For professional clients only

First State Stewart Asia
– India Equities
Client Update
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FIRST STATE STEWART ASIA – INDIA EQUITIES

RISK FACTORS

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Making the same mistakes

Over the last few years, valuations have generally become expensive in our universe of quality companies. Valuations reaching these levels remind me of the mistakes I made running into the 2008 crash. Whilst it is hard to predict a market turn like that, some of the signs look eerily similar (as discussed in our previous newsletters). I have been keeping a close eye on my own behaviour with regards to the changes I have made in the portfolio recently, to consider if it is possible, with hindsight, I am committing the same mistakes I made ten years ago.

When I think back to that tumultuous time, I think I made three kinds of mistakes back then:

1. Sold some great businesses on valuations which seemed high on near-term earnings projections;
2. Went down the quality curve looking for cheaper valuations; and
3. Held on to mediocre businesses on high valuations by getting caught in extrapolating a spark of brilliance long into the future.

Ten years later I find myself struggling with similar challenges. In this newsletter, we look back at some of the difficult decisions that we have taken in the last couple of years, in an attempt to understand if they might be the kind of mistakes that we end up talking about in a few years' time...

Selling too early

Three years ago, in our client letter, we wrote about Eicher Motors, a 2-Wheeler (Royal Enfield) and Commercial Vehicle (Volvo-Eicher) manufacturer that we had known for over a decade. Noting the impressive turnaround executed by the impressive 2nd generation founder, Siddhartha Lal, we wrote *"The stock has been the top contributor to fund performance in 2014, rising as it did by ~200% in US$ terms during the year. As is often the case, however, the pendulum has swung too far in the other direction and valuations are stretched even after taking a long-term view. Sadly, we have had to significantly reduce this position"*.

As one might have guessed, over the subsequent FY2015-FY2018[1] period, Royal Enfield's volumes have doubled, while its larger peers like Bajaj Auto and Hero MotoCorp have grown their sales by circa 5%. Eicher's EBITDA[2] per motorcycle has also increased by around 25%. As a result, its share price increased by over 50% over the period. Eicher's runway for growth remains quite long. Its market share in the overall Indian motorcycle market is still only 6%, and management is now focused on building an international business, where it has a negligible presence. As it builds a stronger supplier eco-system and gains scale, profitability has scope to improve. We rarely find businesses which combine Eicher's quality of management, a brand as strong as Royal Enfield and its growth potential. However, given that it now trades on very expensive valuations (22x 2021 earnings) on aggressive growth estimates (more than 25% 3-year earnings per share (EPS) CAGR[3]) and profitability is at a life time high (23% net margin), we feel that the risk-reward tradeoff is unattractive. This is a business we would love to buy back (although arguably, we shouldn't have sold) when the margin of safety reappears.

Pidilite is another such business, of which we were long-term shareholders. It was set up by the Parekh family in the 1950s as a manufacturer of pigments and expanded into adhesives and sealants. They invested consistently in brand building and developed programs to engage with architects, contractors and masons who influenced consumers' purchases of Pidilite products. Over time, its key adhesive brand, Fevicol, became synonymous with adhesive in India. Under the new CEO, Bharat Puri, who previously headed Mondelez's global chocolate business, the company began to enter large new segments like waterproofing. In the past few years, Pidilite also witnessed significant

1 FY = fiscal year

2 EBITDA = Earnings before interest, tax, depreciation and amortisation

3 CAGR = Compound annual growth rate

margin improvement due to lower input costs (linked to crude). By FY2016, the company's net margin had risen to 15% vs. its historical range of 6-11%. Valuation multiples had risen too and we observed that some family members and professional managers had reduced their shareholding. We sold our holding, based on our concerns related to the sustainability of its margins. As it turned out, over the FY2016-FY2018 period, margins have sustained and the rating has gone higher still (now on 50x prospective earnings!).

Another example is Britannia, which has a 125-year history in India. Britannia is the market leader in the branded biscuits segment in India. We always believed that the company would continue to strengthen its market position. Half the biscuit market was comprised of unorganised players who sold unpacked products. They were losing share to organised players like Britannia as the tax administration improved and modern retailing evolved. Britannia dominated the market in premium categories like cookies and cream biscuits. With rising incomes, these premium categories were gaining share from lower-priced glucose biscuits. While the market moved towards Britannia's portfolio, it was also helped by the management of its largest competitor being distracted by family disputes. However, net margins – which used to be over 6% – had fallen to 2.7% by FY2012, due to high raw material costs, losses at its subsidiaries and high advertising spend. We built our position after gaining conviction that the management was making several changes to address these issues. As raw material prices stabilised, margins began to improve. Loss-making subsidiaries were shut down or sold off. This continued over the years, as a new CEO, Varun Berry, made further changes. One-third of its low-margin biscuit SKUs[4] were discontinued. Discounts to distributors were also cut and re-invested in advertising to support higher margin products. Consequently, net margins went back to 6% by 2014 and valuations re-rated to over 3x EV/Sales[5] (it was 1x EV/Sales when we built our positions). We sold, as we found the valuations expensive compared to its historical multiples and also to transactions such as Danone's sale of its global biscuit business to Kraft at 2.4x EV/Sales.

