in advanced electronic manufacturing and electronic assembly. The FY25 budget is potentially a first step in a long-term company partnership program intended to boost the supply of skilled workers.

Investment driving growth, for now

Over time, the government's focus on supply-side policies to boost youth educational attainment is likely to have a positive effect on consumption and GDP growth. For now, investment remains the primary growth driver. The three-year average growth rate for investment ending in FY24 was 13.2%, compared to 6.9% consumption growth over the same period.[7]

Industrial production has fallen short of expectations, with the service sector leading economic growth. However, investments in manufacturing are building a solid industrial foundation. Coupled with an adequate supply of skilled workers, this foundation could foster the right conditions for a prolonged rise in consumption.

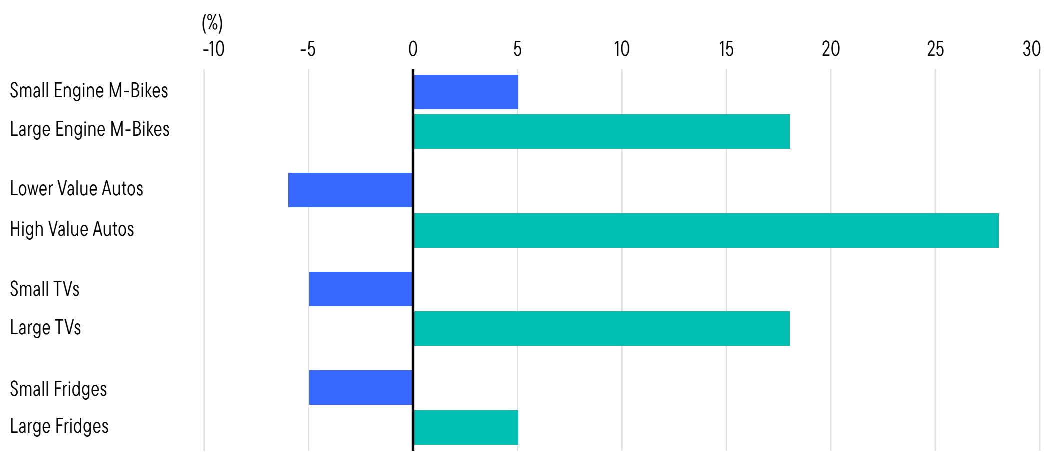
Current consumption trends

The K pattern of consumption growth in India is clearly seen in the "white-goods" market. Sales of refrigerators and televisions declined in the first half of FY24. However, within the aggregate sales number, sales of televisions with a screen size of 55 inches and above surged 18%. A similar pattern is observed for refrigerators, with American-style side by side models rising 5%.[8]

In the auto market, sales of vehicles costing more than US$12,000 rose 28% in the first half of FY24, whereas sales of vehicles below this price point declined 6%. In the motorbike segment, sales of bikes with an engine capacity above 150cc grew 18%, with those below witnessing growth of only 5%.[9]

Exhibit 4: Sales of Televisions/ Refrigerators/ Automobiles/Motorbikes

As of March 6, 2024



Source: Society of Indian Auto Manufacturers, NielsenIQ.

Part of the reason for the softness in mass consumption is weakness in rural incomes, which is a function of poor monsoons and the government's less generous support for farmers. Fiscal policy is clearly pivoting away from supporting consumption and toward supporting investment. This does not imply that the government is cutting back on support for farmers; instead, the gradual increase in support is being directed toward the industrials sector.

