MIKE SELL & KIERON KADER - DECEMBER 2019

TRIP REPORT: INDIA

WHERE HAS THE GROWTH GONE?

INDIAN SUBCONTINENT FUND

Mike Sell and Kieron Kader spent 10 days of December in India travelling to Delhi, Mumbai, Chennai, Lucknow and Kanpur.

The team visited 38 companies including 20 of our fund holdings. In addition, they conducted a range of channel checks and also met one of the Transforming Lives Awards winners, Phool, where they held a consumer survey panel. Kieron below writes from his unique perspective, having visited India many years ago...

5 KEY TAKEAWAYS FROM THE TRIP:

• Overall, our expectation is that growth will follow a U-shape recovery path rather than a V-shape.

• We have successfully avoided all the highly geared companies that defaulted due to the liquidity crisis. However, our portfolio has suffered from the second-round impact, notably in the financial sector.

• The internet and e-commerce is now well penetrated even in semi-urban and rural areas and growing at an exceptional pace.

• ESG – it's here In India, they're just not shouting about it…yet. Corporates have been measuring water intensity, greenhouse gases etc. but haven't been disclosing this information.

• We had said that we expected to see improving macro growth from the festival season (November) onwards. Our initial view has been confirmed by our detailed on-the-ground meetings.

I first visited India some 20 years ago when I was a child. My father's family is from Chennai and we spent most of our time here and in the state of Tamil Nadu. Whilst this was some time ago, there were many features that appeared familiar: the smells of food being cooked on the street, the bustling chaos as people make their journeys by scooter, and the cows, monkeys and goats roaming the roads all evoked a sense of nostalgia.

However, India has changed in many ways. The infrastructure has vastly improved, there are many modern retail channels in addition to the existing mom-and-pop stores and most people now have mobile phones and access to the internet. These are all developments that have formed part of our investment theses – from our longstanding holdings such as **V-Mart** and **Bata** (organised retail), **TCI Express** (logistics) and more. These are long term structural growth stories, which is where we focus.

However, the last twelve months has witnessed significant volatility both in terms of the overall market and the Alquity funds. Is this just a speedbump in the long-term structural growth journey, or is the investment case damaged or broken ?

Firstly, we need to analyse the causes of these events. We believe that the genesis was the corporate failure of Infrastructure Leasing & Financial Services (IL&FS) over a year ago. This was a company with short term borrowings funding long term assets. However, when the lenders (including the Public Sector Banks) stopped lending, IL&FS were unable to raise capital which led to default. This then led rating agencies and bankers to re-assess similar situations. This removal of easy access liquidity has resulted in a number of highly geared companies falling by the wayside. This coupled with various earlier government initiatives such as demonetisation and the introduction of a goods and services tax (GST) meant that liquidity was a further issue for a range of companies. Whilst we have successfully avoided all these firms, our portfolio has suffered from the second-round impact, notably in the financial sector.

That said, the government stands ready to support the economy. Corporate tax rates have been effectively reduced by 10ppt to 25% on par with many of India's emerging Asian peers. We have seen accelerating infrastructure investment following the period of 'purdah' at election time - GMR, one of the largest infrastructure companies noted that there have already been 8 airport privatisations since 2017 under Modi. An infrastructure fund has been set up to support property developers. An asset management company has been set up to support the Non-Banking Financial Companies (NBFC). Furthermore, the key policy interest rates have declined 135bp during 2019, and given controlled core inflation, we expect further interest rate cuts into 2020. This is concurrent with the improving November PMIs, rising to 51.2 from 50.6 in October. All of these efforts combined have or will restart economic growth.

However, we believe that undertaking an intense programme of in-situ company visits across the country provides much greater insight as to the real situation on the ground, and will enable us to address the question – 'Will the Indian economy accelerate, and if so – when ?'

> "Will the Indian economy accelerate, and if so – when ?"

CONSUMERS

Given low levels of urbanisation (34% vs China at 58%) a population of 1.3bn, growing above 1% per annum and expected to overtake China as the world's most populous country in 2027, the consumer sector benefits from long term structural growth opportunities and is a key part of our portfolios.