Since selling our position three years ago, Britannia's sales have grown at 10% annually. Its raw material costs have stayed low and management's efforts to shift its sales mix towards high margin products and gain efficiencies in its manufacturing and distribution have led to net margins improving to 10% (the highest in its history). Britannia is currently valued at over 6x EV/Sales and an astonishing 58x prospective earnings. This valuation is particularly surprising given that Britannia still has to prove that it would be able to pass on the impact of raw material prices when the cycle turns against them.

In hindsight, it may appear that we sold these businesses too early, perhaps anchored to past valuations. But some of these growth estimates and valuations appear too good to be true to be sustainable over a longer time period.

Going down the quality curve

An issue we have debated recently is whether some of our recent portfolio additions have led us down the quality curve. Specifically, we are referring to our holdings in the State Bank of India (SBI), Axis Bank and Bharti Airtel. As one might expect, the debates within our team have focused on the risks in each investment case, which we present below.

The profitability of both Axis Bank and SBI has been impacted by the deterioration in the credit cycle in India. Due to high non-performing loans (NPLs) in the SME[6], agricultural and corporate lending segments, credit cost has increased from 1.5% to 3.7% of assets for SBI and 0.6% to 2.7% of assets for Axis Bank over the last three years. Industry-level credit growth is also near a 60-year low. Therefore, return on assets for both SBI and Axis Bank are at cyclical lows, and valuations are well below their historical levels.

Additionally, the government's majority ownership in SBI means that the bank could be called upon to fulfil "national service" responsibilities. For example, it could be asked to acquire smaller, poorly-performing state-owned banks. Many of these entities have NPL, capital adequacy or return on asset levels which fall below the minimum standards set by the Central Bank. Any such acquisition will bring significant operational and credit risks to SBI. Over the long term, unless the bank is allowed to hire and compensate people without being bound by government regulations, its competitiveness is likely to be impaired.

In the case of Axis Bank, we are concerned about its relatively aggressive culture. During the years of a strong credit cycle, its management built large exposures to sectors such as infrastructure, which more conservative private sector banks avoided. This has led to its weaker credit quality today. We worry that some of these mistakes are being repeated in the retail lending

4 SKU = Stock keeping unit – or an individual item for sale

5 EV/Sales = enterprise value over sales – a valuation measure which indicates the markets' expectation for future sales growth

6 SME = Small and medium enterprises

segment, although our channel checks have come up clean thus far. Unsecured retail loans are the bank's fastest growing lending segment. This now accounts for 14% of its retail loans, after having doubled over three years. In our view, strong growth here comes with significant credit risks, just as some of its peers have faced in the past. We are also concerned about the frequent changes in top management, including the recent resignation of its chief information officer and the Central Bank's directive to the company's board to reconsider the re-appointment of its CEO, following which her tenure has been cut short (we expect a new CEO to be announced before September 2018). Such events could affect management's morale and make it more difficult for them to address the business's challenges.

As with SBI and Axis Bank, we recognise that our investment in Bharti is not without risks. Since Reliance Jio entered the market in September 2016, the Indian telecom industry has witnessed intense price competition. 95% of industry subscribers use pre-paid service plans. Jio has targeted these customers by introducing among the world's cheapest prices for 4G data and voice services. Incumbents like Bharti, Vodafone India and Idea Cellular have matched these offers to maintain their market position. Therefore, revenue per subscriber in India has fallen to US$2, which is a fraction of the amount seen in other emerging markets like Thailand (US$8), China (US$9) and Brazil (US$6). Revenue of the three large incumbents has declined by 20% over two years. Over the long-term, most of the economic value generated by the telecom industry in India has been captured by consumers, who benefit from exceptionally-low prices and the government, which imposes high taxes and spectrum charges on industry players. Therefore, Indian telecom companies have struggled to generate returns on capital employed above their cost of capital over the last decade. We have also been concerned about poor capital allocation by Bharti's promoters in the past. Only two years after launching its operations in India, Bharti invested in a Mauritian telecom company and bought a license for a telecom business in Seychelles, investing US$25 million along with its partners when its own revenues were only US$60 million. Recently, the group chairman also admitted that its acquisition of Zain Africa for US$10.8 billion in 2010 was a mistake. While the company bled cash in Africa for several years, management resources and capital could have been better invested to strengthen its infrastructure and customer franchise in India instead. Following the entry of Jio, it has been forced to accelerate its investments to build infrastructure in India. This has led to higher leverage than in most of our other portfolio holdings. Its Net Debt/EBITDA is 3.2x despite selling some of its stake in Bharti Infratel (its telecom tower subsidiary).

