MARTEN & CO

Update | Investment companies

29 November 2018

India Capital Growth

Shakeout uncovers value

The Indian market slid in September, extending its run of losses in 2018, and has seesawed since. The main culprit was the oil price, which feeds through into inflation concerns, rising interest rates, a falling rupee and what appears to have been, a liquidity squeeze. A sharp fall in the oil price since mid-October may now be heralding a recovery in Indian equities. Against that backdrop, India Capital Growth (IGC)'s manager and adviser (David Cornell and Gaurav Narain, respectively) see real value emerging in the portfolio.

They point out that company earnings are growing once again and, while volatility may persist in the run up to elections in April/May 2019, they have been able to raise cash for redeployment into attractive opportunities. We think that this could prove to be the buying opportunity that some investors have been waiting for. The interest in this trust is illustrated by the resilience in its discount over this period, which is currently narrower than its peers.

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 are predominantly in listed mid-and-small-cap Indian companies.

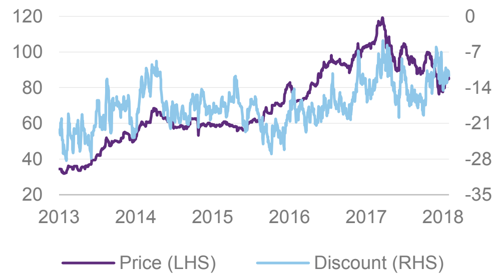
Year ended	Share price total return (%)	NAV total return (%)	Portfolio total return* (%)	S&P BSE Mid Cap TR (%)	MSCI India total return (%)
31/10/14	51.8	51.8	59.4	65.2	30.6
31/10/15	12.2	7.1	10.1	9.7	(4.9)
31/10/16	40.4	40.7	51.4	54.5	32.2
31/10/17	24.7	18.9	18.9	18.0	13.0
31/10/18	(23.1)	(23.8)	(23.8)	(19.2)	(9.2)

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

Sector	Country specialist – Asia Pacific
Ticker	IGC LN
Base currency	GBP
Price	85.00p
NAV	96.24p
Premium/(discount)	(11.6%)
Yield	Nil

Share price and discount

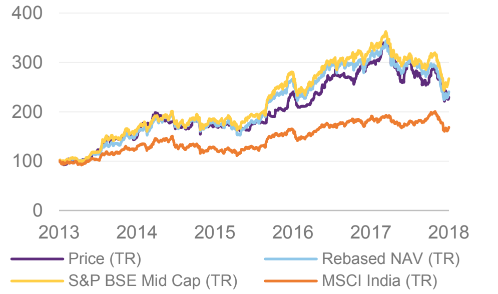
Time period 31/10/2013 to 27/11/2018



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/10/2013 to 31/10/2018



Source: Morningstar, Marten & Co

Domicile	Guernsey
Inception date	22 December 2005
Manager / adviser	David Cornell / Gaurav Narain
Market cap	95.6m
Shares outstanding	112.5m
Daily vol. (1-yr. avg.)	373.1k shares
Net gearing	Nil

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New website

Ocean Dial continues to invest in marketing IGC, as part of its commitment to eliminate the discount over time. One recent initiative was a rebuild of the company's website https://www.indiacapitalgrowth.com.

Oil greases the slide

Small and mid-cap stocks fell further than large cap stocks, driven largely by a rising oil price

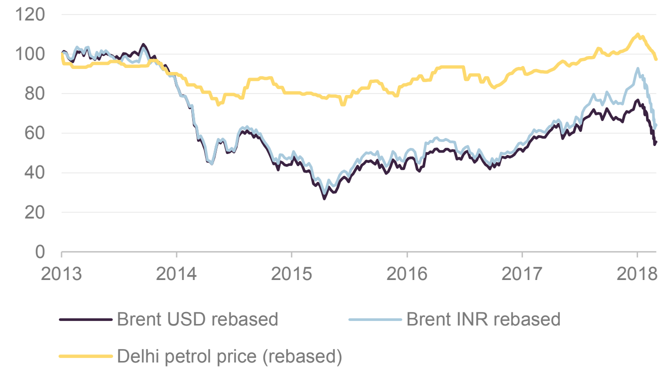
As was evident in the table on page 1, the fall in the Indian market has been concentrated in small and mid-cap stocks (IGC's core focus), with the S&P BSE Mid Cap Index lagging MSCI India by 10% over the year to the end of October 2018. Market valuations were elevated and there was room for a correction, but the catalyst for this has been the rise in the oil price. This, in turn, appears to be due to President Trump's rejection of the Iran nuclear deal and the re-imposition of sanctions that specifically target Iran's oil exports and transactions between foreign financial institutions and Iran's central bank.