Future consumption trends

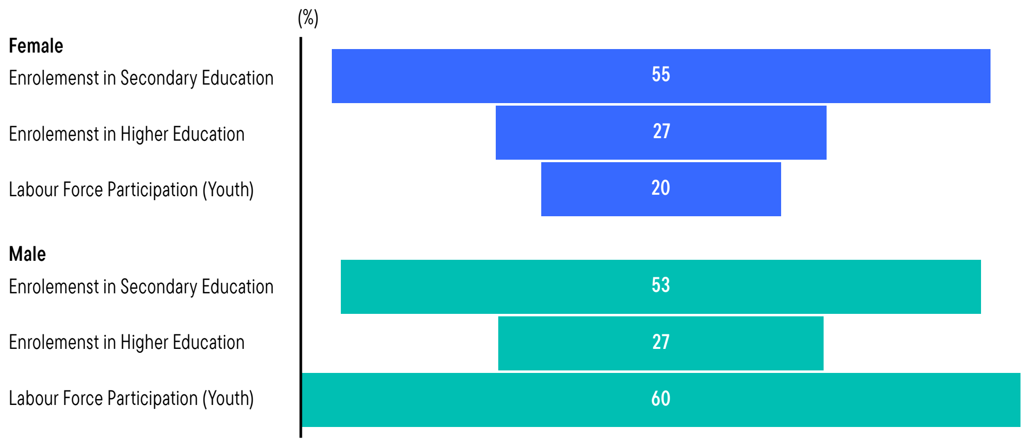
India's urban youth, which number an estimated 126 million[10] are central to changing consumption from K to F shaped. The key to fully unlocking the potential of this consumer demographic is to increase their ability to access higher paying jobs that private investment will create. However, the missing jigsaw piece we see is increasing this groups' employability through education and upskilling. Policies focused on the supply side are crucial for generating middle-income, blue-collar positions, which are expected to boost the demand for housing and escalate the consumption of white goods and automobiles.

Labor-force participation

By raising the female labor-force participation rate in India (which is very low at 20% compared to 60% for men) an additional source of untapped consumption could be realized. The opportunity to substantially increase women's incomes and consumption is evident from their educational enrollment rates, which surpass those of males. Specifically, women account for 54.6% of high school enrollments and 27.3% in colleges and universities, compared to 53% and 26.9% for males, respectively.[11] We recognize the social factors that weigh on female enrollment in high education, but believe potential upside relative to current figures remains.

Exhibit 5: Labor-Force Participation

As of March 6, 2024



Source: Ministry of statistics and program implementation: Youth in India

Tax cuts for middle-income earners

The FY25 budget targeted tax cuts and increased deductions for employees, the value of which is estimated to be US$210 per annum (pa) per salaried worker, with a focus on middle-income employees. The government also committed to subsidizing contributions to the employer provident fund amounting to US$430 pa, over two years.[12] Putting these tax cuts in context, the median salary in India's 10 largest cities in FY2024 was US$4,800 pa.[13]

The tax cuts ease the burden on middle-income earners and incentivize employers to take on new employees. These are in addition to other measures targeting support in the manufacturing sector valued at US$5 billion annually over five years.

Continued focus on production-linked incentive scheme

The government's production-linked incentive (PLI) scheme has been a success, particularly in electronics assembly. The world's largest contract manufacturer now employes over 48,000 people in India, 70% of which are women,[14] assembling mobile phones for export and the local market. It is fortuitous that the launch of the scheme in 2021 coincided with increased tariffs on Chinese exports to the United States, as well as COVID-19-related reorganization of global supply chains. While India is not the sole beneficiary of changes these events sparked, it has reaped the rewards of lower tariff access to the US market, and the ready availability of a large pool of labor. Added to this is the impact of rising incomes on consumption and PLI's, acting as a catalyst for import substitution, particularly for consumer goods.

