13 December 2016

India Capital Growth Fund*

Short-term pain, long-term gain

Fund in the spotlight:
India Capital Growth (IGC)]

IGC Share Price

Source: Morningstar

We spoke to David Cornell, CIO of Ocean Dial Asset Management about the demonetization drive in India. This is reform on a large scale and will inevitably cause short-term pain. It remains to be seen what the impact of a probable short-term decline in GDP will have on the support for this measure. However, one should not underestimate the potential benefits of this move. This is a major reform and if successful holds the prospect for a significant positive re-rating of India's long-term growth potential. We continue to recommend that investors buy India Capital Growth Fund (IGC).

High probability of data rich society emerging in India

The short-term pain could very easily continue for a quarter or two. What is clear is that Prime Minister Narendra Modi has taken a decision which will, if carried through to its logical conclusion, rapidly lead to a society which has a significantly higher level of financial inclusion than what most economic observers would have predicted to have been achieved about a decade from now. A structural break is always difficult to implement but a big bang reform such as what has been introduced, together with the introduction of the Good and Services Tax (GST), should create a data rich society, where the size of the underground economy is likely to be relatively small. The likely redistribution of wealth confiscated from people who had amassed it illegally to the poor is likely to improve Prime Minister Narendra Modi's popularity. It will also lead to significantly higher growth down the road as a data rich society leads to a rapid growth in services. As globalisation falters, it will be imperative for emerging markets to generate growth from internal sources. This move potentially sets the stage for a significant acceleration in India's GDP growth.

Figure 1: India GDP Growth

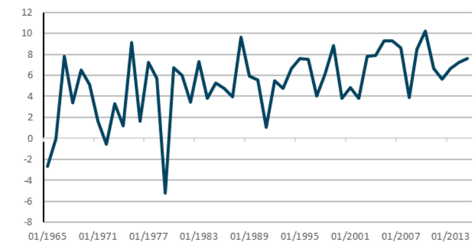
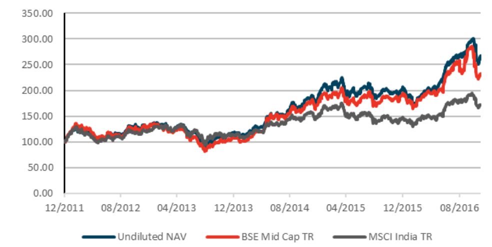


Figure 2: IGC NAV Performance



Source: World Bank, Bloomberg

Buy India Capital Growth Fund (IGC)

We continue to recommend that investors buy India Capital Growth Fund in order to capture India's accelerating growth. The CIO of Ocean Dial, David Cornell, believes that the long-term impact of this move is unambiguously positive even though he believes that the next couple of quarters will be worse than many are predicting. Sectors like automobiles or two wheelers have experienced declines of between 30 and 70% in sales. Cornell estimates that there could be a one-off windfall to the Reserve Bank of India (RBI), which could be as high as US$20bn. He believes that the government is likely to use the annual budget to introduce policy measures that boost growth. In the interim, the fund, which had a reasonable cash position before the demonetisation announcement, is using the decline to increase exposure to certain sectors while being conscious that the pain in the economy could persist in the short-term.

Priced at close
9 December 2016

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Buy India Capital Growth Fund* (IGC)

The situation in India is volatile. While the popularity of Prime Minister Narendra Modi has increased after the demonetisation announcement, it is unclear how long this support will persist. In 1975, when the then leader of the ruling Congress party announced a state of emergency, it initially had broad support. However, the mood of the population turned very rapidly and in 1977 the Congress Party suffered a resounding defeat. While the current action is different, it is difficult to assess the patience of the population, especially if the opposition targets the faulty implementation.

In isolation, we do not view the demonetisation process to be extremely valuable. It is our anticipation that a large part of the illegal money will be declared, partly using the tax amnesty scheme. The short-term impact is unequivocally negative and will cause a significant dent on GDP growth. However, given the pain that the population is enduring, it is highly likely that Prime Minister Narendra Modi will make fighting corruption and black money one of the cornerstones of both the upcoming state and national elections. This means we should see further steps taken on reducing tax evasion. The introduction of GST itself will substantially reduce the scope for regular tax evasion. If the BJP presses forward with this agenda then there is a high chance that India will soon be transformed from a data poor economy to a data rich economy, which should significantly boost the number of jobs in the service sector. Thus, we view this as a step that could cause short-term pain but dramatically increase India's long-term growth potential.

