SHORE CAPITAL
CAPITAL MARKETS

Investment Funds | Issuer Sponsored | 22 July 2019

House Stock
Current price 82p

Fund in the spotlight: IGC

IGC

Figure 1: IGC NAV performance

Source: Company Data, Morningstar

Code	IGC
NAV	97.4
Discount	14%
Mkt Cap	£93.8m
As at 17 July 2019	

India Capital Growth Fund +

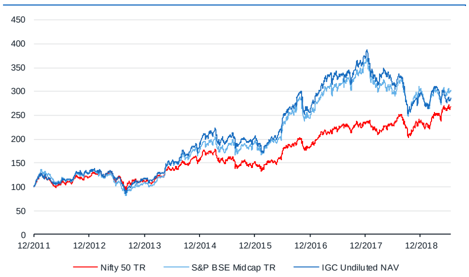
Capitalise on secular growth

The re-election of the NDA led by Narendra Modi sets the stage for continuity of policy and implementation of further reforms. While the Indian economy faces short-term headwinds, the secular growth prospects justify higher valuations. Gaurav Narain, the portfolio advisor of India Capital Growth Fund (IGC), believes that IGC's portfolio of mid-cap stocks is well positioned to benefit from India's growth. The underlying aggregate portfolio earnings for IGC have compounded at 22% in INR terms since FY 2015 and Narain expects earnings for portfolio companies to grow by 27% this year. While recent performance has been relatively weak, the valuations of portfolio companies are at a level, where IGC has typically outperformed large-cap indices such as the Nifty, in the past.

Mid-cap stocks recent underperformance creates an opportunity

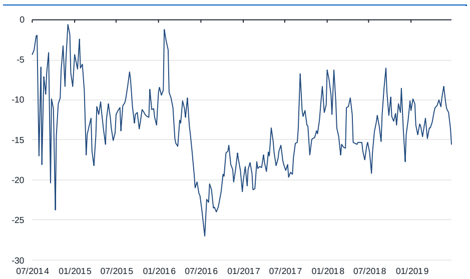
Over the last five years, the S&P BSE MidCap Index delivered an annualised total return of 15.2% vis-a-vis annualised total returns of 14.6% for the large cap Nifty Index. In 2018 and 2019 mid and small cap stocks in India have underperformed the large cap index significantly. Consequently, valuations of mid-cap stocks are now at levels, which are well below their long-term average valuation. The Indian economy faces significant headwinds in the short-term but given the long-term growth prospects investors are likely to be rewarded for gradually increasing their exposure to mid-cap stocks in India.

Figure 2: IGC NAV Performance



Source: Company Data, Morningstar

Figure 3: IGC Discount



Source: Bloomberg

IGC's long-term record impacted by a period of poor performance

The annualised return for the diluted NAV for IGC has been 9.7% over the last five years, while the undiluted NAV performance, which is a better measure of returns for long term shareholders, has been 13% (All figures in GBp terms). The recent underperformance of IGC creates a long-term opportunity, in our opinion, with the portfolio trading at a steep discount, in terms of valuations, to the MidCap Index, despite stronger earnings growth prospects. Narain believes that infrastructure spending by the government should help restart a capex cycle and boost India's long-term economic growth potential. With muted inflationary pressures, declining interest rates should help that process.

Research analyst

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India Capital Growth Fund+ (IGC)

Conference call with IGC at 12pm on Tuesday 23 July 2019

Stock specific issues have caused near term performance to dip. Longer term performance remains robust, whilst outlook on India suggests an opportunity emerging. We will be hosting a conference call with Gaurav Narain, portfolio advisor to IGC, to talk about the stock specific issues and the emerging opportunity at **12 noon, on Tuesday 23 July 2019.**

Dial in- details are provided below

We will be using LoopUp for the call

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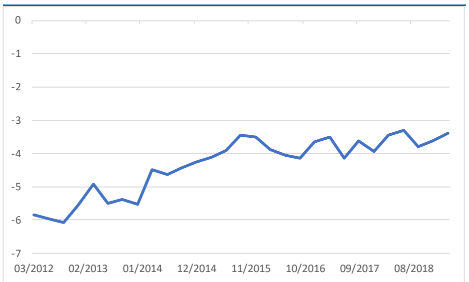
A growth-focused portfolio

