

# COUNTRY REPORT:

# INDIA

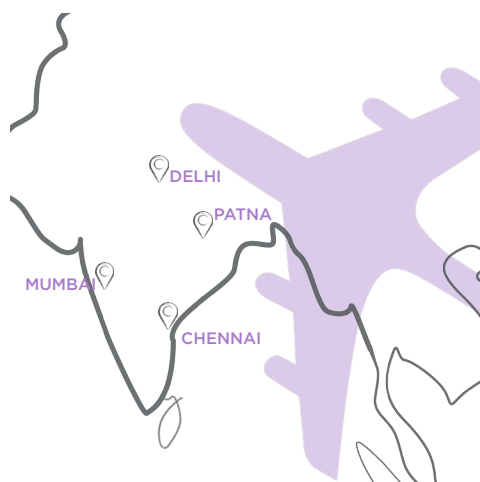
## NOVEMBER 2018



*Mike Sell, Alquity's Head of Asian Investments and Dan Billis, Asian investment analyst spent nine days in India for their regular on-the-ground meetings with local companies.*

*Mike and Dan had 33 meetings in Mumbai, Chennai and Delhi along with a day of store visits in Patna, the capital of Bihar state. The goal of Mike's and Dan's visit was firstly to meet with the majority of our existing holdings and to reassess the outlook for corporate earnings following the second quarter results and recent macroeconomic gyrations.*

*In addition, Mike and Dan met with 19 of our companies' competitors to stress test the sustainability of our holdings' competitive advantage. This included both unlisted and challenger companies, to better understand the competitive ecosystem, notably in the retail and financial sectors where we are largely positioned....*



### FIRST-HAND EXPERIENCE WITH REFORMS

India has finally begun to reap the benefits of earlier measures, such as the Goods and Service Tax (GST), which was implemented on 1st July 2017. A leading unlisted consumer company highlighted that the introduction of the GST has boosted their margins by 600bp. An IT distributor believes that they have only seen less than a third of the benefit on their business so far. Bajaj Corp (hair oil) have already reduced their distribution depots from 28 to 22, and intend to decrease further to 18. A finance company sees increased demand for light commercial vehicles as an efficient hub and spoke distribution system is now created for the first time. All these factors will provide **a long-term boost to the**

**economy**, regardless of political and macro concerns.

All the managements that we met were without exception **positive on the outlook for the economy** over the next 6-12 months. The overall level of positivity is a noticeable improvement from 12 months ago, which in turn represented a better commentary than the year before that. This was a consistent response from every sector – financials, property or consumer, and whether their customers were rural or urban-focused. Indeed, banks commented that their clients were considering leveraging up and adding new capacities. This would be, in fact, a welcome phenomenon, as a

private sector credit cycle has been noticeably lacking over the last few years.

Although the stock market has been upset by higher crude oil prices and a weaker Rupee, the impact on company margins has been limited, as we expected. The depreciation of the currency vs. the USD has been a reoccurring phenomenon for decades in India. As a result, companies have become adept at passing on higher costs to their customers with a short lag. Equally, consumers are accepting of these price rises for leading or critical products. This was also a common refrain across our meetings.

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### CONSUMER SECTOR

Virtually all consumer companies that we met with are expecting a strong next six months. Whether this is due to reaping the benefits of new product launches (Emami), a later Diwali this year (retailers) or just the result of cyclical tailwinds from the strengthening urban and rural economy (Redington, an IT distributor), the message was largely consistent. This was the case for both listed and unlisted consumer companies, such as Cavinkare (with a portfolio of brands in the dairy, beverage and personal care segments) and Viveks (an electronic retailer with over 70 stores across Tamil Nadu). Indeed, one company specifically highlighted that their increase in confidence vs. our meeting 12 months ago is because they can see the on-the-ground improvement taking place. The only exceptions were Maruti Suzuki (due to rising

fuel costs) and Hero Motors. For the latter, a recent government-mandated change in the amount of insurance required has resulted in a significant cost increase and delayed consumer purchasing. However, given rural motorbike penetration of only 20-30% at the household level, structural growth will return, and we expect 10%+ over each of the next two years, helped by Hero Motors' new product launches of a 150cc motorbike ('Extreme') and two new scooter models. Although the quantum of motorbikes purchased through financing vs. cash has increased from 33% pre-demonetisation to 37% currently, the recent rise in wholesale financing rates has not had any impact on demand. Hero also trades at a 30% discount to peers such as Eicher and TVS, both of which we previously exited due to valuation concerns.



