Update | Investment companies

26 May 2020

India Capital Growth

Needs more time

India Capital Growth's (IGC's) board is asking investors to back a continuation vote scheduled for 12 June 2020 and it is important that shareholders make their vote count. COVID-19 has depressed valuations to levels not seen since the financial crisis. The managers see substantial upside when market confidence returns and are asking for more time to deliver that. The board believes shareholders should support continuation. This reflects their confidence in the measures taken to turn performance around. Combined with potential mean reversion in small and mid-cap valuations, IGC's share price could improve meaningfully.

India's response to the COVID-19 outbreak has been robust and this will have serious economic consequences for FY21. This has triggered a further leg down in the Indian market. A stimulus package of up to $266bn announced on 12 May should help stimulate a long-awaited recovery.

In a response to the reversal of fortune that IGC has experienced over the last couple of years, the adviser has strengthened its team and refined its investment approach. Shareholders that give IGC the benefit of the doubt will have the comfort of a full exit opportunity in December 2021.

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 companies.

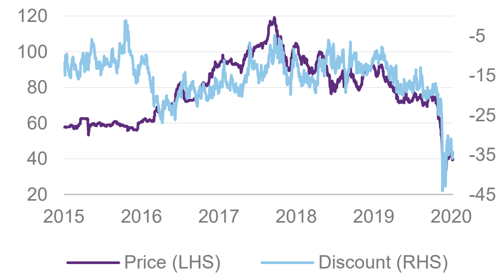
Year ended	Share price TR (%)	NAV TR (%)	Portfolio TR* (%)	S&P BSE Mid Cap TR (%)	MSCI India TR (%)
30/04/16	5.8	2.7	3.8	8.1	(2.1)
30/04/17	50.7	55.7	67.1	58.3	36.0
30/04/18	13.4	2.9	2.9	5.3	6.0
30/04/19	(12.4)	(12.8)	(12.8)	(10.7)	8.6
30/04/20	(53.0)	(36.8)	(36.8)	(21.6)	(17.3)

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

Sector	Country specialist – Asia Pacific
Ticker	IGC LN
Base currency	GBP
Price	40.2
NAV	61.5
Premium/(discount)	(34.6%)
Yield	Nil

Share price and discount

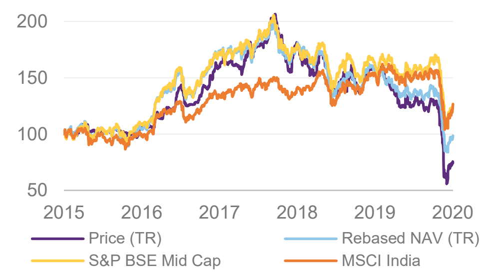
Time period 30/4/2015 to 22/05/2020



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/4/2015 to 30/4/2020



Source: Morningstar, Marten & Co

Domicile	Guernsey
Inception date	22 December 2005
Manager / adviser	David Cornell / Gaurav Narain
Market cap	45.2
Shares outstanding	112.5m
Daily vol. (1-yr. avg.)	408,113 shares
Net gearing	Nil

See page 19 for details of webinar

IGC puts forward proposals ahead of 12 June continuation vote

IGC's manager David Cornell will discuss the proposals at two webinars:

- 29 May 2020 at 12:00
- 3 June 2020 at 12:00

IGC announced on 26 May 2020 that it will hold an EGM on 12 June 2020, in Guernsey, where a continuation vote will be put to shareholders.

The board undertakes a performance assessment every three years and a vote on the trust's continued existence is put to shareholders only in the event that either of the following criteria are met:

i. The company's monthly average market capitalisation million over the past year is below £30m; or
ii. The company's published diluted NAV per ordinary share (per share) has underperformed the benchmark by more than a cumulative 5% over the previous three years.

The IGC board doubts that the company can make up its performance shortfall before 6 August 2020 and is bringing forward the continuation vote

While the first of the criteria has been satisfied, IGC's performance is very unlikely to sufficiently improve to meet the second threshold by 6 August 2020 (the date for the next three yearly assessment). Diluted NAV per share fell 45.8% from 7 August 2017 to 15 May 2020, representing a cumulative underperformance against the benchmark (BSE Mid Cap Total Return Index) of 14.1%.

The board has therefore brought forward the date for proposing the continuation resolution and its proposals. In order for IGC to have a future, the board recognises that the following parameters must be satisfied:

i. Performance will need to improve significantly;
ii. The level of the discount must be brought in significantly;
iii. A pathway to liquidity must be provided; and
iv. Costs must be competitive.

Exit opportunity in 2021 and every two years thereafter

The board believes there is potential for IGC's performance to improve significantly and is proposing the company continues. To this end, the board has put forward the following, to redress the underperformance, subject to the passing of continuation resolution:

i. The introduction of a redemption facility, giving shareholders the right to request the redemption of part or all of their shareholding on 31 December 2021 and every second year thereafter at an exit discount equal to a maximum of a 6% discount to NAV per redemption share;
ii. A change to the investment manager's fee from 1.25% of total assets per annum, to the lower of 1.25% of average market capitalisation (calculated on a daily basis) per annum or 1.25% of total assets per annum with effect from 1 July 2020 with a further review to the investment manager's fee in 2022; and
iii. IGC may seek to satisfy redemption requests by matching such requests with demand for new ordinary shares from incoming investors.

The uncertain impact of Covid-19 on India and the liquidity risk attached to realising the portfolio would likely result in sub-optimal returns for shareholders

If the resolution is not passed, proposals to wind-up, reorganise or reconstruct the company, will be put to shareholders. Given the extremely volatile market environment and the as yet unknown impact of COVID-19 on India, the board considers that the realisation of the company's portfolio of investments at the present time is likely to result in sub-optimal returns for shareholders.

Proposals follow refinements made to the investment process

Ocean Dial, IGC's manager, has made a number of refinements to the investment process, over the past year. These are described on pages 7 to 9.

Stock selection has been the main culprit behind the poor relative returns since 2017, which the manager is redressing through process change and team development. There have been some encouraging signs of progress, with a weighted basket of new entries to the portfolio outperforming the benchmark, over the year-to-date by 9.5% and stocks sold underperforming by 20.5%. This is discussed in the performance section from page 13 onwards.

IGC believes voting in favour of the company's continuation will provide the following benefits to shareholders:

- Being able to redeem some or all of their shareholding, without being reliant on the market liquidity of the shares;
- Progressively reducing the discount at which the shares trade compared to NAV per share;

Shifting the basis of the management fee calculation from NAV to market capitalisation would increase alignment between manager and shareholder

- Addressing, through the redemption facility and the issue of shares from treasury, market imbalances in the supply of, and demand for, the shares;
- An uplift in NAV per share for the company and continuing shareholders as a result of the exit discount applied to the shares that are redeemed;
- A greater likelihood that the value of the shares will reflect the prospects of the company's investment strategy;
- A more effective alignment between the manager and shareholders by switching the management fee calculation from total assets to market capitalisation; and
- A reduction in the manager's fee and so to the operating costs of the company.

The potential for mean reversion in the valuation of Indian growth stocks, the level of IGC's discount and the wider economy could provide a compelling catalyst for much-improved performance

They also feel that this is a very attractive cyclical low point for valuations in the Indian market – particularly the segment focussed on by IGC. Of particular note is the potential for a considerable uplift in returns, were there to be mean reversion in the valuation of small and medium-sized stocks, IGC's discount, and the performance of India's economy.

