FSSA Investment Managers

Fund Manager Q&A

India's resilience amid the pandemic and opportunities for the future

October 2021

For institutional/adviser use only

Vinay Agarwal
Director

Vinay Agarwal, Director, joined FSSA Investment Managers in 2011, with a focus on the Indian Subcontinent Markets in particular and Asia Pacific equities in general. Vinay is lead fund manager of the FSSA Indian Subcontinent Strategy and the FSSA Asia Focus Strategy.

Why should investors consider India?

The most attractive point about India is that there are about 6,000 listed companies across a diverse range of sectors. That gives us the opportunity to invest in high quality businesses across a range of industries. This is unlike some other emerging markets where investors might find themselves restricted to only a handful of industries.

Additionally, India has one of the oldest stock markets in the world. The culture of equity ownership is prevalent and people are familiar with the rules that come with it. Over the years, governance standards, the composition of a board, gender diversity, and protection of minority shareholders – they have all improved.

Over time, corporate governance regulations in India have also strengthened significantly. As regulators have tightened rules related to company privatisation, royalty payments and disclosure of related party transactions, the protection of minority shareholder interests has consistently improved.

Another aspect that makes India stand out from her emerging market peers is the quality of companies there. In India, you will find many high-quality private companies

RISK FACTORS

This is a financial promotion for The FSSA India Strategy. This information is for professional clients only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Indian subcontinent risk:** although India has seen rapid economic and structural development, investing there may still involve increased risks of political and governmental intervention, potentially limitations on the allocation of the Fund's capital, and legal, regulatory, economic and other risks including greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.
- **Single country / specific region risk:** investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **Smaller companies risk:** Investments in smaller companies may be riskier and more difficult to buy and sell than investments in larger companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

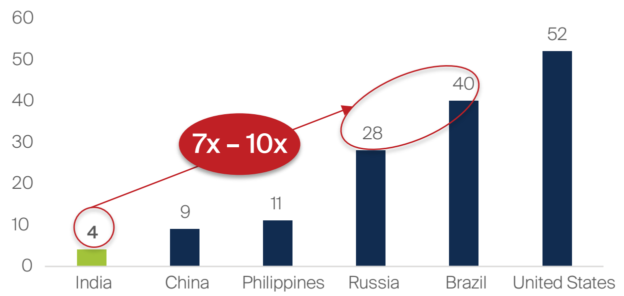
If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

with good governance, and are run by families who think long term. They are fully engaged and focused on delivering attractive returns on capital.

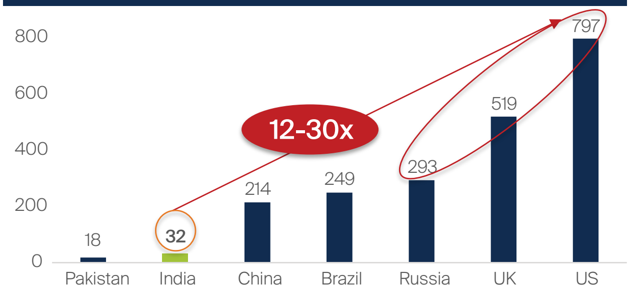
Perhaps more importantly, these companies are accessible during challenging times. For example, if the rules and regulations change and things become difficult, in India it is usually possible to speak to the management team to get a sense of what is happening on the ground. This direct access, which plays a huge part in our level of conviction in a company, is something we do not always see in other markets. It also helps that as a team, we have built very strong relationships with our investee companies over the years.

We find it exciting that market penetration rates in most categories in India are still very low. Whether it is biscuit consumption, vehicles or air-conditioners, most of the market leaders are small companies with decades of growth left. Over the many years we have been managing India equity portfolios, we have seen hundreds of companies creating enormous wealth for shareholders — and we believe there is more to come over the next 20 years.

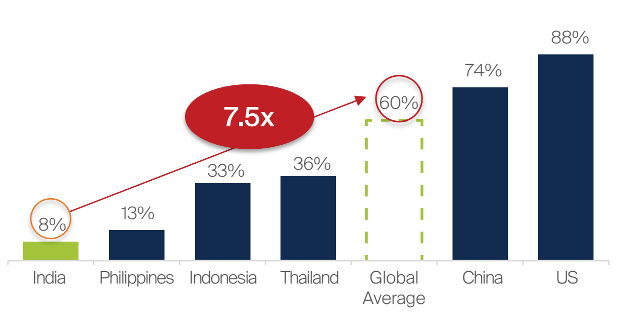
Per-capita biscuit consumption (US$/capita)



Vehicles per 1000 people



Air-conditioner Penetration (% of Households)

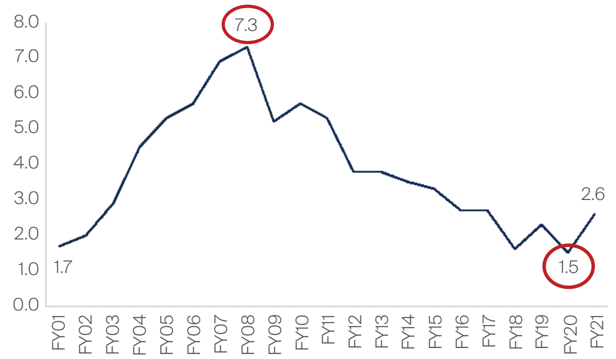


Source: CLSA, Credit Suisse, FSSA Investment Managers, March 2020

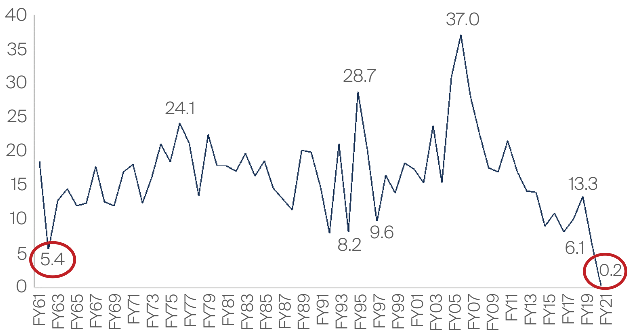
Why now?

