India – Road to Recovery: 2021 and Beyond

Part 1

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This Q&A was adapted from a live webcast presentation Vinay and Sree did in March.

Having spent almost two decades focusing on this market, what do you like so much about Indian equities?

Vinay: Obviously, I am very biased but there are a number of things. First is the quality of companies that are available in India. In India, there are many privately-owned companies – family ownerships, not state ownerships – which are run in a multi-generational way, which we like.

Second – because capital has been scarce in India, we find that there is a higher consciousness of "return on capital" compared to some other places.

Third is that when you meet these Indian owners and managers, they are open to having discussions on the composition and independence of the board, remuneration, succession or even ESG matters, which are very long term and strategic in nature. These company meetings help us find alignment, which in turn allows us to have the conviction to buy these companies.

Another thing, if you look at the number of listed companies in the universe, India is one of the oldest stock markets in the world, and there are about 6,000 companies listed in India. Even if you apply basic governance and growth filters, there are more companies in India to choose from than other places.

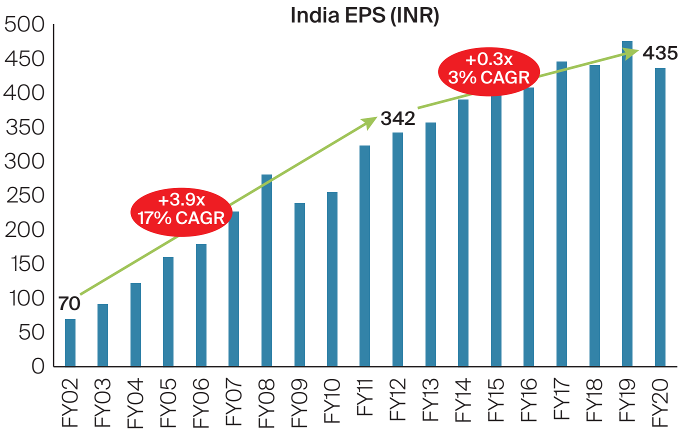
What is even more beautiful is that out of the 6,000 companies listed in India, there are about 700 companies with a market cap of over USD200 million. If you look at China, which has about 5,000 companies, there are 4,000 companies with a market cap of over USD200 million. That is around 80% versus 10% in India, which tells us that Indian companies are still small and that there is a lot of scope for growth in these companies. With 1.4 billion people, there is massive under-penetration across sectors.

Over the last 18 years, I've seen hundreds of companies creating enormous wealth for shareholders, and I think over the next decade or two, there will be even more companies that could do that in India.

India certainly seems very attractive in the long term. However, do you feel that we have actually seen the benefit of that growth in recent years?

Vinay: The answer is no. Between 2002 and 2012, Indian corporate earnings increased by almost five times, going from INR70 to almost INR350. But over the last eight years, it has been rather flat and things have not grown.

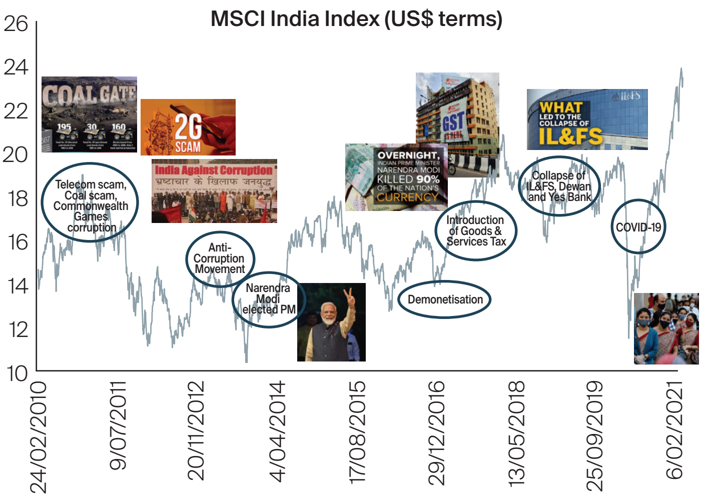
Earnings growth has been weak in recent years



Source: Edelweiss Securities, Nifty 50 Index EPS over FY02 – FY20, January 2021

There have been multiple headwinds that Indian companies faced over the last seven or eight years. Since the early 2010s, lots of corruptions and scams came to light and in many cases, the excesses of these events were felt in the Indian financial system. Indian banks found themselves in trouble, especially stable ones with broken balance sheets.

