MIKE SELL - SEPTEMBER 2017

FUND MANAGER DIARIES: INDIA

INDIAN SUBCONTINENT FUND

Mike Sell, Alquity Head of Asia Investments enjoyed an Indian Summer visiting 26 companies to assess how the economic reforms implemented by Prime Minister Modi were impacting our holdings and seeking out new opportunities for the Indian Subcontinent Fund.

His trip report below provides a detailed assessment of this multi-year growth opportunity.

Travelling to India is always an experience, even after 20 years. More recently, the dramatic improvements in efficiency and infrastructure are particularly impressive. After touch down in the early hours of the morning, I breezed through the surprisingly busy Delhi airport with its vast duty free store and was kerbside within 20 minutes. Of course, this being India, I was immediately confronted by a stray dog running through the drop-off area and a bus that had beached itself on a speed bump and was blocking the road!

Given the strong performance of our portfolio, the objective of my trip was threefold:

- To review our holdings and ensure that their growth outlook is in line with our expectations.
- To identify new potential candidates for inclusion in the portfolio.
- To travel off the beaten track to review the retail environment and potential for disruptive change in the smaller cities and semi-urban areas.

DELHI - THE CAR IS KING?

KEY TAKEAWAYS

1. The ongoing shift from the unorganised "Mom and Pop" stores to organised businesses is a key structural driver across many sectors in India.
2. It is fascinating to see India literally rising from the fields as new estates and suburbs are built in the greater Delhi area.
3. Indian companies will thrive due to their strong brand recognition, dealer networks and following Modi's drive for rural electrification, increasing penetration into smaller cities and rural areas.
4. There remains significant future potential for the private sector banks from not just India's growing population and economy, but direct market share gains from the inefficient state owned banks.
5. The investment case for India remains on track with expectations, if not actually ahead, due to the impact of the Goods and Services Tax (GST).

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THE GROWTH ENGINE: THREE DAYS IN DELHI

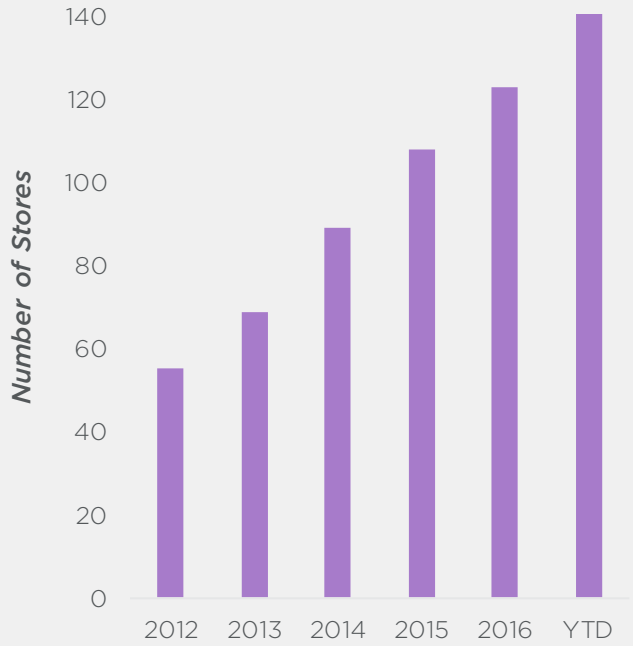
Delhi, or rather the satellite city of Gurgaon, is fast catching up with Mumbai and other Asian mega-cities in terms of ease of doing business. Certainly, the traffic can be awful as the city continues to dig up roads in order to build a metro and the best way to find an address still tends to be to ask a local stallholder. However, in terms of architecture and mindset, this area has more similarity to Canary Wharf than the old Delhi. Many international companies such as Google have set up base here, Uber works efficiently and increasingly companies are beginning to employ professional investor relations staff that are both knowledgeable and shareholder-friendly.

