FSSA Investment Managers

July 2022

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Monthly Manager Views

FSSA Regional India Strategy

Reflections on the past ten years of managing Indian equities

Ten years ago last month, I assumed lead management responsibilities for the FSSA Indian Subcontinent strategy. How time has flown! The PIIGS[1] Euro-crisis, the Fed taper tantrum, the Asset Quality Review by the Reserve Bank of India, the election of Mr Modi's Bharatiya Janata Party (BJP) government, demonetisation, implementation of the Goods & Service Tax (GST), the blow-up of Non-Bank Finance Companies (NBFCs), nationwide lockdowns in response to Covid-19 and a spectacular melt-up in asset prices during 2020 and 2021 (over 220 new listings in 2 years!) — these were just a few of the events that we as a team have navigated over the past decade. It has been a period marked by much lower growth, with the MSCI India Index's earnings per share (a barometer of wider corporate health) only growing at 7.3% CAGR[2] over 2011-2021. We have discussed our views on this topic in previous letters (mainly on the increased formalisation of the economy affecting growth at the aggregate level) and believe that long-term oriented reforms such as GST will eventually underpin India's rapid structural growth.

Performance over the 10-year period since July 2012 has been satisfactory, despite the challenges faced during the pandemic period. A patient investor in the FSSA Indian Subcontinent strategy would have received an annualised return of 14.7% (in US dollar terms, gross of fees) compounded over these ten years, despite the 30% depreciation in the Indian rupee over this period. This return is 150% higher than the strategy's benchmark, which places the strategy in the top decile of performance across more than 500 peers (as per the latest Morningstar review). Our conservative stance in the aftermath of the unprecedented Covid-19 lockdowns in India and our unwillingness to participate in the frothy initial public offerings (IPOs) that debuted last year resulted in performance that slightly lags the benchmark, but we are confident this will change. That said, we are constantly trying to learn and improve our investment process. Naturally then, we felt it pertinent to reflect on the past decade from our perspective and share our learnings.

Hold on to long-term compounders

It is rare to be able to identify companies that have both a quality management team and a franchise that compounds free cash flows (or book value per share — BVPS) at attractive rates for long periods of time. Where we have managed to invest in such companies, we have found that the most important thing to do is to hold on, sometimes through periods of stress and disappointment. Of the top 10 contributors to performance over the past decade, seven are companies we have owned throughout the period (save for a brief hiatus in one case).

HDFC Bank is a case in point — over the past decade, BVPS has compounded at 21.4% CAGR, driving an impressive 18% CAGR total return to shareholders. But, owning a quality company through a period of turbulence can be a test of patience and conviction. For example, Nestle India, one of the top contributors over the period, suffered in the aftermath of allegations that its instant noodle brand had excessive levels of lead (back in May 2015). The share price fell by over 30% and profits fell by 22% in the calendar year (CY)2015, but our conviction in the company's culture and track record of dealing with such incidents resulted in us adding to the position, making it a top holding by the end of that year. Since then, the company has rebounded, driven by an impressive new CEO. It is another matter that valuations have swung

[1] Portugal, Italy, Ireland, Greece, Spain

[2] Compound annual growth rate

to the other extreme, with the stock now trading on 80x prospective earnings, forcing even patient investors like ourselves to part ways. Other notable long-term holdings that have compounded capital for the strategy include Infosys (a 21.6% CAGR return to shareholders over 10 years), Kotak Mahindra Bank (21.1% CAGR) and Kansai Nerolac Paints (17.1% CAGR).

