Fund Manager Q&A
March 2021

India – Road to Recovery: 2021 and Beyond

Part 2

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Vinay Agarwal, Director, *joined FSSA Investment Managers in 2011, with a focus on the Indian Subcontinent Markets in particular and Asia Pacific equities in general. Vinay is lead fund manager of the FSSA Indian Subcontinent Strategy and the FSSA Asia Focus Strategy.*

Sree Agarwal, Investment Analyst, *joined FSSA Investment Managers as a graduate in 2014, providing research support to the portfolio managers, with a focus on Australia, India and Southeast Asian markets. Sree is also the co-manager of the FSSA Indian Subcontinent Strategy.*

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

Could you explain your investment approach to ESG?

Vinay: Our entire research process is predicated on establishing whether a company is good enough quality in the first place to be investible or not. We do not believe that there are perfect businesses. There are shades of gray in every business and once we establish that a company is investible, we will focus on the darker gray areas and start engaging with the company.

In the Emerging Markets or Asia, we have to remember that these are family-owned companies. When we are engaging with them in meetings or writing letters to them (we are always writing letters to them and I am sure some of them dislike us for that), a very hard stance of an activist manager does not work. We have to take a softly, "nudge-nudge" approach – it takes time, over many years. We have to demonstrate to these companies that we are long-term

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partners and are not just in it for a quick buck. We need to earn the right to engage as long-term shareholders and see ourselves in the same boat as them.

What we are focused on, through these engagements, is not whether the company agrees with our view or not, but rather how they approach it and whether they are open to listening to a stakeholder. That tells us something about the culture of a company. Today, it could be a shareholder, tomorrow it could be a vendor or distributor – their approach tells us about their culture and that is the key thing we take away from these engagements.

In our team, we often say that it is better to travel than to arrive and we see the relationships with these companies as a journey.

Could you share some examples of past company engagements?

Sree: We have always held Mahindra Group in high regard and they have high governance standards. One of the things we like about them is that they have a federal structure, where the chairman, Anand Mahindra, hired very high quality, professional management and gave them the freedom to build big businesses. However, over time, we noticed that because of this federal structure and the different businesses being built – some taking a longer gestation period than others – the capital discipline in the group deteriorated somewhat.

Hence, a year ago, we wrote a letter to the chairman, highlighting some of these issues and our concern about the deterioration in capital discipline. He acknowledged all the issues in his reply and highlighted the changes that they are making, such as making policies more stringent when they are allocating capital. Not only that, but to our surprise when we met with the newly appointed deputy CEO, Dr Renishaw, he had our letter in hand, forwarded to him by the chairman. During our meeting, Dr Renishaw again highlighted all the changes that they were making on their capital allocation policies. Thus, through this engagement, it further increased our conviction in our holdings and towards the Group.

Another example that comes to mind would be Blue Star, which is another company that we have been invested in for many years. A few years ago, they appointed a couple of new board members, and we were concerned over some of the other boards that these independent directors were sitting on. We highlighted this in a letter to the CEO, and in his reply, he explained all the reasons why they were brought on, the capabilities and skills the company was looking for and the years of experience these new directors had.

His view was different from ours, but we really appreciated the time he took to explain to us his perspective. In other words, it was more about that process of engagement and the approach he took towards it, rather than whether or not he agreed with our view.

We also see ourselves as responsible members of a broader ecosystem. We believe we have duties and obligations. For example, when the central bank in India introduced a draft regulation, we had a different view on it and so we collaborated with a like-minded investor to engage on the draft regulation.

Collaborative engagement with other stakeholders

Key issues:

1. Creating a blanket regulation to limit the tenure of CEO and directors due to poor governance standards at a few companies may have the unintended effect of constraining all banks. (July 2020)
2. There are several examples of global CEO's who have run banks successfully over 10 years and beyond.
3. Continuity in management creates a consistency in organisational culture and attitude towards risk, which is critical for the performance of banks
4. Request to re-consider the limits on tenure of CEO's and Directors suggested in the draft regulation.

