MARTEN & CO

Update | Investment companies

8 July 2016

India Capital Growth

Indian powerhouse

IGC's NAV is up 28.8% since our last note was published on 23 March 2016 (its price is up 20.1%) yet, in recent weeks, its discount has widened to 20.4%. There is no good reason why the discount should be widening, in our view.

India shines as a bright spot in a world beset by economic problems: GDP growth is running at 7.9%. The managers of India Capital Growth (IGC) believe, that whilst a series of sometimes painful but very necessary adjustments is ongoing, India's economy is now on a more stable footing and earnings growth, to date the missing ingredient in the bull case for Indian equities, is set to materialise. IGC, with its focus on small-cap and mid-cap stocks in India, is ideally placed to benefit. IGC is poised to expand its share capital by 50% as the August exercise date for its subscription shares approaches.

Mid- and small-cap listed investments in India

Investment objective: to provide long-term capital appreciation by investing (directly or indirectly) in companies based in India. The investment policy permits the company to make investments in a range of Indian equity securities and Indian equity-linked securities. The company's investments will predominantly be in listed mid- and small-cap Indian companies.

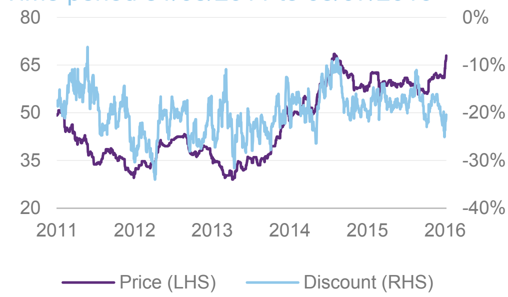
Year Ended	Share price TR (%)	NAV total return (%)*	S&P BSE Mid-Cap TR (%)	MSCI India TR (%)	MSCI World TR (%)
30/06/12	(37.4)	(26.2)	(25.2)	(23.4)	(2.0)
30/06/13	15.9	4.4	(5.5)	9.2	23.2
30/06/14	33.0	30.5	40.7	13.7	10.8
30/06/15	20.3	20.1	18.4	12.2	11.0
30/06/16	12.3	15.4	24.3	10.6	16.0

Source: Morningstar, Bloomberg, Marten & Co, *Note: fully diluted NAV returns – see pages 7 and 8 for undiluted returns.

Sector	Country specialist – Asia Pacific
Ticker	IGC LN
Base currency	GBP
Price	68.00
NAV diluted / undil.	85.45 / 97.67
(Discount) dil. /undil.	(20.4%) / (30.4%)
Yield %	Nil

Share price and discount*

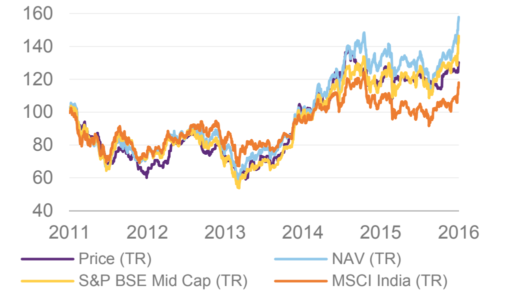
Time period 31/05/2011 to 05/07/2016



Source: Morningstar, Marten & Co *Note: undiluted discount

Performance over five years*

Time period 30/06/2011 to 30/06/2016



Source: Morningstar, Marten & Co *Note: all in sterling terms.

Domicile	Guernsey
Inception date	22/12/05
Manager	David Cornell
Market cap (GBP)	51.0m
Shares outstanding	75.0m
Daily vol. (1yr avg)	65,327 shares
Net cash	4%

Click here for our initiation note

Fund profile

You can access the company's website at: www.indiacapitalgrowth.com

India Capital Growth (IGC) has been managed since 2010 by David Cornell of Ocean Dial Asset Management (Ocean Dial or the manager). He has been assisted in this, since November 2011, by Gaurav Narain (Gaurav or the adviser) who is based in Mumbai. IGC's main focus is on Indian small-cap and mid-cap companies but the fund can and does buy large-cap companies as well. The board and the manager benchmark the performance of the fund against the S&P BSE Mid Cap Index (total return) but we think, given the portfolio's weighting in large-cap companies (21.8% at the end of June 2016), it is also worth comparing IGC's performance against the MSCI India Index. The manager does not take benchmark weightings into account when constructing the portfolio.

