Ashoka India Equity

Update
27 January 2020

AIE offers a pure stock-picking portfolio of Indian equities with a unique fee structure...

Summary

Ashoka India Equity's (AIE) management team uses detailed cash-flow analysis to pick a concentrated portfolio of what they view as the most attractive Indian equities, aiming to outperform the market in all macro environments thanks to stock selection. The team looks for the most compelling investment opportunities across the market capitalisation spectrum, with over 50% of the current AIE portfolio invested in mid caps and small caps.

This stock selection process uses a unique approach to cashflow analysis developed by Prashant Khemka, the founder of the management company, and former head of India and global emerging market equities at Goldman Sachs. The team believes this approach is superior to the standard valuation metrics fund managers use as it properly captures the cash generative qualities of a business.

The performance of the strategy suggests there may be value in this approach: since launch in July 2018, AIE has strongly outperformed the market thanks to stock selection, **as we discuss in full in the Performance section**. It has done so with steady outperformance in rising and falling markets too. The track record of the investment approach itself is longer, both in other funds run by the adviser company White Oak Capital Management, and in Prashant's time at Goldman Sachs. AIE offers access to a process which has taken years to hone, and the track record indicates success in making stock selection the source of returns rather than sector or market cap weight.

Another key element to the process is the focus on corporate governance and forensic accounting. This has so far helped the team avoid various frauds and irregular accounting blow-ups that have affected some Indian companies and mainstream funds exposed to them. The White Oak Capital teams focus on finding companies where management's interests and those of any controlling shareholders are strongly aligned with those of minority shareholders. The team are locally based in Mumbai, and as such bring local knowledge to this endeavour.

AIE has been constructed with similar ideas in mind about aligning interests. At the portfolio level, the analysts are compensated predominantly based on an attribution analysis of their sectors' contribution to the portfolio performance. At the trust level, there is no management fee but only a performance fee worth 30% of the outperformance of the benchmark, **the full details of which are in the Charges section**. There is also an annual redemption facility which allows investors to exit in full at NAV less costs.

AIE has only £69m in net assets, although it has been growing steadily thanks to strong performance leading to demand for issuing shares – the trust has mainly traded on a premium since launch. Last November the board announced a one-year issuance programme which allows it to issue up to 125 million shares (at a premium) over the course of the next year through a variety of means (**see the Discount section**).

Key Information:

As at	23/01/2020
Price (p)	114.5
Discount (%)	+2.6
OCF (%)	0.75
Turnover Ratio	76.2
Yield (%)	0.0
Gearing (%)	0
Ticker	AIE
Shares (£)	62,448,143
Market cap (£)	71,503,124

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Analyst's View

Having met with Prashant, we were extremely impressed with the dedication to his craft and the attitude he has instilled at the heart of the team's culture. Prashant has an iconoclastic attitude, which to us is reminiscent of investors such as Terry Smith: he has designed a process from the ground up, assuming nothing and developing his own metrics to capture what he wants to find. One of his tasks has been to find analysts who share his dedication and his belief that detailed cashflow analysis is the secret to good stock selection.

We understand that Prashant's track record at Goldman Sachs was exceptional. During his nine years as CIO and Lead Portfolio Manager of GS India Equity (GSINDAI LX), the fund returned 118.1% in total returns, net of fees, compared to 25.7% for the MSCI India IMI benchmark. After he was appointed CIO and Lead Portfolio Manager of GS GEM Equity (GSEMEIA LX Equity), over almost four years the fund returned 33.2% in net total returns compared to 13.2% for the MSCI Emerging Markets benchmark. At White Oak he has built a team of dedicated stock analysts to implement the ideas and processes which he developed during his time at Goldman Sachs (and before), which he joined in 2000 before leaving to found White Oak Capital in 2017.

We think investors will benefit from the work put into the unique approach to stock analysis. India is particularly fertile ground for a stock-picking approach, according to recent Wall Street Journal research which concluded that active managers in India generate **the highest and most consistent alpha among all markets in the world**. The canny design of the trust, which aligns the interests of board, management and shareholders, should also give shareholders further confidence. The performance fee-only structure, which is earned over three-year performance, could ensure the team are highly motivated to consistently outperform, as could the annual redemption facility. Meanwhile, the compensation of the team being based predominantly on their performance in their sectors creates accountability and strong personal interest in AIE's success.

Investors may ask themselves why they should bother with an India-only trust. We think India is one of the most exciting places to invest in the world given its economic potential, but like any other emerging market the Indian stock market has a wide spectrum of corporate governance standards which requires a dedicated expert hand to navigate. As India makes up less than 9% of the MSCI Emerging Markets Index, this is unlikely to be forthcoming from a generalist trust.

