Aberdeen New India

ANII offers exposure to exciting growth stories in India...

Update
27 July 2021

Summary

Aberdeen New India (ANII) owns a portfolio of high-quality Indian equities chosen for their strong balance sheets, sustainable earnings and good governance. These characteristics have helped it outperform its peers over the long run by, amongst other things, delivering relative outperformance in periods when the market falls (see **performance**).

ANII is managed by Kristy Fong and James Thom of the ASI Asian Equities Team. While their portfolio is typically more expensive than the market, they look for opportunities where they think future growth is being undervalued, aiming to add alpha by being longer-term in their thinking. Their own valuation of a company is critical in defining acceptable entry and exit prices, on which they tend to be disciplined. As a result, the portfolio is fairly well spread across sectors and styles – this is neither a growth nor value proposition. During the pandemic, the exposure to new economy businesses has risen thanks to the opportunities being thrown up by volatile markets. We expect the portfolio to continue to see a better spread of old and new economy sectors (see **portfolio**).

Stock selection is built on the detailed bottom-up analysis of the large team of analysts and portfolio managers based in Asia. They look for companies with a position of market leadership which should allow them to grow faster than peers over the long run. The team view strong corporate governance as an important characteristic of a quality company (see **ESG**), and it is a key issue in determining whether they invest.

Kristy and James use gearing tactically, and are currently running net gearing of c. 7%, indicating cautious optimism. ANII's shares currently trade **13.6% below NAV** , slightly wider than their five-year average.

Analysts:

Thomas McMahon
+44 (0)203 795 0070

Analyst's View

We think the long-term fundamentals are pretty exciting for India. Speaking to Asia fund managers, it is striking that India repeatedly comes up as an opportunity. Its demographics are stronger than China, its labour is cheaper than China, and it is winning business from multinationals concerned about exposure to China. The reforms implemented by the Modi government have also had a real impact. India has been one of the top ten improvers in the World Bank's Ease of Doing Business Rankings for three consecutive years.

That said, we may be entering a more difficult period for the global economy now that optimism on the vaccine rollout has potentially moderated. With the pandemic far from over and with government support schemes winding down, we think the pressures on individual companies will be significant. For investors wanting exposure to India, this could be a good environment to have exposure to high quality companies via a strategy such as ANII. A focus on quality has meant the trust has lagged in 2021 to date, but we think quality characteristics may soon be in high demand as the strongest companies prove able to weather tough times and steal market share. Kristy and James think the outlook is very good over the next two to three years, but recognise there are potential stumbling blocks for Indian equities along the way.

ANII's discount of 13.6% is wide in absolute terms but close to its five-year average. However, India has rarely been in favour during this period. While we recognise single country trusts may deserve a slightly wider discount than more diversified ones, we think this could prove to be a good entry point if our optimism about India's future proves to be justified.

BULL
Strong long-term record of outperformance based on successful stock-picking
Quality approach has provided resilience in weaker markets
Discount is wide and could be an interesting long-term entry point

BEAR
Gearing can magnify market falls as well as gains
As a single-country emerging markets fund, it has political risk and higher volatility than a more broadly spread trust
Outperformance of Reliance Industries (not held) would be a relative headwind

Portfolio

Aberdeen New India (ANII) owns a portfolio of Indian companies chosen for their quality growth characteristics. Managers Kristy Fong and James Thom aim to buy these companies when their valuations are attractive and hold them for the long-term. Their approach is highly active and stock specific, with the aim being to find companies which will do well despite short-term macroeconomic shocks. Many of the portfolio companies are expected to benefit from long-term structural trends in India, which have been boosted in recent years by market-friendly business reforms.

