

Process evolution; DCB Bank's perfect storm (in a teacup); fragility and Goldilocks – January 2020

Pre-note "disclaimer": this piece will not have any commentary on US-Iran tensions, the likely outcome of trade talks, or what direction we think markets might travel over the near term.

2019 was an eventful year for India which included a national election, a liquidity crunch, a botched budget, the biggest tax reform in a generation, and an equity market characterised by divergence and volatility. It has been a testing period for many investors, Ocean Dial included¹, and whilst the viewpoint that the dust has started to settle is up for debate, it is timely to have a discussion on how our research approach has evolved over this period and our broader outlook for the coming years.

An evolving opportunity-set

Business practices in India have been changing and this has been accelerated by the recent slowdown. Any improvement takes time to filter through into better reputations, stronger profitability, and higher valuations, hence creating an opportunity for mispricing, particularly in a market which has been hyper-focused on "proven-quality" at any price. Beyond the well-known market darlings (many of whom we are proud to be investors in), we are noticing a broader recognition by management teams of minority shareholder rights, transparency, alignment of interests, and professionalisation. This is being driven by a combination of an inter-generational handover of family control, ESG awareness, rapidly growing social media usage², competitive self-interest in having the family shares trade on a higher multiple than peers, and in some cases brutal market pressure on family owned companies overusing leverage.

On the last issue, a common practice has been for promoters to pledge shares in their publicly listed business as collateral to borrow money for other family projects. What may have felt like a sensible way of getting cheaper capital in a sanguine environment, required a re-think as the economy contracted and the risks of banks seizing their collateral rose when those projects began to falter. The selling pressure from investors that feared banks would seize and dump shares was acute and promoters have had to offload chunks of their holdings to pay-off these loans. We feel that deleveraging at the family level is a positive for better managed companies, particularly when their earnings recover, as subsequent re-ratings could prove to be more pronounced, thereby adding to the upside from current prices. An example of this is Bajaj Consumer Company, India's market leader in almond-derived hair oil products (US\$495m market cap). In our interactions with management, amongst

¹ For more detailed numbers on absolute and relative performance of our strategies please email camilla.bryden@oceandial.com

² There were 294 million active users in 2018 vs 136 million in 2016 (We are Social, McKinsey)

other things we were impressed by their admission that low growth and poor stock performance was 95% their fault and 5% owing to market conditions. The family sold a 22% stake at a 15% discount to an already compressed prevailing market price, which enabled us to build a position³ in a highly cash-generative business with a greater margin of safety.

With this backdrop, we re-examined the investible universe over five long sittings towards the end of the year. 850 companies with a market capitalisation higher than US\$100m were whittled into a shortlist of 143. Businesses that we feel are unscalable, conglomerated, overcomplicated, driven by commodity prices, have ESG concerns, are owned by the Government⁴, exposed mainly to overseas consumers, or where we don't have enough knowledge to have an informed view on any of the above are currently excluded. Each analyst covers roughly thirty five names and coverage entails forensic accounting, detailed financial modelling, one-to-one corporate interaction at least twice annually, and a final valuation based on relative and absolute metrics. The universe will be ranked on a live basis in descending order of expected return which then helps guide Portfolio Managers where to direct deeper due diligence.

Delta – a perfect storm (in a teacup)

Part of our edge is to spot a company whose direction of travel is not only positive but where the majority of other investors are fixated on the starting point of its journey. Each team member is responsible for unearthing such instances on a continuous basis and pitching to the rest of the members in the face of pre-prepared scrutiny, as to why the company deserves inclusion in the Ocean Dial universe.

