First State Stewart Asia – India Equities

Client Update

October 2017

Irrational Exuberance

"We have been growing faster than Nestle and Unilever but they are valued at 40x – 50x P/E while we are valued at only 30x" – said the exasperated CEO of a commodity chemicals manufacturer in our meeting with her recently. She was complaining that investors were ignoring the potential of her business. Newspaper headlines during the same week listed the promoters of mid-sized companies who have become billionaires in the last 12 months alone, as the market value of their shareholdings soared.

A construction company founded five years ago completed its initial public offering last week. It was oversubscribed by 186 times – the highest subscription for an Indian IPO since 2000. Such a response is not unique. Almost 50 new companies have been listed in India since 2016. Many of these have had astounding success. This includes Central Depository Services, a government controlled securities depository whose public offer was subscribed 170 times and listed at an 80% premium to the offer price on its first trading day; Avenue Supermart – a supermarket chain, oversubscribed 104 times, has seen its share price increase 4 times since listing in March, and is now valued at 76x forward earnings, among the highest for any retailer globally but that did not stop a sell side analyst from valuing the company on 28x 2029 earnings and rating it as a buy with 50% upside; Au Small Finance Bank, had its IPO oversubscribed over 50 times and is now valued at over 7x P/B – similar to the P/E multiple of some of its regional peers.

Household savings in India has always been a big number (~US$500 billion) and only a small part of it was in financial instruments, let alone equities. The demonetisation exercise in November 2016 encouraged the shift of household savings into financial assets. Historically, real estate and fixed income have been large asset classes for domestic investors. After stellar performance over the previous decade, real estate prices have stagnated or fallen in most major Indian cities in recent years. Benchmark bond yields have also fallen from 9% to 6.4% over three years. Therefore, with few alternatives, corporates and individuals have ploughed savings into equities. Average domestic equity mutual fund inflows in 2017 have been US$1.9 billion per month, 4x the average monthly inflow of the previous five years. The so called discretionary Portfolio Management Service Schemes, popularly known as PMS in India has grown to Rs.1 trillion of AUM as compared to only Rs.50 billion, say five years ago. Driven by liquidity, there seems to be a palpable sense of euphoria in Indian equity markets. An India bull will justify this by saying that as a percentage of household financial savings, only 10% is invested in equities. True, but we should not forget that this number was less than 5% just two years ago. There is merit in believing that this number will go up structurally over the long term, but it almost feels like the belief on the ground is that it will happen overnight. We have seen this enthusiasm before and unfortunately it almost always doesn't end well.

Whilst euphoria reigns supreme, Corporates have used this opportunity to fund growth and de-lever their balance sheets. In 2017, total equity raised through institutional placements and rights issues is almost Rs.1 trillion which is close to the all-time high of Rs.1.16 trillion in 2010, with three months to go and with a big line-up of new capital issues on the horizon. In the three years after 2010, the return from Nifty in dollar terms was -22%. Prior to 2010, the peak of equity issuance was in 2007 when companies raised Rs.89 billion by selling shares in the market. The Nifty's return was -8% in the three year period after CY2007. We hear that a large finance company held a lavish party for its banker after raising money on 40x earnings and 7x book, with the research analyst who wrote the buy report popping the bubbly.

Portfolio Positioning

We are staying away from the heady champagne parties but at the same time we do not want to lose sight of what the long term holds for some of our companies which are perhaps more than fairly valued on a short term outlook. We think that the portfolio is positioned cautiously in this environment. The cash level of over 15% is the highest that we have ever had in the portfolio. As mentioned in previous letters, this is entirely a bottom-up outcome and not a result of us trying to time the market (in our opinion, a futile exercise). Our conviction in the portfolio is as high as ever, with regards to the long term growth potential that it presents. We would happily own a lot more of our companies if prices were to fall – the ultimate test of our confidence in them.