Focus of India's COVID-19 response shifts to stimulus

India recently announced a stimulus package worth up to 10% of GDP. It appears designed to provide impetus for long-term structural change

On May 12, Prime Minister Narendra Modi announced a stimulus package worth up to $266bn, corresponding to around 10% of GDP. Early critics of the stimulus say that the actual measures to boost demand amount to a much more modest 1-2% of GDP. A large part of the package is focused on monetary measures announced by the Reserve Bank of India, guarantees by the government as well as other forms of funding.

IGC's adviser, Gaurav Narain (Gaurav) considers that the lack of measures to boost demand is disappointing, given the anticipation that had built-up following the initial announcement. He notes that a greater focus is being placed on using the crisis as a springboard to enact structural reforms, across several industries. He highlights the agriculture, mining, defence, and power sectors.

The opportunity to enact major structural reforms has seen the current period compared to the 1991 market reforms, which had a transformative impact on growth.

In this sense, the opportunity to enact reforms has seen the current period compared to 1991, when market reforms enacted by finance minister, Manmohan Singh, following a currency crisis, laid foundations that transformed India's growth profile. True reform could be just as impactful.

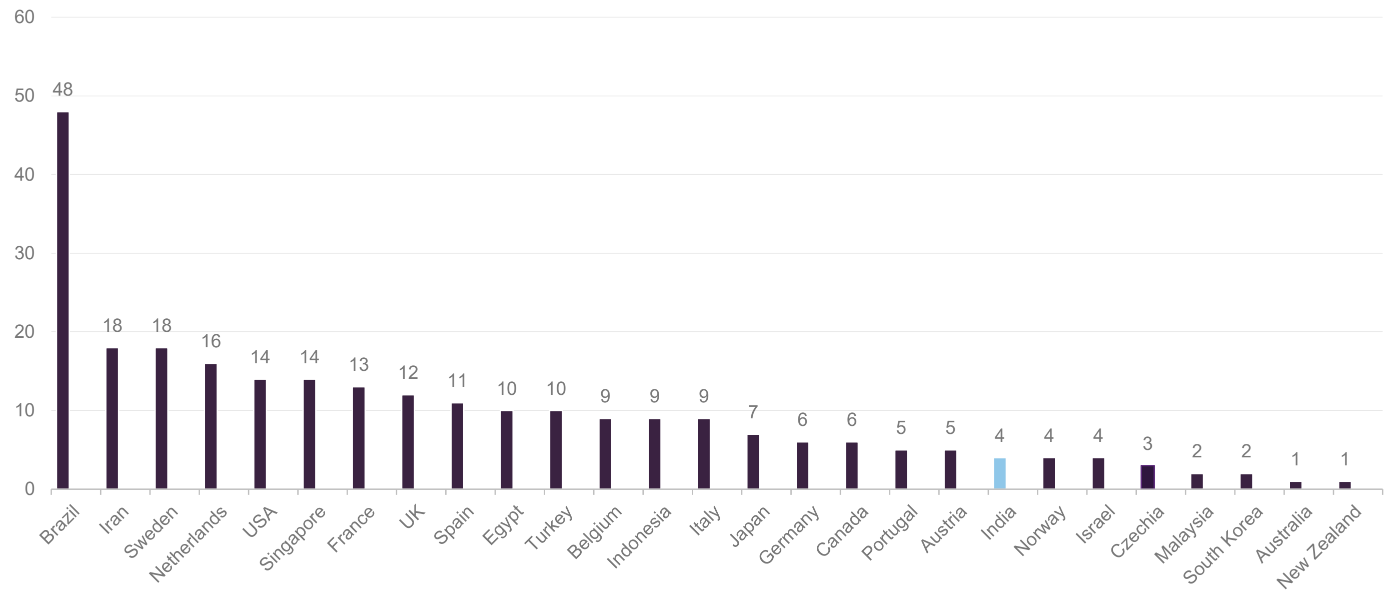
Gaurav believes the agriculture industry could be a major beneficiary. Considerable reforms will take place as the outdated industry is liberalised. Ocean Dial note India has wild food price swings despite being a self-sufficient domestic producer of food, as several centuries of agriculture policy has kept the 50% of the population trapped in unproductive farming.

While India has been able to reduce the growth rate in active new cases, the number of new cases has continued to rise in a number of cities, so any easing of the lockdown will have to be very carefully managed, which poses idiosyncratic challenges in India, given its size and the density of its population.

A harsh lockdown has allowed India to keep fatalities relatively low

The state of Maharashtra has been the worst affected, with around one third of the caseload, though on balance, India has succeeded in keeping fatalities at much lower levels than many countries, helped by a young population. India has not lacked testing capacity in the way many countries have. This has mainly taken the form of targeted testing so far. India has also been able to use the lockdown period to ramp up its stock of ventilators.

Figure 1: COVID-19 detection rates as a % of total tests, as at 11 May 2020



Source: Worldometer, Ocean Dial Asset Management

The debate within India has been shifting increasingly to one of lives versus livelihoods. An initial fiscal response, amounting to just 1% of GDP, was inadequate against a backdrop of 80 million migrant workers being displaced, as business activity came to a standstill. Attempts to incentivise the banking sector – still recovering from the 2018 default of IL&FS (see our most recent annual overview note for detail on this) – to provide liquidity to SMEs proved futile.

Many of the companies Gaurav has spoken to have said that operating beyond 50% of their manufacturing capacity will be very difficult – the focus has been on clearing inventory. Salary cuts of around 15%, across workforces, have been the norm. Once the economy begins to open-up, companies are anticipating a period of 6–9 months for operations to normalise. Corporates are anticipating challenges in re-integrating many of India's labourers, who are still attempting to reach their home villages.

Economy better positioned than in 2008

COVID-19 will leave a dreadful imprint on corporate performance and India still needs to carefully manage the re-opening of the economy over the coming months.

India's macroeconomic fundamentals are firmer than in 2008

Gaurav says India entered the current crisis in better shape than for the most recent shock, the global financial crisis of 2008. While corporate earnings and the Indian equity market have faltered over the past two years or so, the stock market is much smaller in size than it was in 2008, as a percentage of India's GDP. Figure 2 makes a comparison between the two periods.

Figure 2: India in 2008 versus 2020

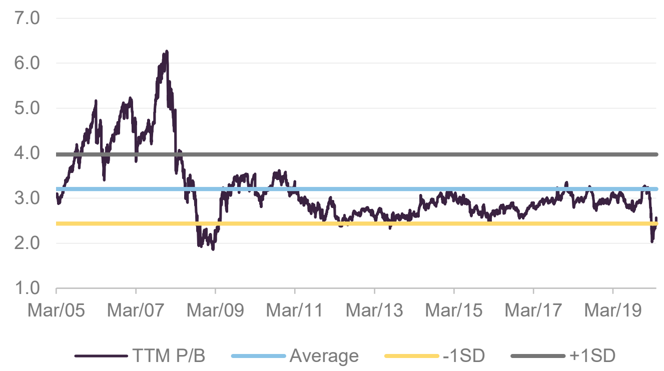
Parameter	Global Financial Crisis	COVID-19
Pre-crisis rally (1 yr)	89%	16%
Intensity of correction (no. of days to correct 38%)	169	66
Market cap to GDP (1 yr before crisis)	149%	70.8%
Corporate profits to GDP (1 yr before crisis)	6.9%	1.8%
Macro vulnerability index*	15.5	8.4
FDI flows ($bn)	15.9	30.7

Source: Ocean Dial Asset Management. *Note: macro vulnerability index = consumer price index + current account deficit + fiscal deficit

The sell-off in the Indian equity market has been severe and broad-based

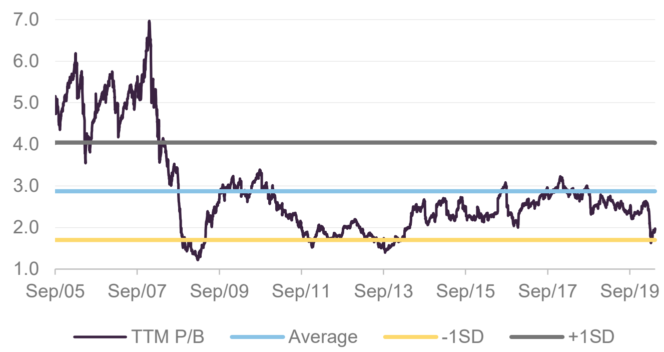
The Indian stock market has been heavily penalised so far this year. As at 30 April, the equity market had contracted by around 30%. Valuations are now below one standard deviation of their 15-year average.