By quality, the managers chiefly mean companies with strong balance sheets, high and sustainable earnings, and good corporate governance, including good attitudes to ESG. The members of the Asian Equities Team, whose stock research Kristy and James draw on, prize companies which have a good track record of performing in tough economic climates and which have the characteristics which would aid this, such as low levels of debt and high free cash flow. These give companies flexibility to cope with weak economic periods and to invest in future growth, and could be invaluable as India deals with the economic consequences of the pandemic. While valuation is important, by looking for these quality characteristics Kristy and James are typically led to more expensive areas of the market. To the extent that the market also expects higher earnings from these companies it will award the company a higher valuation multiple than the market average. As a result ANII's portfolio is typically more expensive than the market on a trailing P/E, or even a one-year forward P/E. However, Kristy and James look for opportunities where they see the valuation is lower than it should be, typically by looking out over a longer-term horizon than many other investors do. As a result, valuations fall to more moderate levels when considering the managers' earnings projections for two or three years out. Turnover is therefore also generally low, although it has been higher than usual over the past 12 months thanks to the disruptions to businesses and valuations due to the pandemic.

The managers' active approach is exemplified by the decision not to hold Reliance Industries, the largest company on the market. This has hurt returns over the past few years, but has been helpful since Q3 2020, when Reliance peaked (see **performance**). Despite the rallying share price, Kristy and James refused to compromise on their expectations for quality, not giving in to the temptation to chase performance. A good example of an active buy decision is the recent purchase of Azure Power. This company is US listed and off-benchmark (the MSCI India), but operates solar farms located in India. It is a good example of a clean energy idea that is starting to be a focus for many countries, including India.

Although India is not traditionally associated with new technologies, that is starting to change and Kristy tells us there are a number of IPOs in the tech space expected in the second half of 2021 which they are looking at as potential purchases for the trust. They will join stocks such as digital marketer Affle India, and ecommerce company Info Edge. Info Edge operates in a number of areas including online recruitment where it is the local market leader. Both Affle and Info Edge were purchased during 2020, with the managers taking advantage of the initial market crash to invest at more attractive prices. IT in India is associated with the outsourcers Infosys and Tata Consultancy Services, and both are large positions in the portfolio and overweight positions versus the MSCI India.

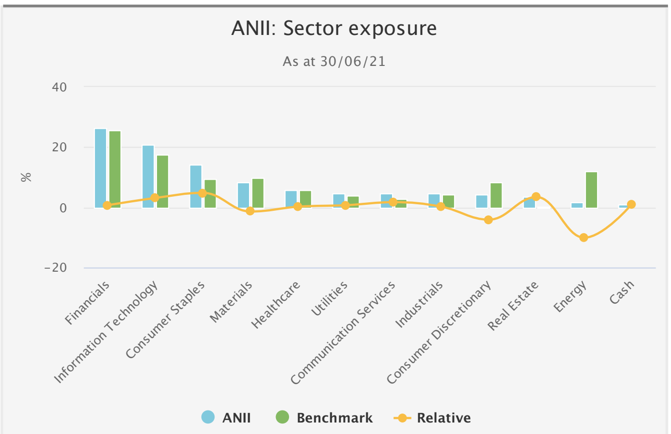
Top Ten Holdings, As At 30/06/2021

HOLDING	WEIGHT (%)
Infosys Technologies	10.2
HDFC	9.1
Tata Consultancy Services	8.5
Hindustan Unilever	6.4
Kotak Mahindra Bank	4.4
Ultratech Cement	4.2
HDFC Bank	3.5
Asian Paints	3.5
Axis Bank	3.1
ITC	2.8
TOTAL	**55.7**

Source: Aberdeen Standard Investments

In fact, ANII is overweight information technology at the sector level, with a 19.6% position versus the 16.5% of the benchmark. It is worth noting that sector weightings are down to bottom-up stock selection and not conscious positioning or indicative of a style bias. While IT is seen as a growth sector, financials are a value sector, and this is another key overweight. The more defensive consumer staples sector is an overweight as is the more cyclical real estate sector. We think the diversity of the portfolio is one of its attractions, although of course it means it will inevitably not keep up in sharp rallies for either the growth or value style, which we have seen in quick succession during the pandemic.