This was a major cause for concern as India is a major oil importer and one of Iran's key customers. However, India is one of nine countries that has been granted a temporary waiver by the US to allow it to import reduced quantities of Iranian oil (individual country targets have not been released but it is reported that all of the countries receiving waivers have agreed to significantly cut Iranian oil purchases further by May 2019). Gaurav does not believe India will want to jeopardise its relationship with the US (and risk exposing its companies to US sanctions) and so will reduce/eliminate its purchases of Iranian oil but the waiver gives it more time to adjust.

A weaker rupee has exacerbated the oil price rise

The collapse of the oil price in 2014 benefited the Indian economy and the government took the opportunity to eliminate fuel subsidies, strengthening its finances. India's current account improved and, for some time, its currency remained fairly stable relative to the US dollar (see Figure 4). For most of the past year or so, the oil price rose. For Indians this trend was exacerbated by a weakening of the rupee, which in turn faltered on the increasing impact of oil imports on India's current account (see Figure 2) as well as rising US interest rates.

Figure 1: Oil/fuel prices in US$ and Indian rupees to 28 November 2018



Source: Bloomberg, Marten & Co, IOCL

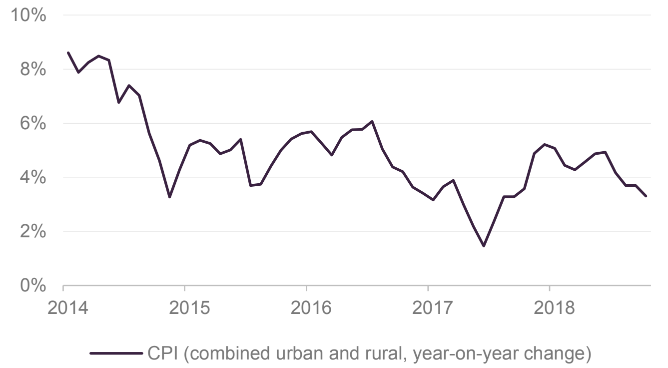
Figure 2: Net oil imports (billions of rupees) to 30 September 2018

Source: Reserve Bank of India, Marten & Co

RBI has held interest rates constant

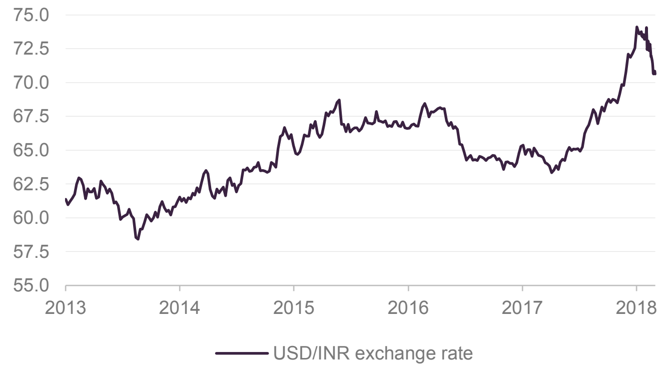
The Reserve Bank of India (RBI) reacted to the unfolding situation by raising rates. In June 2018, it reversed a four-year trend of rate cuts with a quarter point increase to 6.25% and a second quarter point rise increased the rate to 6.5% in August. A third increase that had been anticipated in October failed to materialise. Even though the oil price has fallen back, there have been concerns about the lagged impact of this on inflation. However, this has, to a certain extent, been offset by falling food prices on the back of a good monsoon. In November the RBI committee met for an exceptional 10 hours. This led to decisions to restructure small scale loans, give consideration to relaxing lending rules for banks and a committee is to be established to discuss the controversial issue of transferring surplus reserves to the government. The RBI has also increased its open market operations.

Figure 3: Indian consumer price inflation to end October 2018



Source: Reserve Bank of India, Marten & Co

Figure 4: Indian rupee/US dollar exchange rate to 28 November 2018



Source: Bloomberg, Marten & Co

The adviser does not think there is a particular problem with hard currency debt in India

The current account deficit widened from a low of 1% to 2.4% in the quarter ended 30 June 2018. The rupee's 13.8% decline against the US dollar made it one of the worst performing currencies in Asia. Fortunately, Gaurav does not believe that there is a hard currency borrowing problem within India.

Oil price now falling, share prices responding but further to go

Over the last month, however, the oil price has gone into reverse. Indian equity prices have responded but have not yet recovered their losses. This is especially true of mid and small cap stocks.