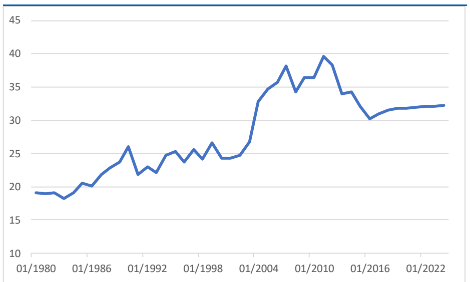
While the Indian economy has slowed down, equity markets tend to be forward looking. We believe the economy is likely to get a major investment boost as the focus on improving India's infrastructure continues without any disruption. Prime Minister Narendra Modi's Bharatiya Janata Party has pledged cash handouts to farmers, investment to build roads, railways and other infrastructure. The focus will be to boost manufacturing significantly increase India's exports. The government continues to show a desire to keep the federal budget deficit under control though the overall fiscal condition remains somewhat fragile.

Figure 4: India Budget Balance (% GDP)



Source: Bloomberg

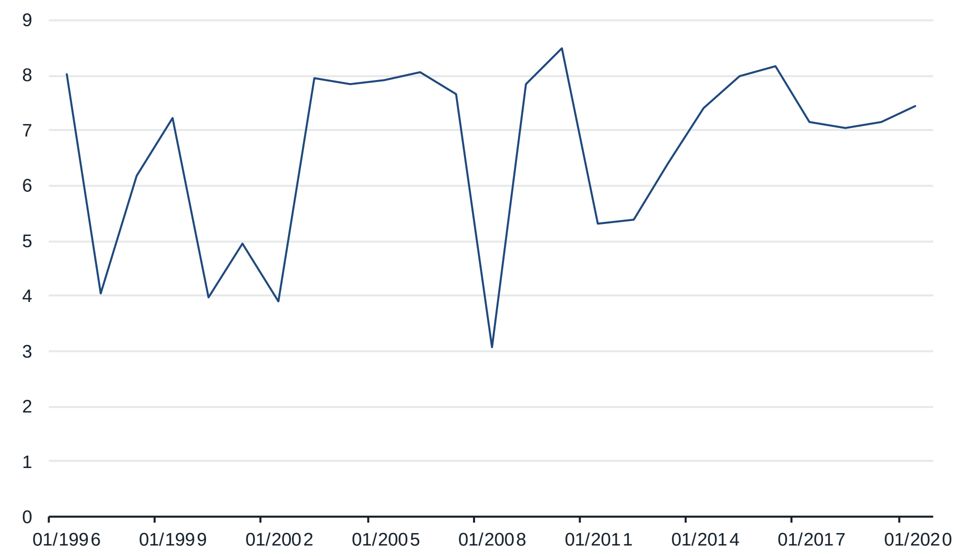
Figure 5: India Investment as % of GDP



Source: IMF

Although India's economic growth has slowed down recently, we believe that this can be partly attributed to the structural changes that have been introduced in the Indian economy such as the introduction of the Goods and Services Tax (GST). Demonetisation was another headwind which have affected growth. In addition, the banking sector has been trying to come to grips with the issue of non-performing loans for which provisioning in the past had been inadequate.