Pay attention to the improvement in quality of owners and managers

Eicher Motors is another company among the top contributors to our 10-year performance. In 2012-13, when we first bought the stock for the India strategy, we had been fortunate to have already known the Lal family for over a decade. The main reason for our interest was that there had been a generational change in leadership and we believed that the third-generation founder-CEO Siddhartha Lal was looking to build a truly world-class franchise in motorcycles and trucks. Siddhartha started turning around the neglected Royal Enfield motorcycle business in the mid-2000s, and this began delivering results from around 2012 onwards. The culture of the company also changed significantly for the better — I remember a meeting with him when he said the phrase "long-term" more than anything else! The construction of the Volvo partnership and the way he had thought about it also provided comfort on how other stakeholders in his company would be treated. Eicher's profit went up four-fold from CY13 to CY17, whilst the share price went up nearly ten-fold. When an erstwhile sleepy or poorly-run management is replaced or shaken up by a new high-quality team, it is often the key ingredient to deliver outsized shareholder returns.

In a similar vein, we invested in Satyam Computer Services, which had been the victim of an accounting fraud by its founder and was subsequently rescued by the Mahindra Group, who we admired for their governance standards. Satyam was eventually merged with Tech Mahindra, transforming the latter from a one-dimensional IT services company (its origins were as a dedicated back-office for British Telecom) into a diversified top-tier IT services player. Again, ownership and management change was the key catalyst for dramatic changes in the fortunes of the company, which has been another top contributor to performance over the past ten years.

A more recent example of such a narrative playing out is at ICICI Bank, currently the largest position in the portfolio. Since the controversial exit of the previous CEO under a cloud of allegations in 2019, the Bank's board underwent wholesale changes and a new CEO, Sandeep Bakhshi, was appointed. He has been instrumental in replacing the hitherto aggressive growth-at-any-cost culture with a long-term oriented, conservative and risk-aware mindset. The results are evident in the Bank's performance, as it now boasts industry-leading asset quality and growth metrics.

Stay away from low ROCE[3] businesses that are hard to understand

The healthcare sector has not been kind to us, given that three of the portfolio's top five detractors over the past decade come from here. HealthCare Global Enterprises, an oncology-focused hospital chain, and Lupin, a generic pharmaceutical manufacturer, are two companies where we have been wrong in the past. In most of these instances, our conviction in the people and business model has tended to be low. We are not the kind of investors who build complex spreadsheets and pore over monthly or quarterly data about research and development (R&D) pipelines, drug approvals, USFDA[4] inspections, price erosion etc., and in both of these instances, we gave the owners/managers too much credit with respect to their capital allocation strategy and improving their ROCE, both of which have been decidedly poor over the past few years.

The biggest detractor to performance over the decade came from a recent purchase — Solara Active Pharma. We were enthused by the arrival of Mr Aditya Puri, the founding CEO of HDFC Bank whom we held in high regard, on to Solara's board. The track record of the founder, Arun Kumar, in smartly allocating capital and creating shareholder wealth was encouraging as well. The business itself was reporting decent ROCE and had a long runway of growth in the Active Pharmaceutical Ingredients (API) industry. What we failed to gauge was the industry dynamics (we mistook cyclicality for structural change — a classic error!), and the management, under pressure due to a combination of factors, had resorted to stuffing the distribution channel — or sending excess products to distributors to inflate sales and profits. The wheels came off the business at the start of 2022 as the company was forced to take drastic action, including firing the senior management team. Typically, we would have sold our position, accepting that we had misjudged the quality of the management and the franchise. However, we appreciate the efforts undertaken by the board and the owner to reach out to investors and hold their hands in this time of distress. Such things make a huge difference to investment outcomes over the long term. The company's fortunes may or may not improve, but for the time being we offer them the benefit of the doubt.

Other notable mistakes include M&M Financial Services, a company that has lurched from one crisis to another, no doubt amplifying the vagaries of rural incomes that most of its customers are exposed to. However, under the new CEO of the parent company (Mahindra & Mahindra Group), promising changes are being put in place and we have cautiously bought back a small stake.

Other areas of poor performance for the strategy were our investments in neighbouring Subcontinent markets like Sri Lanka, Pakistan and Bangladesh. Ultimately, the

[3] Return on capital employed

[4] US Food and Drug Administration

macroeconomic stresses in these economies overwhelm what seems, on a bottom-up basis, like a good investment. We have now consciously chosen to stay away from making new investments in these markets until we are much more confident in their long-term stability.

