

## India Capital Growth

### Indian powerhouse

India Capital Growth's (IGC's) net asset value (NAV) is up 28.8% since QuotedData's 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%. The managers cannot see any obvious reason why the discount should be widening.

India shines as a bright spot in a world beset by economic problems: GDP growth is running at 7.9%. The managers of 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 and IGC, with its focus on small- and medium-sized 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

IGC's investment objective is 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.

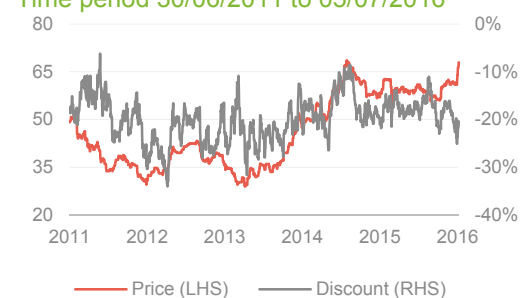
Year ended	Share price TR (%)	NAV total return (%)*	S&P BSE Mid-Cap TR (%)	MSCI India TR (%)	MSCI World TR (%)
30/06/12	(37.4)	(26.2)	(25.2)	(23.4)	(2.0)
30/06/13	15.9	4.4	(5.5)	9.2	23.2
30/06/14	33.0	30.5	40.7	13.7	10.8
30/06/15	20.3	20.1	18.4	12.2	11.0
30/06/16	12.3	15.4	24.3	10.6	16.0

Source: Morningstar, Bloomberg, Marten & Co, \*Note: fully diluted NAV returns – see pages 8 and 9 for undiluted returns.

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

### Share price and discount\*

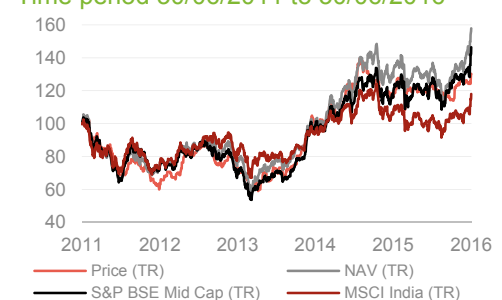
Time period 30/06/2011 to 05/07/2016



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.

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

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[www.indiacapitalgrowth.com](http://www.indiacapitalgrowth.com)

## Fund profile

Since 2010, IGC has been managed 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, given the portfolio's weighting in large-cap companies (21.8% at the end of June 2016), comparisons against the MSCI India Index have also been included. The manager does not take the composition of the index into account when constructing the portfolio.

The basis of the investment philosophy is that investors should make most money, over the long term, by being invested in those companies best placed to benefit from the Indian growth story. However, the managers say that good management is also needed if such companies are going to make the most of the opportunity.

Gaurav describes himself as a bottom-up stock-picker. He says he does not make macroeconomic calls and that he is not 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 (ROCE). Ideally he wants to find companies that have been generating cash for at least six years and are exhibiting returns on equity (ROEs) of 15% to 20%. These companies must also pay dividends and taxes. Gaurav says that cash generation alone is not enough and that there also has to be some unique selling point for the company. He is looking for companies with pricing power. Crucially, the company must also have good management, who Gaurav believes he can trust, and who are shareholder-friendly in their approach.

A fuller description of the investment approach is included in the QuotedData note, (*Compounding Machine*), published in March this year (see page 11 for more details).

## An update on India

Despite India being one of the few bright spots in the global economy, the S&P BSE Sensex has barely changed year to date. IGC's manager says that 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 by investors nervous of economic conditions in China, Brazil or Russia; 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 when results fail to live up to expectations.

Real change is happening within the economy

However, 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 are being forced to address non-performing loans, bankruptcy laws are being shaken up and directors of defaulting companies are under pressure

First, the government and central bank have been proactive in forcing public (state-controlled) banks to address the problems they have with non-performing loans (loans where scheduled payments are at least 90 days overdue, often abbreviated to NPL).

As part of its Asset Quality Review, the central bank identified 150 failing companies. It then told the banks that they must recognise these companies as being in default and treat any 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 the directors of defaulting companies, which prevent them from sitting on other boards. Not surprisingly, this process has depressed the earnings of the whole market as banks are forced to recognise these losses. The manager says that there is more to come but he thinks that the worst is now past.

A huge boost to the 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. By moving to a direct payment method, the government anticipates that 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

Indian GDP growth is running 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.

A 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, which is still an important part of Indian GDP, as well as accounting for 60% of the population.