India's strong demographics mean there is huge potential for businesses to grow serving the local market. Meanwhile, the current government is reform-minded and focused on a once-in-a-generation shift of the economy to the digital age. This, allied with an entrepreneurial culture, means that India offers a rich and diverse set of businesses to invest in. However, corporate governance assessment can be complicated, with companies often having family ownership or other key shareholders whose motivations and interests need to be understood. This is likely to reward local knowledge. We think the sheer weight of coverage that White Oak Capital Management can bring to bear on this portfolio (with nine dedicated analysts, all based in Mumbai) means that AIE has the potential to consistently generate insights others can't and to create alpha.

Analyst's View

BULL	BEAR
Strong alignment of interests between board, manager and investors thanks to fee structure	Relatively short track record in this structure
Unique, rigorous fundamental analysis with track record of avoiding stock blow-ups	The trust is too small for many large investors and probably needs to grow
Globally experienced but locally based team with great access to Indian companies	Performance fee-only structure may provide unintended incentives depending on circumstances

Portfolio

Ashoka India Equity (AIE) owns a concentrated portfolio of Indian equities, selected for attractive company-specific characteristics. The strategy aims to identify the best companies in their respective industries when they are trading on attractive valuations, using detailed, proprietary research. Macroeconomic exposures are minimised, ensuring that stock selection is the overwhelmingly important driver of returns.

AIE is advised on its investment decisions by White Oak Capital Management, a Mumbai-based firm founded by Prashant Khemka, former CIO and Lead Portfolio Manager for Global Emerging Markets Equity and India Equity at Goldman Sachs (GSAM). Prashant has used his over 20 years of investing experience in India, emerging markets and developed market equities to cultivate a culture and process that he believes will enable the team to deliver the outstanding long-term returns he achieved at his former employer.

The culture has been designed around perfecting stock selection, which is intended to be the main driver of returns. This begins by selecting the right people. Idea generation is the responsibility of a team of nine analysts, each assigned to specific sectors. Five are senior analysts who lead on their sectors, and they are supported by four junior analysts. The analysts have been selected for their passion and commitment to investing as well as for their strong track records. Great care has been taken to ensure that they will work well together in a flat, meritocratic structure without office politics, and compensation is predominantly a function of the individual's contribution to portfolio returns.

Prashant ensures that all new team members share the same basic commitment to the valuation of cash flows as the core of stock selection. Analysts attempt to identify superior businesses, defined as those which can generate high returns on incremental capital, and which are enjoying a scalable opportunity thanks to the quality of their product or service and / or the competitive environment in their industry and the wider economy. At any one time the team is closely tracking around 150-200 companies which they think are of high quality and potential additions to the trust.

Team members assess the intrinsic value of the companies in their sectors using a cash flow centric framework, aiming to identify those which are more valuable than the market currently prices in. This determines which of the c. 150-200 ideas make it into the c. 40-50 stocks that make up the portfolio. Analysts derive an 'asset lite' cash-flow valuation which isolates the recurring cash returns in the business once all capex and financing costs are accounted for. This is intended to flush out businesses which have optically high returns, but which require heavy investment to generate and sustain them. It also helps to avoid value traps, as companies can sometimes appear cheap on the more commonly used P/E, P/B or EV/EBITDA metrics, without accounting for the fact that high current returns could require substantial incremental investments in the future. This is why, for example, AIE has positions in Nestle and Info Edge despite the companies having optically high P/Es. The White Oak team believe they can continue to generate greater cashflows with minimal investment, and their valuation is justified by this growth potential and the relative absence of fixed-life, depreciating assets which have to be replaced.

Valuation is therefore at the core of the stock selection process, which means that there is a reasonable degree of turnover in the portfolio. Stocks are assessed rigorously against their business prospects and the proper valuation of these prospects, and are sold when the valuation reflects the team's assessment of fair value. Nevertheless, because of the focus on proprietary valuation metrics, the portfolio can trade on a higher P/E multiple than the market, which with higher return on equity (ROE) and expected earnings growth figures give it the classic profile of a growth strategy, as visible in the table below. However, on the Asset Lite P/CF measure preferred by the team, the trust's portfolio is trading at a similar multiple as the Sensex (Indian equity index) despite the portfolio having better growth and profitability characteristics.