Ceramics and tiles are a beneficiary of these growth drivers, as people move to more formal accommodation with tiled bathrooms and ceramic toilets, etc. We met with our holding, **Somany Ceramics** and competitor **Kajaria**, where both companies had strong festive season sales with the momentum carrying through subsequently. Given costs are largely fixed, this will be positive for Somany's margins and thus we are comfortable with our positioning. Kajaria is also a beneficiary and will form part of our research agenda for the coming months.

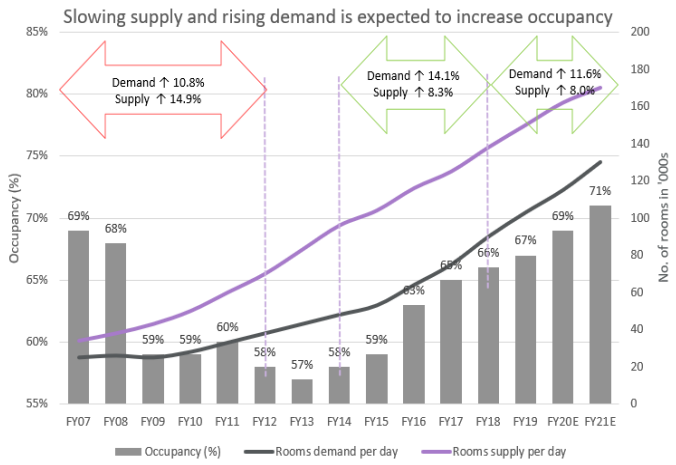
Somany's offerings of high-quality tiles

The hotel companies we met had also experienced a similar growth profile, with strong occupancies throughout and after the festive period. **Lemon Tree**, a mid-end domestic hotel company has 78 hotels and 7900 rooms with well-located properties that are positioned in the business districts, where the demand has been strong. The firm has consistently achieved occupancy rates above peers.

Furthermore, the sector cyclical positioning is favourable as demand growth has exceeded supply growth since 2015 (see figure 1 below), driving room rates and occupancy higher. This will continue and was confirmed by **Chalet**, a company that owns, develops and manages high-end hotels under brands Hyatt and Marriott. Lemon Tree also benefits from monetisable structural growth as demand grows with increasing urbanisation, higher disposable incomes and the aspirational shift towards branded hotels.

As the company fits all of our core themes, we have since added a position to the Alquity India fund.

Figure 1: Slowing supply and rising demand is expected to increase occupancy



Source: Hotelivate trend and opportunities report 2019

Another exciting meeting was with our holding, **Amrutanjan**, a company that produces pain balms (with a 125-year old brand) and personal hygiene products. Amrutanjan has been growing quickly and has been taking market share from competitor, Emami, with April-October sales exceeding 20% growth year-on-year.

They have also grown their distribution and are expanding into untapped locations such as gyms and sport-centres which provides an additional leg of growth. We engaged with Amrutanjan to produce more data on water usage, though it was noted that they have a solid waste management system and recycle 100% of wastewater.

This is a relatively small company ignored by most buy and sell side investors

We also met with our core holding **V-Mart**, as well as various other players in the retail eco-system such as **V2**, **TCNS Clothing** and **Shopper Stop**.

V-Mart had been hurt by one-offs in Q2 such as the political issues in Jammu & Kashmir and flooding in Bihar (East India). However, the monsoon was particularly good which should lead to higher incomes for many in the lower tier cities (as agriculture comprises 70% of employment) - hence further improving consumption in the next 6 months.

Thus, we expect a re-acceleration of growth for V-mart in the coming months. We met other competitors to understand the ecosystem such as TCNS Clothing and Shopper Stop – for TCNS we were concerned that whilst they had grown reasonably quickly, the company lacks a sustainable competitive advantage and is already facing competition from much bigger players, particularly on the aggregator websites like Amazon and Flipkart.

Mike outside a V-Mart in Kanpur, a well-located store with ample parking space

Channel checks in Kanpur

We travelled to Kanpur, a smaller city of 4 million people in the state of Uttar Pradesh. We visited a range of over 20 retail sites – from very large high-end malls such as Z-square to traditional malls, to standalone stores as well as mom-and-pop stores. We analysed prices, quality and quantity of offering, store amenities (e.g. air-conditioning, washrooms), lighting, etc. We did notice however that competitors had improved their offerings, and essentially copied some of the features that V-Mart had implemented several years ago. This indicates that the competitive intensity has increased, though V-Mart remains priced below many peers, and thus offers value. We are confident that the growth potential is still large, and we have seen V-Mart continue to grow their stores to capture this opportunity.