Figure 3: Sensex Index price/book valuation and standard deviations



Source: Ocean Dial Asset Management, Marten and Co

Figure 4: S&P BSE MidCap price/book valuation and standard deviations



Source: Ocean Dial Asset Management, Marten and Co

Ocean Dial believes the portfolio has an upside of 15.4%, based on a standard deviation-based model

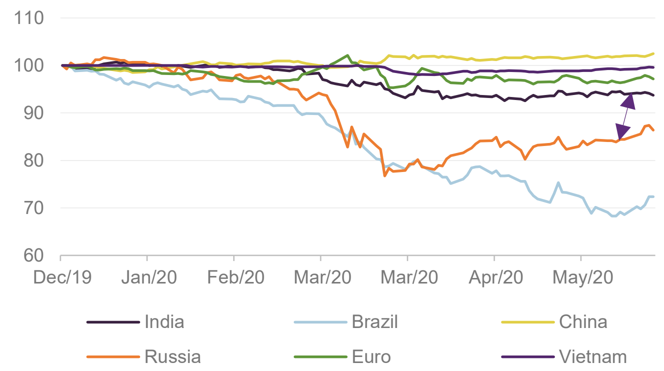
Ocean Dial says that based on valuations that are one standard deviation below long term averages the portfolio has 15.4% upside, as at 15 May 2020. This is based on P/E, P/B and EV/EBITDA multiples on historical (FY20) earnings.

As a net energy importer, India benefits from low oil prices. It is also building out its natural gas capacity, which IGC has added exposure to, in the form of Gujarat Gas (discussed in the asset allocation section). As illustrated by Figures 5 and 6, Brent crude oil prices are at levels not seen since 2003. So far this year, the rupee is down by less than 7%, against the dollar. Many EM currencies have fared far worse.

Figure 5: Brent crude oil price ($)

Source: Bloomberg, Marten & Co

Figure 6: Selected currencies performance versus USD, re-based – YTD to 22 May



Source: Bloomberg, Marten & Co

India expected to benefit from supply-chain diversification

India sees the post-COVID-19 era as a major opportunity to take market share away from China, with supply-chain diversification likely to be one of the economic legacies of this crisis

Along with perhaps Vietnam, India is amongst the best-positioned countries to provide an alternative to China in supply-chain manufacturing. Gaurav mentions chemicals and healthcare as two industries that are best positioned. China's chemicals industry is presently around 10 times the size of India's, so this has the potential to materially move the needle for Indian chemical companies. The agrochemical company, PI Industries, is well positioned to benefit, as one of the market leaders. The company is IGC's second largest holding; it is discussed in greater detail in the asset allocation section.

Whilst India's generic drug manufacturing industry is very well established, most of the world's active pharmaceutical ingredients (APIs) are manufactured in China. As well as growing in-house API capabilities, India will see a major opportunity to take global share away from China. IGC has significant exposure to this through its second-largest holding, Divi's Laboratories. The company is a core component in the supply chains of many of the world's largest pharmaceutical companies. As at 13 May, Divi's shares had increased by 30.9% over the year-to-date.

We also note that In March, the government announced a $1.3bn incentives package for local manufacturing of drugs as well as plans to establish industry manufacturing hubs. India will also look to expand its footprint in other areas of healthcare, such as medical devices.

As well as proving supply chain outposts for international companies, India will look to grow its export trade, across several industries, including consumer durables and textiles. India will be looking to deepen its technology industry as well.

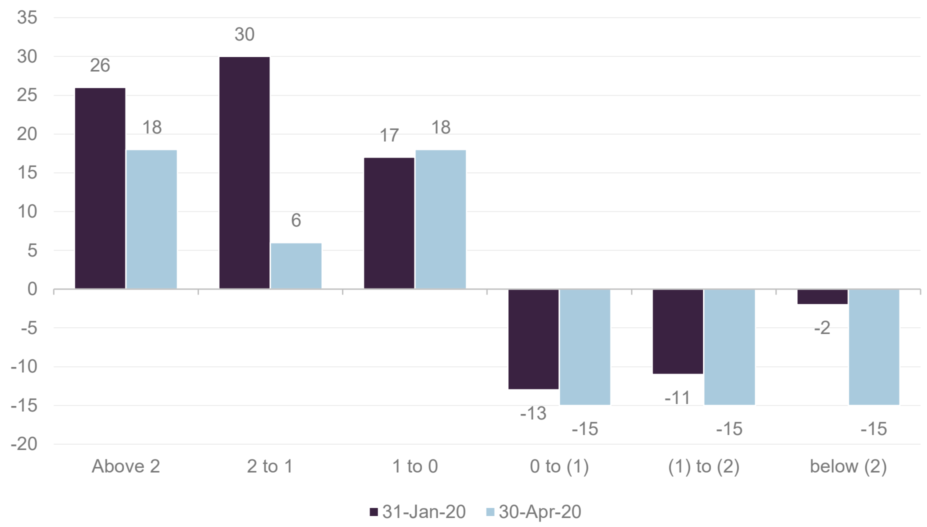
In the past, India has often underwhelmed when opportunities to grow its manufacturing base have emerged. For example, when wage growth made garments increasingly uneconomical to produce in China, it was Bangladesh and Vietnam who benefited most. The stakes are higher this time, in higher value industries.

Broad-based sell-off brings more value to mid-caps

Around a third of mid-cap stocks are valued below one standard deviation of their five-year average

Gaurav notes that, at the end of April 2020, 30% of mid-cap stocks in India were trading at below one standard deviation, compared to their five-year averages – the equivalent figure was 13% as at 31 January 2020. We discuss what this has meant for the makeup of the portfolio in the asset allocation section below.

Figure 7: India mid-cap universe ($7bn > mid cap > $2bn) standard deviation profile – FY20 valuation vs. 5 yr historical average



Source: Ocean Dial Asset Management, Marten & Co

The manager is looking for opportunities in companies with sound business models that have been overly penalised

Smaller and medium-sized companies are most vulnerable to lockdown and many have found it difficult to access credit to fund their working capital requirements. In assessing value, Gaurav says he is paying more attention to historical earnings (forward earnings estimates hold little value at the moment), looking to cross-reference dislocations based on standard deviation movements and seeing how this interacts with business models in this environment, as well as leverage. Inevitably, there are companies that perform well in a crisis, which are caught up in a market route.

