Update | Investment companies

21 October 2016

India Capital Growth

India at a significant discount

In August, India Capital Growth (IGC) saw the successful conversion of its subscription share issue, which increased net assets by 29.2% before costs. This expansion should improve liquidity in the company's shares and lower its ongoing charges going forward. However, despite these positive developments, an improving outlook for India and superior performance relative to its immediate peers, IGC's discount has widened both absolutely and relative to its peer group. We feel this is not justified and see a number of potential catalysts for it to narrow, particularly if IGC continues to grow and passes the £100m market cap threshold (£91.5m as at 20 October 2016).

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.

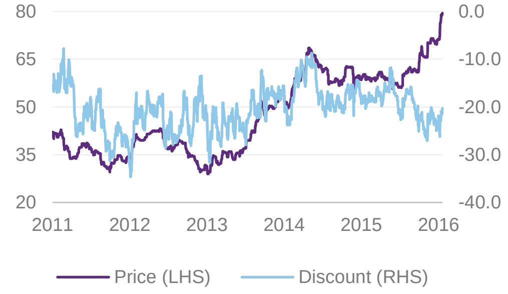
Year ended	Share price total return (%)	NAV total return (%)	Portfolio total return* (%)	S&P BSE Mid Cap TR. (%)	MSCI India total return (%)
30/09/12	(19.3)	0.9	0.9	(1.9)	3.9
30/09/13	(11.8)	(22.6)	(22.6)	(27.4)	(12.5)
30/09/14	74.6	65.3	69.7	74.3	37.1
30/09/15	11.7	12.7	18.5	16.1	1.3
30/09/16	21.6	28.0	38.0	41.5	23.5

Source: Source: Morningstar, Bloomberg, Marten & Co, *Note: rebased NAV returns.

Sector	Country specialist – Asia Pacific
Ticker	IGC LN
Base currency	GBP
Price	81.375p
NAV	101.31p
Premium/(discount)	(19.7%)
Yield	Nil

Share price and discount

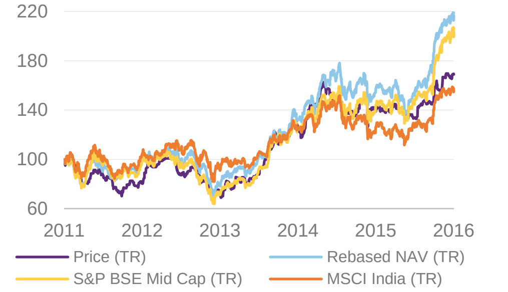
Time period 30/09/2011 to 18/10/2016



Source: Morningstar, Marten & Co

Performance over five years*

Time period 30/09/2011 to 30/09/2016



Source: Morningstar, Ocean Dial, Marten & Co *Note: all in sterling terms. See page 6 for explanation of rebased NAV.

Domicile	Guernsey
Inception date	22 December 2005
Manager and Adviser	David Cornell and Gaurav Narain
Market cap (GBP)	91.5m
Shares outstanding	112.5m
Daily vol. (1-yr. avg.)	208k shares
Net cash	7.1%

Click here for our initiation note
Click here for our most recent update note

Fund profile

Further information is available at 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 hold large-cap stocks 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 that given the portfolio's weighting in large-cap companies (those in the US$2bn to $7bn range represented 11.6% of the portfolio at the end of September 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.

Focusing on companies exposed to the 'Indian growth story'

IGC is focused on companies exposed to the 'Indian growth story', which have good management.

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

Bottom-up stock selection

The advisor is searching for companies that can grow and generate high cash returns on capital employed. He wants companies with at least six years of cash generation and which have ROEs between 15% and 20%.

Gaurav is a bottom-up stock picker. He says that he does not make macroeconomic 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 - the company must have a USP. 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, which are shareholder friendly.

A fuller description of the investment approach is included in our initiation note, (*Compounding Machine)*, published in March this year (see page 10 of this note for details).

Significant increase in fund size as subscription shares exercised

A successful subscription share exercise has increased IGC's size. All things being equal, this should lead to improvements in liquidity and a lower ongoing charges ratio.

