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.

Wipro Limited (Information Technology), 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 (Azim Premji) 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, Wipro, announced a leadership change. Abidali Neemuchwala, who joined the business in 2015 as the COO has been promoted to become the CEO. Before joining Wipro, he was the COO of Tata Consultancy Services (TCS), India's largest IT company. He is currently building a new leadership team, utilising talent from within and outside Wipro (some of his erstwhile colleagues from TCS 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, Wipro'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 Wipro's valuations (12x PER on estimated March 2018 earnings, with little growth expectations, a net cash position of US$2.8 billion and a 2.5% dividend yield) reflect these financials accurately. Over the past decade, Wipro's earnings per share has compounded at the rate of 10.6% (in US$), only marginally lower than Infosys' 13.5%. Yet, the de-rating in Wipro's 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 Wipro. We will continue to engage with the company and build on our position if our conviction increases.

Cipla Limited (Health Care), India's largest domestic pharmaceutical company, is another 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, Cipla was left without proper leadership after the death of its former CEO, Mr. Amar Lulla, 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 Hamied family took longer than usual to appoint a new CEO. In 2013, they appointed Subhanu Saxena, ex-Novartis, 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, Cipla hired two senior executives from Dr Reddy's – Umang Vohra (ex CFO) as the new COO and Kedar Upadhye (ex VP Finance) as the new CFO. Recently, Mr. Vora was appointed the CEO with the departure of Mr. Saxena. We met Mr. Vora and are quite encouraged by his plans. Meanwhile, the market's expectations have also been tempered and the valuations are more reasonable. In our view, Cipla'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 Cipla 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: **Hexaware** (Information Technology), which is 70%-owned by Barings Private Equity, has appointed a new CEO who joined from HCL Tech where he built a strong healthcare and infrastructure management business; and **Mphasis** (Information Technology), which has recently been sold by Hewlett Packard to Blackstone. The contours of these transactions suggest that these businesses will be run with more of a commercial mindset than before. We bought a stake in Mphasis sometime back based on very attractive valuations and more recently in Hexaware. Both look well positioned for next two to three years.

Another important management change amongst our top holdings took place at **Nestle India** (Consumer Staples), where Suresh Narayanan was appointed the Chairman and MD last year. Coming as it does in the wake of the Maggi noodles episode, we believe this is a positive move and that it could mark an inflection point in the 100-year old subsidiary of Nestle regarding its expansion into newer products. Prior to his latest appointment, Suresh headed Nestle Philippines, and before that, North-East Africa and Singapore for Nestle. Indeed, our recent meeting with the Chairman of Nestle, Peter Braebek, suggested that the Indian subsidiary had not lived up to its potential in recent years (punched his palm in disappointment). He believes that Suresh 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 – Maggi 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

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.