# Indian Opportunity in the Air

India's May 2014 general election saw the victory of the business-friendly Bharatiya Janata Party, led by Narendra Modi - and raised hope that more foreign investment would come flooding into the country as a result. Since the election, India's new trade minister Nirmala Sitharaman announced that the government would stay tough in trade talks and keep India's retail market closed, but also try to attract more foreign investment by lowering barriers to business and clarifying tax laws; a move that should be welcomed by international investors.

Gaurav Aggarwal, co-founder and portfolio manager of Mauritius-based Indian listed equity investment firm Metis Capital Management Ltd., explains: "From a macro perspective it's definitely a step in the right direction for the country as well as for the overall fund flow and sentiment. Even without the 'Modi effect' the Indian economy was poised to improve a bit this year from 4.7% to 5%+ GDP growth this coming fiscal year, so we will see higher growth, which will lead to more cyclical sectors continue to perform well.

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He adds that from late 2010 to end of 2013 foreign investors were the ones that kept the market going when confidence was faltering as a result of a growth slowdown. "Domestic people have sold and foreigners have propped up the market; they've had more faith in the Indian story generally than the Indians themselves."

Trust in the government has always been an issue for Indian investment, and Indian citizens tend to either keep their savings or invest them in hard assets like gold and real estate. Though motivated by cultural reasons, this also proved to be a wise business decision, as Indian real estate and gold has provided investors with double-digit returns in the past four years, while the stock market underperformed.

But now that the government is starting to execute its announced vision, domestic investors are slowly coming into the market.

"You can see the domestics starting to come into the picture and foreigners are even increasing their allocations, but we feel there's still a long way to go especially on the domestic institution and retail side so that's what will be the next leg up in terms of the technical driver of the market," says Aggarwal.

## International investment

Though gauging where international money is coming from is tough as a lot of investors use Mauritius or Singapore as intermediaries between their country of origin and their investments in India, US and European mutual funds (including ETF's) form the biggest per-

centage of foreign institutional investors in the Indian market. “One fifth of the Indian market is foreign and half of that is mutual funds,” says Aggarwal.

He points out that now is a good time to invest in the country, as both the cyclical and structural factors are improving due to the political changes and economic climate.

“The thing to remember is that India has times of extreme optimism and pessimism while underlying growth continues at 5% plus - very high relative to the rest of the world. There’s huge amount of micro work to be done in India so one has to keep it long-term focused; at least two-three years. Large multinational companies are even starting to increase their exposure and priority ranking of India so there will be better FDI flows, not just foreign institutional flows.

“In every sector of the economy I could talk to you about there are so many issues and constraints, and how they will tackle these is quite mind-boggling, but decisions have to be made and the vision has been clearly laid out. If Modi doesn’t deliver the same thing will continue to happen and he’s very well aware of that - expectations are extremely high. The whole world is watching and I think he’s the kind of a leader who has the best chance to deliver, the only one in Indian history who has come from the ground up, has a clear free market vision and has a verifiable track record.

# Unique market

India is very different from other emerging markets both in terms of sector mix - with its developed technology segment - and pace of development. Moreover, its structure and politics make it an extremely complex market potential investors need to be prepared for.

Metis co-founder and portfolio manager Piyush Sharma explains that in order to successfully invest in India, prospective investors must ‘unlearn’ some of the things developed markets taught them. “For many businesses you may have to throw metrics such as returns on invested capital, and free cash flow out of the window when you’re evaluating Indian businesses, and for a good reason. Those metrics were designed for geographies where most of the capital expenditure would be for maintenance and inflation remains structurally muted. When I look at an economy like India most of the cap ex would be expansion capital.

"Similarly, something like return on invested capital: I can show you several relatively new businesses in India where marginal returns on invested capital would be higher than some of the other legacy peers, but the conventional calculation of returns on invested capital might be lower. You're looking at an economy where there's an average 7-8% inflation in the last decade. Legacy businesses that have been here for 30-40 years have an artificially deflated invested capital denominator base. In comparison, some of the newer smaller businesses that have started in the last 15 years would have more attractive marginal metrics, but their typical return on invested capital metric would look worse."

Focusing on absolute value and doing due diligence on the ground are also paramount.

According to Sharma, the perfect investor in India needs two critical things: One, they need to recognize that price discovery is extremely poor, in a market where half of all volume is retail, with liquid derivatives on only a handful of names. "However, going back 30–40 years, over any three-year rolling periods, India is as efficient a market as any developed market. Its earnings and asset prices disconnect during periods of panic and euphoria,

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but unless you see one of those two, you'll typically see earnings and stock prices generally tracking each other. So when investing in India, look three years out because dislocations can occur over shorter periods ," he says. Second, they should aim for a 'superior up-down capture': Though highly correlated with the market, they can grab more and more of the upside, and as little of the downside as possible. "If you believe that you will be immune to the asset price downside in the short-run, then you shouldn't be investing in India. Even though you might be invested within a business that's perfectly clean and not decelerating in a broader downturn, it's valuation is likely going to fall during periods of panic when broader stock prices drop 20%+, but you would see lot of our holdings drop much less. So it's critical that investors appreciate those two things."

# About Metis Opportunity Fund

Although the fund launched in March 2014, the strategies that the fund employs, namely India Undervalued and India Underserved, have an audited track record since late 2010. From the start, the managers have been investing in 'clean' businesses run by managers with a proven ethical track record, deploying an extensive forensic approach to their evaluation process.

The two co-founders chose India not because of their origins, but because of market's macro and micro structure. They believe that the country suffers from extreme skepticism when it comes to small and mid cap names and these are names where they can selectively pick clean assets at attractive valuations. They point out how the sell side "concierge service" isn't required as they screen and dive deeper into most of these names.

Aggarwal points out that the firm started at a peak time, and that shortly after, economic growth started slowing down. As a result Metis adopted a rather conservative approach, digging into the mid and small-cap sector and putting consistency on top of its priorities. "You want consistency of growth in the past ten years; even through the down cycle and falling earnings you want to see management who have withstood the pressures (and indeed prospered/invested for future growth) of the last four years of sharp slowdown.

“We are value investors in a very high-growth economy. The cost of capital is high so our hurdle rates are high and we are looking for very clean businesses with high growth and very clean management in terms of ethics and capability. Valuation has to make sense in the long run and in the short run- these are some of the reasons why we’ve delivered over short and long run versus our peers and benchmarks.”

Sharma adds that although the firm is capitalization agnostic, its book includes only a single large cap name. “Small and mid caps: that’s where we continue to currently see the biggest opportunity.  Over eight-hundred million people (more than 1/10 of humanity living under $2/day) must have their standard of living catch up with the rest of the world- we humbly feel this is the world’s greatest challenge and opportunity.