The basis of the investment philosophy is that you will make most money, over the long-term, by being invested in those companies best placed to benefit from the Indian growth story. You also need good management in these companies if they are to make the most of this opportunity.

Gaurav is a bottom-up stock-picker. He says he does not make macro calls nor is he a thematic investor. When he is searching for investments to recommend to the manager, he is looking primarily for stocks that can grow and generate high cash returns on capital employed. Ideally he wants companies that have been generating cash for at least six years and are exhibiting ROEs of 15% to 20%. These companies must also pay dividends and taxes. Cash generation alone is not enough, there has to be some USP for the company. He wants to avoid commoditised businesses as he is looking for pricing power. Crucially, the company must also have good management that he can trust and that are shareholder friendly.

A fuller description of the investment approach is included in our note, (*Compounding Machine)*, published in March this year.

An update on India

India is one of the few bright spots in the global economy yet, year-to-date, the S&P BSE Sensex has barely changed. Many factors may be at work here – a tendency by some investors to lump all emerging markets together, resulting in indiscriminate selling of investments in India, a lingering concern about the pace of reforms being undertaken by the government and a tendency for analysts to overestimate earnings growth for Indian companies, leading to disappointment.

Real change is happening within the economy

Ocean Dial thinks that there are many reasons why India is capable of growing at a faster pace than other leading emerging markets and says that real change is taking place within India's economy, which is laying the foundation for growth for years to come.

Banks forced to address non-performing loans, bankruptcy laws shaken up, directors of defaulting companies under pressure

First, the government and central bank have been pro-active in forcing public (state-controlled) banks to address the problems they have with non-performing loans. As part of its Asset Quality Review, the central bank identified 150 failing companies that they said the banks must recognise as being in default and address these loans accordingly. Banks have been encouraged to force debt for equity swaps on some companies. At the same time, new bankruptcy laws were introduced to speed up the process of recoveries (companies will be forced into liquidation if no agreement is reached in 270 days) and restrictions were placed on directors of defaulting companies, preventing them from sitting on other boards. This process has depressed the earnings of the whole market. The manager says that there is more to come but he thinks the worst is now behind us.

Huge boost to m-commerce market

As part of the drive to reduce corruption, 213m new bank accounts, accessible by mobile phone, have been created for all recipients of certain state payments. The initiative should reduce "leakage" considerably, boosting India's fiscal balance sheet. This has the added benefit of vastly increasing the size of India's m-commerce (mobile commerce) market.

7.9% GDP growth

GDP growth is at an annualised rate of 7.9% and the manager expects it to rise from here. Ocean Dial says that this is being achieved even though the economy is not "firing on all cylinders". Private sector investment is growing more slowly, running at an annual rate of 3.8% at the end of Q1 2016 and this is being accompanied by slower credit growth as companies fix their balance sheets. Foreign direct investment (FDI) is buoyant however. FDI for the year to the end of March 2016 (the fiscal year or "FY") was $54bn, up 15% on the previous year.

Good monsoon season forecast

The monsoon started late but the rainfall is on-track to exceed forecasts (after two years of poor rains). Although agricultural output has been held back over the past couple of years and rain is badly needed to refresh reservoirs, food price inflation has been kept under control. A good monsoon will relieve the government of much of the need to inject subsidies into the rural economy, still an important part of Indian GDP, as well as accounting for 60% of the population.

Motorbike and cement sales up

Sales of motorbikes have been climbing in recent months, which may reflect a better outlook for the economy generally but might also be in response to increasing optimism about the monsoon. Evidence of economic growth is also showing up in areas such as rising cement sales and price increases (as infrastructure investment and low-cost housing programmes take effect), airline traffic and electricity generation.