Hero Motors



Dan Billis

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However, there are threats. For example, in discussing the growth plans for Butterfly Gandhimathi (a manufacturer of kitchen appliances) it became clear that they are planning to aggressively target the market share of TTK, which we own in the Alquity Indian Subcontinent Fund. Butterfly is not yet suitable for investment, as it has suffered from recent management changes, and in addition, targets market share rather than profitability, which is one of our greatest concerns. In any case, our store visits clearly highlighted that TTK continues to dominate. We see this as an emerging threat, which we will monitor actively.



Cavinkare



Future Retail

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**The Indian retail sector is rapidly changing.** Companies such as Aditya Birla and Future Group are aggressively increasing their store numbers throughout the country. For example, Future Retail have added 128 standalone stores and 45 Pantaloon department stores over the last 12 months, to reach 1897 and 288, respectively. At first glance this would be a concern for our holding in Vmart. For this reason, we undertook a day of retail site visits in Patna, the capital of Bihar (with respective populations of about 2.7mn and around 103.8mn). The security situation has dramatically improved over recent years, and the economy is now growing strongly. In our view, the pricing strategy of Aditya Birla Group which is expanding

rapidly into smaller cities – is too high (e.g. a pair of jeans is almost five-times the price than in a store of Vmart). This confirms our conclusion from our visit to Aligarh in 2017, where we again felt that Pantaloon suffered from mispricing and a subsequent lack of customers during our visit.

Future Group's pricing of jeans and shirts was certainly cheaper, albeit still at a premium. However, it was the smaller chains that represent a greater threat, such as Vishal, who seemed to have fixed their supply chain issues from last year, as evidenced by much greater product availability. Meanwhile, the pricing strategy of V2 is similar to Vmart's, but the ambience of the stores is markedly different.

Vmart's stores look noticeably more professional, are air-conditioned with a colourful and lively atmosphere. The Vmart store we visited was also considerably busier than any other competitors' store we visited, except that of V2. We have followed the latter for some time, but currently have corporate governance concerns. All in all, our take away from the day in Patna reaffirmed our conclusion from our meeting with Vmart's management in Delhi, namely that the company retains a sustainable competitive advantage in a sector where there is significant structural growth opportunities. Consequently, we have continued to add to our positions on unjustified share price weakness.



*Pantaloon*



*Mike Sell at V2*



*Vmart store*

## FINANCIALS

As opposed to our peers, we do not own the leading private sector financial institution, HDFC Bank. This is a very well managed bank, which was initially successful by gaining share from public sector banks, but – in our view – has slowed down in recent years. This was a view we discussed with several ex-employees, who concurred. In addition, **challenger banks have emerged over recent years**, such as Indusind Bank, Yes Bank and Kotak Mahindra Bank. We have owned or currently do own these.

The financial sector never remains static, especially in India, and there are now challengers to the challengers. Many of these banks are managed by ex-HDFC or ex-international

bankers, who have desired a more entrepreneurial culture. Thus, we met with AU Small Finance Bank, Equitas, Federal Bank and RBL Bank to understand their competitive advantage, their niche and their disruptive potential to the sector. As a result, we believe there are potential candidates for inclusion into the portfolio following further analysis, but no threats to our existing positions.

The rural economy provides an even greater opportunity given the very low levels of penetration of financial products. Despite the strength in wholesale funding rates, Mahindra and Mahindra Financial (the market leader in this area) is positioned to benefit from a rising margin and

stronger lending growth, combined with declining bad debt levels. This is a testament to the positive rural economic cycle that is currently prevailing and is an area that we have tilted the portfolio towards over recent months. Chola Finance, at the opposite end of the country, which focuses on truck and housing lending concurred.

Despite recent headlines, there does not seem to have been any liquidity crunch impacting the real economy. This was confirmed by both lenders (such as PNB Housing Finance, who built up an excess liquidity buffer earlier in the year) and companies whose customers use credit to finance their purchases.