Fig.1: Sector Exposure



Source: Aberdeen Standard Investments

What is important for stock selection is the long-term fundamentals of the business. Often the team's best ideas come from companies serving structural growth in the Indian economy. This is true of the financials sector, where the positions in the private sector banks and mortgage provider HDFC have been key convictions for many years. ANII has made good money historically by investing in what they have deemed to be the best-run private sector banks, which have steadily been increasing their market share at the expense of the cumbersome state-owned banks ever since the 1990s reforms which established them. As the Indian economy develops and the standard of living rises, demand for more sophisticated financial products is rising. The managers believe this is a trend which has a long way to run.

While the banking sector as a whole has been under pressure during the pandemic, Kristy and James believe their preferred companies are the strongest players in the industry and should ultimately benefit from this period by stealing market share and consolidating their positions at the expense of their weaker rivals. The current government is shifting NPLs from the public sector banks into a 'bad bank'. Kristy and James believe this could lead to better performance by the public sector banks in the short term, but that it won't change the long-term advantages the better run private sector banks have. In keeping with their long-term approach, they won't look to ride these short-term momentum shifts. That said, in the short run the outlook looks particularly good for HDFC according to the managers. House prices are recovering from a five to six-year downturn and interest rates are low, creating a bullish environment for mortgage lending which is rapidly expanding.

One of the key attractions of a strategy focussed on identifying high quality companies is that the resulting portfolio should in theory be well adapted to tough economic periods such as the one India is undergoing as it exits the pandemic. In fact, India had been experiencing the negative effects of a banking crisis before the pandemic hit, and the economy was also struggling to deal with some of the radical reforms of the current government such as the demonetisation of the economy. While the Indian market has performed strongly this year, Kristy tells us it has been the reopening stocks which have outperformed after a period in which the COVID-19 winners – largely tech and ecommerce – had done well. Steel companies have also surged as global supply constraints have also resulted in a strong recovery in the commodity cycle. Kristy believes that there has been some irrational exuberance in the market moves. For example, one top-performing group of companies was the Adani Group. This group of companies with a free float of only 5% operates in the green energy sphere and did very well until its finances were called into question and the share price collapsed. Kristy believes the market will increasingly come round to focus on quality as the crisis recedes – although this may be a slow process on both counts.

These events underline the importance of paying close attention to corporate governance issues. This is particularly true in India where companies are frequently tightly held by families or connected shareholders. It has long been a point of emphasis within the Aberdeen Asian Equities Team, and is a key element of an ESG-conscious approach. Kristy and James consider corporate governance to be a vital element of a quality company. As we discuss in ESG, this is embedded in the research process of the analysts and considered at every stage. Meeting company management is a crucial part of this assessment too, and generally speaking the managers are cautious with making new investments, preferring to take their time and wait for the right valuation rather than rushing in.

Post-pandemic and after a multi-annual reform programme, India is arguably in a better competitive position than it has been for years. The Modi government has implemented a number of business-friendly changes, including liberalising bankruptcy law, rationalising the sales tax system and expanding the availability of bank accounts. India has shot up the ease of doing business rankings created by the World Bank over the past three years as a result. This is fortuitous timing, because the pandemic has left many companies looking for an alternative to China as a base of operations or supplier. India is not the only option, but is certainly winning some business, with Samsung and Apple both investing in smartphone production in India last year, encouraged by strong government incentives. The spurt of IPOs referred to above may indicate there is the chance to create a tech cluster in a country with lower labour costs than China which could be advantageous for the country and provide opportunities for investors. In keeping with their cautious attitude, Kristy and James see the opportunity but warn of potential stumbling blocks – in particular they note that reforms often create losers as well as winners and note that anti-corruption drives have contributed to the current banking crisis. However, they agree the future does look bright, in both the old and new economy sectors, and note the commitment to infrastructure spending in the coming years could boost private sector capex and encourage FDI.

