

FIRST STATE STEWART ASIA – INDIA EQUITIES

Will he or won't he?

A worried client asked us recently, *“Will Mr Modi be re-elected, or won't he? How will the ongoing elections impact the investment case for Indian companies?”* We don't know whether Mr Modi will be re-elected. But we strongly believe that the results of the election will have little bearing on the long-term investment case for Indian equities.

Firstly, Indian people and businesses are used to political change. Since India liberalised its economy in 1991, we have had several governments with different ideologies, political strength and, what is more, very different tenures as well. A government in 1996 lasted for only 16 days, while another ruled from 2004 to 2014. The current, right-wing government of Mr Modi has an absolute majority in the lower house of parliament whereas a previous government had as many as 27 coalition partners with varied agendas.

The process of reform in India, however, has been un-interrupted under each of these different governments. The Goods & Services Tax (GST) is one of the best examples of this. The idea was first mooted in 2000. Each successive government built political consensus for its implementation and it was finally introduced into law in 2016. Although the process was slow, none of the different governments went back on their commitment towards implementing the GST. Similarly, several industries have been opened to private competition, from insurance to mining. Foreign investment has been permitted across sectors such as telecom, insurance and retail. In every case, once a reform had been implemented, future governments

did not change its course, even if their own political ideology was different.

We find that this is often not the case in other countries. Malaysia introduced its version of the GST in 2015, but it was abolished when the government changed. In our view, this consistency of reform in India is one of the main reasons why the economy has grown at an average rate of 6.7% over the last 25 years, despite a number of challenges including the Asian and Global Financial Crises, a war with Pakistan and several droughts in large parts of the country.

Secondly, the role of the central government is often overplayed. India is governed by a federal structure. Its 29 states play the dominant role in delivering government services to people and businesses. 95% of the administrative workforce which deals with people and businesses are employed by states, not the central government. These officials regulate businesses at the local level. Almost 2/3rd of total government spending in India is also funded and controlled at the state level, rather than by the central government. Therefore, a change in the national government after this election would only have a limited impact on daily livelihoods.

Finally, we do not invest in companies whose prospects are affected by political change, industries which are highly regulated or prone to political interference. Corrupt practices are common in such industries. As a result, we find ourselves being biased against investing in sectors such as mining, fertilisers or sugar companies. Our focus is on identifying strong business franchises run by honest and

competent managers, in under-penetrated industries. These companies have the potential to prosper irrespective of the political party in power.

There can be short-term volatility in share prices from election results. In the last five elections, over 20 years, the index has moved by an average of 6.8% on the day that results were announced. However, this does not affect the business performance of our companies or long-term shareholder returns. Annual US dollar returns of the MSCI India index over 20 years has been 9.8% compared to 6.4% for the MSCI China index, 8.1% for the MSCI Asia-ex Japan index and 7.7% for the MSCI Emerging Markets index. Our own strategy has delivered annual US dollar returns of 12.5% over this period¹. Given the large universe of high quality companies operating in under-penetrated industries in India and the consistency of reform across governments, we believe returns from Indian equities will remain attractive over the long term. Therefore, we would gladly use any kneejerk reaction as an opportunity to increase our holdings in companies.

Dry powder

The level of cash held by the strategy over the last few years (9% currently) has been higher than we would like. We are often asked, and we ask ourselves too, whether the high cash level lies in conflict with our strong conviction in the long-term performance of our investments.

We do not hold a view about the appropriate level of cash in the portfolio. It is a residual outcome of bottom-up stock selection and the portfolio construction process. We focus on capital preservation and

1 Source: Bloomberg. All return figures over 20 years, as at 31 March 2019

absolute long-term returns. Hence, we pay little attention to the cash drag (or whatever it is called) in periods of rising markets.

We meet 350 Indian companies each year and continue to find good quality businesses. This has led to our investible universe growing from 140 companies in 2012 to 220 today, of which 40 are owned in the portfolio. However, valuations across this universe of companies have also been rising over this period. This has had a bearing on position sizes in the portfolio.

For example, Nestlé India, with its strong brands, holds dominant shares in under-penetrated markets, which makes it one of the strongest consumer franchises in our investible universe. The newfound aggression under its current CEO, Mr Suresh Narayanan has re-ignited growth aspirations of the group. He joined the company during a period of crisis, when its highest-selling product, Maggi noodles, was temporarily banned. We were confident about management's ability to deal with the crisis and used the opportunity to increase the position to almost 9% of the portfolio. Since then, the Maggi issue has been resolved, growth has accelerated and its share price has almost doubled; it is now valued at 49x forward Price/Earnings (P/E), compared to its own 20-year median of 36x forward P/E and the 21x forward P/E of its parent, Nestlé SA. Given its expensive valuations, we have been forced to reduce the weighting to 5% currently.