### INFRASTRUCTURE, LOGISTICS AND BUILDING MATERIALS

The meetings with the founder of Oberoi Property and the entire management team of Heidelberg Cement, both highlighted that despite global trade concerns, Rupee weakness and general adverse sentiment towards assets in the EM universe, the situation on the ground remains very different. Heidelberg has been expanding capacity through de-bottlenecking, and is expected to benefit from rising margins in the coming years, as the company is very well positioned to monetise India's domestic structural growth opportunity. **There has been no slowdown for any of these companies.** Prince Pipes – a competitor to our holding in Astral Pipes – reaffirmed this view.

India remains in desperate need of infrastructure – whether housing, roads or airports. Our trip to Patna anecdotally reaffirmed this. Patna is a Tier 1 city, yet neither the airport nor the road network have been upgraded. Traffic jams were horrendous – even worse than the legendary Jakarta traffic. I fear that many investors, who do not venture outside conferences in modern hotels in Delhi and Mumbai (where the situation has dramatically improved) do not grasp the multi-decade opportunity that India represents.



Patna airport

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The transition to a modern logistics industry will result from not just more effective infrastructure, but also the structural shift from the unorganised to organised sector. TCI Express, one of the market leaders, expects to grow their revenue by 25-30% over the next three years, with economies of scale resulting in margin improvements. This is a company that has been spectacularly poorly covered by local brokers, let alone international firms, which is beginning to change as the investment case becomes more widely understood.

Although our performance in India has been strong over the last three years, Somany Ceramics has been a poor performer, declining 67.7% over the first ten months of 2018 in USD terms. In addition to meeting with Somany's management, we also spent some time with a non-exclusive dealer in Chennai to understand the perception of the brand and whether there is a company specific structural issue that we could have misunderstood. This proved not to be the case, in fact, Somany has improved dramatically in relation to the industry leader, as it has leapfrogged the third player to become the challenger brand. The external data point, along with a face-to-face discussion with the founder of the company, involving a frank discussion of the issues over the last six months, proved

reassuring and we expect to see a significant improvement over the next 12 months.

A common refrain over the last two years has been the lack of a private sector capex cycle in India, as utilisation levels remained relatively low. **This has decisively changed** with companies such as Escorts (tractors and construction equipment) and KEI (electrical cable and wiring) expanding capacities to meet rising demand. Both are also benefitting from cyclical tailwinds and margin expansion (due to new product launches for Escorts and a greater focus on the retail segment for KEI), declining gearing and remain on a forward price to earnings ratio of below 10x. KEI commented that their order book is the highest in their history. Escorts' tractor sales have been growing 10ppt ahead of the industry over the last six months, with their construction equipment sales rising 44% in volume terms. Both have sustainable competitive advantages due to their well-established brands and distribution networks, within an oligopolistic market structure.

Interestingly, the hotel sector is also profiting from rising occupancy, and thus, room rates and margins, as the economy and specifically business sentiment improve. We have identified a beneficiary of this trend where we will undertake further analysis.

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### AUTO COMPONENTS

Meetings with both Subros and Jamna confirmed the growth potential in the auto industry. Both companies **dominate their respective segments**, namely air conditioning units and axle springs (Jamna has over 70% market share). Their competitive advantages are sustainable, with no imminent new entrant, and thus due to their technology and dominance have an element of pricing power which is rare in this industry globally. Furthermore, by supplying most

major auto brands, the companies benefit from overall market growth (and the upgrade cycle) rather than being concerned with the vagaries of changing customer market shares. Both also benefit from structural drivers in the economy – government-mandated increased standards for the trucking industry requiring air coolers in truck cabs, and better roads combined with greater efficiency in the logistics industry post-GST. Jamna commented that GST implementation

has resulted in a 10-12-hour journey time saving between Delhi and Mumbai, and the better roads are now suitable for multi-axle trucks and trailers (all of which require more springs). Jamna is one of our larger positions across all our funds, and we expect the company's margins to rise structurally, earnings to more than double in the next three years, and valuations remain lower than the overall market.