We have previously said that IGC would benefit from being larger. We believe that this would benefit shareholders by increasing liquidity and by lowering IGC's ongoing charges ratio, by spreading its fixed costs over a wider asset base. This in turn should make it more attractive to a wider range of investors and, all things being equal, increase demand for its shares, which should help to narrow the discount.

In this regard, IGC has made a significant step forward following the successful exercise of its subscription shares in August 2016. The subscription shares were issued in August 2014 as a one for two bonus issue. At maturity, on 6 August 2016, there were 37,500,710 subscription shares in issue, with an exercise price of 61p, and 75,001,463 ordinary shares in issue with an undiluted NAV of 104.41p per ordinary share. The overwhelming majority of existing shareholders took up their subscription rights (91%) and the rump was placed in the market so that all of the subscription shares were converted. As a result, the subscription share exercise saw IGC's total NAV increase by 29.2% from £78.3m to £101.2m. As at 20 October 2016, IGC has 112,502,173 ordinary shares in issue.

Asset growth, share issuance and discount narrowing could see IGC's market cap exceed £100m. Passing this threshold would open IGC up to a band of new investors.

In addition to the expected benefits of both an improvement in liquidity and lower ongoing charges (discussed above), the subscription share exercise has contributed to an increase in IGC's market cap (£91.5m as at 20 October 2016). At this level, IGC's market cap is relatively close to the £100m threshold used as a cut-off point for many investors, below which they do not invest. It seems reasonable that, with some asset growth, further issuance or discount narrowing, IGC's market cap could pass this threshold, which would allow some previously excluded investors to purchase shares, which could support further demand for the company's equity.

Readers interested in further details of IGC's subscription shares should see page 12 of our March 2016 initiation note and pages 5 and 6 of our July 2016 update note.

An update on India

The manager is very positive on the outlook for India. He says that the market has been sceptical on Modi's ability to deliver his reform agenda but, in his view, Modi is making huge leap forwards that are transforming the country (for example the new bankruptcy laws and a new Good and Services Tax, as well as a host of other regulatory changes). The manager thinks that the market is starting to wake up to this and that there is a lot more potential upside as further reforms come through and the markets come to recognise that the improvements are real. He also says that the economy showing signs of meaningful recovery.

India already stands out as one of the faster growing countries of the emerging world, but the last few months have seen some developments that could both underscore and even accelerate that growth in the medium term.

A good monsoon after three years of below-average rainfall, which supports consumption.

The first of these was a good monsoon. Three years of below-average rainfall had depleted reservoirs and put constraints on agricultural incomes. This year's monsoon appears to have delivered normal rainfall across much of the country with the exception of east and north east India and a few southern states. This bodes well for consumer spending and inflation.

There has been a 25% increase in state employees' incomes, adding further support to consumption.

To add to the good news on consumer disposable incomes, there have been 25% wage increases for state employees. Gaurav says that consumer companies are expecting to see a strong uplift in sales during the festival season and they have been building inventory in anticipation.

The government's Goods and Services Tax Bill has passed through parliament. This replaces a labyrinth of taxes and should lead to various efficiency improvements.

In another potential boost to the domestic economy, the government has managed to get its Goods and Services Tax (GST) Bill through parliament, paving the way for an introduction of India's equivalent of VAT by April 2017. The managers believe that this will have far reaching benefits for India's economy. They expect its implementation will add between 0.9% and 1.9% to India's GDP growth per annum. GST replaces a labyrinthine collection of state and federal taxes that are collected at state borders. The collection system is bureaucratic, vulnerable to fraud and creates a myriad of inefficiencies. For example, companies often resort to having duplicate warehouse and manufacturing facilities, across states. The new system could have a significant positive impact on India's logistics sector allowing companies to introduce more efficient 'hub and spoke' models.

For the government, the IT development needed for GST's implementation is largely complete and it is confident that the April 2017 deadline can be met. Gaurav is less convinced that the private sector is ready, however. One other significant factor that needs to be addressed is agreeing what the GST rates will be. A negotiation is taking place, designed to soothe the states' concerns that their overall tax income will be adversely affected. However, Gaurav believes that the implementation of GST will increase tax income overall as more companies are brought into the tax net and there is less leakage at the point of collection.