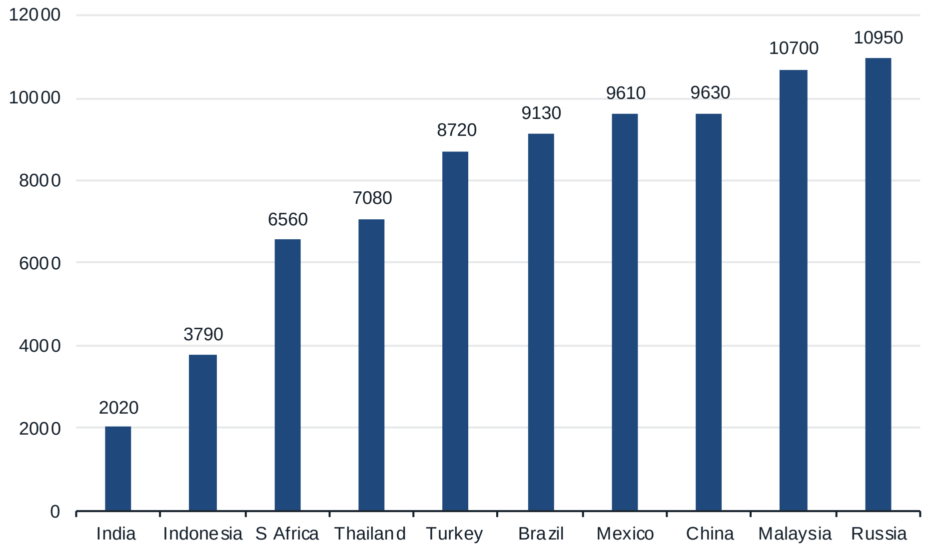
Figure 6: OECD Economic outlook India GDP Growth (%, YoY)



Source: Organisation for Economic Co-operation and Development (OECD)

All of these have caused GDP growth to decline but the OECD does expect the Indian economy to re-accelerate. Capacity utilisation is running at a level where we expect the investment cycle to accelerate. As we can see in figure 6, India's per capita GDP is at a level where it should continue to experience robust growth over the next several decades.

Figure 7: Emerging Market per capita GDP (US$, 2018)



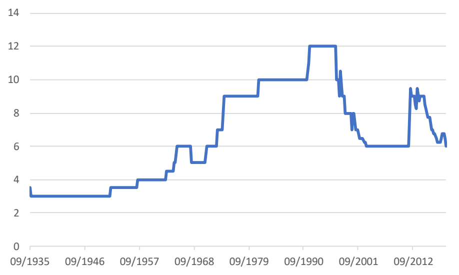
Source: IMF

There has been a structural decline in the inflationary pressures facing the Indian economy as well. We believe that the decline in inflationary pressures will allow the Reserve Bank of India (RBI) to decrease interest rates substantially, supporting economic growth and boosting the attractiveness of Indian equities, especially for domestic investors

Figure 8: India Combined CPI (YoY, %)

Source: Central Statistics Office, India

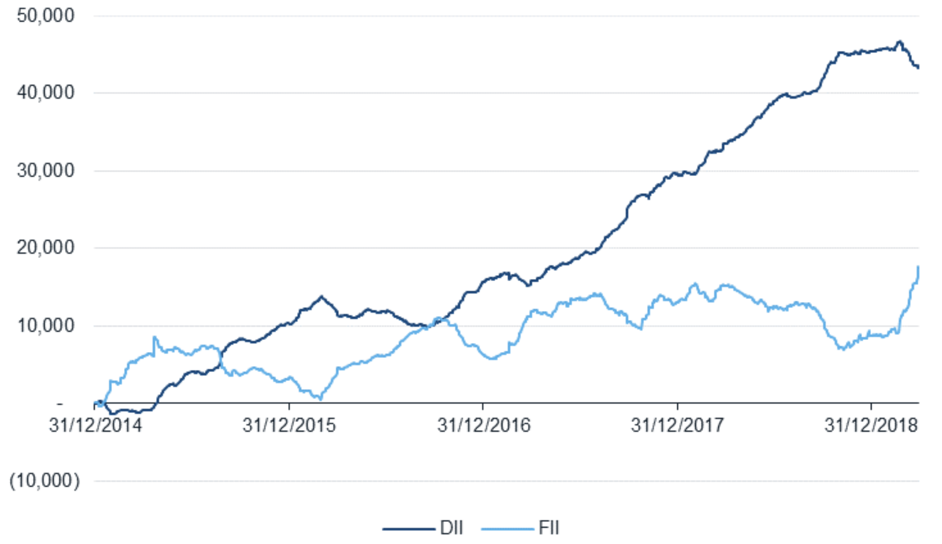
Figure 9: RBI Bank Rate (%)



Source: Reserve Bank of India

Indian equity markets are trading at a substantially higher valuation than other emerging markets. We would argue that this comparison is somewhat misleading, given the composition of India's indices. In addition, India is a capital-controlled economy and relative valuations vis-à-vis other emerging markets is somewhat irrelevant for the domestic investor. We believe the domestic flows into equity mutual funds are likely to remain strong. Following the introduction of the Real Estate Regulation Act (RERA) the incentive to speculate in real estate has been significantly diminished. The government is discouraging investment into assets like gold. The reduction in interest rates will cause domestic investors in India to further pivot towards equities. This implies that while Indian equity markets are more vulnerable to downside risks from a relative valuation perspective, the buy on the dip mentality that has now been ingrained into the Indian domestic investor is likely to create relatively shallow corrections unless this is conviction of the domestic retail investor is shaken.