Portfolio Characteristics

	PORTFOLIO	SENSEX
Number of holdings	46	30
Weighted average market cap	$14.6bn	$60.0bn
FY20 ROE	19.30%	13.30%
FY21 Asset lite P/FCF	43.2x	41.0x
FY21 P/E	26.6x	20.4x
Projected revenue 3-year CAGR	16.84%	10.89%
Projected earnings 3-year CAGR	22.02%	17.49%

Source: White Oak Capital Management, as at 31/12/2019

On top of valuation, another crucial foundation of the team's stock research is the weighting given to good corporate governance. Poorly governed firms threaten the destruction of shareholders' capital, either through outright corruption or illegality, or simply through poor business decisions which often result from misaligned interests. Analysts therefore spend a lot of time trying to understand the ownership structure of a business, as well as familial relationships of key shareholders and managers, not to mention picking apart the accounting practices used.

One persistent overweight in the portfolio is to the mid- and small-cap areas of the market. For a highly active stock-picking strategy such as this one, the team find many more opportunities in the less well researched and less efficient areas of the market. At times SMIDs have outperformed and at times underperformed, but the overweight has been consistent, indicative of the fact that the team do not aim to tilt their holdings based on how they read the prospects for different factors.

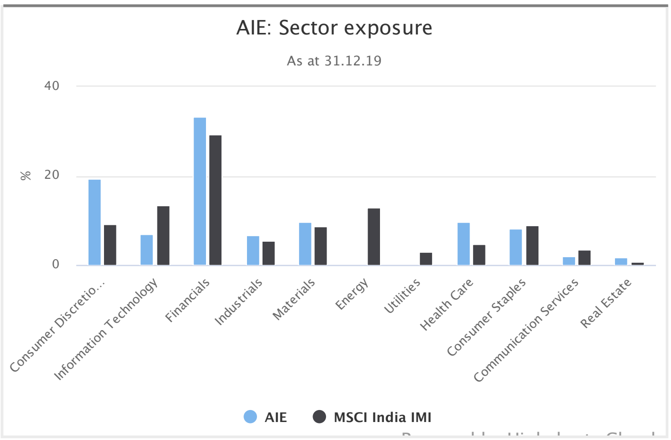
Market Capitalisation Breakdown

	AIE	MSCI INDIA IMI
Large cap	43.90%	80.00%
Mid-cap	31.70%	15.00%
Small cap	21.80%	5.00%

Source: White Oak Capital Management, as at 31/12/2019

Although the team aim to ensure that sector allocation is not the major driver of returns, they do not buy the 'best of a bad bunch' if they find nothing attractive in a sector because companies need to be attractive in their own right to make it into the portfolio. That said, there are some biases due to the nature of the Indian stock market. For example, the consumer discretionary sector is a fertile source of ideas thanks to the large number of businesses and heterogenous business models which reward rigorous research. The energy sector, on the other hand, has very few companies and those that are there tend to allocate capital poorly and might have suspect corporate governance. The trust's portfolio has more than double the index weighting in consumer discretionary and is zero-weighted in energy, despite it being 13% of the index.

Fig.1: Sector Allocation



Source: Morningstar

Sector weightings are therefore a derivative of stock selection. That said, financials make up a major part of the portfolio, with a 33% weight versus 29% in the benchmark. Top-two holdings Bajaj Finance and Bajaj Finserv are non-bank financial companies forming a part of the Bajaj Group, a family-run conglomerate. Third-largest holding HDFC Bank is India's largest private sector bank, followed by HDFC AMC, India's leading asset management company (we reproduce the full top ten below). With 45% in the largest ten positions and between 40 and 50 stocks in the portfolio at any one time (currently 46), the trust is concentrated.

Top Ten Holdings

HOLDING	SECTOR	WEIGHTING (%)
Bajaj Finance	Financials	7.2
Bajaj Finserv	Financials	7.1
HDFC Bank	Financials	4.9
HDFC Asset Management Co	Financials	4.7
Asian Paints	Materials	4.2
Titan Co	Consumer discretionary	3.7
NIIT Technologies	Information technology	3.5
L&T Technology Services	Industrials	3.5
Navin Fluorine International	Materials	3.4
Maruti Suzuki India	Consumer discretionary	3.2
TOTAL		45.2