Elections next year

The government did not intervene to dampen the effects of fuel price rises through the reintroduction of subsidies. However, it did cut fuel duties, by 1.5 rupees per litre and asked oil companies to cut their marketing margins by 1 rupee a litre. This latter idea was not well received by investors across the board, who saw it as undue interference in the market. and oil marketing stocks suffered as a result.

New support measures for agricultural produce prices

There is an expectation that the government will announce some market/consumer friendly measures ahead of next year's elections. In the meantime, the government has revised its minimum support prices for a range of crops. In the past, the government has chiefly bought rice and wheat in these support operations but there was a concern that this was leading farmers to abandon other crops. The new minimum support prices have been calculated on the basis of cost plus a 50% margin. It remains to be seen whether this has any impact on the rural vote.

Problems in non-bank financials

At the end of September, Infrastructure Leasing and Finance Services (ILFS), an AAA-rated, unlisted infrastructure finance company with a $13bn loan book and 349 subsidiaries around the country, defaulted (IGC was not an investor in ILFS but the effects of the default have been felt across the market). ILFS' founders included Life

Insurance Corporation of India, HDFC, ADIA and State Bank of India. Most banks and mutual funds along with several cash rich companies have had direct exposure to ILFS bonds. It appears that a number of ILFS projects may have run into problems acquiring the land they needed and the projects suffered from cost inflation.

Default of infrastructure finance business had a knock-on effect on non-bank financials including Dewan Housing Finance

The default has triggered a liquidity squeeze in the short-term commercial paper market in India (the default has caused yields to spike). The adviser thinks that the liquidity squeeze may also have been exacerbated by companies paying taxes and the central bank selling dollars in an attempt to stem the rupee's slide.

The Government has acted swiftly to prevent a contagion effect. TheILFS board has been refreshed (Uday Kotak, managing director of Kotak Mahindra Bank, has been parachuted in as the new non-executive chairman). Efforts are being made to liquidate some of its business and boost capital through a rights issue.

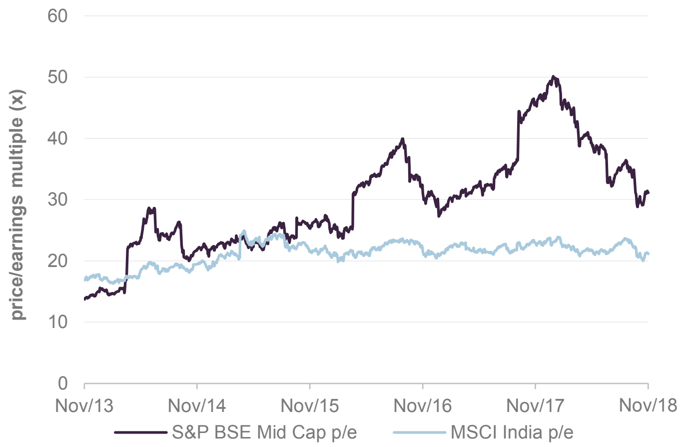
Figure 5: Dewan Housing Finance share price

Source: Bloomberg, Marten & Co

In the immediate wake of this, a mutual fund sold Dewan Housing Finance (Dewan) commercial paper at an 11.2% yield, well-above the level it had been trading at. A rumour immediately circulated, that Dewan was going to default on its debt, and its share price collapsed. A number of other non-bank financials stocks also experienced share price declines as fears grew of a wider problem. It is also expected that the rate of growth of these stocks will slow. In the event, there have been some commercial paper issues by some of these entities at reasonable yields since then and Gaurav thinks calm is returning to this area of the market. However, in the current environment he favours banks over non-bank financials stocks and thinks rising rates could allow them to expand their margins. Prior to the share price fall, IGC's adviser had been reducing the holding in Dewan. The adviser says that 60% of the position was sold. The average selling price was INR 630 per share, with an average buying price of INR 120 per share at an average. This 425% return has been made over an average holding period of around five years. IGC is still sitting on a substantial book profit for the remaining holding.