Refined investment process

The investment team has expanded to seven, including the appointment of Tridib Pathak, as co-head of equities

IGC have refined their investment process since we last published. With the addition of a new co-head of equities and some new analysts, the investment team now has seven members – an eighth member is expected to join shortly.

Other recent changes of note include the introduction of artificial intelligence (AI) tools to the screening and monitoring process. AI has been introduced to the screening and monitoring process through a tool that pulls information on an investee company from multiple sources of unstructured data onto a single dashboard that is readily accessible by the investment team.

Team structure

Among the additions is Tridib Pathak. He joined Ocean Dial in October 2019, as co-head of equities, sitting alongside Gaurav Narain. The analyst team was strengthened by the addition of Saurabh Rathore and Ashutosh Garud, earlier this year.

Biographies of the investment team are provided in the appendix on page 20.

"House of Ocean Dial"

Gaurav and the rest of the India-based team at Ocean Dial are bottom-up investors, operating in a market with historically strong and consistent earnings growth, where periods of elevated volatility have provided regular mispriced entry points.

Ocean Dial seeks out companies whose management practices are culturally aligned with theirs and whose business models are capable of creating long-term shareholder value in a sustainable manner. A focused universe of companies from which potential investments are scrutinised is referred to as the House of Ocean Dial. More specifically, companies with the following attributes are eliminated:

- Market capitalisation of below US$100m
- Environmental, Social, and Corporate Governance concerns
- Business models which are
  - Incomprehensible
  - Not scalable
  - Driven by global commodity prices
  - Conglomerated
  - Unable to create sustainable economic value
- Business-to-Consumer companies where the consumers are predominantly based outside of India
- Insufficient knowledge to have an informed view on any of the above

An investment universe of around 140 companies forms the basis of a target portfolio of 30 holdings

This has resulted in a current universe of approximately 140 companies from which the managers can invest in. Each analyst covers roughly 35 names and coverage entails forensic accounting, detailed financial modelling, and one-to-one corporate interaction twice annually.

Portfolio Construction – aiming for 30 holdings

The House of Ocean Dial is a universe of companies on which the team can build focus. The manager will allocate to approximately 30 holdings which are independent both of the IGC's benchmark and the market capitalisation of the business.

Exploit the long-term Indian growth story but stick to well-run companies

The starting point is to examine the highest ranked companies in the universe in terms of expected return and from this the manager has discretion to dive deeper. In addition to meeting regularly with senior management, the team meets with suppliers, customers, and business competitors where relevant. The portfolio looks to invest with a minimum position size of 2%. This could range to up to 8% depending on the liquidity of the traded volume and the strength of conviction.

Investment Committee

The House of Ocean Dial is a continuously evolving universe of investible opportunities. An investment committee (IC) exists to ensure that existing names continue to pass filters set, and to provide a forum for members of the investment team to propose new names for inclusion into the universe.

The IC meets quarterly and acts as a gatekeeper for stocks under consideration, with any changes needing to be approved by the Committee. The agenda also includes the following issues.

Mitigating Behavioural risk

The team is cognisant of the challenge of distinguishing, without the benefit of hindsight, between temporary downward fluctuations caused by volatility from a genuine loss of capital. To diminish the probability of the latter, the research process is structured to ensure that each investment thesis is constructed on a sound basis whilst allowing the decision-making framework to react effectively should a change in the thesis occur over the course of the holding period. All investments are documented on initiation to enable the manager to assess the effectiveness of decisions made without being clouded by viewing them through the lens of hindsight.

Cognisant of the potential pitfalls of behavioural biases

Direct management interaction is limited where appropriate to twice a year, with healthy scepticism accorded to guidance to ensure the team remains detached in its assessment of a given company. Moreover, the IC provides an open forum for discussion on price movements or changes in fundamentals to ensure a continuous and systematic re-assessment of each investment thesis. The universe ranking tool provides a quantitative basis for guiding where the highest expected return opportunities exist, whilst triggering a re-assessment of holdings that are falling down the ranking.

Valuation risk

A broad range of relative and absolute measures are used in comparison to the company's own history, its relevant peer group, and the broader market to create an expected return which is then ranked relative to the rest of the universe. A core part of mitigating valuation risk is to utilise a reverse DCF which uses the share price as the starting point to guide as to how much cash the company would have to generate to justify the current market valuation.

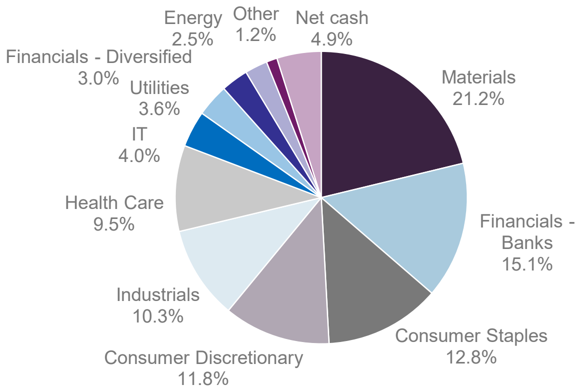
Asset allocation

At the end of April 2020, IGC's portfolio comprised 35 holdings. Since our last note was published in October 2019, exposure to the materials, industrials and healthcare sectors has increased. This has come largely at the expense of financials and IT. A number of banking exposures have been reduced – these are listed on page 11.

Over the year to date, turnover in the portfolio has inevitably been higher than the norm. Gaurav has pursued an incremental approach to buying and selling. Over the initial China-centric phase of the pandemic, Gaurav reduced the portfolio's exposure to what seemed a likely collapse in Chinese aggregate demand, in areas such as auto ancillary parts. The period was also used as an opportunity to take profit in some stocks, both in anticipation of a global slowdown and to build up cash reserves. The latter provided resources to buy good-quality companies at discounted prices.

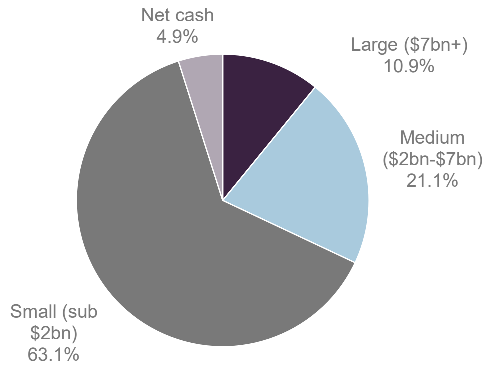
A current net cash weighting (IGC is unleveraged) of 4.9% is slightly above average, though Gaurav notes that this is a by-product of the increased turnover in the portfolio, rather than a 'view' on cash.

Figure 8: Portfolio breakdown by industry sector as at 30 April 2020



Source: India Capital Growth Fund, Marten & Co

Figure 9: Portfolio breakdown by market capitalisation as at 30 April 2020



Source: India Capital Growth Fund, Marten & Co

Top 10 holdings

Many of the stocks in the list of the top 10 holdings have been discussed in earlier notes (see page 19 for a list of these), having been longstanding positions within IGC.