We still expect an amount of old Rs.500 and Rs.1000 notes not to be finally deposited with the banks, and this will reduce the liability of the Reserve Bank of India, though the number is likely to substantially lower than initial predictions of US$25bn-US$50bn.It remains to be seen how the RBI uses this windfall but there is an anticipation that the government will introduce targeted measures that help the poorer sections of society which should both help with maintaining popular support and boosting consumption.

Figure 3: Tax Revenue (as a % of GDP)

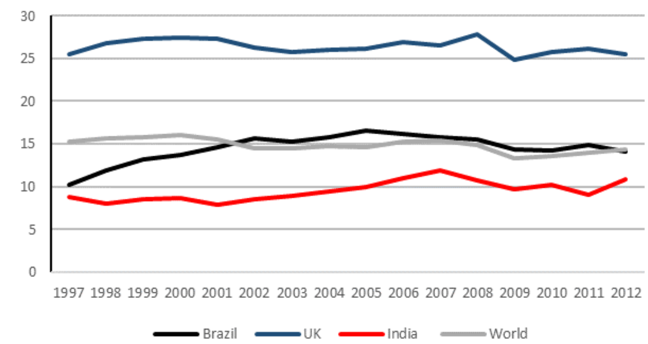
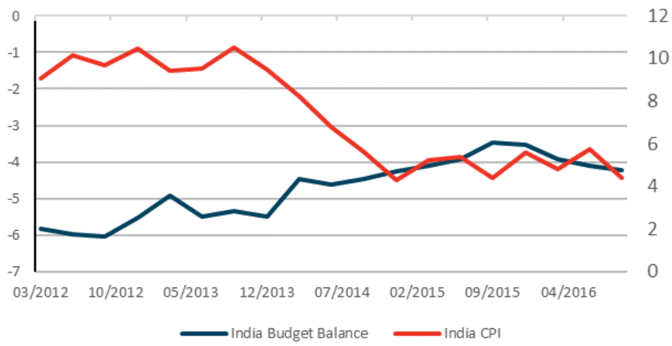


Figure 4: India Deficit (% GDP, LHS axis) and CPI (%, YoY)



Source: World Bank, Bloomberg

Cornell, expects liquidity conditions to improve rapidly but is monitoring them on a regular basis. According to him, demonetisation is clearly part of a well thought out strategy. It builds on the Aadhaar system, introduced by the previous UPA government. In the first two years of the current government's rule, there was a push to open bank accounts for households who had, till then, no access to the banking system. The Aadhar system which assigns a unique identity (UID) to every citizen linked to their biometrics, was key to helping rural India open zero-balance or Jan Dhan bank accounts and to allow direct cash transfers to the poor through welfare schemes. He anticipates that these accounts are likely to see significantly higher levels of use going forward. Additional steps taken to reduce black money such as the tax amnesty scheme had had more modest success but it is becoming apparent to most players in the Indian economy that the government is likely to make the fight against corruption and increased financial inclusion key themes going forward. He expects further measures that boost growth to be introduced in the Budget, which is scheduled to be presented at the end of February 2017. Other measures such as discouraging the purchase of gold may also be introduced.

Speaking to various corporates across the spectrum the managers of IGC feel that sectors like IT and Pharmaceuticals should be relatively unaffected. However, companies in sectors like two wheelers and four wheelers are seeing a sharp decline. Companies like Titan (TTAN IN), have commented that multi-brand watch dealers have seen a decline of between 15-20% due to the cash crunch, as retail outlets operate predominantly on cash. However, they are predicting a recovery from the current decline in about three months. Cornell expects the situation in most sectors to revert to normal in a couple of quarters. However, for sectors like banking the injection of this new liquidity should lead to consistently lower interest rates over time. While non-banking financial companies may also struggle in the short-term the long-term impact is positive. Thus, Gaurav Narain, who is responsible for day to day activity within the fund, is happy with his position in the financial sector. Having had a significant cash position when this move was announced has meant that Narain and his team can gradually put the cash to work in companies that they believe will emerge stronger.

While we see the risk of further downside in the equity market in the short-term, we believe that the improved long-term growth dynamics of India far outweigh the short-term risks and this decline should be viewed as a buying opportunity. We believe that increased growth that is likely to emerge as India moves from a data poor country to a data rich country should help accelerate India's medium and long-term growth potential. We continue to recommend that investors buy IGC to capture India's accelerating growth.