I met a range of companies across the automotive, cement, transportation and retail sectors including our holdings Astral Polytech, Vmart and Heidelberg Cement. The resounding message on Goods and Service Tax (GST) implementation was that it had been relatively straightforward and the benefits, such as a 20% reduction in journey time, as no more queuing is required at state borders, were already being felt. Margins will be further boosted over time as warehouses and supply chains are rationalised. Additionally, after several quarters of disruption from demonetisation and GST, the growth outlook is clearly improving. Management were consistently more positive and less guarded about their future sales and profitability than has been the case over the previous three years.

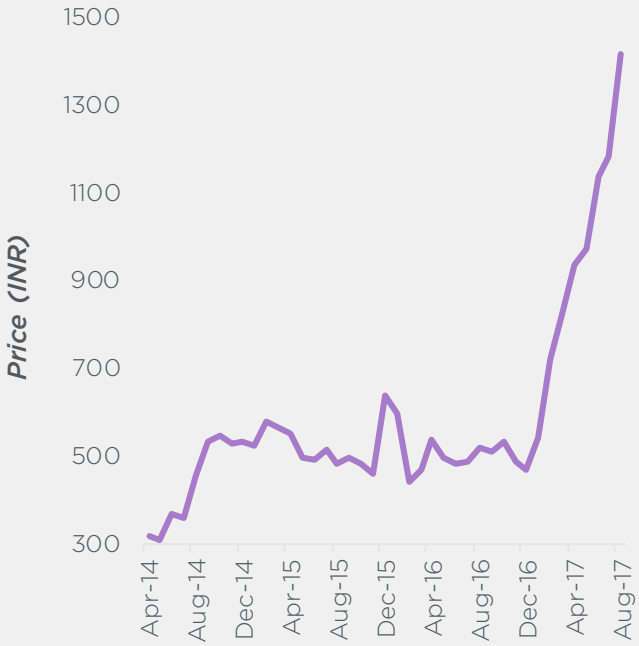
It is also clear that India's growth journey is just beginning. As an example, Vmart, a retailer whose share price is up over 200% this year, estimates there are 5,000 cities large enough to accommodate one of their stores. Despite being one of the largest organised retailers in India, they are currently in only 150 cities, with a market share of just over 3% in those locations. Given their strong free cash flow generation, which increased substantially in the last financial year, they are now considering accelerating their store opening plans. As we have seen elsewhere in Asia, the ongoing shift from the unorganised "Mom and Pop" stores to organised businesses is a key structural driver across many sectors in India.

COMPANY SITE VISITS

VMART STORE GROWTH:



VMART STOCK PRICE GROWTH:



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THE JOURNEY FROM DELHI TO ALIGARH & HATHRAS

Whilst the potential of India in terms of demographic advantage and the impact of Modi's reforms have received significant media coverage, the scope of this shift towards the organised sector is not fully appreciated by investors. This factor alone provides an inherent longevity to the Indian investment case. The introduction of GST, acting as an accelerant as all businesses are now required to provide proper documentation and to pay tax, removes the previous cost advantage from smaller and unorganised entities in every sector.

In terms of idea generation from Delhi, two companies justify a deeper analysis as potential investment candidates. Firstly, PNB Housing Finance, which listed in November 2016 and is a major beneficiary of the government's drive to increase affordable housing through tax breaks for both developers and households. Housing affordability in India is the highest it has been for 20 years. Secondly, Somany Ceramics, which has restructured its business model over the last few years, also provides exposure to the theme of urbanisation, through both their tile and sanitary ware divisions. The company has risen from sixth place in 2011 and is now the second largest in the sector. Over the last three years it has increased margins from 6.7% to 11.5%, and ROCE from 15.5% to 21.3%. Our preliminary ESG analysis indicates that these companies will meet our behaviour and quality standards, although we require a more detailed investigation.

THE MULTI-YEAR GROWTH OPPORTUNITY: OFF THE BEATEN PATH TO ALIGARH AND HATHRAS

Whilst face-to-face company meetings at their offices is a key part of our work, it is also vital to view their products or services outside the big cities, where their stated competitive advantage can be assessed for real.

