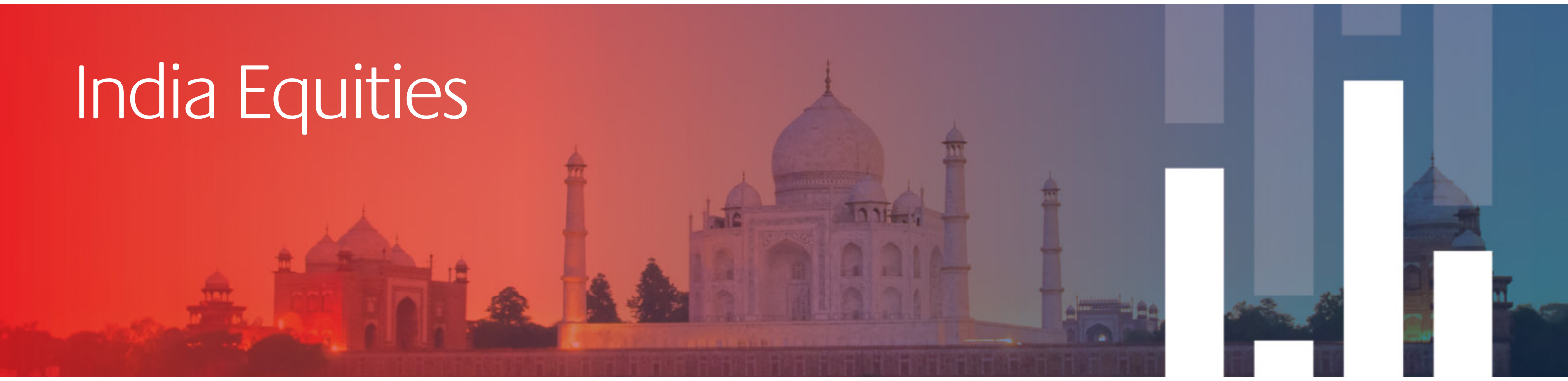
Client Update
February 2020



India Equities

Soaps and Bubbles (2.0)

The attributes we like in a company are a strong management team, an effective board, strong alignment with its majority owners and management, a conservative and introspective culture, a franchise which has pricing power and generates superior returns on capital employed, and the potential to become a bigger business over time. In our experience, we have found these characteristics in certain sectors more than in others. India provided a large market where consumers were getting younger, more urban and aspirational, basic consumer product categories remained under-penetrated, and leading consumer businesses had built moats in the form of brands and distribution networks. The management teams of these companies had been trained in multinationals and adopted similar best practices in India. Therefore, the consumer staples industry had generally been our favoured sector to find investment opportunities.

In recent years, however, we have seen the valuations of our favoured consumer companies becoming excessive; and we believe that they no longer discount many of the risks these businesses face. I had first talked about it in my **September 2016 newsletter (Soaps and Bubbles 1.0, please click here for the full article)** when I was beginning to get worried about the disconnect between valuations and the structural change in the consumer industry.

An excerpt from the September 2016 letter -

> *"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."*

The Fund's weight in consumer staples companies has fallen from around 36% to 13% over the last seven years. It has been the single biggest shift in our portfolio over this period. Our holding in consumer staples companies is now the lowest it has ever been. Our long-standing clients are aware that we do not take a top-down view of a sector's prospects. This change is entirely a result of bottom-up stock selection. There are more headwinds for most Indian consumer staples companies which are not discounted in their valuations.

	Nov-2012	Nov-2016	Nov-2019
Portfolio Weight of Consumer Staples	36%	23%	13%

As disposable incomes have grown consistently, we find that basic consumer needs such as for soaps and shampoos have largely been met. These consumers will now move up to buy more premium products, or start looking to buy more discretionary products which they could not previously afford. This includes air-conditioners (helped by the availability of financing and better electrification), property (where regulations are a tailwind for home buyers), and financial products. As is often the case with financial markets obsessed with forecasting the coming quarter's results, we find that these long-term changes are not priced-in to valuations. This is reflected in our holdings across companies.

