Aberdeen New India

Update
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Summary

Aberdeen New India invests in high quality growth stocks in the Indian stock market with the aim of generating long-term capital returns.

The trust has outperformed the market handsomely over the past five years thanks to good stock selection, although the past few months have been more difficult. As the market has sold off, the managers have extended use of the trust's gearing facility to take advantage of cheaper valuations on offer in stocks that have fallen.

The trust offers exposure to the huge domestic market in India, which is growing thanks to favourable demographics, with significant allocations to consumer staples companies and financial services companies that are rolling out services to the growing middle class.

The discount is at 15%, near to the cheapest end of its five-year range, having widened from the under 10% it reached during 2017's bull market.

The trust hasn't paid a dividend since 2005, and is unlikely to do so this year, with the managers focused entirely on capital growth.

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Portfolio

Aberdeen New India invests across the market capitalisation spectrum in India to maximise capital growth. The team-managed trust focuses on quality growth companies, which means they look for those able to generate superior returns on shareholders' funds throughout the business cycle. This has proven a highly successful strategy in recent years, as borne out by the strong five-year returns.

A key feature of the Aberdeen strategy is its highly disciplined nature. The Aberdeen Standard Asian Equities Team, based in Singapore, insists upon meeting a company before investing and meets at least twice a year with companies in the portfolio. They also conduct extensive research before entering into a new position and consensus must be reached in the team for investment to go ahead. The upshot is a low turnover strategy which aims to identify the highest quality companies in the market and invest for the long run.

The team places a high importance on corporate governance, which aligns with their long-term perspective on investments. The quality of management and the respect for good corporate governance are important factors considered when buying companies, and ensure the trust is not caught out by ostensibly strong businesses being run in the interests of management or family owners, which can be highly destructive to an investment. By engaging with boards and with management teams, the trust aims to improve the treatment of minority shareholders and therefore unlock value for investors.

This is particularly important in a market like India, which is dominated by family-run businesses, many of which are run for the dominant shareholders rather than in the interest of all investors. The team are unafraid to reject the fastest-growing companies if they are uncomfortable with the people at the top.

Tangible recent achievements in this field include the CEO and chairman of Jyothy Labs agreeing to leave the audit and remuneration committees, which should improve due diligence by those committees. Aberdeen has also encouraged the chairman to reconsider the bonus share issuance programme, which leaves minority shareholders at a tax disadvantage, and he has accepted this proposal. Aberdeen is also in discussions with the president of Max Financial Services to improve the growth strategy and firm up succession planning with the aim of narrowing the holding company discount, which would be accretive to shareholder returns.

Stock selection focuses on quality characteristics, with a strong emphasis on bottom-up stock analysis rather than managing to a benchmark. The team aims to identify high quality companies with the potential to grow faster than the market consistently over the longer run.

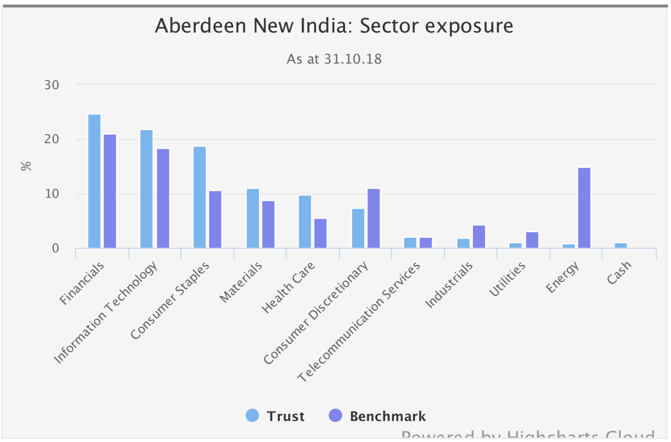
The team looks for high and sustainable return on equity, strong balance sheets with low or easily manageable levels of debt and then for good valuations. An attractively valued entry point is important, and the team will look at a company's valuation relative to its history as well as to its peers to be sure that they are not paying over the odds. However, quality is very much the priority rather than value, and it is the strength of a company's financial, business and management positions which is critical to it being bought.