Conclusion: CEO's of Kotak and HDFC Bank have built their banks into the most successful and best reputed banks across emerging markets. The proposed regulation seeking to put a cap on their tenure risks creating sub-optimal returns for shareholders, as well as having a detrimental impact on the development of India's banking sector. As long term stakeholders, we must engage with the regulator on this issue.

Source: FSSA Investment Managers

Earlier you mentioned that some of these engagements may take years. Could you share some examples of an engagement that took place over multiple years?

Sree: We have been engaging with Godrej Group on different issues over the years. For example, in December 2012, we wrote a letter to the chairman, highlighting the growing need to source palm oil more responsibly. In his response, he accepted the issues and mentioned all the changes that they were making there.

More recently in 2019, as plastic packaging was becoming a more serious issue, we highlighted this and introduced them to a firm, Polymateria, which came up with a solution for biodegradable packaging. The CEO of Godrej Consumer Products got in touch with the company and began a pilot program. Godrej even helped Polymateria get their certification in India so that they could scale up their solutions.

Were there any examples of companies that, because of your engagement, took two steps forward but later took a step back?

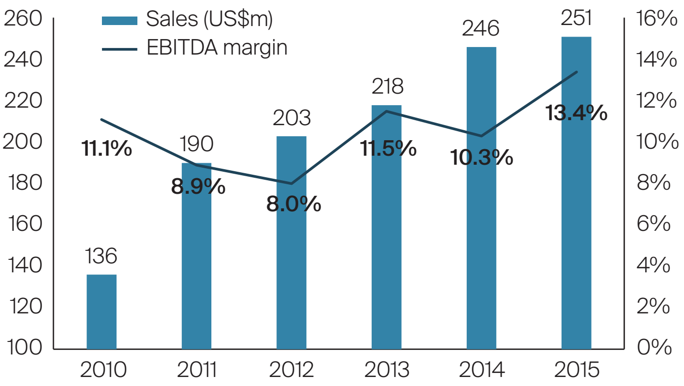
Sree: There was one company, Jyothy Labs, which we owned for a few years. Jyothy Labs is a fast-moving consumer goods (FMCG) business and they became successful with a fabric whitener. They listed in the mid-2000s, and in 2012, they acquired Henkel India's consumer business, which brought with it a lot of debt.

They hired a professional CEO, Mr Raghunandan, who we have high regards for and have known for many years as he has held senior roles at Dabur India (another company that we have owned for many years). We knew he had the capabilities to turn Jyothy Labs around and so we initiated a position in the company.

Over the next three years, Raghu did exactly what we had expected – the acquisition was integrated, debt was reduced, there were very strong cash flows, margins improved and shareholder returns were very strong over this period.

Our meeting in 2015

Jyothy Labs Revenue Growth



Meeting Note in 2015 – *"The new management has done its job by turning around Henkel's loss-making business. The growth opportunity is significant. It seems very likely that Henkel will exercise its option to take a 26% stake, with them eventually going to a larger shareholding over the years."*

Source: FSSA Investment Management, Company Annual Reports

In 2016, Raghu resigned as the promoter family started to take on larger roles in the business. We wrote to them explaining these issues and the implications it had on the professionals who are part of the company. They were very willing to listen to us and told us that that is why they continue to look for good quality professionals.

Our Engagement Journey with Jyothy Laboratories

Our letter to the management	Management's response
Key issues:	**Key issues:**
We refer to several events in the recent past that concern us, specifically: 1. The untimely exit of Mr. Raghunandan as the CEO. 2. The delay in cementing a partnership with Henkel. 3. The appointment of key family members to senior executive positions.	I like the way they want to listen. We made the point that we come across many small companies who become mid-sized but only a very few go on to become large businesses and Jyothy has that opportunity if they were to join hands with Henkel. Henkel wants to buy more than 26%. They want management control and this is where they are stuck. It continues to be an option but I will not pin my hopes on it.

