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KBK CAPITAL MANAGEMENT Q&A

WHY INDIA NOW? HOW INDIA IS POISED TO BENEFIT FROM THE US-CHINA TRADE WAR

NOVEMBER 20, 2019

ABOUT KBK CAPITAL MANAGEMENT

KBK's India strategy is designed to take advantage of India's compelling secular growth profile by utilizing a distinctive top-down investment approach that incorporates macroeconomic trends with quantitative stock selection. The process generates alpha by allocating to those stocks believed most likely to outperform given the current stage of the business cycle. The fund's risk level is actively managed by utilizing both long and short stock and currency futures to maximize returns while maintaining the fund's risk budget.

ABOUT BHAVANA KHANNA

Prior to co-founding KBK Capital Management in 2016, Bhavana Khanna, PhD was the lead Portfolio Manager for Blue Shores' India Opportunity Fund. She focused on macro, fundamental and technical research on Indian markets. Prior to joining Blue Shores, Bhavana led the development of the CEDI Capital Markets India Private Capital and Foreign Direct Investment practice. Before CEDI Capital Markets, Bhavana founded Udvesta Consulting LLC, a hedge fund marketing firm based in New York City catering to Indian high net worth investors. Through Udvesta, Bhavana developed an extensive understanding of the unique challenges and opportunities faced by hedge funds and the Indian markets. Bhavana began her career with Merrill Lynch, first on the Foreign Exchange desk and then in the Debt Division where she marketed, structured and traded callable bonds and structured notes. She was instrumental in building out the business for middle market institutional investors. Bhavana earned a BS from St. Stephen's College Delhi, a Masters from the University of Oxford and a PhD from Cornell University. Bhavana was awarded the Rajpal Memorial Award for the woman who contributed to the total life of St. Stephens College Delhi, a Radhakrishnan (Rhodes/Marshall) Scholarship for studies at the University of Oxford and the John H. McMullen Fellowship at Cornell University.

ABOUT KEVIN BUSH

Prior to co-founding KBK Capital Management in 2016, Kevin served as Blue Shores Capital's Chief Investment Officer since 2008. He oversaw the firm's flagship global/long short equity strategy and provided leadership to the firm's five investment professionals. Prior to Blue Shores, Kevin joined Independent Portfolio Consultants, Inc. in 2002 where he started as a portfolio analyst and was ultimately promoted to Managing Director. He has presented global investment strategy to investment professionals across the United States, as well as, to numerous banks and family offices throughout the Middle East and China. He has a B.A. in Economics and Political Science from Amherst College. Additionally, he is a Chartered Financial Analyst® charter holder (CFA) and a Chartered Market Technician (CMT).

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DIVYA NARENDRA, SUMZERO: *Broadly speaking, how would you compare growth in India vs China, Europe, and the US? What secular trends are driving this growth? Is this growth real?*

KBK CAPITAL: India is now unmistakably the fastest growing large economy in the world and only recently took that title away from China. While there have been headlines addressing concerns India's official GDP numbers may be overstating growth, this should not confuse the fact that the growth is fast and real. If India actually grew at 6.4% last year rather than the official 7.4% number, that does not change the fact that India is a big country growing quickly.

When comparing growth between countries, it helps to review the fundamental drivers of a country's economic growth. Economic growth is a function of labor force participation growth (the number of hours worked by the population) and productivity growth (how efficient this work is completed). When viewed through this lens, it becomes clear the huge secular advantage India has versus other large economies. Approximately 65% of the India's population was born after 1980 and the median age is 27. According to the UN, India's working age population is set to continue to rise from 900 million currently to 1.1 billion in 2039. This will eclipse China's working age population around 2026 as China's working age population declines from 1 billion presently to a little less than 900 million in 2039. While the U.S.'s demographic profile is superior to Europe's, it cannot match India's. The thing about demographics is that they are tough to fake and difficult to change.

