FSSA Investment Managers

December 2021

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Monthly Manager Views

FSSA Regional India Strategy

Mistakes of Omission

50x P/E![1] 70x P/E! 100x P/E! Valuations that were outrageous just a few years ago are commonly bandied about by most of the investment community these days. But, ask any respected business owner and they would shake their head in disbelief. The difference in perspective is critical. The entrepreneur is looking at the free cash flows the business could generate over the long term, and how long it would take to recoup his or her investment if they were to buy a business in its entirety. At 80x P/E, which is not uncommon in India these days, it would take a full 19 years to recover the purchase cost, even if the business' underlying cash flows (or earnings) compound at 15% annually, and there is no re-investment to achieve this growth. Business owners whom we rate highly would not allocate capital to such opportunities. Yet, we have seen many listed companies in India witness a significant re-rating of valuations in recent years, on the back of which they have delivered exceptional shareholder returns. Our decision to not invest, or sell out of such businesses on valuation grounds have been our mistakes of omission. Yet, when we analyse these errors, as we always do, we believe that these decisions were in keeping with our disciplined investment process, which has withstood the test of time. We discuss a few below.

We were long-term shareholders of Pidilite until we sold our shares in 2015. The Parekh family have been excellent stewards of the business and introduced top-quality professional management, including CEO Bharat Puri, whom we had known since his days heading Cadbury India. We admired Pidilite's ability to build and nurture strong brands that command a price premium in categories that are otherwise commoditised, such as Fevicol in adhesives. The management is also pursuing opportunities in categories like waterproofing, which can become big businesses in the coming years. With healthy Returns on Capital Employed (ROCE) (5-year average ROCE during the 2010-2015 period

[1] Price to earnings

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- **Indian subcontinent risk:** although India has seen rapid economic and structural development, investing there may still involve increased risks of political and governmental intervention, potentially limitations on the allocation of the Fund's capital, and legal, regulatory, economic and other risks including greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.
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was 25%) and decent growth rates (sales growing at roughly 17% compound annual growth rates (CAGR) in that period), it was a core holding of ours. Given the high quality, it was not "cheap", trading at around 22x P/E during the 2012-2014 period. Subsequently though, valuations kept rising and by 2015 they had gone past 40x P/E — a level that was higher even than fast-moving consumer goods (FMCG) peers Hindustan Unilever and Nestle India at the time! At this point, we reluctantly sold our shares, confident that we would get the chance to buy them back at more sensible valuations. Unfortunately, since then, we have seen its valuation multiple double to over 80x today. While we admire the business, its people and the opportunity ahead of it, we simply cannot fathom paying such multiples.

Instead, Colgate-Palmolive (India) and Godrej Consumer Products are today still among our largest holdings. Colgate's brand in oral care is unrivalled. It had lost some market share in recent years, as the herbal segment grew rapidly in India. Under new CEO Ram Raghavan, it has stepped up its investments in brand building and launched innovative products, which has begun to yield results in the form of market share gains. Over the medium term, it also has the opportunity to launch other leading brands from its parent's portfolio. Godrej Consumer Products has faced some challenges across its geographies (notably Africa) in recent years. In response, its board has appointed several strong professionals, including Sudhir Sitapati, who has spent over two decades at Unilever, as its CEO. Mr Sitapati recently laid out his plans to accelerate Godrej Consumer's growth and improve its profitability over the medium term. We expect the company's performance to improve under his leadership.

When we view the performance of our holdings against Pidilite, we note that Colgate has grown its earnings per share substantially faster over the last five years. It generates exceptionally high ROCE as well. Despite the challenges across Godrej Consumer's businesses, earnings have also grown faster than at Pidilite over this period and its ROCE is only slightly lower. Yet, valuations of both Colgate-Palmolive India and Godrej Consumer are at approximately half of Pidilite's levels (though admittedly, still high in absolute terms). Based on the strength of their franchises and the improvement we expect under their current management teams, we find the risk-reward with these companies to be much more attractive.

INR	5-year Earnings Per Share CAGR (FY16 - FY21)	Pre-Tax Return on Capital Employed (FY21)	March 2023 Estimated P/E
Pidilite	8.6%	29%	80.4x
Colgate-Palmolive (India)	12.4%	348%	34.8x
Godrej Consumer Products	9.0%	23%	42.9x

Source: FactSet, as at 31 December 2021

We were anchor investors in the Initial Public Offering (IPO) of Avenue Supermarts in 2017. After its valuations more than doubled after listing to over 50x forward P/E, we felt compelled to sell our holding. It is currently valued at 7x forward Enterprise Value (EV)/Sales and 115x forward P/E, compared to industry leaders such as Tesco, Sun Art and Dairy Farm which are valued below 0.5x EV/Sales and at 12x to 20x forward P/E. In fact, Avenue Supermart's market capitalisation of USD 40bn is 35% higher than that of Tesco, while its sales are 1/23rd and profits are 1/18th of Tesco. Similarly, we find it difficult to pay 9x forward Price to Book (P/B) for India's largest non-banking finance company valued at USD 63bn, when ICICI Bank, with a leading deposit franchise, has a market capitalisation only 20% higher and forward P/B of 3x. In some instances, our mistakes of omission have been for reasons other than valuations. We have not owned one of India's largest conglomerates, due to our concerns around its governance practices and culture. The company is known for using its connections in the government to change policies and regulations in order to benefit itself or exert pressure on its competitors. We simply do not view this as a sustainable competitive advantage. Irrespective of how attractive its prospects or valuations become, we would not own such a business.

Fundamentally, our investment philosophy is focused on capital preservation and absolute returns and as such, we accept these mistakes of omission as an outcome of our adherence to it.

Performance Commentary

The FSSA Indian Subcontinent Fund rose in December. The key contributors to performance were **Infosys and Godrej Industries**.

Infosys gained following the announcement of strong quarterly earnings and an upward revision of earnings guidance by one of its leading global peers. This indicated that customer demand for information technology (IT) services outsourcing remains strong.

Godrej Industries rose following an increase in the share price of Godrej Consumer Products, after its new CEO, Sudhir Sitapati announced the medium-term ambitions and strategy for the business. Its stake in Godrej Consumer

Products accounts for 45% of the net asset value of Godrej Industries.

The key detractors were **Solara Active Pharma and Kotak Mahindra Bank**.

Solara Active Pharma declined due to concerns about inflation in prices of its key raw materials. Our discussions with the management reassured us that the long-term prospects are still bright. The management has an ambition to grow revenues nearly four-fold over the next five years.

Kotak Mahindra Bank declined due to concerns related to the emergence of a new variant of Covid-19, which could lead to disruptions in economic activity. The bank has built a strong track record of withstanding such disruptions while maintaining strong asset quality. We expect this to continue.

Composite Performance (to 31 December 2021)

Discrete 1 Year Returns	12mths to 31/12/21	12mths to 31/12/20	12mths to 31/12/19	12mths to 31/12/18	12mths to 31/12/17
Indian Subcontinent	22.51%	11.08%	5.18%	-6.42%	41.10%
MSCI IN Gross	26.66%	15.90%	7.58%	-7.30%	38.76%

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 USD, the return may increase or decrease as a result of currency fluctuations.

The strategy performance figures is the weighted average performance of FSSA IM's funds that contribute to the strategy in question, is based on monthly performances and are net of a default annual management fee of 0.85%. The strategy was launched 7 February 1994.

Source: Lipper IM / First Sentier Investors (UK) Funds Limited.

*Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 December 2021 or otherwise noted.

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