We have observed this shift in China. Categories which grew rapidly during the early 2000s have slowed down during the last decade. Want Want and Tingyi operate dominant brands in low-ASP[1] categories such as rice crackers, flavoured milk and mass-market instant noodles. Their sales grew 5.8x and 7.3x respectively over the decade 1998 – 2008. However, during the last decade (2008 – 2018), their sales only doubled. This growth shifted to premium staples and more discretionary products. Vitasoy, which sells premium soy-based milk and ice-tea, grew its sales in China by 2.1x over 1998 – 2008. Its sales growth accelerated to 2.7x over the last 10 years and, as affordability of its products increased, its growth accelerated too. Discretionary categories grew much faster. Gree Electric, a leading air-conditioner brand, and Travelsky, which gets a share of every airline ticket purchased in China, grew their sales by 4.0x and 4.7x over the last 10 years.

[1] Average selling prices

Name	Description	Change in Sales over 1998-2008	Change in Sales over 2008-2018
Want Want	Rice-cracker and flavoured milk brands	5.8x	2.0x
Tingyi	Mass-market noodles and beverages	7.3x	2.1x
Vitasoy China	Premium soy-milk and ice-tea	2.1x	2.7x
Travelsky	Monopoly global distribution system for air-tickets in China	7.8x	4.0x
Gree Electric	Leading air-conditioner brand	3.2x	4.7x

In India, many basic consumer categories have grown rapidly over the last decade. Their distribution networks are now well-penetrated and we believe their growth is likely to slow – as has happened in China in recent years. The valuation of these companies has also increased significantly – median shareholder returns are 6.6x compared to 4.2x median profit growth and 3.1x median sales growth over 10 years. We have observed that as the growth of Chinese consumer businesses slowed down, their valuation multiples declined. Want Want and Tingyi were valued at 23x and 30x forward P/E[2] a decade ago. This has fallen to 16x and 23x forward P/E. Annual shareholder returns for both companies have been less than 5% including dividends over the last decade. We believe the Indian consumer companies face similar risks, given valuations are at all-time high levels.

10-year change (INR)	Sales	Earnings per share (EPS)	Total shareholder return
Dabur	3.0x	3.7x	6.0x
Marico	3.1x	5.3x	6.5x
Britannia	3.2x	8.0x	18.0x
GlaxoSmithKline Consumer Healthcare	3.1x	4.7x	6.6x
Hindustan Unilever	1.9x	2.5x	8.7x
Nestle India	2.6x	2.9x	6.0x
Colgate India	2.6x	2.7x	4.2x
Godrej Consumer Products (India)	3.1x	6.5x	8.7x
Median	**3.1x**	**4.2x**	**6.6x**

The most attractive growth opportunities are likely to be found in other categories. India sells only 6 million air-conditioners every year compared to 80 million units sold in China. This should change rapidly. India has reached a level of per-capita income at which air-conditioner purchases typically accelerate. **Blue Star** has built a leading air-conditioner brand. Its sales have grown 2.2x over the last five years. Even as consumer financing for durables reduced significantly last year on the back of a scare in the Indian financial system, it continued to grow its sales by over 20%. Vir Advani, from the third generation of its founding family, was appointed CEO in 2016. Under his leadership, the company has gained market share in every year since. The majority of consumers purchasing air-conditioners are first-time buyers in India. It is an expensive product with high running cost. High service levels are thus a key differentiator among over 30 brands that operate in the category. Vir ensured that Blue Star became the largest air-conditioning service provider in the country. Most of his peers focus on scale rather than profitability. Under Vir, Blue Star has not compromised on profitability or working capital to chase scale. It earns operating margins of 8% - 10%, while Daikin, Hitachi and LG earn operating margins of 1% - 4% in India. Today, it manages to earn revenue of less than a billion and yet commands a market cap which is just higher than its annual sales as a result of its net margin which is sub-5%. As India's air-conditioner penetration rises from abysmally-low levels, and Blue Star strengthens its market position and improves profitability, there is no reason why it should not be valued several times higher in the years to come.