With this backdrop, we have added substantially to our largest positions, **Nestle India** and **HDFC Bank**. We also continue to find small businesses which could emerge as long-term winners in large markets. We have met with over 250 companies since our last update six months ago. Encouragingly, through our recent travels across Tier-2 and Tier-3 towns in India, and other countries in the subcontinent; the breadth of our investable universe continues to grow. There are now close to 200 companies in our universe which pass through our quality filters, compared to less than 100, five years ago.

As mentioned, the largest holding in the portfolio is Nestle (8.5% of the portfolio). We have always believed that **Nestle India's** business has the potential to be multiple times larger than its current size. Nestle has been operating in the country for over 100 years, and has dominant positions in categories like packaged foods, infant nutrition and coffee. Despite this, its sales per capita of US$1 in India is dismally low compared to its global businesses, for example; US$5.5 in Pakistan, US$10 in Sri Lanka, andUS$85 in US. The parent (Nestle SA) has 28 brands with sales of over US$1 billion globally. Of these, currently only eight of these brands have been launched in India.

During 2011 – 2013, the company invested more than US$600m to double its capacities across categories. However, instead of focusing on gaining market share and new product development, management prioritised margins and rationalised stock keeping units. This led to declining volumes – in fact, aggregate volumes in 2016 were lower than they were in 2009, a period over which many of their peers doubled their total volumes. In 2015, the food safety regulator also temporarily banned sales of its highest selling product, Maggi noodles, due to suspected product quality violations. The crisis that followed brought Suresh Narayanan, who was then successfully running Nestle's operations in Philippines, as the first Indian CEO of Nestle India in 17 years. Nestle in Philippines did sales US$ 25 per capita.

We met Mr. Narayanan last month and he is resolutely focused on bringing back volume growth and gaining market share across segments. Over the last 18 months, 43 new products have been launched, many of these are at lower price points, thus reaching out to a larger consumer base. Advertising spends to support new launches have almost doubled from a historical base of 4-4.5% of sales to currently 8% of sales, along with the company's distribution footprint consistently increasing. In addition, they have absorbed recent input cost increases instead of passing them on to customers as in previous years, to ensure affordability. Maggi has also regained its position as the dominant leader in its category. With these changes driven by the new CEO, combined with increasing penetration and per capita incomes, our conviction in Nestle India's ability to achieve its long-term potential has never been stronger. We agree it is insanely expensive on 50x P/E if one were looking at next year's earnings. 20 years ago, Nestle India was trading on 35x P/E and was relatively perhaps even more expensive when global equities generally were not as expensive as they are today. Regardless, its earnings grew by five times in the next 10 years and if someone took a long term view in 1997, it was only trading on seven times earnings. In 2007 however, it continued to trade on rather expensive 37 times P/E. In the last 10 years, Nestle has managed to only double its earnings because of the issues outlined above. Given our research and confidence in the CEO, we believe earnings growth is set to accelerate once more.

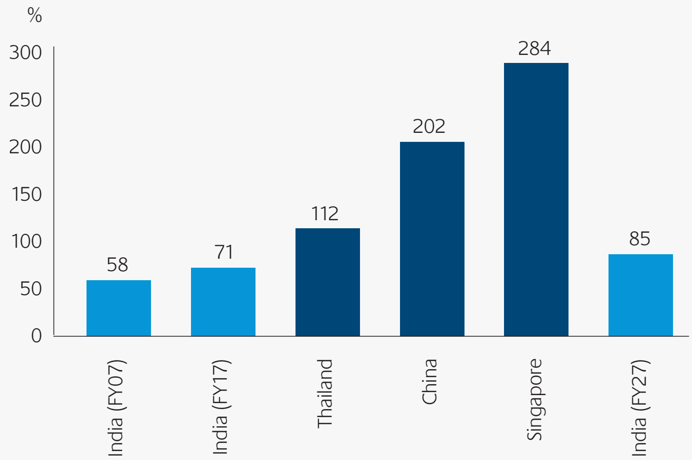
The second largest position in the portfolio is HDFC Bank (6% of the portfolio). In 2017, system credit growth in India fell to its lowest level in 60 years. In this environment, **HDFC Bank** continues to grow its customer deposits and loans at over 20% per year, with low credit costs. This has led it to achieve incremental loan market share of 24%, compared to its overall share of only 7% (based on stock of loans outstanding). We think this gap will only grow further. In a recent meeting, the head of one of the most successful non-bank finance companies in India spoke about the larger and more profitable lending opportunity being outside the top 100 Indian cities. He highlighted that when his sales teams try to infiltrate these markets, the only competitor they consistently come up against is HDFC Bank.

