Stockdale

28 July 2016

India Capital Growth Fund

Capturing India's accelerating growth

Today's fund in the spotlight:
India Capital Growth Fund (IGC)

IGC undiluted NAV performance

Source: Morningstar, Company data

One of the major headwinds for the global economy in general has been the decelerating growth in emerging markets. Indeed, if corporate profits are likely to grow at a similar pace then companies in developed markets which tend to have significantly higher corporate governance standards should trade at a premium multiple to those in emerging markets. With accelerating GDP growth, India stands out. In addition, the companies in the portfolio of India Capital Growth Fund should compound their earnings at a pace that is significantly higher than India's nominal GDP growth, which we estimate to be c.12% per annum.

IMF estimates India's GDP growth to rise to 7.4% in 2016

In its recent World Economic Outlook (WEO), Too Slow for Too Long, the IMF reduced its estimate for global growth in 2016. In particular, it highlighted the recessions currently underway in Brazil and Russia and the risks in China. In sharp contrast it was relatively upbeat on the growth prospects for India, where it expects GDP growth to rise from 7.3% to 7.4% per annum. We see several catalysts that should support growth in the medium term. In addition, inflation, which had been a major issue between 2010 and 2013, seems to be coming under control. The combination of falling inflation and rising infrastructure investment should allow higher productivity and lower interest rates thereby creating a virtuous cycle. Under these circumstances we expect the Indian equity market to deliver reasonable returns.

Figure 1: BRICS GDP Growth

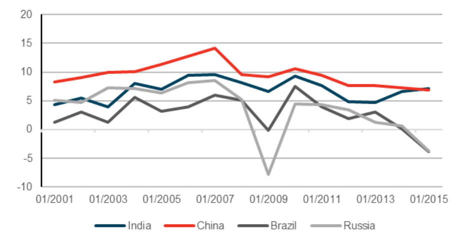

Figure 2: India Consumer Price Inflation

Source: Bloomberg

India Capital Growth Fund offers significant long-term potential

Gaurav Narain, the portfolio advisor of IGC, 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 is 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 as most of the 30-35 stocks that constitute the portfolio have tended to be what Gaurav Narain would term as 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. We believe the diluted discount of c.24% (assuming that the subscription shares are exercised) is too wide given the strong historic performance and recommend that investors buy the fund for their long-term exposure to India's accelerating GDP growth.

Priced at close
25 July 2016

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Investment Funds

India Capital Growth Fund (IGC)

Both the Indian economy and the Chinese economy are in the midst of massive transformation. In the case of China, we are near the end of a credit growth fuelled expansion whilst in the case of India we have embarked on a new phase of infrastructure investment led growth. FDI limits have been raised in defence, railway infrastructure, and insurance. The Make in India Initiative designed to facilitate investment; foster innovation; enhance skill development; protect intellectual property, and build best-in-class manufacturing infrastructure in India should help boost the investment to GDP ratio in the medium term. Simultaneously the Clean India campaign is focused on targeting environmental issues that have the potential to hamper future growth.

We have seen significant policy initiatives that have been launched. In order to increase the ease of doing business, a key goal of the Modi government, after a long period of policy paralysis. For example, a number application/approval processes have been moved online. Diesel prices have been deregulated, new gas pricing policy introduced and a new coal auction is in process. Several BJP ruled states have already introduced pro-business labour laws. In order to promote financial inclusion there has been a strong push to open bank accounts. According to the Ministry of Finance, 222 million new bank accounts have been opened since September 2014. The process of paying benefits directly has already been introduced in a few regions and is expected to be implemented on a national basis soon. The deepening of the financial sector should help the government reduce wastage in terms of the distribution of subsidies to the population. It is anticipated that all government services are to be moved online by 2018.