India has seen several disruptions over the last decade

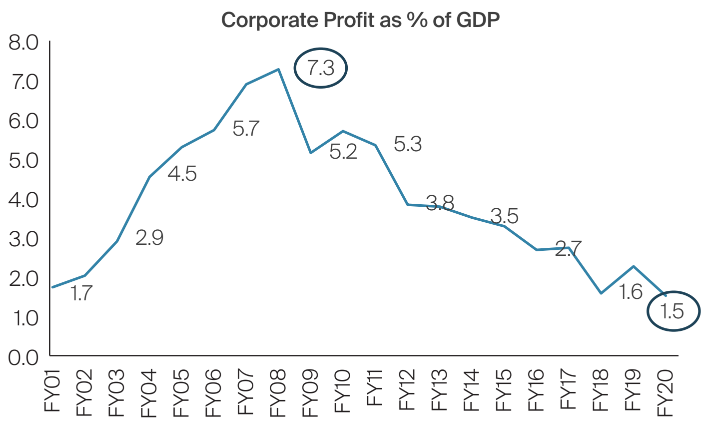


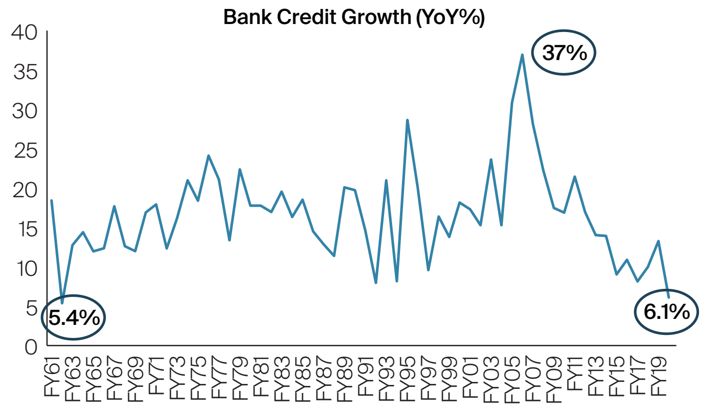
Source: FSSA Investment Managers, BusinessToday.com, Financial Times, Outlook India, December 2020.

There was a freeze in decision-making, there was a freeze in the economic system – and it resulted in a massive slowdown. The slack was then picked up by non-banking finance companies (NBFCs). By the mid-2010s, everyone wanted to go to India to set up a new NBFC and lend indiscriminately, and obviously, the writing was on the wall. By 2018, we had another blow-up, this time a non-banking financial crisis with a number of NBFCs going bust. So, that created another leg of uncertainty and lack of confidence in the system.

If we look at profits, over the last 20 years, corporate profit as a percentage of GDP is at 20-year low. If you look at bank credit growth in India, it is at a 60-year low right now. All this is because of what has been going on over the last 10 years or so.

Growth and profitability have fallen to the lowest levels in decades





Source: IIFL Securities, March 2021

In 2014, the Bharatiya Janata Party (BJP) came into power, and over the next few years, they started implementing a number of reforms and, to my mind, these reforms are very positive for India in the long term. For example, the implementation of Goods and Services Tax (GST) in India is, I think, the single most important reform that India has seen for many, many years. However, that has resulted in chaos and confusion in the short term and resulted, in aggregate, in a slowdown in the economy. Even at a sector level, there have been many reforms. For example, in the real estate sector, the implementation of Real Estate Regulation Act (RERA) created a slowdown in that sector.