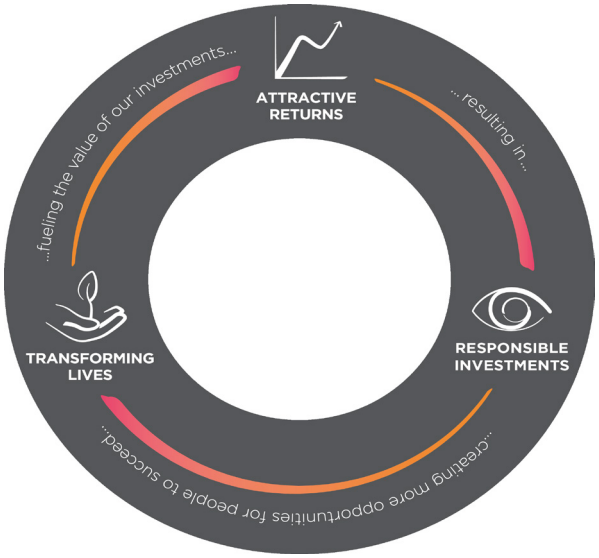
An older style shopping mall – these have fewer Western and modern brands, and less variety of Food and Beverage outlets.

Z-square mall – an impressive high-end shopping mall

COMPLETING THE VIRTUOUS CIRCLE

We met with **Phool**, a winner of a Transforming Lives Award - the foundation that Alquity supports by donating 10% of revenues. Phool take flower waste from temples and recycle it into incense sticks, thereby reducing environmental harm and employing underprivileged members of society.

Our virtuous circle starts with attractive returns, driven by responsible investments, which transform lives through our donations, and then ultimately create the consumers of tomorrow. In order to square the last part of the circle, we had the unique opportunity to conduct a panel survey with employees of Phool to understand how their spending habits changed after entering formal employment.



The panel consisted of six women and three men who were from underprivileged backgrounds. We asked them all as to how they were spending their additional income.

Interestingly, all cited savings as important and that these are now mainly banks-based with a much lower focus on gold compared to previous generations. All wanted to buy a house (or were in the process of buying) as they have ancestral homes that were located far away. Government house purchase schemes were particularly integral. This bodes well for our building product and cement names.

All participants enjoyed shopping which involved going to the organised sector such as the high-end Z-square mall, as well as the unorganised market, depending on the occasion. We were also able to cross check a number of our positions – all members had shopped at Bata (shoes), all members used Bajaj's almond oil hair drops, and all members had heard of V-Mart and TTK Prestige cookware.

The key takeaway, however, was relating to the penetration of the internet in lower tier cities. We were pleasantly surprised to learn that the internet is well penetrated even in semi-urban and rural areas and growing at an exceptional pace. All of our participants had mobile phones and used the internet for shopping, social media and staying up to date with the news. This confirms the comments from other enterprises, including Phool, that a growing part of their sales comes from e-commerce in these areas.

Mike and Kieron conducting the panel survey

The whole team wanted to take a picture with us!

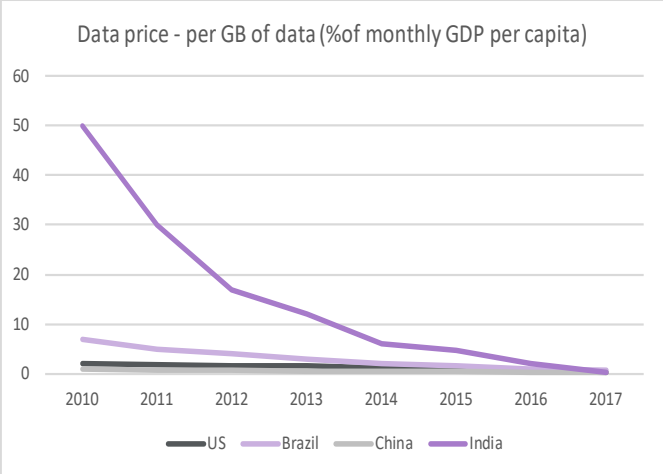
Our virtuous cricle, with the Transforming Lives Foundation and consumer panel provides a unique insight and competitive advantage.

