Ashoka India Equity

AIE is the top-performing India specialist trust and is trading on a rare discount...

Update
14 July 2020

Summary

Ashoka India Equity Investment Trust (AIE) has been the best-performing India specialist trust since it was launched in July 2018. In that time AIE has been the only one of four India trusts to generate positive returns, and has done so with strong performance on the downside – most especially in 2020 to date, as we discuss in the **Performance section**.

This strong performance has led the trust's shares to regularly trade on a premium to NAV, but following the pandemic they have fallen onto a discount of 3.5%. The impact on the market has seen valuations fall significantly too, and both Indian equities and AIE's portfolio are trading on a 30% discount to its historical price to book. The premium versus the MSCI Emerging Markets Index has also collapsed by the same amount.

The philosophy of AIE's advisory team is to invest in great businesses when they are available at a discount to intrinsic value. The team use a unique proprietary framework, the Capital-Light Excess Investment Return (CLEIR), to uncover these opportunities. The process is designed to make sure stock selection determines relative returns and ensure the portfolio is not overexposed to any macroeconomic outcome. Good corporate governance is highly prized and the team look for management whose interests are aligned with their own.

The investment manager White Oak Capital Management was founded by Prashant Khemka, former CIO and lead portfolio manager for Global Emerging Markets Equity and India Equity at Goldman Sachs. Apart from the stock-selection process, key distinguishing features include the performance-fee-only charging structure designed to align the managers' interests with those of shareholders (see the **Charges section**).

Analysts:

Thomas McMahon
+44 (0)203 795 0070

Analyst's View

While this trust's track record is relatively short, the proportion of alpha coming from stock selection and the strong performance on the downside have both been impressive. We think the strong, results-focussed culture of independent research and accountability for individual stock picks is a good foundation for longer-term success.

India has lagged the MSCI Emerging Markets Index in recent years, with China and other North Asian countries seeing huge inflows. However, in our view, an allocation toward India remains part of a balanced portfolio for the long term. As well as the secular tailwind provided by a growing population and one of the best entrepreneurial ecosystems in the world, the country has, unlike China, a strong legal system and independent institutions.

In fact, the pandemic could be an opportunity for India to gain market share as an outsourcing destination and to attract FDI which would otherwise have gone to China. Certainly the Indian government is keen to take advantage. In the short term, the country is also one of the key beneficiaries of a low oil price, as it imports practically all its energy. The price falls have so far been harvested by the government by tax rises, garnering it a war chest to be able to use in order to stimulate the economy and offset the impact of the pandemic.

BULL
The best track record amongst India specialist peers since inception
Wide discount relative to its history
Uniquely aligned fee structure aligns managers' interests with those of investors

BEAR
Currently too small for many large investors (but placing programme active when shares on a premium)
As a single-county trust, highly exposed to the politics and economy of one state
Relatively short track record in this structure

Portfolio

The strategy behind Ashoka India Equity Investment Trust (AIE) is to build a concentrated portfolio of Indian equities selected for attractive company-specific characteristics. The approach centres on detailed, proprietary bottom-up research by a team of sector specialists. The portfolio is constructed in such a way as to minimise macroeconomic exposures and maximise the contribution to relative returns made by stock selection.

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 Asset Management. Prashant serves as mentor to the team he set up at White Oak.

One of the key elements of the stock-selection process is a keen focus on corporate governance. This, as well as the financial characteristics the analysts look for, helps explain why the portfolio has performed particularly well in the recent market crisis. Longer term, the trust has generally done very well on the downside, as we discuss in detail in the **Performance section**.

White Oak's analysts aim to find great businesses and buy them when they are trading on attractive valuations. Analysts attempt to identify superior businesses, defined as those which can generate high returns on incremental capital, and which have a long-term 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 are closely tracking around 150 to 200 companies which they think are superior and potential additions to the trust.