So all these things, along with the crisis in the financial system, went against India over the past 10 years.

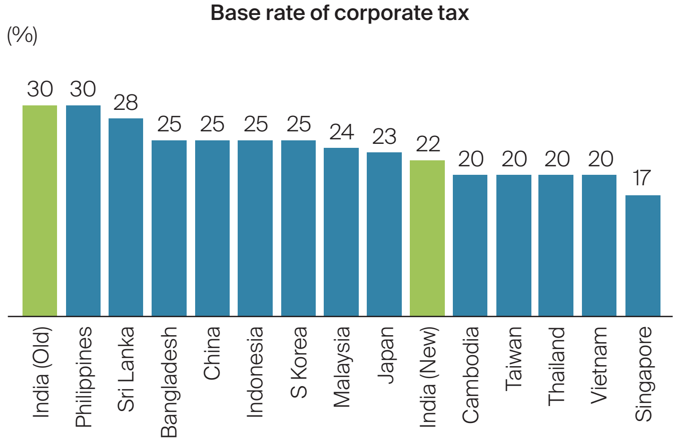
Do you see light at the end of the tunnel for India? Do you think growth is likely to improve going forward?

Vinay: I think things are starting to come together. Over the last few years, we had teething issues from the implementation of these reforms, but these issues have now gone and we are seeing an increasing rate of formalisation in the economy because of these reforms.

It is often said that India responds when its back is against the wall. When things are desperate politically, it becomes easier to implement reforms. As a matter of fact, some of these reforms were put in place to accelerate growth in recent desperate times, for example, the much needed Labour Law Reform, the corporate tax rate reduction, or the various incentives to increase manufacturing activity. We will have to see how these are being executed, but I believe these reforms are the right things to do for the long term.

Corporate tax rate reduction

Base rate of corporate tax

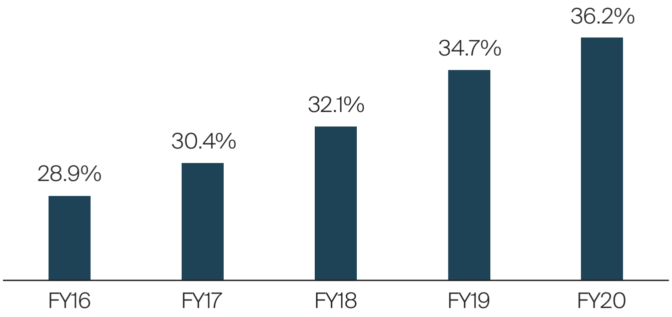


Source: Bennet & Coleman (October 2020), Kotak Securities (March 2020), Business Standard (November 2020).

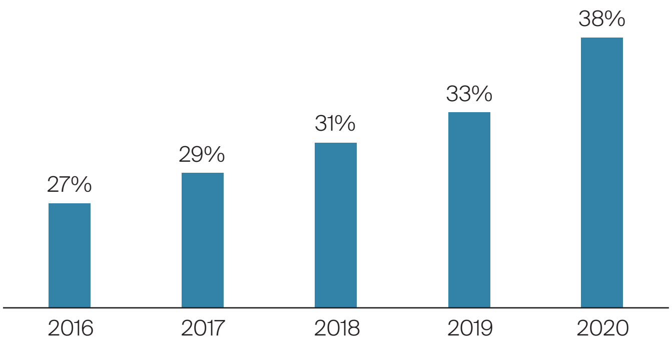
As a result of these reforms, we are seeing our company holdings across sectors gaining market share. Whether it is air conditioners (Voltas, Blue Star), biscuits (Britannia), banking (HDFC Bank) or the real estate companies – each of them are gaining market share because of the formalisation happening in the economy. The reforms have made it difficult for non-compliant companies, or businesses that were used to evade tax. These companies are losing market share, while quality companies are gaining share. As things start to improve from here on, these quality companies will be an even greater beneficiary of that.