Infrastructure investment underway

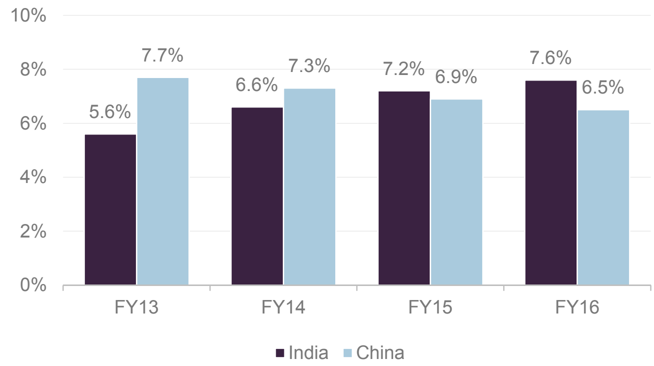
To add more detail on the government's infrastructure programme than we included in the last report, new road construction is set to rise from 4,500km in FY2015 to 6,000km in FY2016 and 10,000km in FY2017. A quarter of India's existing roads will also be upgraded to four-to-six lane highways over the next three years. India's vast rail network is crying out for investment too. An annual budget of $10bn in FY2015 became $16bn in FY2016, part of a $128bn five-year budget. The money is being spent on programmes such as laying dedicated freight lines, speeding up both passenger and freight traffic and, hopefully, reducing the cost of freight transport. The government also is setting up an independent rail regulator for the first time. In the electricity sector, investment in transmission lines and an additional 16.7GW of generating capacity for FY2017 are forecast to mean, overall, that India will have a net energy surplus in FY2017, although some states will still experience power shortages.

Recovering oil price not a problem at these levels

India is a major importer of oil and the fall in oil prices did much to improve government finances (as subsidies were withdrawn), improve the balance of payments to the benefit of the currency and hold back inflation. The oil price is off its lows and there have been some increases in fuel prices but the manager does not see any material impact on the economy at least until it reaches $60 (which at the moment seems unlikely) and is encouraged that the government is standing firm on fuel subsidies.

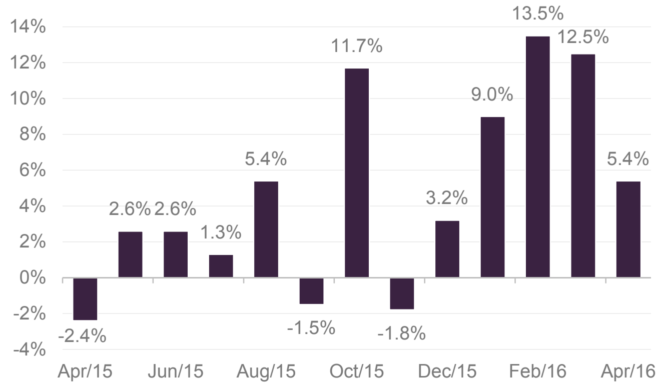
Inflation is running at around 5% to 6%, in line with central bank targets. Agricultural subsidy increases have come in at 4% to 5% which will help keep inflation within target levels.

Figure 1: India and China real GDP growth (%)



Source: Bloomberg, Marten & Co

Figure 2: Monthly change in cement production (%)



Source: Bloomberg, Marten & Co

> Rajan's departure creates uncertainty but manager believes both central bank and government committed to reforms

The central bank governor, Raghuram Rajan, is well regarded and has been given much of the credit for revitalising India's economy. He has just announced that he intends to step down when his contract expires in September this year. Some market participants are nervous that the programme of reforms instigated by Mr Rajan will falter. However, Ocean Dial were very disappointed by the announcement but are convinced that both the central bank and the government will be keen to replace him with someone of equal calibre and believe that the government sees the importance of a strong, independent central bank. The manager sees the conditions in place for a 50 basis point cut in interest rates later in the year, subject to no material change in the wider global economy or a disappointing monsoon.