An earnings recovery

Figure 6: S&P BSE Mid Cap and MSCI India trailing p/e multiples



Source: Bloomberg, Marten & Co

Figure 7: Premium/discount of S&P BSE mid-cap index trailing p/e versus Sensex Index trailing p/e

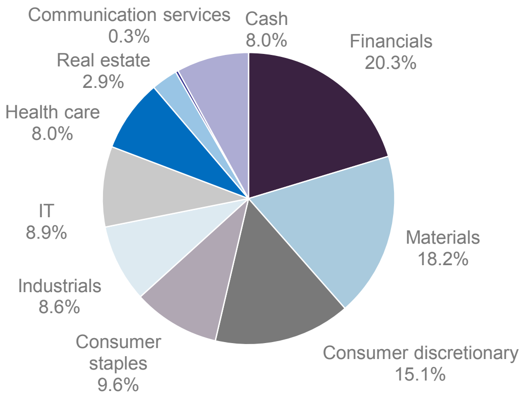
Source: Bloomberg, Marten & Co

Ocean Dial is expecting earnings growth from its portfolio over the next two years of 23.7% and 30.7% respectively

Ocean Dial believes that negative earnings impact of GST and demonetisation appear to be in the past and that a combination of falling markets and rising earnings is making valuations look more attractive (as illustrated in Figure 6). Furthermore, the adviser is expecting strong earnings growth from the portfolio over the next two years (23.7% for FY19 and 30.7% for FY20 respectively), which more than offsets a less positive short-term macro outlook. As illustrated in Figure 7, the adviser highlights that the S&P BSE Mid-Cap has tended to trade at a valuation premium to the broader Sensex Index. This premium has compressed recently so that is now modestly above its five-year average but the adviser comments that, when the market has experienced such falls in the past, the recovery has tended to be sharp and it believes there is strong potential for this to reoccur at some point.

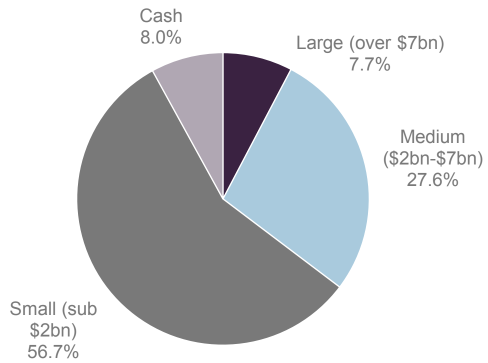
Asset allocation

Figure 8: Portfolio breakdown by industry sector at 31 October 2018



Source: India Capital Growth Fund, Marten & Co

Figure 9: Portfolio breakdown by size of company at 31 October 2018



Source: India Capital Growth Fund, Marten & Co

Since we last published on IGC, the largest change to the industry sector exposure within the portfolio has been a fall in the financials weighting, reflecting the reduction in exposure to Dewan, and an increase in cash as the adviser suggested that the trust take profits on some positions.

10 largest holdings as at 31 October 2018

At the end of October, the 10 largest holdings in IGC's portfolio accounted for 38.7% of the fund.

The list of IGC's top 10 holdings is not much changed from when we last published on the trust, reflecting the adviser's long-term investment horizon. Notably however, Dewan fell out of the list and Exide Industries, Divi's Laboratories and Aurobindo Pharma have moved up into it. We discuss some of these below. The reduction in the size of the NIIT Technologies position reflects some profit taking from what has been one of IGC's best performing stocks in recent times.

Figure 10: 10 largest holdings as at 31 October 2018

Stock	% of total assets 31/10/18	% of total assets 31/05/18	% Change	Sector	Business
Tech Mahindra	4.6	4.0	0.6	IT	IT, networking technology and BPO
Federal Bank	4.3	3.6	0.7	Financials	Private bank
City Union Bank	4.0	3.5	0.5	Financials	Full service bank
Jyothy Laboratories	4.0	3.8	0.2	Consumer staples	Household goods
NIIT Technologies	4.0	5.1	(1.1)	IT	Digital services
Divi's Laboratories	3.8	2.3	1.5	Healthcare	Active pharmaceutical ingredients
Motherson Sumi Systems	3.7	3.9	(0.2)	Consumer discretionary	Auto components
Ramkrishna Forgings	3.7	4.4	(0.7)	Materials	Auto components
Aurobindo Pharma	3.3	0.0	3.3	Healthcare	Generic pharmaceutical manufacturer
Exide Industries	3.3	2.7	0.6	Consumer discretionary	Batteries
Total	**38.7**				

Source: Marten & Co

Dewan Housing Finance

Over 60% of IGC's holding in Dewan had been sold before its share price fell

As explained on page 4, Dewan's share price collapsed after investors feared it would default on its debt. Following its earlier share price appreciation, it had become IGC's largest holding. Gaurav had advised IGC to trim the position, on valuation and risk control grounds, and over 60% of the holding had been sold before the events of September 2018. This limited the impact of Dewan on IGC's performance such that, as you can see in Figure 16 on page 8, Dewan ranks fifth in the table of IGC's five largest negative contributors to performance over the first 10 months of 2018 (it has taken 1.5% off the NAV over this period).