### ENVIRONMENTAL, SOCIAL AND GOVERNANCE

It is noteworthy that companies are **increasingly focused on ESG reporting**, and – unlike Hong Kong – this is not due to greater disclosure requirements imposed by the stock exchange. The best companies are improving in this area, because they are beginning to understand that publishing the data results in a wider and more long-term shareholder base. This was the most common area that we engaged on during the trip. However, it is rarer that companies apply the same standards to their own suppliers and this is an area we discussed in several meetings.

The review of our portfolio by Impact Cubed has also led us to undertake further discussions around remuneration. This has particularly been flagged where management and owner are the same person, and this (along with the pricing of employee share option schemes) will be an ongoing discussion.

Nevertheless, despite the general improvement in the quality of the conversation on this subject, there remain significant outliers. Two of our meetings (potential new ideas) gave rise to significant Governance concerns on this trip, and thus proved unsuitable for future analysis.

Having spent two days in Delhi traffic, we can certainly confirm the appalling air quality from first-hand experience. Our companies are increasingly focusing on this issue, with leaders such as Heidelberg Cement publishing data on emissions on their website to ensure maximum transparency and compliance with environmental laws. Scarcity of water is another concern in many parts of India. We do not typically own companies that are large users of water, but it is clear from our meetings that more firms are actively recycling their used water and moving towards zero discharge of waste.



Mahindra Finance



Hero Motors

### CONCLUDING THOUGHTS

*Our on-the-ground meetings with 33 companies were very fruitful, as they reaffirmed our longstanding view that the domestic economy is in a solid shape. Furthermore, economic activity has not been derailed by spiking oil prices or trade tensions, and thus the structural domestic growth will continue without being adversely impacted in a meaningful manner. Once elections are behind us, idiosyncratic sources for asset price volatility should subside. Any volatility before then will provide opportunities for investors.*

***Specifically, we believe that there are three key trends that investors are missing: the accelerating growth in the rural economy, rising margins across certain industries, and the re-emergence of the private sector capex cycle.***

*Overall, we remain extremely positive on India, as the economy is on a firm footing and has the potential to deliver one of the best performances within the EM space over the coming 3-5 years.*

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### MACRO OVERVIEW

The underwhelming performance of the Indian stock market and currency in the period between August and October have been in stark contrast with Indian macroeconomic fundamentals. The impact of systemic adversities (e.g. globally tightening USD liquidity, skyrocketing crude oil prices, etc.) on Indian asset prices were exacerbated by idiosyncratic issues, such as liquidity concerns related to non-banking financial companies, and disputes between the central bank and the government. Incoming macroeconomic data (e.g. GDP growth hit 8.2% YoY in 2018 Q2, benign inflation below-4%, close-to-normal quantity of monsoon rains, etc.) reaffirmed our view that the Indian economy is in a solid shape, and the strong case of domestic growth has not been derailed by ongoing trade tensions between the US and the rest of the world or by elevated oil prices.

National elections are always of great importance in India, and the upcoming one is no exception. History shows that GDP growth usually accelerates in a meaningful manner afterwards, as visibility on economic policy clears, which in turn can lead to the strengthening of private sector investment activity. Furthermore, from a capital market point of view, net portfolio flows to India usually accelerate, as uncertainty is removed for the next several years. Consequently, the 17th Lower House (or Lok Sabha) elections (in April or May 2019) will be closely scrutinised by markets. We are of the view that the incumbent Prime Minister, Narendra Modi and his BJP party will retain their legislative majority, via a coalition, and carry on with the implementation of reforms that are crucially needed for the next leg of the long-term structural development of the Indian economy.

As an aside, India still needs to be considered as a collection of regions rather than one country. The economy of the South is very different to that of the North. Tamil Nadu, a South Indian state, has historically been one of the better-run and faster growing states, but this has changed due to political mismanagement by the AIADMK party. This was evident from the frequent power outages, which just do not happen in Mumbai, the capital city of Maharashtra state in the western region of the country. Tamil Nadu has dropped down growth rankings, which was a common complaint from the retailers we met. In contrast, Bihar (a state in the North) has overtaken Tamil Nadu in terms of nominal GDP growth. Between FY2015-16 and FY2017-18, Bihar's annual growth was 12.5% on average, 2.5ppt higher than Tamil Nadu's. Companies such as Vmart, who have high exposure to Bihar, are thus better positioned, in our view.

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