The result is a portfolio that is consistently valued more richly than the market, but with greater returns on equity and assets and lower levels of debt. In fact, the portfolio as a whole is net cash, exceptional even in India where debt to equity ratios are low by global standards.

Given the bottom-up focus of the stock selection process, it is to be expected that relative returns are dictated largely by stock selection rather than industry allocation. The trust is concentrated, with historically around 40 holdings, although this has risen to 46 in 2018. Almost 50% of the trust is in only ten stocks. Sector allocation is a result of stock selection, with the team unafraid to depart significantly from the benchmark's breakdown. This is also true of market cap exposure: the trust has averaged around 14% exposure to small and mid-caps over the past year compared to the 1% in the benchmark.

The trust has a long-standing overweight to consumer staples, which it tends to like for the growth trajectory that serving a growing, young population dictates, as well as the steady growth characteristics. Major holdings in this sector include Hindustan Unilever, Nestle and Bosch, all of which are generating sales growth from a growing domestic market. By contrast, it has little in the energy sector where cash flows and profits tend to be more cyclical and there are greater levels of government interference.

Fig.1: Sector Exposure



Source: Aberdeen Standard

When we met with Kristy Fong recently, she told us that the team was most excited about the banking sector, specifically the private sector banks. The trust's largest position is in Housing Development Finance Corporation, a financial services group, plus significant holdings in its subsidiaries HDFC Bank and Gruh Finance, which take the fund's overall position above the 10% single stock limit - it is allowed to break this passively but cannot add to it. Kotak Mahindra Bank is another significant position in this sector. The trust has recently sold out of ICICI Bank, having become disillusioned by the quality of management decisions.

The trust also has significant holdings in the IT sector, notably Tata Consultancy Services, Mphasis and Infosys. These have been trimmed this year after strong performance, as have key holdings in the healthcare sector Piramal Enterprises, Sun Pharmaceuticals and Sanofi India.

The materials exposure is largely there as a safer proxy for infrastructure. Around 6% is in cements companies and the remainder in paints.

Turnover tends to average 25% to 30%, but most of this is topping and tailing positions rather than buying or selling new stocks. This year there has been greater volatility

Portfolio Characteristics As At End Oct

	P/E 2018	P/E 2019	P/E 2020	P/B	PORTFOLIO YIELD	DEBT / EQUITY	ROE	ROA
Fund	29.7	27.8	23.4	4.1	1.10%	-10.40%	22.7	11.3
Benchmark	22.3	19.2	15.8	2.7	1.40%	14.40%	20.5	10

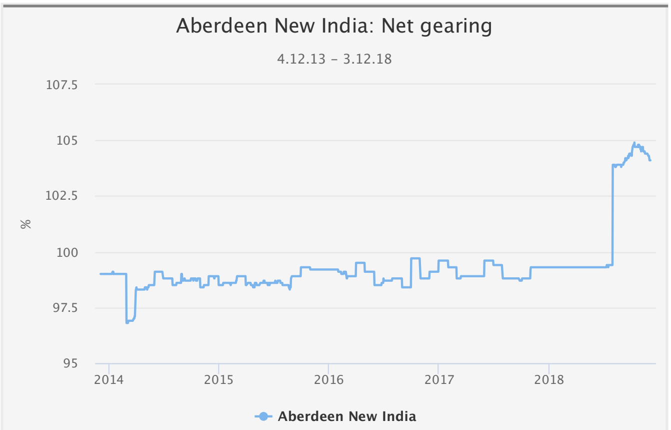
Source: Aberdeen Standard

in the markets which has made some interesting stocks cheaper, so the team has taken advantage, picking up stocks like Maruti Suzuki and SBI Life, and the turnover has been higher with the number of stocks ticking up to 46 from 40.

Gearing

In the poor markets in the second half of this year the team has been borrowing to invest in cheap ideas following the sell off, and the gearing has ticked up to 5%. The company didn't have a gearing facility until July 2018, when it took out a two-year, £30m multi-currency revolving facility. That would allow gearing to rise to around 10%. The trust is permitted to go up to 25% geared, which would require the arrangement of further borrowing facilities.

