

## INDIA: SECULAR OPPORTUNITY TO CAPTURE VALUE IN THE MARKET RECOVERY

### FINDING THE RIGHT KEY SEGMENTATION TO TAKE ADVANTAGE OF INDIA

For investors seeking to invest in an emerging market whose current economic transformation is supportive of the emergence of the next global players, India presents an excellent opportunity to capture this growth. European investors have been actively investing in the space and we are seeing US investors taking a greater interest in the market and hope through this thought leadership you will want to learn more.

While investors in the US have been waiting for the downturn, this known event is happening in India making for a prime opportunity for investors.

The 3 key takeaways are:

1. **Economic reforms and corporate clean up** by the Indian government are creating a more **level playing field for smaller but higher quality businesses to gain market share domestically as well as grow into globally competitive companies.**
2. Companies with high earnings growth over a long period of time across different market cycles not only generate higher returns but also superior alpha. Therefore, the ability to identify and invest in these companies earlier in their structural growth stage is key. This **opportunity is present within the small and mid-cap space in India** at a much attractive valuation versus the large-caps – especially following the recent market correction.
3. Companies in the **“new economy” sectors/industries** are the next wave of companies to offer higher earnings growth vs the respective industry or nominal GDP growth, achieved through their cost-efficient business models to capture the market share both domestically and globally.

We have asked CIO of SageOne Investment Advisor LLP, investment advisor to Lighthouse Canton on their India Long Only fund which focuses on high growth, quality businesses in the small and mid-cap space, to walk us through the opportunity sets.

### INVESTING OPPORTUNITY IN HIGH GROWTH COMPANIES IN A HIGH GROWTH INDIAN ECONOMY UNDERGOING A MEGA TRANSFORMATION

With the Modi government re-elected for the next 5 years with a full majority, the momentum of reforms they started in 2014 have picked up. Some of the key reforms will result in a profound transformation in the way in which corporate India works. There will be many companies run by competent and genuine management that will take away market share from companies run by questionable managements who were able to succeed (survive) only because of their ability to take advantage of the corrupt system. This structural transformation will make it very difficult for these questionable managements to survive and enable many competent managements to grow earnings at a significantly higher rate than the Indian GDP (nominal GDP CAGR of 12% over the last two decades). **Many of these companies are trading at the lowest valuations in the last 6 years and some in their history as Indian (outside of top 100 largest companies who dominate the headline indices) markets have seen a massive drawdown over the last 20 months.**

### IS BIGGER ALWAYS BETTER?

The divergence of performance between the large caps (represented by the Nifty) and mid-small caps started in 2018 when SEBI (market regulator) changed the regulation for mutual funds enforcing the funds categorized as large caps to invest 80% of their corpus in the largest 100 companies (by market capitalization).

This regulation was enforced upon identifying that the mutual funds have been misrepresenting their products with the intention of gaining market share of the retail

Table 1: Valuation Comparison

Universe	Median drawdown from Jan 31, 2018 to Aug 16, 2019	Current Median TTM P/E	Avg Qtrly YoY Earnings Growth Since Jan '18 Peak	Median Market Cap (US\$bn)
Top 100	-4.5%	24.1	13%	6.26
101-250	-12.9%	25.7	16%	1.52
251-500	-32.5%	18.9	14%	0.41
501-750	-48.6%	12.8	18%	0.13

Source: Bloomberg, SOIA

market. During the Indian bull market in 2017 where BSE Mid Cap Index posted a 50% performance, the mutual funds loaded up their portfolio with the small and mid-cap stocks to “boost” their returns. The implementation of this regulation started the rotation of funds from the rest of the universe into the top 100 and some into the next 150 (mid-caps) as they scrambled to meet the hard deadline of June 2018, resulting in a massive underperformance of the mid-cap and the small cap universe. This was followed by margin increase in futures & options and then the financial crisis in the non-banking financial space triggered by payment default by IL&FS in October. These events further exacerbated the underperformance of the mid and small cap stocks as investors sought flight to safety and herded into the performing top 100 stocks.

As of January 2018, the entire markets (across market caps) was trading at elevated valuation of close to 30x (TTM PEx). **Today the median valuation of the top 100 stocks is close to 25x and the median valuation of the next 900 companies have fallen at an increasing rate as the market cap goes down. There is no correlation of the drawdown to the earnings growth.**

## REFORMS AND CORPORATE CLEAN UP

India has significant parallel economy (operating informally by escaping taxes) in almost all industries. In some industries it is as high as 70% of the industry. **The government has over the last 5 years taken strong structural steps that has made and will make it extremely difficult to avoid taxes.** Below are some updates on the key implementations:

- Over 1.3 billion people have been digitally authenticated and over 305 million new bank accounts have been opened under the ‘Aadhar’ (unique ID card) and ‘Jan Dhan Yojana’ (debit card) implemented by the government
- India is undergoing massive raids by the income tax authorities on businessmen who were notorious in avoiding taxes and who accumulated huge illegal wealth
- Along with digitization, demonetization and GST (Centralized and Online Goods & Services Taxes) are making the economy more formal and increasing the tax compliance
- Strict actions have been taken against the rating agencies and auditors to significantly improve quality/authenticity of the financial statements and debt risks
- Government along with RBI has implemented big reforms in the banking sector, especially the ones state owned ones to take care of huge non-performing assets (around 12% of book)

Many founders in collaboration with the banks, ratings agencies and auditors gold-plated project costs that needed funding. This enabled debt approved much higher than the actual project cost. The excess money was siphoned off through shell companies into the pockets of the above parties. The result was founders and other service providers enriching themselves and the shareholders ending up holding unviable projects that couldn’t service the debt.

