First State Stewart Asia - India Equities

India Update

September 2016

Travelling, and not arriving

In previous editions, we discussed the impact of generational changes amongst the owners of our holdings, and how the business families in India have responded to succession challenges. We continue to monitor such developments, in particular any resulting changes in the professional management teams, very closely. Encouragingly, we have encountered a number of positive changes in some of the companies that we have been watching from the sidelines over the last 12 months. We have taken a small stake in each of these businesses.

India's 3rd largest IT services company by revenue has an interesting history. It began business in 1945 as a vegetable oil manufacturer, forayed into soaps and other consumer products in the decades after, and got into manufacturing personal computers in the early 1980s. It was only in the 1990s that it jumped onto the Indian IT outsourcing bandwagon and swiftly became one of the market leaders. In 2000, it ranked number 1 based on its revenues of US$525m. Then, in the early 2000s, it started to lose its magic touch following the departure of some key people. It experimented with several management structures over the next ten years ranging from the founder-led model to one with joint CEOs running the business. In hindsight, these measures were insufficient in an industry which had become very competitive. As a result, its revenues grew at 12.6% CAGR over the last ten years versus an industry average of 16%. Earnings grew slower still, at 10.6% CAGR, reflecting the competitive pressures.

At the beginning of 2016, the company announced a leadership change as the COO was promoted to become the CEO. Before joining the company he was the COO of India's largest IT company. He is currently building a new leadership team, utilising talent from within and outside (some of his erstwhile former colleagues have joined the new team). We have spoken with the CEO and met with some members of the senior management team. Feedback from our checks in the industry have been encouraging. As a franchise, this IT company's problems seem to be a consequence of its concentration in industry segments that are going through a cyclical downturn e.g. their clients in sectors like Oil & Gas and Telecom, which form about 25% of their sales, are struggling. This reflects poorly on their management of such risks, but we wonder if valuations (12x PER on estimated March 2018 earnings, with little growth expectations, a net cash position of US$2.8 billion and a 2.5% dividend yield) reflect these financials accurately. Over the past decade, the company's earnings per share has compounded at the rate of 10.6% (in US$), only marginally lower than a competitor's 13.5%. Yet, the de-rating in this IT business' valuation (PER multiples) has been much more severe – from 20x in 2010 to ~12x now vis-à-vis peers.

If the new leadership can restore growth, it stands to gain from the dual impact of a revision in earnings growth estimates and a re-rating of the valuations. However, whilst we are enthused, there are reasons to be sceptical too. The CEO's letter to its shareholders in the latest annual report made us cringe. He set the vision as - *"To earn our clients' trust and maximise value of their businesses by providing solutions that integrate deep industry insights, leading technologies and best in class execution"*. The message one takes away from the letter is 'clutter', rather than 'clear'. Since we believe in 'travelling rather than arriving' and realise that any benefits from the anticipated changes will take a long time to show up in the numbers, we have built a small position in this IT services company. We will continue to engage with the company and build on our position if our conviction increases.

India's largest domestic pharmaceutical company is a similar story. It too has been left behind by its faster growing peers on account of its absence from the US Generics market. More importantly however, the company was left without proper leadership after the death of its former CEO in 2011. Some suspicious related-party transactions were discovered after his death, which sent shock waves through the company's corridors, and as a result, the founding family took longer than usual to appoint a new CEO. In 2013, they appointed an ex-Novartis executive as the CEO. We met him and the new team several times in the last three years, but were left unsure about the aggressive moves being planned. Moreover, the valuations during this period did not afford much scope for mistakes. However, in the last 12 months, this pharmaceutical company hired two senior executives from a competitor as the new COO and CFO. Recently, the CFO was appointed the CEO.

We met the new CEO and were quite encouraged by his plans. Meanwhile, the market's expectations have also been tempered and the valuations are more reasonable. In our view, this company's domestic franchise, with US$800m in sales, is quite valuable in itself. In fact, if we apply the multiples at which other domestic pharmaceutical franchises have been acquired in recent years, its domestic business alone would be worth at least as much as 80% of the current market capitalisation of the entire company. The management is focused on increasing total spend on Research and Development and building a larger US business, which should also improve margins over the long term.

