FSSA Investment Managers

Summary

Travelling, rather than arriving, with companies in India

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Sree Agarwal and Shivika Srimal, investment analysts at FSSA Investment Managers, believe there are a number of reasons to be positive on India in the long run, and shared their rationale at the FSSA Forum 2023. First, as one of the oldest equity markets globally, India offers an attractive long-term opportunity for investors. There is a large universe of high-quality listed companies, including many large businesses of the future currently hiding in small market capitalisations. Second, owners and management teams are engaged and accessible, and focused on returns. Finally, governance standards and minority shareholder protections have consistently improved over the years – a reassuring point for long-term investors like FSSA.

Why now?

Over the past decade or so, India has navigated a series of events that affected domestic demand, including several corruption scandals in 2011; the demonetisation program in 2016, ostensibly aimed at tackling money laundering and counterfeiting; the Goods & Services Tax (GST), which aimed to simplify India's tax system; the collapse of several Non-Bank Finance Companies (NBFCs) in 2018, which sparked a credit liquidity squeeze in the entire financial system; and then, in 2020 the world went headlong into Covid-induced lockdowns.

While reforms like GST, the adoption of Aadhaar (India's Unique Identity Number, used to simplify access to services such as banking and healthcare) and the launch of a digital payments ecosystem were all designed to make India a more effective and efficient place to do business, it was during Covid that the benefit of these reforms came to the fore. And, though there were short-term teething issues at the start, these are now largely in the past and the structural benefits are beginning to be realised.

There are other positives as well – speaking at the FSSA Forum 2023, Sree and Shivika highlighted market leaders such as HDFC Bank[1], which gained market share during the cyclical downturn, as have the top 10 developers in India's largest cities. Despite even the worst macroeconomic backdrop, great management teams with dominant franchises usually find ways to improve their competitive advantages and come through the market weakness even stronger than before.

Why invest with FSSA?

A core part of FSSA's investment approach is their engagement with management teams. On average, the team conducts around 300 meetings a year with Indian companies, of which almost 90% are with the founders or C-suite executives. Due to the team's long history of investing in India and the relationships they have built over years, they are often viewed as the shareholder of choice. This gives them the benefit of being able to engage with management on a variety of topics, including succession planning, environmental impact, safety issues and board independence.

While the FSSA team are bottom-up investors, there are a few common threads amongst the FSSA Indian Subcontinent strategy's holdings, which includes top private banks and finance companies, dominant consumer staples brands, consumer discretionary market leaders, leading exporters of technology services and healthcare, and infrastructure companies. It is a relatively

1 Largest bank holding in the FSSA Indian Subcontinent Fund, as at 31 August 2023

concentrated portfolio, with high returns on capital employed (31% based on the weighted average), attractive earnings per share (EPS) growth (24.7% based on the weighted average 2-year EPS compounded annual growth rate) and a weighted average forward price-to-earnings ratio of 22.7x (all figures as at 31 August 2023).

FSSA are also disciplined about what they will *not* do, companies they will *not* invest in, and people they will *not* back. For example, weapons manufacturers and tobacco are completely excluded from FSSA's investment universe, while coal and gambling, as well as governance issues like bribery, are covered in FSSA's exclusion policy. The outcome of this inherently conservative investment style is that the FSSA Indian Subcontinent strategy tends to perform better in down-markets compared to up-markets, and in the long run has provided better returns than the index in the majority of periods (based on the last 10 years of monthly data to 31 August 2023).

Case study: ICICI Bank[2]

Over the past two decades ICICI Bank had grown explosively and, unsurprisingly, found itself at the centre of most asset-quality bubbles in India. The FSSA team had met with various members of the management team over the years but was wary of the bank's risky attitude – past meeting notes described ICICI Bank as being sales-driven and aggressive, with a culture that promoted growth at any cost.

In 2018, the CEO was sacked after allegations of corruption, which strengthened FSSA's view. However, the appointment of a new CEO, Mr Sandeep Bakhshi, piqued the team's interest – and marked a turning point in ICICI's journey to becoming a more risk-aware bank.

In the years following Mr Bakhshi's appointment, the FSSA team observed a number of positive changes taking place. First, the majority of the board was reconstituted with better independent directors. And there was a wholesale cultural transformation which involved reducing hierarchy and bureaucracy, and improving risk management on lending decisions.

Then came the franchise improvements. The bank decreased its risky project loans, while its international business has been wound down to less than 5% of the loan book today. Commensurately, the share of retail loans, which is more profitable and has lower risk than corporate lending, has increased from 42% of total loans in 2015 to 70% currently. ICICI Bank also has the lowest funding cost among all private banks in India, due to its high share of low-cost current and saving account (CASA) deposits.

These positive changes, along with the strength of ICICI Bank's customer franchise and the lack of competition in an under-penetrated market, led to the following conclusion in the FSSA team's Company Report on ICICI Bank: "Valuations are fair and could re-rate significantly if ICICI Bank transforms itself. Looks like one that we could potentially own a lot of over time."

Case study: Indian conglomerate

There is an Indian conglomerate company that the FSSA team have known for many years. FSSA's portfolios have owned a number of the group's companies over the years.

The team have always held the group in high regard for the benchmarks of corporate governance standards they have set in India. However, the group's capital allocation discipline over the last decade had started to deteriorate. New businesses and acquisitions increased the group's complexity and caused it to struggle with losses. At the same time, existing businesses with significant potential were not being held to account for their consistently weak performance.

The FSSA team engaged with the senior management on these issues in a series of calls and meetings. These efforts culminated in 2020 with a letter to the group chairman, which emphasised the team's concerns.

The chairman wrote back and acknowledged the issues, then highlighted the initiatives being taken to improve the group's returns. He also introduced the CEO-designate, who was creating a framework to categorise businesses based on their potential to achieve a return on equity (ROE) threshold of 18%. If a business could not achieve this goal within a stipulated time-frame, the group would exit.

So far, in the three years since that letter, the group have exited or shut down 13 businesses, including a South Korean auto manufacturer, a Turkish agricultural machinery business, an aerospace subsidiary in Australia, and its entire stake in an auto components company.

In 2022, several FSSA team members met with the CEO in India and left with an optimistic sense of change in the air. In the meeting note conclusion, the author wrote that "...this was one of the best meetings that I have done in recent times. But perhaps that is the context here – capital allocation had become so bad – and this guy now is setting the company back on the right course... Change here will definitely be positive..."

2 Second largest bank holding in the FSSA Indian Subcontinent Fund, as at 31 August 2023

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