Figure 3: IMF estimates of Investment as % of GDP

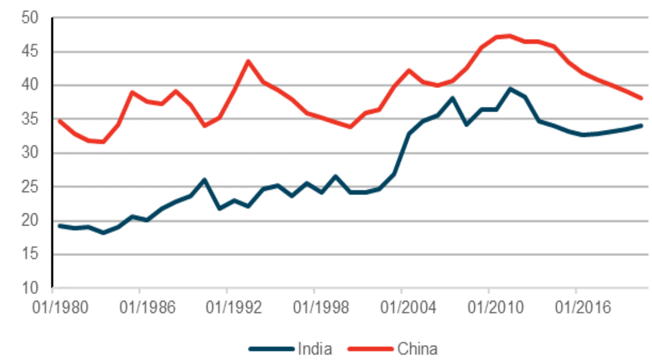
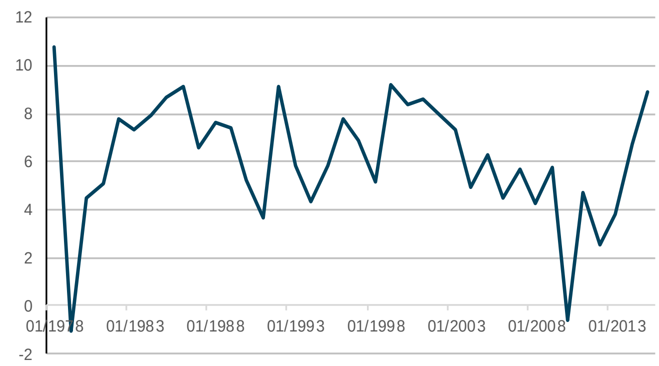


Figure 4: India Real Interest Rate (World Bank estimates)



Source: IMF, World Bank

As we can see, real interest rates are at the upper end of the spectrum and have considerable scope to fall. Although headwinds still remain in parts of the banking sector, the overall earnings cycle appears to have bottomed out and consumer and business confidence is high. We view oil prices as range bound and this has positive implications for both the inflation rate and the current account deficit. With the implementation of policy measures that have already been adopted, the fiscal deficit has also fallen. The Indian government has recently approved a 24% increase in the salaries and pensions of more than 10 million civil servants across the country. This increase, which was based on the recommendations of the Pay Commission, typically happens once a decade. While the increase is smaller than on earlier occasions it is still a boost for consumption. In the past, we have such wage increases leading to a surge in inflation. This time around we believe that the inflationary pressures are likely to be somewhat lower because of the higher degree of integration of India in the global economy as well as the improved fiscal position of the government.

Against an uncertain global back drop the Indian equity market stands out in terms of relative attractiveness. However, this is also reflected in higher valuations even as the RoE of the overall on market has declined. Thus, valuations are a key risk for the equity market if earnings fail to deliver. Equally we believe that the Indian equity market is vulnerable to macro-economic shocks like a Renminbi devaluation given its relatively high valuation. While large cap companies in India are expected to deliver relatively strong growth, we believe that the rapid transformation that the domestic economy is likely to witness should lead to strong outperformance from a well-crafted portfolio of mid-cap companies in India in the long-term. Over the last two years we have seen significant outperformance from the mid-cap stocks and the mid-cap stock are relatively more vulnerable to an abrupt correction. However, given the improving macro-economic backdrop, we still believe that IGC offers significant long-term potential and is our favoured vehicle for exposure to the Indian equity market.

Figure 5: P/E multiples on MSCI India

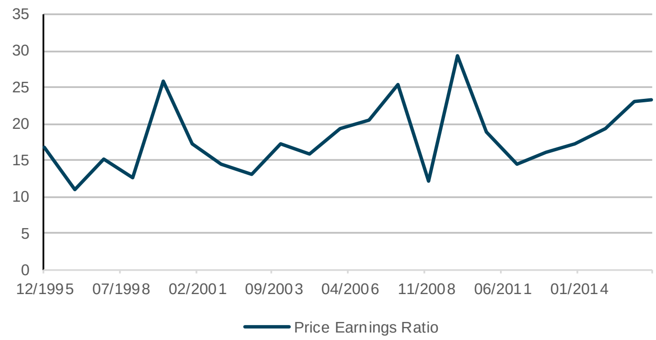


Figure 6: Return on Equity (RoE) on MSCI India

Source: Bloomberg

The portfolio of IGC 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 of the portfolio 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 and the long-term sustainability of the businesses. Equally, he is happy to pay higher multiples where he has reasonable visibility on earnings that might grow significantly.

Investing in emerging markets is often fraught with difficulty. Narain believes that it is critical to monitor cash flows rather than merely focus on profits in order to reduce the risks. Therefore, Narain tends to favour companies in the habit of paying a dividend and tries to identify companies where these will grow over time. Typically, he is looking for companies that have RoE of over 15% and have a history of positive cash flow. One of the themes that one often sees in the portfolio is established companies in the middle of a transformation.

For example, Federal Bank is an old private sector bank with a network of over 1,000 branches and a dominant presence in the southern Indian state of Kerala. The Bank's lending is dominated by the SME (small and medium enterprises) and retail segments (30% each of the loan book). Having re-engineered its credit underwriting process and put in place solid risk management architecture over the last 2 years, Federal Bank is now poised for the next phase of "Growth with Quality". The management team at Ocean Dial continue to believe that the bank is a potential re-rating story, on the back of improving profitability and growth, aided by a healthy capital position. Based on the closing market price on June 30th 2016, the stock trades at a price to projected FY2017 earnings ratio of 13.3x and 1.1x projected FY2017 book value.