In our experience; we have found that as organisations grow large, their cost structures often become rigid and decision-making becomes bureaucratic. Our meetings with management have confirmed that this is certainly not the case here. The way customers interact with their banks is changing. The vast majority of transactions now take place through digital channels, instead of at bank branches. By investing ahead of peers, HDFC Bank has built leading market shares across alternative channels. The number of mobile banking transactions on its platform is already the highest among all banks. As their strong digital channels have replaced branch transactions, the number of employees per branch has also fallen by 20% over the last five years. While large state-owned and private banks deal with legacy problems of asset quality and capital adequacy, management here can remain focused on strengthening its relationships with its clients and improving profitability. With this in mind, looking at valuations from a different perspective, highlights that high short-term multiples mask an attractive long-term investment case.

India's deposits/GDP has increased from 58% to 71% over 2007–2017. As this momentum continues to increase at a similar rate over next 10 years (likely a conservative estimate given the increasing preference for saving through financial assets over cash), deposits/GDP should reach ~85% by 2027. This would still be lower than deposit growth of many regional markets. India's nominal GDP itself can easily grow at ~5% annually in US dollar terms, compared to ~8% annual growth over the last 10 years.

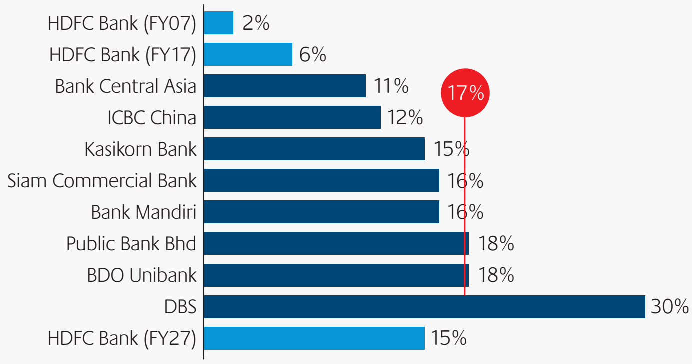
HDFC Bank has tripled its deposit share from 2% in 2007 to 6% to date. Most strong regional banks have deposit shares of 15% - 30% in their domestic markets. As its large peers struggle with high non-performing loans, we believe the bank can increase its deposit share to ~15% by 2027. Therefore, even if its market cap/deposits more than halves from 75% now to 29% (median of its strong regional peers), investors would stand to make ~120% US$ returns over the next 10 years.

Deposits to GDP



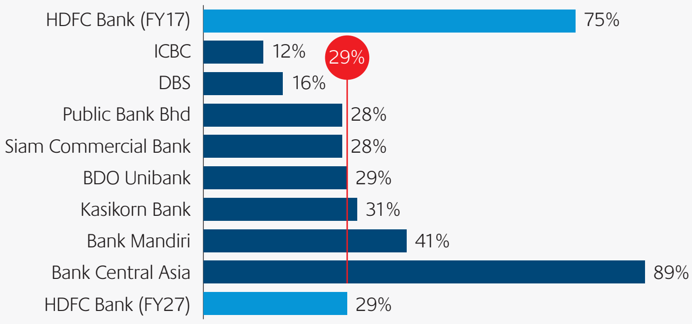
Source: Bloomberg, Credit Suisse and CLSA, as at March 2017.

Deposit Market Share



Source: Bloomberg, Credit Suisse and CLSA, as at March 2017.

Market Cap to Deposits



Source: Bloomberg, Credit Suisse and CLSA, as at September 2017.

As outlined, we continue to find businesses which are currently small but operate in large, fragmented markets. Led by focused management teams, they could emerge as long-term winners as these industries consolidate. In our view, their large long-term potential is hidden in small market capitalisations. One such example is **HealthCare Global Enterprises (HCG)**.

