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FOR PROFESSIONAL INVESTORS ONLY

Update on India

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Emerging equity markets have been on the back foot for the last few years, hit by both tighter global liquidity and the effects of various trade wars. In this environment, we have generally focused our portfolio strategy on either defensive holdings (e.g. China, gold miners), idiosyncratic, internally-driven opportunities where value is unlocked (e.g. corporate governance reform in Korea, Petrobras, Naspers), and opportunistic exploitation of excessive risk premia (e.g. Brazil and Dubai in 2018, Turkey in 2019).

Our favourite market

The one market where we have had a more assertively pro-cyclical tilt is India. Since 2014, we have variously had exposure to Indian banks and non-bank financials, autos and components, energy, consumer and infrastructure. That view has been based on a mix of India's high trend growth rate (the fastest of the 26 emerging markets since China began to struggle), an extremely attractive political environment with the election and re-election of Narendra Modi, and, crucially, the potential for a positive credit cycle. These top-down tailwinds and their expression in the portfolio have been successful for most of that period, but this year has seen some serious challenges to that success.

...But problems in the wholesale financing markets and banks

At the end of September 2018, IL&FS, a large Indian non-bank financial focused on infrastructure development, defaulted on some of its debts and was taken into state control the following month. The default set off a chain of spreading risk aversion in Indian wholesale financing markets that in turn spread to parts of the banking system. This risk aversion was amplified by more assertive interventions by regulators into the owners and managers of some of the larger financial firms. As funding became harder to obtain, system loan growth began to slow. The key measure of non-food credit grew 9.8% in the year to August 2019, down from a 12.4% growth rate a year earlier. As this did, credit-sensitive sectors began to struggle. Credit to industrial sectors grew only 3.9% (note that consumer price inflation is at 3.2%), while credit extended to industrial SMEs actually shrank. Consumer vehicle loan growth fell to 3.9%. Interestingly, credit extended by banks to non-bank financial companies grew 38.8%, but this reflects the stress in wholesale money markets rather than any sign of strength.

Our Indian stock successes (and failures)

In equity markets, the more leveraged financial firms and firms in the auto and auto component sectors have been the hardest hit. Year-to-date, the MSCI India index has returned 1.4% and the MSCI India Financials index has returned -0.3% (all returns data in Indian rupee terms unless stated otherwise), but the latter includes a wide range of individual

stock performances.¹ Banks with strong balance sheets have performed well, such as **ICICI Bank** (CET-1 capital adequacy of 13.2%; held in the portfolio), which has returned 18.5%, and **HDFC Bank** (CET-1 capital adequacy of 14.8%; held in the portfolio), which has returned 12.8%. However, **Yes Bank** (CET-1 capital adequacy of 8.0%; previously held in the portfolio but sold in 2018), has fallen 78.4% year-to-date, with its 2023 US dollar bonds now trading at 83 cents on the dollar. There have also been problems in the non-bank financial space, including **Indiabulls Housing Finance Limited** (held in the portfolio). Despite having CET-1 capital adequacy of 8.0%, it has seen its share price fall 75.0% year-to-date, and its 2022 US dollar bonds fall to 71 cents on the dollar.

Meanwhile, vehicle sales, which are highly dependent on credit, have slumped. In the year to September 2019, passenger vehicle sales volumes were down 28%, two-wheeler sales volumes down 23%, and medium and heavy commercial vehicle volumes down 67%. Share prices have followed, with the large auto companies' share prices down 10-30% year-to-date.

Falling inflation is allowing both policy interest rate cuts and more aggressive fiscal policy in India. Both should support both economic growth and the equity market, and most of our Indian holdings continue to do well, both in terms of corporate results and stock performance.

We must, however, be cognisant of the risks developing in some of our positions. Despite weak sales and an unimpressive year-to-date share price return of -26.3%, we continue to find vehicle manufacturer Mahindra and Mahindra attractive. This is both in the form of the extremely compelling implied valuation of the core vehicle business – the group has a market cap of INR 700bn and INR 42bn in net debt, but also INR 368bn in quoted equity investments; the implied enterprise value for the core business of INR 373bn, most recently an annualised EBITDA of INR 72bn, implying an EV/EBITDA for the core of 5.2x, compared with peer Maruti Suzuki at 24.1x – and from the diversification provided by the group's investments in the technology, tourism and insurance sectors.

We also retain our faith in **Apollo Tyre**, which has been funding future capacity expansion even as new vehicle sales in India have disappointed. Year-to-date, Apollo has returned -27.6%, but we believe that the eventual recovery in credit in India should largely align with the coming on stream of Apollo's new capacity, driving substantial medium-term upside in the stock.

No such optimism extends to Indiabulls. Whilst the current balance sheet is highly liquid, and the company trades at about 50% of tangible book value, a failure to refinance at

reasonable rates will cause the shrinking of the firm through sales of loan assets. If these sales are forced in the current market environment, substantial downside exists. With the news last week that the firm will not be allowed to acquire a banking licence, we have reluctantly moved to sell the stock.

The coiled spring of credit

We retain our broad belief that, when global liquidity eases (probably through a weaker US dollar), India will be a prime beneficiary, principally through credit growth. We are therefore retaining our position in India. One name we have been adding to is Indian FMCG business **ITC**. Slower volumes in its core tobacco business have led to a dramatic de-rating of the stock to below 20x 12-month forward earnings, which is a substantial discount to the stock's history and to Indian and global FMCG peers. These multiples were last seen in the aftermath of the 2008 global financial crisis, and we believe do not reflect the recent recovery in tobacco volumes, nor the attractive exposure that ITC offers to the robust Indian consumer market.

We will continue to monitor developments in the Indian credit system as part of our top-down framework for investing in emerging markets. While India is one of our preferred markets, we will hold diversified exposure to the industries, sectors and themes that we think will most benefit from the macro environment, and we will continually monitor and reassess the holdings for upside opportunity and downside risk. Ours is generally a low turnover approach, but when we need to sell, we will, even if that is after some painful underperformance at the stock level. Process discipline is the antidote to behavioural bias and emotionally-led decision-making.

¹All prices and returns as at 11 October 2019.

JOHCM Global Emerging Markets Opportunities Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.09.19	30.09.18	30.09.17	30.09.16	30.09.15
A USD Class	-0.14	-1.63	21.56	17.70	-12.98
Benchmark	-1.97	-0.65	22.22	17.10	-19.59
Relative return	1.87	-0.99	-0.54	0.52	8.22

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 30 September 2019. The A USD Class was launched on 30 June 2011. Benchmark: MSCI Emerging Markets NR (12pm adjusted). Performance of other share classes may vary and is available on request.

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