India Capital Growth Fund – Portfolio Commentary, August 2019

This has been a tough period for Indian equity markets, particularly in the small and mid cap space where the India Capital Growth Fund operates. The Indian equity market experienced its worst July in seventeen years. The BSE Mid Cap Index fell 7.6% in Rupee terms leaving the Index down 11.0% for this calendar year and the Fund's NAV has commensurately fallen by 12.4%[1]. With August offering no respite it is timely to have an examination of the key drivers behind where we are and how we are positioning ourselves going forwards.

Some macro context

Sentiment is weak and the key issues at hand are as follows:

- A liquidity squeeze in the non-banking financial system following the default of IL&FS – an AAA-rated quasi-Government owned lending institution - in September 2018
- Excess capacity in the private sector and a fiscally constrained Government leading to anaemic investment growth in the economy. Consumption had become the core contributor to GDP, which is now in turn also slowing down
- Muted lending from Public sector banks (65% of the market) during an extended period of stressed assets and balance sheet repair, leaving the economy capital constrained
- Consistent, year-on-year downgrades to earnings expectations
- A poorly received inaugural Union Budget from the new BJP Government
- Businesses adapting to a new operating environment. For example: new currency notes in circulation (Demonitisation), the Goods & Services Tax (a nationwide VAT) and the Real Estate Regulation Act.

Whilst many of these factors appear circular (it's hard to ascertain which one is *cause* and which one is *effect*), the last bullet point is pertinent. The economy is adjusting to a systematic clean-up from the first term of Modi's Government, namely to corruption, tax collection, bankruptcy procedures, and lending norms. Whilst parts of this process have been mishandled, there is little sign of this clean-up abating, much to the chagrin of more short-term minded members of the investment community. Fiscal constraints aside, expectations of government measures in the near future to revive confidence are high amongst investors and industrialists in equal measure – something that the Finance Minister is now aggressively consulting on.

The market environment

It is in the nature of investing in Emerging Market economies – with India no exception to this – that market participants undergo periods of both excessive optimism and pessimism. We believe we have entered the territory of the latter.

Over this period the small and mid cap index' PE ratios have de-rated considerably (see Chart 1)[2]. For the past ten years the BSE Mid Cap Index has on average traded at a 7% premium to its older brother, the BSE Sensex, primarily driven by the expectation of superior growth in the domestic facing engine room of India's economy. One can see from the chart that this premium has all but dried up and mid caps are now actually trading at a discount (one standard deviation below the long term average). For some context, during the bull market prior to the Global Financial Crisis; mid caps traded at over a 20% premium. This gives an indication of potential returns once an economic recovery is underway. There may well be further challenges in the near term (Chart 2 indicates a further de-rating is still a distinct possibility) but we are very much in the camp that an attractive buying opportunity is upon us. Looking at some metrics for the portfolio corroborates this.

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[1] For returns in GBP, please refer to the factsheet by clicking here

[2] The data for the small cap index show similar results, only more pronounced

Portfolio positioning

Across the team's track record of running the strategy, analysis on the recent period of difficult performance has illuminated an interesting parallel with the previous time performance was in a downturn:

1. The Fund has just gone through its worst drawdown[3] of 32.0% as of 5th August 2019[4] in Rupees (31.5% in Pound Sterling)
    a. Subsequent to this drawdown this portfolio is now trading at a PE of 11.7x

2. The second worst non-overlapping drawdown culminated in a 23.3% loss in Rupees and 37.5% in Sterling as of 28th August 2013
    a. The portfolio at the end of that drawdown traded at a PE of 11.9x
    b. The three year return from this period was 197% in Pound Sterling – a 44% compounded annual return

3. The 10 year average portfolio PE has been 16.3x with a standard deviation of 3.4x (see chart 3)
    a. Therefore the portfolio trades at more than one standard deviation below its long term average

4. The average forecasted portfolio earnings growth has been 27% with a tight standard deviation of 4% (see Chart 4)

5. The average annual portfolio turnover since 2013 is 13%

Before exploring the parallels between the two periods, it is important to stress the low portfolio turnover. The majority of companies we own have been the same across the track record enabling a suitable regime for comparison. To re-iterate, we try to invest in companies that can deliver strong and consistent earnings growth (see Chart 4) and generate superior returns on invested capital, with a view to holding them across multiple economic cycles. To do this, part of our task is to isolate relevant information in an ocean of noise, and remain objective in order to be able to continuously update our investment theses effectively. Whilst we have been disappointed with recent negative returns, our conviction in the quality of the overall portfolio remains steadfast.