Market leaders have gained share during the cyclical downturn

Voltas + Blue Star Market Share in Room Air-Conditioners

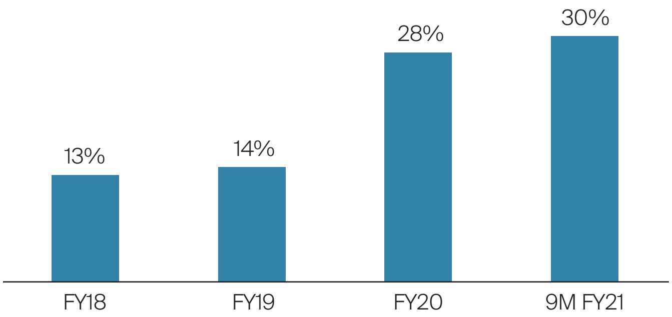


Britannia Market Share in Biscuits

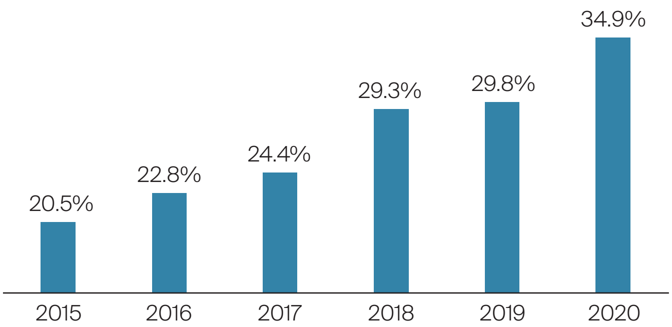


Source: Morgan Stanley, Company Presentations, FSSA Investment Managers, as of December 2020

HDFC Bank Incremental Market Share of Loans



Share of Top 10 Developers in 7 largest cities



Source: Credit Suisse (January 2021), Edelweiss Securities (September 2019)

In short, I think we are due for a bounce, not from a Covid-low, but from a multi-decade low in a cyclical sense, which falls into the long-term structural growth story.

How is the portfolio positioned and what is your outlook for India?

Vinay: The portfolio is diversified across many sectors where I think there will be lots of growth over the long term – consumer companies, financials companies, infrastructure and industrials. When I say infrastructure, we do not invest in asset owners directly, because they tend to be very leveraged and in many cases, corporate governance levels are very low. We invest in companies, which are suppliers to businesses that will benefit from rising infrastructure spend or industrial activity. These are companies that are market leaders with higher return on capital and have gained market share through the cycle.

Portfolio breakdown

Sector	Weighting*	Company
Consumer staples - Dominant franchises	25%	Colgate, Godrej, Hindustan Unilever Limited
Financials – Top banks and finance companies	19%	ICICI Bank, HDFC BANK
Consumer discretionary – market leaders in under-penetrated categories	22%	BAJAJ, VOLTAS
Infrastructure – picks & shovels	18%	HEIDELBERGCEMENT, SKF
Exports – IT services and healthcare	11%	Infosys, Mphasis The Next Applied
Turnarounds, undiscounted change and others	6%	QUESS DELIVERING GROWTH, TATA, JAGUAR, LAND ROVER
Cash	2%	

Source: FSSA Investment Managers, as of January 2021, *Does not aggregate to 100% because of inclusion of "Turnarounds & Undiscounted Change" with sector weights.

If you look at the top ten holdings in the portfolio, the names have not changed much. Going a few years back – if you look at the top ten holdings of our portfolio back then, you would still find the same names. The portfolio has evolved over the last few years, becoming more concentrated and it is now a higher conviction portfolio.