All said, it is worth noting that the sum total of the drag to performance from our top five detractors over the past decade was less than the positive contribution of any one of the top five contributors. This outcome is important, because it shows our investment philosophy at work, which emphasises capital preservation and utilising constructive debate within the team to try to weed out investment risks (although we cannot eliminate risk completely). In the past decade (i.e. 120 months) there have been 53 months where markets have fallen. The strategy has performed better than its benchmark in 41 of those instances (i.e. nearly 80%).

Prudence comes at a cost

The other silent detractors to performance were cash and taxes. Cash positions are entirely a residual of our bottom-up stock-picking approach. In recent years as valuations have risen to record highs, particularly for quality stocks that we have long favoured, we found ourselves running much higher cash positions than ever before. The situation was exacerbated during the Covid-19 induced lockdowns (no one could have been prepared for a time when the entire country was completely shut down for months), when our conservative mindset aimed at preserving capital meant that we minimised exposure to companies where risk was the highest (including banks, which are, at the end of the day, the most leveraged businesses across all industries). A side-effect of having a large cash balance, which I hadn't realised, was that it subconsciously made me overly pessimistic. So, at a time when vaccines were looking feasible and it seemed like the immediate danger had passed (it hadn't, as the second wave proved), we were conservatively positioned. In hindsight, this was a mistake. When stocks went from richly valued to red hot during late-2020 and 2021 (driven by record money printing globally), the portfolio's cash position resulted in a sharp deficit in relative performance. We have since seen the froth (and valuations) come off significantly and are now what we consider to be fully invested (the latest cash position was around 2%).

Another aspect of prudence and its cost to performance comes in the form of the accrued taxes that we account for in our calculation of the portfolio's net asset value (NAV). This is the single biggest detractor to recent performance given the incidence of capital gains taxes in India (we account for them conservatively, assuming we sell the entire portfolio tomorrow and therefore incur the higher short-term levy on all our stocks).

Constant improvement is key

As mentioned at the beginning of this note, we believe that growth among India's top corporates will accelerate over the long term and our portfolio companies are well poised to capture this trend. The higher concentration among the top 20 holdings and the lower number of total holdings in the portfolio reflects our increased conviction. The weighted average ROCE of the portfolio is healthy, at around 33% despite the lingering effects of Covid-19, and has improved over the past five years. Given the quality of our holdings, the likelihood of earnings momentum to accelerate and the reasonable valuations, we are quietly confident about the portfolio delivering attractive returns to investors over the long term.

FSSA Indian Subcontinent Strategy	31st July 2012	31st July 2017	31st July 2022
Number of holdings	44	44	35
Top 20 as a % of the portfolio	72%	65%	78%
Weighted average Net Debt to Equity (ex-Banks)	19%	15%	-5%
Weighted average ROCE %*	47.8%	28.7%	32.7%
Weighted average 2-year expected earnings per share (EPS) CAGR**	11.3%	21.7%	18.1%
Weighted average forward price-to-earnings (P/E)**	23.1x	31.5x	21.9x

* Return on Equity (ROE) for GICS Financial companies, and Pre-tax ROCE (i.e. earnings before interest and taxation (EBIT)/Capital Employed) for other portfolio companies. ** Based on Bloomberg consensus estimates

As we look forward to the next decade (and more), I am especially pleased with our team and the investment process that we have in place. Over the past decade, we have added four more team members who spend most of their time analysing Indian companies. As a result, our watch-list of quality companies in India has expanded significantly over this period, from around 75 back then to over 180 today. We regularly meet more than 250 Indian companies each year and our knowledge of them has grown significantly over time. The relationships we have built with business owners and managers have only gotten stronger.

All this gives us confidence that the best is yet to come.

* 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 2022 or otherwise noted.

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