Meeting Note in 2016 – *"The founder and CEO have fallen out here. The family is stepping in temporarily. The talks with Henkel continue. We are engaging with them to introduce Henkel as a partner."*

Source: FSSA Investment Managers

However, in 2019, it became evident that instead of professionalising, the family was taking a step backwards by appointing younger, inexperienced family members to senior roles and giving them large responsibilities in the company. The promoter's daughters were appointed CEO and CFO, and their husbands given senior roles in the IT and supply chain departments. We had a series of meetings with the newly appointed CEO over the years and we realised that the new management did not have the skills or the experience to run the company, especially in a highly competitive environment where you have world class multi-national corporations like Reckitt Benckiser or established domestic leaders like Godrej Consumer. As a result, we divested shortly after, which is disappointing but it happens.

Jyothy Labs Share Price

2019 Conclusion – *"It is a shame that a good business will be destroyed because the family is adamant to maintain its control, just so that each of them has something to do. A shocker of a meeting with the next CEO."*

Source: FSSA Investment Managers

The team has been particularly strong on the G (governance) side of things. What about the E (environmental) and S (social)? How do you feel those themes have evolved, as part of the team and from an India equity context?

Vinay: I think when you are investing in companies, if you get the G right, the E and S will come. In these markets, most of the time it is not that these companies do not want to do the right thing. It is often that these companies do not know much about it. When the governance is right, they just need some hand-holding or nudging to work out better E and S practices. I find companies producing the thickest sustainability reports usually run the most unsustainable businesses. Hence, getting the G right is the most important thing and we have focused more on that. As far as E and S is concerned, we are learning and we are trying to get better at it.

Do you have any thoughts on Reliance?

Vinay: Reliance is a company that we have never owned, in the whole of our history over the last 35 years. One of the reasons for this is because we believe the way they gain competitive advantage by influencing policymaking is not sustainable. Having said that, things seems to be improving over the last few years, with the board becoming more independent and appointments of new auditors and partners. Yet, I do not feel comfortable owning them and as things stand today, I do not think we will be adding Reliance to our portfolios.

What are your thoughts on initial public offerings (IPOs) and are there any specific sectors that you would focus on to look for them?

Vinay: We usually do not invest in IPOs and there are a number of reasons for that. One being we like to see the track records of companies; and as we have been talking about, we see it as journey, so we like to know our companies very well before we invest in them. Secondly, when these companies come to a listing, they usually sell at very high valuations, since there is an information arbitrage against you, somewhat of a price arbitrage against you.

That is not to say we have never invested in IPOs. If I look back over the past 10 years, we have participated in around four or five IPOs across sectors. In that sense, there are no sector preferences, but there are certain sectors that tend to have certain characteristics that we like – such as high return on capital employed, high pricing power and economic moats. With that said, it all starts with a reluctance to invest in IPOs in the first instance.

What is your view on the Indian quick-service restaurant (QSR) space, companies like Westlife, Burger King or Dominos? Is it attractive, given the easing of lockdowns and expected pent-up demand?

Vinay: We used to own Jubilant Foodworks, which is the Dominos franchise in India. I think it is a very high quality business with a good management team. It is just that the valuations are very expensive and we sold it when it got too expensive for us. On Westlife, which is the McDonald's franchise in India, I have reservations on the governance side and also the high royalty rate that Westlife has to pay to McDonald's.

Jubilant Foodworks has to pay a royalty to Dominos too, but at a much lower rate than Westlife pays to McDonald's. And the average bill for a pizza at Jubilant is much higher versus a burger at Westlife. That makes the margins easier, in the case of Jubilant versus Westlife. But it will be a challenge to improve their margins in the long term and the valuations are ridiculous in that context.

Burger King was listed recently, but I find myself misaligned because the parent is owned by private equity and this business, which is listed in India, is also owned by private equity. Private equity firms tend to have a short-term time horizon on their businesses, which we do not like. They have quite aggressive targets on store openings, which I do not agree with. So, I would wait and watch to see how things go.

