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The Contrarian Opportunity in India –

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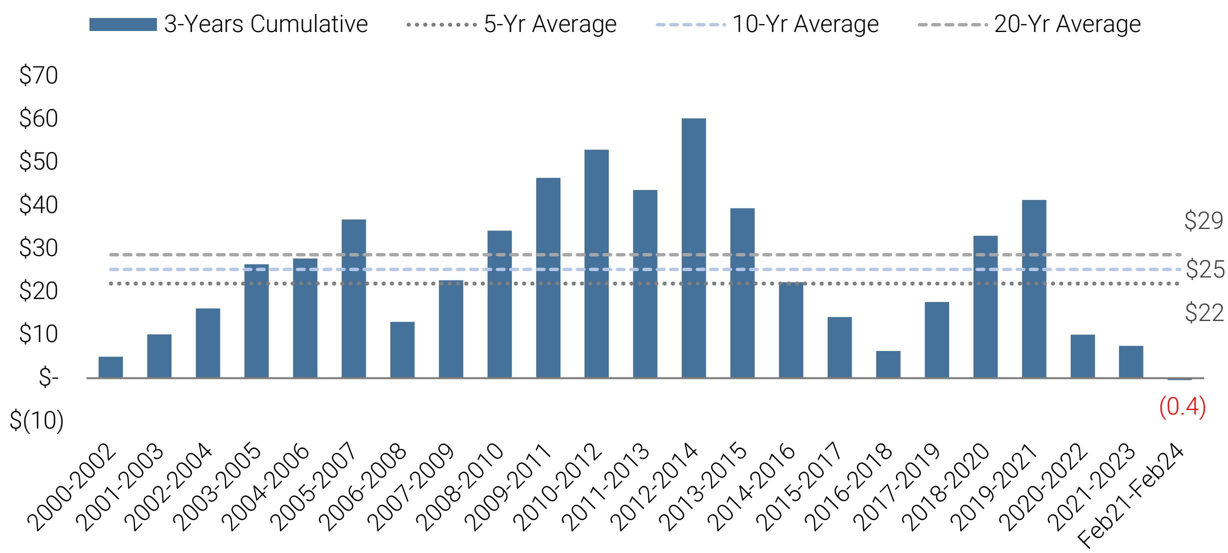
The prevailing opinion amongst institutional investors appears to be that India is a "consensus buy" and that its stock market is trading at a stretched level of valuations. While parts of the market are indeed showing signs of frothiness, we believe that a segment of the market is trading at a highly attractive valuation, having been abandoned by many large foreign investors. These Indian stocks comprise a major part of Dalton's regional strategies and the bulk of our dedicated Indian strategy. In our opinion, these stocks represent a compelling long-term return opportunity.

Foreign Investor Outflows

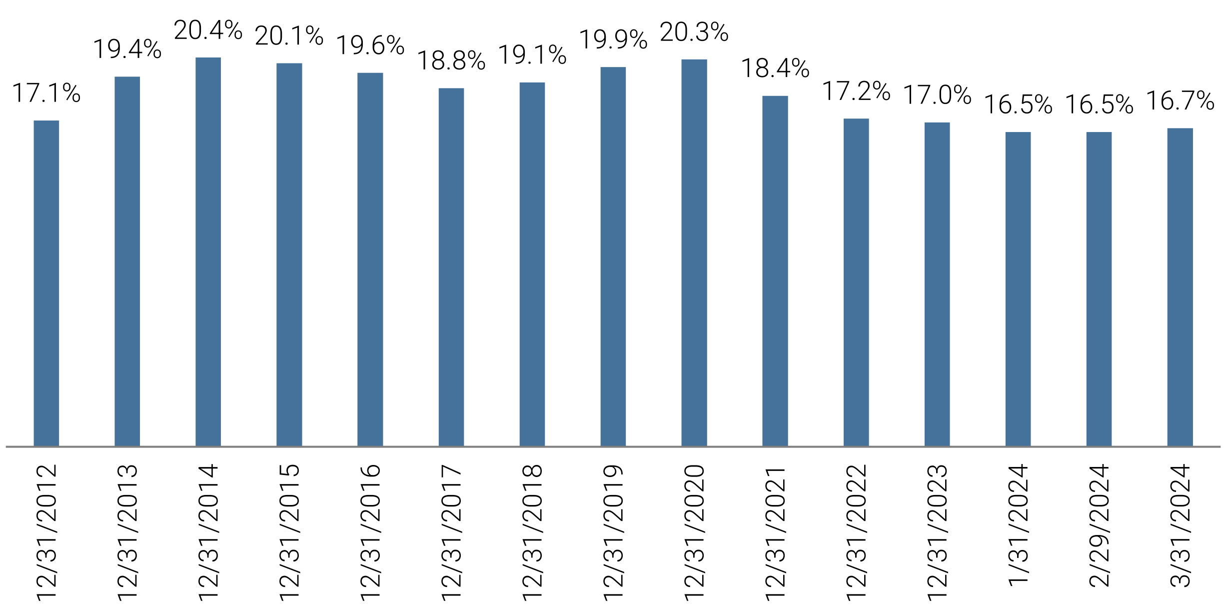
The first sign that this "consensus buy" view can be called into question, comes when we make a closer examination of Foreign Institutional Investor (FII) flows (Figure 1) in India. As of February 2024, the cumulative 3-year FII flow hit a historic low, plummeting to -$417 million, marking the first instance of negative flow over a 3-year period in two decades. Notably, as the chart shows, the recent 5-year average of these 3-year cumulative flows stands at $21.9 billion, significantly trailing behind both the 10-year average of $25.2 billion and the 20-year average of $28.6 billion. Additionally, FII holdings in the Indian stock market (Figure 2) have fallen to below 17% of the total market capitalization, which is around the lowest level in more than a decade.