The infrastructure for cancer treatment in India is woefully inadequate. Only half of all cases are diagnosed and 70% of cancer-related deaths in India are due to a lack of access to treatment. **HCG**, founded by an oncologist, Dr. Ajaikumar, has built the largest network of cancer treatment hospitals over more than 25 years. The company's focus on a single specialty (oncology) allows them to attract high-quality medical professionals. They often form joint-ventures or enter profit share agreements with doctors, who manage clinical operations of each hospital; while HCG provides infrastructure, clinical research and administrative support. This partnership model has allowed them to grow their network from 14 hospitals in 2016 to currently 24. The focus on a complex specialty like cancer also leads to attractive economics. HCG's hospitals typically break-even over 12–18 months, compared to 3–5 years for larger multi-specialty hospitals. The dire need for effective and affordable cancer treatment, along with healthy unit economics and management's operational focus, should allow the company to become much larger in the coming years. With a market cap of only US$ 350 million for the largest cancer hospital chain in India, and the prospect of manifold growth of its operating profit over the next 5-10 years, we find it attractively valued. Through our travels, we have also expanded our research coverage of companies in other countries of the subcontinent (Pakistan, Bangladesh and Sri Lanka). They offer opportunities similar to India in the form of large populations with favorable demographics and underpenetrated markets, and often with more attractive valuations.

We recently initiated positions in two Pakistan auto OEM's – **Pakistan Suzuki Motors** (majority owned by Suzuki Japan) and **Indus Motor** (37.5% owned by Toyota). The Pakistan auto market is among the most under-penetrated globally, with 15 vehicles per 1000 people, compared to 22 per 1000 in India and 83 per 1000 in China. Consumer financing, which typically drives higher levels of auto-ownership across markets, contributes to only 30% of passenger vehicle purchases in Pakistan compared to 70% in India. Industry volumes have been flat over the last 10 years, due to political and social instability and weak economic growth. Since 2016, this has started to change; driven by the government introducing new regulations to encourage new players to enter the market and reducing waiting periods for vehicle orders. Although it may cause existing players to lose some market share, such regulations are likely to lead to expansion of the industry size, which benefits companies with strong market positions over the long-term.

Pakistan Suzuki and Indus Motor control 80% share in a three-player market. While several players have entered, struggled and exited the market, they have compounded EPS at 23% and 30% respectively over 15 years. Given Suzuki's dominance in India, a market with similar income levels and demographics, and Toyota's success in regional markets like the Philippines, Thailand and Indonesia; both companies are well positioned to benefit from increasing car ownership permeation in Pakistan. Indus Motor is valued at 9x forward P/E and pays 7.5% dividend yield; while Pakistan Suzuki is valued at 8x forward P/E and pays 2.5% yield (in contrast, Maruti Suzuki India trades at 25x future earnings). We find the combination of the long-term market development opportunity, strong parentage and cheap valuations attractive.

Dry powder

The top five holdings in the fund, which account for approximately 27%, are Nestle India, HDFC Bank, HDFC, Kotak Mahindra Bank and Godrej Consumer. These businesses have never been cheap – 10 years ago, Nestle was trading on over 35x PER, HDFC Bank on 4.5x PBR, HDFC on 5.2x PBR, Kotak Bank on 5x PBR and Godrej Consumer on 25x PER. These five companies have delivered an average total shareholder return (including dividends reinvested) of 27.5% in US dollar terms over the past 20 years, i.e. 130 times. In this period, India witnessed a war with Pakistan, two banking crises, three substantial stock market crashes, rupee has depreciated by almost 50%, four severe droughts and five prime ministers!

We believe that these businesses still have a tremendous opportunity to keep growing. They will continue to plug away. It would have been a bad decision to sell these companies based on valuations then, it would be bad decision to sell them now. In fact, we would like to own more of each of our holdings, but it would be prudent to use market corrections to add to them. For which we will wait patiently, with a lot of dry powder.