Fig.2: Net Gearing

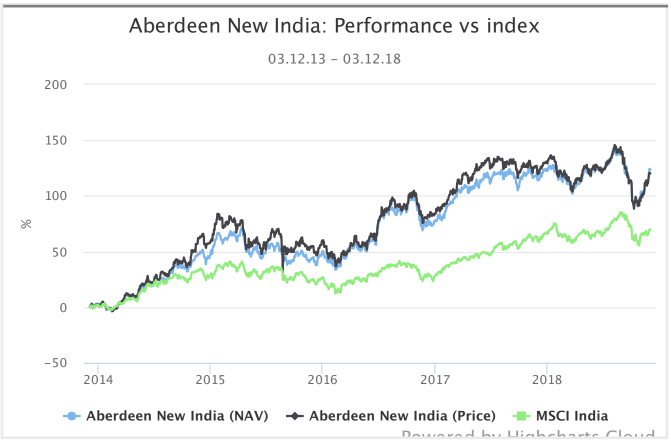


Source: Morningstar

Returns

Good stock selection has helped the fund outperform strongly in NAV terms over the past five years, with NAV total returns 123% compared to the MSCI India's returns of 70%. The vast majority of this is due to stock selection rather than industry allocation, a validation of the bottom-up approach the team takes.

Fig.3: Five-Year Performance



Source: Morningstar

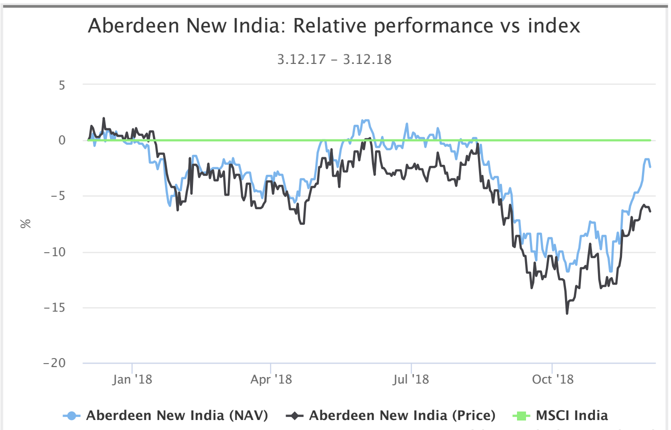
In particular, stock selection has been outstanding in the healthcare sector and in financial services. Within healthcare, the largest contributor has been Piramal Enterprises. The company entered into financial services after the sale of its domestic formulations business to Abbott Laboratories. The trust has been top-slicing the position after a strong run in the earlier half of the year. Its share price corrected along with the IL&FS-triggered sell-off among non-banking financial companies at the end of the third quarter. However, the team has since added to the position as it had confidence in the quality of the credit portfolio and had the view that the share price was oversold.

Other key performers in healthcare were Biocon, a unique biosimilars play, and Sanofi India, which generates most of its revenues serving India's huge domestic market. Within financials, the trust's preference for private sector banks over public sector banks has paid off; HDFC Bank and Kotak Mahindra Bank have been key performers.

Overall, the growth stocks have been the greatest source of returns thanks to good stock picking, and the trust has also benefited from its low allocation to value stocks, which have underperformed.

More recently the trust has underperformed, falling more than the market in the late summer sell-off which has hit India disproportionately. Decreasing global liquidity thanks to Federal Reserve rate rises and concerns over cross-border trade falling have led to a poor period for the emerging markets as a whole. India has been hit by a double whammy of this poor sentiment towards emerging markets and a rising oil price, to which it is particularly exposed.