The weight of any holding in our portfolio typically depends on three factors – the quality of its management and its business franchise, the future prospects for growth and return on capital employed, and its valuations when viewed from a long-term perspective.

Oberoi Realty is another example of a business whose long-term potential we are excited by. It is one of the largest property developers in India. In an industry which has historically been marred by poor governance practices, we

find Vikas Oberoi's commitment to employ high governance standards very refreshing. He has a counter-cyclical approach towards capital allocation, which we like. He prefers his balance sheet to remain net cash while most of his peers find themselves over-leveraged when the tide runs out. After recent regulatory changes, customers are rapidly shifting towards well-reputed developers like Oberoi, which has a track record of delivering its projects on time and of promised quality. We believe that Oberoi will emerge as a much larger business in the long term. Its current valuation of 2x forward Price/Book (P/B), and a 20% discount to its net asset value (NAV), is similar to its average valuation since listing in 2010.

Yet, the portfolio weight of Oberoi Realty is just 2.5%. The relatively small position size is due to the inherently higher risk in the real estate business. The industry is cyclical and capital intensive. Changes in macro-economic variables like interest rates can have a substantial impact on demand for Oberoi's relatively premium apartments. These risks, which are inherent to its business model, limit the position size of Oberoi in the portfolio to 2-3% at this stage, despite our confidence in the quality of its management and its potential for long-term growth.

These two examples illustrate how I think about the position size of each investment. Every position in the portfolio at any given juncture is weighed accordingly. Cash is the residual. One of my colleagues recently asked, "Why speak to clients and keep the strategy open? With almost 10% cash, should we not be returning money to clients?" We like companies which have net cash balance sheets. One could argue that this is an inefficient use of capital from time to time. But we back the management teams to use this strength in periods of crisis – when the most attractive opportunities arise – and create long-term value for shareholders. We would like our clients to view us in a similar way. Our focus aims to preserve capital and grow

it sensibly. Cash gives us the tremendous option value to do this. As the saying goes, "Put your trust in God; but mind to keep your powder dry."

New positions – undiscounted change

"We now have absolute clarity on what not to do." We sat up in our seats when we heard the new CEO of ICICI Bank, Sandeep Bakhshi, say this in our meeting with him. In our experience, drawing clear boundaries around things that an organisation will not do helps in several ways – it frees up management bandwidth that would have otherwise been tied up in pursuing low value-add (or value-destructive) activities. More importantly, organisational culture then adapts to the new rules and self-selects the 'right' kind of people. This sort of clarity is often a good marker of cultural change being set at the top.

ICICI Bank had grown explosively and, unsurprisingly, found itself at the centre of most asset quality bubbles in India over the past two decades. Our meeting notes over the years had described it as being accident-prone, aggressive, pro-cyclical and a victim of its scale and poor culture. The fact that the previous CEO was sacked after allegations of corruption surfaced strengthened this view. Indeed, our meeting was more to check if there was any change underway, rather than to actively consider an investment.

"I worry about our next accident. In recent times we have avoided a few mistakes, but, we need to be humble." He went on to acknowledge the problems at the bank and diagnosed the root causes as being poor culture and misaligned incentives. He was making changes at several levels to address these issues. They had already stated their intent to exit high-risk lending segments, such as project finance and their international lending business, both of which witnessed poor asset quality in the past. The risk team has been empowered to veto any

lending decision, which we learnt was now happening frequently. Environmental, social and governance (ESG) criteria was now included in the lending process. This was based on Mr Bakhshi's view that *"an entrepreneur who doesn't respect the environment or his community will not respect the lender either."* Incentive structures across the bank were also being simplified. The key metric to which all incentives are now tied is risk-adjusted operating profit. There were anecdotal changes as well – the executive dining room, previously reserved for top management, had been shut down.

In our view, the bank's board, particularly its independent directors, had not done enough to hold management to account for its actions in the past. Five of its seven independent directors, including its chairman, were replaced over the last year. The new directors include Neelam Dhawan, the ex-CEO of Microsoft as well as Hewlett Packard in India; Rama Bijapurkar, an academic who has had experience on the boards of many of India's best companies, including Titan, Godrej Consumer, Infosys and Nestlé India; B Sriram, who spent 37 years with India's largest bank, State Bank of India; and Girish Chandra Chaturvedi, a senior bureaucrat who has previously served on the boards of several banks and insurance companies. The experience and reputation of these directors gives us comfort that they would play a stronger role in protecting the interests of minority shareholders than the board had done previously.