To keep the reform process going, the ruling party, the BJP, needs to be able to push its agenda through parliament. Big potential reforms such as the introduction of a goods and sales tax (VAT) have been resisted by the opposition, although the outlook for this may change. State elections held in May boosted the BJP as it won control of Assam from the Congress Party. The other contested states are ruled by regional parties and saw no change of control but the BJP's share of the vote rose. Congress MPs are regularly being linked to corruption investigations, further weakening their position and leaving the BJP as the only effective nationwide political party. Ocean Dial thinks that the political balance continues to move in the BJP's favour.

Figure 3: MSCI India

Source: Bloomberg, Marten & Co

Figure 4: MSCI India forward price/earnings ratio

Source: Bloomberg, Marten & Co

Manager convinced earnings growth is on the horizon, justifying current valuations

Valuations are running a bit above long-term averages although have been on a declining trend during the last 12 months. The adviser points out that there is considerable variance between relatively expensive sectors such as consumer and private sector banks and inexpensive sectors such as infrastructure and public sector banks, largely reflecting their relative growth prospects. The manager says that analysts have consistently overestimated earnings growth at the start of each year and reduced forecasts as the year progressed. This year has seen a similar pattern. However, the adviser thinks that we could see earnings upgrades, especially towards the end of this year and early next year.

Reflections on the impact of Brexit on India and IGC

Sterling's post Brexit depreciation has boosted IGC's NAV.

A first consideration is that sterling's depreciation in the wake of the UK's EU referendum results has given a translational boost to IGC's NAV. If this adjustment turns out to be more permanent in nature, then the boost to IGC's NAV should also persist.

However, looking beyond this initial leg up, investors considering an exposure to India may will be concerned about the potential impact of "Brexit" on UK and European growth prospects, their trade with India and therefore Indian growth prospects. Our conclusion is that these effects are likely to be limited. First, India is a relatively domestically focused economy and so therefore less vulnerable to external shocks than many other countries. According to the World Bank, exports of goods and services ranged between 25.2% and 23.2% of India's GDP between 2011 and 2014.

India is a net exporter to the UK and has been for over 10 years. The depreciation in sterling, which seems likely to persist, changes the terms of trade but India's trade with the UK is relatively small (3.4% of exports and 1.4% of imports in 2015/16 according to the Department of Commerce). IGC's managers think that India's trading relationship with the UK could actually improve post Brexit. They are of the view that UK-India trade may have been hampered by India's agreement with the EU but that a more flexible arrangement could be established directly with the UK that could see the overall level of trade expand.

Exports to the EU account for 17% of Indian exports in 2015/16 and, whilst this is more significant, Ocean Dial do not see a clear catalyst for a significant change in this level. Brexit could trigger a slowdown in global growth but the managers think that that India and China should be amongst the more resilient emerging economies.

Exercising the subscription shares

There is little doubt that IGC would benefit by being bigger. A larger fund should be more liquid, have a lower ongoing charges ratio (as fixed costs are spread over a wider base) and would attract a wider range of shareholders, which in turn should help narrow the discount. As part of an effort to address this issue, IGC issued subscription shares to shareholders in August 2014, on the basis of one subscription share for every two ordinary shares held.

Subscription shares in the money. IGC set to grow by £22.9m

Today there are 37,500,710 subscription shares in issue. Each subscription share carries the right to subscribe for one ordinary share at a price of 61p, a 37.5% discount to the undiluted NAV (at the 5 July 2016) of 97.67p and a 10.3% discount to the share price of 68.0p. The subscription shares are exercisable on 6 August 2016. Assuming nothing changes between now and then, we would expect them to be exercised, increasing the assets of the fund by £22.9m (approximately 30%).

