November 2017
FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

A View From Asia

Samir Mehta, JOHCM Asia ex Japan Fund

AstroTurf™: A proprietary name for a type of artificial grass surface

This year I've made significant changes in the portfolio. In our monthly updates and calls, I've mentioned the challenges I've had with performance over the past 12 months. The reasons can be summed up in three buckets:

- A couple of stock-specific mistakes (Giant Manufacturing and PChome Online, both listed in Taiwan) where disruption of their businesses by internet-enabled competition affected them in a sudden and unexpected manner.
- Giant's bicycle manufacturing business, which I thought was relatively immune from the challenge of online retail, was upended by the proliferation of app-based bicycle sharing business models in China. The novelty and ease of renting bicycles has dramatically cut back the desire to own them, especially the high end ones. Giant's sales growth in China and margins overall suffered as a result.
- PChome Online had a reasonably dominant hold on online shopping in Taiwan until a private/venture capital-funded company (which only recently listed) came up with a much better user interface and offered free delivery for goods, forcing PChome Online to respond and sacrifice margins and profits. I have since sold out of those names.
- Post the US elections, interest rates rose a trifle, coinciding with a global cyclical recovery. China Mobile and KT&G in Korea, (both are cash-generating business with low to slow growth) suffered a de-rating on their multiples. I sold out of both.
- Indian Prime Minister Modi's decision to demonetise high value currency notes in November 2016 caught me off guard – some of our holdings were rural consumer focused; the impact of the withdrawal of notes was felt mostly in rural India where cash still remains the primary medium of exchange. Small businesses across the country and the agricultural sector were hurt badly and many people employed in these areas witnessed a tough economic situation. Many consumer-oriented businesses reach rural India through the 'wholesale' trade. The wholesalers – middlemen – in turn reached far corners of the country dealing with 'mom and pop' stores in rural areas. This part of the chain deals in physical cash. This link of the distribution chain was severely affected. Some of our holdings had an adverse adjustment to their business models and they are still recovering from that blow.

Indian summary

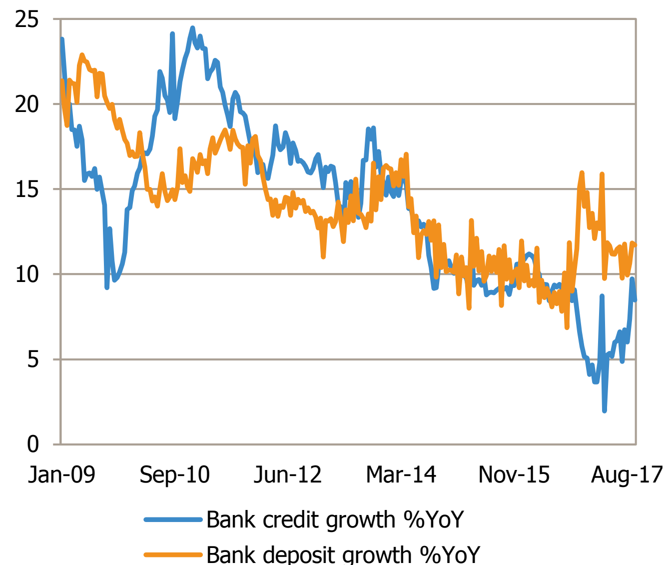
A year since demonetisation, I thought it would be apt to take stock of its impact, the performance of stocks as well as the exposure of our portfolio to India, which as you know has come down over the past one year. It's not just my reduced holdings but also the composition of those holdings which has changed. From 2015, when almost one third of the portfolio was invested in quality Indian stocks, our exposure to India stands at around 12%, of which half is in cyclicals.

Many commentators rightly point to the long-term attractive nature of the Indian market. I have never disagreed with that premise. I won't bore you with the details but favourable demographics, rising income, aspirational middle class, well-managed businesses and, of course, a change in government in 2014 were just some of the arguments in favour of India. Yet, in my opinion, the Indian stock market does not seem to be as attractive relative to the other Asian markets.

For any asset to deliver positive investment returns, we need a combination of three factors: the asset has to be cheap on an absolute or at least on a relative basis; the asset should display either rising earnings or improving cash flow profile; and we must encounter a benign and improving liquidity environment.

A benign liquidity environment, thanks to a depreciation of the US dollar, has been a common factor for all of Asia. However, only in North Asia have all three factors come together in my view. India, on the other hand, remains a haven for liquidity. The external benign liquidity remains turbocharged by the super abundant domestic liquidity. This was a direct result of demonetisation, when all of the cash in circulation was forced into the banking system. Deposit growth surged at a time when loan growth moderated due to a much weaker economy.