E-COMMERCE IN LOWER TIER CITIES – AN UNDENIABLE THEMATIC

Our learnings from Phool and other companies had challenged our views on the prevalence of e-commerce in lower tier cities and we decided to investigate the reasons behind the rapid adoption.

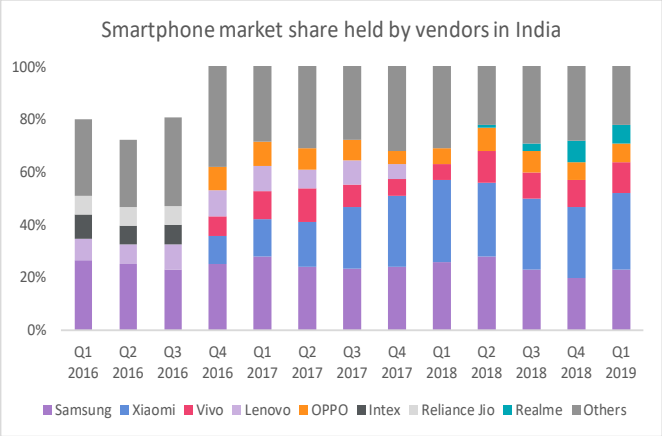
The first point is that data plans have drastically decreased in price. This is largely due to the introduction of low-cost plans by players such as Reliance Jio.

Figure 2: India's data consumption grew 10-fold in 4 years as data plan prices fell sharply



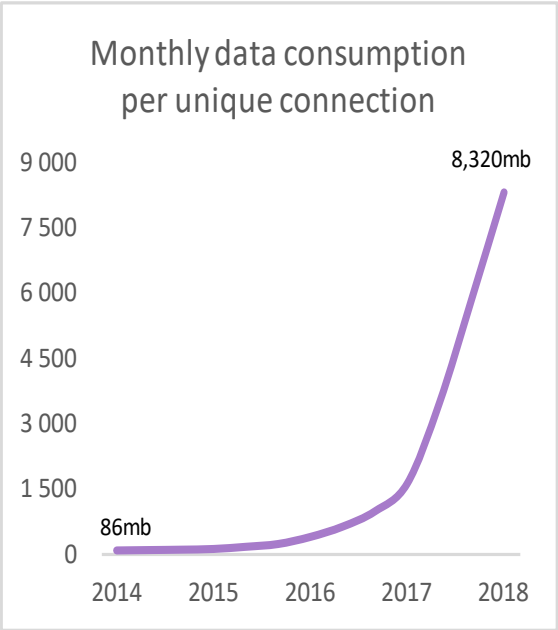
Secondly, the cost of mobile phones has also decreased drastically. A mid-range phone costs approximately INR 4000 (~£40), which is accessible for a large proportion of the population. This has arisen due to the introduction of cheaper Chinese smartphone brands such as Xiaomi and Oppo. Our holding, **Redington**, a distributor of mobile phones in India, are expecting 30%+ CAGR smartphone growth for the coming years.

Figure 3: Xiaomi, Vivo and Oppo have grown rapidly since 2016



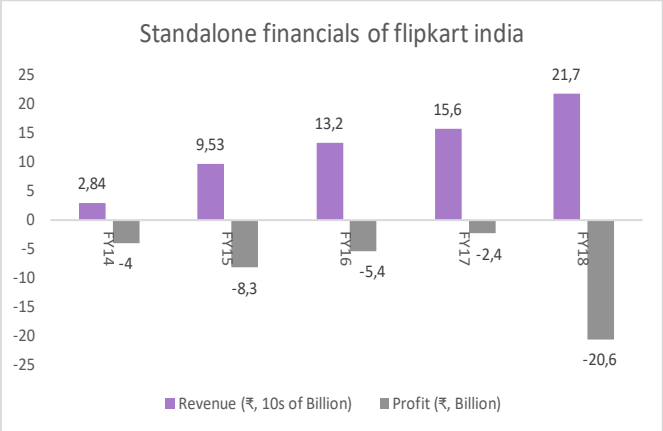
These lower costs have led to a subsantial increase in data usage over the last 4 years.