Top 10 Holdings

Company	Fund (%)	Sector
Bharti Airtel	8.7%	Telecom Services
ICICI Bank	7.5%	Financials
HDFC Bank	6.2%	Financials
Colgate Palmolive India	4.7%	Consumer Staples
Infosys Limited	4.5%	Information Technology
Godrej Consumer Products	4.3%	Consumer Staples
Dabur India	3.8%	Consumer Staples
Godrej Industries	3.3%	Capital Goods
Emami Limited	3.2%	Consumer Staples
Mahindra CIE Automotive	3.1%	Automobiles & Components
	51.0%	

Source: FSSA Investment Managers, as of January 2021

If you look back three years ago, the top 10 holdings were only 42% of the portfolio and top 20 holdings were 63% of the portfolio. The portfolio has become more concentrated since then.

In 2020, the pandemic presented a fantastic opportunity to invest in high quality businesses that we have been watching from the sidelines. Over the last few years, our residual cash position was quite high as our favourite high quality names became more and more expensive; but last year's sell-off allowed us to buy back these companies and now the portfolio is fully invested again.

If you look at the weighted average return on capital for the portfolio, it is at 38%. It is the highest that we have had for many years, which reflects the quality of the companies in the portfolio.

Portfolio Characteristics

	Jan 2018	Jan 2019	Jan 2020	Jan 2021
Top 10 %	42%	41%	46%	51%
Top 20 %	63%	66%	72%	74%
Cash %	13.4%	11.5%	9.7%	1.6%
Weighted average ROCE %	24.3%	16.0%	20.0%	38.1%
Weighted average 2 year EPS CAGR	18.4%	16.7%	7.6%	23.5%
Weighted average forward PE	25.4x	21.3x	26.2x	25.9x

Source: FSSA Investment Managers, January 2021

The earnings potential for these companies in the next two to three years is very strong and it is higher than what it has been in the last few years. Hence, I expect a lot of growth from our portfolio companies. I would also point out that these valuations are in the context of where everything is, or has been in the last few years, which is reasonable for such a high quality and high growth portfolio at 25x price-to-earnings (P/E). These valuations are based on the real earnings of real companies. They are not based on gross merchandise value (GMV) or on renewable energy, electric vehicles or internet companies. There is none of that. They are all real businesses.

Valuations are quite rich at the moment. How much of a bounce back and corporate earnings growth has the market priced in?

Vinay: As mentioned, the portfolio is currently valued at around 25x P/E, which is clearly higher than what it used to be six or seven years ago. I think over the last 12 years, with money printing and the zero cost of money, valuations of everything has gone up.

I do believe some of the earnings bounce back has been priced in, but it would be a mistake to just look at the earnings and say 25x is expensive, because these are companies that will compound earnings over the long term. They are market leaders in their own categories, where the category itself is small. They are companies that are gaining market share and have strong net cash balance sheets and have high return on capital employed compounding over the long term. Whether it is 25x or 20x will not matter. These are real earnings.

Do you see the impact of China-India relations on the portfolio?

Vinay: No, there is no impact on the portfolio. Not just from China-India relations but also the Sino-US trade war. Lots of multinationals corporations (MNCs) have been adopting a China-plus-one strategy for their sourcing requirements and India could be a beneficiary of that. With the reforms that have been put in place to increase manufacturing activity in India, I believe some of our company holdings may benefit from that. That said, we do not change our portfolios on the basis of such short-term noise.

How important is Prime Minister Modi to the continuing equity story and what are your thoughts on the recent social media crackdown?

Vinay: I am quite disappointed by the things that are going on – the increasing intolerance towards minorities or any kind of dissonance. Having said that, whether it affects the equity story or how businesses will evolve in India, I do not think so.

Since the early ’90s when the India market was opened up, we have had a number of things happen. We had a government that lasted for 10 years and a government that lasted for two weeks. We also have had a government that was supported by a very influential left.

If you are investing in the right companies that are in the right industries, with strong balance sheets and high return on capital, it does not matter, because the structural tailwinds of a young population, high aspirations and urbanisation – these are very strong structural tailwinds and I think India grows despite its government not because of it.