Figure 10: Foreign (FII) and domestic (DII) incremental fund flows (US$m)



Source: Ocean Dial

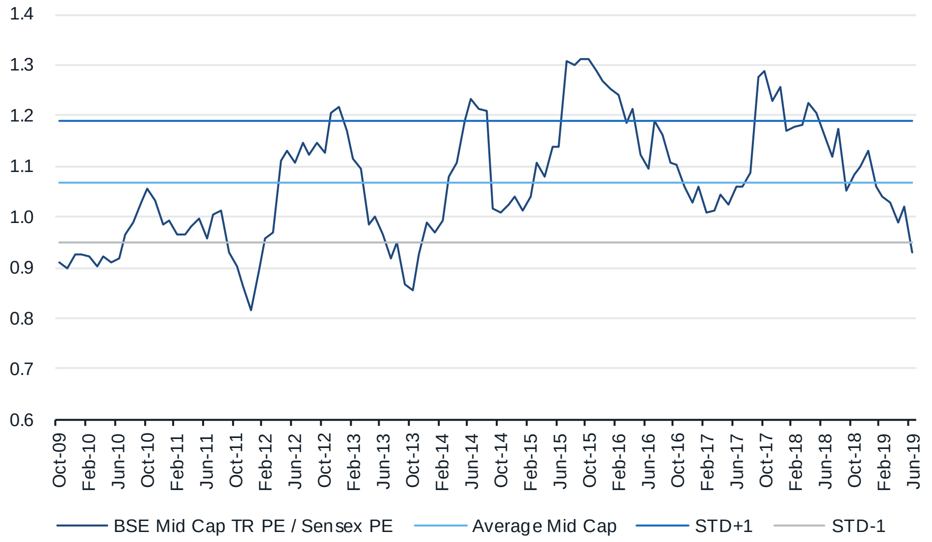
Post a surge in in 2017, valuations for mid and small cap stocks tumbled in 2018. As of the end of June 2019, all the excess performance that had been generated by the BSE MidCap Index vis-à-vis the BSE 30 Sensex since the beginning of 2015 had been eroded.

Figure 11: Large Cap stocks vs. Mid Cap Stocks (Relative performance)

Source: Ocean Dial

While Narain was cautious about valuations the fund is run on a fully-invested basis. Thus, the level of cash in the portfolio rarely tends to exceed 5% of net assets, though the cash level as at the end of June 2019 was at 7.3%. While he is keen to add to several of IGC's holdings he is conscious about the short-term macro-economic headwinds as well.

Figure 12: BSE MidCap current year PE / BSE Sensex current year PE



Source: Bloomberg, Ocean Dial

Based on analyst expectations the S&P BSE MidCap Index is trading at 22x June 2019 earnings and 17.3x Dec 2019 earnings. While the earnings growth trajectory for the second half of 2019 may be somewhat optimistic, it is clear that the premium that the midcap stocks were trading at has disappeared. Historically, there have been periods where the midcap index has traded at a discount to the large cap index, we believe that over the medium to long-term we should see better performance from the midcap index. Over the last ten years, the total returns from the midcap index has been slightly higher than that of the large cap index.

The financial sector in India is under stress despite high overall levels of liquidity. The concerns about IL&FS and related companies has had a negative impact on infrastructure lending and the overall NBFC sector. As public sector banks had been struggling for the past few years to address the issue of NPLs on their books, NBFCs were a major source of funding for a number of sectors including real estate.