Figure 4: Monthly data consumption evolution - per unique connection, per month



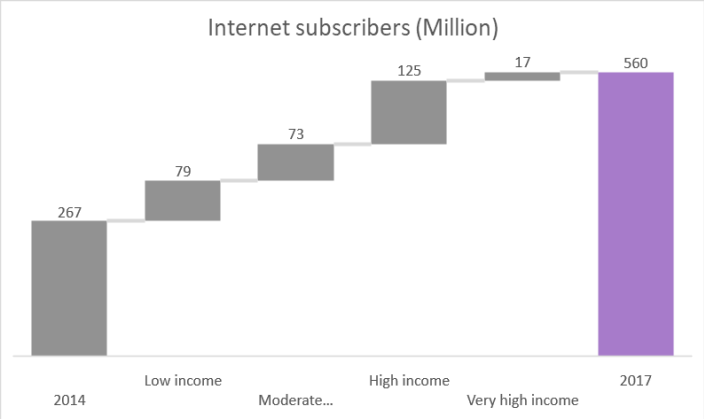
We also spoke to a number of clothing retailers who reported that FlipKart and Amazon were quickly becoming a significant part of their sales. This has been accelerated due to incentives such as free delivery, heavy discounting and accepting cash on delivery as both players compete intensely for market share. This bypasses the need for credit cards / bank accounts.

Figure 5: Flipkart is using huge amounts of cash to gain market share, resulting in a very cheap offering for costumers



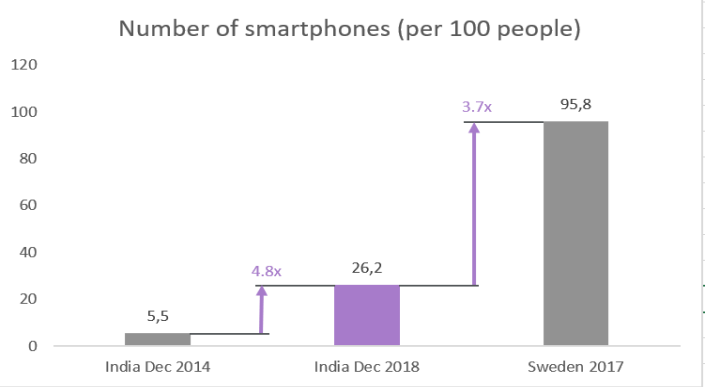
And these trends are not just common to urban, richer consumers.

Figure 6: online users have grown in both poorer and richer indian states



And whilst the growth has been rapid, the potential is still massive. Thus, Redington has a strong growth profile for the next years, which is not reflected in their valuation.

Figure 7: India has almost 4 times fewer phones per 100 people compared to a developed country like Sweden.



Figures 2-7 Source: McKinsey

Key takeaway: India has changed – and this will impact our views of the retail sector. We will take learnings from China, Indonesia and Philippines over the last 10- 15 years and apply them to India. Our view is that the formalisation of retail will now happen even faster with the exceptional penetration of e-commerce, as mom-and-pop stores will find it harder to compete for the consumers attention and buying preference.