DCB Bank is an example of a company which was already in the universe but where the current exercise resulted in added exposure⁵. The team has been following the company for five years, intensifying management interaction over the last eighteen months with five separate meetings. Its largest shareholder is the Aga Khan Fund for Economic Development, an international development enterprise that promotes stability and good governance, and the bank itself is a professionally run institution with top quality management. However, it has a lower ROA and ROE profile than similarly well managed banks, and thus trades at a discount:

FY21e⁶	DCB Bank	City Union Bank	HDFC Bank	IndusInd Bank
ROA	1.2%	1.5%	2.2%	1.9%
ROE	13.2%	14.9%	18.4%	19.2%
P/Adj BV	1.6	3.5	3.4	2.8
Market Cap	US\$0.8bn	US\$2.4bn	US\$99.0bn	US\$14.6bn

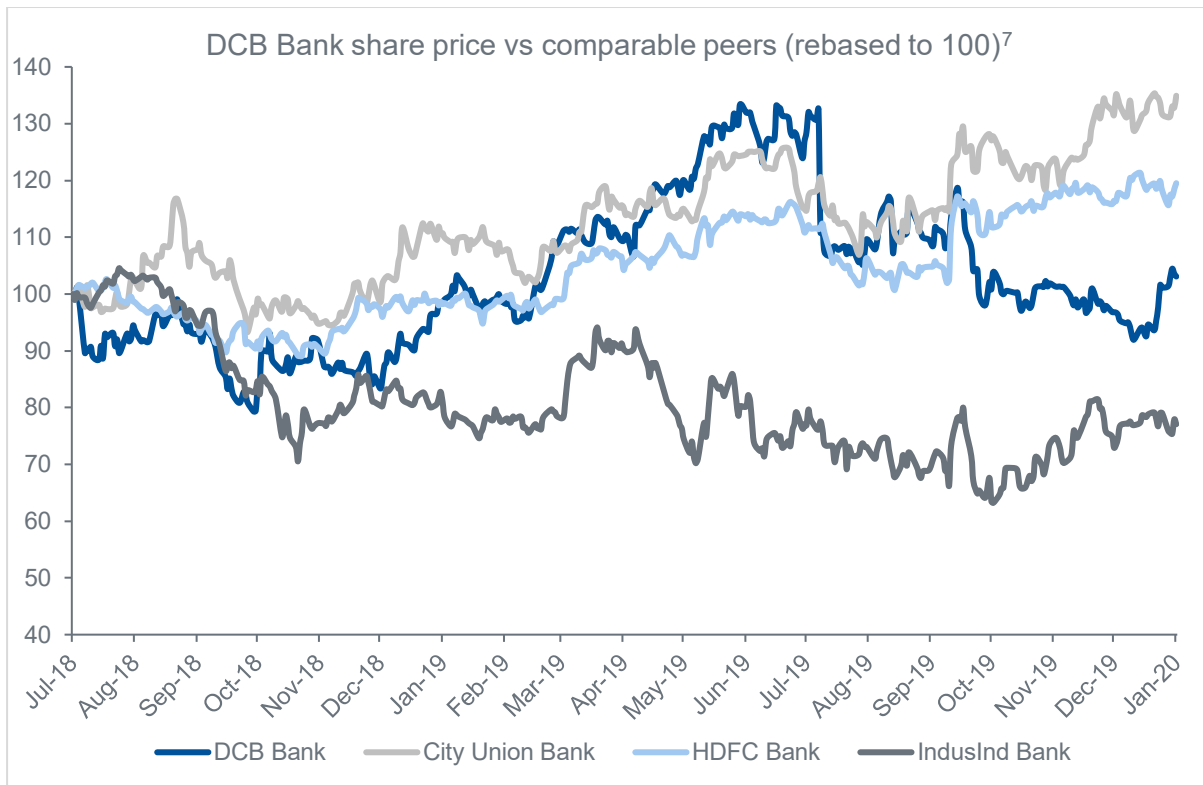
³ India Capital Growth Fund – 4.6% weighting (31 December 2019)

⁴ Barring a small number of well-known exceptions where detailed coverage is necessary to understand the broader sector

⁵ India Capital Growth Fund – 3.0% weighting (31 December 2019 – fund audited monthly), Gateway to India Fund – 4.3% weighting, Emerging India Fund – 4.5% weighting (8 January 2020 – funds audited daily)

⁶ Ocean Dial research, Bloomberg

The reason for the lower returns profile was a perfect storm (in a teacup): the blend of tea leaves was a decision to double branches in October 2015 to over three hundred, mixed with the milk which was last year's credit squeeze leading management to slow growth in advances over the last two quarters to 12% from a five year average of 24%, whilst the sweetener as ever was operating leverage – all sat on a saucer of a small and midcap bear market.