Over the last decade, India has seen numerous headwinds, including the anti-corruption movement of the early 2010s, the chaotic demonetisation process, the introduction of Goods and Services Tax (GST), the Non-Banking Financial Crisis and now the Covid-19 pandemic. As a result, if we look at corporate profit as a percentage of India's GDP in the chart below, it peaked at 7.3% and dropped to 1.5% in 2020 — the lowest it has been in over two decades. Not only that, 2020 credit growth was also the lowest since all the way back to the 1960s.

Corporate Profit as % of GDP



Bank Credit Growth (YoY %)



Source: IIFL Securities, August 2021

It is often said that India responds best when its back is against the wall. It is only when things are difficult that there is enough political will to make the necessary changes happen.

In our view, this is what happened over the past few years. Whether it is the introduction of GST, increasing financial inclusion, improving governance, labour reforms, corporate tax reductions or incentives for manufacturers — they are all coming together. These reforms provide a tailwind to the formal economy, as the weaker players find it tougher to survive, leaving the strong players to become even stronger. Hence, we believe India is poised to bounce not just from a Covid-low, but from a multi-decade cyclical low.

Could you give an example of an investee company that navigated the pandemic well and has emerged stronger from it?

In India, the pathology and diagnostic industry is still highly underpenetrated and fragmented. Metropolis healthcare is among the market leaders, but still has less than 2% of overall industry share. It is leading the growth and consolidation of the sector. Metropolis saw the pandemic as an opportunity to transform the business.

There are about 150,000 labs in India and of those, only 2,000 labs are approved to run Covid-19 tests. Out of those 2,000 labs, only a handful have the capacity to run thousands of tests each day. Many of these are owned by Metropolis Healthcare.

Through the pandemic, Metropolis was able to add new customers and strengthen its brand further. The management has also taken the opportunity to build stronger systems with better controls, and improve the system's automation and weed out inefficiencies. Technology is a huge focus for Metropolis. The company has invested heavily to offer an omni-channel customer experience with aspirations to provide the best of both worlds to consumers – an established healthcare brand with strong credibility and scientific expertise, along with the best tech experience and consumer convenience.

Metropolis has introduced new features where patients can track their phlebotomist on a mobile app, along with their sample and when the test results will be ready. Its vision is to be able to offer various degrees of customer touchpoints. Patients can engage with the company through its call centers, physical service centres or through the mobile app to book a test or track their report.

In India, the diagnostic industry is not regulated. There are no minimum quality standards imposed by the government. Out of the 150,000 labs in India, only 10% are run by pathologists. In contrast, Metropolis is considered amongst the top 1% labs in the world, according to the College of American Pathologists[1], a global accreditation board. We think that is a remarkable achievement – and a testament to the company's strong and visionary management team.

Consumers are rapidly moving in favour of better quality and credible chains like Metropolis. The Covid-19 disruption has accelerated this process.

How did banks fare in the pandemic?

As the pandemic broke out and the first lockdown shut down the economy, there were fears that corporate delinquencies would rise, leading to massive uncertainty in the financial system. However, the 2015 Asset Quality Review, which carried out inspections on selected Indian banks' balance sheets with the objective of making sure that stress in the bank system was being identified in a proper manner, meant that this time round the banks were in a much better position to deal with the disruption.

It was following the Asset Quality Review that ICICI Bank established its Enterprise Risk Management (ERM) framework on how the bank should look at risk. The quality of its loan book gradually improved and provision coverage reached more than 70%. Thus, going into the pandemic and despite facing one of the toughest years in the bank's history, ICICI Bank was actually in much better shape than anticipated. Its portfolio has performed well under the circumstances, to the extent that there is positivity and optimism about the future.

ICICI Bank, like many other private companies in India, launched vaccination programs for their staff in order to keep them safe. As these companies prioritised the health of their employees, this gave us confidence in their preparedness and ability to weather the pandemic.

The economy has now rebounded somewhat, but it appears to be a "K-shape" recovery, meaning that there are some parts of the economy which are still lagging, while other parts of the economy are doing exceedingly well.

Banks are not out of the woods yet, but in terms of long-term opportunity, the size of the Indian banking sector is currently about USD 2.5trn[2]. There are various estimates about how fast the Indian economy will grow and when it will reach USD 5trn or even USD 10trn. While the pace of growth can be debated, the economy should continue to grow steadily. With higher per capita incomes, the penetration of financial services will also increase. We believe the market will need to grow twice or three times the current size over the next 10 years. This implies plenty of room for ICICI Bank – and other leading private sector banks such as HDFC Bank, Kotak Mahindra Bank – to grow.

[1] Source: As at August 2020
[2] Source: As at Fiscal Year (FY) 2020
https://www.ibef.org/industry/banking-presentation

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at October 2021 or otherwise noted.