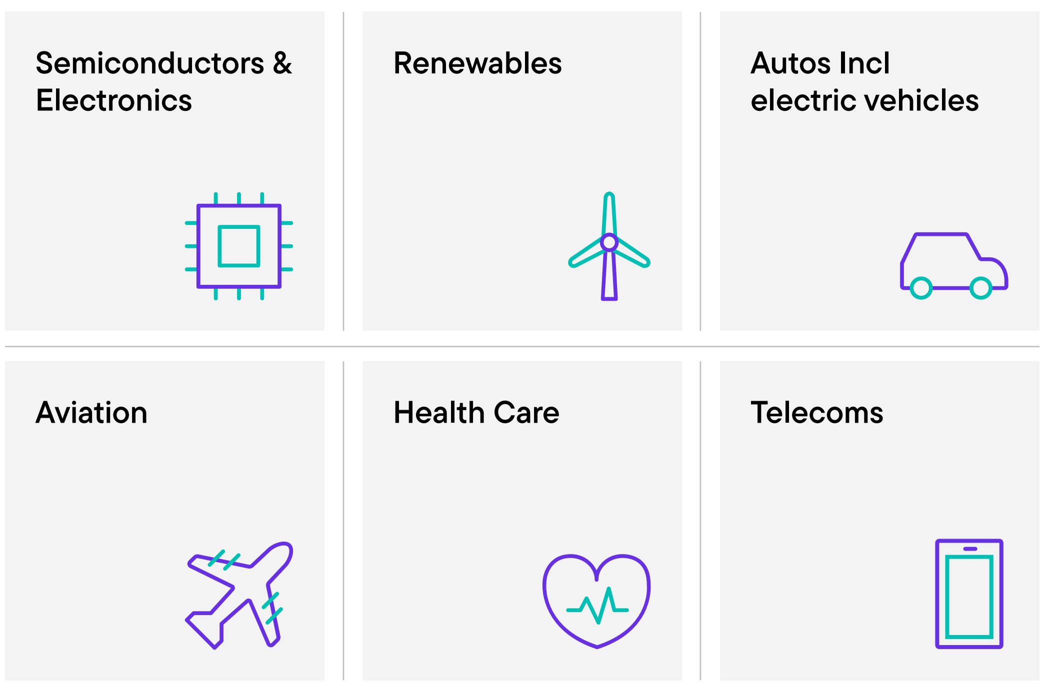
In an expansion of the PLI scheme's initial estimated value of US$40 billion,[15] the government recently increased the scheme's allocation to automobiles from US$60 million to US$400 million. The increase is targeted at encouraging local and foreign manufacturers to build new plants. In particular, those focused on electric vehicles, as auto penetration increases and the demand for higher end vehicles rises in tandem with rising urban incomes.

PLI 3.0 in 2026

The PLI scheme will expire at the end of 2025. Given its success, the government may extend the scheme a third time through the end of the decade, recalibrated to target sectors with the greatest potential for growth and employment. These are likely to include semiconductors, automobiles, renewables and health care. The potential absence of sectors such as petrochemicals, telecoms and aviation from any new scheme reflects the ability of these sectors to perform without government support. Nevertheless, we note that these views are based on assumptions that could change by the time PLI 3.0 is rolled out.

Exhibit 6: Production Linked Incentives (PLI) 3.0

As of March 6, 2024



Source: Government of India.

Sector implications

MSCI India earnings growth in 2024 is almost double the emerging market (EM) average of 30%, and on par with 2025 at 16%.[16] Relative to the concentration of the incremental change in earnings growth in the industrials and energy sectors in 2024, growth is forecast to be more broad-based next year. Our portfolio managers continue to find particularly attractive investment opportunities in the banks, consumer discretionary and industrials sectors.