The analysis of valuations is done using a unique metric that White Oak's team developed over the years. Analysts derive a 'capital light' valuation through the firm's proprietary CLEIR™ (Capital-Light Excess Investment Return) analytical framework. In essence this framework isolates recurring cash returns in a business once all capex and financing costs are accounted for, in order to give unique insights into the business's cash-flow-generation characteristics which are not captured by traditional valuation metrics. This is intended to flush out businesses which have optically high returns, but which require heavy investment to generate and sustain them, and it also helps to avoid value traps. The White Oak team believe the traditional metrics such as P/E, P/B or EV/EBITDA are unfit for purpose and often highly misleading as they don't capture the level of capital investment required to maintain rates of return. This is why, for example, AIE has positions in Nestle India and Info Edge. These companies are amongst its best-performing picks since inception, despite them having optically high P/Es. The White Oak team believe they can continue to generate greater cash flows 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. A good example of this is the position that was taken in Hindustan Unilever earlier this year, after the combination of a sentiment hit thanks to the pandemic and a short-term overhang of stock led to an attractive valuation. 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 ROE and expected earnings-growth figures gives it the classic profile of a growth strategy, as visible in the table below. However, on the capital-light P/FCF measure preferred by the team, the trust's portfolio is trading at a similar multiple as the Sensex (the Indian equity index), despite the portfolio having better growth and profitability characteristics.

Portfolio Characteristics

	AIE	SENSEX
FY20 ROE (%)	18.8	14.0
FY21 CLEIR P/FCF (x)	45.8	53.3
FY21 P/E (x)	32.8	34.5
Three-year expected revenue growth (%)	10.2	5.3

Source: White Oak Capital Management, as at 30/06/2020

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 the familial relationships of key shareholders and managers, not to mention picking apart the accounting practices used.

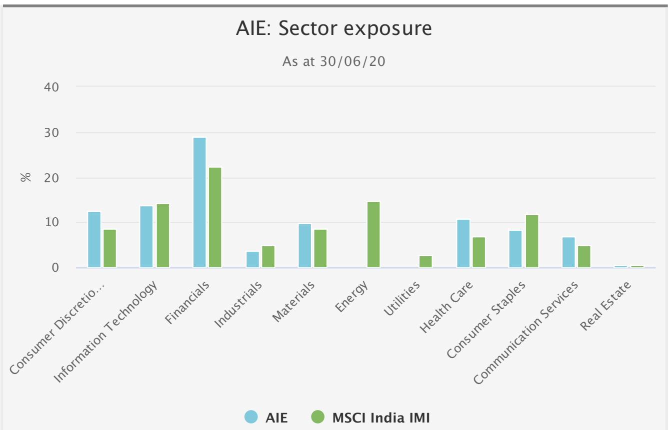
One persistent overweight in the portfolio is to the mid- and small-cap areas of the market, which account for 36.9% of the portfolio. For a highly active stock-picking strategy such as this one, the team find many more opportunities in the less well-researched and less efficient areas of the market. In fact, they report that often these businesses are dominant in their respective industries. 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. Notably in 2020 this has not been a hindrance, as small and mid caps have held up well thanks probably to prior underperformance leaving them on lower starting valuations.

Fig.1: Market-Capitalisation Breakdown

Source: White Oak Capital Management, as at 30/06/2020

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. 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 heterogeneous 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 index's weighting in consumer discretionary and is zero-weighted in energy, despite it being 13% of the index.

Fig.2: Sector Allocation



Source: Morningstar

Sector weightings are therefore a derivative of stock selection. That said, financials is a large overweight, at 29% versus 22.3% in the benchmark. This sector has been a source of considerable alpha since launch – the most of any sector, in fact. AIE owns the private-sector banks HDFC Bank and ICICI Bank. These have been strong performers, while peer and competitor Yes Bank (not owned) was taken under the control of the central bank earlier this year thanks to its loan book falling into difficulties, which pre-dated but was accelerated by the pandemic. The team believe that HDFC and ICICI have strong risk-management and underwriting practices, and while they expect impairments to the loan books due to the COVID-19 crisis, they think these banks are likely to benefit from a flight to quality which has seen a rise in deposits at the stronger banks. They should also benefit from the presence of a state banking system which means the private banks are unlikely to see too much political interference and don't need to be used as conduits for government policy (as they have been in the UK, for example).

With just over 45% in the largest ten positions and between 40 and 50 stocks in the portfolio at any one time (currently 49), the trust can be considered concentrated.

Top 10 Long Holdings

HOLDING	SECTOR	WEIGHT (%)
HDFC Bank	Financials	6.0
Nestle India	Consumer staples	5.9
Infosys	Information technology	5.4
Bharti Airtel	Communication services	5.0
ICICI Bank	Financials	5.0
Asian Paints	Materials	4.7
Bajaj Finserv	Financials	4.4
COFORGE	Information technology	4.0
Navin Fluorine International	Materials	3.2
Cipla	Healthcare	3.1
TOTAL		**46.7**

Source: White Oak Capital Management, as at 30/06/2020

The team do turn over their portfolio given the focus on valuations, although a large part of the turnover is due to changing position sizes as valuation and conviction develop.