Gaurav acknowledges that there is something of an asset/liability mismatch within Dewan's business model in that relatively short-term paper was helping to fund longer-term mortgages. This has not been a problem in the past as Dewan regularly experiences prepayments within its mortgage book that effectively reduce its duration. It may be that rising rates have a dampening effect on this. Dewan is now trading on 4.8x FY19 earnings, 4.0x FY20 earnings, 70% of its current book value and 0.6x forecast book for FY20.

Divi's Laboratories

Figure 11: Divi's Laboratories share price

Source: Bloomberg, Marten & Co

We discussed Divi's Laboratories in our note published 29 March 2017. At that time, it had fallen out of IGC's list of its 10 largest holdings. The US Food and Drug Administration had inspected the company and made a number of adverse observations on its manufacturing facility in Vizag. At the time, the adviser said that it was adding to the position and believed that Divi's Labs would come through this period of adversity stronger than it was before. The adviser has proved to be correct. IT increased IGC's holding by 20% at the INR 760 a share level. Today the stock trades closer to INR 1600 per share.

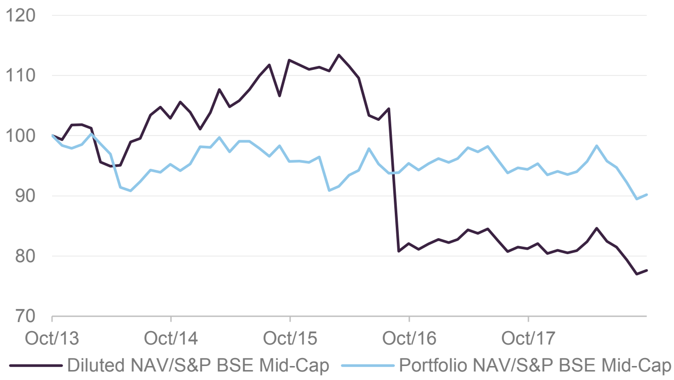
Today, Divi's can claim to have the world's largest manufacturing facility for active pharmaceutical ingredients. Its quarterly report for the three months ended 30 June 2018 showed revenue up 22.7% year-on-year, and earnings per share up 50.8%. Notwithstanding recent market weakness, its share price has been on a recovering trend.

Aurobindo Pharma

One new investment is Aurobindo Pharma. Unlike Divi's, which manufactures active pharma ingredients, Aurobindo Pharma is a formulations manufacturer with revenues predominantly from the US and European markets. This pharmaceutical company is already making a positive contribution to IGC's performance (adding 0.22% to IGC's NAV year to date). Gaurav says his principal focus, for the moment, is on identifying opportunities to add to existing holdings at attractive prices.

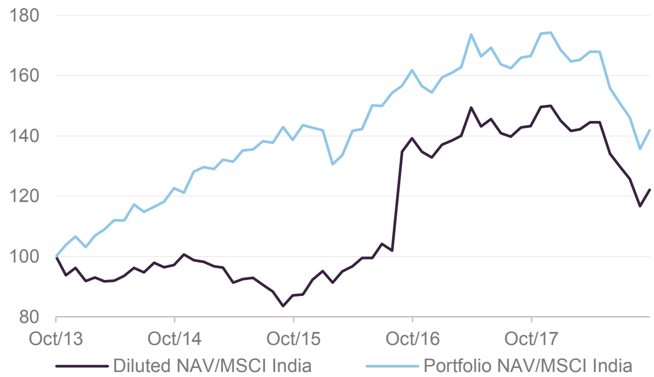
Performance

Figure 12: IGC performance relative to S&P BSE Mid Cap*



Source: Morningstar, Bloomberg, Marten & Co. *Note: monthly data

Figure 13: IGC performance relative to MSCI India*



Source: Morningstar, Bloomberg, Marten & Co. *Note: monthly data

The data in Figures 12, 13 and 14 show returns for both IGC's published NAV and for an adjusted, 'portfolio' NAV. The portfolio NAV removes the dilutive effects of IGC's subscription shares (which were exercised in full in August 2016) and represents the performance generated by the manager and adviser.

Figure 14: Cumulative total return performance for periods ending 31 October 2018

Heading	1 month	3 months	6 months	1 year	3 years	5 years
India Capital Growth NAV (diluted)	(0.0)	(17.0)	(20.9)	(23.8)	27.5	107.3
India Capital Growth NAV (portfolio)	(0.0)	(17.0)	(20.9)	(23.8)	37.2	140.9
India Capital Growth share price	(9.1)	(14.9)	(24.3)	(23.1)	34.6	129.3
S&P BSE Mid Cap	(0.8)	(12.9)	(16.0)	(19.2)	47.3	167.0
MSCI India	(4.9)	(12.4)	(6.6)	(9.2)	35.8	68.8

Source: Morningstar, Bloomberg, Marten & Co

IGC's short-term performance has been adversely affected by a few stock-specific issues and this has dragged down its long-term numbers.