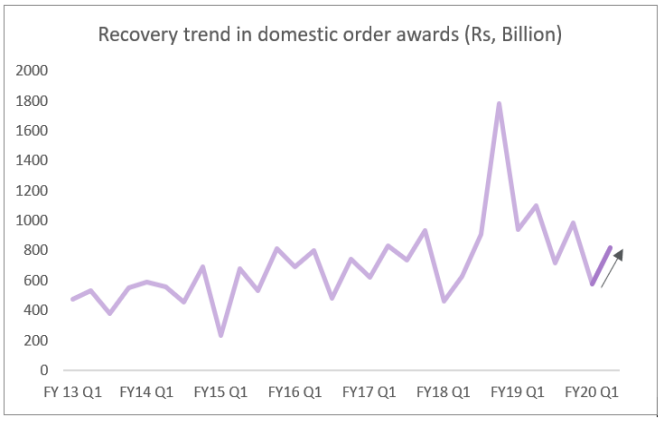
AUTOS

The worst is over – visible green-shoots for renewed demand

The Auto sector has been particularly affected by the liquidity issues at the NBFCs, as they were a core provider of loans for purchases. However, speaking to our holdings **Hero MotoCorp** (2-wheelers) and **Maruti** (cars), it was noted that year-on-year sales for October and November showed positive growth, and that inventory levels at the dealerships were now better than expected. Thus confirmed our view that the worst is over. Both companies expect volumes to start to accelerate from here, as the monsoons were better than expected. In addition, there is a new emission standard which is effective from April 2020 called Bharat-Stage VI (BS-VI), which is at par with Euro VI, the highest emission standard set by the European Union. Hero and Maruti have produced a suite of BS-VI compliant vehicles and are therefore in a stronger position compared to peers. We also engaged with Hero to address the issue of poor attendance of some independent directors, as this increases the protection for minority shareholders.

Furthermore, a scrappage scheme has been discussed within government for some time as a means to boost new auto sales. This would be a welcome positive, though not our base case. Our holding, **Jamna Autos**, a truck-parts manufacturer would be a huge beneficiary of this scheme. The company is well managed and has limited downside risk with a massive potential catalyst. As a channel check, we met with **Ashok Leyland**, the second largest commercial vehicle (CV) producer in India. They again confirmed that the inventory levels had normalised and the company had increased production since October in anticipation of increased demand in the coming months. Our holding, **Escorts Tractors**, also reverted back with a positive message as the post-festival growth momentum had sustained, and management are expecting a recovery in organic demand, particularly due to the monsoon. Finally, several companies commented that the post-election government spending boost has been delayed – however, we have now seen a pickup in key states (e.g. Maharashtra). This will be another positive for infrastructure and construction.

Figure 8: Trend in domestic order awards (ew-railway loco order)



Source: Media articles, companies, NHAI, NHIDC, PowerGrid, Investec securities research

Ashok Leyland's office

Hero MotoCorp's office showcasing a simple and elegant motorbike design

FINANCIALS

Being selective is paramount

Banks

As mentioned, the banking sector has been challenged in the short-term for a variety of reasons. However, this is an environment where size and quality can actually thrive. This has been seen in the large high-quality private sector banks who have gained market share from the public sector and weaker private players. Our holding **ICICI Bank**, falls in the prior category and has returned approximately 50% year-to-date. That said, the overall sentiment from management of almost all banks including Indusind, **Axis**, **Kotak** and **Yes Bank**, was fairly subdued for the shorter term. Our pre-trip expectation was that this sector may present an interesting undervalued opportunity, however we believe it is too early.

Although managements stated that the worst is over operationally, they indicated that there is still further stress in certain areas (e.g. property) to be recognised. Hence our expectation is that credit costs may inch up for the next two quarters, but ultimately, we should see improvements in the banking environment in mid 2020.

However, there are some positive signs. The Supreme Court in November ruled that the seniority of security creditors must be upheld when admitted to the National Company Law Tribunal (NCLT). This essentially favours the banks as it allows them to claw back funds from companies that have defaulted. This is very positive, but it will take time for resolutions to come through.

Non-Banking Financing Companies (NBFC) and property
The three most important words: quality, quality and quality

The NBFC industry has seen extreme volatility and has been particularly affected by the liquidity issues as banks had stopped lending to NBFCs who were deemed lower quality (highly indebted, poor lending practices etc.). We met with an NBFC who falls in this category, Indostar.

These NBFCs had seen serious spikes in defaults, an inability to gain capital from banks which led to a rising cost of funds, and also reduced loan demand which led to falling market share. On the contrary, we met with our holdings **Mahindra & Mahindra Finance** and **HDFC** who have seen decreasing cost of funds, improving loan demand, rising market share and have not had any issues obtaining liquidity. This stark contrast is exactly the reason we own quality NBFCs, and we remain confident that they will continue to consolidate the market and improve their margins, especially as the accelerating rural economy provides a cyclical tailwind.

