2022 will sort the darlings from the dogs

2020 and 2021 were bumper years for India bulls, defying all but bona-fide contrarians. Once the pandemic broke the naysayers prophesised India's rapid economic downfall; given the lack of precedent, it was hard to pushback.

Since then it has been a steady climb. Underpinning the sentiment shift has been a combination of factors working in favour of equities. A vigorous mix of compelling valuations, abundant liquidity, foreign investor "under ownership", all working alongside policy makers with the wind truly "up them". Without warning the narrative shifted from doomsday to nirvana, and the India story was hot once more. Being a small and mid-cap specialist, and benefitting from the closed-ended nature of the structure, India Capital Growth Fund, managed by Ocean Dial Asset Management, was uniquely placed to capture this turnaround, as the net asset value per share rose 42.1% over the year (pre capital gains tax adjustment), whilst its comparable benchmark (S&P BSE Midcap Index) rose 39.7%. All figures are quoted in GBP.

On top, the pandemic accelerated irreversible change in two key economic areas, supporting this belief that change *really was afoot*. First; was the "mainstreaming of digital." Companies and consumers forced to live and work from home rapidly adopted technology to rescue their livelihoods; as was the case universally. This sparked a surge in digital activity across the Indian ecosystem, creating a tidal wave of interest from global investors (both private and public) and a surge in valuations. In investors' minds, India was now *finally* catching up China in a key sector, and fast. Although the rise has been dramatic, we stress that this is the tip of the iceberg with many years of wealth creation to come. Second, was the realisation that the pandemic was pushing global supply chain risk to unacceptable levels. This required multi nationals to look beyond China in order to diversify away from single source dependency. Given the work government has been doing these last five years to improve "ease of doing business" and the positive labour arbitrage that clearly exists, Indian companies (and global behemoths choosing to manufacture more from India) are well placed to benefit from this multiyear shift. Another tip of the ice berg you could say.

Less well understood perhaps is the ongoing shift in India's foreign policy that resulted from well publicised Himalayan border skirmishes that took place in early 2020. One consequence of the sabre rattling was a proactive push to unwind India's dependency on Chinese imports. This prompted the introduction of production linked incentive schemes (PLIs) across major industries to manufacture more domestically that which was otherwise imported. As such Indian business is experiencing something new; namely government that is willing to listen to, and support, industries disposed to invest in capacity expansion and job creation, alongside the government's own ambitious infrastructure spending plans. This is, as always, "a work in progress" and implementation will be fraught, but with an election two years from now, a spending step up seems timely. What is also refreshingly new is that tax collection is improving, as GST finally beds in and begins to demonstrate its worth, thus supporting government finances at the inflection point.

It's the right moment to note that alongside a recovery in private sector investment, after an extended bear market, India is also experiencing a residential housing recovery. Affordability has improved, inventory is tight, and the house building sector has been thoroughly "cleansed". Banks look ready to lend again, in housing, as well as the broader opportunity set. GDP growth can surprise positively from here as the economy fires on all cylinders.

However, despite the positive thrust, it's clear that since the lows of 2020 the easy money has been made. Much of the good news has to be in the price. Market performance has been driven by a steep valuation re-rating on the back of easy liquidity, rising business optimism, and a healthy tick up in profits. But for the market to sustain from here, profits must continue upwards for equities to do likewise. A setback, or mean reversion, particularly if global equities find themselves on the back foot, cannot be ignored. There are always reasons to take a more bearish tack, should investors choose, both in a global and a domestic context.

But since the Indian market is now moving beyond the "the rising tide lifts all boats stage", this is the opportunity for stock pickers to take up the challenge. Active managers running high conviction portfolios steeped in bottom up analysis, are best placed to deliver consistent returns from here. For although market valuations are expensive in aggregate, on a case by case basis, both at sector and stock level, there are numerous opportunities for stock selection to deliver.