Figure 10: IGC 10 largest holdings as at 30 April 2020

Stock	Sector	Business	% of portfolio as at 30 April 2020	% of portfolio as at 31 August 2019	% change
PI Industries	Materials	Agricultural chemicals	6.7	4.1	2.6
Divi's Laboratories	Health Care	Active pharmaceutical ingredients	6.2	3.3	2.9
Federal Bank	Financials – Banks	Private bank	5.4	5.5	(0.1)
Jyothi Laboratories	Consumer staples	FMCG	4.2	3.6	0.6
Bajaj Consumer Care	Consumer discretionary	FMCG	3.8	-	3.8
Berger Paints India	Materials	Paints	3.8	4.1	(0.3)
Gujarat Gas	Utilities	Natural gas	3.6	-	3.6
City Union Bank	Financials – Banks	Full service bank	3.6	5.3	(1.7)
Tech Mahindra	IT	IT, networking technology and BPO	3.6	5.7	(2.1)
Emami	Consumer staples	Health and beauty products	3.5	3.6	(0.1)
Total			**44.4**		

Source: India Capital Growth Fund, Marten & Co

At 30 April 2020, the 10 largest holdings in IGC's portfolio accounted for 44.4% of the fund. Since we last published, Gaurav's selling activity has followed three main themes:

- Reducing stakes in companies sensitive to export weakness.
  - Motherson Sumi, a leading auto ancillary company was exited completely, while the exposure to Tech Mahindra was reduced. Its business lines include IT process outsourcing, which could suffer in the wake of the global recession. As at 22 May 2020, the company's shares were down by over 30% over the year-to-date.
- Taking profit on holdings that were looking richly valued.
  - Gaurav has reduced weights to Berger Paints and PI Industries. Berger Paints is one of the four major paint producers in India – it is the portfolio's most richly valued holding, trading at a trailing P/E ratio of 69x, as at 13 May.
  - PI Industries remains a high conviction holding – Gaurav says it has strong relationships with Japanese and European Agro chemical companies; the company is also building out a pharmaceutical business line. We note that the shares have rebounded considerably over recent weeks. PI Industries fits the profile Gaurav believes can benefit from global supply-chain diversification. Its shares have climbed by over 45% from the March-nadir.
- Reducing exposure to the financials sector.
  - Exposure to City Union Bank was reduced, having been the third largest holding as at end-August 2019. Positions in DCB Bank, Indian Bank, Yes Bank and Jammu & Kashmir Bank have been sold in their entirety.

Figure 11: PI Industries share price

Source: Bloomberg, Marten & Co

Figure 12: IGC 10 largest holdings as at 30 April 2020 – valuation multiples

Stock	Market cap (INRbn)	Trailing P/E ratio	5-year average ROE (%)	Total return YTD (%)	Financial leverage	Dividend yield (%)	Quick ratio*
PI Industries	224.4	44.3	24.6	+6.5	1.4	0.3	0.9
Divi's Laboratories	617.7	48.2	21.3	+30.9	1.2	1.0	2.4
Federal Bank	88.7	5.0	9.8	(52.1)	11.9	3.4	-
Berger Paints India	477.0	66.3	24.6	(9.5)	1.8	0.4	0.8
Bajaj Consumer Care	19.9	9.0	42.4	(43.0)	1.3	-	2.7
Gujarat Gas	167.2	15.9	19.4	+3.9	2.7	0.4	0.7
Emami	82.7	24.7	18.7	(39.3)	1.4	2.8	0.8
Tech Mahindra	515.0	10.9	20.5	(27.7)	1.7	3.2	1.8
Kajaria Ceramics	55.5	19.0	20.3	(36.6)	1.5	1.4	1.2
DCB Bank	22.2	5.7	11.1	(61.6)	11.4	1.5	0.9

Source: Morningstar, Marten & Co. *Note: the quick ratio is a short-term liquidity measure that is defined as: current assets – inventory / current liabilities

Figure 13: Bajaj Consumer Care share price

Source: Bloomberg, Marten & Co

Elsewhere within the top 10, Gaurav said that companies that predominantly take payment in cash (predominantly FMCG companies) had an advantage, as they have more of a cash-flow cushion. The lack of receivables and the paying of creditors in 60 days or so allows them to stretch out their cash conversion cycle. Bajaj Consumer Care was discussed as an example. It is a major player in India's hair oil industry, a category which has grown 11% in value over the last decade. Gaurav says the company has gross margins of 67%, a ROCE of 40% and cash in its books equivalent to 25% of its market capitalisation. Gaurav expects the shares to re-rate.

Gaurav also raised the fund's holding in Jyothy Laboratories, which sits fourth in the top 10. The company sells a wide range of staple consumer goods, including insecticides and soap/detergent products. Gaurav says 90–95% of its range can be classified under sticky essential products. It is currently trading at around 19x trailing earnings – about half its typical range. The manager does not expect the company's margins to come under too much strain. Gross margins of 47% provide a buffer, while it can also trim advertising expense if necessary. The informal nature of most of

India's retail market means companies tend to not have to negotiate with powerful retailers as much.

Figure 14: Federal Bank share price

Source: Bloomberg, Marten & Co

Banks have weighed on performance for some time. Federal Bank remains among the largest holdings, with Gaurav noting that its wholesale asset book contains largely triple-A-rated debt exposures, while its retail book is moving to higher yielding assets. He believes the bank is fundamentally sound on both asset and liability sides.

He expects high loss provisions to kick in, as they have been doing in banking across the world, but ultimately for Federal Bank's shares to move back up. They are currently trading at about 0.6x book value, which the manager says is less than half the typical range.

Gujarat Gas leads new additions to the portfolio

New additions to the portfolio include: Multi Commodity Exchange (Mumbai-based commodity exchange); Gujarat Gas (profiled below); Aegis Logistics (logistics provider to the oil, gas, and chemicals sectors); ICICI Lombard (general insurance) and CCL Products (instant coffee manufacturer).

> Instant coffee manufacturer, CCL Products, is benefitting from 'sticky' demand for coffee

Gaurav discussed CCL Products as an example of a good-quality company that became attractively valued. It is one of the largest private label manufacturers of instant coffee, operating in a sector that has been performing well through the global lockdown. Coffee consumption has simply shifted from the workplace and the retail market to the home.

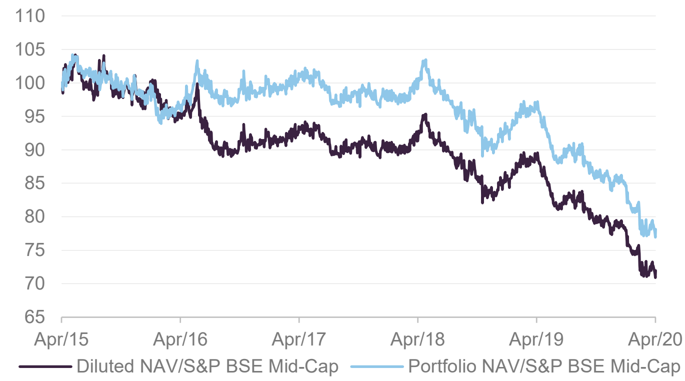
Figure 15: Gujarat Gas share price

Source: Bloomberg, Marten & Co

Gujarat Gas (www.gujaratgas.com) is the largest of the recent portfolio additions. India is investing to shift more of its energy need from oil to gas, with new gas pipelines being installed across the country. Based in Gujarat, which Gaurav notes is India's most industrialised state, Gujarat Gas operates across the gas sector. Gaurav notes that there has been more focus on pollution within India and it has observed China's success in reducing pollution with gas.

