AARON ARMSTRONG

TRIP REPORT: MUMBAI, JUNE 2018

INDIAN SUBCONTINENT FUND

Senior Investment Analyst Aaron Armstrong has just returned from a three day conference in Mumbai.

Having met with representatives from 23 companies, as well as a host of other market participants, he shares his latest thoughts on the investment case for India below.

At Alquity we deploy a range of desk-based and on the ground research approaches when analysing companies. Sitting in London, we benefit from a broader perspective on Asia and emerging markets as a whole, rather than becoming absorbed in a narrow viewpoint on any one market. We complement this, however, with extensive travel to the countries in which we invest. For example, myself and Alquity's Head of Asia Investments, Mike Sell, have visited India four times in the last nine months, conducting over 100 management meetings, as well as a range of site visits.

Following my most recent trip to India in June 2018, I returned with an especially positive range of insights.

From the very first meeting, this was a trip brimming with optimism and enthusiasm regarding the outlook for India. Across the three key interrelated spheres of the economy, politics and corporate earnings, an almost unanimous message of positivity was conveyed. Whilst we have been more positive than most participants over the last three years, which has helped deliver our peer-leading performance, it is encouraging that the local investors who are typically very short-term orientated are beginning to see the long term structural investment case that we see, rather than continually fixate on the next quarter's results.

Having met with companies operating in a wide variety of sectors, from consumer and banking through to infrastructure and insurance, there was a striking level of homogeneity regarding the positive outlook for earnings growth. As I progressed from meeting to meeting, CEO after CEO began explaining how the disruptive impacts of demonetisation and GST implementation have now faded, and that economic growth and consumer confidence are making a strong comeback.

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These meetings also enable us to focus in more detail on Environmental, Social and Governance (ESG) factors, in addition to our detailed financial analysis. There are a wide range of companies in India with strong ESG performance. However, in many cases we find that communication and transparency around this issues can be lacking. This is in partly an outcome of the lack of emphasis most local investors and sell-side analysts place on these factors. Conversely, ESG analysis forms a core part of Alquity's investment process, facilitating a deeper understanding of oft-overlooked factors which can be pivotal in understanding whether a company is able to capitalise on its potential and deliver commensurate returns to minority shareholders.

A recent example of our ESG process delivering value in the Indian market is the avoidance of Vakrangee - a former market darling which has now fallen 95% from its peak over the last five months. Our blend of desk-based and on-the-ground research raised several red flags on this otherwise interesting investment proposition. In avoiding this company, we have watched from a distance one of the most spectacular blow ups in India in recent years.

While conducting ESG analysis on this trip, we developed a number of concerns regarding a fast-growing retail company. This is another stock which has attracted capital from high-profile investors but we believe our ESG process has given us a deeper understanding of the risks to the outlook, and means we will not be considering investing in the company.

One of the most significant detractors from India's economic performance in recent years has been the struggling rural economy. **The key takeaway from the trip is that this is now finally demonstrating early signs of a resurgence.**

With 60% of India's workforce directly employed in farming related activities, and with rural economic activity accounting for 35% of India's GDP, a newly thriving rural economy has the potential to launch India in to a new phase of accelerated growth.

Having met with our number one position in the India fund, rural-focused lender Mahindra and Mahindra Financial services, there was a clear sense from management that the rural recovery will likely now feed through to faster lending growth and improved asset quality, with compounding positive impacts on profitability. We expect to see loan growth of at least 25% in the coming year, with stable net interest margins and declining bad debt provisions. We do not believe this is reflected in valuations, and expect 50% share price appreciation based on our core dividend discount model-based scenario. Whilst not in attendance at the conference, our position in tractor maker Escorts India stands equally well positioned to benefit from this rural trend, the duration of which is underappreciated by the market.

In addition, with a year now passed since the implementation of GST, and 18 months since demonetisation, the structural benefits of these reforms are now beginning to accrue.

When the Modi government implemented these seismic reform policies, it was very much a case of short term pain in exchange for long term gain. Whilst the pain was felt acutely across much of India, scepticism was abound in the early days following implementation, as to whether the long term benefits of increasing formalisation of the economy would ever materialise as hoped. Two industries shone out during this trip as particularly sharp beneficiaries of the early gains already made in terms of a shift in competitive advantage from unorganised to organised players; logistics and retail.

Both these industries are currently over 90% unorganised, and offer significant potential for the formal sector to attain multi-year structural growth as this balance begins to shift.

TCI Express, a logistics company specialised in time-bound parcel delivery, reported a noticeably increasing preference from customers to work with organised logistics players in response to GST implementation. In addition, the impact of GST in terms of removing state border stops for truck drivers has led to a significant improvement in asset utilisation. We expect TCI Express to deliver revenue growth approximately double the rate of India's GDP growth rate, at 16%. With an asset light business model based on hiring trucks from third party operators, this growth rate can be achieved with minimal capex, with the balance sheet remaining net cash. A small amount of margin expansion is possible, as price undercutting from unorganised competitors disappears, though this remains a volume-driven investment case. With these factors combined, we see potential for multiple years of high-teens profit growth for this company.

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In the retail space, one of our favourite companies across Asia and a stalwart of the India fund for three years now, affordable apparel retailer V-Mart continues to benefit from increasing formalisation of the economy. Management described customers continually migrating *en masse* away from buying clothes from roadside market traders and towards buying from V-mart's air-conditioned stores at lower prices, and enjoying all the benefits associated with buying from a modern retailer. Our forecasts for new store growth of 30 per annum, and our 10% Ebidta margin assumption both now appear overly-conservative, and we will be revisiting our forecasts and DCF valuation scenarios.

Lastly, politics remains a key part of the Indian investment opportunity, with the Modi government winning a second term at the 2019 general election the market's most preferred scenario. A widely discussed topic at the conference, I came across not a single CEO, investor or other market participant predicting anything other than a win for the Modi government next year.

This is of course no guarantee. However, perhaps more tellingly, not one person was able to describe for me what an opposition victory would look like, in terms of electoral arithmetic or pragmatically how a ragtag grand coalition of opposition parties would stand any chance at forming a government.

CONCLUDING THOUGHTS

Placed in the context of the last four years, since the Alquity India Fund was first launched, this is among the most positive set of insights we have ever come away with from an investment trip. With harmonised positive outlooks for economic growth, corporate earnings and political developments, we maintain conviction that India offers one of the most exciting investment opportunities anywhere in emerging markets at present.

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