Figure 7: Federal Bank Share Price

Figure 8: Federal Bank Price to Book

Source: Bloomberg

Another holding in the fund, Essel Propack (ESEL IN), highlights both the discipline and methodology employed by Narain and his team. Narain identified from his screening models and company visits that the company is potentially in the middle of a transformation. However, he was patient in establishing his position, waiting for market corrections to increase his exposure to the company. The company is one of the largest specialty packaging players globally, manufacturing laminated plastic tubes, extruded plastic tubes, caps & closures and flexible laminates. Its products are extensively used in packaging of oral care products, cosmetics, food and pharmaceuticals. ESEL sells over 6 billion tubes to over 400 clients globally. The company's clientele includes Colgate, Unilever, P&G and GSK. It has manufacturing operations at 25 facilities in 12 countries across the world. The Company has been gaining market share in laminated tubes due to investment in innovation and to propel growth it has entered the non-oral market. While the 10 year CAGR of the stock price stood at 8% there seemed to be an acceleration in the company's earnings growth. Over the last five years the CAGR of net profit has accelerated to 29%. As at 30 June 2016 ESEL was trading at 14X March 2017 earnings, after having achieved earnings growth of 22% for the year ending March 2016.

. Figure 9: ESEL Share price performance

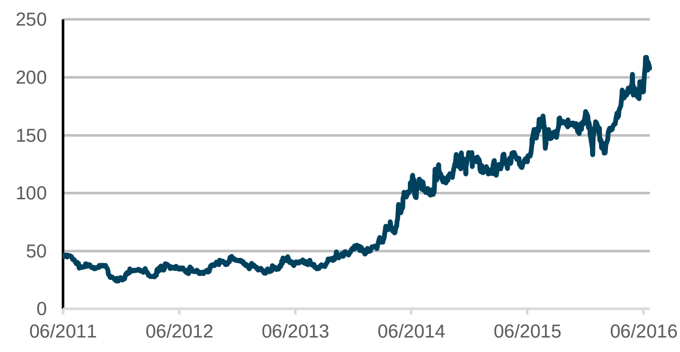
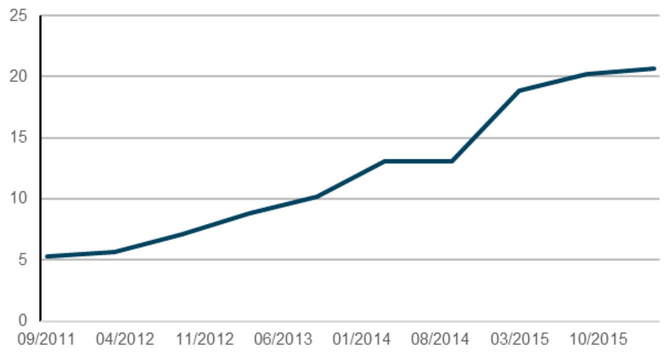


Figure 10: ESEL RoE



Source: Bloomberg

Valuations, while important, are often trumped by the long-term growth prospects of the business. For example, Jyothy Laboratories (JYL IN) was trading at 31.4X estimated March 2016 earnings at the end of 30 November 2015, but was the fund's largest holding. Jyothy Laboratories (Jyothy) manufactures fabric care, mosquito repellents and dish washing soaps categories under the Ujala, Maxo and Exo brands respectively. Narain believed that the company was in the midst of a major transformation after purchasing Henkel's (HEN GY) consumer portfolio in India. This puchase enhanced its product basket with the acquisition of brands in the detergents, toothpaste, soaps, and dish washing and deodorants space.

Spearheading the transformation has been the CEO S.Raghunandan who joined Jyothy in May 2012, and is highly respected in the Indian FMCG industry. With all the hard work done and a strong brand portfolio and management team in place, the team at Ocean Dial see a period of sustained above market growth along with operating leverage driving earnings. The share price has remained relatively stable over the last few months but the forward PE multiple has fallen as a consequence of earnings growth to 28.7X March 2017 earnings estimates, as at 30 June 2016. As we can see, the stock is still one of the top ten holdings of IGC.