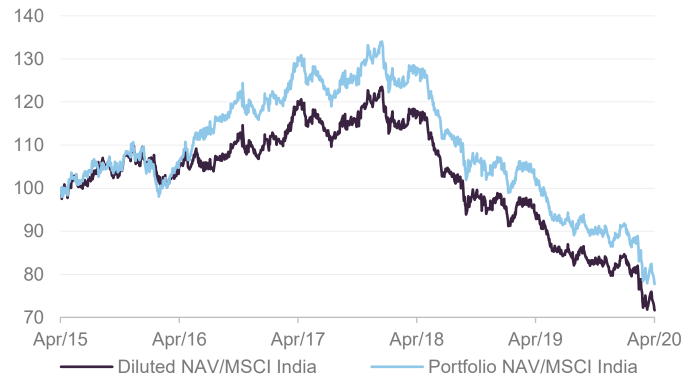
Performance

Figure 16: IGC performance relative to S&P BSE Mid Cap* over five years ended 30 April 2020



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

Figure 17: IGC performance relative to MSCI India* over five years ended 30 April 2020



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

The data in Figures 16, 17 and 18 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.

Small- and mid-sized companies have been underperforming in India since 2018 and this trend has been exacerbated by COVID-19. This has weighed on IGC's relative performance against the MSCI India and S&P BSE Mid Cap indices.

Figure 18: Cumulative total return performance for periods ending 30 April 2020

Heading	1 month	3 months	6 months	1 year	3 years	5 years
IGC NAV (diluted)	12.1	(28.1)	(29.0)	(36.8)	(43.3)	(9.2)
IGC NAV (portfolio)	12.1	(28.1)	(29.0)	(36.8)	(43.3)	(1.5)
IGC share price	19.4	(40.8)	(41.5)	(53.0)	(53.3)	(25.5)
S&P BSE Mid Cap	12.2	(22.1)	(21.0)	(21.6)	(26.3)	26.1
MSCI India	13.8	(15.3)	(16.9)	(17.3)	(4.8)	26.7

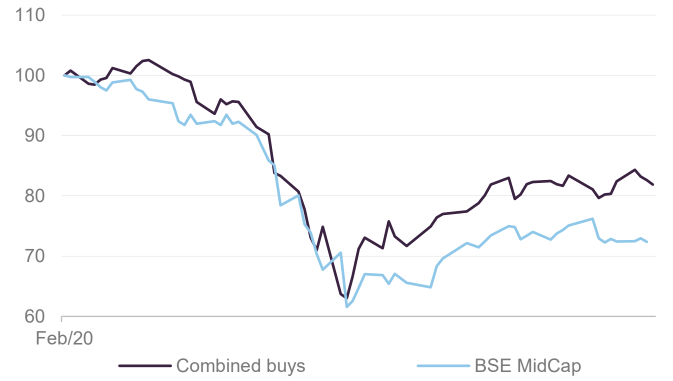
Source: Morningstar, Bloomberg, Marten & Co

New holdings performing well

There have been some encouraging early signs of progress in redressing stock selection performance. The universe ranking tool, discussed in the investment process section, is seen as adding more quantitative rigour to the investment process, as part of processes installed to mitigate behavioural risk.

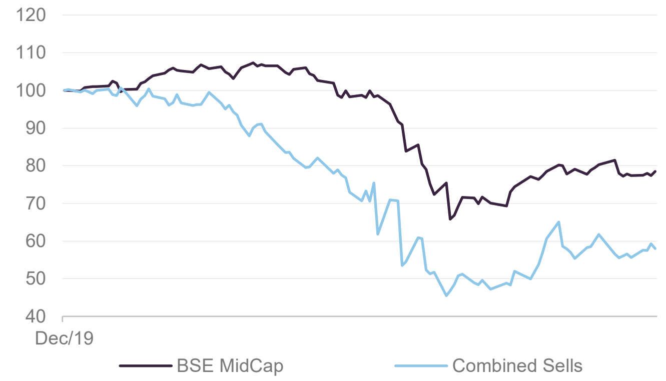
Over recent months, a weight-adjusted basket (portfolio weights compared to the benchmark) of the new holdings mentioned above, has outperformed the benchmark. Similarly, the manager's selling activity has been adding value. A concerted effort has been to reduce the portfolio's exposure to India's underperforming banking Sector. Stocks that have been sold include: Indian Bank, Yes Bank, Motherson Sumi Systems and Jammu & Kashmir Bank.

Figure 19: Weight adjusted re-based performance of new IGC buys versus the BSE MidCap Index – 6 February 2020 to 14 May 2020



Source: Ocean Dial Asset Management, Marten and Co

Figure 20: Weight adjusted re-based performance of outright IGC sells versus the BSE MidCap Index – 19 December 2019 to 14 May 2020



Source: Ocean Dial Asset Management, Marten and Co

Performance attribution

Ocean Dial kindly supplied us with performance attribution data for IGC's portfolio relative to its benchmark. This covers both the five-year period and the three-month period ending 30 April 2020.

Looking first at the long-term picture, at a sector level, the portfolio's longstanding underweight exposure to the energy sector accounted for 4.2% of the fund's underperformance of its benchmark. An underweight exposure to health care cost 2.1%. The underweight to energy reflects the adviser's longstanding aversion to business models driven by global commodity prices.

These adverse sector stances were offset by an overweight exposure to materials, which added 3.5% to relative performance, (chiefly cement companies, which have often been good investments for IGC) and the absence of any utilities exposure in the portfolio, which added 3.0%. The latter position reflects the adviser's reluctance to have exposure to State-owned enterprises or business that are heavily reliant on them.

Overall, sector allocation was a net positive to relative returns over the five years ended 30 April 2020. The same cannot be said for stock selection.

Manpasand Beverages share price collapsed in 2018 when its auditor resigned (see our June 2018 note). Welspun was hit by accusations that it mislabelled some of its products as Egyptian cotton (see our October 2016 note). Emami's share price fell when the founding family was forced to sell stock which it had pledged as collateral for a loan (see our October 2019 note). Ramkrishna Forgings and Motherson Sumi are victims of slowing economic growth and weak export markets.

The effects of COVID-19 on performance

In absolute terms over the three months ended 30 April 2020, the best-performing sector was healthcare, while financials, real estate and IT were hit hardest. The poor performance of IT shares in India is somewhat inconsistent with the general performance of technology equities globally. This probably reflects the large business outsource sub-sector within Indian IT. Overall, sector selection added 1.7% to returns.

Looking at absolute contributions to performance in stock selection terms, some stocks were able to deliver gains over the period. Chief of these for IGC were the holdings in Divi's Laboratories, Aurobindo Pharma and PI Industries, the first two of which are health care stocks (India's pharmaceutical sector is one of its strengths and, the adviser believes, a great hope for the future of the country) and the latter stock is an agrochemicals company.

Figure 21: Top five positive contributors to return, quarter-ending 30 April 2020

Holding	Position Size %	Index weight %	Return to Portfolio %	Return to Index %	Attribution %	Contribution %
Divi's Laboratories	5.14	4.29	19.85	17.98	0.31	1.06
Aurobindo Pharma	1.75	-	18.22	-	0.66	0.64
PI Industries	5.64	-	0.23	-	1.17	0.45
Aegis Logistics	0.96	-	(13.06)	-	0.20	0.34
Neuland Laboratories	1.25	-	3.81	-	0.31	0.25

Source: Ocean Dial Asset Management

Figure 22: Divi's Laboratories share price

Source: Bloomberg, Marten & Co

We highlighted Divi's Labs and Aurobindo Pharma in our November 2018 report on IGC.

Divi's has been a real success story, but also illustrates how dramatically the fortunes of these companies can change in a relatively short space of time. Back in 2017, the stock was hit by an FDA investigation into drug manufacturing facilities across India, including Divi's facilities. Gaurav advised that IGC increase its position in the company and IGC has benefitted as the share price has recovered since. Divi's is a core supplier to many of the world's leading pharmaceutical companies.

