India Capital Growth Fund - Investing in Pandemic times

Managing a small and mid-cap portfolio over the last six months has been one of the most challenging periods in my 27 year career. Echoing Demonetisation[1], on 24th March the Indian Government made an overnight announcement to lockdown the entire country for three weeks. No advance warning. It was subsequently extended and whilst it was an *audacious* move (considering there were only 500 active cases at the time) it is too soon to opine on its efficacy. What we do know is that for India; GDP growth of +4% would be viewed as a recession and it is now staring at close to -8% for the current year. To top it all, after three years of declining growth, in the first quarter of this calendar year we were finally seeing green shoots of an economic recovery and entering the lockdown the portfolio had been rejigged to capitalise on this inflection.

Despite such a backdrop, **volatility and uncertainty are the core ingredients for active stock pickers to prove their worth.** Step one is to survive and step two is to thrive. This note[2] attempts to outline the thinking and actions behind such intentions which can be summarised into three points:

- Reduce exposure to businesses that will struggle
- Add more to portfolio holdings whose business models will survive the pandemic where the share price indicates otherwise
- Find companies whose business models can thrive in a post-Covid world

The portfolio and broader opportunity set was systematically reviewed along these lines to capitalise on market fear and mispricing to maximise our chances of delivering excess returns for shareholders going forwards.

Screening for fragility

As the Pandemic was flaring overseas we exited our most globally consumer facing business, Motherson Sumi Systems. It supplies car parts to all the global auto-makers, and although it is stewarded by an excellent management team the headwinds appear too great relative to its valuation. Subsequent to India's lockdown, we lowered our banking exposure, particularly to businesses most exposed to unsalaried borrowers and SMEs; DCB Bank specialises in this space and was fully exited. We like both companies and will look to reallocate when the risk reward looks more favourable.

Beyond this, underlying stock specific risks were re-assessed name by name. While the bulk of the portfolio's holdings had (and still have) balance sheets with net cash positions, three names whose net debt / equity positions were in excess of 50% gave pause for thought and so were re-assessed threadbare – Ramkrishna Forgings, Sagar Cements, Welspun India. We stripped out the fixed and variable cost components to understand the cash burn and ascertain how many months of lockdown (i.e zero revenues) their businesses could sustain. We were confident they would be able to ride out the downturn. Welspun's debt position was as a consequence of capex that had

[1] An overnight cancelling 85% of currency notes in circulation in 2016

[2] For more colour on recent performance or additional portfolio data, email my colleague for a copy of our latest factsheet camilla.bryden@oceandial.com

already been completed and the company had been generating sufficient cash to put it in deleveraging mode. Sagar Cements eventually recorded its highest every quarterly profit as the post-lockdown period saw a rise in prices and lower material costs more than offsetting the sharp volume decline. Ramkrishna Forgings used the price fall as an opportunity to buy-back shares and felt confident in its debt servicing abilities to the extent of not taking advantage of the moratorium being offered by the banks. As such we felt confident in these three companies' ability to survive and so far feel validated by their operating performance since our review.

Fear equals opportunity

We presently own four private sector banks, each with its own unique traits. While City Union Bank and Federal Bank are regional in nature focusing on SMEs & corporate banking, IndusInd Bank and IDFC Bank are more retail focused banks. They are well capitalised and have used the RBI's moratorium to boost their provision coverage ratios in anticipation of higher non-performing loans. During the initial phase of the market fall we reduced our exposure in the expectation of economic uncertainty depressing valuations. However, we do ultimately believe these four banks will emerge amongst a pack of stronger survivors. Moreover, the next leg of economic momentum will also have to be provided by banks such as these and we are now feeling confident about gradually increasing their weight in the portfolio.

Switching from borrowing to spending, our long-held thesis that companies most geared to rural consumers in India will provide the strongest returns has been tested over the last 18 months in the wake of government reform and a credit crunch in early-2019. Our confidence has however been reinforced of late. Rural India is less impacted by Covid and has a lot of tailwinds – a good Monsoon and massive doses of investment by a government now looking to stimulate rather than disrupt. Our three names most focused in this space are dominant players to whom we have been adding. Bajaj Consumer Care in almond hair oil, Emami in the increasingly popular Ayurvedic segment and Jyothy Laboratories in household and personal care. They have participated in the sharpest end of the recovery in sales and are very attractively valued relative to both their own history and the peer group.

