NOTES FROM THE ROAD

MIRABAUD 1819
Asset Management

CHARLES WALSH, PORTFOLIO MANAGER ON MIRABAUD'S GLOBAL EMERGING MARKETS EQUITY TEAM, OUTLINES SOME OF HIS OBSERVATIONS FOLLOWING A RECENT TRIP TO INDIA

AT A GLANCE

- In our opinion, further systemic risk exists within the banking sector.
- A key consideration for investors is the next election, which is scheduled for April / May 2019.
- The recent challenges demonstrate that good stock selection will be more important.

INTRODUCTION

Following my trip to India, I would like to share my key observations which, following a strong year for Indian Equities, has recently experienced weakness. The key driver of recent headwinds appears to be a liquidity event in the wholesale banking sector. With general elections rapidly approaching, politics is likely to be the focus for the next six months. I've summarised important factors that we have observed and are considering as part of our investment process for the both the Mirabaud Global Emerging Market Equity and Asia ex-Japan Equity portfolios.

LIQUIDITY EVENT

In the third quarter of this year, a liquidity event led to a sell-off in Indian banks and non-bank specialist lenders. This contributed to a general decline in the Indian equity market that continued throughout October. This resulted in a sharp decline across financials stocks, which then broadened into other industries[1]. Events are still unfolding. However, the overall impact in certain sectors could be incredibly damaging.

The liquidity event was triggered in September when IL&FS, a large conglomerate with over 100 subsidiaries, defaulted on some of its debt repayments. Wholesale liquidity, the main source of funding for non-bank financial companies (NBFCs), had been moving tighter for some time. However, the IL&FS default caused a sudden reduction in liquidity and NBFCs suddenly lost access to this important area of funding. The liquidity event exposed an issue whereby some low quality NBFCs have been boosting their returns by lending at high interest rates to property developers with long term projects and few short-term cash flows. The reduction in liquidity meant that these loans could no longer be rolled over, causing immediate distress for many 2nd tier and poor quality developers, as well as the NBFCs that had been engaging in these high risk practices. A sharp sell-off in listed NBFCs ensued, also impacting other financial stocks and damaging sentiment for Indian equities overall.

Calm was restored by the Reserve Bank of India (RBI), who stepped in to guarantee the debts of IL&FS. However, short-term loans to property developers are unlikely to resume now that investors and management teams are more aware of these risks. This funding had also reached a natural plateau as banks, the main source of wholesale lending, are at or very near their regulatory limits.

[1] Source: Bloomberg

Consequently, some larger property developers now have an opportunity to purchase additional land bank at much lower prices in the form of distressed sales. However, in our view, it's likely that there will be low demand for the majority of assets held by the struggling developers, resulting in possible bankruptcies and defaults. Whether this causes further weakness in the property market is uncertain, however, it represents a very real risk.

Further systemic risk exists within the banking sector, which is still struggling with very high levels of bad debt, inadequate coverage ratios of these bad loans and low capitalisation ratios of the banks themselves. If all bad loans were fully provided for, the banks would need significant injections of fresh capital in order to maintain their business operations. General market commentary highlights that the Ministry of Finance is involved in a dispute with the Reserve Bank of India to push for a public sector bank recapitalisation. The RBI is an independent body, but with an election looming this independence may well be tested.

ELECTIONS

Another key consideration is the upcoming general election – to be held by May of next year. The previous election in 2014 resulted in the BJP party being installed with the largest majority India has witnessed since 1984[2]. The equity market rallied strongly as a result. Much of the strength in the past 4 years has been predicated on the political reform and anti-corruption agendas of the BJP - the MSCI India has returned around 50% in local terms since they were elected[3].

The next election, in 2019, may see the BJP lose their majority and they may be forced into a coalition, possibly with multiple partners. It is currently unclear which parties would work with the BJP as a result of ideological differences, meaning key ministerial positions in government may need to be offered as incentives. The current Prime Minister, Narendra Modi, has the reputation of being uncompromising, which makes such a power-sharing agreement unlikely. In our view, there's a very real possibility that the BJP's governing organisation could remove Mr Modi as head of BJP post the election if a weak majority were returned. In our view, such a scenario is likely to provide a significant headwind to the market, which is currently not factoring in this scenario into prices or valuations.

SUMMARY

Despite the various headwinds mentioned above, we are finding, meeting and investing in Indian companies that continue to do well despite the challenging environment. India's long term growth potential is still undeniable, but the rate and trajectory of this growth is becoming perhaps less obvious in our opinion.

The challenging events within the property, bank and non-bank lending sectors suggest good stock selection is likely to be even more important going forward in order to differentiate between potential winners and losers in what is an increasingly polarised environment. Furthermore, the end of BJP's dominance may remove one of the more compelling themes from the India bull case.

Our disciplined approach to investing feels more relevant than ever with regards to the Indian market. Since 2014, passive investing has been a cheap and effective way to gain Indian exposure. However, we believe that the benefits of active management are likely to become more pronounced in the current environment.

[2] Source: https://factly.in/history-indian-elections
[3] Source: Bloomberg

We remain focused on finding well-run companies with strong financials, defensible business models and good long-term structural opportunities, whilst being acutely aware of the risks. We believe that our structured Quality GARP (Growth at a Reasonable Price) approach to investing will help to position the Mirabaud Global Emerging Market Equity and Asia ex-Japan Equity portfolios to benefit from the best of India's growth potential whilst avoiding the many pitfalls.

ANNUAL PAST PERFORMANCE

Index	2013	2014	2015	2016	2017
MSCI India Index	8.58%	26.41%	-1.61%	1.12%	30.49%

Source: Bloomberg, in Indian Rupee. For information purposes only. It is not possible to invest directly in an index.