Figure 23: Aurobindo Pharma share price

Source: Bloomberg, Marten & Co

Also within healthcare, generics drugs company Aurobindo Pharma has performed very well so far this year – its shares are up over 40%. The adviser suggests that the recent technical breakout in the shares (see Figure 23), reflects current sentiment. Aurobindo supplies active pharmaceutical ingredients (APIs) to pharma companies globally and its own product portfolio includes antibiotics, anti-retrovirals, cardiovascular and central nervous system drugs.

IGC has additional exposure to this area through a holding in Neuland Laboratories (1.6% of the portfolio). It thinks that the pharmaceutical industry will be looking to de-risk global drug supplies by increasing diversification of sources away from China, to India's benefit.

Figure 24: Top five negative contributors to return, quarter-ending 30 April 2020

Holding	Position Size %	Index weight %	Return to Portfolio %	Return to Index %	Attribution %	Contribution %
Kajaria Ceramics	3.62	-	(32.92)	-	(0.40)	(1.7)
IDFC Bank	2.70	-	(44.41)	(46.55)	(0.40)	(1.4)
JK Lakshmi Cement	3.05	-	(39.82)	-	(0.56)	(1.4)
Bajaj Consumer Care	3.94	-	(34.54)	-	(0.49)	(1.3)
Ramkrishna Forgings	2.08	-	(46.07)	-	(0.57)	(1.1)

Source: Ocean Dial Asset Management

Companies that are particularly cyclically exposed to the downturn have led declines. Kajaria Ceramics and JK Lakshmi Cement have been amongst these, following the curtailment in construction activity. Bajaj Consumer Care's presence is probably more surprising.

Figure 25: Kajaria Ceramics share price

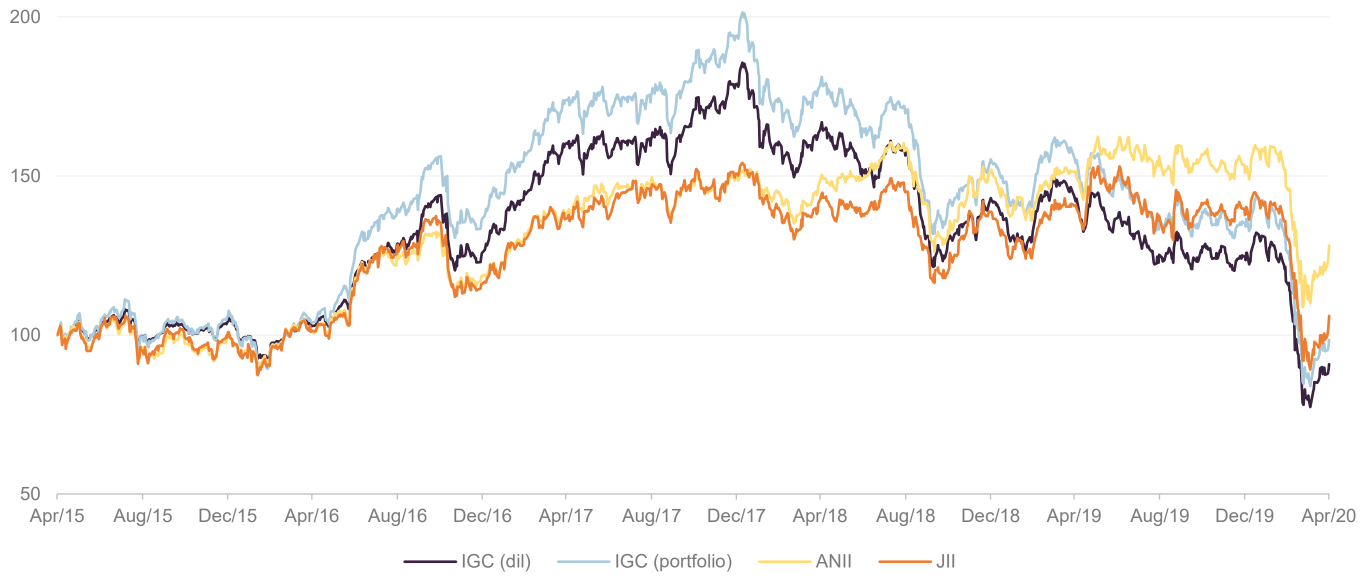
Source: Bloomberg, Marten & Co

Peer group comparison

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

Compared to its listed peer group of three funds (Aberdeen New India, JPMorgan Indian and Ashoka India Equity), IGC follows a smaller-cap strategy. Ashoka is probably most similar in style to IGC. However, as is this case with all of the peer group IGC's peer group, there continues to be very light overlap in the stocks held. Ashoka launched relatively recently, in July 2018, so is therefore excluded from Figure 26.

Figure 26: IGC NAV performance versus listed peers over five years ended 30 April 2020



Source: Morningstar, Ocean Dial, Marten & Co

As Figure 27 shows, IGC outperformed Aberdeen New India and JPMorgan Indian up until; early 2018. In the period since, small- and mid-cap stocks have lagged larger ones, weighing down on IGC.

Figure 27: Indian equity funds subsector comparison (NAV total return data in sterling as at 30 April 2020)

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
IGC (diluted)	12.1	(28.1)	(29.0)	(36.8)	(43.3)	(9.2)
IGC (portfolio)	12.1	(28.1)	(29.0)	(36.8)	(43.3)	(1.5)
Aberdeen New India	10.8	(16.9)	(18.3)	(15.3)	(6.9)	28.1
Ashoka India Equity	13.1	(12.0)	(9.0)	(3.3)	n/a	n/a
JPMorgan Indian	12.3	(23.2)	(24.7)	(24.6)	(22.3)	6.0

Source: Morningstar, Marten & Co

IGC is the smallest of the four UK-listed India-focused funds. Though performance over the past year has suffered, this has been true for all four funds – only Ashoka India has come close to a positive total return over the past year. Given that the none of the listed funds pay much in the form of income and the fact that IGC's portfolio trades at a deep discount, based on data from Morningstar, its discount does seem overly wide.

IGC's small-cap bias and the deeper discount of its portfolio suggests it has the most to gain from India successfully managing the re-opening of its economy and the implementation of the $266bn stimulus. This is without considering the discount to its peer-group.

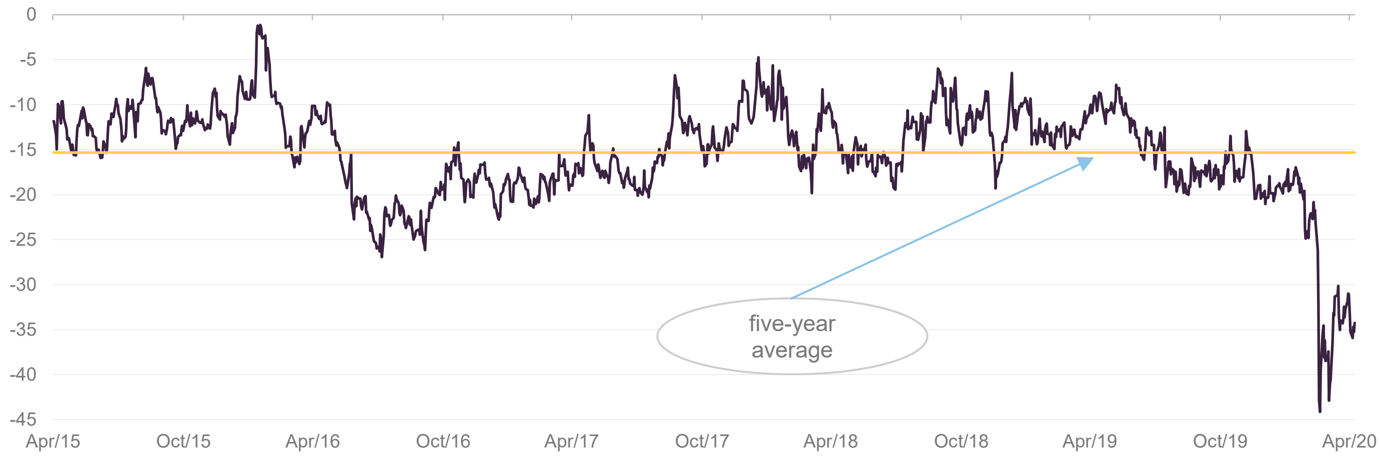
Figure 28: Indian equity funds subsector comparison, as at 22 May 2020