The near term catalyst for re-rating is our understanding that the company is now entering into steady state of opex with the addition of around twenty branches a year, allowing the benefits of operating leverage to deliver, with the cost to income ratio dropping by 5% to 53% over the next financial year. We conservatively estimate 17%⁸ loan growth over the next three years allowing last year's 1.0% ROA to improve to 1.4% in FY22 with ROE thereby improving from 11.0% to 16.3%.

In terms of long term compounding, we see secular growth in DCB's target market of the self-employed and MSMSEs (micro, small, medium sized enterprises) located in Tier 2 to Tier 6 cities. The disruption that has resulted from the formalisation of the Indian economy from measures such as GST (more on this shortly) has expanded the needs of an already underserved segment, leaving the bank well positioned to make this space its own.

The risks are mitigated by the bank's robust asset book. When the Indian banking sector's NPAs ballooned into double digits over the last six years, DCB's never

⁷ Source: Bloomberg

⁸ Management is targeting 22% growth over three years

exceeded 1% on a net basis⁹. As such, whilst our thesis shows that the share price offers a wide margin of safety with 46% upside, we feel comfortable to add to our position should a delay in the mean reversion of growth lead to further de-rating – an unlikely scenario for a bank of this calibre. The change in fundamentals can be a key component of excess returns, and we believe that the embedded delta potential in DCB Bank relative to other high quality banks should see a dramatic reversal in its status as a serial underperformer.

The top-down; fragility and Goldilocks

[In a note from August 2019](#) following a dramatic correction in small and mid cap stocks, enough value had emerged for us to state with confidence “*that we are buyers in today’s market*”. Since then, fear of contagion has diminished somewhat, liquidity has improved, interest rates have fallen and corporate tax rates are now the most competitive in Asia. Whilst the mid cap market has stabilised since August (up 11% by the end of the year versus -12% from January to August¹⁰), we are not sure when GDP growth is going to pick up from its lowest level since 2012 (5.8%) and corporate profitability is to recover from its lowest level since 2001 (1.8% of GDP). It has been a fool’s errand to try and predict the arrival of an earnings recovery in India and the reason is best explained by Benoit Mandelbrot, father of fractal geometry:

“To all the complexity of the physical world of weather, crops, ores, and factories, you add the psychological complexity of men acting on their fleeting expectations of what may or may not happen – sheer phantasms. Companies and stock prices, trade flows and currency rates, crop yields and commodity futures – all are inter-related to one degree or another, in ways we have barely begun to understand.”¹¹

It is for this reason that we choose not to be macro-driven in our research, but rather macro-aware with conviction being driven from the bottom-up. Whilst a dozen indicators can be given to demonstrate a bullish disposition, a dozen others are ready to be brandished by the bears, with each side choosing to add greater weight to the data points supporting their position. Indeed, in our August note we outlined the current debate in India as to whether the slowdown is cyclical or structural. This in our view rather misses the point. Structural issues have existed in India since its independence in 1947, yet long-term equity investors have enjoyed significant periods of strong returns. In contrast, Goldilocks investors who need everything from the macro environment, to the politics, to the volatility, to the valuations to look *juuust right* before taking the plunge tend to enter the market when it is at its riskiest. Instead, thinking in terms of fragility can be more elucidating.