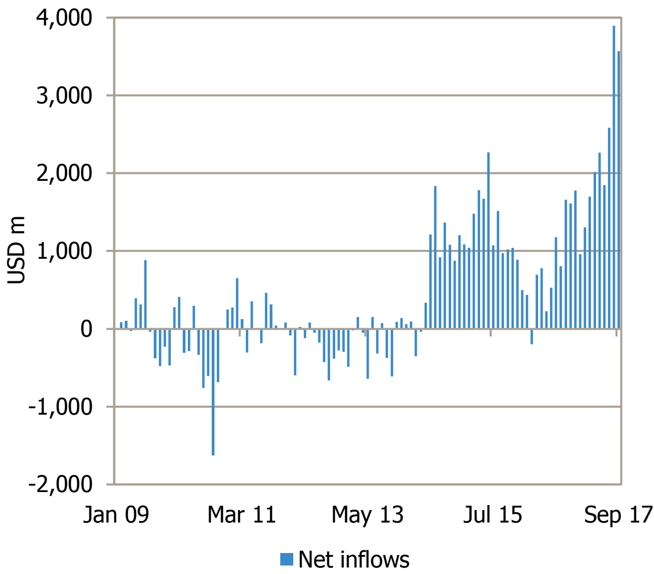
Indian bank deposits surge



Source: CLSA as at October 2017.

Two traditional stores of value, gold and property, were adversely affected by demonetisation. These asset classes were typically the repositories of unaccounted cash and, after 8th November 2016, it was not easy to transact in those assets. In effect, savers in India had very little choice. By default, equities became the preferred asset. Inflows into the domestic mutual funds have sky-rocketed in the past year.

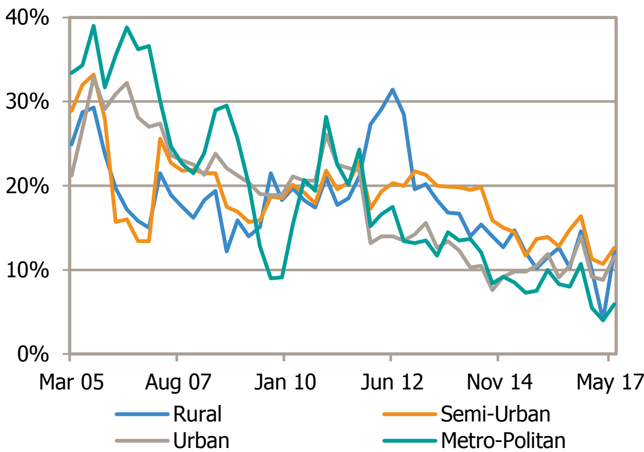
The equity chase: Indian mutual fund flows



Source: CLSA as at September 2017.

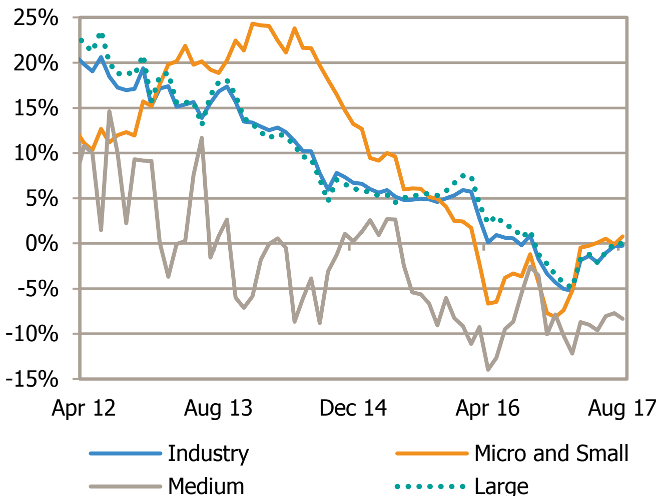
This mismatch between deposit growth and the need for loans/funding by the economy was so wide that interest rates started to come off sharply. Since that initial shock to demand, especially in the rural and agricultural parts of the economy, demand conditions have remained subdued. Reported GDP numbers for India have shown the nature of the slowdown in India. Witness the credit growth conditions in India broken down by regions and scale of industries below.

Loan growth by region



Source: Credit Suisse & Reserve Bank of India as at 1 June 2017.

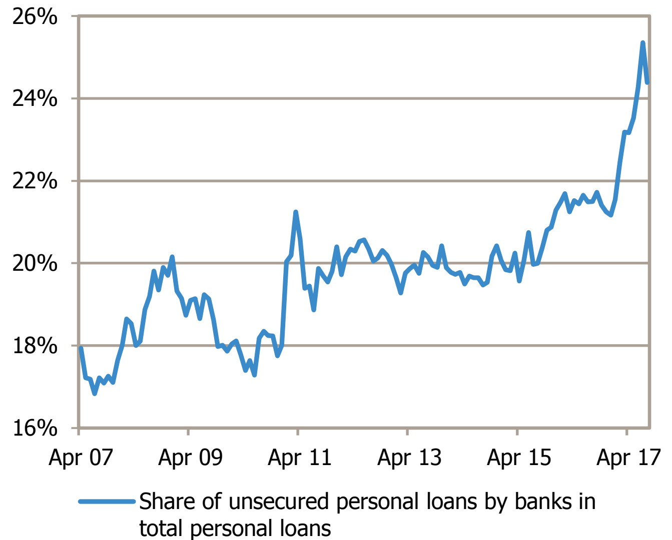
Loan growth by industry



Source: Credit Suisse & Reserve Bank of India as at 1 June 2017.