Fig.4: One-Year Relative Performance

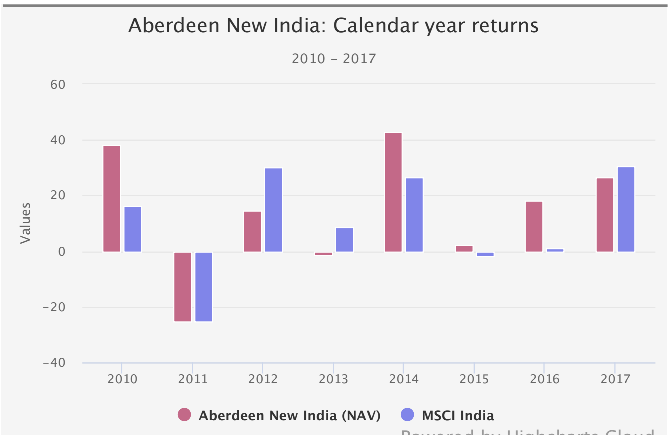


Source: Morningstar

It is predictably the company's large holdings in the mid-cap growth segment that have hurt relative performance in a falling market (the MSCI India is a large cap index).

The trust has performed strongly in the years since Modi was elected in early 2014, outperforming in 2014, 2015 and 2016. In 2017, the trust underperformed slightly in a sharply rising market, which is to be expected in a trust with a quality tilt.

Fig.5: Returns



Source: Morningstar

Dividend

The company is managed for capital growth and has not paid a dividend since 2005. Income is used to pay expenses and offset by past tax losses.

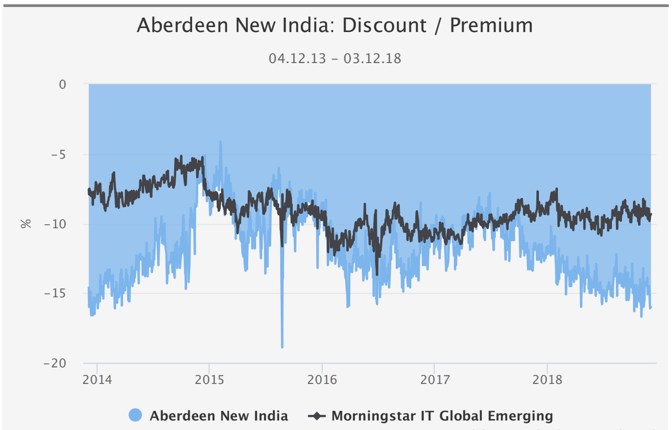
Management

The trust is run by the Aberdeen Standard Asian Equities Team who are based in Singapore. The team structure has not changed with the merger with Standard Life, although some senior personnel have been promoted upwards. The Asia Pacific Equities Team is now led by Flavia Cheong from Singapore, with her Deputy Kwok Chern-Yeh being based in Tokyo. Aberdeen have a team-managed approach which means that consensus is needed on their stock picks across the region. However, there are four team members with special responsibility for this portfolio: Kristy Fong, Adrian Lim, Yoojeong Oh and James Thom. These four are the key decision makers regarding what goes into the trust and how it is managed on a day to day basis. Aberdeen as a house had a rough time in the 2015 to 2017 period, and one of the enhancements to the process brought in was the adoption of sector specialisms for the analysts. This allows greater accountability and the ability to make quicker decisions, although the requirement for decisions to be made in consensus remains. Across the board, Aberdeen places a great importance on corporate governance and engaging with companies to improve how they treat minority shareholders, as well as on quality growth characteristics and strong management teams.

Discount

The discount has tended to be in a range between 6% and 16% in recent years. After the election of Modi and the BJP Party in the spring of 2014, the discount came in sharply to 4% before widening again when the euphoria in the Indian market dissipated in 2015. The discount has widened from 10% in mid-2017 to around 16%, while discounts to broad emerging markets trusts have remained broadly static. This is a period when the appetite for Indian equities has waned as the market has come under pressure from a rising global oil price, to which India is particularly sensitive.

Fig.6: Discount



Source: Morningstar

The board has the authority to buy back shares, however this has not been used in recent years. We understand the board is unlikely to employ it while its competitor trust is trading on a similar discount and sentiment remains weak towards single country funds.

Charges

The OCF is 1.25% which compares favourably to the 1.46% average of the Asian single country specialist sector. The management fee is charged at 0.9% on the first £350m and 0.75% on the remainder.

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