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In terms of productivity, India can do better than it is currently. In an emerging economy, productivity growth is relatively easy to come by as workers move out of the agricultural sector, as is the current case in India. India has an underdeveloped manufacturing sector that is being stunted by labor laws that incentivize companies to remain relatively small. Reform is needed here, and if achieved, would have a profoundly positive impact on India's productivity growth and further improve its growth profile.

SZ: *Are Modi's growth targets realistic?*

KBK: Prime Minister Modi recently announced that he wants India to become a $5 trillion economy by 2025 at a time the country is going through an economic slowdown. A $5 trillion economy by 2025 is an ambitious target that is possible, but far from a sure thing. Such an

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achievement would result in India's economy being the fourth largest in the world in 2025 only behind the U.S. China, and Japan. This started a debate among economic experts whether the slowdown is cyclical, structural, or perhaps both.

If we think of India's economy as moving on four wheels - public investment, private investment, consumption and net exports - all the wheels are turning slowly. The GDP peaked at 8% and latest data shows it running at 5.5%. The downward trend in private capital formation continues, public investment is constrained to keep fiscal deficit in check, exports have taken a hit, and more recently, consumption has slowed down. Given all that is transpiring, we believe the slowdown is primarily cyclical in nature, but are quick to point out that there are several important structural impediments that need to be addressed. The decline in consumption has been thought to be one of the reasons for the slowdown with each sector having its own idiosyncratic slowdown issues. Some are alarmed by the noticeable decrease in automobile sales. However, there are structural changes in the car market taking place that should not be confused with a collapse of overall demand. Automobile sales have gone down, at least in part, because millennials prefer to take Uber and Ola. In the food industry, biscuit manufacturers are crying the blues because their sales have dropped. Biscuit sales are very sensitive to rural demand and have been affected by disproportionately slow wage growth in rural areas.

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We believe a lack of private investment is probably the biggest constraint on India's growth at the current juncture. India's long-term capital utilization rate is hovering around 75%, which is near its long-term average. When this is the case, private investment needs to rise to move the economy along at a faster pace. This is not happening and both domestic production of capital goods, as well as imports of capital goods, have decelerated over the same period of time. In fact, over the past few months, industrial production growth has dipped into negative territory. This implies that private investment is impeded due to lack of confidence in the future of the economy. One solution that many propose is aggressive monetary easing, and indeed, India is in the middle of an easing cycle that will help alleviate the cyclical element of a slowdown in private investment. However, there is certainly a structural component to unimpressive private investment growth facing India.

First, India suffers from an acutely weak corporate bond market. It is the corporate bond market that usually does all the heavy lifting to finance long-term projects. For example, the stock of corporate bonds as % of GDP is 80% in Korea. It is around 40% in Malaysia, Singapore and Hong Kong, but a mere 5.5% in India. The corporate bond market needs to be pulled out of its current malnourished condition.

The second structural impediment is the poor capacity of risk assessment in India with a limited pool of qualified risk assessment professionals that do due diligence for banks and credit agencies. During the Infrastructure Leasing & Finance Services "IL&FS" crisis (India's leading infrastructure finance company defaulted in payment obligations of bank loans and other short-term deposits), the corporate bond market saw trouble approaching. The credit rating agencies should have been leading the way, but instead they found themselves following the market. Risk assessment needs to be better addressed which would help lower the cost of capital.

Another needed major reform needs to originate within the government itself concerning delayed payments by the government. If the fiscal deficit goes off target, which happens, then payments by the government are delayed. Once again referring the IF&LS crisis, the company plunged into default as they were not paid by the national highway authority for a road they had constructed. This has become a disease and boils down to fiscal responsibility by the government.

Our conclusion is that, in addition to the monetary easing that is taking place, policy makers should also be focused on the structural bottlenecks in place in order to get private investment back on track, and hence, allowing for India's long term secular growth story to play out in the most favorable fashion possible. The case with India continues to be one of slow structural reform. The good news is that it there is a general consensus among the population that gradual structural reform is the best path forward. The bad news is that the government needs to provide more clarity on its end and present a clear path forward to remove these structural bottlenecks in a timely fashion.