Motorbike and cement sales are 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 is underway

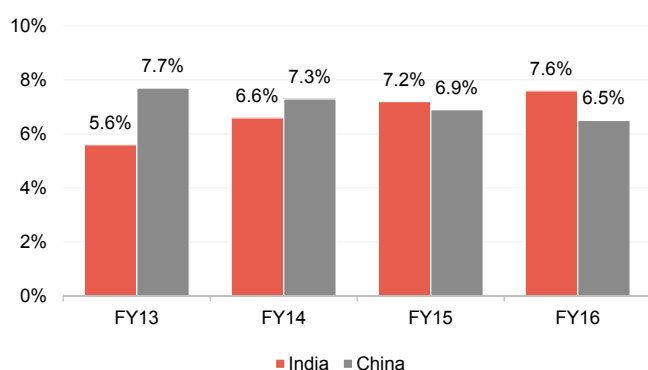
To add more detail on the government's infrastructure programme than was included in QuotedData's last report, new road construction is set to rise from 4,500km in FY2015 to 6,000km in FY2016 and 10,000km in FY2017. A quarter of India's existing roads will also be upgraded to four-to-six lane highways over the next three years. It is widely accepted that India's vast rail network is crying out for investment too. An annual rail 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 is also 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.

The recovering oil price is not a problem at these levels

India is a major importer of oil and the fall in the oil price 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 now off its lows and there have been some increases in fuel prices, but the manager does not see any material impact on the economy until the oil price reaches at least \$60 per barrel. The manager does not think this is likely at the moment and is encouraged that the government is standing firm on fuel subsidies.

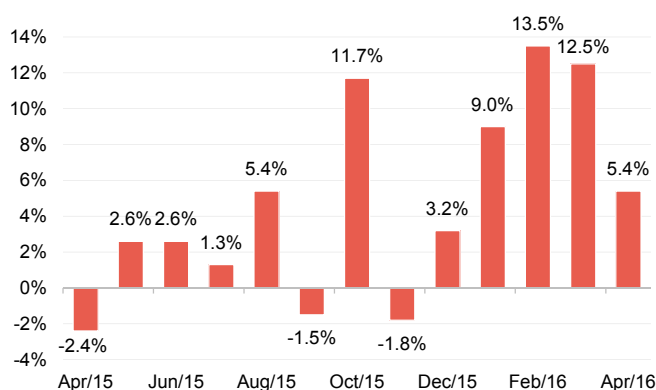
Inflation is running at around 5% to 6%, in line with central bank targets. Agricultural subsidy increases have come in at 4% to 5% and the manager says this will help keep inflation within target levels.

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 the manager believes that both central bank and government are committed to reforms

The current central bank governor, Raghuram Rajan, is well-regarded and has been given much of the credit for revitalising India's economy. However, 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 in the absence of his leadership. Ocean Dial was very disappointed by the announcement that he will not be continuing in his role, but is convinced that both the central bank and the government will be keen to replace him with someone of equal calibre and believes that the government sees the importance of a strong, independent central bank. The manager also sees the conditions in place for a 50 basis point (0.5%) 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 be changing. 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 (the primary opposition) are being linked regularly to corruption investigations. The manager says that this is 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.

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

Valuations are running a bit above long-term averages although these 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

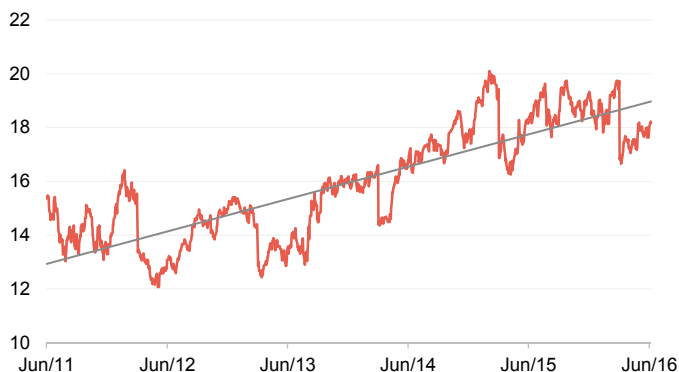
private sector banks and inexpensive sectors such as infrastructure and public sector banks, largely reflecting their relative growth prospects. The manager says that analysts have consistently overestimated earnings growth at the start of each year and reduced forecasts as the year progressed. This year has seen a similar pattern in the manager’s view. However, the adviser thinks that there could be earnings upgrades, especially towards the end of this year and early next year.