> *"The pessimist complains about the wind. The optimist expects it to change. The leader adjusts the sails."*
>
> *- John Maxwell*

Our stock selection is not just about finding a tailwind for an industry or a category that will make our investments grow. It is more often about finding management teams who understand the long-term headwinds and tailwinds and who are humble enough to identify the risks and change themselves to sail with the winds and not against. This is what great track records are built on. In our meetings with Vir, the way he talks about navigating the increasing competitive landscape or about how inevitable it is for the air-conditioner industry to find an alternative which releases less polluting gases, makes us believe that he has set his sails prudently for a long-term haul. Sometimes it is a change in management which brings a fresh mindset to change the course. We have seen that with Nestle and Colgate in India, which we continue to own in our portfolio despite high valuations.

Other than spending moving to discretionary items, another longer-term trend which is clear to see is premiumisation – and it is likely to occur across categories. People consuming plain glucose biscuits currently will shift to chocolate biscuits and cookies, while those shaving with basic razors will generally trade up to a fancier-sounding blade. Yes, there will always be a Dollar Shave Club but generally the trend will be towards premiumisation. Consumer aspiration is homogeneous. While most Indian consumer businesses reported low or mid-single digit

[2] Price-to-earnings

sales growth in the first half of CY2019[3], **Nestle India** continued to grow its sales in double-digits. This was driven by its premium products which grew 2x faster than the rest of its portfolio. Its key categories like chocolates, instant coffee and infant food are at the cusp of an inflection point. We have observed that chocolate consumption across countries begins to take off when per-capita incomes are around India's current level. The appointment of Mr Suresh Narayanan as CEO in 2015 has also transformed the company. In the first 18 months of his appointment, Nestle India launched 43 new brands and doubled advertising spend from 4% of sales to 8%. Its volumes had declined in aggregate over 2009 – 2016; it has led the industry's growth over the last two years after these changes. Nestle's sales per-capita in India is still 1/10th of that in Sri Lanka and 1/25th of that in Philippines. With this premiumisation opportunity and the changes driven by its new CEO, we believe that Nestle India should close this gap rapidly in the coming years.

Colgate-Palmolive India is at an early stage of a similar journey. Its previous CEO, appointed in 2014, did not have experience of operating in India. He had spent several years managing the toothbrush category for Colgate across different markets. It was no surprise that during his tenure, the company gained market share in toothbrushes, where profitability is low. However, as natural and herbal toothpastes gained 25% category share after the emergence of new competitors, Colgate was behind the curve and lost market share. The appointment of its new CEO last year, Ram Raghavan, has led to a change in focus. Mr Raghavan started his career in India and spent several years managing the toothpaste business across emerging markets. Since his appointment, Colgate has accelerated the launch of new naturals products at attractive price points, increased engagement on better oral health in schools and in rural areas (there are still rural areas where people brush only twice per week on average), and launched new products with the Palmolive brand. Per-capita consumption levels are still only half of those in other developing markets due to weak hygiene habits. Average selling prices are also a fraction of those in other emerging markets. This will change as consumers graduate from using basic toothpastes – Colgate Strong Teeth – to its premium brands – Colgate Total and Colgate Sensitive. It also has the option to introduce new products from the parent's large portfolio of personal, home and pet care products as such products increase in affordability for Indian consumers. As it regains market share in its core toothpaste business and exploits these new opportunities, it has the potential to grow much faster than it has in recent years.

The advantage which Nestle and Colgate has is that it can tap into its global management pool and product portfolio and introduce them in India. The relative disadvantage of not having this resource is, in our view, not reflected in the valuations of some other Indian companies. While some of the management changes in companies like **Dabur** are encouraging, we would like to watch intently from the sidelines for now.