More efficient logistics should benefit GDP in time although, in the short term, there could be a small hit to demand as inventories fall. Depending on where rates are set, GST could also prove to be mildly inflationary in the short-term.

In our last update note, we noted the resignation of Raghuram Rajan as central bank governor. This created some nervousness amongst investors given Rajan's good track record. Since then, we have seen the appointment of his deputy as his replacement and the creation of a new Monetary Policy Committee to advise him. This news has been well received. Overall inflation is falling despite some recovery in fuel prices and this has allowed the central bank to cut rates again to 6.25%.

A more moderate approach to banking regulation is expected going forward.

Gaurav thinks that the authorities will ease up a little on the banking sector and welcomes this. The efforts that the central bank had made to force banks to clear up their balance sheets were very positive but, in his view, this had gone too far. For example, loans that had been swapped for equity still had to be treated as non-performing and provided for.

The manager thinks that one of the missing links in the Indian growth story is a lack of private sector investment. He believes that, in part, this can be attributed to a lack of available finance, despite the growth of the alternative sources of finance. With less pressure on the banks, consumer demand picking up and capacity utilisation rates climbing, companies may start investing.

Another issue holding back growth is the knock-on effect of anaemic growth in the rest of the world. This is showing up as slow demand for Indian exports. IT outsourcing businesses have also been affected adversely.

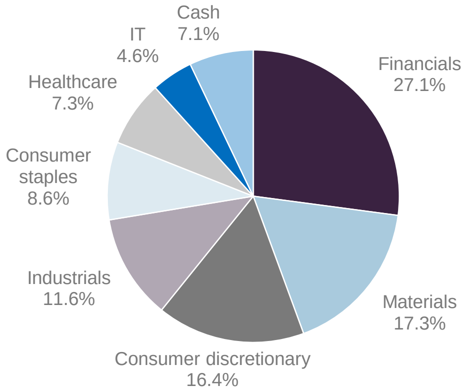
Asset allocation

Deploying the subscription share proceeds

The manager has been investing the proceeds of the subscription share conversion and this process is now complete. Three new stocks have been added to the portfolio.

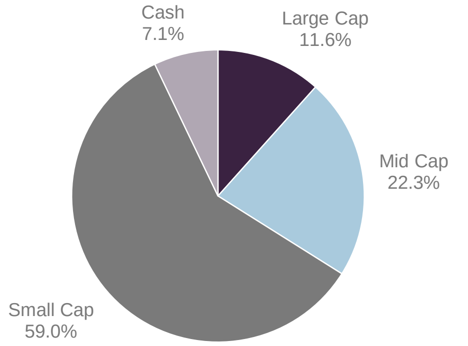
The manager has been investing the cash raised from the subscription share conversion and this process is complete. Most of the new money has been invested in existing holdings although there have been three new stocks added to the portfolio (Skipper, Kitex Garments and Welspun India). The new cash deployed has been tilted towards the small- and mid-cap stocks. As a consequence, the allocation to the large caps has fallen, as has the concentration of the top 10 holdings (see Figure 3 overleaf). These three new additions are discussed in further detail below (please see our March 2016 initiation note and July 2016 update note for discussions of other holdings). Other than this, the manager says that there has been little change in the portfolio, with most changes being performance driven.

Figure 1: Portfolio breakdown by industry sector



Source: India Capital Growth, Marten & Co

Figure 2: Portfolio breakdown by size of company



Source: India Capital Growth, Marten & Co

Figure 3: 10 largest holdings as at 30 September 2016

Stock	% of total assets 30 Sept. 16	% of total assets 30 June 16	% change	Sector	Business
Yes Bank	5.1	5.2	(0.1)	Financials	Private bank
Federal Bank	4.4	4.3	0.1	Financials	Private bank
Dewan Housing	4.2	3.7	0.5	Financials	Home loans
Jyothy Laboratories	4.0	3.9	0.1	Consumer staples	Household goods
Kajaria Ceramics	3.7	4.5	(0.8)	Industrials	Tiles
Motherson Sumi Systems	3.5	3.1	0.4	Consumer discretionary	Automotive components
Dish TV India	3.3	3.7	0.6	Consumer discretionary	DTH Television
PI Industries	3.1	3.8	(0.7)	Materials	Agricultural chemicals
IndusInd Bank	2.9	3.8	(0.9)	Financials	Private bank
Sobha	2.9	2.7	0.2	Financials	Real estate development
Total of top 10	37.1	40.0	(2.9)		