Figure 1 – Cumulative 3-year FII Flows



Source: NSDL

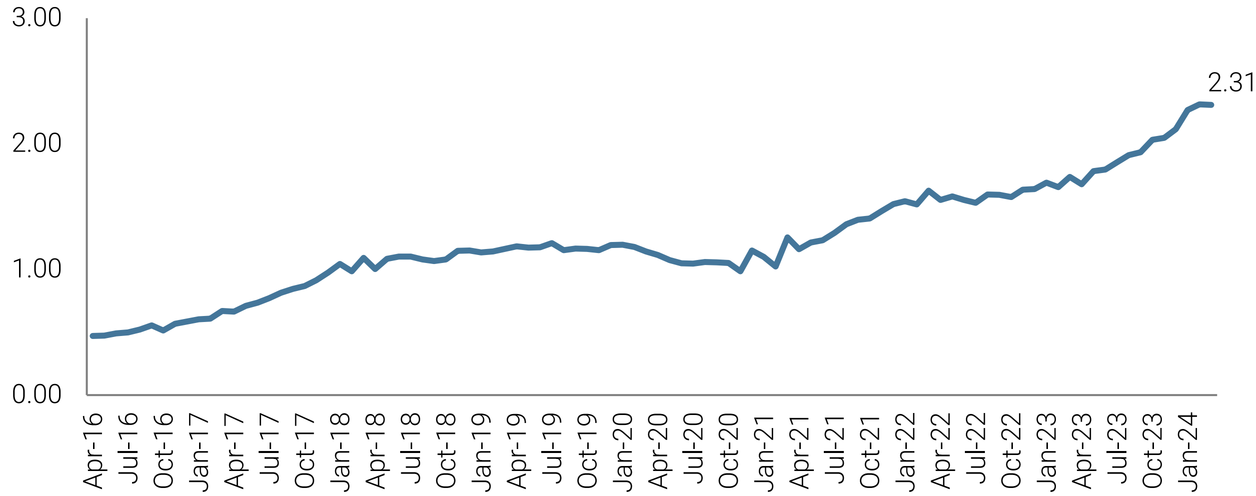
Figure 2 – FII holdings as a percentage of total Indian market capitalization



Source: NSDL and Bloomberg

The counter trend to these FII outflows is the record level of domestic retail buying, particularly from the country's Systematic Investment Plans (SIP, Figure 3). These domestic flows are being disproportionately invested into the small cap section of the market, which is now trading at around a 100% premium to its 10-year historical average.

Figure 3 – Monthly SIP Flows ($Bn)