The liquidity concerns have further curbed lending and investments have slowed as a consequence. This is likely to lead to GDP growth slowing to c.6.5% as per latest estimates. Narain believes that the reforms instituted by the Modi government and previous governments have laid the foundation for a higher rate of growth, in the medium to long-term. In order to reap a demographic dividend India needs to continue the process of investing in human capital and infrastructure. He believes that the re-election of the BJP introduces a significant degree of certainty in the decision making process. While Narain believes that investment in infrastructure and manufacturing is likely to be one of the key areas of focus of the BJP government he is still careful about direct exposure to the infrastructure sector choosing instead to use select cement manufacturers and other sectors to benefit from this investment in infrastructure.

With an entrepreneurial culture, strong bench strength in managerial talent and a broad range of investible sectors many of which are globally competitive, mid-cap stocks in India are the ideal hunting ground to create a portfolio of companies that Narain refers to as 'compounding machines'.

Narain has been involved with the fund since October 2011. The fund looks to invest predominantly in mid-cap companies that operate in markets where they can defend and grow their earnings and translate these into cash returns on investment. The team, led by David Cornell, the CIO at Ocean Dial Asset Management, has instituted a strong focus on liquidity that should allow the fund to exit positions quickly should the fundamentals deteriorate. In practice, turnover is low (13% per annum since 2013) as most of the 30-40 stocks that constitute the portfolio have tended to be "compounding machines", delivering consistent long-term earnings growth. The team tends to use cash flow models for companies, which generally go back as far as ten years, and typically monitors about 300 names.

The portfolio is entirely driven by bottom-up stock selection. Thus, the sector representation in the fund is a derivative of the stock selection process. Equally, as part of the risk management process the team will limit aggregate exposure to any given industry. The management team will typically use downside volatility to exploit irrational behaviour. While valuations tend to be significantly higher than those typically encountered in an emerging market portfolio, Narain believes that this can be justified by the quality of the companies in the portfolio and the long-term sustainability of the businesses. He is happy to pay higher multiples where he has reasonable visibility on earnings that might grow significantly.

Figure 13: IGC Top Ten Holdings P/E , P/ABV and % earnings growth as at 30 June 2019

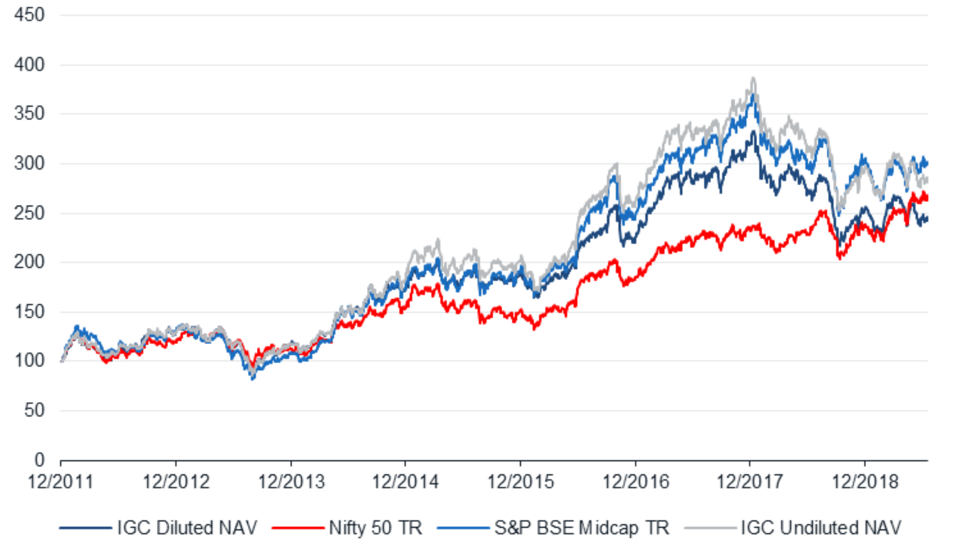
Portfolio Company	% of Portfolio	P/E FY20e	P/E FY21e	P/ABV FY20e	P/ABV FY21e	% Earnings Growth FY20e	% Earnings Growth FY21e
Federal Bank	5.7	13.1	10.4	1.5	1.3	31.6	26.3
City Union Bank	5.2	20.3	17.2	2.9	2.5	12.4	18.2
Tech Mahindra	4.7	13.5	12.2	2.7	2.4	8.1	10.8
NIIT Technologies	4.5	17	14.8	3.5	3	19.5	14.7
Kajaria Ceramics	4.0	30.9	25.1	5.4	4.7	34.3	22.9
PI Industries	3.9	31	25.2	6	5	27.5	23.1
Divi's Laboratories	3.6	27.8	23.8	5.3	4.6	14.5	16.9
Jyothy Laboratories	3.5	26	22.2	4.1	3.8	9.4	17.0
Berger Paints India	3.3	48.8	40.7	11	9.6	26.8	20.0
IDFC Bank	3.2	27.2	22.1	1.1	1.1	N/A*	22.6
Portfolio Average		**15.7**	**12.5**	**1.9**	**1.7**	**27.2**	**25.3**
BSE MidCap Index (INR)		18.0	15.5	2.4	2.1	25.4	5.3
BSE SmallCap Index (INR)		15.5	13.2	2.2	1.9	3.2	18.0