Sree: What we noticed over the past decade is that there has been some degree of policy continuity, regardless of which government is in power. It is not like an important law is introduced and then the next government comes and reverses it. To give you an example, in Malaysia, GST was introduced and when the government changed it was reversed. Whereas in India, GST has been in the making for the last 15 years, a period over which there have been different governments in power from different parties and ideologies. Each of those governments took the regulation forward and enacted it. It will continue forward. Nobody wants to take it back irrespective of who comes to power.

Have there been any concerns about liquidity, especially in the event of significant redemptions?

Vinay: Over the last 18 years of my career, I have always been mindful of liquidity. It all boils down to portfolio construction and how big a particular holding is in the portfolio. If it is a consumer business, which is very predictable and growing in an under-penetrated category, I find it very easy to have a big position in it. If it is a property company, for example, where its fortune or its destiny is not entirely in its hands – such as what is happening now in the economy with interest rates, currencies and sentiment – I would be more cautious with that position. Similarly, if it is a very illiquid company, I would not have a very high position in it. As a team, we have our risk parameters that we look at and stick to.

Have you made any adjustments to your portfolio in view of the recent budget? How much attention do you pay towards it?

Vinay: None at all. It is always an unknown event that is quite hyped up. I never make any portfolio changes based on the budget.

However, what was quite different this time was the tolerance towards a higher fiscal deficit, which was quite surprising. In any other year or in any other period of time, if such a high fiscal deficit was expressed, the Indian currency would have been smashed. That probably did not happen this time because governments are running deficits everywhere.

I think what was also different this time is the fact that foreign debt is quite low. India's forex reserve is quite high at around USD600 billion and at least it is a growth deficit. Historically, it was entirely about subsidies – for fertiliser, food and oil.

If an investor has allocated funds into an Asia or Global Emerging Market (GEM) strategy, how would you build the case for your Indian strategy as a standalone single country allocation?

Vinay: What you would find in most Asia or GEM funds, is that the Indian businesses owned in those funds are usually the big banks, such HDFC Bank, or IT companies, such as Tata Consultancy Services (TCS) or Infosys, and then maybe consumer companies like Hindustan Unilever.

This is an all-cap portfolio. More than 50% of the companies that we hold in the portfolio are small-caps and mid-caps, which you will not find in a regional portfolio that has 20% invested in India. These companies, as I was saying earlier, are market leaders, which are hiding in small-caps, and I believe over the long term will be multiple times bigger than they are today. Hence, I definitely see people who believe in India's growth story owning this as a standalone allocation.

Any particular reflections on navigating the portfolio during a Covid-19 environment?

Vinay: One of the key lessons was that things that we believed in strongly, as highlighted in our process and our philosophy, were further amplified during Covid. For example, one of the things that we do not like are companies that have leveraged up. When the pandemic hit, there was so much uncertainty with businesses largely shut down; and the first question we asked all our investee companies was, where do they stand from a liquidity perspective and how strong was their balance sheet? We were very happy to note that almost all of our companies had net cash balance sheets and all of them had very strong liquidity positions.

We think of risk as losing money and not underperforming the index; hence, capital preservation is key to us. It was with this mindset and survival instinct that we steered the portfolio towards safe, strong balance sheets, and the more liquid and bigger companies, which we believed would withstand volatility better during those uncertain times.

On the other hand, one of the learnings from last year is that I could have acted quicker and deployed cash faster. Having said that, I also think, from a prudence point of view, it was good to just watch and let things evolve before we invested.

What do you think sets you and the team apart from peers?

Vinay: It would be our philosophy and investment process – it is all that we have – and the discipline to stick to it. As a team, we think a lot about what we will not do, and then we just don't do it. To us, not everything has a price. If we do not find alignment in a business, or if we do not think the business is being run properly, we just will not buy it, no matter how attractive the valuations or the growth opportunity.

The discipline to stick to that philosophy is something that I think sets us apart. And also, we have a team of around 25 analysts who are very experienced, with many years of experience investing in India.

I think, over the years, our clients have come to understand what we are trying to do and they have been long-term supporters.

Source: Company data, as at March 2021