With the abovementioned reforms and clean up, the modus operandi has been broken. It will be extremely difficult for such founders to succeed in the reformed system thereby providing the genuine entrepreneurs a level playing field. This is going to be a massive change that will reshape how India corporates work and succeed. We expect that **many of the poor-quality companies will perish and the good quality mid and small cap companies will grow at super-normal rates to becoming large caps.** These should be the companies investors be betting on.

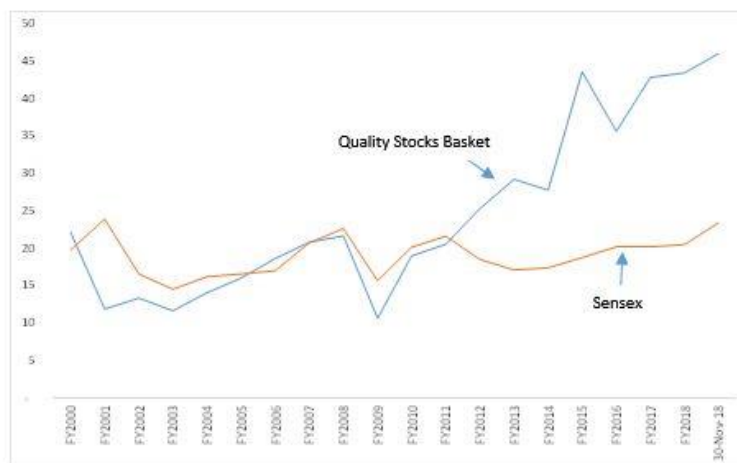
**Government reforms are targeting reduction in cost of doing business in India.** The result so far has seen stagnant (or lower) land prices in the last 6 years, low interest rates, availability of electricity at reasonable rates and faster approval of permits to start a business. As US and China engage in trade war, customers worry about one country sourcing and plan to diversify their vendor base going forward. Chemical industry is already seeing huge momentum from such shift as many companies in that industry (all mid-small caps) growing at well above 20% earnings growth over the last 5 years. **India is full of extremely smart and ambitious entrepreneurs and if a level playing field is made available to them, they can create globally competitive companies as already evident in the Chemical, Pharmaceutical and IT space.**

THE OPPORTUNITY FOR ALPHA

There are more than 5,700 stocks listed on National Stock exchange (NSE), but if we were to take liquidity into consideration, the hunting ground would most realistically be limited to the 500 companies after the top 100. As shown on Table 1 earlier in the memo, these companies offer much higher earnings growth and at the same time are currently available at 40-50% lower valuation compared to the top 100. As the effects of the reforms transpire a more level playing field over the next few years, growth will be achieved by the most efficient players which have significant sustainable competitive advantages against the competition. The next question is, in a dynamic market like India, which factor has proven to be most reliable for successful investment in the long-term across different market cycles?

In our opinion, the ability of a company to generate high earnings growth consistently across different market cycles is key. This is not only relevant to India but universally. We ran an interesting analysis which supports this thesis. To run this analysis, we put together a basket of Quality Stocks (i.e. Top 20 stocks on NSE Top 500 with highest ROE) and ran this against Sensex over the period between FY 2000 to Nov 2018:

Chart 1: Quality Stocks P/E vs Sensex P/E



Source: Bloomberg, SOIA

Table 2: Valuation Metrics

Period	PE x Range		Earnings Growth		Returns	
	Quality Portfolio	Sensex	Quality Portfolio	Sensex	Quality Portfolio	Sensex
2000-08	11 - 22	14 - 23	15%	15%	15%	15%
2008-18	13 - 47	14 - 23	11%	5%	18%	8%

Source: Bloomberg, SOIA

- As you can see from Table 2 and accompanying Chart 1 above, the basket of Quality stocks not only delivered a 6% earnings growth premium versus the Sensex but this was accompanied by an approximately 10% alpha over the next 10 years.
- Testing this thesis on a more global portfolio, we also performed a comparative study of Berkshire Hathaway Fund ("BRK") under Warren Buffett's management versus the S&P.

As shown on Table 3, BRK's consistency in holding on to companies with high earnings growth over a long period not only generated higher returns but also more superior alpha. As the earnings outperformance decreased, Alpha disappeared over the last 2 decades.