Banks

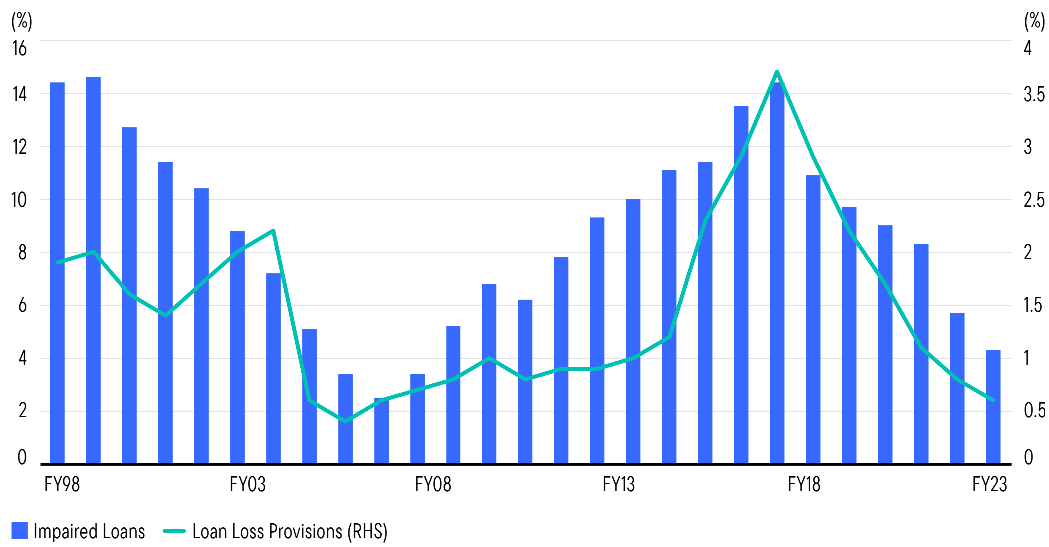
Banks remain a preferred sector for us to leverage the growth opportunity in India. Earnings for bank stocks in our coverage universe are expected to increase in the high single digits in 2024/2025.[17] Competition for deposits among banks is creating some pressure on net interest margins (NIMs), which are likely to reach a cycle low in 2025 and bounce back in 2026.

Demand for consumer loans is healthy, but differs by segment. Passenger auto demand is stronger at the premium end of the market, and softer in the mass market segment. Motorbike sales continue to recover from a low base. Sales of motorbikes with higher capacities are growing faster than lower engine capacity.[18]

The guidance the Reserve Bank of India issued in November 2023 involved raising risk weights for unsecured retail loans and loans to non-bank financial companies, which has effectively ensured that the growth of consumer credit remains controlled. However, current loan loss provisions as a percentage of loans is low, as highlighted in Exhibit 7. As we may be near the cycle low for credit costs, some normalization on the upside is likely in FY25.

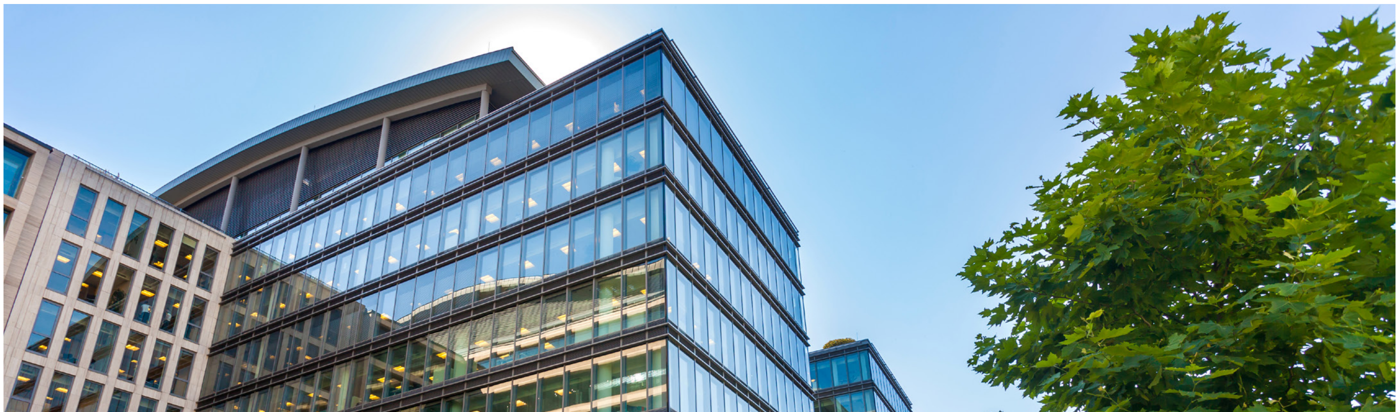
Exhibit 7: Impaired Loans and Loan Loss Provisions

As of March 6, 2024



Source: Reserve Bank of India.

