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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

5th December 2017

Market review

Asian equities edged higher in November with the MSCI AC Asia ex Japan Index gaining 0.6% while the MSCI AC World Index advanced 1.9%. Singapore (+3.9%) and Thailand (+1.8%) outperformed while India (-0.7%) slipped. By sector, Consumer Staples (+2.6%) and Consumer Discretionary (+1.9%) rose while Energy (-1.0%) gave up some ground.

All returns above are stated in USD terms.

India - Babbu the builder

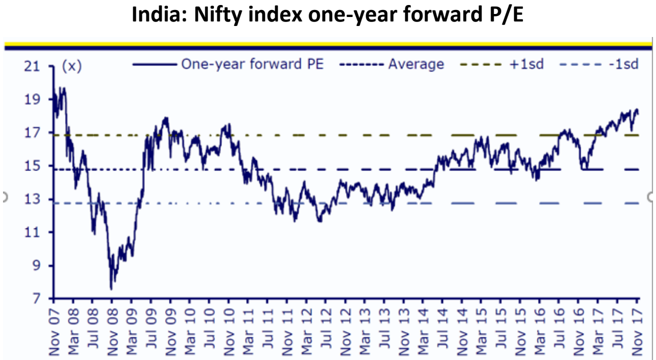
We travelled to a very well attended conference in Gurgaon (New Delhi) last month. We learnt nothing to change our oft stated view that the Modi administration is doing an unbelievably good job. In an interesting parallel with China, the word is that the corridors of Delhi are now squeaky clean with even those who view Modi's policies with suspicion agreeing that brown envelopes are out of fashion, probably for good.

If anything we feel we have underestimated the enormous impact of the 'Housing for All by 2022' policy on the broader economy. This ambitious policy targets the construction of 50mn new homes between now and 2022 - some 10mn per annum compared to the current annual construction of some 6mn. Put another way, residential housing construction currently accounts for under 5% of GDP, substantially down from circa 8% of GDP five or ten years ago. The broad multiplier effects of such a large increase in construction activity are obvious and, to our mind, justify the admittedly large cost to the Government of the PMAY mortgage subsidy program.

The difficulty with the equity market however, lies in that famous Warren Buffett quote 'price is what you pay, value is what you get'. While the corporates presenting at the conference were unanimously upbeat, it is a fact that Indian equities have had a fabulous run since the 2013 taper tantrum and are now expensive by their own historical standards (see the Price/ Earnings ratio (P/E) chart below).

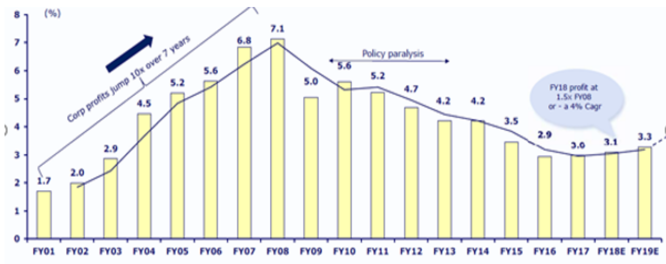
The bulls argue that the current high P/E valuations merely reflect compressed margins due to the cyclical downturn of recent years. The second chart illustrates how severely corporate profit margins have been compressed from 7.1% in FY08 to just 2.9% of GDP in FY16. We are happy with our current investments and left Delhi with several new ideas.

India: Nifty index one-year forward P/E



The Nifty Index now trades on 18.1x one-year forward PE, compared with a 10-year average of 14.8x.
Source: Bloomberg

India corporate profit as % GDP



Source: Bloomberg, CMIE, ACE Equity, MOSPI, CLSA

India – Another way to skin the cat

In addition to our three listed Indian holdings the portfolio has exposure to a somewhat oblique Indian consumer play. Purchased in the middle of last year, Silver Heritage has not covered itself, or indeed your manager, in glory thus far but, after cost overruns and various other delays, the 100 room five star Tiger Palace Resort Bhairahawa is finally open for business. The casino should receive its operating licence shortly.

Situated just 12km north of the Indian/Nepal border, Tiger Palace is the first purpose-built integrated resort in South Asia and will provide stiff competition to the tired, run down facilities in Goa, Colombo and Kathmandu - the only other casino options in the subcontinent for an Indian citizen. Uttar Pradesh, with a population of 215mn, is the adjacent state to Bhairahawa and Silver Heritage estimate that 15mn middle class Indians live within a six hour drive of the resort. Bhairahawa's domestic airport, just a ten minute drive from the resort, is being upgraded to an international airport over the next 18 months.

There are longer term plans to substantially increase the number of hotel rooms at Tiger Resort and sites for additional integrated resorts have been identified. Tiger Resort will be the third casino managed by the group and will almost triple the number of gaming tables. While the existing two casinos in Kathmandu and Bắc Ninh City have generated modest cashflow in recent years, the Tiger Resort is an absolute game changer for Silver Heritage's revenue and earnings profile. All yours for an enterprise value of US$70mn (source: Bloomberg). Without a shadow of a doubt this is the most exciting investment in the regional portfolios. It currently trades 'by appointment' but that's our stocking filler for the adventurous investor this Christmas.

We also managed to squeeze in two days in Colombo. A combination of floods and droughts, plus an outbreak of dengue fever which depressed tourist arrivals, has seen domestic consumption struggle this year and corporate earnings have suffered accordingly. The long term story of rising foreign direct investment (from China in particular) and huge opportunities for growth in tourism remain in place. Another market trading by appointment but, on under 10x 2018 earnings, it remains a steal.

Outlook

Year end profit taking has seen a general retreat in some of this year's high fliers. It has been reassuring to see some of the ASEAN markets perform better of late and we still see good investment opportunities across the entire region as we look toward 2018.