Gearing

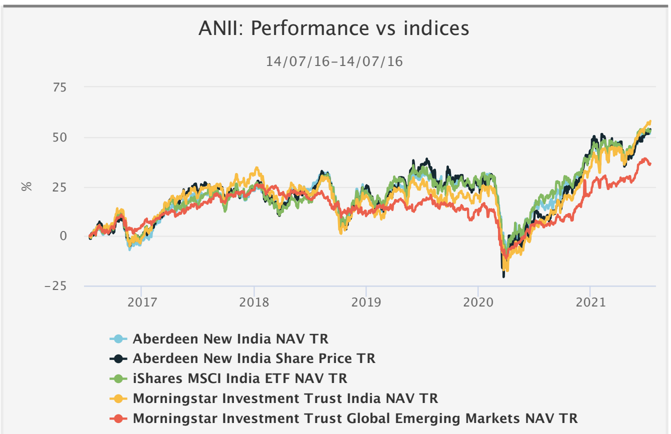
The board of ANII has given the managers discretion to alter gearing levels within the framework the board sets. Kristy and James take a cautious attitude to gearing, but aim to be opportunistic, altering the net gearing level based on their view of valuations and the opportunity set. Given markets are at all time highs and the pandemic is still ongoing they see reasons to keep gearing down to c. 7% of NAV on a net basis. As of the end of June the figure was 5.6%, with the managers having built up some cash to allow themselves to participate in upcoming IPOs. The managers were active in adjusting the gearing level through 2020. After the February/March sell-off they used gearing to invest in a few names, but locked in some profits after the rebound and reduced gearing by trimming or selling some exposure. Net gearing had crept up to 6.3% as of 31 December.

ANII can gear up to 25% of NAV at the time of investment, but is in practical terms currently limited by a £30m multicurrency revolving credit facility which was renewed in July 2020 for another two years. This amounts to c. 8% of NAV at current levels, so any substantial increase in gearing would require the addition of new facilities. Kristy tells us the board is open to the idea of raising the gearing levels, but it views 10% as a reasonable limit for now.

Performance

ANII is the top-performing India trust over both ten and five year periods (of the three trusts with a track record that long) to 14/07/2021. Over ten years it has returned 141.9% in NAV total return terms compared to the MSCI India's 95.5%. Over the past five years ANII has generated NAV total returns of 53% (to 14/07/2021). This is lower than the MSCI India, which has risen by 62.8%. However, it is higher than the two peers with a five-year track record. India Capital Growth, the mid-cap specialist, has made 47.7% thanks to a sharp rally in the past 12 months while JPMorgan Indian has returned 26.6%.

Fig.2: Performance



Source: Morningstar

Past performance is not a reliable guide of future returns

ANII's managers take a highly active approach, and over the past five years one key decision has worked against them. Kristy and James decided not to own Reliance Industries, the largest stock in the index. Over the whole period this has detracted from returns as the stock has more than trebled in value – it is therefore noteworthy that ANII managed to perform reasonably well despite this headwind.

ANII's performance has been achieved with attractive downside characteristics. The NAV volatility has been lower than the index and peers, while the beta of 0.92 indicates relatively low sensitivity to market movements. The maximum drawdown figure is also superior to the index and the two peers with a track record that long, meaning that its worst negative period was better than those of its peers. The downside capture ratio of 0.9 indicates it has tended to outperform the index when the latter falls.