Source: White Oak Capital Management, as at 31/12/2019

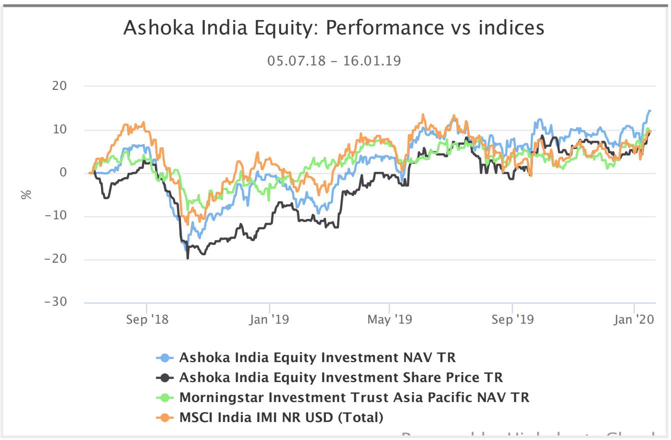
Gearing

AIE has the flexibility to add up to 20% of NAV in gearing, although it is currently ungeared. We understand the board has not so far arranged any debt facilities but is open to taking on gearing in due course.

Performance

Performance has been strong since launch in July 2018. As we illustrate in the graph below, since the end of the first day of trading the NAV is up 14.4% on a total return basis at the time of writing (mid-January). The share price total return has been lower at 9.6%, thanks to the deflating of a 6% premium that opened up on the first day. Nevertheless the trust has traded on a premium for most of its life as discussed in the Discount section. The benchmark MSCI India IMI index has returned 9.4% over the same period, so the manager has added significant alpha over this relatively short time period. Over the past year, the NAV total return has been 18% and the share price total return 18.8%, both more than double the benchmark return of 8.9%.

Fig.2: Performance Since Launch



Source: Morningstar

In fact, AIE has outperformed its competing UK-listed Indian investments trusts by a wide margin amid challenging conditions for small- and mid-cap stocks.

Although it is a relatively short period of time, in the 18 months since launch AIE has shown the ability to outperform in rising and falling markets. Performance has been overwhelmingly driven by stock selection rather than sector allocation or market direction, in line with the goal of the strategy. From 31 July 2018 to 31 December 2019 (the last available data), stock selection added 15.5% to benchmark returns, drowning out the minimal sector allocation effect of -1.5%.

NAV TOTAL RETURN	ASHOKA INDIA EQUITY	INDIA CAPITAL	JPMORGAN INDIAN	ABERDEEN NEW INDIA
31 July 2018–16 January 2020*	14.40%	-15.30%	-0.70%	2.10%
06 July 2018–16 January 2020	14.70%	-11.90%	4.10%	6.00%

Source: Morningstar

*Funds raised from the IPO were substantially invested by the end of July.

The outperformance is particularly impressive when it is considered that small and mid-caps underperformed over this period. Picking good companies also overwhelmed that effect. From July 2018 to December 2019, the overweight to small and mid-caps versus the index lost the trust 15.5% in relative returns, but stock selection within those cap bands added 26.1%.

The India Acorn Fund, an institutional, open-ended and Mauritius-domiciled fund advised by White Oak since September 2017, provides a slightly longer track record on a very similar strategy. In seven of the ten quarters, the trust added positive alpha. In the three quarters of negative alpha the average was 100bps detracted, whereas in the seven positive quarters the average added was 310bps.

Dividend

AIE aims to generate capital growth rather than an income. As such, the trust pays 100% of its expenses out of the income received from portfolio holdings. It has therefore not paid a dividend to date and won't do so until its income exceeds its expenses. Even then, it is likely only to pay the amount necessary to retain investment trust status (which for regulatory reasons is 85% of net income).

Management

Ashoka India Equity is advised by White Oak Capital Management, which is based in Mumbai, India. White Oak Capital was founded by Prashant Khemka, former CIO of India and emerging markets equity at Goldman Sachs Asset Management (GSAM). The trust is very much team-managed, given the structure of the investment team and decision-making process.

The team advising AIE is currently made up of nine analysts, five of whom are considered senior analysts and who take the lead on their sectors. The four more junior analysts work alongside the senior members of the team, in each case shadowing more than one senior member on their sectors. Prashant considers the culture and shared philosophy of the team to be crucial to the consistent success of the approach he has seeded. The analysts are selected for their skills, their ability to work as part of a team and their adherence to the basic philosophy of the stock-selection process (**discussed in detail in the Portfolio section**). The founder believes that investing is a skill like a sport or form of art, and so he selects analysts with a real passion for their field.