But in this subdued environment, there is just one area which has witnessed an exceptional boom: personal lending – some for mortgages but mostly for unsecured loans – soared.

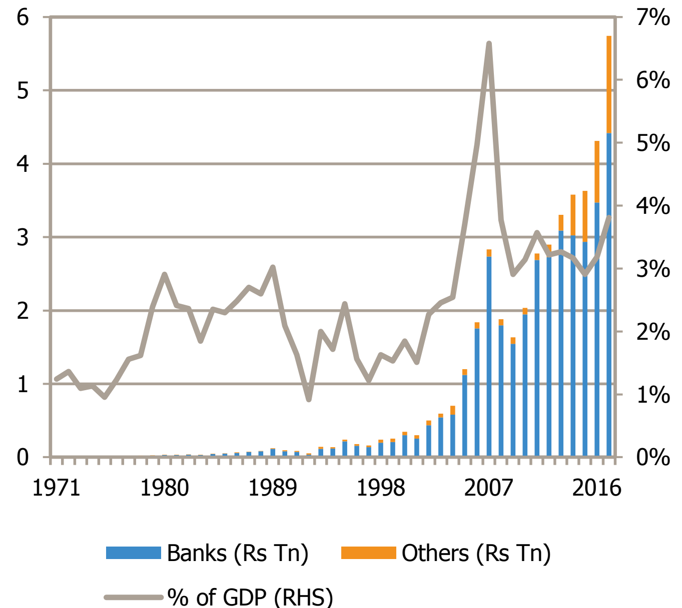
Ask and you shall get



Source: Credit Suisse & Reserve Bank of India as at 1 August 2017.

There are several explanations for this. As the shock of demonetisation affected smaller industries, many smaller businesses and individualsd were forced to borrow money to stay afloat. State-owned (SOE) banks are in dire condition due to non-performing loans (NPLs) and are in no position to lend. As interest rates fell, non-banking financial companies (NBFCs) benefited the most from a reduction in their cost of borrowing; they have more than adequate capital. Along with better technology to assess borrowing needs, wider reach through branches and agents in urban areas and credit bureau infrastructure to assess risks, almost all NBFCs have powered ahead in their lending spree.

Penetration low but rapid rise in loans



Source: Credit Suisse & Reserve Bank of India as at 1 June 2017.

There is no doubt that a good credit bureau system and use of technology to assess risks are big positives. As I mentioned, SOE banks are on the floor and in no position to compete. With unsecured loans still a very small percentage of GDP, there is genuine room for growth.

All these are very valid and sane arguments. Yet there is always an element of unbridled optimism when it comes to unsecured lending. Currently in India, there is a surge in new finance companies (not just fintech) starting up to take advantage of this big opportunity. With the government

about to recapitalise the SOE banks, they, too, might be in a somewhat better position to compete in this space. I do not mean better from a risk assessment or technology standpoint, just better on interest rates. Ultimately, similar to any banking system in the world, the price of loans will be the key area of competition, thus in a way undermining the risk characteristics of this lending opportunity.

Near-term blues

The bigger question that plagues my mind is the effect of a slowing economy on disposable income. So far, almost every company we meet remains very optimistic for the long term, but over the next 12-18 months suggest a very uncertain and muted demand environment. The effect of the Goods and Services Tax (GST) in consolidating industry structures in favour of the bigger listed firms is self-evident. Yet there are teething troubles in implementation of GST. That is a minor impediment. The bigger one is the disruption to small-scale businesses which leads to a fall in employment. Similar to the rest of the world, technology disruption will also have a dampening effect on employment generation in India. Data is hard to come by, but anecdotal evidence suggests that job creation still remains the single biggest challenge for the country. Demonetisation and introduction of GST in quick succession has dealt a significant blow to small enterprises.

While the liquidity situation in India remains very conducive, in a regional context, the stock market is not cheap. Indian stocks have always enjoyed a premium over the region, but that was at a time when the rest of the region had little to no earnings growth. As we look into March 2018 and March 2019 earnings growth estimates, what strikes me is the very narrow group of stocks, particularly in the materials/commodities and banks/NBFC sectors, that will contribute to the earnings growth expectations.

While private sector banks and NBFCs will likely deliver 15-20% earnings growth, for March 2019 estimates they trade on P/E multiples of over 20x while their price-to-book ratios average 4x for 20-22% ROEs. That is not cheap in my view, by any means. These premium multiples I cite for banks are what I also observe for comparable Indian businesses in the quality space. As the saying goes, that the grass is always greener on the other side. But my question is: is this grass or AstroTurf™?

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