If one was to summarise our investment philosophy in one statement it would be *to find compounding machines (well managed companies that can sustain earnings growth of 15-20% over a long period of time) and add to them when they are out of favour*. Across the next economic cycle, rural India coupled with the intermediation of financial services, are the best spaces to help our philosophy self-fulfil. In addition to a normalisation in earnings growth, allocating at this time has another powerful returns component of an upward reversion towards the long term mean in the valuation of our companies.

Who will thrive?

Our most recent addition to the portfolio is Dixon Technologies. Using its dominance in LEDs (top four global player) it has expanded its base to be an outsourced manufacturer for the likes of Xiaomi, Panasonic, and Samsung for items including televisions, mobile phones, and medical equipment. At a time when global companies are looking to broaden the geographic sources of their production, and the Indian government is providing significant incentives to reduce its electronics import bill of over $40bn (mainly from China) - Dixon is at the right place at the right time. It is rapidly adding brands to its portfolio across segments and is set to grow at a staggering pace over the next few years. Currently a small cap, we don't expect it to be so for very long.

Beyond electronics, an area of the portfolio that has performed well during this period is the broader chemicals space. Long term holdings such as Divi's Laboratories, Neuland Laboratories (active pharmaceutical ingredients and custom research) and PI Industries (agrochemicals) have seen strong growth as their customers have sought to build up their inventories. To this we added Aarti Industries a global leader in the benzene chemistry chain supplying to the likes of Pfizer, Bayer, BASF, 3M, Dow and Unilever, as well as a whole host of Indian blue chips. Both these sets of customers are looking to de-risk their sourcing from China whose chemicals manufacturing base is ten times the size of India's. Our holdings have a strong order book and have an excellent track record in executing on their product pipeline. With huge structural tailwinds we have high visibility of a conservative 20% growth trajectory for the coming years.

The global stock market collapse was used as an opportunity to add to three distinct but exciting new names – ICICI Lombard General Insurance, CCL Products, and Multi Commodity Exchange (MCX).

ICICI Lombard is India's largest private sector general insurance company that is building a technology platform like no other in India. The company has been replacing manually-repetitive paper-intensive processes with artificial intelligence in areas such as claims adjudication and fraud detection to lower costs and improve customer experience. It is set to gain market share from cumbersome public sector companies and is well placed to capitalise on a highly underpenetrated but growing part of India's wallet-spend.

Second is CCL Products which is the world's largest private label instant coffee manufacturer. Aside from steady growth of 19% over the last five years, we think the business can earn a higher valuation as it takes on Nestlé in India with a domestic brand called Continental. It will do this armed with low cost manufacturing and economies of scale, a strong reputation amongst its long term client relationships for consistency and quality, and technical know-how to produce high-quality instant coffee using all grades of raw coffee beans.

Finally we have MCX, India's largest commodity exchange. It has just under 100% share in non-agricultural commodities such as energy, base metals and bullion. The sophistication of India's financial market ecosystem is accelerating as the regulator has permitted new distribution channels (banks' broking subsidiaries), new products (option contracts, commodity index futures) and new participants including mutual funds. These initiatives will go a long way in growing the commodity market in India, and MCX being the dominant player is well placed to benefit the most due to its head start and the strong network effects the business enjoys.

Looking forwards

It has been a busy and active time for the team with a reorientation of the portfolio that I believe leave it well calibrated for strong returns going forwards. We remain fully invested but are mindful of economic challenges on the horizon:

- Indian companies have slashed their costs and many aim to keep them down – who loses out as a result?
- Most management teams claim their businesses are back to 80-90% of pre-pandemic levels, but they have little clue as to when the final ~10% recovery may happen in the short run
- With the central government having initially implored people to stay at home, will they listen now it is imploring them to do the opposite?

We are realists when it comes to the challenges and uncertainty in the short run but optimists when it comes to the medium term desire for Indians to spend, socialise, borrow, innovate, and invest for a better future. We have spent the last few months ensuring that the portfolio is a reflection of these two perspectives. It is robust enough to match our realism and looks set to capture returns that mirror the level of our optimism.

Gaurav Narain
September 2020

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