Figure 3: MSCI India



Source: Bloomberg, Marten & Co

Figure 4: MSCI India forward price/earnings ratio



Source: Bloomberg, Marten & Co

### 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 well be concerned about the potential impact of “Brexit” on UK and European growth prospects, their trade with India and therefore Indian growth prospects. However, these effects could 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 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). Ocean Dial think that India’s trading relationship with the UK could actually improve post Brexit. It is 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 does 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 India and China should be amongst the more resilient emerging economies.

## Exercising the subscription shares

There are a number of potential benefits that could accrue to IGC shareholders if its subscription shares are exercised and the fund becomes larger. Specifically, a bigger fund should be more liquid, making it easier to buy and sell, and it should have a lower ongoing charges ratio (as fixed costs are spread over a wider base). In turn this should allow it to attract a wider range of shareholders, which in turn should help narrow the discount. It was as part of an effort to address this issue that IGC issued subscription shares to shareholders, in August 2014, on the basis of one subscription share for every two ordinary shares held.

IGC's subscription shares are "in the money". IGC is 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 and the subscription shares remain in the money (IGC's share price remains above the exercise price), it seems reasonable that they will be exercised (either by existing holders or by a trustee appointed to act on the behalf of those that chose not to subscribe). If this occurs IGC's assets will increase by £22.9m (approximately 30%).

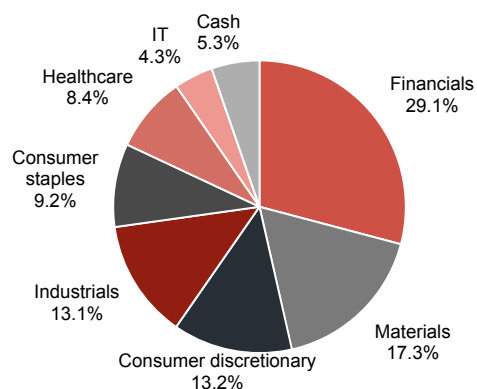
IGC's manager believes that the discount may well narrow, post the exercise date, regardless of the outcome. This is because, as discussed above, the subscription shares are exercised and the fund benefits from being larger and more liquid or, once the dilution effect of the subscription shares disappears, new demand is seen from potential shareholders who have been holding back.

## Asset allocation

There were 37 holdings in the portfolio at the end of June 2016 with a median market capitalisation of £785m. The adviser says 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.

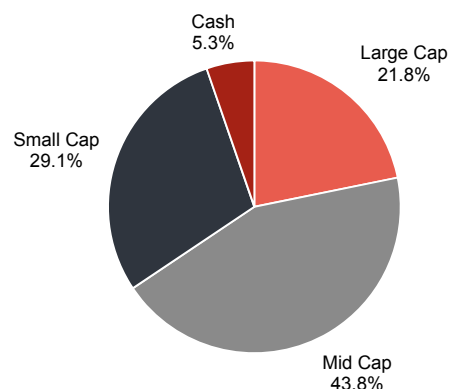
Figures 5 and 6 show the distribution of the portfolio at the end of June 2016.

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 the top 10 on performance

The Ramco Cements is a new entry into the list of top 10 holdings as the cement production volume and price increases, 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 31/05/16	% 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
<b>Total</b>	<b>40.0</b>				

Source: Marten & Co, India Capital Growth

Gaurav says he 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 the last QuotedData note (*Compounding Machine – 23 March 2016*), 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.

IGC's adviser says that it was all too easy, in past years, for borrowers to exploit corruption and poor management within the public sector banks. This problem was exacerbated as state-appointed managers (who tended to have relatively short tenure at each bank) refused to recognise NPLs and extended new lines of credit to companies in default as a way of meeting state-imposed lending targets.

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

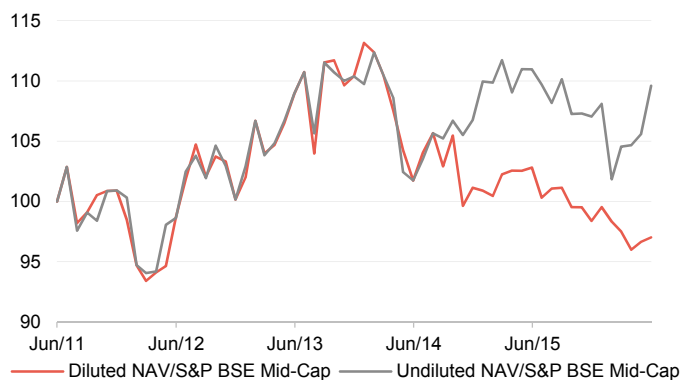
Gaurav believes that the actions of the central bank to force these banks to acknowledge and address this issue are now beginning to resolve the problem. The public sector banks trade on low multiples, but Gaurav believes that the best of these will rerate over the course of one to two years. He is seeking 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

As illustrated in Figures 8, 9 and 10 below, IGC's subscription shares, which were issued on a one for two basis, have quite a large dilutive impact on NAV returns. Whilst the diluted NAV returns are those that ordinary shareholders actually receive, undiluted NAV returns have also been in the figures below to show the portfolio's actual performance.