Source: Company Data; Shore Capital Markets, IDFC Bank earnings growth NA due to impact of merger

NAV Performance of IGC

In order to analyse the performance of IGC we believe that we need to look at the undiluted NAV performance of IGC. The difference between diluted and undiluted performance occurs as a consequence of a historic subscription share issue in IGC, which was concluded in 2016 and does not impact long-term shareholder total returns. We observe that since December 2011, IGC and the BSE MidCap Index have outperformed the large cap index. However, since December 2017, IGC and the MidCap Index have underperformed the large cap index substantially. We would note that despite the underperformance since 2017, the undiluted performance of IGC is still better than that of the large-cap index.

Figure 14: NAV Performance of IGC, BSE MidCap Index and Nifty Index



Source: Company Data, Morningstar, Shore Capital estimates

While stock specific issues have been part of the problem, the portfolio itself has been de-rated substantially and now offers an interesting risk reward proposition, in our opinion. IGC's portfolio consists of a combination of small and mid-cap stocks. Since the beginning of the year, several of the long-term holdings of IGC have come under pressure, even though the fundamental investment thesis remained intact in these companies.

We have been in regular contact with Narain and the team at Ocean Dial about the issues with the individual companies. In our opinion, the investment management process remains robust and the long-term opportunity is extremely attractive.

Figure 15: IGC and peer group mkt cap (£m), gearing, discount, NAV TR performance (%)

	Mkt Cap	Net Gearing	Discount	1 Year	3 Year	5 Year
Aberdeen New India (ANII)	306.6	104	-9.5	5.4	33.3	99.4
Ashoka India Equity (AIE)	62.1	99	4.2	9.7		
IGC (Diluted)	93.4	95	-13.4	-9.8	11.4	58.8
IGC (undiluted)	93.4	95	-13.4	-9.8	13.4	84.2
JPMorgan Indian (JII)	813.6	102	-9.5	4.5	23.9	82.5

As at 17 July 2019, Source: Morningstar, Ocean Dial, Shore Capital calculations

Recent performance detractors in the portfolio include stocks like J&K Bank (JKBK IN), Yes Bank (YES IN), Jain Irrigation (JI IN) and Manpasand Beverages (MANB IN). In a couple of these cases there have been instances of fraud, while in others like JI and YES, the NBFC crisis has had a major role.

At MANB the auditor had resigned in 2018, which caused a sharp decline in the share price. Subsequently, individuals closely associated with the founder of the company have been arrested for evading some of the taxes that MANB was supposed to be paying. The newly appointed auditor has resigned as well leaving the company in a precarious position. The shareholder register of the company included a private equity investor as well as other institutional investors and Narain has been in touch with them about how to bolster the prospects for the company. Narain believes that the franchise remains strong and there is a reasonable probability that the company is acquired given its brands.