⁹ Sub-2% on a gross basis

¹⁰ S&P BSE MidCap Index TR 31st December 2018 – 31 August 2019 vs 31 August 2019 - 31st December 2019 (INR)

¹¹ Professor Mandelbrot, *The (Mis)behaviour of markets, A fractal view of risk, ruin and reward*, pg 185

India has been, and in the near term will continue to be, a fragile economy. Fragility as defined by Nassim Taleb is suffering from volatility¹². Exogenous shocks – poor weather (Monsoons), oil price spikes, global risk appetite, political gridlock – have a disproportionate impact on sentiment and economic output relative to more developed economies. What is encouraging is that the exogenous shock driving the current slowdown is structural reform – inflation targeting, the Goods & Services Tax (100 categories reduced to five), Demonitisation, the Insolvency and Bankruptcy Code, the Real Estate Regulation Act, the Prompt Corrective Action Framework (forcing recognition of non-performing loans) to name a few.

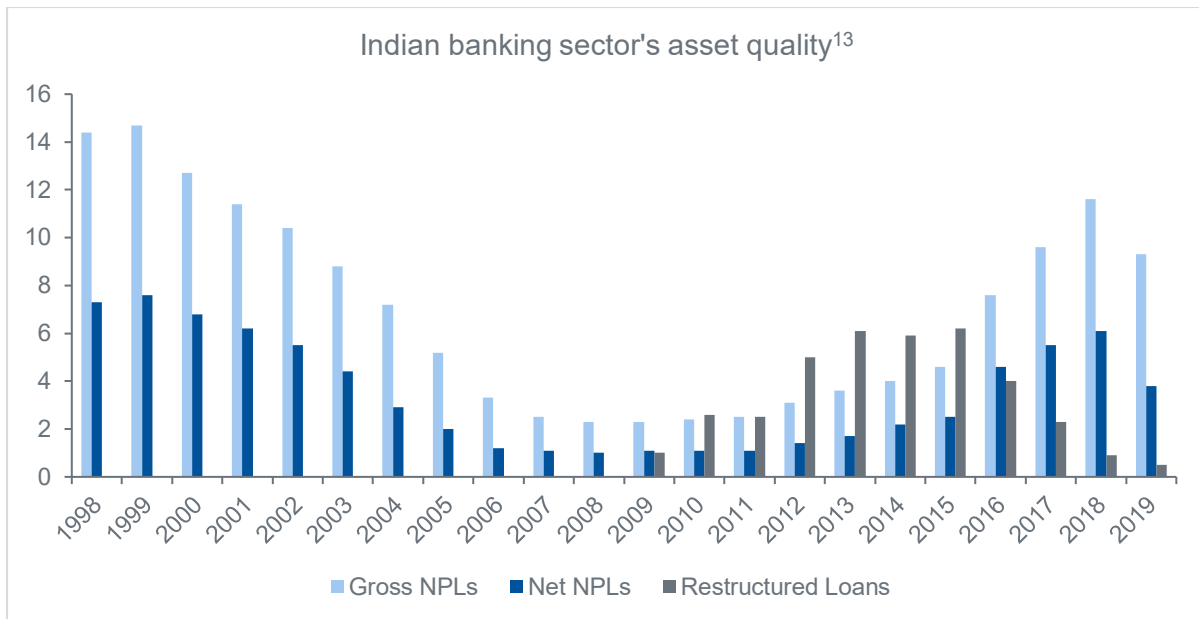
A rules based system is replacing a patronage based one, the use of technology is driving transparency and accountability in the bureaucracy, successive parliamentary majorities have ended gridlock allowing overdue legislation to address moral hazard and force market discipline onto private enterprises. The attack on corruption can be seen for instance through the lens of more robust regulation in the real estate sector which was the main channel for directing black money. It is here where the recent slowdown and its knock on effects on asset quality and demand have been most pronounced.

Financial inclusion and sound monetary policy is helping shift savings from non-productive assets such as gold, with domestic mutual funds' Systematic Investment Plans seeing monthly flows since May 2018 in excess of \$1bn, mitigating the capital markets' reliance on foreign fund flows. Meanwhile FX reserves are at an all-time high of \$457bn – approximately one year of imports cover. India's fragility is being addressed systematically, and whilst there is a long way to go the country is moving fast. The risks involved in entrepreneurial activity are coming down, and so the cost of capital should follow.