Source: India Capital Growth, Marten & Co

Skipper

One of the top three transmission tower manufacturers in India. It is a cash rich, high ROCE company.

Skipper (www.skipperlimited.com) describes itself as one of the top three transmission tower (pylon) manufacturing companies in India and among the top 10 in the world. IGC's manager says that it is a cash-rich, high ROCE company that is a play on expanding power distribution and a growing power supply market. IGC's manager says that it has a number of advantages: it is focused only on tower manufacturing (unlike peers who also do engineering, procurement and construction (EPC)), hence is a partner of choice for all bidders for Power Grid Corporation of India (the world's largest electricity transmission utility) orders.

The company offers a complete solution that includes design and the entire manufacturing process, which not only gives it 100% materials traceability, but its in-house rolling mills allow it to operate with lower inventory levels. Skipper is one of a small number of manufacturers that are able to supply 1,200kv towers and transmission monopoles, which are now being deployed in India.

Kitex Garments

Kites Garments is the second largest producer of children's clothes in the world. High barriers to entry allow it to achieve high margins and a high ROCE.

Kitex Garments (www.kitexgarments.com) is the second largest producer of children's clothing in the world. It employs over 7,000 people at its facility in Kochi and is the largest private sector employer in the state of Kerala. IGC's managers consider it to be a high-quality company that has high margins (c35%) and a high ROCE (c20%). They say that these can be achieved because its niche market has high barriers to entry. Kitex's focus on children's clothing, particularly for infants, requires the use of non-standardised dyes as well as traceability of materials. Kitex is able to offer these and is a supplier to a number of US and European retailers, including Walmart. IGC's manager says that it is difficult to replicate Kitex's business (he says it has one major competitor in Taiwan and one in China) and so the company continues to grow strongly, at around 20% per annum.

Welspun India

Welspun India is one of the largest home textile manufacturers globally.

Based in Mumbai, Welspun India (www.welspunindia.com) is one of the largest home textile manufacturers in the world. It exports to over 50 countries and has a strong presence in the US (approximately 30% market share). Gaurav started building a position in the stock in July 2016 but, during August 2016, Target, the second-largest discount retailer in the US, severed ties with Welspun India accusing the company of labelling cheaper bedsheets as being made of Egyptian cotton.

In September, Walmart removed Welspun's Egyptian cotton products from its stores but is continuing to stock other Welpsun products. Other retailers, such as Ikea which does not sell Welspun Egyptian cotton, are waiting for the outcome of Target's investigation before taking any action. Two class action law suits have been filed against the company in the US.

Welspun India's share price has suffered heavily following accusations that it falsely labelling some products as Egyptian cotton.

Following the emergence of the scandal, Welspun India sold off dramatically with its share price falling some 55% between 19th and 30th of August. Gaurav felt that the market had overreacted. He has met management twice and is following the position very closely. He believes that Welspun's management is handling the issue well, both in terms of addressing the problem and informing the stock market, and has been adding to the position at what he considers to be depressed valuations.

Performance

Introducing the rebased NAV

With a view to providing investors with a means to assess IGC's historic performance, in the absence of what the manager sees as the distorting effect of dilution caused by the subscription shares, IGC's manager has calculated a rebased NAV series. In effect, this takes the company's portfolio size following the subscription share exercise (just over £100m) and applies, on a day by day basis, the historic performance of the (smaller) portfolio prior to the exercise of the subscription shares.

This impact of the diluting effect is illustrated in Figures 4 and 5 below with the rebased NAV series outperforming that of the ordinary's shares diluted NAV from September 2014.

