JON THORN/INDIA CAPITAL FUND

Foreign investor interest in India will be strong in 2018

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SINGAPORE

Indian markets are not expensive at current levels, says Jon Thorn, co-founder and director of India Capital Fund, adopting a stance contrarian to that of his peers among global fund managers.

"Company earnings are at a trough and total market profits relative to nominal GDP (gross domestic product) is at the bottom of the historical range. With the recap of the public bank sector and the start of a recovery in the private capex cycle, there is massive potential for an acceleration of earnings growth and thus expansion of stock price multiples," Thorn said in an interview.

Edited excerpts:

Your take on the Indian markets in 2018. Where do you forecast Sensex to be at December-end 2018? What is your 2018 target for Nifty?

Index EPS (earnings per share) had been stubbornly flat or shrinking for most of the past couple of years, declining by 4.4% in the financial year ending this past March. Growth in the two quarters since then has now averaged 10.5%.

That's still a little low by Indian standards, but represents a nearly 15 percentage point gain even as the economy works through the lingering effects of demonetisation and the introduction of the new goods and services tax (GST). So we have a tangible sign that the favourable macro is flowing down to corporate level, and we expect India to do well in 2018 with the pick-up in index earnings driving stock prices.

As a stock picker we have pricing targets for the stocks that we hold but no forecast for the Sensex and Nifty. Also our fund also has low overlap with the index, much lower than other foreign India funds.

I can only say that we expect the index to be at a higher level in December 2018 than today's level. Another supporting factor is that the shift from gold and real estate to financial savings in India today is driving strong domestic equity flows. In Jan 2014, mutual fund equity investments were around 2.6% of India's market cap—today the figure has risen to close to 5% . Total mutual funds' AUM (assets under management) increased 40% to reach a record $359 billion at the end of November.

Are you finding markets expensive at current levels? Is it still a buy-on-dips market?

There is a lot of comment that Indian stocks are expensive in terms of forward PE (price/earnings) ratios and the like. But we adopt a differentiated, fundamental research-driven strategy and if you look a bit deeper like we have, we come to the conclusion that India is not expensive. Company earnings are at a trough and total market profits relative to nominal GDP is at the bottom of the historical range.

With the recap of the public bank sector and the start of a recovery in the private capex cycle, there is massive potential for an acceleration of earnings growth and thus expansion of stock price multiples. The India Capital Fund is a research driven long-term investor, and we buy when we see earnings growth potential at the right price rather than specifically focusing on dips in the market. We may, however, add to a position if we feel that the stock price of one of our positions is being unfairly punished for a transitory negative factor, and we are confident that profits will recover once the company overcomes the temporary negative factor.

STREET WISDOM

What are the sectoral trends we can see in 2018? Which are the sectors that you would prefer—is it still consumption on top, and what is your take on some of the beaten-down sectors that are now coming back into action?

We like consumption-related themes given India's GDP growth and growing working age population. Stocks which are a proxy for domestic consumption are banks, non-bank financials, autos and commercial and professional services. We don't like consumer staples, or FMCG (fast-moving consumer goods). Or IT (information technology) or pharma. Those last two sectors will have their day again, but we are not sure that day is now.

It's less of a case of investing into beaten down sectors—our strategy is to put our money into stocks with earnings growth.

Are you taking any bets in midcap IT or midcap pharma?

We do not have any positions in midcap IT or pharma stocks.

What are the sunrise themes you may look at?

We are always looking at new opportunities but what is a very attractive macro opportunity does not necessarily translate into an attractive investment proposition. Some up and coming new themes are renewable energy and within that industry, solar power is a sector where the government has enabled tremendous growth in capacity, by way of legislation, investment incentives and supporting infrastructure. Another sunrise theme is the growing surge of personal fitness and in turn fitness centre operators.

As crude is hovering around $60-65 a barrel, do you think this could be a big concern for the Indian economy? What are the biggest risks—apart from crude—for Indian markets in 2018?

Rising oil prices would put pressure on inflation without a doubt. But the Saudis and Opec (Organization of the Petroleum Exporting Countries) want to keep oil prices at a steady level rather than increase rapidly. There is also a lot of excess production capacity which will come back on if oil prices start to climb steeply. So the oil price threat is manageable. The problem regarding crude is a spike closer to $100, but that's a problem for everyone! Very few people see that as a serious likelihood, and so I think or hope we are safe.

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What can trigger a correction in Indian stock prices?

This can be India-specific such as politics—in 2018, assembly elections are due in eight states—or it can be a global sell-off of emerging market stocks. GDP is so strong, though if there were to be a correction, it's hard to see that starting a persistently lower market.

What are your expectations on foreign portfolio flows into India next year?

We expect foreign investor interest in the Indian market to be strong given the country's favourable macro, continuity on reforms—although these will be on a much smaller scale than DeMo (demonetisation) and GST—and an expected pick-up in corporate earnings.

But foreign portfolio flows are also, in many instances, dictated by what's happening in other emerging and developed markets, as a part of risk-on or risk-off, so they can be volatile and unpredictable.

There is a problem, if you like, for some foreign investors as they reacted to DeMo and GST by reducing their exposure to India, which, while understandable, was nevertheless wrong. Those foreign investors lost gains and they will have to reconsider their India reduction early in 2018. I would assume they will reverse them at some point.

September quarter results have been mixed. How do you see earnings shaping up going ahead?

GDP growth, and in turn corporate earnings, has been choked by the high NPLs (non-performing loans) in the public banking sector—public sector banks account for over 70% of the total bank sector assets—corporate leverage and elevated real lending rates.

But the government's decision in late October to implement a Rs2.11 trillion ($32 billion) recapitalization of the public banking sector is the game changer. In my view, the final impediment to longer and stronger GDP growth and corporate earnings is now gone and instead the spark needed to re-ignite the long dormant investment cycle has now arrived.It's been a long time coming. Near-term uncertainty is something to look through, and earnings growth should start to accelerate soon. This is not a cyclical or a fadeaway economic shot, but an old-school, long-term and structural change which starts to reposition the painful part of the Indian banking industry, and therefore economy. Therefore, I think it's really important to understand where the market and many companies are in this cycle, which is a cycle of change, and quite a kick-start. The proof of the pudding is in the eating, as they say, and therefore we need to see that EPS (earn-ings per share growth) happens, but our assumption is that when it comes through it will be persistent.

After having secured a very narrow victory in Gujarat, do you expect that a rural pivot from the government in terms of its policy focus going forward? If so, with rural India coming off a low base, and with policy support, what are the stocks that will benefit from rural and infra spending

In Gujarat, the BJP (Bharatiya Janata Party) won 99 seats in the 182-seat assembly, 16 seats less than the previous results in 2012. However, this result was not unexpected given DeMo and GST-related factors. We also have to remember that the BJP managed to take the state of Himachal Pradesh from Congress at the same time.

The government has made a big push on infrastructure spending to make up for the slack in private capex. With the bank recap programme, private capex should start to pick up. Similarly, the government has provided the rural industry policy support and we expect that to intensify in the coming year.

The fund is invested in the beneficiaries of rural and infra spending such as cement stocks. I would also like to add that although Mr Modi (Prime Minister Narendra Modi) is determined to get reelected in 2019, the government's major initiatives such as the 'Housing for All' programme have not been populist measures. The looming Gujarat state election did not deter the government from implementing GST. So this government has refrained to a large extent from wasteful populist measures as a way of buying votes. I think May 2019 is something that should be in everyone's mind as a target—if Modi keeps a strong majority in that next general election, one can assume the market will rise.