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But we do see turnaround on the horizon. The latest data on the rural economy has already started showing early signs of recovery. Improving terms of trade for farmers, surplus rains this year, and income support for farmers seems to be boosting spending power for farmers. A rural recovery would bode well for a broader rebound in growth.

SZ: *What is your assessment of Modi's impact on the Indian markets and valuations along with his attitude toward foreign investment?*

KBK: From an empirical perspective, Modi's impact on India's markets appears to be very positive. The median P/E of the BSE 500 Stock Index has averaged 25x earnings since his initial May 2014 election victory, compared to just 14x earnings the previous five years, and similarly, 17x earnings over the past 20. Although, it should be noted that only in the past five years has the RBI has

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become a credible inflation fighting force, which also certainly has supported Indian valuations during this time, probably more so than Modi holding office, in our opinion.

To be fair, Modi may receive too much credit for the India reform story. The story really began in the 1990s when business leaders decided that instead of competing head to head with China and other emerging markets to make itself a manufacturing hub, India would utilize its relatively young and English speaking workforce to offer services to the world. That reform strategy propelled it to be the 3rd largest economy in Asia and 7th largest in the world. Remember in the early 2000s when low-level workers in California were cribbing that their job had been outsourced to Bangalore!

SZ: *Is US-China trade war an opportunity for India and how?*

KBK: The most important thing for India is to continue to develop trading relationships, whether that be with China or the U.S. Now, with the U.S. and China in the midst of a trade war, there is a greater than usual opportunity for India to convince both the U.S. and China to embrace India as a trade partner and not the other country. There have been several suggestions by foreign policy experts that India is late to capitalize on the trade war and that Vietnam and Bangladesh have been the biggest beneficiaries by aggressively pushing ahead to take advantage of the situation, while India was slow in getting into value chain. India still has room and in late August, India got its act together. The government ministries have been asked to submit their policies and incentive structures to “Invest India”, the country's foreign investment promotion agency. Nine sectors including electronics, autos, pharmaceuticals, and telecoms will be targeted. Apple, Foxconn, Wistron Corp, and Pegatron Corp are among the U.S. companies India wants to encourage to shift their businesses out of trade war hit China.

When looking at the broader trading relationship India has with China, a couple of things stand out. First, there has been a nine-fold increase in Chinese investment in young Indian start-ups between 2016 to 2018, from about $600 million to $5.5 billion. Secondly, while trade between Asia’s two economic giants is on the rise and is set to reach $100 billion this year, India’s trade deficit with its neighbor now amounts to $53 billion. That deficit does not seem economically sustainable. For example, India produces 20% of the world’s supply of affordable generic drugs, yet China purchases a mere $200 million worth each year. The trading relationship between the two massive neighbors is largely defined as the Chinese investing in India. If China actually starts manufacturing in India, creating jobs for

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Indians and producing products in India, that would work for India and would be far easier to deal with the merchandise deficit. In an ideal scenario, India would like China not just to invest but also manufacture in India.

Irrespective, there is a significant upside to this for India. As per a very recent UNCTAD report, India is likely to increase its exports by as much as $11 billion in the long term due to the fall out between the US and China. The increase would come in items that are currently being imported from China where US companies do not have the competitive edge to match India. Similarly, Indian exports would also gain in China for the goods that it today imports from the US.

Even if the US and China do strike a deal eventually and a full blown trade war is averted, India would still be a beneficiary. A Chinese firm with large exports to the US would be wise to hedge & invest in a subsidiary in India & transfer its scale-manufacturing skills. In a battle between two behemoths, India is in the best position to lap up the spoils.