Readers interested in further detail regarding IGC's historic performance should see pages 9 and 10 of our March 2016 initiation note and pages 7 to 9 of our July 2016 update note.

Recent performance

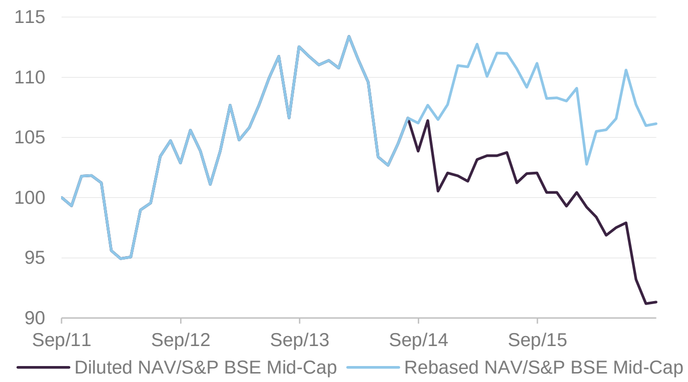
The Indian market has benefitted from a good monsoon. This tends to benefit consumer companies.

Since we wrote our last note, in July, Indian markets have continued to move up, buoyed by good news including the passing of the GST bill and the and the monsoon. This has a number of benefits for the Indian economy. For instance, a good monsoon supports agriculture, which serves to lower food prices, thereby freeing up income for other consumption, and consumer companies tend to benefit. IGC's managers say that many consumer companies have since been building their inventories ahead of what is expected to be a strong festival season.

IGC's bank holdings (Yes Bank, Federal Bank and Indian Bank) were broadly strong contributors in July and August, but this tailed off in September. This may in part reflect the news of changes at the Reserve Bank of India (see pages 3 and 4) although IGC's managers say that the stocks have had a good run and there has been some profit taking by the market.

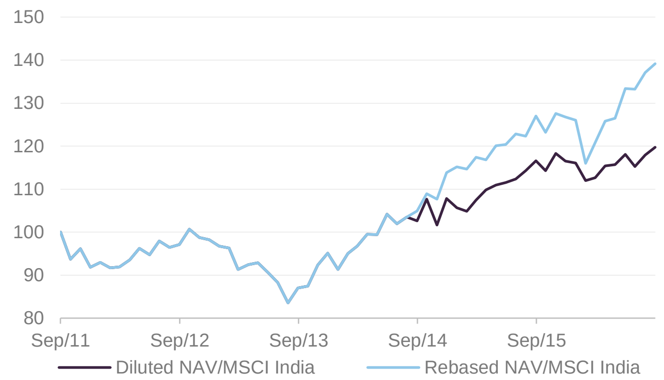
Welspun India, discussed on page 6, was a negative contributor in August as a scandal concerning the false labelling of some products as Egyptian cotton emerged. Ramkrishna Forgings also suffered, but IGC's managers say that there are signs that industrial and infrastructure demand is picking up.

Figure 4: IGC performance relative to S&P BSE Mid Cap



Source: Morningstar, Bloomberg, Marten & Co,

Figure 5: IGC performance relative to MSCI India



Source: Morningstar, Bloomberg, Marten & Co

Figure 6: Cumulative total return performance for periods ending 30 September 2016

Heading	3 months	6 months	1 year	3 years	5 years
India Capital Growth NAV (diluted)	11.4	29.0	28.0	138.4	86.3
India Capital Growth NAV (rebased)*	14.3	39.5	38.0	177.4	116.8
India Capital Growth price	11.1	26.2	21.6	137.1	68.8
S&P BSE Mid Cap	17.1	37.4	41.5	186.2	103.8
MSCI India	8.3	21.7	23.5	71.5	56.0

Source: Morningstar, Bloomberg, Marten & Co *Note: ICG's rebased NAV is calculated by the company's manager. It is calculated by taking IGC's NAV as at the exercise of its subscription shares (89.84p as at 6 August 2016) and rebasing this value by applying the performance of IGC's undiluted NAV, prior to the exercise of its subscription shares. This generates a rebased series, which is comparable in size to that of IGC's diluted NAV but adjusted to reflect the undiluted NAV's performance prior to the exercise of IGC's subscription shares.