NAV Performance Characteristics Of India Trusts Over Five Years

	MAX DRAWDOWN (%)	BETA	STD DEV, ANN. (%)	DOWNSIDE CAPTURE
Aberdeen New India	-33.0	0.92	23.8	0.9
MSCI India NR USD	-35.9	1.00	24.4	1.0
India Capital Growth	-58.3	0.92	25.4	0.75
JPMorgan Indian	-42.18	1.00	25.63	0.96

Source: Morningstar, to 01/07/2021

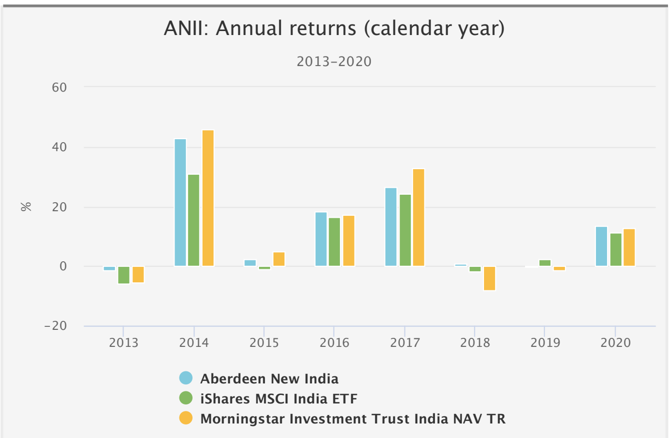
Past performance is not a reliable guide to future returns

Performance has been relatively sluggish in the aftermath of the pandemic. In the initial crash on February/March 2020 ANII outperformed, in keeping with its tendency to do better when markets struggle. However, it lagged in the market recovery when Reliance was a strong outperformer. As Reliance slowed in Q4, relative performance of ANII improved. Markets in India and globally have been volatile in 2021, with a rally in value followed by a sharp snap back favouring growth. Kristy tells us that she believes the quality companies ANII looks for have been relatively over-looked, while the market has chased high near-term growth or momentum. This has meant that ANII has lagged the market in the year-to-date, with NAV total returns of 9.3% compared to 12.4% for the MSCI India (as at 18/07/2021).

In general, Kristy and James have been wary of chasing performance and shifting the portfolio around in the short term, but aim to look through the current moment in the cycle to the long-term potential in their companies. We believe the portfolio should potentially be resilient if the current global optimism subsides while at the same time still offering good catch-up potential through its more cyclical, value-exposed holdings. Kristy believes the portfolio should do well in absolute and relative terms as the economy recovers from covid. While she is cautious about the potential for setbacks along the way, she thinks any further wave will have a less severe impact to the economy (given the existence of vaccines). Furthermore, in the long-term the opportunities in the internet space are expanding and the commitment of the government to spend more on infrastructure is another potential catalyst for future earnings growth in many sectors.

The below chart shows that out of the last three years in which the Indian market has ended down, ANII has beaten the market and generated positive NAV total returns in two of these years. In fact, ANII outperformed the ETF in each of the six years to 2018 inclusive, and in 2020 too, showing the benefit of active management.

Fig.3: Returns



Source: Morningstar

Past performance is not a reliable indicator of future returns

Dividend

ANII is managed for capital growth. Income is used to pay expenses and the trust rarely pays a dividend. A 1p dividend was paid for the financial year ending March 2020 thanks to a small positive revenue account, but this is not expected to recur. There was no dividend paid for the financial year ending March 2021.