Thus, I journeyed three hours outside Delhi to Aligarh, a city with a population of 872,000 in the state of Uttar Pradesh. Although greatly improved since my first visit here, large parts of the highway still need upgrading and my car had to contend with oil tankers on the wrong side of the road, carts pulled by oxen, and the ubiquitous five people on one scooter. However, it is fascinating to see India literally rising from the fields as new estates and suburbs are built in the greater Delhi area.

My first goal was to investigate the threat from e-commerce and e-banking outside the major cities. This disruptive threat has been much discussed recently, and so I attempted to visit four of the leading "clicks and mortar" exponent's stated locations in various villages and towns such as Junedpur and Bulandshahr, as well as those in Aligarh. These are meant to act as hubs for parcel deliveries and banking transactions. From what I saw, the reality does not match the hype and, at this stage, we will not be investing in this company. Additionally, the competitive advantage held by Vmart in smaller cities does not face significant risks in the near future

ASTRAL POLY TECHNIK PROMOTIONAL MATERIAL

STREET SCENES IN ALIGARH & HATHRAS

from this new channel.

Secondly, I wanted to better understand the physical competitive retail environment for Vmart. In Aligarh, there are two other chain stores, as well as a huge number of independent stores. Vmart was certainly busier than both Vishal Mall and Pantaloon, with Vishal Mall suffering from a terrible retail experience and poor product availability. Pantaloon was more ordered and modern, but this was reflected in substantially higher prices. One key difference with shopping in an equivalent developed city was the open sewer along the side of the street, whilst the contrast with the shopping experience back in Delhi was equally stark.

Moving on to Hathras, a city of 136,000 people a further hour away, Vmart has even less competition. The store is located in the city centre, in an area that looks like an old bazaar. There are a few modern Mom and Pop stores, but they do not have Vmart's extensive product range. Most competition is from traditional stores, that look unchanged in generations, with the proprietors seated on the floor in open storefronts with merchandise stacked around them. Vmart clearly has a significant opportunity as consumer tastes develop.

Turning to banking penetration, despite Aligarh's size, there was only one branch for each of the private sector banks that we invest in, namely Indusind, Yes and Kotak Mahindra Bank. In Hathras, HDFC Bank, the largest private sector bank was the only one with a presence. This again vividly illustrates the under penetration story of India, and the multi-year opportunity the banking sector provides.

> *Indian companies will thrive due to their strong brand recognition, dealer networks and following Modi's drive for rural electrification, increasing penetration into smaller cities and rural areas*

A FLYING VISIT TO AHMEDABAD

Following Delhi, I embarked on a day trip to Ahmedabad, Prime Minister Modi's hometown, to visit our holding in Astral Poly Technik. Since we initially invested in March 2016, several sell side brokers have also identified the opportunity here, driving the share price higher.

Driven by urbanisation, an improved rural economy and continued investment in new technology, processes and capacity, we expect 15-20% volume growth and margin improvement building on Astral's existing 30% market share in pipes. Their entry into the adhesives segment, through earlier acquisitions in India and the UK, provide a second growth driver. As their major capital expenditure investment programme is now complete, Astral should also see a rising ROCE and will become debt free in the next 2 years leading us to conclude that the valuation is still attractive.

I met with an interesting provider of high-end steel piping which will benefit from planned refurbishments of Indian refineries to meet tighter emission regulations. Finally, before flying to Mumbai, I met with Gruh Finance. This is a very well managed company, providing housing loans to lower income customers, with non-performing loans consistently below 1%. We will need to do more due diligence on these prospects over the coming months.

MODERN, CONFIDENT INDIA: THE FINANCIAL HUB OF MUMBAI

The city may only be an hour away from Ahmedabad by plane, but as India's financial capital, the atmosphere is a world away. For example, the airport has a dedicated pick up area for Uber and Ola and as you drive along the expressway there are numerous advertising billboards for the latest stock market IPOs.