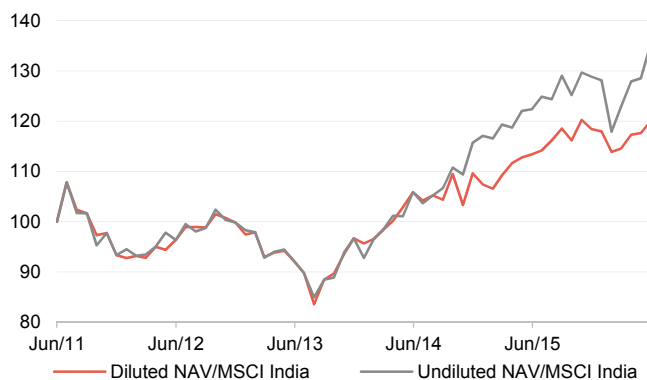
Markets have been volatile over the course of 2016 and the Indian market has not been immune to this. Selling by foreign investors in January and February (as they cut exposure to emerging markets) drove down prices in Indian shares, but in recent weeks they have been returning to the market. Mid-cap stocks have been outperforming larger ones for some time and IGC's large-cap exposure is holding back its performance relative to the S&P BSE Mid Cap Index. The adviser says 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 as he doesn't believe that there is sufficient liquidity in these stocks.

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 says 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 they deducted 4.2% from IGC's NAV.

Federal Bank was the largest holding in the portfolio when QuotedData published its last note but, as can be seen in Figure 7, it had slipped to number three by the end of June. Unlike Yes Bank, which was one of IGC's best-performing stocks, Federal Bank had some legacy non-performing loans and, according to IGC's adviser, investors seem to be treating it in a similar way to the public sector banks. Gaurav is optimistic though, that the proportion of NPLs on Federal Bank's 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 by the market in time.

Gujarat Pipavav Port is a listed subsidiary of Danish trade, shipping and energy conglomerate A.P. Moeller-Maersk. India's economy is not export dependent, but its exports have fallen and this has driven down the volumes that are passing through the port. The company has a history of being managed conservatively, which is one of the reasons that Gaurav says he is attracted to it and he believes it is better placed to weather the slowdown of exports than some of its peers.

A fall in exports was also behind the weakness in Ramkrishna Forgings' share price (the company manufactures and exports a variety of steel forgings for a range of applications including railways, automobile, defence, and mining). However, Gaurav says that there are signs that its domestic end markets are picking up.

## Capital structure - changes to CGT arrangements in India.

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

Short-term CGT (capital gains tax) in India is charged at a rate of 15% for domestic investors. In India, short-term capital gains are those arising from trades where shares are bought and sold within a 12-month period. If the shares are held for longer than 12 months, any capital gains are classified as long term. Long-term gains do not currently attract CGT in India.

IGC invests through a Mauritian subsidiary, which is a common arrangement for foreign investors in the Indian stock market. The reason is that this structure allows IGC to pay the lower of short-term capital gains due in India and Mauritius (short-term CGT, in Mauritius, is effectively zero). However, this is all set to change.

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.

Although this potentially increases IGC's liability to pay short-term CGT, the manager welcomed the announcement. This is because there had previously been concerns that the change could have been applied retrospectively, potentially creating a liability for IGC, but in the end the government chose not to take this approach.

The manager says that its long-term approach to managing IGC and the relatively low level of portfolio turnover should mean that the change should have relatively little impact on IGC and the way it is managed. However, when the new regime starts, any potential CGT liability will be accrued within the NAV and 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

QuotedData's initiation note, *Compounding Machine*, published on 23 March 2016, contains much more information about the workings of India Capital Growth. It can be accessed by [clicking here](#) or by visiting our website, [www.quoteddata.com](http://www.quoteddata.com). For ease of reference, the contents page of that note is reproduced below:

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# QuotedData

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