FSSA Investment Managers

July 2021

For professional clients only

## Monthly Manager Views

# FSSA Regional India Strategy

## On the one hand, we are nervous...

Year to date, 34 companies have listed on the Indian exchanges raising a total of USD7.2 billion[1], a figure which has been surpassed in India only twice before in the last 12 years on an annual basis. In our *Monthly Manager Views* in April 2021, we spoke about the initial public offering (IPO) rush that we had begun seeing in India early this year. Unsurprisingly, we have seen this frenzy continue, similar to what has been observed in many global markets.

Free capital has flooded financial markets with liquidity for more than a decade, fuelled by low interest rates and sustained quantitative easing by central banks. The result has been a meteoric rise in the availability of capital, as well as the valuations that companies are able to raise money at. In these cases, it is not unusual for a premium to be attached to disruptive "new-age" business models, where traditional valuation methods fail to apply given the lack of profitability. This year so far, the Indian start-up ecosystem has already added 22 new "unicorns", which implies a valuation above USD1 billion. This compares to 11 new unicorns in all of 2020 and six in 2019.

The latest and largest of these in India to come to the public markets has been food delivery platform, Zomato, which listed in July 2021 with a market capitalisation of nearly USD8.5 billion. As a team, we did a lot of work on the company and had an encouraging meeting with the management team who we liked. Appreciating the long-term opportunity, we applied for this IPO, but withdrew eventually as we saw the euphoria around the issue. The company did their IPO at an eye-watering valuation of 14.9x Price-to-Sales (P/S), which is significantly above peers in other markets. Not only was this lapped up quickly by eager investors, but the share price then more than doubled upon listing. The demand for this IPO was also reflected in one of the longest anchor investor lists that we have seen in our years of experience.

[1] Source: NSE Prime Database, Kotak Securities; as of 10th August 2021.

### RISK FACTORS

This is a financial promotion for The FSSA India Strategy. This information is for professional clients only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **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.
- **Single country / specific region risk:** investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **Smaller companies risk:** Investments in smaller companies may be riskier and more difficult to buy and sell than investments in larger companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

**If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.**

On the one hand, there is a long runway for growth for such companies given that only 4% of India's population actively consumes on internet-based platforms[2]; and, with rising purchasing power, such companies can see strong growth for many years to come. However, on the other hand, growth rarely happens in a straight line. We believe a large part of this potential opportunity seems built into Zomato's current valuations, and despite making optimistic assumptions over the long term, we were unable to get any upside at all. Our investment approach focuses on capital preservation and thinking about risks is a big part of what we strive to do. This froth in the market makes us nervous.

## ...and on the other, we are very excited

The last decade has been a difficult period for Corporate India. After muddling through the stress of multiple scandals as well as severe asset quality issues in the banking industry, companies have faced a number of obstacles including demonetisation, the introduction of the Goods and Services Tax (GST), a liquidity crisis following the bankruptcy of a large infrastructure financier, and finally, a pandemic. Growth has been anaemic across sectors. Corporate profit fell to only 1.6% of GDP in 2020, compared to a peak of 7.8% in 2008[3] , and was the lowest in 25 years.

The silver lining of this prolonged pain has been that certain reforms like GST and the Real Estate Regulation Act (RERA) have been introduced, which we believe will be positive for India's development over the long term. Further, this period has helped market leaders in each category gain at the expense of weaker, unorganised[4] competition. Our portfolio consists of many such dominant companies which have used this period as an opportunity to strengthen their market position in the categories they operate. As the country recovers from the pandemic, we believe these companies are positioned to capture the strong growth from the cyclical lows we are currently at.

Commentary from management teams is also more positive now than has been in the last few years. In a recent conversation with portfolio company **Mahindra CIE Automotive**, its CEO mentioned that during the sharp down-cycle in the automotive industry over the last two years, the company has won business from several new customers. They are running their factories 24/7 and are expanding capacity across divisions backed by customer orders.

The management teams of **Oberoi Realty** and **Mahindra Lifespaces** have been witnessing customers move to organised sector real estate developers with strong balance sheets and a track record of delivering projects on time. They have received strong bookings for their new project launches. We have also seen that as disposable incomes rise, the share of customers' wallets for discretionary products is increasing. This includes air-conditioners, property and financial products. The CEO of **IIFL Wealth**, the largest independent wealth manager in India, recently told us that over the last decade he has not felt this confident about the prospects of the business as he does now.

Our current portfolio is better quality than in the past. As per the table below, the Return on Capital Employed (ROCE) is 42% for the portfolio, which is attractive in absolute terms, and is higher than our own portfolios from three and five years ago. Growth is expected to pick up, with expected earnings per share (EPS) growth over the next two years estimated at 28% CAGR[5] from a depressed base. Valuations for the portfolio are not significantly different from the past, with forward Price-to-Earnings (P/E) ratio of 27x.

| **Portfolio metrics[6]** | **July 2021** | **July 2018** | **July 2016** |
|---|---|---|---|
| Weighted average ROCE % | **42.1%** | 34.9% | 39.3% |
| Weighted average 2-year forward EPS CAGR | **27.8%** | 12.6% | 10.1% |
| Weighted average forward P/E | **27.0x** | 26.3x | 22.7x |

[2] Source: Bain & Company; The Ken newsletter.

[3] Source: Statista

[4] Organised vs. unorganised sector companies refers to those that are licensed and regulated by the Indian government and are subject to labour laws vs. those that are unlicensed or unregistered. Organised or formal companies include publicly traded companies, corporations and large businesses, while unorganised companies are typically smaller, owner-managed enterprises ("mom and pop" stores).

[5] CAGR = Compound Annual Growth Rate.

[6] Source: Bloomberg; as of 31st July for each corresponding year.

## Composite Performance (to 30 June 2021)

| Discrete 1 Year Returns | 12mths to 30/06/21 | 12mths to 30/06/20 | 12mths to 30/06/19 | 12mths to 30/06/18 | 12mths to 30/06/17 |
|---|---|---|---|---|---|
| Indian Subcontinent | 44.7% | -14.5% | 2.6% | 9.8% | 15.3% |
| MSCI IN Gross | 48.7% | -15.8% | 10.7% | 4.0% | 14.4% |

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

With capital preservation at the heart of our investment philosophy, we believe the current portfolio is attractively positioned.

* Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 July 2021 or otherwise noted. Any stock mentioned does not constitute any offer or inducement to enter into any investment activity.