Figure 11: JYL Share price performance

Figure 12: JYL P/E multiple

Source: Bloomberg

The portfolio tends to have a strong quality bias and hence the valuation of the portfolio is likely to be higher than the market. As at 30 Jun 2016, the portfolio was trading at 22.8X March 2017 estimated earnings. Earnings for companies in the portfolio were expected to grow at 19.8%. The portfolio's trailing 12-month dividend yield was 1.02%, and the median market cap was £965m. Narain's search for compounding machines implies that the expected earnings growth from these companies should be similar in nature, for the next few years. It is this growth that allows him to hold on to quality companies when valuations temporarily expand. On a sector basis, two of the key core sectors in the portfolio are the consumer and healthcare.

Table 1: Sector weightings and top ten holdings as at 30 June 2016

Sector weightings	% of portfolio	Top ten holdings	% of portfolio
Financials	29.1	Yes Bank	5.2
Materials	17.3	Kajaria Ceramics	4.5
Consumer Discretionary	13.2	Federal Bank	4.3
Industrials	13.1	Jyothy Laboratories	3.9
Consumer Staples	9.2	Indusind Bank	3.8
Health Care	8.4	PI Industries	3.8
IT	4.3	Dish TV	3.7
		Dewan Housing	3.7
Net Cash	5.3	City Union	3.6
Total	100	Ramco Cements	3.5

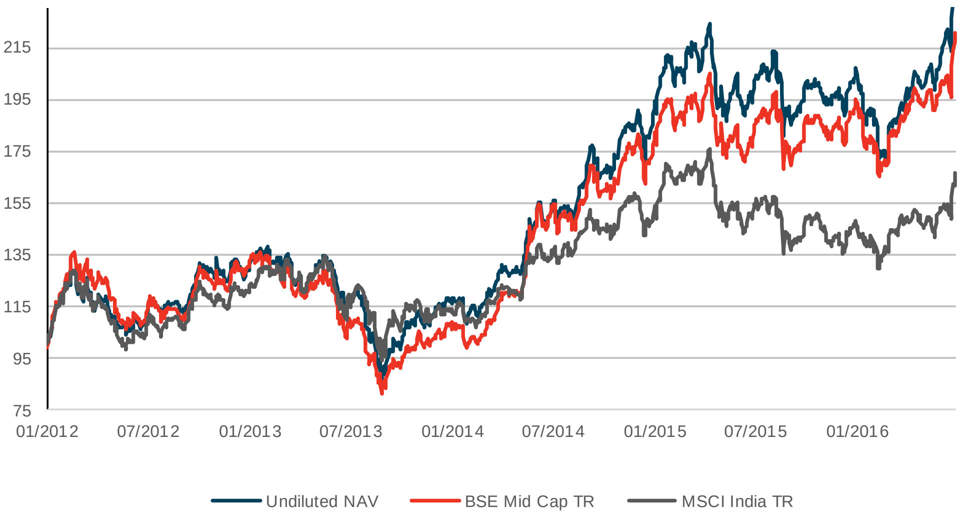
Source: Company data

We believe that there is a high probability that the 37,500,710 Subscription shares rights in issue will be exercised at their subscription price of 61p on the subscription date of 6 August 2016. Following the exercise, the liquidity in IGC is likely to improve. While the subscription shares have been a drag on diluted NAV performance we view this as a one-off to increase the size of the fund and its liquidity.

We highlight the undiluted NAV performance of the fund as we believe it better reflects the team's stock selection and its estimated beta, going forward. Since 30 December 2011, when

Narain took over the charge of the portfolio, the undiluted NAV of IGC is up 138.61% (as at 30 June 2016) as opposed to a 120.9% increase in the BSE Mid Cap Index. We also plot the fund's NAV performance vis-à-vis the MSCI India Index in order to gauge the benefits of owning IGC rather than an ETF. We view a diluted discount of 24% as excessive. Given the fund's relative performance, we believe the diluted discount will narrow over time, once the overhang of the subscription shares disappears and thus will enhance shareholder returns. The fund's beta relative to MSCI India Index was 0.91 and to the BSE Mid Cap Index was 0.92.