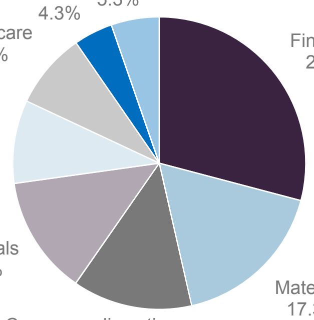
We believe IGC's discount should narrow post the exercise date regardless of the outcome as, either the fund benefits from being larger and more liquid or the NAV increases as the dilution effect of the subscription shares disappears.

Asset allocation

There were 37 holdings in the portfolio at the end of June 2016 with a median market capitalisation of £785m. The adviser tells us that there have been no new additions to the portfolio and two complete disposals. He has also advised that the fund took some profits in some areas that have performed well and increase weightings in other stocks that have experienced weakness. Of the disposals, one was mid cap technology services company, KPIT Cummins, where the manager says that, following a period of strong share price appreciation, he felt that the valuation looked full and they were able to achieve a strong exit for IGC. The second disposal was a very small position, which had entered the portfolio when it had been spun out of Max Financial Services. The managers say that they did not have a strong view on the prospects for this company and had been selling down as liquidity became available and this process is now complete.

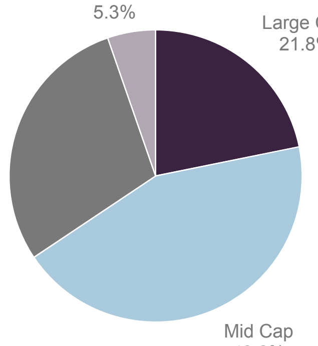
Figures 5 and 6 show the distribution of the portfolio at the end of June 2016.

Figure 5: Portfolio breakdown by industry sector



Source: Marten & Co, India Capital Growth

Figure 6: Portfolio breakdown by size of company



Source: Marten & Co, India Capital Growth

As Figure 6 shows, 21.8% of the portfolio is invested in large-cap companies (the manager defines these as companies with market capitalisations in excess of INR250bn (£2.8bn) and mid-cap as companies with market capitalisations between INR60bn (£675m) and INR250bn – the rest are small cap. Gaurav does occasionally recommend large-cap companies but the manager says that most of the large caps in the portfolio started as small or mid-caps and grew.

The Ramco Cements makes it into top 10 on performance

The Ramco Cements is a new entry into the list of top 10 holdings as the volume and price increases, that we referred to on pages 3 and 4, have helped boost its share price. It features as one of IGC's best-performing stocks over the year to the end of June 2016.

Figure 7: 10 largest holdings as at 30 June 2016

Stock	% of total assets 30/06/16	% of total assets 29/02/16	% Change	Sector	Business
Yes Bank	5.2	4.2	1.0	Financials	Private bank
Kajaria Ceramics	4.5	4.2	0.3	Industrials	Tiles
Federal Bank	4.3	4.9	(0.6)	Financials	Private bank
Jyothy Laboratories	3.9	4.3	(0.4)	Consumer staples	Household goods
Indusind Bank	3.8	3.7	0.1	Financials	Private bank
PI Industries	3.8	4.0	(0.2)	Materials	Agricultural chemicals
Dish TV India	3.7	2.8	0.9	Consumer discretionary	DTH Television
Dewan Housing	3.7	3.6	0.1	Financials	Home loans
City Union Bank	3.6	3.4	0.2	Financials	Private bank
The Ramco Cements	3.5	3.0	0.5	Materials	Cement
Total	40.0				

Source: Marten & Co, India Capital Growth

Gaurav has been busy in recent weeks, meeting up to 20 companies a week as he searches for new ideas for the portfolio. One area that he is now considering is an investment in the public sector banks (although this may not result in an increased weighting to banks as some of the successful holdings in private sector banks are likely to be top-sliced). Readers of our last note (*Compounding Machine*), may remember that the public sector banks have been struggling under the weight of non-performing loans (NPLs) and that this has held back the banking sector. However, the adviser believes that valuations of the public sector banks have reached extremely low levels and the manager points out that the combined market capitalisation of all 27 public banks is less than the market capitalisation of HFDC Bank, the largest private sector bank. This is despite the public sector banks having 74% of outstanding credit compared to 6.7% for HFDC.