All this is not to say that there are no redeeming characteristics to these investments. For all their faults, these three companies are also strong franchises in their own right and are run by competent managers. In the case of SBI and Axis Bank, their survival across economic cycles over decades has been underpinned by strong deposit franchises, which continue to grow. Axis Bank has increased its market share of total deposits over the years whilst SBI, which controls almost 30% of the total deposits of the Indian banking sector, has maintained its deposit market share (unlike other state-owned banks that have consistently lost share). Therefore, both banks benefit from among the lowest costs of funding in the industry. Their management teams have performed credibly in other areas too. SBI has incubated several subsidiaries in adjacent businesses such as life and general Insurance, credit cards, capital markets and investment banking. By being one-step removed from government ownership, these are run as private sector businesses (no government regulations on hiring or employee compensation apply) and are joint ventures with leading global players such as BNP Paribas, Amundi and Carlyle Group. Based on their market-leading positions and high returns on equity, these subsidiaries should become larger over time. Axis Bank has also seen a significant transformation in its business over the last decade. It has built a stronger deposit base, as the share of low-cost retail deposits has increased from 40% to almost 70% over 10 years. At the same time, the share of more profitable retail loans has doubled from 23% of total loans in FY2008 to 45% in FY2017. Along with low funding costs and a strong fee-income business, this has allowed it to maintain among the highest levels of Pre-Provision Operating Profit/Assets in the industry.

For both Axis Bank and SBI, an improvement in the credit cycle should lead to higher asset growth and the high NPLs to be gradually reduced. They should earn higher return on assets over the medium term and this should be reflected in higher valuation multiples. Both banks are unlikely to face any capital adequacy related risks. The government has recently announced a plan to inject additional capital into state-owned banks, of which SBI is expected to be among the largest beneficiaries. Axis Bank has also received a US$1.8 billion capital injection from a consortium of investors led by Bain Capital – our recent discussions with them suggest that they are cognizant of the issues and are working on mitigating them via their position on the board.

In the case of Bharti Airtel, we are encouraged by its determination to maintain its market share and consolidate the industry, by acquiring Tata's telecom business as well as Telenor India. After these acquisitions, it has maintained its position as the market leader with approximately 40% revenue share. The company's management has also focused on improving its profitability in other businesses. It has exited unprofitable markets in Africa, following which its EBITDA margin in Africa has improved from 20% to 32%. Its non-mobile businesses in India (such as Direct-to-Home television and enterprise services) continue to improve profitability too. Therefore, consolidated EBITDA margin has marginally improved over FY2016-FY2018, despite much lower profitability in its core Indian mobile operations. Over the same period, its peer, Idea Cellular, has seen its EBITDA margin fall from 36% to 21%. Management's efforts to consolidate the industry and turn around its underperforming businesses give us conviction that as industry pricing stabilises, Bharti is likely to emerge as the long-term winner with higher profitability.

In affording them a space in our portfolios (only around 7%, in aggregate, is invested across all of them), we acknowledge the risks and keep a vigilant eye on them.

Holding on to mediocre businesses on high valuations

"We come from a low margin, B2B business mindset; cost and capital-consciousness is all we know. So we do not chase market share, we chase profits." Vir Advani, the 3rd generation of his family to lead Blue Star (an air-conditioning products and projects company), was laying out his vision for the future of the business. The Indian air-conditioner industry is at an inflection point. Penetration of air-conditioners in India is only 3% and industry volumes are expected to double over the next 3-5 years. While every competitor is chasing volumes, Vir's focus is on increasing Blue Star's profit share. After a long downturn in their projects business, new orders are more easily available here. But, he stressed the learnings from their past mistake of taking on too many low-margin contracts. His focus is to improve return on capital employed (ROCE) of the segment by focusing on profitability instead. He also described his intention to enter new, fast-growing categories like water purifiers, air purifiers and air coolers. But this expansion will happen in a cost- and capital-conscious manner – he will not bet the farm. After every interaction with Vir, our conviction in Blue Star's long-term potential has grown. Our discussions with him often remind us of those with a young Siddhartha Lal and our experience with Eicher Motors. But, as is our wont, we ask ourselves every now and then – is Blue Star really that good or are we making a mistake?