Performance attribution

Ocean Dial kindly supplied us with performance attribution data covering the period from 1 January 2018 to end October 2018.

Figure 15: Top five positive contributors to return Jan-Oct 2018

Company	Average portfolio weight (%)	Total return (%)	Contribution to return (%)
NIIT Technologies	4.40	92.5	2.66
Tech Mahindra	3.81	50.8	1.22
Divi's Laboratories	2.50	36.2	0.84
Radico Khaitan	2.60	34.2	0.58
Exide Industries	2.68	19.5	0.43

Source: Bloomberg

The line-up in Figure 15 is not much changed from our previous note, which looked at the contributors to IGC's performance over the five months to the end of May 2018. We discussed drivers of performance then (please see page 10 of that note). NIIT Technologies remains the largest positive contributor to IGC's performance. IndusInd Bank, which featured in the table last time, is still making a positive contribution to return. Nevertheless, Divi's Laboratories, which we discussed on page 7, has replaced it in the table.

Figure 16: Top five negative contributors to return Jan-Oct 2018

Company	Average portfolio weight (%)	Total return (%)	Contribution to return (%)
Skipper	2.23	(66.1)	(2.03)
Ramkrishna Forgings	4.19	(37.8)	(1.80)
Manpasand Beverages	1.42	(80.1)	(1.72)
Motherson Sumi	4.08	(35.0)	(1.56)
Dewan Housing Finance	4.88	(61.2)	(1.50)