Within this framework, if one compares the current environment of negative sentiment (Bullet 1 above) and the previous similar environment ending in August 2013 (Bullet 2) – four things remain constant:

i. The quality of the portfolio's holdings
ii. The portfolio's prospective earnings power[5]
iii. An all-pervading sense of gloom amongst the sell-side and news outlets
iv. A dramatic fall in valuations for the portfolio towards bargain levels

Two things have changed however. Firstly, from a bottom-up perspective, is our increased knowledge and understanding of the key drivers impacting the businesses we continue to own. Secondly as a brief segue back to the macro environment, India is in a significantly better position than it was in 2013. *Policy paralysis* plagued the previous coalition Government, inflation was rampant, both the current account and the fiscal deficits were unsustainably high, crony capitalist

[3] Maximum observed loss from a peak to a trough of a portfolio.
[4] The Fund's NAV is audited monthly so daily returns are based on the manager's best estimate.
[5] Whilst we are wary of long term forecasting, we need confidence in the defensibility and sustainability of our portfolio companies' profitability.

norms were entrenched, and India ranked 144th in the World Bank's Ease of Doing Business Index (it is now 74th). Whilst the economy is grappling with short term challenges and is adjusting to structural reforms discussed earlier, macro fundamentals are relatively stable and the country is establishing a more robust platform for steady growth going forwards.

Whilst this sell-off has been indiscriminate (as they usually are), it is important not to hide behind this when looking at one's own investment decisions. Whereas bullish markets can cloud our ability to spot bad judgment, it is often during difficult market environments that investors learn (with the benefit of hindsight), almost boot camp-style, that they have allocated to certain companies that they shouldn't have. We are no exception to this and it is worth sharing over the past twelve months – a period that encapsulates the worst drawdown discussed earlier - what the key detractors have been and why:

- Over twelve months the portfolio returned -12.4%
- Of that -12.4%: -9.9% was from five names:

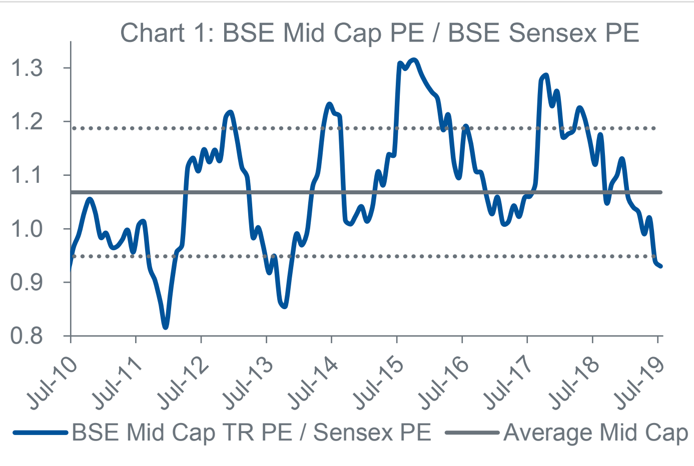
Dewan Housing Finance **Price change** -80.8% **Contribution to return** -2.5%	A name that has generated strong returns in the portfolio and whilst considerable profit was booked on valuation grounds, the position was not fully exited. The company was caught in the wake of the IL&FS default where liquidity for housing finance companies has all but dried up. With valuation forming the core rationale for paring back, not selling out fully was an error of omission that led to the recent capital loss.
Yes Bank **Price change** -73.0% **Contribution to return** -2.4%	A succession issue following the RBI's decision not to renew the tenure of the Founder and Promoter, Rana Kapoor. A bank with renowned underwriting skills and a strong presence in SME lending, which is now also looking to beef up its retail franchise. As expected, the new management has thrown the kitchen sink, during which we have added to our position.
Motherson Sumi Systems **Price change** -46.1% **Contribution to return** -2.0%	An exceptionally high quality business with global market share across multiple auto-ancillary segments, with a strong track record in rational capital allocation. MSS has been hit by a slowdown in the global auto-industry and high profile fears over a deterioration in cross-border trade. Nevertheless this is a company that we would like to own across multiple cycles and will use further market overreaction to add to the position.
Skipper **Price change** -64.8% **Contribution to return** -1.6%	A manufacturer of electricity transmission towers, a space which has witnessed a delay in order book flows on account of the systemic liquidity crunch and reduced Government spending in the power sector. Whilst the company has little debt, operational leverage caused a pronounced contraction in profitability which has seen the company's PE (2y fwd) dramatically de-rate from 18.2x to 3.8x. The company is looking to diversify its customer base to smooth out future cyclicality, but in the short term we believe the order book has stabilised and the valuation offers an exceptional opportunity to be exposed to a recovery in margins and Returns on Capital.
Manpasand Beverages **Price change** -77.4% **Contribution to return** -1.4%	With a market leading position in the mango juice space and an expanding product portfolio the investment thesis was to enjoy the power of compounding in a long term secular consumer growth story. Our mistake was on the assessment of management quality. First the company was dropped by its auditor Deloitte (which is in turn facing a petition to be banned in India, filed by the Ministry of Corporate Affairs), and second, the promoters appear to be subject of an example-setting-exercise from the Income Tax Department over the implementation of the new GST across their distribution chain. Whilst the dust is still settling, we are working to salvage value from what is ultimately a high quality franchise and asset base.

