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Playing India's Growth Story – In Conversation With Ocean Dial

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London-listed India Capital Growth Fund invests, as the name suggests, in the rapidly growing Indian economy. Coinciding with recent Diwali celebrations in the Indian community in the UK, this news service spoke to Gaurav Narain, fund advisor and co-head of equities India. He works at , the investment manager for the fund. (We have interviewed Ocean Dial before.)

India is now the world's fifth-largest economy, benefiting from its being a major link in the world's supply chains (accelerated after the pandemic and due to US trade tensions with China), its youthful demographics, vibrant IT and related sector, and other factors. Over the past decade,the country's government has enacted reforms including moves to root out excessive use of cash and digitalise the country, improve tax collection and invest in infrastructure. Once a protectionist country with a plethora of restrictive practices, and hobbled by extensive red tape, the country is – hopefully – moving in a more open direction. Of course, there can be no room for complacency.

This news service talked to Narain about the fund, its operating philosophy, the prospects for India, and where this sort of investment should sit in the portfolios of wealthy investors.

Why would you say India is a promising country to invest in?
India has never looked better as an economy. Multiple factors are falling into place which make the India growth story look sustainable for years to come – reforms which touched every sector have now been embedded and any bumps in the road have been addressed. Along with this, digitisation is enabling the mainstreaming of rural India with urban India through low-cost distribution of services.

Post-Covid, the government's focus has shifted to growth, and we are seeing investments in infrastructure, as well as in the private sector. Geopolitics is also favouring India, as the supply chain de-risking is accelerating the shift into the country.

What are the potential risks and causes for concern, and what, on the upside, are the positive forces that people aren't sufficiently aware of?
Elections pose the main risk. However, while they can have a short-term market impact, the implemented reforms cannot be reversed, so we do not see them majorly impacting the economy. India has been fortunate in that it has had a stable government for the last two terms (since 2014) with a single party majority. This has meant that the government has been able to take tough decisions. Nevertheless, expectations are that the government will once again win with a majority, so if this does not happen, markets will likely be disappointed.

On the upside, India is entering a phase of high GDP growth of 6 to 8 per cent, which is likely to sustain over several years to come, meaning that the short term is not too concerning. India's digital infrastructure is also amongst the best in the world, leapfrogging many developed countries in this area. The main difference is that India's digital infrastructure is owned by the government, so it is both very low-cost and high-volume. Hence, it can have a transformative impact on lives in small town and rural India.

Remind me of what is the investment philosophy of the fund – is it a stock picker, thematic, top-down, other?
We are bottom-up stock picker, high conviction, know our companies inside out and buy at a sensible price. We invest in the small and mid-cap segment of the market (market cap. Below $8 billion). We always look at investing with a long-term horizon, hence our portfolio turnover is low at just 10 to 12 per cent and over 65 per cent of the stocks in the portfolio are held for over five years.

We are sector-agnostic, but are very conscious of owning only quality businesses, with a high weightage on quality of management and corporate governance. Hence, we have created a universe of about 145 companies which meet our quality criteria, from which we pick our portfolio companies. We also have elimination criteria for businesses when we find we are unable to do any value addition.

India has a very broad range of sectors and no one single sector dominates all the others. Overall does this diversity work to the fund's advantage or does this mean you have to have a lot of analysts on the ground?
I think this is a big advantage for us as it gives us a lot of choice. We spend a lot of time meeting with managements and understanding businesses. With many listed entities, it helps us identify the best business models within a sector and the companires that we ideally want to own in our portfolio. As highlighted earlier, our portfolio turnover is low, and we invest

with a long-term mindset. So, for many companies that we invest in, we have been consistently meeting over several years, getting comfortable with the management and closely monitoring performance. We have a watch list at any point and at the right valuation we can include in our portfolio, so we find that a small team helps as we are all focus on the top companies.

India also has a very well-developed equity market with many sell side equity research firms – both domestic and global. So, there is no shortage of external research which we also leverage upon.

Would you say that Indian equities are fully valued, expensive, other? How do they fare versus other emerging market valuations in your view?
Indian companies have always looked expensive, particularly when compared to other emerging markets. At about 20xPE multiples, the market is trading at a slight premium to historical valuations and the premium to emerging markets has also expanded from about 60 to 70 per cent on average to 80 to 90 per cent at present.

However, one should look at it from the following perspective:

• India has consistently high growth. The nominal GDP growth over the last decade would have ranged between 10 and 12 per cent. This is expected to continue for the next few years; and

• The composition of the market is very different from emerging markets. It is diversified and not a single sector/commodity heavy market. What this implies is that the return on equity and return on capital employed of India is much higher than emerging markets, hence India will always trade at a premium.

Because of the above reason, even if we take long time periods of 10/15 or 20 years, India's market returns have been amongst the best in the world (even ahead of the US) as there is earnings growth along with quality.

Hence my belief is one should not get carried away by one-year valuations, as over the longer term the earnings growth will drive the market.