My meeting with Oberoi Realty gave me the opportunity to assess the impact of the Real Estate Regulatory Act on them and their peers. Stricter rules regarding payment collections from customers will result in fewer speculative projects, and thus

VISTING VOLTAS

FUND MANAGER DIARIES: INDIA

ON THE ROAD IN INDIA

lower overall supply. Consumer confidence has returned to the Mumbai property market, following the disruption from demonetisation, and I remain very comfortable with our investment.

Voltas, the air conditioning company, was additionally reassuring as management shared their view of the increasingly competitive environment and their strategy to counter it. The experienced management team has delivered to date; building a franchise that dominates with a 21% market share. We believe that air conditioning, like the automobile sector will see an acceleration in competition in the main cities. However, Indian companies will thrive due to their strong brand recognition, dealer networks and following Modi's drive for rural electrification, increasing penetration into smaller cities and rural areas. Maruti, with whom we met in Delhi, still has a market share of almost 50% despite the entry of Hyundai, Toyota and Honda. I frequently spotted their dealerships on the road trip to Aligarh. As Voltas stated, there is wealth outside the major cities, and this is proven by car sales in these areas, which account for approximately 35% of Maruti's total sales. This confirms that air conditioning is an affordable modern convenience and once reliable power is available, it becomes an accessible necessity.

Additionally, I scouted for new ideas in the construction sector as, anecdotally, Mumbai is currently building out the largest amount of infrastructure since India's independence.

I had an informative introductory meeting with J Kumar Infrastructure, a major beneficiary of India's focus on building metro systems in cities with a population over 5 million.

I also met with Sun Pharmaceutical, perceived as the market leader, to determine whether the intensified pressure on US generic drug pricing is adequately reflected in share prices and as a comparison to our position in Glenmark Pharmaceutical. The meeting reaffirmed our belief that whilst headwinds for the sector will persist for an extended period, Glenmark's differentiated product offering and significant focus on environmental standards will result in continued profitable growth.

Similarly, I met with HDFC bank and LIC Housing Finance to ensure I understood the competitive environment in their respective segments. HDFC Bank is one of the best-run companies in India, and one I first met in the mid 1990s. As they reminded me, at that point the public sector banks' market share was 90%, with international banks on 8% and private sector banks on 2%. 20 years later, the split is 68%, 5% and 27% respectively. In addition to the impressive growth this represents (including taking market share from international banks) there remains significant future potential for the private sector banks from not just India's growing population and economy, but direct market share gains from the inefficient state owned banks.

Our long-term themes of urbanisation and demographics naturally lead us (but not exclusively so) to consumer related companies, and I met with four new potential ideas in Mumbai. Unfortunately, a number of these suffer from a lack of sustainable competitive advantage and so we will not

undertake further analysis, but there is one potentially interesting addition to the portfolio in this sector.

BEYOND THE NUMBERS: FORWARD-LOOKING ESG AND ENGAGEMENT

There remains a significant divergence between companies in terms of Governance. Some of the best, such as Jamna Auto and TCI Express, have huge untapped opportunities ahead of them but are determined to grow at a sustainable, steady pace and with a focus on margins and returns to shareholders. My meeting with the Chairman of Container Corporation of India (distribution logistics), the only company with a public sector background that we own, is a great example of this mindset. They have a longstanding culture of focusing on profit rather than 'national service', which has been accentuated since the Chairman joined last year. This is in stark contrast to public sector banks, for example.

Elsewhere, however, there is still a tendency for companies to either act as a tool of their founding family and/or to 'go for growth' at all costs, typically leading to balance sheet problems and further equity raising. I met with a few examples of this during the visits. As our interests as minority shareholders are not aligned with those of management here, we do not invest.

We also believe it is key to discuss governance with management, rather than operating a screening or 'tick box' approach. For example, only by speaking directly with Prabhat Dairy, was I able to discover the valid reasons for their numerous changes in auditors and internal control function personnel over the last two years. These were symptomatic of the company professionalising and refusing to compromise in terms of management quality, rather than anything untoward.