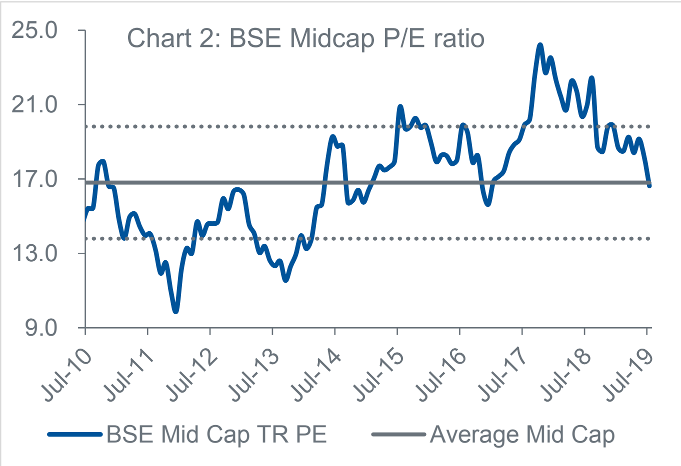
Picking up from an earlier train of thought, difficult markets tend to provide a powerful feedback mechanism by shining a spotlight on investment mistakes. The team is working hard to identify and incorporate lessons learned in the recent period but is cognisant of avoiding a potential second order consequence of learning the wrong lessons. The aim is to stick to our long-held philosophy whilst continuously improving how we do things. It is this long-held philosophy that tells us that we are buyers in today's market, and with the portfolio's cash position currently at 14.9% we are excited about the prospect of utilising current weakness to deploy that dry powder.

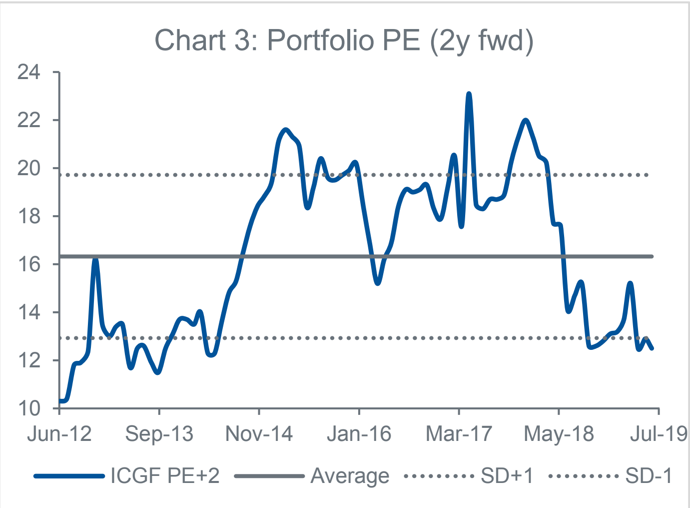
Risks are prevalent; oil, currency weakness, trade wars, all continue to pose challenges to investor sentiment – however it is our view that the recent slowdown in India is more cyclical in its nature rather than structural, and as such the market's reaction is not justified. Since 31st December 2017 the large cap index has returned 9.6% compared to -23.9% for the mid cap index and -34.6% for the small cap index (the Fund composition is split evenly amongst small and mid cap companies). For us the main risk is not volatility but the permanent destruction of capital and as such it is crucial to understand the distinction that what makes a good investment is not how it makes you feel but the price that you pay for it. **With the portfolio valued well-below its long term average and the Fund's share price now trading at a 18% discount to that portfolio – we believe that the time is now right**.

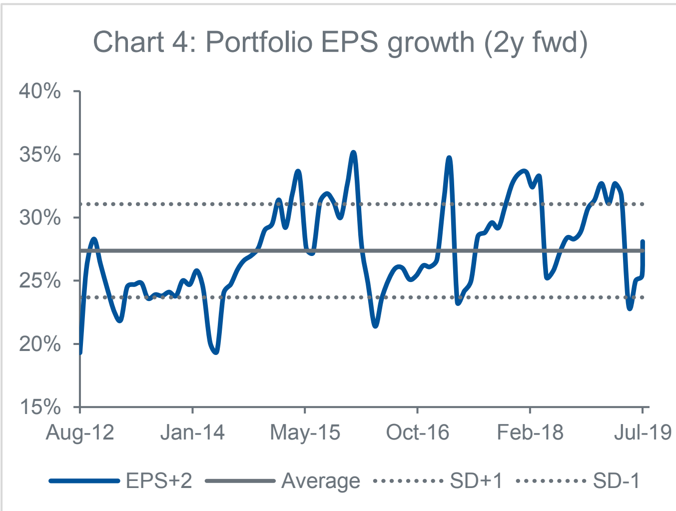
Howard Marks goes one step beyond this by arguing that "most great investments begin in discomfort" and on the flipside a rosy economic environment has often been a strong predictor of sub-par returns. If one widens the time frame then the current combination of infective pessimism, attractive valuations, and a stable investment process builds a compelling case to allocate. In our view the current discomfort bodes well for returns going forwards.

Gaurav Narain, Head of Equities, August 2019.









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