Peer Group

Figure 7: Indian equity funds subsector comparison (data as at 20 October 2016)

	Market cap	Discount	Ongoing charge	Annualised NAV total return performance periods to 20 October 2016			
				1 year	3 year	5 years	10 years
	(GBPm)	(%)	(%)	(%)	(%)	(%)	(%)
India Capital Growth	92	(19.7)	1.98	38.3	33.5	16.2	0.6
JPMorgan Indian	712	(14.1)	1.24	35.2	25.5	14.4	10.6
New India	241	(12.7)	1.21	34.0	23.9	14.9	12.8

Source: Morningstar, Marten & Co, *Note: IGC's ongoing charges of 1.98% is a historic figure. The increase in size should lead to a reduction in ongoing charges, for the current financial year, as IGC's fixed costs are spread over a larger asset base. The manager estimates ongoing charges to be 1.85% for an AUM of £100m.

Please visit QuotedData.com for a live comparison of IGC and its 'Country Specialists – Asia Pacific' peer group.

In comparing IGC with its peers, it is worth noting that IGC's proposition is distinctly different from the other two. IGC has a small- and mid-cap focus, whilst the other two are focused on large-cap Indian stocks. IGC's manager says that the mid-cap segment is where they see the strongest value and growth opportunities.

All three funds have grown, since we last wrote about IGC in July, assisted by the weakness of sterling post Britain's referendum on EU membership. However, of the three, IGC has seen the largest proportionate increase, as it has also benefitted from the exercise of its subscription shares. IGC remains the smallest of its immediate peers, but it is now approaching the £100m market cap (£91.5m as at 20 October 2016). If IGC continues to grow, and move beyond this level, we think it could see an increase in demand from many institutional investors for whom a market cap below £100m is a cut-off for investing. A narrowing of its discount, the widest in the subsector, could help in this regard.

All of IGC's Indian focused peers have seen their discounts widen recently.

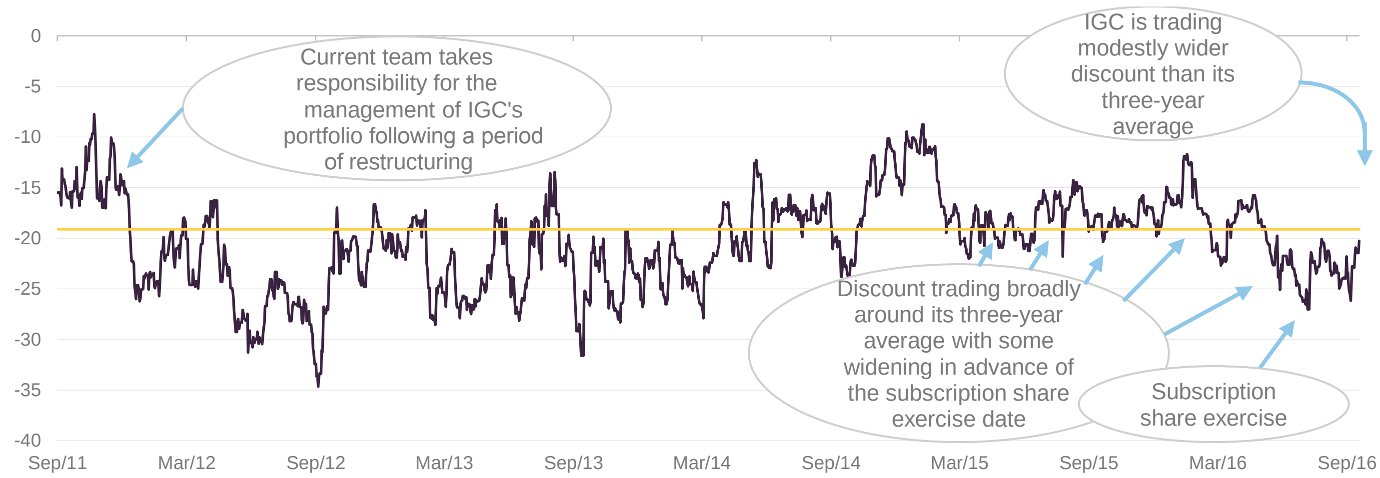
All of the funds in IGC's subsector have seen their discounts widen since we last wrote in July. However, IGC, which previously had the widest discount, has seen its discount widen the most. We feel that this is unjustified. IGC's undiluted NAV performance has been superior to that of its peers in recent years and, as discussed in the performance section on pages 6 and 7, longer-term shareholders who retained their subscription shares would have achieved superior performance to that illustrated in Figure 7 above. It should be noted that the 10-year and, to a much lesser extent, the five-year performance numbers, illustrated in Figure 7 above are distorted by the poor performance of IGC's legacy portfolio – before David and later Gaurav became involved with the management of the portfolio (see page 4 of our March 2016 initiation note for more details), following a period of restructuring.