The **property sector** has seen an elongated downturn, which has pressured both developers and financing companies. Part of the issue has been related to the implementation of GST where the tax benefits of pre-buying (i.e. buying a property before completion) were reduced, hence pre-buying rapidly slowed down, and developers effectively lost a significant part of their short-term funding. For the heavily indebted, low quality developers, this was very negative, and we have seen a number of these fall into default. Housing finance companies like HDFC, despite having healthy balance sheets, have been reluctant to fund the remainder of these projects because they would have to recognise their assets as non-performing loans.

However, the government has recently introduced a scheme to support these nearly-finished projects. Overall this has the potential to unblock liquidity in the sector. In addition, our holding, **Oberoi**, has been able to thrive due to their proper balance sheet management and will see a wave of demand once the properties are completed. Furthermore, with fewer competitors, they will be in a prime position to take market share going forward.

Life insurance
A clear long-term winner

India is severely underinsured – the protection gap (a measure of required insurance vs actual insured) is one of the highest in the world, and premium per capita is particularly low. We met with our holding **ICICI Prudential** who has shown resilience and has consistently grown their Value of New Business and profitability. We also engaged with ICICI Pru to incorporate ESG in their stock purchase decisions, as they are large equity investors. Management were receptive to this idea and recognised that this was an opportunity to pursue, and we will continue to engage with them.

Figure 9 & 10: Protection opportunity: Income replacement

1. As of FY18 for India, FY15 for US, FY17 for Germany and others
2. Source: McKinsey estimates.
3. Protection gap (%): ratio of protection lacking/protection needed
4. Source: Swiss Re, economic research and consulting 2015

WATER - ARE INDIAN COMPANIES RESPONSIBLE STEWARDS OF WATER?

Water is a particularly crucial topic for India. The monsoons dictate the strength of the harvest, on which 70% of people are dependent. We engaged with all our companies to increase their disclosures on water, and to have active water intensity reduction targets.

This was particularly pertinent to our cement holdings **Ultratech** and **HeidelbergCement India**. Pleasingly, both companies are net water positive (2x and 6x, respectively), meaning that they collect more water than they use by recycling water as well as capturing rainwater in their reservoirs. HeidelbergCement have doubled their reservoir capacities, which means that they are better placed than peers as their production would be less disrupted in the event of a drought. Both companies have also been pioneers in using waste heat recovery methods, and the use of renewable energy such as solar (which will form 10-15% of their energy usage).

We also discussed this with other companies such as **Bajaj Corp** (personal care products) **Amrutanjan** (pain balms). We learned that both companies have adequate water supply from the state, and also recycle wastewater with efficient waste management systems.

ESG – IT'S HERE, THEY'RE JUST NOT SHOUTING ABOUT IT…YET

Indian corporates appear to lag behind their counterparts in Asia in terms of ESG disclosures. However, we found that many corporates are actually starting to measure water intensity, greenhouse gas emissions etc. and many did have active targets to reduce these.

Indeed, it might be surprising to note that India has doubled its renewable energy usage in the last 3 years.

The missing part of the puzzle is that corporates haven't been disclosing this information, as they were not required to do so. Others believed that investors simply didn't care about this information.

As pioneers in ESG, we actively encouraged all the corporates to do more in terms of disclosures and targeting. We had extended conversations with **ICICI Bank,** relating to global standards, peer examples, overview of ESG investor types, acceptability of various potential loans (defence, coal etc) and incorporation of environmental factors in lending decisions. In addition, **Redington, Motilal Oswal** and **Bajaj Corp** asked for our views on best practice.

Furthermore, **Escorts** and **Somany** will be publishing an ESG report after engaging with them for several years, and similarly **HDFC** have been working on an ESG report and have hired additional resources.

> These are all deeply encouraging signs that India is taking ESG more seriously going forward.

Actions have already been taken on some of our concerns. We spoke with **Jamna Autoparts, Ultratech Cement** and **Hero Motocorp** about poor meeting attendance by one or more independent directors. Pleasingly, the companies had already removed them from the board which is a sign that companies are taking this issue much more seriously.

Environmentalism has become prominent – the picture shows a sign in Mumbai to reduce plastic bag usage

Though we see leaps of improvements in many companies, some remain unaligned to our interests.

We met with a number of retail companies who did not closely monitor their supply chain, often citing that, "the responsibility lies with the supplier only".