We find Blue Star to be at a similar stage today as Eicher was a few years ago. The turnaround at Eicher Motors was driven by generational change. Blue Star is at the early stages of such a change – Vir Advani was appointed group managing director in 2016. Both businesses have a long growth runway. Eicher achieved this by creating a new market segment. Blue Star benefits from the dismally-low penetration rate of air-conditioners in India and has doubled its industry market share over the last five years. Based on 1-year forward earnings, Blue Star is also similarly valued as Eicher was in 2015 (at 35x forward price-to-earnings). However, based on EV/Sales, Blue Star is valued at only 1.3x vs. 7.5x for Eicher Motors. The difference is due to its lower profitability. At its peak, Blue Star's net profit margin was 7.9% in 2007 and 2008 vs. only 2.9% in 2017, as the profitability of its projects business declined along with the weak economic cycle. Vir's focus on gaining profit share in air-conditioning products and improving profitability in the projects business should help the company achieve a step change in its net margins over the coming years. Combined with strong industry volume growth and its consistent market share gains, profits could grow multi-fold over 5-7 years. Our experience with Eicher has taught us that selling a high quality business run by an ambitious and committed steward due to expensive near-term valuations is a mistake. We are keen not to repeat it.

In summary

We are under no illusions that we won't make any mistakes with our investments. Neither are we ashamed to admit it when we do; rather, we look to learn from our mistakes. That said, we do feel the growing pains with each lesson learned. A bedrock to our investment philosophy is to protect our clients' capital. As a result, we obsess about the hidden risks in our portfolios. By discussing the mistakes made in the past and combing through our portfolios looking for similar ones, we find comfort in the belief that the companies we have partnered with are compounders of capital. We are also mindful of the Mark Twain quote: "History does not repeat itself, but it often rhymes." Analysing our past mistakes does not automatically future-proof our portfolios; but, constantly questioning and testing the quality of our companies takes away the worry of trying to predict the future, of which we are thoroughly incapable.

First State Indian Subcontinent Fund Class I USD

Annual performance (% in USD) to 30 June 2018

Period	12 mths to 30/06/18	12 mths to 30/06/17	12 mths to 30/06/16	12 mths to 30/06/15	12 mths to 30/06/14
Fund return	11.7	17.5	3.4	26.4	35.9
MSCI India Index	6.5	17.5	-6.5	3.3	27.4

Cumulative performance (% in USD) to 30 June 2018

Period	3 months	6 months	1 year	3 years	5 years	10 years	Since inception
Fund return	0.7	-3.8	11.7	35.7	133.0	297.6	960.1
MSCI India Index	-0.6	-7.5	6.5	16.9	53.8	65.7	493.0

Holdings by market capitalisation

Market capitalisation	< USD1 bn	USD1 bn to < USD2 bn	USD2 bn to < USD5 bn	USD5 bn to < USD10 bn	> USD10 bn
No. of holdings	15	10	8	3	10
% of fund	17.5	17.5	11.8	9.1	40.2

Fund since inception date: 23 August 1999. These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than the share class currency, the return may increase or decrease as a result of currency fluctuations.

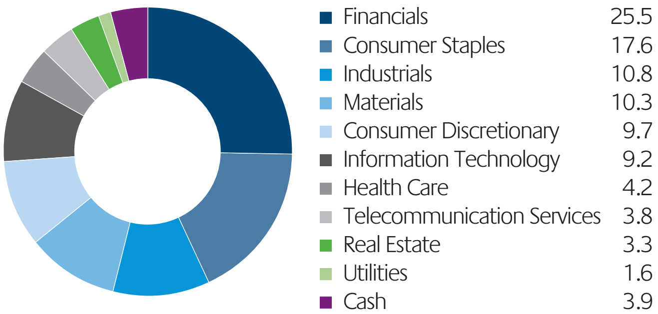
Performance data is calculated on a net basis by deducting fees incurred at fund level (e.g. the management and administration fee) and other costs charged to the fund (e.g. transaction and custody costs), save that it does not take account of initial charges or switching fees (if any). Income reinvested is included on a net of tax basis.

Source: Lipper IM/First State Investments (UK) Limited.

Top 10 company holdings (%)

	Sector	Fund
HDFC Bank	Financials	6.9
Kotak Mahindra Bank	Financials	6.6
Nestle India	Consumer Staples	6.0
Godrej Consumer Products	Consumer Staples	5.8
Housing Development Finance	Financials	4.2
Ambuja Cements	Materials	4.2
Jyothy Laboratories	Consumer Staples	3.9
Bharti Airtel	Telecommunication Services	3.8
SKF India	Industrials	3.5
Blue Star	Industrials	3.1

Sector breakdown (%)



Source: First State Investments (UK) Limited.

Note: The Fund may hold multiple equity securities in the same company, which have been combined to provide the Fund's total position in that company. Index weights, if any, typically include only the main domestic-listed security. The above Fund weightings may or may not include reference to multiple securities.

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