With regards to India REITs, if in the future more of such firms emerge, will you be tempted to invest in them?

Vinay: I feel misaligned as a minority shareholder with the REIT managers. It is a very recent phenomenon and we have met some of them, but I did not feel particularly compelled to own any.

Sree: The fees that the manager gets is based on growing their asset size – the larger the asset size, the higher the fee. That is what they are incentivised to do. Therefore, that does not necessarily always translate into higher earnings per share or dividends per share and at least 90% of the earnings has to be paid out. In so many cases, owners would keep injecting assets owned by them, which are outside of the REITs. We do not get much comfort on owning REITs.

Is your thesis on Indus Motors still intact?

Vinay: Indus Motors is the leading car company in Pakistan. Toyota owns 40% and the Habib family in Pakistan, which is one of the better, more renowned families in Pakistan, has an almost equal ownership. From a governance and management point of view, we have met the CEO a number of times and we feel he is quite capable.

Indus Motors is the leader in terms of market share and the Pakistan market is one of the most under-penetrated car markets in the world. I think that market penetration will increase, which was happening until two or three years ago when Pakistan had some issues. The valuations are incredibly attractive, trading on 10x P/E with 8% or 9% dividend yield. The market cap of the company is about USD500 million, which is almost 50% market share. I think it is still very attractively valued.

What are your thoughts on Asian Paints and the overall outlook for cement companies?

Vinay: Annually, as a team, we run an exercise to list the best companies that we do not own and the worst companies that we do own; and for years, I have written Asian Paints as the best company that we do not own in India.

It is a fantastic business, but I just cannot digest the valuations that it trades on. Very recently, it has corrected a bit, trading on 100x P/E, but I would wait. I believe if oil prices continue to go up, in the near term there could be headwinds for their margins and the market could get frustrated with that. That said, they have so much pricing power that in a couple of quarters, they will be able to pass that along with price hikes. At the moment, it is still very expensive.

On cement, it depends on which region you are looking at. In India when you are looking at the cement industry, you have to look at the North, East, South, West and Central regions separately. I find that the Central region's demand and supply situation is quite favourable. We own a cement company, Heidelberg Cement, and have done for some time. I think Heidelberg as a parent, in terms of governance and treating minorities in a listed subsidiary, has been fair over time. We find comfort in that. Even in terms of thinking about ESG risks, we find comfort in the way the CEO, Jamshed Cooper, thinks about ESG headwinds.

Sree: They are always setting industry-leading standards. As an example, employee safety in cement plants is really important and a lot of India cement companies have not done too well in that regard. Heidelberg tried to create a cultural change where the plant manager has the final responsibility. All the systems and processes are set up to give responsibilities to the plant manager whose incentivisation is directly linked to the safety of employees.

Not only that, while others optimise their raw materials based on the lowest cost, Jamshed optimises it not only for cost, but also for the sustainability of those raw materials. A few years ago, there was a regulation introduced in India where certain raw materials that were very energy intensive were not allowed to be used anymore. Heidelberg was not affected because they were ahead of the curve and had already stopped using them.

Vinay: From an industry point of view, in the longer term it is quite positive as there will be infrastructure spending and housing demand, which is underpenetrated at the moment. These will increase demand for cement.

What are the biggest risks to your portfolio?

Vinay: I think ESG-related headwinds will become more and more critical for businesses over time and that could be a risk. If 1.4 billion people have to grow at a fast pace for all of this growth to materialise, that will put enormous pressure on resources, and if companies are not thinking about the ESG headwinds that they are going to face in the pursuit of this growth, they will struggle.

Secondly, I think the unemployment situation in India is quite dire. India produces more than 10 million people who join the workforce every year and we are not creating enough jobs for them. A demographics tailwind can become a significant headwind for India if the unemployment situation worsens. It is somewhat a ticking time bomb, so I am worried about that. However, looking at what has been happening recently in terms of pushing manufacturing activity and putting out the right reforms to do that, I'm hopeful – but that is a risk as well.

Source: Company data, as at March 2021

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