Price-to-book valuations among Indian banks are at discounts to historical averages, excluding one of the largest private sector banks, which trade at a premium. We see the potential for positive medium-term returns driven by a combination of compounding earnings and valuation re-rating. We expect healthy returns on equity to sustain, potentially supported by increased leverage in the sector.



Case study:
HDFC Bank

HDFC Bank is India's largest private sector bank by loans, and is one of the fastest-growing large banks with consistent market share gains and strong asset quality. The bank is a leader among Indian private sector banks, with one of the strongest deposit franchises.

Business breakdown

The merged business of HDFC Bank and HDFC Ltd. is dominated by the core banking business of receiving deposits and making loans, accounting for 90% of our estimate of fair value. Businesses accounting for the remaining 10% include: HDFC Life, HDFC Securities, HDB Financial, HDFC Asset Management and HDFC ERGO insurance.

The opportunity

Cross selling. The banks online home loan platform is designed to create an end-to-end digital journey. After completing this journey, customers are prompted to input up to four data points, which will then generate product suggestions including opening a savings account, obtaining a credit card, or applying for a consumer loan, as well as non–lending products, with necessary personal details pre-filled.

Growth

The proven strength of the banks franchise indicates it will likely continue gaining market share over the medium-term, in our view. This is reflected in the bank maintaining 18-20% incremental share in deposit gathering. A gradual normalization in NIMs and better branch productivity are likely to improve returns over the medium-term, in our view.

Execution

The key to improving HDFC Bank NIMs will be replacing higher cost HDFC Ltd deposits with lower cost HSFC Bank deposits, initially with bonds or time deposits and eventually with current and savings accounts. Given that some of HDFC Ltd. deposits are longer-tenure, the pace of replacement with lower-cost short-term deposits is likely to be gradual, but clear progress is expected in FY25.

Risks

There are concerns about the sustainability of growth, given the near-term challenge of growing incremental deposit at a pace that is significantly faster than the industry average. Failure to increase NIMs to a level in line with peers is a risk to profitability.

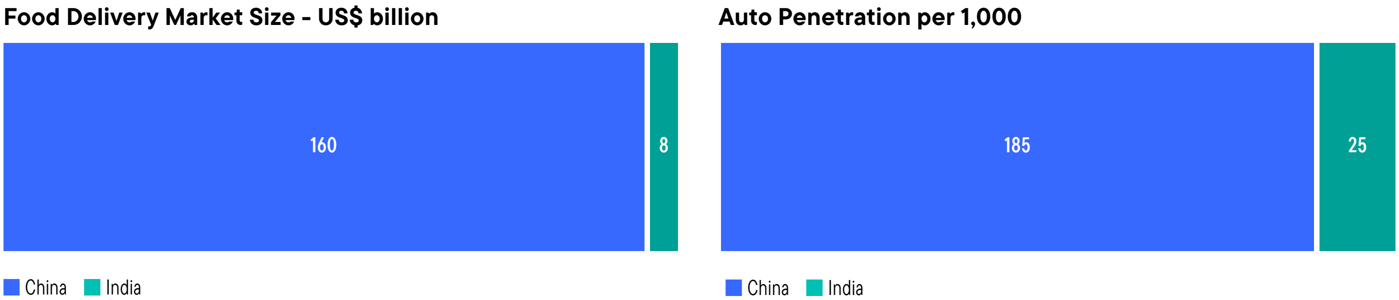
Consumer discretionary

Reflecting our positive view on the outlook for consumption, we strongly favor the consumer discretionary sector in our India strategy. We are particularly positive on companies servicing the food delivery and quick commerce segment in India, which are witnessing rapid growth reflecting the increased spending power of India's urban youth.