We expect IGC's ongoing charges to fall following its increase in size.

IGC's ongoing charges ratio is higher than that of its peers but, in our view, is not much higher given the size differentials. The 1.98% figure quoted in Figure 7 is a historic value for the year ended 31 December 2015. However, we expect this to fall in the current financial year and the year ended 31 December 2017 as, following the exercise of its subscription shares, IGC spreads its fixed costs over a larger asset base. IGC's managers estimate its ongoing charges to be 1.85% for an AUM of £100m.

Premium/discount

Figure 8: Premium/(discount) to diluted NAV over five years



Source: Morningstar, Marten & Co.

As illustrated in Figure 8, during 2015, IGC's discount traded in a relatively narrow range around its three-year average of 19.1%. Global markets wobbled in the early part of 2016, as concerns about China came to the fore, and Indian markets were weak in both January and February, hampered additionally by concerns that the Indian government was going to allow fiscal deficit targets to slip in favour of providing additional stimulus; and that there could be changes to long-term capital gains. During this period, IGC's share price saw limited movement whilst its NAV contracted and the discount narrowed to below 12%. However, these concerns proved unfounded and as Indian markets recovered in March, IGC's share price failed to keep pace and the discount widened.

IGC's discount has widened this year as its share price has failed to keep pace with NAV growth.

We see various catalysts for discount narrowing

This has largely been the trend for the remainder of 2016: Part of the lag may be related to the subscription share exercise and the potential to create an overhang in the market. Following the subscription shares exercise, and the removal of this overhang, the ordinary share's discount has broadly been on a narrowing trend.

It is our view that, given the significant increase in IGC's size (and the improvements in liquidity and lower ongoing charges that this should bring) and IGC's superior performance, the widening, ahead of its peers, does not seem justified (IGC was trading at a discount of 19.7% as at 20 October 2016). The discounts on all of IGC's Indian-focused peers have widened; possibly a reaction to concerns over changes at the central bank. However, we believe that the new governor is of a similar discipline and that, as markets get comfortable with this, there is the prospect for discount narrowing. Other potential catalysts for discount narrowing include continued outperformance by both IGC and the Indian market, an improvement in the outlook for the Indian market and the prospect of IGC being opened up to new shareholders should its market cap pass beyond the £100m threshold.

We continue to maintain the view that IGC is a relatively small company, but it is making efforts to increase investors' awareness of its performance track record and the attractions of the Indian market. We continue to envisage a scenario where the discount narrows sufficiently over time to allow the fund to expand further.

Previous research publications

Readers interested in further information about IGC, such as investment process, fees, capital structure, trust life and the board, may wish to read our initiation note *Compounding machine,* published on 23 March 2016 and our update note, *Indian powerhouse,* published on 8 July 2016. The contents pages have been reproduced below. You can read the notes by clicking on them in Figure 9 or by visiting our website, www.martenandco.com. For ease of reference, we have reproduced the contents page of the notes below.

Figure 9: Marten & Co. previously published research on IGC

Title	Note type	Date
Compounding machine	Initiation	23 March 2016
Indian powerhouse	Update	8 July 2016

Source: Marten & Co.

Compounding machine – 23 March 2016

Indian powerhouse – 8 July 2016

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