Figure 16: MANB share price

Source: Bloomberg

Figure 17: Jain Irrigation (JI IN) share price

Source: Bloomberg

Jain Irrigation (JI IN) is India's largest micro irrigation company and one of the largest food processing companies (onion dehydration/mango processing). It also has a large pipes business which is used for micro irrigation as well as water irrigation. The micro irrigation and food processing businesses are working capital intensive. Despite this, JI has been focussed on deleveraging with its net Debt/EBIDTA reducing from 4.3x in FY16, to 3.7x in FY18, and working capital reducing from 148 days to 125 days in FY18. The net debt/ EBIDTA was expected to reduce further to 3x in FY19. However, due to the recent elections the working capital requirements increased to 145 days and consequently net debt/EBDITA increased to 5x, which was disappointing. JI has been a long-term holding in the fund but the disappointment in the results had led Narain to consider reducing his position.

However, the share price has already fallen substantially as a consequence of the liquidity crisis across the economy, which has been triggered by the default of a non-bank finance company (NBFC). The liquidity crunch shows no signs of abating as fixed income funds saw significant outflows in June 2019, as Dewan Housing Finance Ltd (DEWH IN), delayed debt payments in June. Many of the NBFCs had lent to unlisted Indian business houses with share pledges of their main listed entities as collateral. As a result, shares of all companies where there are high promoter pledges have been falling as there are fears that these NBFCs will invoke their pledges and sell in the market. JI is one of several holdings in the IGC portfolio which has been affected by the concerns about pledges by the promoters.

Figure 18: JKBK Share price

Source: Bloomberg

Figure 19: Yes Bank (YES IN) share price

Source: Bloomberg

YES suffered an initial decline when the Reserve Bank of India (RBI) decided not to extend the tenure of the CEO Rana Kapoor as there was a divergence between the Bank's disclosure of NPAs and the regulator's assessment of its asset quality. YES subsequently recruited the ex-Head of Deutsche Bank in India as its new CEO and also revamped its Board. Recently the market has become concerned about the bank's exposure to the NBFC sector and the stock trades at a discount to book value. Narain believes that YES is looking attractive at a discount to book value and may add to the position.

In the case of JKBK, senior management has been changed following accusations of impropriety. The majority shareholder is the state government and new management has been put in place. This bank is critical to the economic progress of the state of Jammu and Kashmir. While the bank now trades at 0.33x historic book value, investors are cautious as the new management may write off several loans, impacting book value. Narain remains confident that while these issues may impact the company in the short-term, the long-term strength of the franchise and the valuation of the company makes this a compelling long-term investment opportunity.

While the fundamentals have deteriorated in some of the cases mentioned earlier, Narain attributes a large portion of the decline in the NAV since the beginning of the year to sharp falls in the price of several other companies in the portfolio which have been held in the portfolio for a long time and where the fundamental investment thesis remains unchanged. In several of these cases the fear of pledged shares of the promoter of the company acting as an overhang on the share price has been the culprit. In other cases, it has been the lack of liquidity combined with a forced seller. Narain believes that as the NBFC crisis eases, we should see the share prices of these companies recover and broader sentiment in the mid-cap space improve. On a portfolio level, Narain believes that most of the companies are poised to witness significant growth in earnings.

Several other companies in the portfolio have been consolidating for a while and are showing signs of breaking out. For example, PI Industries (PI IN), which a leading agrochemical company in India, has been in the portfolio since 2013 has had a period of strong growth. The two main lines of business are domestic agrochemicals and custom synthesis and manufacturing business. In the last three years growth has been subdued due to an inventory glut in global agrochemicals. However, the company has added several new molecules during that period and these are now driving strong growth and the company has a robust product pipeline. PI trades at 31x March 2020 consensus earnings estimates.

Figure 20: PI IN Share price (INR)

Source: Bloomberg

Figure 21: NITEC IN Share price (INR)

Source: Bloomberg

Another company that entered the portfolio in 2013, NIIT Technologies (NITEC IN), has been a strong performer. A midcap IT services company based on niche sectors of travel & transportation as well as non-life insurance, it competes effectively with the tier -1 players in its focused verticals. A new CEO has revitalised the sales engine. The restructuring of sales has positively impacted deal wins. NITEC trades at 17x current year (FY2020) earnings estimates as per Bloomberg estimates.

As discussed earlier, several of IGC's holdings have been negatively impacted because of the de-rating of companies where the founders had pledged their shares. This has led to the portfolio itself getting de-rated even though the fundamentals for most of the companies in the portfolio remain relatively robust. Narain estimates that the average stock in the portfolio was trading at 20x March 2019 earnings estimates. The average P/E for the portfolio, based on March 2020 earnings estimates was 15.7x as at the end of June 2019.