1. Domestic economic recovery

We see value in the financial sector, specifically the banks; Indusind Bank, Federal Bank, City Union, IDFC First, which are well exposed to a mixture of wholesale, retail and SME lending. These are emerging from the 2018-19 liquidity crisis, the 2020-21 Covid crisis and a regulatory overhaul, and are installing fin-tech across their product suite in order to stay ahead of the emerging competition. Although lending books have been cleaned up, the pandemic overhang is holding the sector back, and stocks are trading well below long term averages.

Kajaria Ceramics (household tiles) and Finolex cables (residential wiring) provide the portfolio with exposure to the residential housing recovery as do cement stocks (JK Lakshmi Cement, Sagar Cements), which are seeing strong demand from government's expanding infrastructure plans, as is PSP Projects (construction).

2. Digital advancement

The structural shift in digital evolution is captured across a variety of industries. In the digital space directly, exposure is taken through Affle India (digital advertising), whilst Jubilant Foodworks (Domino's pizza franchise) captures the increased demand for "food tech".

More traditional companies which are employing better technology to enhance supply chain management (Bajaj Electricals) and product delivery such as Emami (FMCG) are already benefitting from increased digital adoption. The IT services sector, which has supplied global business with low cost software maintenance since the early 90's is experiencing high demand as companies globally adopt digital and cloud computing. These trends are captured through Persistent Systems (digital business acceleration) and Tech Mahindra (5G, block chain & cyber security, analytics)

3. China plus 1

The global shift away from China as the single source for critical supply chain is benefitting India. This long term theme is met through ownership of Dixon Technologies (outsourced electrical equipment manufacturing), Aarti Industries (specialty chemicals), Welspun India (textile manufacturing) and Sona BLW (precision engineering for electric vehicle industry).

Investee companies are expected to remain in the portfolio for three to five years and to deliver healthy risk adjusted returns through the economic cycle.

It is now almost two years since the pandemic lows. As we enter the third year, India Capital Growth's portfolio is trading at a 12 month forward multiple of 18.5x for expected underlying earnings growth of 35% and an aggregate Return on Equity of 19.5%, a PEG ration of 2x or as near as. With risk to growth on the upside still, these valuations remain attractive not least when considering the growth on offer, as India continues to force its way onto the global investment stage.

HOODstock – Welspun India; A towel for champions

Welspun India (Mkt Cap £1.5bn) is a company that forms a part of Ocean Dial's investible universe, or "House of Ocean Dial". It has been included in the India Capital Growth portfolio since 2016

Welspun is India's largest home textile company. It has a presence in cotton bedsheets, towels, rugs and carpets, and is Asia's largest producer of terry towels, (terry being a style of weaving using uncut loops, known as "pile"). The company exports more than 94% of its home textile products to more than 50 countries. 65% goes to the USA, 25% to Europe and the balance to the Middle East, Australia and Japan. It supplies to 18 of the top 30 retail chains in the world, including names such as John Lewis, Tesco, Ikea, Walmart and Costco in the US. Perhaps best known is its production of the iconic Wimbledon Championship towel used on court and the real prize every player covets. As global retailers have started de-risking their supply chain capacity from China, large players like Welspun are expected to benefit. This is particularly since the Indian government is supporting Indian business to take advantage of the opportunity. Government has introduced policies (across 13 sectors) to support domestic manufacturing, better able to compete with China. In the case of Welspun, this is also helped by Chines cotton exports being banned by the United States on human rights grounds.

Welspun's ESG strategy stands on three pillars of economic growth, environmental conservation and social empowerment with acceleration at its core. The Company is independently assessed on over 170 ESG factors and has been reporting ESG related issues in its annual report since 2017.

The company's strength is its integrated manufacturing facilities and focus on innovation. It has 32 patents with over 43% of revenues coming from innovative products. Welspun is also diversifying its revenue base by launching its own brands in domestic and overseas markets as well as forays into new segments like flooring and technical textiles (wipes and surgical masks). Welspun trades at 15.4x twelve month forward earnings for expected earnings growth of 28% and a return on equity of 21%; the latter is expected to rise over the next three years leading to a valuation rerating combined with strong sustainable earnings growth. It has compounded at 12.5% in GBP since its inclusion in India Capital Growth's portfolio.

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