From a diplomatic standpoint, India is clearly seeing an economic convergence with China, but as far as trade goes, India needs to negotiate its terms better. India needs to exert foreign pressure to make changes and reforms that are good for India. The Japanese have used this philosophy for years. The word for it in Japanese is "gai-atsu," literally "foreign pressure". It covers all those things like extracting billions of dollars to help pay for the gulf crisis, pushing on the sacrosanct ban against rice imports, trying to set market quotas on semiconductor chips

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SZ: *What would you say are the key near, medium, and long-term catalysts that will drive Indian markets forward?*

KBK: Near term, Indian markets are trading alongside most other Asian markets as sentiment is being driven largely by daily developments in the U.S and China trade war, despite India having minimal exposure to China or the U.S. in terms of merchandise exports either directly or indirectly. An inadvertent effect of India failing to develop a robust manufacturing base is that is now has little exposure to China's manufacturing supply chain. An improvement in overall sentiment, as it is related to U.S. and China trade, would boost Indian markets as a greater appetite for risk would emerge for the region's assets.

Medium term, a definitive turn higher in the earnings cycle is the most important catalyst for a sustained move higher in the Indian equity market. We believe the cycle bottomed last quarter and an unambiguous turn higher in the coming quarters would warrant the attention of long-term investors. Profit margins are now coming off cycle lows and India's labor market has plenty of slack, thus enabling margins to improve for a period of time alongside a return in demand and pricing power. In terms of the stock market itself, our conjecture is that the combination of proactive fiscal and monetary policy initiatives has recently gained enough momentum to warrant smart money's attention at a time when the consensus has now fully embraced India being in the midst of an economic slowdown. (Anecdotally, India's slowdown was the first question we were initially asked for this interview.) There is a high probability India's nearly 18-month long bear market in mid and small cap stocks ended in September on the back of monetary and fiscal reaching stimulus in the pipeline reaching a tipping point combined with the recent surprise cut in corporate tax rates.

Long term, India has the demographics to support both high real GDP and corporate earnings growth for many years. The key is for structural reforms to continue at a fast enough phase in "Modi Season 2". Specifically, agriculture reforms are a top priority. With more than half the population of India dependent on a sector that contributes less than 18% to GDP, agriculture has been a policy puzzle that has remained unresolved since Independence. Land and labor reform are huge issues that need to be addressed as the current laws are impeding the growth of the manufacturing sector. Low-skill manufacturing jobs are an obvious next step up the value-added chain for many of these individuals. Next is infrastructure reforms. India's infrastructure story is like a badly written novel, with several authors across multiple ideologies scripting a patchy, chaotic path with no climax in sight.

Of what we know, there are two things we are clear about. First, the government does not have the resources to build a 21st century infrastructure for India. And second, private sector money is willing to make good the shortfall. What is needed is to rethink infrastructure policymaking that takes this into account. Financial sector reforms are imperative given the current shadow banking crisis. Shoring the weak corporate bond market is important for infrastructure reforms and private investments. Lastly, in Season 2, Modi needs to simplify the goods and services tax (GST) system — it is perhaps the lowest of the low-hanging fruit. The cobwebs have been cleared and India's indirect tax structure is in tune with that of 140 countries across the world. This was the GST 1.0. Bringing politics and economics together over three decades, made the GST one of the longest reforms in Independent India. Simply put, GST 2.0 needs to deliver outcomes in the form of greater tax collections.

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SZ: *How is KBK positioned to take advantage of the recent fiscal boost by the government?*

KBK: Of the recent fiscal measures taken by the government to boost growth, the slash in the corporate tax-rate is the most

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significant. As investors who use a factor rotation investment process, we had already been targeting quality factors prior to this announcement given the current stage of the earnings cycle. We believe the new tax rate will further boost our long positions relative performance. Such a cut in taxes helps companies to cut prices to enhance demand, undertake extensive product promotion, pay above normal dividends, fund capex and working capital, pay down debt and enhance strategic investments in fields like R&D. Quality stocks are particularly well positioned to outperform. From the start, companies that can absorb the tax relief rather than compete it away will most likely be rewarded the most by the market. These are those with high profitability, high operating margins, low debt, and earnings stability.