Our holding V-Mart takes the opposite stance and hence stands out as an ESG leader in supply chain management as they ensure that suppliers do not use child labour and have proper health and safety procedures, eliminating companies from their supply chain for failing to meet their standards.

We visited a particular competitor at their offices which demonstrated strong indicators of organisational chaos, whereas V-Mart's management have always been transparent and professional. This is precisely the reason why we do in-situ meetings as opposed to just conferences.

One meeting was particularly disappointing. This company had communicated a credible intention to improve over the last 18 months which has not come through.. The tax auditors and statutory auditors were expected to be changed due to the completion of their terms.

The company believed it was appropriate to switch the tax auditors to take up the statutory audit, and vice versa. They also believed it was appropriate that the partners of the audit firms conducted the audit and visited their offices weekly. This close relationship between the auditors and company is not best practice and is frankly concerning. Equally, two long-serving independent directors had been retained on the board for no adequate reason except their good-relationship with the company. We thus have concerns as to whether this company can be operated in the interests of the minority investors or just the founding family. Hence, given our concerns, we score the company as a D in our proprietary ESG rating system – namely a 'fail' and not suitable for investment.

CONCLUDING THOUGHTS

We had said that we expected to see growth from the festival season onwards. Despite the last two GDP prints of 5% and 4.5% which were worse-than-expected and caught everyone by surprise – our initial view has been confirmed by our detailed on-the-ground meetings. The short-term volatility has been pervasive and worse than expected, but the stimulus provided by Modi's government, the accommodative monetary policy and the strong monsoon has started to buoy the economy from November, and we should thus see improving growth and sentiment. There have also been delays in the construction sector, which have now started to subside even in the key state of Maharashtra which has experienced a change in government. The Kharif crop harvest between January and March will be a strong support for the rural economy. Overall, our expectation is for growth to follow a U-shape recovery rather than a V-shape, with the financial sector a noticeable laggard. Thus, we expect GDP growth of 3.9 - 4.7% in Q4 followed by 5.1% in Q1. Longer term, our view is that the liquidity issues, demonetisation and GST are ultimately positive, as they leave better quality companies in the system and refocuses them on proper capital allocation.

Overall, we remain positive on India and combined with current valuations (especially in the mid cap space, which are compelling, see figure 11 and 12 below), we believe that this market has the potential to deliver one of the best performances within the EM space over the coming years.

Figure 11: BSE Absolute Mid Cap Price/Book Value +/-2stdev

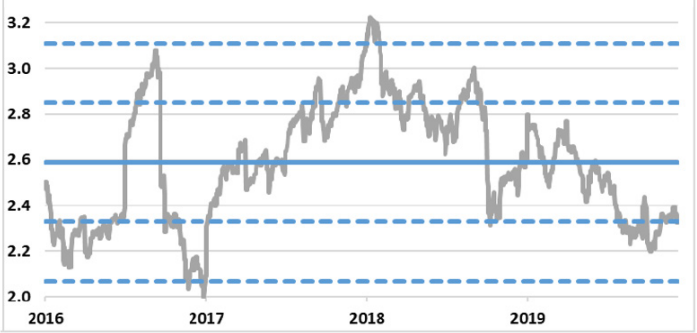
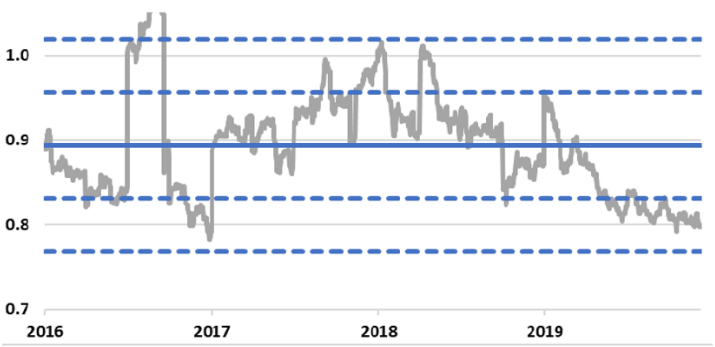


Figure 12: BSE Relative Mid Cap Price/Book Value +/-2stdev



Source: Bloomberg

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