Table 3: Comparative Analysis of BRK vs S&P

By Decade	BRK Earnings Growth	BRK Returns	S&P Earnings Growth	S&P Returns	Alpha in Earnings	Alpha in returns
1965-1970	15.6%	17.3%	-0.2%	4.1%	15.9%	13.2%
1970-1980	23.2%	26.3%	11.2%	8.4%	12.0%	18.0%
1980-1990	27.7%	31.7%	3.7%	13.8%	24.0%	17.9%
1990-2000	24.3%	26.7%	8.9%	17.5%	15.4%	9.2%
2000-2010	9.0%	5.4%	4.5%	1.4%	4.5%	4.0%
2010-2017	12.1%	13.8%	3.8%	13.8%	8.3%	0.0%
<b>Total</b>	<b>19.2%</b>	<b>21.0%</b>	<b>5.9%</b>	<b>10.0%</b>	<b>13.3%</b>	<b>11.0%</b>

Source: Bloomberg, SOIA

Bringing our focus back to India, while domestic and consumer-oriented themes have been a more common play among the India funds, we have found that the true "hidden gems" lie with companies in the "new economy" sectors/industries such as data consumption and specialty chemicals with cost-efficient business models to capture the market share both domestically and globally, hence offering a much stronger earnings growth vs the respective industry or nominal GDP growth. Earnings growth historically has been higher in emerging (mostly mid and small caps) companies and such companies in the current market are trading at significant discount to the market.

## 2 COMMON WAYS OF INVESTING INTO INDIAN PUBLIC MARKETS

- **ETFs:** Given the complexity of investing in India from offshore jurisdiction and given the need for ID and tax issues, the easiest and cheapest way to invest in India is to invest in Indian ETFs which tracks the benchmark indices. However, most ETFs on India are benchmarked against the Nifty 50 Index (in USD terms) and this index is completely skewed towards the top 10 stocks, which make up more than 40% of the index weight. The large caps (top 100) space currently is overcrowded with 82% of institutional money invested in it. It is therefore extremely difficult to generate alpha with such crowded space that is trading at historically high valuation.
- **Actively Managed Funds:** Over the years, there has been decent growth in India-focused actively managed funds which are accessible to offshore institutional investors. However, it is very important for investors to not only have a strong grasp of the investment philosophy but also do their due diligence on the consistency of the fund's investment process, risk management and portfolio construction over different market cycles, experience and knowledge of the portfolio managers and investment team in conducting companies research analysis as well as their willingness to be transparent with investors. Based on the various factors discussed throughout this memo, there is a huge potential for alpha to be extracted in India over the medium to long term. Hence, manager skills in stock selection is key.

In today's market environment macroeconomic events are becoming increasingly difficult to predict, let alone invest in. While macro factors are outside of the control of the manager, the discipline and consistency of the investment process implemented by them are well within. **At the end of the day, there are no shortcuts when an investor seeks for strong risk-adjusted returns that are sustainable over multiple market cycles, especially in a market like India.** As counterintuitive this might sound, if there is ever a time for an investor to start considering one's allocation into India, this might be a good opportunity for one to do so.

### Special Thanks to Our Contributor:



Lighthouse Canton is an independent asset manager to institutional investors and accredited private clients. We are headquartered in Singapore with a subsidiary in Dubai International Financial Centre (DIFC) to better service our growing clientele in Middle East, Europe, and Africa. We collaborate with top-tier institutions to provide our clients access to unconstrained investment opportunities within a robust operational and regulatory infrastructure. We develop long term relationships with our clients by constantly examining their needs and providing bespoke solutions with superior results.

We partner with SageOne Investment Advisors LLP who has over a decade of experience investing in the Indian markets in structural growth companies with superior earnings growth, high profitability and strong corporate governance, within the small and mid-cap space.

[www.lighthouse-canton.com](http://www.lighthouse-canton.com)

### Mariana Ibrahim

Director Institutional Sales & Investor Relations

[ir@lighthouse-canton.com](mailto:ir@lighthouse-canton.com)

Lighthouse Canton Pte. Ltd.

d +65 6713 0570

f +65 6713 0599

1 Phillip Street  
#07-01 Royal One Phillip  
Singapore 048692

### Important Disclaimers

This article (the "Article") is for informational purposes only and does not constitute an offer to sell or a solicitation of an offer to purchase any investment or any securities. This Article does not constitute investment advice and is not intended to be relied upon as the basis for an investment decision, and is not, and should not be assumed to be, complete. Readers should make their own investigations and evaluations of the information contained herein. The information contained herein does not take into account the particular investment objectives or financial circumstances of any specific person or entity who may receive it. Each reader should consult its own attorney, business adviser and tax adviser as to legal, business, tax and related matters concerning the information contained herein. Except where otherwise indicated herein, the information provided herein is based on matters as they exist as of the date of preparation and not as of any future date and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after the date of preparation. Certain information contained in this Article constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "project," "estimate," "intend," "continue" or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. Readers should not rely on these forward-looking statements. Certain information reflects subjective determinations which may prove to be incorrect. There can be no assurance that the estimates or projections will be accurate or that historical trends will continue. In considering the prior performance information contained herein, readers should bear in mind past performance is not necessarily indicative of future results. **All rights reserved. The material may not be reproduced or distributed, in whole or in part, without the prior written permission of PrimeAlpha LLC.**