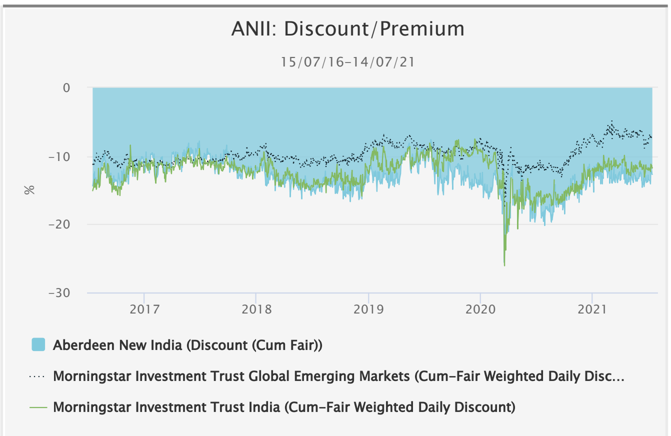
Management

The trust is run by the Aberdeen Standard Asian equities team who are based in Singapore. They take a team-based approach which means they aim to build consensus on their stock picks across the region. However, there are two team members with special responsibility for this portfolio: Kristy Fong and James Thom. Kristy and James are the key decision-makers regarding buys and sells and the day-to-day management of the portfolio. The Asian equities team are led by Flavia Cheong and her deputy Kwok Chern-Yeh, both based in Singapore. The team share a common investment framework across their single-country and regional portfolios. This framework seeks to identify high-quality companies which have sustainable earnings streams, and places great importance on corporate governance and engaging with companies to improve how they treat minority shareholders.

Discount

ANII's shares currently trade on a 13.6% discount to NAV, slightly wider than the 13.2% five-year average for the trust. The weighted average of the four Indian trusts is 12.6%, according to JPM Cazenove data. We note ANII and the India sector are both on significant discounts despite India outperforming the emerging markets index in the year to date. The sector fell out of favour in the aftermath of the coronavirus crash as the country struggled medically and economically to handle the pandemic. While NAVs benefitted from the vaccine rally that began in Q3 2020, the discounts in the sector have been persistent. The local market held up well during India's devastating second wave in April 2021, and actually outperformed considerably from this point. We think this may indicate investors are looking through the disruption to the long-term fundamentals in India: cheap and plentiful labour, improving governance and the prospect of winning business from China. The current discount could well prove an excellent long-term entry point in our view, although it is hard to see a specific catalyst for it to narrow.

Fig.6: Discount



Source: Morningstar

Charges

ANII's last published OCF is 1.16%, which compares favourably to a weighted India sector average of 1.11%, as calculated by JPM Cazenove. However, charges may be lower on an ongoing basis, as the board has agreed a fee cut with the manager effective for the 2022 financial year starting in April 2021. The management fee has fallen to 0.85% from 0.9% on the first £350m of net assets, with net assets above that charged at 0.7% rather than 0.75%. Net assets are £371m, so we calculate the effective management fee is c. 0.84%. Furthermore, fees are to be charged on net assets rather than total assets less current liabilities as before. There is no performance fee. The KID RIY is 1.39% compared to a sector weighted average of 1.41%, although calculation methodologies can vary.

ESG

The Asian Equities Team at Aberdeen Standard Investments (and previously at Aberdeen Asset Management, before it merged with Standard Life in 2017) were early adopters of what has become known as ESG investing, having long championed a focus on the ethical quality of management teams as well as their financial acuity. Originally, governance was the key focus, with the team always viewing good governance as an essential attribute of a quality company. Over time the commitment to ESG has grown and broadened, and Aberdeen Standard Investments now employ over 50 dedicated ESG experts and ensure these issues are considered as a part of the analysis of every company under coverage.

Asian equity team members conduct their own assessment of the performance of candidate companies on ESG grounds, but also consider the ratings of external analysts at MSCI and try to understand the reasons for any differences. Another modern trend the team anticipated was a focus on active engagement to improve governance issues. The team work to encourage better ESG policies in portfolio companies and view themselves as being in partnership with the management of their portfolio companies. They believe this should lead to better long-term returns to shareholders, as they believe ESG issues are frequently material to long-term company performance.

Given the importance they place on governance, the team will often not invest if they think governance practices are particularly poor and there is no or limited scope for them to improve this as management are unlikely to be receptive to their input. This means they have been happy to sit out the gains on a fashionable stock if they think its standards of behaviour are not acceptable and management have not indicated any willingness to change. As such we think ANII could appeal to investors who want a moral dimension to their investments, and we note the trust and the manager have both been highly rated by external experts for ESG. As a house, Aberdeen Standard Investments has been awarded A+ on the UN Principles for Responsible Investing framework for equities. ANII meanwhile has been awarded a 'High' rating from Morningstar Sustainalytics within the India Equity category, meaning it is considered to be among the best in this group.

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