FSSA Investment Managers

April 2022

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Monthly Manager Views

FSSA Regional India Strategy

Mahindra & Mahindra: A rejuvenation in progress

After a recent meeting in Mumbai with the top management of Mahindra & Mahindra (M&M), we came back with a clear message — M&M's commitment to its purpose does not mean that it will continue to operate loss-making businesses. This strengthened our conviction in the changing culture and capital allocation of the group.

We have always held the Mahindra group in high regard for the benchmarks of corporate governance standards they have set in India. Over the years, we have been shareholders of many group companies, including Mahindra Lifespaces and Mahindra CIE Automotive (both still held in the portfolio today), as well as Tech Mahindra and M&M Financial Services in the past. However, we have observed a weakness in the group's capital allocation discipline over the last decade. M&M had set up or acquired a range of businesses from Ssangyong in South Korea to two-wheelers in India, which increased the business complexity and caused the group to struggle with losses. At the same time, we found that businesses with significant potential such as Mahindra Lifespaces were not being held to account for their consistently weak performance. We have not been shareholders of M&M in recent years.

Our engagement with the senior management of M&M culminated in a letter in February 2020 to the chairman, Mr Anand Mahindra, where we highlighted our concerns:

> As we look back at M&M's history, however, one aspect has been bothering us, which is the capital allocation of the Company. When you took over in 1997, the standalone profit of M&M was USD 58m. The 14 subsidiaries of the Company produced a further USD 5m of profit. But in 2019, whilst the standalone profit was USD 730m, the remaining c.200 subsidiaries, JVs and associates **detracted** about USD 50m from this sum. This is not a one-off occurrence. In fact, M&M's subsidiaries, in aggregate have been loss-making for 5 of the last 7 years.
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> *Source: Excerpt from FSSA's engagement letter to Mahindra & Mahindra in February 2020*

In his reply, the chairman acknowledged these issues and pointed towards the initiatives being taken to improve the group's returns. He also introduced us to the recently appointed CEO-designate, Dr Anish Shah. In our first discussion with Dr Shah, he came with a copy of our letter. He had created a framework to categorise businesses based on their potential to achieve a return-on-equity (ROE) threshold of 18%. Those that could not achieve this goal within a stipulated time-frame would be exited. The company's recent 2021 Annual Report admitted to the mistakes made and the poor shareholder returns, and publicly stated the intention to introduce strict controls in the capital allocation process.

We also noted that there was an ongoing generational change in M&M's board and management team. As longstanding directors and key senior executives retired, younger board members and managers took charge. High-quality independent directors such as Nisaba Godrej (executive chairperson of Godrej Consumer Products) and Muthiah Murugappan (a senior leader at the Murugappa group) joined the board. A new Group CFO was appointed and the farm and automotive businesses were consolidated under the management of Rajesh Jejurikar, who had led a strong performance at M&M's tractor business. Management at several subsidiaries also changed. A new CEO, Arvind Subramanian was appointed at Mahindra Lifespaces, with a mandate to accelerate the company's growth. Following these changes closely, we gained confidence in Dr Shah's plans to improve capital allocation and performance. We initiated a holding in M&M.

We have been encouraged by the management's decision to "walk the talk" by stopping incremental investments and exiting several poorly performing businesses. This includes Ssangyong which had bled losses since its acquisition in 2013, an aircraft manufacturing business in Australia, an electric two-wheeler manufacturing business in the US, a metal fabrication business in Turkey and an automotive service business in India. Our discussions have indicated that there will be more exits from larger operations if they fail to meet ROE targets. The group has increased its focus on growing its core businesses – automotive, farm, financial services and IT services. These businesses have long track records of profitable operations and the opportunity to scale-up significantly in the coming years. At Mahindra Lifespaces, we have seen a marked shift in the company's growth aspirations under its new CEO.

Scanning the radar for signs of management and ownership changes is a critical part of our investment process. Be it generational change at Eicher Motors, a transformation of the culture at ICICI Bank, the improvement in capital allocation across the Tata group companies under the new group chairman, or the change in ownership to Heineken at United Breweries, we have repeatedly observed that these events can lead to substantial shareholder returns in subsequent periods. We believe we are at the early stages of such a rejuvenation at M&M. Based on this conviction, it is now among the strategy's largest holdings.

* Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 April 2022 or otherwise noted.