However, it is important to remember that this company is trying to move away from its old contract manufacturing mindset, wherein it relied on its partners for growth and direction, to a new mindset that aims to build its own footprint in key overseas markets. This journey will be full of challenges and by no means easy or quick. Again, we have built a small position with a view to firm up our views in the near future and hopefully be a shareholder for the long term.

We have witnessed similar changes in two other smaller IT companies: one which is 70%-owned by Barings Private Equity, where a new CEO had joined from HCL Tech where he built a strong healthcare and infrastructure management business; and another which had recently been sold to Blackstone. The contours of these transactions suggest that these businesses will be run with more of a commercial mindset than before. Both look well positioned for next two to three years.

Another important management change amongst our top holdings took place at a Consumer Staples company where a new Chairman and MD was appointed last year. Coming as it does in the wake of the instant noodles episode, we believe this is a positive move and that it could mark an inflection point in the 100-year old Indian subsidiary of a major multinational consumer company regarding its expansion into newer products. Prior to his latest appointment, the new executive headed the business in the Philippines, and before that, North-East Africa and Singapore. Indeed, our recent meeting with the Chairman of the parent company suggested that the Indian subsidiary had not lived up to its potential in recent years (punched his palm in disappointment). He believes that the new appointee is the best man for the job in India, and perhaps, should have been here earlier (punched his palm again!). Immediate results (admittedly short term) have been encouraging – the instant noodles brand has regained most of its lost market share and there have been a slew of new product launches – something that has been missing for a long time.

Soaps and Bubbles

We have been shareholders in Indian consumer companies for a very long time. Most of them demonstrate the characteristics that we generally like – long-term owner families or multi-nationals, high quality management teams, pricing power afforded by strong moats, strong cash flow generation, growth visibility due to under penetration, rising incomes and favorable demographics. They truly are well placed to capture the opportunities created by rising affluence.

We continue to be long-term supporters and this sector still forms the largest part of the portfolio at about 25% of the First State Indian Subcontinent Fund. However, there are a number of things that concern us, especially now given that the valuations of Indian consumer companies are probably the highest they have ever been.

Distribution moat: Indian Fast-Moving Consumer Goods (FMCG) companies treat a number of stockists or sub-stockists as the primary customers, who in turn sell to 'mom-and-pop' stores or wholesalers. This group of customers has historically paid cash in advance and employed their own sales teams so that consumer companies do not have to employ thousands of 'feet-on-street' – this model has worked well for these companies for several decades. Given the complicated taxes across states, the sheer size of the country and significant cultural and language differences, this has also been a significant competitive moat against new entrants.

A few changes are gradually taking place though. First, the next generation of these stockists' families do not want to work in the family business with its typical 'hole in the wall' kind of office. They want a better working environment or wish to do some other business altogether – this trend broadly means that companies might need to incur higher distribution costs over time. Secondly, the introduction of the Goods and Services Tax (GST) will make it easier for this multi-tier distribution model to get simplified – e.g. companies will question maintaining warehouses in each state. Lastly, with online shopping gaining acceptance in India, it is perhaps becoming easier (at the margin) for new companies to launch their products more widely. All this points to a gradual erosion of the 'distribution' moat that large FMCG companies in India enjoyed.

Advertising expenditure: For many years, most of the advertising expenditure for these companies have been on television – and generations of Indian consumers before the advent of mobile phones would remember some iconic ads for many top Indian FMCG brands, which still enjoy tremendous brand recall. When I was growing up, we had only one television channel till the early 90s with limited hours of airtime. This meant that watching ads before a movie on Sunday was part of our entertainment time. Today, the media spending mix is rapidly changing with increase allocation to online and social media platforms. The younger generation does not (or need not) watch TV ads - entertainment has evolved drastically in the last few years giving rise to an overwhelming range of options - attention spans have also shortened correspondingly. We wonder what that means for brands in the long term. How can they engage with the younger people over the internet without annoying them too much by appearing too much on their Facebook pages? Will the whole industry become more promotion driven and hence more short term? If they do that, will they play into the hands of the new entrants selling on the internet?

