FSSA Investment Managers

June 2021

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Monthly Manager Views

FSSA Regional India Strategy

Undiscounted change

At a team discussion last month to track management and board changes across our investment universe, a notification on the stock exchanges piqued our interest. Mr Aditya Puri, who had only recently retired as the CEO of HDFC Bank, had joined the board of a small, unlisted pharmaceutical company, Stelis Biopharma. Given Mr Puri's remarkable leadership at HDFC Bank, we dug deeper into his new role. In addition to his board role at Stelis, he had accepted the position of an advisor to the broader Strides Group. Over the following weeks, we spoke to the CEOs of various Strides Group companies, their competitors, ex-employees and engaged with Mr Arun Kumar, the group's founder and majority owner. He has a track record of creating significant shareholder value through organic growth and mergers & acquisitions (M&A). We gained confidence that Solara Active Pharma Sciences, a group company, is strongly positioned to capitalise on the opportunities arising from the changes to pharmaceutical supply chains after repeated disruptions in recent years. We believe the growth opportunity ahead of it and its valuations are attractive. We recently purchased a holding in the company.

> Our core philosophy is to back people. Our focus is on assessing our alignment with the owners and managers of a company, what drives them, their ambition and approach to risk and the organisational culture they are building.

We follow changes to management and ownership closely. In our experience, such changes can drive an improvement in the quality of governance, growth or capital allocation of a business. This often remains undiscounted by market participants focused on predicting the next quarter's earnings per share (EPS), and can lead to attractive shareholder returns over the long term. We have witnessed the transformative impact of such changes in several of our holdings in recent years.

Mr Sandeep Bakshi became the CEO of ICICI Bank when its previous CEO left amidst corruption allegations. He inherited a bank with a track record of being at the forefront of every asset quality problem in India over the last two decades. In our first meeting, we were surprised that Mr Bakshi, who had spent over three decades at the group, accepted all the problems at the bank and clearly laid out his plans to revamp incentive systems, build a less hierarchical organisational culture and a more conservative approach towards risk. We gained conviction as we observed that unlike previous crises, the bank's balance sheet and competitive position had strengthened during recent disruptions. Based on its opportunity to gain substantial market share from inefficient state owned banks, ICICI's market-leading deposit franchise and attractive valuations of 2x Price/Book (P/B), it became the largest holding of the strategy.

In 2015, we purchased a toehold position in Mphasis Limited, a mid-sized IT services company, which was then majority-owned by Hewlett-Packard (HP). HP had indicated its intention of selling its majority stake, given its own organisational changes. Due to the lack of support from its owner, Mphasis' growth was weak. It was valued attractively at 11x forward price/earnings (P/E) and paid a 5% dividend yield. We were aware that under a new owner and CEO, there was potential for an improvement in the company's growth and its valuation multiples. Subsequently, Blackstone Group acquired HP's majority stake and appointed Nitin Rakesh, an experienced industry executive, as its new CEO. In our meetings, Mr Rakesh explained his strategy of hiring talent which could scale up the fast-growing digital services business and entering new markets to accelerate growth. In the four years since Mr Rakesh was appointed, Mphasis has grown its EPS at 14.4% compound annual growth rate (CAGR) compared to a marginal decline in EPS during the previous four years, and its valuation has re-rated from 11x to 27x forward P/E. We have remained shareholders through this period.

Often, the changes underway are not straightforward, as we saw in the case of Mahindra Lifespaces and Tata Consumer Products. Mahindra Lifespaces is a developer of residential property and industrial parks, owned by the Mahindra Group. Residential buyers are rapidly shifting from poor-quality local developers to reputed companies as industry regulations become more stringent. Mahindra Lifespaces had not capitalised on this tailwind due to a weak project development pipeline. We purchased a holding when its parent company recognised the problems and laid out their intent to make changes. But execution remained weak under a new CEO they appointed and she left after two years. Finally, Arvind Subramaniam, an external hire, was appointed its new CEO last year. He has ramped up land acquisition and new project launches – the company finally appears to be realising its growth potential. We experienced a similar journey at Tata Consumer Products, which operates the Tata Tea and Tetley brands. When we purchased a holding in 2013, we had expected the company to exit poorly performing global businesses and focus on the fast growing and more profitable domestic business. But under two new CEOs appointed over six years, change took place slowly. It was only after Mr Chandrasekaran was appointed chairman of its parent, Tata Sons, and Mr Sunil D'Souza (ex-CEO of Whirlpool India) was appointed CEO of Tata Consumer Products, that there was a concerted effort to exit underperforming global markets and gain scale in the more attractive domestic business. We sold our holding when its valuation rose to over 50x forward P/E, as these changes were reflected in its performance.

The common factors among these cases are that each company is a fundamentally strong business, with the potential to generate high returns on capital and a long runway for growth. In some cases, the changes took longer than we anticipated. But backing the right people to do the right thing has always held us in good stead.

Performance Commentary

The strategy's performance gained in June 2021. The key contributors and detractors were:

Contributors

Mahindra CIE rose after its parent, CIE Automotive, released its five-year operating plan which highlighted significant growth opportunities for Mahindra CIE in the coming years. The parent has been increasing its stake in the company through market purchases.

Infosys Limited is expected to benefit from the acceleration in demand for digital transformation and cloud services among clients. The recent depreciation of the Indian rupee against the US dollar is also likely to support its profitability.

Mahindra Lifespaces gained following strong demand for residential property in Mumbai, its key operating market. The management has communicated its plans to accelerate the company's growth with a revenue target of INR 25 billion in fiscal year (FY) 2025 compared to INR 7 billion in FY 2021.

Detractors

ICICI Bank declined marginally without any change to its operating performance or business outlook. The bank's growth and return on assets have been improving consistently.

Colgate Palmolive (India) declined marginally without any major changes to its business outlook. Following several initiatives undertaken by its new CEO, Colgate has been gaining market share.

HDFC Bank was affected by continuing digital outages. The company is investing significantly to migrate its technology applications to cloud based architecture and improve recovery systems and user experience across its interfaces.

* Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 June 2021 or otherwise noted. Any stock mentioned does not constitute any offer or inducement to enter into any investment activity.