SZ: *How is KBK positioned to take advantage of the easing cycle and transmission of the rate cut (110 bps YTD)?*

KBK: Amid a sharp decline in GDP growth rate, the RBI cut the benchmark rate by 110bps so far this year, though the transmission of rate cut has been lackluster. The market as a whole benefit from the easing cycle as does the KBK portfolio of quality stocks though the fiscal boost specifically benefits our quality companies relative to others, in our opinion.

SZ: *Any predictions on the value of the rupee? I know a lot of US investors worry about the continued relative decline of INR against the dollar.*

KBK: In our view, near term USD/INR is likely to remain range bound with a weakening bias and continue to be pegged to USD/CNY movement. The currency saw a volatile August with huge depreciative swings led by Trump's renewed trade rhetoric. Such a move implied that global volatility, risk aversion and fear of weak global growth was back. This, combined with domestic political and economic noises, has given the currency a negative bias since August.

The KBK India Opportunity Fund approaches the currency conundrum by opportunistically hedging the rupee versus the dollar. An analysis of the spot movement of the USD/INR currency cross over the past 10 years shows that the depreciation in the spot price for that time period is less than the cost of hedging via forwards. As such, we utilize a quantitative hedging model that advises us to hedge the fund's INR currency exposure when tail risk (the risk of a large depreciation) it higher than normal. This approach is designed to capture the benefits of currency hedging without the prohibitively high costs. The factors of the model are grouped to create sub-models which feed into the overall model to provide us the hedge/ unhedge signal.

SZ: *How is KBK is uniquely positioned to take advantage of the above opportunities?.*

KBK: To take advantage of the India opportunity, one must be structured correctly as an investment entity. Many US investors and those investors outside of the US, do not realize that of the over 5,000 listed companies in India, they cannot legally invest in the overwhelming majority of them unless they are registered with the Indian government as a Foreign Portfolio Investor "FPI", as the KBK India Opportunity Fund is. That registration process, together with creating the operational and legal infrastructure to trade such names as a foreign entity, is not one for the impatient or unfunded investor. Nonetheless, it is critically important so as to be able

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access the middle-market companies that are positioned to benefit from the remarkable middle-class growth that will define India for at least the next decade. While these companies have almost no representation in India's headline market cap weighted indices, they are at the heart of the India opportunity. A portfolio of mostly mid and smaller sized companies in an emerging market falls into the "risk" bucket of an institution's overall allocation. Importantly, in India's case these companies and their stocks

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operate in a relatively closed economy. As such, they have a remarkably low correlation to the global equity market as a whole making them a great source of diversification. The India Opportunity Fund's USD daily correlation to the S&P 500 in since inception is 0.19.

The advantage we have over other strategies is our distinctive top-down approach to security selection and risk budget. As students of India's corporate earnings cycle and the corresponding stock factors that outperform on a relative basis at different parts of the cycle, we are able to create a fully diversified portfolio of long stock positions with none exceeding 2% of gross exposure. This avoids the risk that bottom-up strategies may be exposed to, which is too much concentration in a single name in a market that has well-known corporate governance/corruption risks (as do most emerging markets).

The fund's risk budget forces us to keep our hands on the handlebars in terms of risk. The risk budget ensures the fund has equal to or less downside deviation than the broader MSCI Emerging Market Index over rolling three year periods. This is where short positions and opportunistic currency hedging can play a large role in our process. What results is dedicated country fund with higher expected returns than the broader emerging market equity complex while providing a similar risk profile. For those allocators looking to become more granular in their emerging market allocations, which is a growing trend, the KBK India Opportunity Fund is a great place to start.

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SumZero is the world's largest community of investment professionals working with the industry's most prominent hedge funds, mutual funds and private equity funds. With more than 16,000 pre-screened professionals collaborating on a fully transparent platform, SumZero provides direct access to thousands of proprietary investment reports every year and fosters on-going communication within the network.

The research on SumZero cuts through the noise that pervades the industry and provides its community with in-depth, actionable investment research and data. SumZero offers several ancillary services in support of our research platform. These services include capital introduction, buy-side career placement, media placement and more.