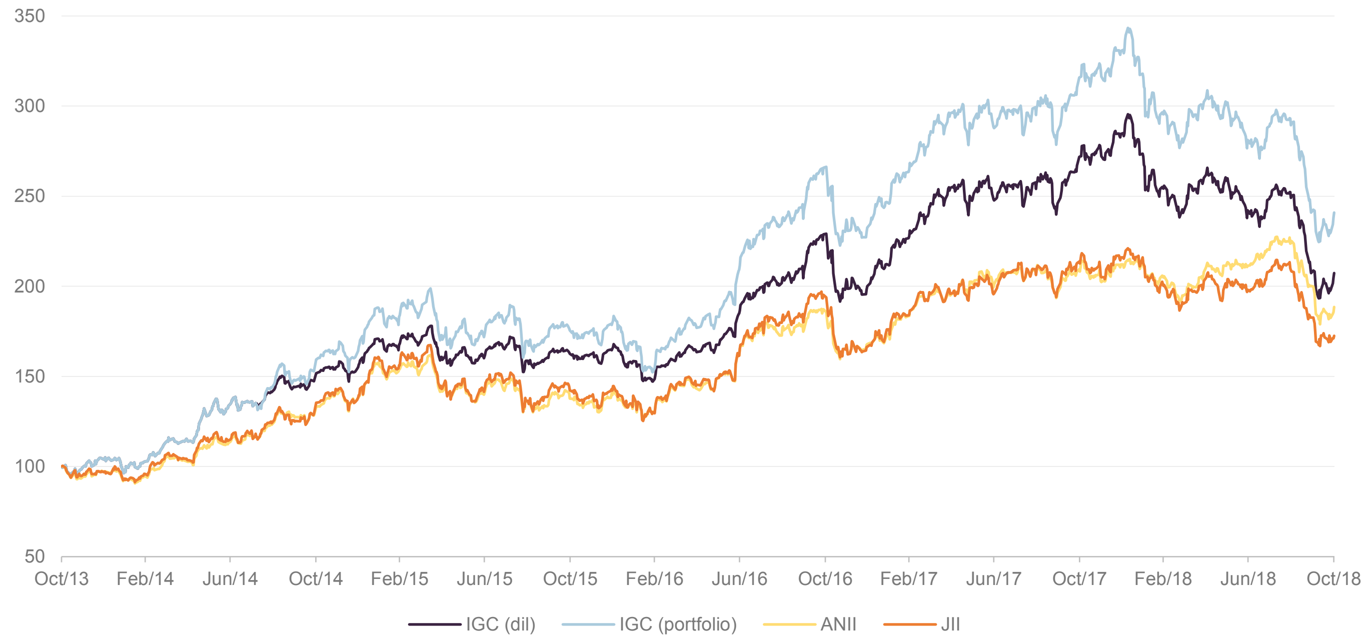
Source: Bloomberg

Skipper

The manager tells us that Skipper's share price has been badly hit this year as a consequence of poor operating performance in both its transmission and distribution business (T&D), and in its polymer business, where it has moved away from manufacturing agricultural pipes in favour of pipes more suited to plumbing. In T&D, margins have come under pressure from rising commodity prices affecting profitability in fixed price contracts, plus an urgency to complete lower priced contracts (mainly in the telecom space) ahead of the monsoon. Inventories in steel also rose, crimping working capital, as supply disruptions have picked up since some steel producers have been taken into administration. On the polymer side, the business has sacrificed some margin pressure for growth in new markets, particularly plumbing. This has led to a significant fall in the company's returns on capital and has led to a derating in the share price. The adviser believes that the outlook for the business remains healthy with revenue growth forecast at 15% and margins set to recover to circa 11.5%.

Peer group

Figure 17: IGC NAV performance versus listed peers over five years ended 31 October 2018



Source: Morningstar, Ocean Dial, Marten & Co

Up- to-date information on IGC and its peers is available on the **QuotedData website**

As Figures 16 and 17 show, notwithstanding the short-term underperformance of small and mid-cap stocks, IGC's longer-term performance remains well ahead of both Aberdeen New India and JPMorgan Indian. Its listed peers have more of a focus on large cap companies than IGC does and there is little commonality between IGC and the other two portfolios.

Figure 18: Indian equity funds subsector comparison (NAV total return data in sterling as at 31 October 2018)

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
India Capital Growth (diluted)	(0.0)	(17.0)	(20.9)	(23.8)	27.5	107.3
India Capital Growth (portfolio)	(0.0)	(17.0)	(20.9)	(23.8)	37.2	140.9
Aberdeen New India	(5.8)	(15.3)	(10.5)	(9.4)	36.9	88.6
JPMorgan Indian	(5.6)	(17.4)	(15.7)	(18.9)	21.2	72.5

Source: Morningstar, Marten & Co

IGC is the third largest of the four funds focused on India and listed in London and has a higher ongoing charges ratio than its larger peers by virtue of its size. (Ashoka Indian Equity, which listed in July 2018 is the smallest fund – market cap of circa £40m. We have not included it in this analysis as we consider that it is still too soon to draw any meaningful conclusions.) IGC's liquidity has improved greatly in recent years, following the exercise of its subscription shares in 2016 and IGC's increased marketing spend.

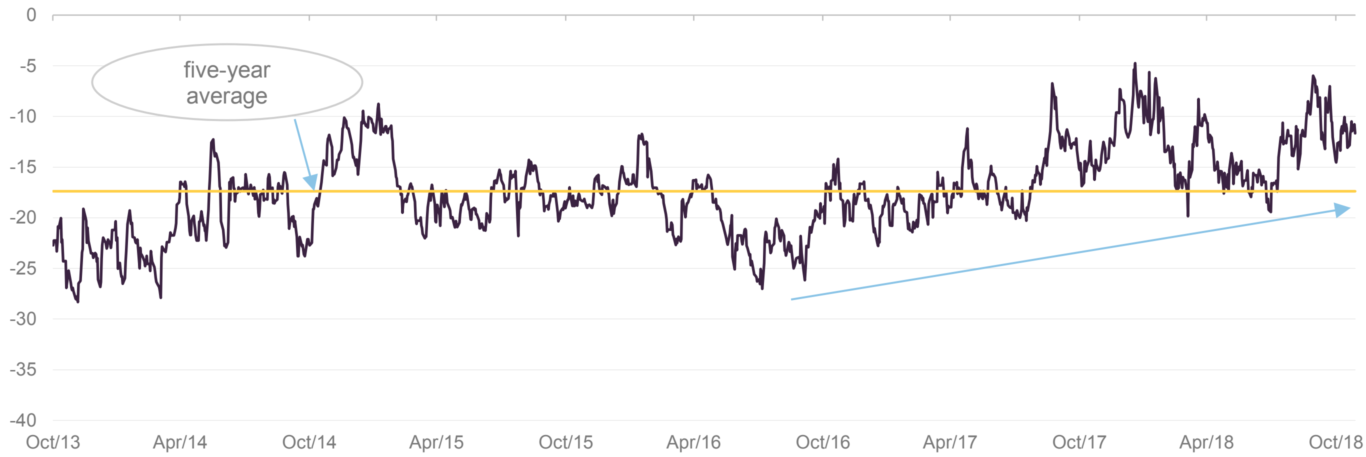
Figure 19: Indian equity funds subsector comparison (data as at 27 November 2018)

	Market cap (GBPm)	1 yr. avg. daily volume (GBP '000s)	Daily volume as a % of market cap (%)	Discount (%)	Ongoing charge (%)
India Capital Growth	95.6	317.1	0.33	11.6	1.23
Aberdeen New India	257.5	353.7	0.14	14.3	1.19
JPMorgan Indian	690.2	899.9	0.13	14.5	1.86

Source: Morningstar, Marten & Co

Discount

Figure 20: Premium/(discount) to diluted NAV over five years



Source: Morningstar, Marten & Co.

