

Monthly Manager Views

FSSA Regional India Strategy

Resilience, inflation and earnings growth

“We have raised prices by 8% across our products in the first five months of the year. We expect to take another price hike in the coming months.”

We had entered the meeting with a leading air-conditioner company in our portfolio worried about the risks to its growth and profitability, as the second wave of Covid-19 affected consumer demand and raw material costs rose sharply. But the company's CEO told us about the acceptance of increased prices by their channel partners and customers and strong demand before localised lockdowns were introduced in April. The company had reported a 24% growth in sales and more than doubling of its operating profit in the quarter ended March 2021, compared to the same period last year. He was optimistic about an improvement in their profitability despite a significant increase in raw material costs and was continuing their investments in expanding capacity.

We have closely followed earnings across our portfolio companies to assess how successfully they have emerged from the initial impact of the pandemic. We have been positively surprised. In the quarter ended December 2020, median revenues across our strategy holdings grew by 14% and median profits by 18% over the same period last year. Growth accelerated in the most recent quarter, as median revenues across the portfolio's holdings grew by 26% and profits by 39% over the same period last year (albeit this was on a lower base affected by the initial impact of Covid-19). Cash flows have been strong and the balance sheets of almost all the companies held in the strategy remain in net cash positions¹.

We noted some key trends across our investment universe during this period.³

(1) Accelerated market share gains by organised sector² companies:

Smaller companies in the unorganised sector with limited capital availability and weak information technology (IT) systems struggled to cope with the extended national lockdown last year. This allowed industry leaders to gain significant market share across sectors. Metropolis Healthcare, a leader in the highly fragmented diagnostics industry witnessed 41% growth in its revenues and an almost tripling of its profit in the most recent quarter. Consumers are shifting rapidly from small local laboratories to those of established brands like Metropolis with higher quality standards and accreditations.

(2) Price hikes to pass on the impact of rising inflation in raw material and labour costs:

In industries ranging from electrical products to IT services, customers have accepted significant price increases. KEI Industries, a manufacturer of electrical wires and cables, raised prices of its wires used in household applications by 35% over the last six months. The CEO of Mphasis, a fast-growing IT services company, told us that unlike previous years in which they witnessed consistent pricing pressure from their large corporate clients, most customers have been willing to discuss price hikes due to wage inflation.

(3) Investments in capacity expansion: There hasn't been much corporate capital expenditure (capex) during the last decade in India. Recently, sharply rising commodity prices has led to large capex announcements by several commodity producers. Thermax, the largest manufacturer of boilers used across heavy industries indicated a significant improvement in customer enquiries across sectors such as oil & gas, steel and cement after years of weak industrial demand.

Their performance in recent quarters shows that companies across our investment universe have emerged from the pandemic stronger than they were before.

Corporate India's resilience was severely tested over the previous decade, as it dealt with a long-drawn downturn. The material price hikes taken by companies indicates a return of confidence which we have not seen for a long time. In our view, it signals strong underlying demand as well as significant gains in market share by these resilient businesses.

One of the key reasons for weak corporate earnings growth in nominal terms in recent years was low inflation. It seems like this is changing and the companies held in the strategy are exercising their pricing power. It is difficult to predict their performance over the next few quarters, as most businesses have been affected by the explosive second wave of Covid-19. We also expect that rural demand, which had remained strong last year, is also likely to be weak in the coming months. Despite this, our conviction in the businesses held in the strategy has become stronger during this period. Their recent performance gives us confidence that as these companies emerge from the pandemic, they are positioned to potentially deliver strong earnings growth in the years ahead.

People before profit³

As the deadly second wave of Covid-19 has ravaged India, we have witnessed relentless efforts by high quality companies to ensure the safety of their employees and local communities. Companies such as Infosys, Tata Consultancy Services (TCS), HDFC Bank and Hindustan Unilever are among the largest private employers in India. They have partnered with thousands of hospitals across the country to provide free vaccinations for their employees. The campuses of many IT services companies have been turned into vaccination centers. HDFC Bank has partnered with hotels across India to provide isolation facilities for affected staff, with online platforms to provide e-consultations with doctors. Bosch, a leading auto component company, has created Covid-care facilities for the broader community at its campus. In many other countries, such measures are the responsibility of governments. As usual, it has been the socially responsible private companies that are leading the efforts to battle Covid-19 in India.



Performance commentary³

The strategy's performance in May was strong. The key contributors to performance were **Godrej Consumer Products**, **ICICI Bank** and **Colgate Palmolive India**. Each of these is among the top five holdings of the strategy.

Godrej Consumer Products announced the appointment of Mr Sudhir Sitapati as Group CEO. Mr. Sitapati has led several businesses at Unilever across India, Europe, South East Asia and Africa. His experience is likely to help Godrej Consumer Products accelerate the growth potential across its businesses.

ICICI Bank continues to benefit after its strong performance in the most recent quarter. Its competitive position is likely to continue strengthening as large state-owned banks and smaller non-bank finance companies struggle with weak balance sheets and poor asset quality.

Colgate Palmolive India reported strong quarterly performance ending March. Its sales grew by 20% and profit after tax by 54% compared to the same period last year. Its management has increased the focus on the fast-growing modern trade and e-commerce distribution channels. Its strong pricing power and increasing share of premium products can also drive improvement its profitability over the medium term.

The key detractors were **Blue Star Limited** and **Strides Pharma Science**.

The decline in the share price of **Blue Star** was related to concerns about the impact of the second wave of the Covid-19 pandemic on customer demand. Our discussions with its management have strengthened our conviction in its medium-term prospects. They have launched a new range of more affordable air conditioners which should help the company continue gaining market share. Its management is also focused on driving cost efficiencies to improve its profitability.

¹ Source: Bloomberg, FSSA Investment Managers, as at 31 May 2021

² Organised vs. unorganised sector companies refers to those that are licensed and regulated by the Indian government and are subject to labour laws vs. those that are unlicensed or unregistered. Organised or formal companies include publicly traded companies, corporations and large businesses, while unorganised companies are typically smaller, owner-managed enterprises ("mom and pop" stores).

³ Any stock mentioned does not constitute any offer or inducement to enter into any investment activity.

Strides Pharma Science's recent performance was affected by a weak flu season in its key US market. However, the company has a strong pipeline of new products which should help it gain further scale in its core markets. Its investments to build its product portfolio in

emerging markets with low penetration should also help to strengthen its growth prospects over the coming periods. It is a toehold position in the portfolio.

*Company data retrieved from company annual reports or other such investor reports. As at 31 May 2021 or otherwise noted.

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