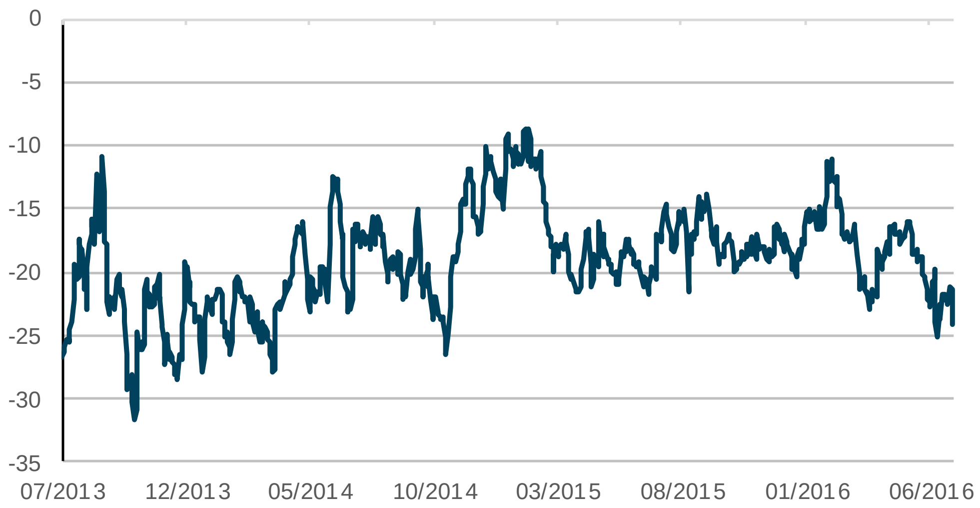
Figure 13: IGC Undiluted NAV Performance



Source: Company data, Morningstar

In a secular growth market like India, with a drift component of around 14% per annum, in INR terms, it is easy to book profits. However, quality matters and when the market falls the higher quality companies outperform, more often than not. Given the relative outperformance, at that stage, it is equally difficult to justify why investments in these companies that have outperformed should be made. Over the long-term it is precisely these highly valued companies that tend to outperform as earnings growth allows them to grow into their valuations. Equally, Narain believes that it is important to be disciplined so that the fund can react when we have major market events. Historically, David Cornell and his team have been adept at walking the fine line between the desire to book profits in 'expensive' stocks and letting the compounding machines do their job. Equally, we have been impressed by the ability of Narain and his team to identify new investment opportunities. Despite the relatively high valuations of some of the stocks in the portfolio we find the team's strong bottom-up expertise and relatively small size to be a major attraction given the capacity constraints that prevail in the mid-cap/small cap space.

Figure 14: IGC Diluted Discount



Source: Company data, Westhouse estimates

We note that IGC has outperformed both JPMorgan India Investment Trust (JII) and New India Investment Trust (NII) over the last three years. The charts below depict both the diluted NAV performance and the undiluted NAV performance of IGC relative to the performance of both JII and NII for the three-year period ending 30 June 2016. Despite this outperformance, IGC has tended to trade at a significantly wider discount, which we believe is unwarranted.

Figure 15: IGC diluted relative NAV performance

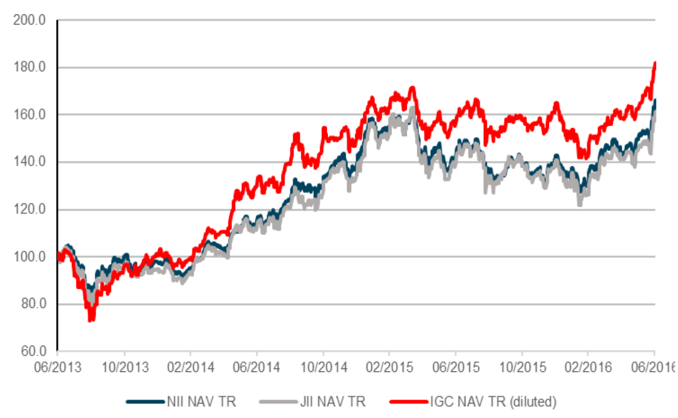
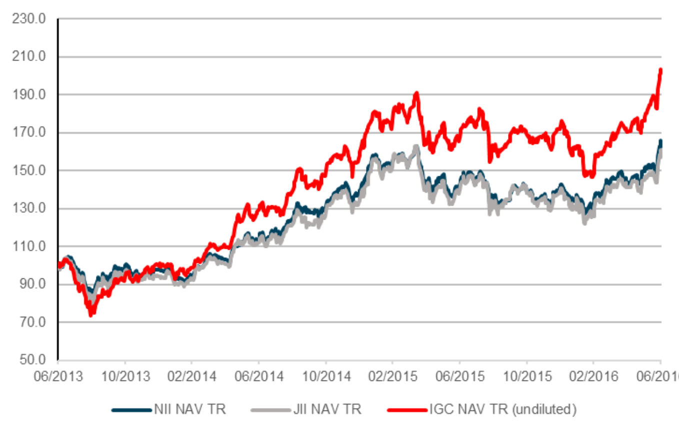


Figure 16: IGC undiluted relative NAV performance



Source: Morningstar, Company data

We think an ability to capture opportunities effectively in this area will be critical to generating alpha in a market like India over the long-term and recommend that investors buy IGC to gain exposure to one of our favoured emerging markets

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