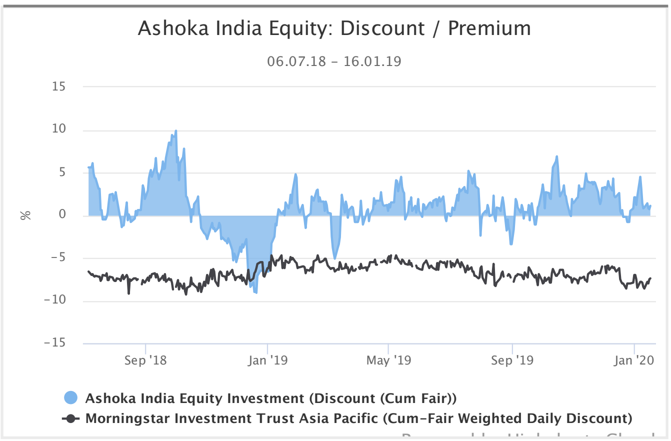
Analysts are compensated according to their contribution to client portfolios in their areas of expertise, which we believe creates strong alignment of analyst and shareholder interests. In effect, an attribution analysis is done for every analyst, which forms the majority of the performance assessment. Members of the investment team have significant investments in similar strategies managed by White Oak Capital (which are all Indian equity funds run with the same basic process and philosophy).

The relationship with the board has also been designed to maximise the alignment of interests. Board members are entirely compensated by shares in the trust, while the manager has no representation on the board.

Discount

Demand for AIE's shares has been strong since the trust's IPO in July 2018, leading it to trade on an average premium to NAV of 1% since then, indicating that strong performance has driven enough investor appetite to grow the trust through share issuance. In November 2019 the board announced its intention to issue up to 125 million shares over the next year at a premium to NAV (this would amount to £141m at the current share price). Thanks to issuance and organic growth, the trust has steadily grown from £45m at issue to the current level of £69m. The board has the authority to issue or buy back shares to control the discount, and the premium is currently 2.6%. As the graph below shows, this is a significant premium to generalist investment trust peers in the AIC's Asia Pacific sector. It is also much tighter than the other three India specialist trusts, whose simple average discount has averaged 12.7% since AIE was launched, with no trust trading tighter than a 6% discount.

Fig.3: Discount



Source: Morningstar

In addition to the performance fee-only structure, another example of the managers backing themselves is that the trust has an annual redemption facility which allows shareholders to redeem all of their investments at NAV less costs should they wish. Last year just 0.23% of the share capital was surrendered that way, and in our view this should act as a powerful discount-control mechanism while also ensuring that the manager can use the closed-ended structure to shareholders' advantage.

Charges

Ashoka India Equity has an unusual charging structure designed to create strong alignment in the interests of shareholders and management and provide incentives to the latter to outperform. There is no management fee, but only a performance fee. The performance fee is 30% of the outperformance of the benchmark in NAV total return terms, calculated on a rolling three-year basis and capped at 12% for a three-year period. This long-term time horizon means that there is an effective 'claw back' mechanism of sorts as the manager will not be rewarded for one strong year if it is followed by weak performance in another. Furthermore, the performance is paid in shares of the trust, with the majority locked up for another three years. Clearly, the founder Prashant Khemka is backing the long-term track record of the process he has designed, and we believe investors can be confident that the incentive to outperform rather than to gather assets and harvest the management fees will remain strong. White Oak Capital Group manages/advises c. $1.9bn in Indian equity portfolios that do earn management fees, meaning that the company is not just reliant on performance fees from the trust. That said, performance fees can at times incentivise the manager to take more risk to increase their earnings and at times incentivise them to take less risk to hold onto the gains they have made.

The OCF is 0.75%, compared to an average of 0.84% for the Asia country specialist trusts, according to JPMorgan Cazenove. While this may seem high because any future performance fee would be on top, the trust had an average NAV of just £45.8m during the year, and we would expect the charges to drop as NAV increases (with an issuance programme already underway). Ashoka India Equity's KID RIY is 1.73% compared to a sector average of 2.11%, although we caution that methodologies can vary.

ESG

Environmental, Social and Governance (ESG) issues are considered during the detailed bottom-up analysis done by the team. Corporate governance is a major focus of stock-selection efforts, **as discussed in the Portfolio section**. The team place a great deal of emphasis on avoiding misgoverned companies, which means they aim to avoid those companies with a misalignment of interests between shareholders and management. Sometimes this is evident in dishonest accounting or market behaviour which potentially cheats shareholders or investors at large, and can even involve unethical or corrupt practices. The team also look to avoid companies which have a disregard for the environment or cause harm where there are other viable alternatives available. Meanwhile, they also avoid companies with weak compliance to labour laws or which deal in products detrimental to public health and safety. India has a Corporate Social Responsibility (CSR) programme which mandates companies must spend 2% of their three-year average net income on CSR. Overall, this means the team cover all three elements of ESG. AIE's management team look for whole-hearted compliance with the CSR programme rather than a box-ticking culture.

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