It was all too easy in past years for borrowers to exploit corruption and poor management within the public sector banks. Also, state-appointed managers (who tended to have relatively short tenure at each bank) refused to recognise non-performing loans and extended new lines of credit to companies in default as a way of meeting state-imposed targets.

One or two public sector banks could enter portfolio as recovery situations

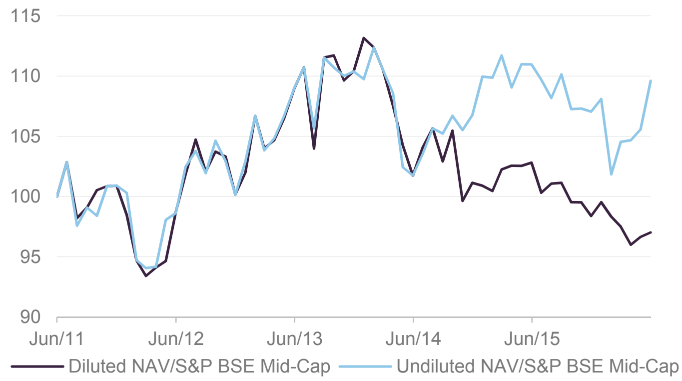
Gaurav believes that the actions of the central bank to force these banks to acknowledge and address this issue are beginning to resolve the problem. The public sector banks trade on low multiples but Gaurav believes the best of these will rerate over the course of one to two years. He is seeking to identify one or two of these banks, where he can be comfortable with earnings prospects and asset quality, to recommend to the manager.

Performance

The subscription shares have quite a large dilutive impact on NAV returns. To show you the actual portfolio performance, we have also included undiluted NAV returns in the figures below.

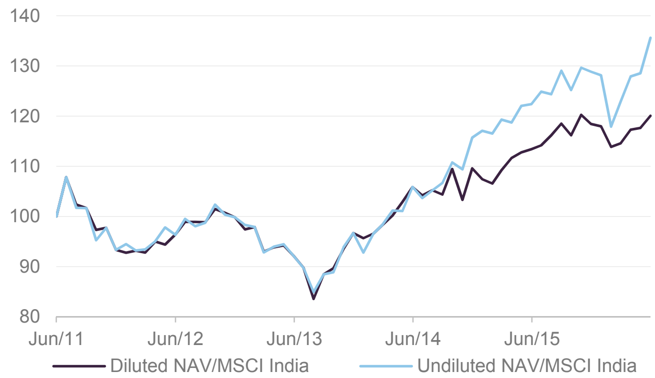
Markets have been volatile over the course of 2016 and the Indian market was no exception. Selling by foreign investors in January and February (as they cut exposure to emerging markets) drove down prices but in recent weeks they have been returning to the market. Mid-cap stocks have been outperforming larger ones for some time and IGC's large-cap exposure is holding back IGC's performance relative to the S&P BSE Mid Cap Index. The adviser tells us that there are also a few stocks in the Mid Cap Index that have been strong performers, yet he would not advise holding these in the portfolio on liquidity grounds.

Figure 8: IGC performance relative to S&P BSE Mid Cap



Source: Morningstar, Bloomberg, Marten & Co,

Figure 9: IGC performance relative to MSCI India



Source: Morningstar, Bloomberg, Marten & Co

Figure 10: Cumulative total return performance for periods ending 30 June 2016

Heading	3 months	6 months	1 year	3 years	5 years
India Capital Growth NAV (diluted)	15.8	12.4	15.4	80.1	39.3
India Capital Growth NAV (undiluted)	22.0	17.0	21.4	105.1	57.9
India Capital Growth price	13.5	4.9	12.3	79.6	30.3
S&P BSE Mid Cap	17.4	15.2	24.3	107.1	46.3
MSCI India	12.3	12.4	10.6	41.2	18.0