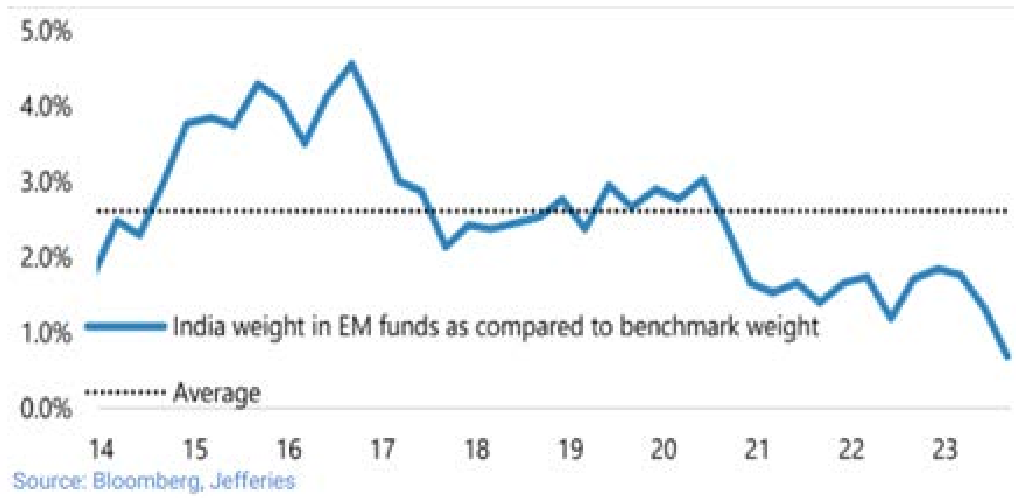


Source: Association of Mutual Funds in India (AMFI)

Global Emerging Market Manager Positioning

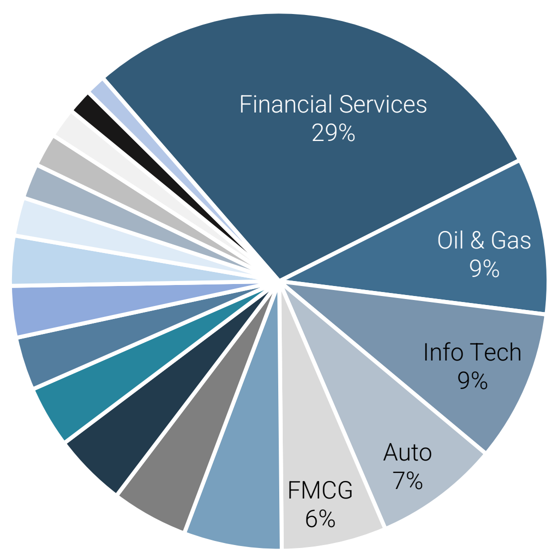
The second piece of evidence we can present to question the "consensus buy" view is the average positioning of Global Emerging Markets equity managers. As Figure 4 shows, Global Emerging Markets managers have been structurally overweight India over time (an average of 2.5% overweight over the last ten years), in part due to the underrepresentation of India in the MSCI EM index relative to its true market capitalization weight. India is punished by MSCI for its limited float, due to large ownership stakes being held by the founding families of many companies – an attribute of the market Dalton finds highly appealing! This structural overweight has now all but disappeared.

Figure 4 – India Weight in Global Emerging Markets Portfolios Relative to MSCI EM Weight



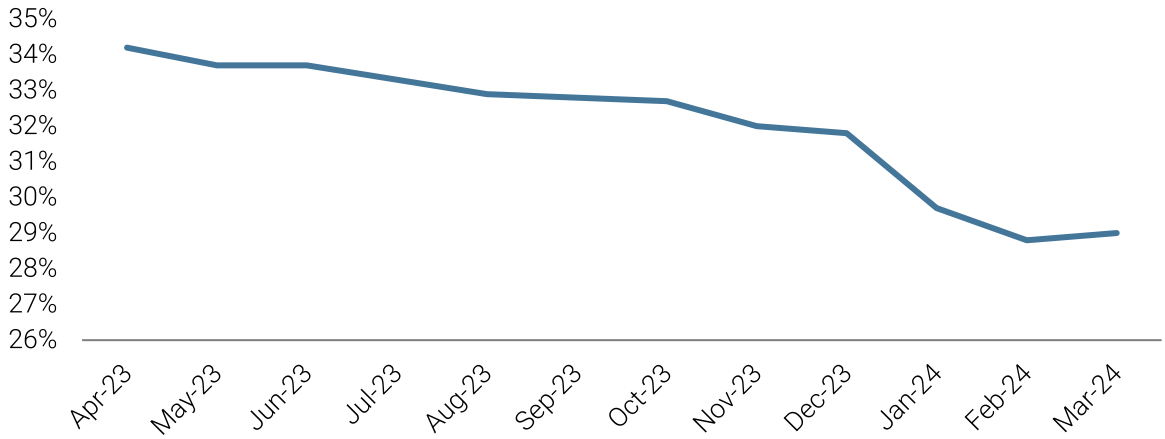
So what exactly have these large foreign investors been selling? The data shows that FIIs are disproportionately positioned in large cap stocks (due to liquidity needs) and have a large weighting in specific sectors (Figure 5), the largest of which being Financials. The evidence would suggest that Indian financials in particular have been subject to the most aggressive foreign selling, with their weight in FII portfolios falling from around 34% 1 year ago to their current 29% weight (Figure 6).