	Market cap (GBPm)	1 yr. avg. daily volume (GBP '000s)	Discount (%)	Ongoing charge* (%)	Portfolio trailing P/E ratio	Portfolio trailing P/B ratio	Three-year portfolio beta, as at 30 April 2020
IGC	45	114.6	(34.6)	1.85	17.4	3.6	1.15
Aberdeen New India	212	338.8	(16.9)	1.17	22.9	4.6	0.90
Ashoka India Equity	58	103.0	(10.1)	1.04	28.5	7.1	1.05
JPMorgan Indian	382	1,021.0	(16.6)	1.06	21.4	4.1	1.10

Source: Morningstar, Marten & Co. *Note: Year to 31 December 2019

Discount

Figure 29: IGC premium/(discount) to diluted NAV over five years to 30 April 2020



Source: Morningstar, Marten & Co.

> The stimulus package is likely to improve sentiment towards mid-caps in India, which should provide a catalyst for IGC's discount to narrow

IGC's discount has widened sharply since March 2020.Over the year to the end of April 2020, it traded within a range of (44.1%) to (7.8%) and. At 22 May 2020, the discount was (34.6%).

A catalyst for a narrowing of IGC's discount would be an improvement in sentiment towards small-cap Indian stocks, which could be on the horizon as more details of the stimulus package emerge. Should the portfolio companies start to perform better, this is likely to provide momentum for the discount to narrow, as more focus turns towards attractive valuations and India's long-term opportunity to widen its manufacturing base.

As discussed on page 7, 30% of mid-cap stocks in India were trading at below -1 std deviation, compared to their five-year averages at the end of April 2020.

Fund profile

Further information, including videos and podcasts, is available at www.indiacapitalgrowth.com.

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, a company owned by Avendus Capital Private Limited, which in turn is backed by KKR. 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 over 25 years of experience in Indian capital markets, having started his career as vice president of research for SG Asia. 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.

Alignment of interest

Ocean Dial manages two funds investing in India, IGC and an open-ended fund, Gateway to India fund. Ocean Dial had AUM of US$122.2m as at the time of publication. Employees of Ocean Dial collectively hold 403,822 shares in IGC, while members of IGC's board collectively own 92,500 shares between them. Combined Ocean Dial employees and the three directors hold 0.4% of IGC's issued share capital.

IGC invests through a Mauritian subsidiary (ICG Q Limited) in a portfolio of Indian securities. Changes to the Indian tax regime in 2018 mean that ICG Q Limited is now liable to pay capital gains tax at 15% on short-term gains and 10% on its long-term (over 12 months) gains. IGC will accrue any potential CGT liability in its NAV. Given the manager and adviser's focus on holding companies for the long-term, it might be reasonable to expect that the bias will be to the realisation of long-term gains. No CGT was accrued as at 31 December 2019.

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.

Previous research publications

Readers interested in further information about IGC may wish to read our earlier notes listed in Figure 30. All of these are available on our website, www.martenandco.com.

Figure 30: 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
Shakeout uncovers value	Update	29 November 2018
Discounted value	Annual overview	1 October 2019

Source: Marten & Co.

Webinars

David Cornell, manager of IGC, will be discussing the proposals at two webinars. The first of these is on 29 May 2020 at 12:00 and the second on 3 June 2020 at 12:00.

Registration for these webinars is possible by clicking the links in the dates above or by visiting the Events section on Marten & Co's QuotedData website.

Appendix 1 – investment advisory team leadership

Gaurav Narain – co-head of equities

Gaurav Narain joined Ocean Dial in November 2011 and has been involved with the Indian markets for the past 25 years. He has held senior positions as both a Fund Manager and an equities analyst for New Horizon Investments, ING Investment Management India and SG (Asia) Securities India. He holds a Master's in Finance and Control and a Bachelor of Economics from Delhi University and is based in Mumbai.

Tridib Pathak – co-head of equities

Tridib Pathak has a career in the Indian financial markets that spans over thirty years with stints in project finance, credit analysis and latterly pan-Asia equity research for UBS Securities. His buy-side career began in 1999 since when he has been investing in Indian equities for both domestic and international investors at firms including Lotus Asset Management and DBS Cholamandalam where he served as CIO. Tridib joined Ocean Dial in 2019 from the Enam Group where he was Senior Portfolio Manager for four years. He is a Chartered Accountant from the Institute of Chartered Accountants of India.

Shahil Shah – assistant fund manager

Shahil Shah was part of the original investment team which was set up in 2005 and specialises in Telecommunications, Consumer, Healthcare, and Media sectors. He holds a Master's in Commerce and Finance from Mumbai University and is based in London. Shahil supports the Co-Heads of Equities in the day to day maintenance of the funds.

Saurabh Chugh – analyst

Saurabh Chugh was the part of the original investment team and joined in 2006. He specialises in Information Technology, Energy, Transport, Infrastructure and Soft Commodities. He holds an MBA in Finance from Nirma Institute of Management, Ahmedabad and is based in Mumbai.

Ankush Kedia – analyst

Ankush Kedia joined Ocean Dial team in April 2018 and is based in Mumbai. He has 12 years of investment experience in public markets and private equity. He previously worked for Avezo Advisors (a division of Avendus Capital) as Principal and Co-fund Manager focusing on private equity style investments in small and mid-cap listed companies in India. Prior to Avezo, Ankush worked with Mayfield Fund and Axis Bank. Ankush holds an MBA in Finance and Economics from XLRI, Jamshedpur and BTech in Mechanical Engineering from IIT Roorkee.

Ashutosh Garud - analyst

Ashutosh Garud joined Ocean Dial in 2020 after working as Associate Portfolio Manager in the Avendus Wealth Management Team. Prior to joining Avendus, Ashutosh worked with Reliance Wealth Management. Ashutosh holds an MBA in Finance from Chetana Institute of Management Studies, a Bachelor of Commerce & Economics from Mumbai University and is a CFA charterholder.

Saurabh Rathore – analyst

Saurabh Rathore joined Ocean Dial team in January 2020 and is based out of Mumbai. He has 3 years of experience in financial services across global markets, investment analysis and due diligence, business strategy and risk management. Prior to Ocean Dial, Saurabh has been associated with Avendus, Credit Suisse and J.P. Morgan. Saurabh holds a B.E(Hons) in Electrical and Electronics Engineering from BITS-Pilani and an FRM Charter and has cleared CFA Level-III examination.

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IMPORTANT INFORMATION