Such structural reforms have meant that India's position in the World Bank's Ease of Doing Business Index, has gone from 141st in 2014 to 63rd, however it is clear that an economy driven by the self-employed and SMEs cannot sustain such a battering for too much longer. The Government's Chief Economic Advisor Sanjeev Sanyal [recently tweeted](#):

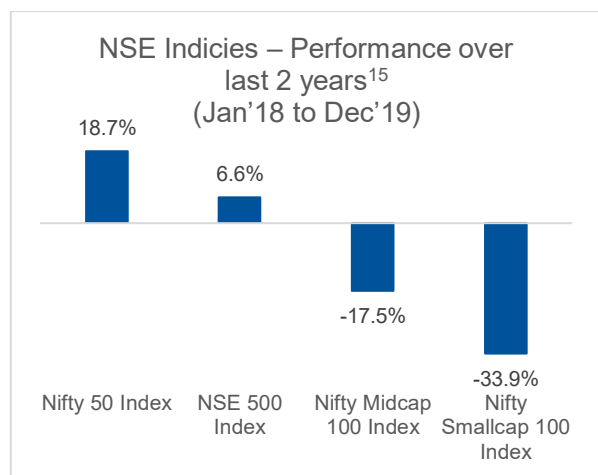
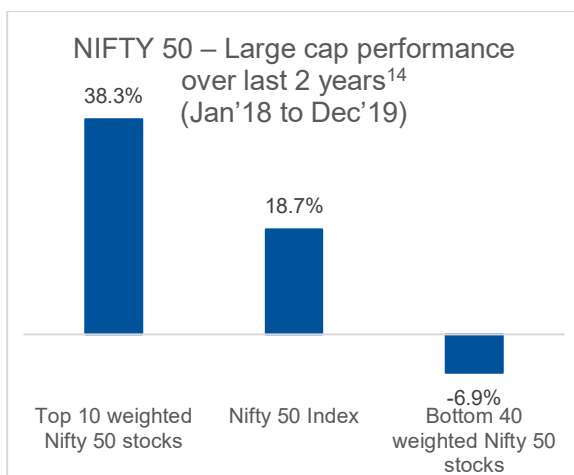
“Clear message from PM: India's business sector and banks have been cleaned, and a rules based system introduced. The next stage is to build a risk taking culture & trigger the animal spirits of the Indian entrepreneur.”

¹² The opposite of fragility is not robustness, but anti-fragility – something that benefits from volatility. The example Taleb gives from an economic perspective is Switzerland – when Black Swans occur, the country receives capital. See Nassim Nicholas Taleb, *Antifragile: Things That Gain From Disorder*



The banking system's level of provision coverage, credit costs, restructured and non-performing loans are trending in the right direction. The NBFC crisis has diminished as a systemic risk and is now isolated to weaker players who are in bankruptcy proceedings or raising equity. In conjunction with lower interest rates (135bps of easing since February 2019), and after years of stress culminating in a liquidity squeeze last year, the banking system is expected to be in a much better position to lend to a capital constrained economy.

What this means for equity investors depends on time horizons. For the last two years divergence has been the main topic, with the ten largest stocks outperforming the rest of the market.



¹³ Source: Reserve Bank of India, Kotak Institutional Equities

¹⁴ Source: Bloomberg

¹⁵ Ibid

Whilst delivering two years of considerable underperformance, the Nifty Midcap 100 has returned 163% since 2013. What is interesting is that 75% of the positive returns came from just 50 trading days. The significance of this for those who believe in mean reversion is clear - market timing should be avoided. Historic returns, and the steps taken to address the underlying fragility in the economy create a compelling case for a dedicated allocation to India. Furthermore, mega-cap divergence and *flight-to-proven-quality-at-any-price* mentioned earlier is opening up a plethora of mispriced opportunities that cannot by definition be captured by passive vehicles. All of this is dependent on two things however - an evolving research process that can adapt to harness alpha and the only weapon available to fight the challenge posed by volatility: a long-term time horizon. We look forward to keeping you updated in the coming quarters.

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