Figure 5 – FII Equity Portfolio in India as of 31 March 2024



Source: NSDL

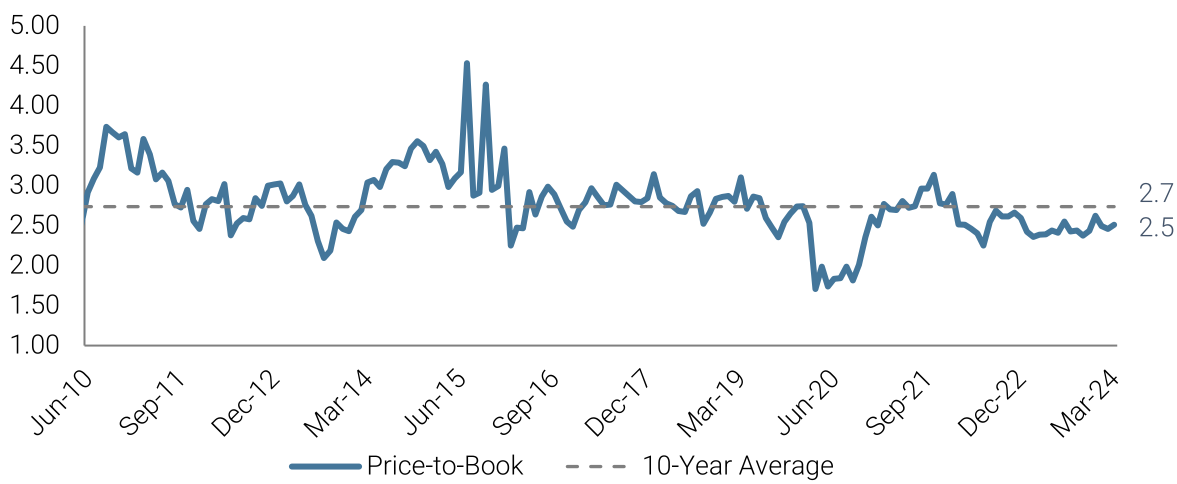
Figure 6 – Financial Services Weight in FII India Portfolio Over Time



Source: NSDL

This aggressive selling of Indian banks is creating a valuation cushion, with the sector now trading at a discount to its 10-year average (Figure 7).

Figure 7 – Price to book of MSCI India Bank Index



Source: Bloomberg

Another large sector exposure in FII portfolios is Information Technology, with the key exposure being to business process outsourcing (BPO) firms. These firms, once market darlings, handle the back offices of most of the Fortune 500 companies and have demonstrated a tremendous track record of compounding capital over time. The firms have been subject to additional selling pressure, due to a belief in the market that AI will cause major disruption to these businesses. At Dalton, we take the counterview that the integration of AI into large Western firms will be another avenue of growth for leading Indian BPO firms.

Dalton's Positioning

Since the inception of the Dalton India Fund in 2014 and the Dalton India UCITS Fund in 2020, we have emphasized the value of having the ability to look for opportunities across the market capitalization spectrum and to make material changes to the portfolio when the opportunity presents itself. This is an advantage not available to our larger rival Indian managers, due to their liquidity needs. While Dalton has previously had a large amount of small cap and mid cap exposure, the portfolio has now rotated to its highest ever level of large cap exposure.

Due to selling by large Global Emerging Markets funds and other FIIs, we now find highly attractive valuation opportunities in areas such as private banks and BPO businesses.

Conclusion

Rather than all Indian stocks being overvalued momentum stocks, we believe that there is a contrarian investment opportunity developing in the large cap segment of the Indian market. Our regional mandates and dedicated Indian funds are heavily exposed to high quality businesses in the private banking and business process outsourcing industries. We believe these stocks represent compelling long-term investment opportunities.

Unlike large caps, many small cap Indian stocks look overvalued and there are signs of frothiness in this market segment, due to continued buying from domestic retail investors. As ever, it is impossible to tell when this trend will reverse, but what we can say with some certainty is that there will come a sell-off in these small caps at some point, in response to an as-yet unknown negative event. Our smaller size and flexibility to change the market capitalization composition of our portfolios quickly mean we stand ready to take advantage of any future sell-off.

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