Food delivery represents a significant investment opportunity in India, with a current market size of US$8 billion vs. US$160 billion in China.[19]

Quick commerce also represents a significant opportunity for investors given the under-penetration of organized retail. The service offers consumers a high level of convenience given the 10-minute delivery target in urban areas. The Indian grocery retail market size is estimated to be US$450 billion,[20] and quick commerce has the potential to capture a significant portion of this market—focusing on a higher convenience, wider stock selection and lower costs relative to the smaller unorganized traditional stores. In addition, quick commerce also has scope to capture part of the e-commerce market in India, which is estimated to be US$112 billion.[21]

Exhibit 8: Estimated India and China Market Sizes



Source: Mordor Intelligence. There is no assurance that any projection, estimate or forecast will be realized.

We are also positive on the travel and leisure industries and have investments in hotel and online travel agency businesses. Luxury retail is an industry grou.p where we have selective exposure, and we may benefit from the reductions on gold and silver duty to 6% from 15%—announced in the FY25 budget.

We are positive on the long-term outlook for auto sales in India, noting that auto penetration is below emerging market peers at 25 cars per 1,000 people, compared to 82 in Indonesia and 185 in China.[22] Nevertheless, we maintain a selective approach to investing in the auto sector, focusing on industry leaders with upside potential as opposed to a cross-section of companies.

India is witnessing a growing shift toward consumerism and premiumization, evident in urban consumers' preference for higher-priced goods and services. This trend is putting pressure on companies in the personal care sector that have traditionally focused on offering low-priced, single-serve packaged goods.

In our view, the promising demographics and increased spending capacity of 126 million urban youth, fueled by enhanced educational achievements and better job prospects, are likely to boost demand for premium goods and services.

Case study:
Zomato

Zomato is a leading food delivery and quick commerce platform in India. Founded in 2008 as a restaurant listings platform, the company has since built a successful e-commerce business focused on online food delivery, quick-commerce and business-to-business food supplies.

The opportunity

The company has built a dominant market position and is well placed to expand into adjacent businesses. It has launched numerous apps and has shown a willingness to scale up and down depending on the success of new businesses and their likely path to profitability. District is one such app which caters to entertainment opportunities in users' geographic areas.

Growth

The Indian retail market is valued at US$ 1.1 trillion and is projected to expand by 13% compound annual growth rate (CAGR) between 2022 and 2027.[23] Given food delivery is currently valued at US$8 billion, there is a long runway of growth in food delivery, in our view. Quick delivery and the Hyperpure business-to-business food supply is an additional growth opportunity.

Execution

Zomato has a strong execution track record and has integrated the acquisition of a rival at pace. It has also demonstrated track record in creating new opportunities with existing assets, as reflected in using Blinkit warehouses to carry stock for the hyperlocal business.

There is a clear network effect across food delivery, quick commerce and hyperlocal delivery. Zomato has proven capabilities in establishing and scaling up new businesses. There has been a significant improvement in profitability and cashflows over last 12 months, and the company has a strong balance sheet with over US$1 billion in cash.