Sectors: which ones do you really like?
I think India has a unique situation where most sectors have a positive story. Until a few years back, it was the consumer sector driving growth, today the investment cycle has also picked up, hence a lot of opportunities. The only sector which is weaker is pure export-oriented businesses such as IT, chemicals, textiles etc. However, as the supply chain rebalances, many companies in these sectors are also witnessing new growth opportunities.

For us, the largest component of our portfolio is in our consumer-facing companies, playing on the Indian demographics story. The second largest is in financials, which is a play on the growth in the overall economy and investment cycle. However, most stocks in the portfolio have their own unique story. What we try to ensure is that the stocks in our portfolio are leaders in their segment and have some entry barrier which gives us the confidence that their growth is sustainable.

Let's talk about data, the reforms of the Modi administration regarding financial services, the ID system, etc. How transformative are these changes?
The digital stack has been transformational for India. There are now 850 million mobile phone users and, as a population, we consume more data than the US and China combined each month. The digital ID system has allowed the population in rural India to become part of the mainstream. Following the non-mandatory implementation of identification, banks were then encouraged to open bank accounts for each household, resulting in 400 million new bank accounts being opened in two years.

The impact of this has been quite transformational in India. To give a perspective:

-- The government is making huge savings on subsidy payments as all subsidies are paid directly to the recipient bank accounts. So, leakages and frauds have been eliminated and the government is able to roll out many more, targeted schemes;

-- For the banking system, there is an immense amount of data being collected. Before implementation, small shopkeepers, vegetable vendors etc. were forced to go to money lenders to take short term loans (at 2 per cent interest per month). Today, banks are able to lend to them as they have access to a lot of data like their bank transaction, electricity bill, rent etc. The informal economy is getting formalised, meaning that retails credit for the system have been growing at 20 per cent per annum; and

-- Even for consumer companies, the entire supply chain has become more efficient at the front end and back end due to digitisation. Hence earlier companies found it hard to service retail outlets in smaller towns due to limited purchasing power/high cost of doing business. This is now changing, and companies are rapidly expanding their direct distribution reach, a key driver for growth.

The biggest change today is that everyone is connected. Most families in a village will have a member working in the city; they are all connected on the phone (India has amongst the lowest telecom tariffs in the world) and can transfer money in a few seconds to the families. This was not possible five to seven years ago.

Are there sectors you think are being ignored or falling "under the radar"?
I do not think that is the case. While, some sectors, particularly the global-facing sectors such as IT, chemicals, have underperformed and seen valuations correct. Also, financials surprisingly are trading at below historical average valuations. So, there are opportunities in these sectors.

Are there firms in the portfolio that you and your team would cite as outstanding examples of the trends and qualities you look for?
There are many such companies in our portfolio:

-- PI Industries: This is an agro chemical company which works with global innovators in their R&D for new product development. We have owned it for a decade and over this period, its earnings have compounded at 20 per cent per annum. More importantly, over this period, it is being recognised amongst India's leading agro chemical companies and has also expanded its market opportunity size to pharmaceutical, as well as electronic chemical etc. Its ROCE is over 20 per cent.

-- Sona BLW: This is an auto ancillary company manufacturing high precision components such as differential gear assemblies etc. It is very strong on R&D and is winning multiple contracts with global electric vehicle manufactures in both Europe and the US. As they are for new platforms, the order visibility is high as the life of a platform is about eight years. There is thus high earning visibility and, even in a depressed global auto industry, Sona's earnings are growing at over 25 per cent per annum. It has operating margins ranging from 26 to 28 per cent and a ROCE of more than 20 per cent which is reflective of its pricing power.

-- Welspun India: This is a textile company manufacturing home textiles like bedsheets and towels. It is the market leader in the US. It also owns the Christy brand in UK (Wimbledon towels). While Welspun was a pure B2B manufacturer selling to Walmart, Costco etc, over the years it has diversified itself by doing in-licence brands (such as Martha Stewart etc) and launched in the Indian market under its own brands. This is transforming it from a B2B player to a branded player. It has been a front runner in technology with 100 per cent traceability of raw material and is also ranked among the leading ESG companies in the textile industry globally. Hence there are many stories shaping its future which will drive both earnings growth and return ratios leading to a rerating of the business.

What sort of returns do you target over the next three to five years?
We typically look for the ability of the company to deliver an earnings growth of 15 to 18 per cent per annum over a three-year period with a reasonable amount of predictability. Hence if the portfolio has earnings growth of 15 to 18 per cent, all things being the same, the returns should also compound at the same rate (adjusting for currency depreciation). Over the last 10 years our portfolio has returned about 14 per cent per annum.

How many stocks does it hold, and what is your approach to the concentration of a portfolio?
We currently have 35 stocks in the portfolio. Our idea is to have between 30 and 35 stocks, so that in each company we own we have a meaningful position.

What is the discount to net asset value?
It generally sits between about 5 to 8 per cent.

Do you have a policy on how to control that?
The board is mindful of the discount. There is a provision of a buy-back if the discount exceeds a particular level.