For a long time, the bulk of Indian consumers were from the bottom of the wealth pyramid. This was a consumer who lived in a joint family set up where the basket of goods never changed. Today's consumers are more savvy, have higher disposable incomes, no longer live with an extended family and are used to expressing their individualism more than ever before. The range of options available to them are ever increasing (as some of the traditional entry barriers are fading) which means that they are no longer beholden to any brand loyalty, but are more fickle.

Return on Capital Employed (ROCE): Colgate spends 17% of sales on advertising – and they pay these TV companies after more than 120 days – this means a huge negative working capital for them. Now with the changing trends in media spending and also with the consolidation of distribution channels (which pay in advance or cash today) – does it mean that ROCE of consumer companies will fall dramatically over the next ten years?

ROCE % CY15/FY16	Indian Subsidiary	Parent (unadjusted)	Parent (adjusted for goodwill)
Unilever	100% *	18%	40%
Nestle	88%	12%	20%
Colgate	71%	44%	70%

*Capital employed is negative
Source: Bloomberg, FSSA Investment Managers

The above concerns are obviously exaggerated and even if material, they will only start having an effect in the very long term. Probably, when modern retailing first burst onto the scene in the western markets – similar questions were asked of Colgate and Unilever. Also the better-run companies will continue to find ways to launch new products which the next generation wants and will continue to find ways to engage with them through newer mediums. It is just that there appears to be a lot of uncertainty in the horizon that the current valuations do not factor. But then again, whilst a semblance of broader growth remains elusive and money is for free – these businesses, which will definitely keep growing, will probably continue to trade on very expensive valuations. But the market caps are a lot bigger now and finding growth will not be easy from here on. We are hopeful that the businesses we own will make necessary amends and we will continue to engage more with our companies on this.

First State Indian Subcontinent Fund†

Cumulative performance (%)

	Since Inception	5Y	3Y	1Y	YTD	3M
First State Indian Subcontinent Fund	100% *	18%	40%	40%	40%	40%
MSCI India Index	88%	12%	20%	20%	20%	20%

Calendar year performance (%)

	2015	2014	2013	2012	2011	2010
First State Indian Subcontinent Fund	5.1	45.6	7.3	29.9	-22.3	30.7
MSCI India Index	-6.1	23.9	-3.8	26.0	-37.2	20.9

Holdings by market capitalisation

Market Capitalisation	< US$1 bn	US$1 bn to < US$2 bn	US$2 bn to < US$5 bn	US$5 bn to < US$10 bn	> US$10 bn
No. of holdings	15	8	6	29.9	-22.3
% of fund	19.8	12.2	12.7	26.0	-37.2

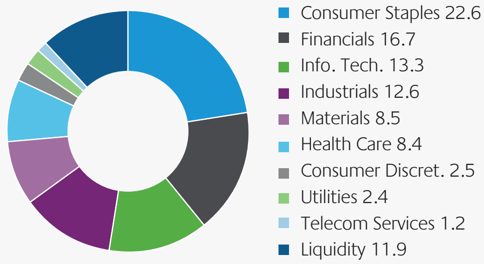
Source: First State Investments as at 31 August 2016.

Holdings (%)

	Sector	Fund Weight
Nestle India	Consumer Staples	5.3
HDFC Bank	Financials	4.6
Infosys	Info. Tech.	4.1
Wipro	Info. Tech.	4.0
Cipla	Health Care	3.8
Hindustan Unilever	Consumer Staples	3.3
Kotak Mahindra Bank	Financials	3.2
Tube Investments of India	Industrials	3.2
Dabur India	Consumer Staples	2.9
Container Corporation of India	Industrials	2.9
Top 10		**37.2**
Top 20		**61.7**
Total Holdings (44)		**88.1**
Liquidity		**11.9**

Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 August 2016.
* The First State India Subcontinent Fund Class I (USD - Acc) - inception date: 23 August 1999.

Sector breakdown (%)



† The First State Indian Subcontinent Fund is not available for investment by US persons.