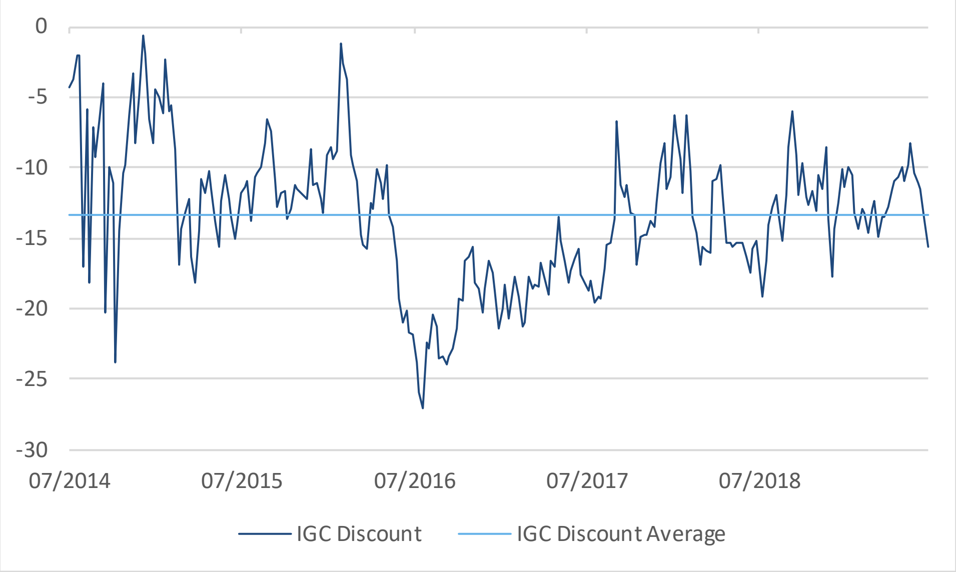
Narain is confident that companies in the portfolio are poised to witness substantial earnings growth in the next twenty-four months. As at 31 May 2019, the underlying aggregate portfolio earnings have compounded at c.22% in INR terms since FY 2015. Narain expects this to improve to 27% for the current financial year before declining to 25% for the financial year ending March 2021.

IGC's portfolio is trading at an attractive multiple and should the projected earnings growth materialise, we would expect IGC to significantly outperform the mid and large cap indices. IGC has been negatively impacted by several one-off negative shocks. The management of IGC believes that it is unlikely that we will see a similar situation being repeated and would expect the NAV of the portfolio to track or exceed earnings growth in the portfolio over the medium term.

IGC Discount

We note that IGC is trading at a discount (14%) that is slightly wider than its recent average discount range and the peer group. We expect IGC's relative performance to improve and mid-cap stocks in India to reflect the earnings growth of the companies in question. We would expect the IGC's discount to contract from current levels if these events were to occur.

Figure 22: IGC Discount to NAV



Source: Bloomberg

Conclusion

While the decline in the NAV of IGC is disappointing, we would argue that the bulk of the decline has been as a consequence of issues not related to the fundamentals of the underlying companies. The Indian equity market is facing short-term headwinds and small and mid-cap stocks are at the epicentre.

Given the long-term growth prospects of the economy, the medium -term earnings growth prospects of the portfolio and the valuation of the portfolio relative to both history and the BSE MidCap Index we view IGC as having the potential to deliver strong NAV returns over the medium term. The recent widening of the discount should allow investors to establish exposure at relatively attractive levels and we expect a contraction in discount to boost returns for shareholders.

Key Risks

The principal risks associated with IGC include the following:

- Premium/discount of IGC may be volatile
- India is a developing economy and investors should anticipate a higher degree of volatility in the equity market because of a combination of macro-economic factors.
- The Trust has a substantial investment in mid and small cap companies, which can be more volatile than the large cap indices.
- Even though the fund is sterling denominated the underlying holdings are in India and investors will be exposed to foreign exchange fluctuations, which would impact the NAV.

Returns for investors in Indian equity markets may be impacted by taxation on foreign investors.

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