IGC's discount has continued to narrow, reflecting perhaps the opportunity that investors see for the trust, following the recent setback, as well as the board and manager's efforts to attract new investors to the trust. Over the year ended 31 October 2018, the discount has traded within a range of 19.8% to 4.7%. At the time of publication, IGC's discount was 11.6%.

Fund profile

Further information is available at www.indiacapitalgrowth.com

The fund has recently updated its website, which now includes new media such as videos and podcasts.

IGC is an investment company listed on the Main Market of the London Stock Exchange. It invests in India, predominantly in listed mid-and-small-cap Indian companies. The trust is aiming to generate capital growth for shareholders. IGC has not paid dividends in the past and the manager says it is unlikely to do so in the near future.

Management arrangements

IGC has been managed since 2010 by David Cornell of Ocean Dial. He has been assisted in this, since November 2011, by Gaurav Narain (Gaurav or the adviser) of Ocean Dial Asset Management India Private Limited, which is based in Mumbai. Gaurav has 25 years of experience in Indian capital markets, having started his career as vice president of research for SG Asia.

Ocean Dial has been owned since November 2017 by Avendus Capital Private Limited, an Indian financial services company backed by Kohlberg Kravis Roberts (KKR). The key members of the Ocean Dial team are incentivised to stay with the business.

In addition to IGC, Ocean Dial manages three open-ended funds, the largest of which, Gateway to India, had AUM of US$229m as at 31 October 2018. The seven-strong investment team is split between London and Mumbai. Each of the analysts is assigned responsibility for a number of industry sectors. The manager is responsible for monitoring portfolio risk and all dealing is done from London.

Employees of Ocean Dial's collectively hold 345,590 shares in IGC, while members of IGC's board collectively own 75,500 shares between them. Combined Ocean Dial employees and the three directors hold 422,900 shares, which is equivalent to 0.4% of IGC's issued share capital.

The board has an oversight role. Its permission must be sought before IGC can take on any permanent borrowings, invest in any unlisted investment or buy back shares. It is worth bearing in mind that the manager says it is highly unlikely that it will invest in unlisted investments. The board also sets the company's policy on currency hedging.

Changes to the taxation of capital gains

IGC invests through a Mauritian subsidiary (ICG Q Limited) in a portfolio of Indian securities. In India, short-term capital gains attract a capital gains tax (CGT) of 15%. Long term CGT was reintroduced in the February 2018 Budget at a rate of 10% for disposals made after 1 April 2018. Gains made before 31 January 2018 are exempt. A double taxation treaty between Mauritius and India used to allow investors to pay CGT at Mauritian rates (0%). This has been amended so that, between 1 April 2017 and 31 March 2019, Mauritian-based investors pay tax at 50% of Indian CGT rates (for example, 7.5% on short-term gains). Post March 2019, Mauritian-based investors will pay the same rates of CGT as a domestic Indian investor. IGC will accrue any potential CGT liability in its NAV.

Index comparators

IGC's main focus is on Indian mid-and-small-cap companies, but the fund can and does hold large-cap stocks as well. The board and the manager use the S&P BSE Mid Cap Index (total return) for performance evaluation purposes, although the portfolio is not constructed with reference to this index. Given the portfolio's weighting in large-cap companies (those with a market cap greater than US$7bn represented 7.7% of the portfolio at the end of October 2018), we believe that it is also worth comparing IGC's performance against the MSCI India Index.

Previous research publications

Readers interested in further information about IGC, may wish to read our earlier notes listed in Figure 21. All of these are available on our website.

Figure 21: Marten & Co previously published research on IGC

Title	Note type	Date
Compounding machine	Initiation	23 March 2016
Indian powerhouse	Update	8 July 2016
India at a significant discount	Update	21 October 2016
Full steam ahead	Annual overview	29 March 2017
Moving to the main board	Update	30 January 2018
A return to earnings growth	Annual overview	26 June 2018

Source: Marten & Co.

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IMPORTANT INFORMATION