This year COVID-19 has laid bare the vulnerability of global supply chains by exposing the overdependence on China. The White Oak team believe there could be an accelerated shift of manufacturing out of China as companies, and countries at large, find themselves overexposed and look for credible alternatives to de-risk and diversify, so India could be a large beneficiary. Furthermore, this trend is arguably complemented by prime minister Narendra Modi's 'Make in India' vision, which envisages the country as the next global manufacturing hub. The recent border disputes could accelerate the competition between the two countries too. AIE is invested in leading businesses in speciality chemicals, pharmaceuticals and electronics-manufacturing services which the team believe are well positioned to benefit from this.

Changes to the portfolio have been limited as a response to the pandemic, however. The team have cut back their exposure to unsecured lending, but given they aim to own low-levered, quality businesses with good governance, they would have expected the portfolio to outperform in a crisis, and it has (see the **Performance section**).

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.

Returns

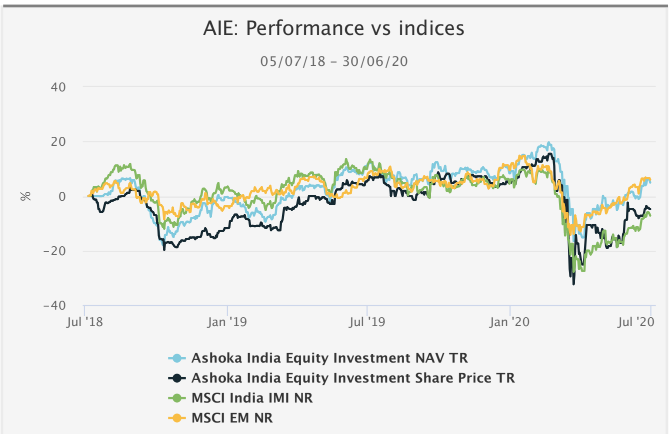
Since it was launched on 6 July 2018, AIE has been the standout performer among the four specialist Indian investment trusts. It is the only one to have generated positive NAV total returns in that time, and has done so with the lowest volatility. In fact, outperformance is largely due to much better performance on the downside. The downside capture ratio over this period has been just 0.73. Although the upside capture ratio is low relative to that of peers, the upside/downside capture ratio is over one, which isn't the case with any of the trust's peers.

Thanks to this strong performance on the downside, despite the poor performance of the Indian market over the period, AIE has performed roughly in line with the MSCI Emerging Markets Index, as the below chart shows. AIE has generated NAV total returns of 4.9% compared to a 4.8% loss from the MSCI India IMI Index (the benchmark). The MSCI Emerging Markets Index is up 6% over the period.

As discussed in the **Portfolio section**, the investment process is designed to ensure that stock selection is the major driver of returns. This has been borne out in the results, with all the outperformance from 31 July 2018 to 31 May 2020 owing to stock selection within sectors. There was a slight negative effect from the sector positioning over this time of -1.9%, which was more than offset by the 24% added through stock selection. The outperformance came in spite of a structural overweight to small and mid caps which has been unhelpful as those parts of the market underperformed. On a market-cap basis, 39% was gained by stock selection while the allocation to small and mid caps lost 17%. Almost ten percentage points of the excess returns versus the benchmark were delivered by five stocks: HDFC Asset Management (not in the index), Nestle India, Muthoot Finance, Navin Fluorine and Info Edge. Three of these almost doubled over the period, while the MSCI India IMI benchmark lost 19.7%.

The team note that thanks to the impact of the pandemic on the markets, valuations look much more attractive. Given the volatility of earnings at the moment, they prefer to look at price to book, and on that basis the MSCI India Index is on a 30% discount to its long-run history and its premium versus the MSCI Emerging Markets Index, which has fallen by the same proportion.

Fig.3: Performance Since Launch



Source: Morningstar

Performance Characteristics Since Launch

	LATEST NET ASSETS	RETURN (ANN.)	STD DEV (ANN.)	DOWNSIDE CAPTURE	BETA	UPSIDE CAPTURE	UPSIDE/ DOWNSIDE
Ashoka India Equity	£70m	2.9%	27.2%	73.0%	0.85	76.1%	1.04
MSCI India IMI NR		-3.7%	30.1%				
Aberdeen New India	£286m	-4.4%	29.7%	95.0%	0.94	93.0%	0.98
JPMorgan Indian	£507m	-9.9%	31.9%	101.7%	1.00	95.4%	0.94
India Capital Growth	£79m	-19.0%	29.3%	77.6%	0.85	62.1%	0.80

Source: Morningstar

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 Investment Trust is advised by White Oak Capital Management, which is based in Mumbai, India. White Oak Capital was founded by Prashant Khemka, former CIO and lead portfolio manager for India Equity and Global Emerging Markets Equity at Goldman Sachs Asset Management. 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. The analysts are chosen for their ability to work well together in a flat, meritocratic structure without office politics.