Figure 5: IGC Undiluted NAV vs. MSCI India and BSE Midcap Index

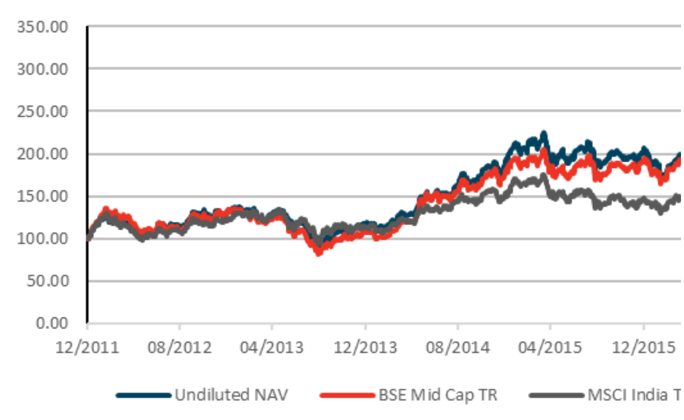
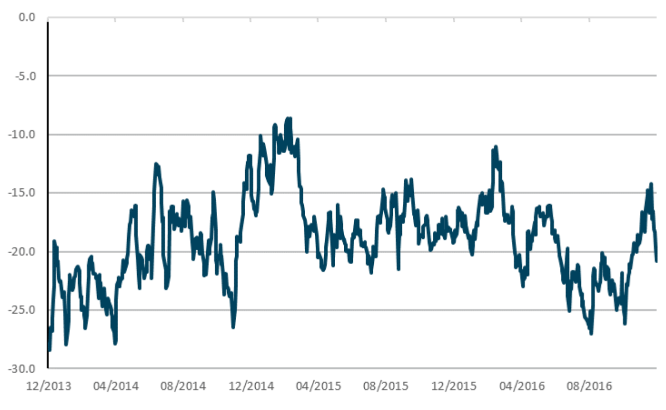


Figure 6: IGC Discount (Diluted)



Source: Morningstar

Key risks

The principal risks associated with IGC and this asset class include the following:

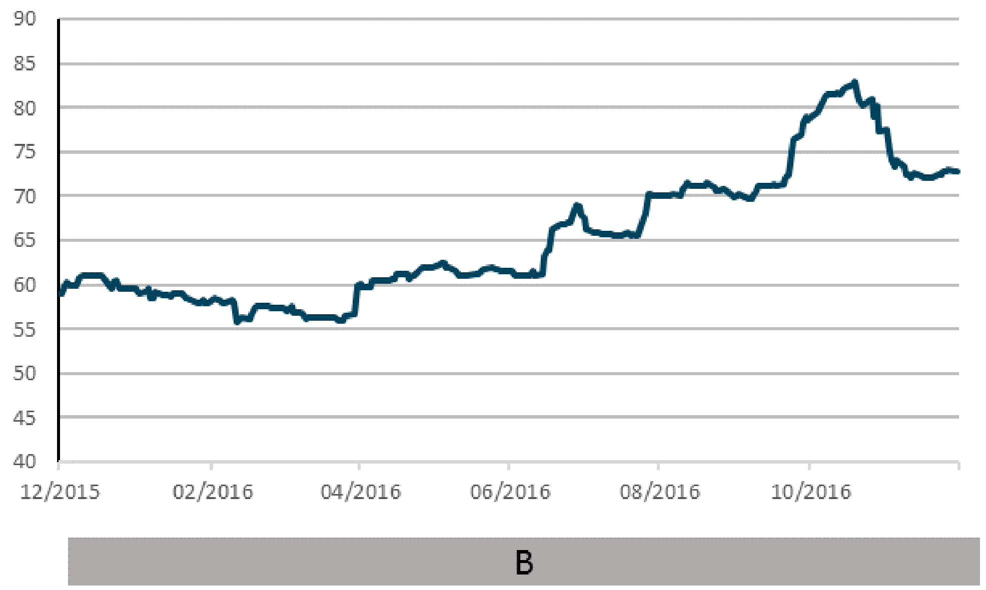
Key asset class risks include

- Rising dollar may lead to higher volatility in emerging markets
- Interest rates globally are low and may rise over the medium term
- Stock-specific risk
- Strategy or sector-specific risks

Key fund risks

- Premium/discount of IGC may be volatile
- The trust has a substantial investment in mid and small cap companies in India, which can be more volatile than the large cap indices.

Figure 7: Share price & recommendation tracker graph



Source: Bloomberg, Stockdale Securities

Investment Funds research disclosures

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HOLD: Total returns expected to be in line with those from the fund's benchmark

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	BUY	HOLD	SELL
Funds to which Stockdale has supplied investment banking services	100%	0%	0%

Source: Stockdale

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