In addition to the dialogue that we undertake with the senior management of the companies that we invest in, we also engage with them on topics of concern to us and share best practice from our experience elsewhere in the region. As we focus on investing in transparent companies, who are open to having two-way dialogue with their shareholders, this is also valued by management teams. Engagement on this trip comprised of two main areas: disclosure and independence.

One of the largest risks facing Oberoi Realty, a Mumbai property developer, is health and safety during construction. Given their premium product positioning, there is significant reputational risk from any accidents or fatalities. My discussions with management determined that the company is well aware of this, and safety issues are tracked by internal audit, published on hoardings at each site, and discussed at each audit committee meeting. I urged management to publish this data more widely, which will help to highlight Oberoi's differentiation versus peers, and contribute to a share price rerating over time. Similarly, accident rates are also a critical risk for Heidelberg Cement. However, not only are they tracked internally in India, they represent a key part of the country head's performance indicators and are reviewed monthly by the Head of Sustainability at the parent level. The same standards are applied to both employees and contractors which is still relatively uncommon here. I do not believe that this impressive focus on safety, as well as publishing their monthly emissions for each plant on their website, has gained a wide audience. Investors reward industry leading ESG, and thus I engaged with the management team as to why this data is important for shareholders and urged more effective dissemination

Whilst our companies always meet local standards in terms of the composition of board committees, it is regional best practice to operate a fully independent audit committee. This increases the confidence of

MORE SCENES FROM THE ROAD IN RURAL INDIA

minority investors that their interests are fully recognised and respected, especially where management are also the founders of the company. I engaged with both Astral Poly Technik and TCI Express on this, sharing our experience in other markets and explaining the rationale for our request for change.

Environmental and Social factors are becoming more frequently discussed in India. Pollution and emission levels are discussed regularly in our meetings with management, with disclosure in this area needing to improve in the coming years as investors increasingly require greater granularity. Voltas, an air conditioning company, has always had some of the most energy efficient products in India. They have also made great strides over the last three years in replacing existing refrigerants with more environmentally friendly alternatives. I discussed at length the changing Indian and international standards, and how Voltas will manage this transition, as there are always further improvements to be made.

Following successful conversations with Vmart over several years on their supply chain, I shifted the focus in this meeting to the environmental impact of their logistics chain. Our companies, including Vmart, ensure that their in-house transport fleet complies with environmental best practice, but do not often extend this to their contractors. This is an area that we can help influence over time, hopefully resulting in more energy efficient vehicles, lower costs and less pollution.

In terms of Social factors, my first ever visit to Eicher Motors' office was a revelation. Their main product is Royal Enfield motorbikes, which are iconic in India (along the lines of Harley Davidson in the USA) and thus the design buzz is essential. Their offices are open plan, with young team members moving throughout the shared space with their laptops, akin to a Silicon Valley tech company. This appears to deliver the necessary creativity, in a manner that would be unthinkable for a hierarchical public sector company, or indeed many private sector companies that are driven entirely by their founders. Again, this is not something that can be ascertained from desk based analysis

A conversation with Jamna Auto was also very revealing in this regard. Jamna has the leading market share in axle springs for trucks in India – 73% overall, rising to 93% for parabolic springs. Due to their cost competitiveness, management are looking to increase their exports from the current minimal levels. However, the CFO believes that a cultural shift is first required, both in terms of a younger, more dynamic workforce and a greater appreciation of the importance of product quality throughout the firm. Thus, hiring and retraining is taking place, in order to successfully break into overseas markets in two years' time. This is a great example of a company investing in human capital, to ultimately boost profits and thus returns to shareholders

CONCLUDING THOUGHTS

In total, I met with 26 companies during the trip and my clear conclusion is that the investment case for India remains on track with expectations, if not actually ahead due to the impact of GST. None of our existing holdings disappointed, and thus none will be exited from the portfolio. We also have some potentially great new ideas to consider adding to the portfolio over the coming months.

ROYAL ENFIELD PROMOTIONAL MATERIAL 2017

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