70% of the Indian banking sector is still controlled by inefficient and corrupt state-owned banks, which are consistently losing share to more efficient private banks. The new CEO recognises that ICICI Bank had not done enough in past years to capitalise on this opportunity. This is set to change. Most of the bad loans in its corporate loan book have been recognised and provided against. The share of retail loans has increased from 28% of its total loans in 2013 to 48% currently. This segment is more profitable and has lower risk than corporate lending.

It also has the lowest funding cost among all private banks in India, due to its high share of low cost current and saving account deposits. Given the strength of its own customer franchise and competition against weak peers in an under-penetrated market, its long-term growth opportunity is exceptional.

In our view, the changes being made under the new management are as yet undiscounted by its valuations. The bank is valued at 2.1x forward Price/Book, compared to 3.7x for HDFC Bank, 5.0x for Kotak Bank and 2.6x for Axis Bank. Lower provisions against bad loans and the shift towards the more profitable retail segment can lead to sustainably-higher return on assets. Following this, we believe that its valuations can increase to levels which are similar to its peers.

Yet, we have also vigorously debated the various risks involved. A large part of the investment case relies on the new CEO, and his commitment towards driving cultural changes. As an insider who has spent almost three decades in various roles at the bank and its life insurance subsidiary, he may be too wedded to the culture to make the drastic changes required. He has also not made many changes to the top management team. The same people who demonstrated an aggressive approach to risk in the past may find it difficult to work effectively under the new processes, systems and culture. As its profitability and balance sheet improves, the controls and incentive structures introduced recently could be diluted if management decides to prioritise growth once again. The shift towards retail lending when most peers are growing aggressively in this segment also raises the concern that it may be pro-cyclical, and could lead to asset quality problems in the future.

Given the long-term opportunity, changes under the new management and valuations, the risk-reward appears attractive. But due to its poor track record and the above-mentioned risks, we would be cautious and continue to assess

the changes being made, as well as the risks, in our meetings with management. As we often say, it is better to travel than to arrive.

A similar example is the RP Goenka group, which we previously considered as being un-investible. The group has gone through a generational change, as Anant Goenka, from the 3rd generation of the promoter family, joined the business in the early 2000's, but has only more recently taken over the reins of the group. In our meetings with him over the last three years, we have been impressed by his commitment towards improving the group's governance standards. These changes were led by the group's listed information technology services company, Zensar Technologies. Apax Partners, a private equity investor, had acquired a minority stake here, while the family was still its majority shareholder. The family used the opportunity to learn about best practices in corporate governance from its private equity partner. They subsequently made several changes across group companies – high quality professional managers were hired, well-reputed independent directors were introduced across their boards, and governance processes were strengthened.

Sandeep Kishore, who had spent almost three decades at a much larger IT services firm (HCL Technologies), joined as CEO of Zensar. He hired other senior professionals, such as a new CFO from Wipro and a new head of HR from Ericsson. Reputable independent directors, including the ex-chairman of Unilever Philippines, the ex-head of technology investment at Citigroup, the ex-CEO of Schneider Electric UK and the founder of the Indian consumer company Marico, were brought on to the board. Underperforming teams, such as the entire sales team in the US, were replaced. The company exited unprofitable contracts and stopped doing business in markets in which it did not have enough scale. Those resources were utilised to build strong capabilities in digital application development and in

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hiring a larger sales force. From our experience of investing in similar cases of management change at other mid-sized IT services companies, such as Mphasis and Hexaware, we were aware that these changes would initially have a negative impact on Zensar's growth and profitability. Indeed, the company's earnings per share (EPS) had declined by 20% over FY16 to FY18². However, in our meetings with management, we were impressed by their willingness to make decisions which may hurt short-term performance but would

lead to a much stronger business over the long term.

Management's initiatives have begun to deliver results. As some of its larger peers have been slow to adapt to the industry's shift from traditional services to digital application development, Zensar has been gaining market share. Its new contract wins grew from USD350 million to USD750 million over the last year and led to sales growth of 28% and EPS growth of 29%, among the highest in the industry. Though its profitability is currently lower than its peers,

this is likely to change as it gains operating leverage from its larger scale. Valuations have not yet discounted these improvements in the quality of the business. Zensar is valued at 1.1x forward EV/Sales³, compared to 1.8x – 2x forward EV/Sales for most of its mid-sized peers, such as Hexaware, Mindtree and Mphasis. We believe the long-term opportunity to gain scale and improve its profitability under the new management team, along with its attractive valuations, make the risk-reward attractive.

² Fiscal years 2016 to 2018

³ Enterprise Value/Sales

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