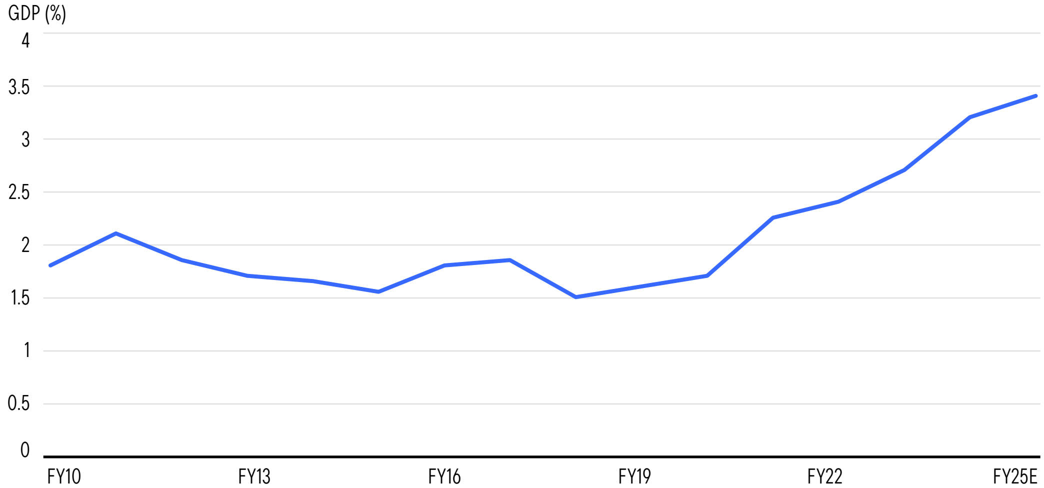
Risks

Competition is likely to increase as more companies enter the market. There is a risk of regulatory intervention if local retailers suffer a significant loss of business and source of employment. Quick commerce does not offer the touch and feel experience of physical shopping. Food delivery and quick commerce are reliant on delivery drivers, which may lobby for higher delivery fees.

Industrials

The outlook for the industrials sector is one of change, with an increased focus on manufacturing as the India capital expenditure (capex) cycle slows, due in part to rapid growth in prior years. Capex as a percentage of GDP almost doubled from 1.7% in FY20 to 3.2% in FY24. The government's support of high value-added manufacturing via the PLI scheme, and the trend for supply-chain diversification continues to create investment opportunities in infrastructure.

Exhibit 9: Indian Capital Expenditure as a % of GDP



Source: Government of India.

We find attractive investment opportunities among companies benefiting from the structural rise in capex in recent years, as well as those related to the supply of electrical equipment providing the power to drive the ramp up in manufacturing output. We prefer companies providing power equipment and related support services—as opposed to power generators given the uncertainty around the long-term take off agreements and revenue required to support these projects.

The industrials sector has the potential to act as a significant source of employment growth in the coming years, and in turn a source of income to drive the F-shaped consumption pattern we view as the key to sustained growth in India.

Conclusion

With investment growth likely to plateau following double-digit CAGR over past five years, consumption has taken on renewed importance as a growth driver in India.

The recent K-shaped pattern of consumption growth, with surging growth in upper income households, contrasting with a slower pace of growth in lower income households, needs to broaden to F-shaped, in our view. The government is focused on supply-side measures to boost labor productivity and raise incomes to achieve this. The focus is on providing incentives to companies to hire and train more workers and raising the educational attainment among the youth population.

We see the potential for a PLI 3.0 scheme in 2026 given the success of the first two versions. The government may recalibrate it to target those sectors with the greatest potential for growth and employment.

Within the India market, our portfolio managers continue find particularly attractive investment opportunities in the banks, consumer discretionary and industrials sectors. Our on-the-ground presence and extensive coverage of local companies represents a clear competitive advantage in researching these new trends and identifying individual company beneficiaries trading at a discount to intrinsic worth.

Endnotes

1. Source: "India's FMCG market remains resilient and is poised for growth in 2024." NielsenIQ. March 6, 2024.
2. Source: National institute for education planning & administration.
3. Source: India Budget.
4. Ibid.
5. Source: World Bank Group. US data used as a proxy for developed world.
6. Source: World Bank: Education in India 2011
7. Source: MoSPI June 1, 2024
8. Source: Society of Indian Auto Manufacturers. June 1, 2024.
9. Ibid
10. Those aged between 15-29. Based on an urbanization rate of 36.6% and youth population of 345 million. Source: India demographics 2024, worldometer.com.
11. Source: Ministry of statistics and program implementation: Youth in India 2022.
12. Source: Government of India.
13. Source: Payscale.com.
14. Source: Hon Hai Precision Industry.
15. Source: Government of India (includes semiconductor grants of US$10 billion).
16. Source: MSCI, Bloomberg. August 15, 2024.
17. Source: Franklin Templeton.
18. Ibid.
19. Source: Statista.
20. Ibid.
21. Source: Mordor Intelligence.
22. Source: CRISIL mobility report, ANATRA.
23. Source: Globaldata. There is no assurance that any projection, estimate or forecast will be realized.

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