Another change which we have followed closely in recent years is at Tata Sons. Since Mr Natarajan Chandrasekaran's (Chandra) appointment in 2017, we have met management members of the group's listed companies on over 30 occasions. Through these discussions, we have come to appreciate the comprehensive changes that Chandra is driving across the group. Eight of the group's listed companies have witnessed CEO changes. The group has introduced employee stock options for the first time in its history. The focus of its capital allocation has changed from aggressive expansion to maximising free cash flow, reducing debt and improving returns on capital employed.

Nowhere are these changes more pronounced than at **Tata Global Beverages**. We were invested in the company for several years. Despite repeated engagements with the management, we were frustrated to see that no changes were being made to achieve the company's potential, and sold our position. The conclusion from our meeting note before we sold in 2016 highlighted this –

> *"They are obsessed by market share, because profits (let alone returns) appear to be an afterthought. The change in its name from Tata Tea to Tata Global Beverages, clearly signaled management's intentions. They shifted focus from a dominant, growing tea business in India, to acquire a presence in a confused mix of countries where the category is declining and market shares are fragmented. These markets are barely breaking even, goodwill from acquisitions is being written-down, but they still press on with investments here. There is so much potential, but I wonder, will it ever be realised? It has been a mistake."*

Chandra was appointed chairman of the company in mid-2017. He has driven comprehensive changes. New directors were introduced to its board. We gained confidence from the appointment of Bharat Puri, the CEO of Pidilite, one of India's best consumer businesses, as an independent director. Its management team has also been transformed. This included a new Head of Marketing in India from GlaxoSmithKline, Head of Sales from ITC, Head of the International Business from Reckitt Benckiser and Head of Marketing in the UK from Diageo. Most recently, Sunil D'Souza, who had a strong track record of accelerating the growth of Whirlpool's business in India, joined Tata Global Beverages as its new CEO. Under this team, there has been a shift in the company's focus back to its profitable and growing domestic businesses. It has sold or shut down several of its poor quality international businesses, such as in the Czech Republic, Russia and China. Its domestic operations have grown steadily, as the management increased investments to strengthen

[3] Calendar year

the tea brands. These are gaining share from their unorganised competitors. The Tata Group also decided to merge all of its food businesses into the company, including brands in pulses, spices and salt. As these products share a common distribution network in India, this should provide increased scale and bargaining power with distributors.

These changes have led to a shift in the composition of its business. In FY2011[4], only 30% of sales came from the Indian tea operation, which generated high returns on capital employed. By FY2019, businesses with high returns on capital employed, including those being merged from other group companies, comprised 65% of sales and profit. The company also owns a 50% stake in Tata-Starbucks, which was set up in 2012 and now operates over 160 stores across the country. After management changes and experiments to find the right operating model, the joint-venture has broken even. Its store expansion is now accelerating. We have seen packed stores and long queues in several Starbucks stores we visited across cities. Its sales of only USD90 million are a fraction of its long-term potential. Finally, the group has dropped "global" from its name and has changed it to Tata Consumer Products. As in the past, we believe this strongly indicates the new management's intentions – to build a larger consumer products franchise in the attractive Indian market.

We re-initiated a position in the company last year. The investment case is not without risks. Somewhat frustratingly, the changes being made have led to an increase in its valuation multiples rather quickly. However, with the management and board changes, the quality of Tata governance and the opportunity which the company has in front of it, we believe it still has the potential to deliver attractive shareholder returns over the long term.

Change is the only constant

We own less of consumer staples now than we ever did, but we would own more if they were properly valued. We now have more in banks, where changes in the management teams at ICICI Bank and Axis Bank have made them more suitable to enjoy the longer-term tailwinds of greater financial inclusion in India and private banks gaining market share from incumbent state-owned banks. We have more in the property sector too, as we believe that the number of people wanting to live, work and shop in a more urban setting will only increase; and recent changes in the industry have made it easier for the better-quality developers like Oberoi Realty to gain share in what is an extremely fragmented industry. We own a small stake in India's leading wealth management business and another small position in India's leading hotel business – as we think growth will accelerate in these two companies over the next 10 years. With the same investment philosophy and process, we have started to set our sails for the next decade – and toward where we believe the greater opportunities are.

[4] Fiscal year

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