Source: Morningstar, Bloomberg, Marten & Co

IGC's diluted NAV has outperformed MSCI India by 4.8% over the year to the end of June 2016 and is 8.9% behind the S&P BSE Mid Cap over that period. The manager tells us that the top five positive contributors to the performance of the fund over that period were The Ramco Cements, Kajaria Ceramics, Yes Bank, Finolex Cables and Neuland Laboratories. Between them, these five stocks added 5.6% to IGC's NAV with the largest contribution (1.26%) coming from The Ramco Cements. Its share price rose by 54% over the year. The best performing stock in this list was Neuland Laboratories (+125%) adding 0.95% to NAV. It has been very volatile however. Neuland is a manufacturer of active pharmaceutical ingredients and a provider of custom manufacturing solutions to a number of major pharmaceutical companies; 70% of its exports go to the US and Europe.

The main detractors from IGC's NAV performance, of the stocks that IGC holds, were Federal Bank, Indian Bank, Gujarat Pipavav Port, Ramkrishna Forgings and Sobha. Between them these took 4.2% off the NAV.

Federal Bank was the largest holding in the portfolio when we wrote our last note, by the end of June, as you can see in Figure 7, it had slipped to number 3. Unlike Yes Bank, which features in the list of best-performing stocks, Federal Bank had some legacy non-performing loans and investors seemed to be treating it in a similar way to the public sector banks. Gaurav is optimistic though, that the proportion of NPLs on the balance sheet is falling (it was 2.8% at the end of March 2016, down from 3.1% six months earlier). The loan book is growing again (total advances rose by 13% in Q1 2016) and Gaurav thinks that Federal Bank will be rerated in time.

Gujarat Pipavav Port is a listed subsidiary of AP Moeller Maersk. India's economy is not export dependent but exports have fallen, driving down volumes passing through the port. The company is managed conservatively, which is one of the reasons that Gaurav is attracted to it, and so is perhaps better placed to weather the slowdown of exports than some of its peers. A fall in exports was behind the weakness in Ramkrishna Forgings' share price as well. Domestic end markets are picking up, however.

Capital structure - changes to CGT arrangements in India.

IGC will be subject to short-term capital gains tax but manager will work to minimise impact and long-term gains do not attract CGT

The short-term CGT in India for domestic investors is 15%. Short-term gains are those arising on trades where the shares are bought and sold within a 12-month period. If the shares are held for longer than 12 months, gains are classified as long term. Long-term gains do not attract CGT.

IGC invests through a Mauritian subsidiary, a common arrangement for foreign investors in the Indian stock market. This structure allows IGC to pay the lower of short-term capital gains due in India and Mauritius (effectively zero).

In May 2016, the Indian government moved to align the tax treatment of domestic and foreign investors in India. From 1 April 2017 to 31 March 2019, investments in India will be liable to pay short-term CGT at 50% of the current 15% rate, (i.e. 7.5%), and, from 1 April 2019, investments in India will be liable to short-term CGT at the full rate, currently 15%. Short-term losses can be offset against short-term gains.

The manager welcomed the announcement. This was something that had been under consideration for some time but, apparently, there were concerns that the tax could have been applied retrospectively. The manager says that its long-term approach to managing IGC and the relatively low level of portfolio turnover should help minimise the impact of the change. When the new regime starts, any potential CGT liability will be accrued within the NAV. The manager will also consider potential tax implications when making investments.

Board changes

On 29 June 2016, IGC announced that Vikram Kaushik would be stepping down from the board. He ceased to be a director from 30 June 2016. The company says that there are no plans currently to seek a replacement. If this remains the case, then IGC will be left with a board of three non-executive directors and will save the £20k per annum paid to Vikram as his annual director's fee.

Previous notes

Our initiation note, *Compounding Machine,* published on 23 March 2016, contains much more information about the workings of India Capital Growth. You can access that note by clicking here or by visiting our website, www.martenandco.com. For ease of reference, we have reproduced the contents page of that note below:

Compounding machine – 23 March 2016

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