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.

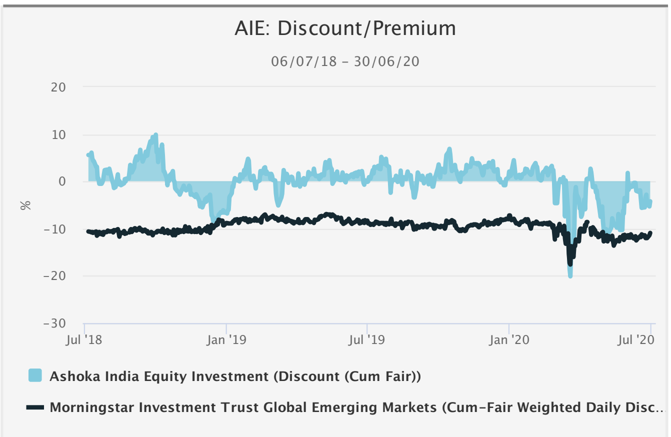
Due to the pandemic, the team have been working from home and communicating with each other and with companies via video calls, which they report as being arguably more efficient thanks to the loss of travelling time. They also report that the transition to home-working has been seamless.

Discount

AIE's strong performance relative to the other India specialist trusts has seen it regularly trade on a premium. Following the emergence of the pandemic in February and March, the shares fell onto a discount of c. 20% at one point, although markets were extremely volatile, making the time differences between when Indian and UK markets were open particularly important. As the initial impact has receded, the discount has closed somewhat and is now (as at 02/07/2020) 3.5%.

The shares could return to trade above par as risk appetite returns. However, as markets have been so sensitive to news about the spread of SARS-CoV-2, we could well see further short-term volatility in the discount.

Fig.4: Discount



Source: Morningstar

In November 2019 the board announced its intention to issue up to 125m shares over the next year at a premium to NAV. Almost 9m were issued prior to the crisis, which then pushed the shares onto a discount. Nevertheless, thanks to issuance and organic growth, the trust has steadily grown from £45m at issue to the current level of c. £70m. The board has the authority to issue or buy back shares to control the discount.

Charges

Ashoka India Equity has an unusual charging structure designed to create strong alignment between the interests of shareholders and management and provide incentives to the latter to outperform. There is no management fee, only a performance fee. This 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 – the manager will not be rewarded for one strong year if it is followed by weak performance in another. Furthermore, the performance fee is paid in shares of the trust, with the majority locked up for another three years.

Clearly, the analyst team at White Oak have high conviction in the process's ability to continue to generate market-beating returns, 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 Management manages/advises c. $1.8bn in Indian equity portfolios. These do earn management fees, meaning that the company is not reliant on performance fees from the trust alone to survive.

Annualising the charges over the past six months, the OCF (excluding any performance fees accrued) is 0.72%, which clearly compares favourably to the 1.44% average of the Asia country specialist trusts, according to JPMorgan Cazenove statistics. Prior to the coronavirus crisis AIE's shares were trading on a premium and the board could regularly issue shares, which has the helpful effect for shareholders of reducing the per-share fixed costs of running the trust. We understand the board is keen to continue this process when the shares are trading on a premium again. Ashoka India's KID RIY is 1.73% compared to a sector average of 2.18%, although we caution that methodologies can vary.

ESG

Environmental, Social and Governance (ESG) issues have always been considered during the detailed bottom-up analysis done by the team. A formal ESG policy will be adopted and its summary will be included when the annual report is published in September. 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. This means they aim to avoid those 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. Avoiding companies with poor governance is an important element of the focus on quality which supports the good risk-adjusted performance of the portfolio by avoiding the blow-ups.

However, as well as considering corporate governance, the team view the environmental and social impact of a company's operations as important, believing that in the long term shareholders' interests are served by management behaviour which serves wider stakeholders. Therefore they 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. This covers all three elements of ESG. AIE's management team look for wholehearted compliance with the CSR programme rather than a box-ticking culture.

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 9/10 Savile Row, London W1S 3PF with registered number OC334771.