28th October 2020

One year up…

Twelve months is a short time in investing. As October brings a close to my first year as Principal Advisor to the Gateway to India Fund, I can however confirm that there has been plenty of time for investment related thinking and action. As such, this piece takes you through that journey.

What a year it has been! When I started there was an air of optimism as India finally appeared to be ready for a strong turn in the corporate earnings growth cycle. This, after a few years of many structural economic reforms which necessarily involved short term 'disruption' to economic activity (more on this later). And then COVID-19 struck.

Our new approach

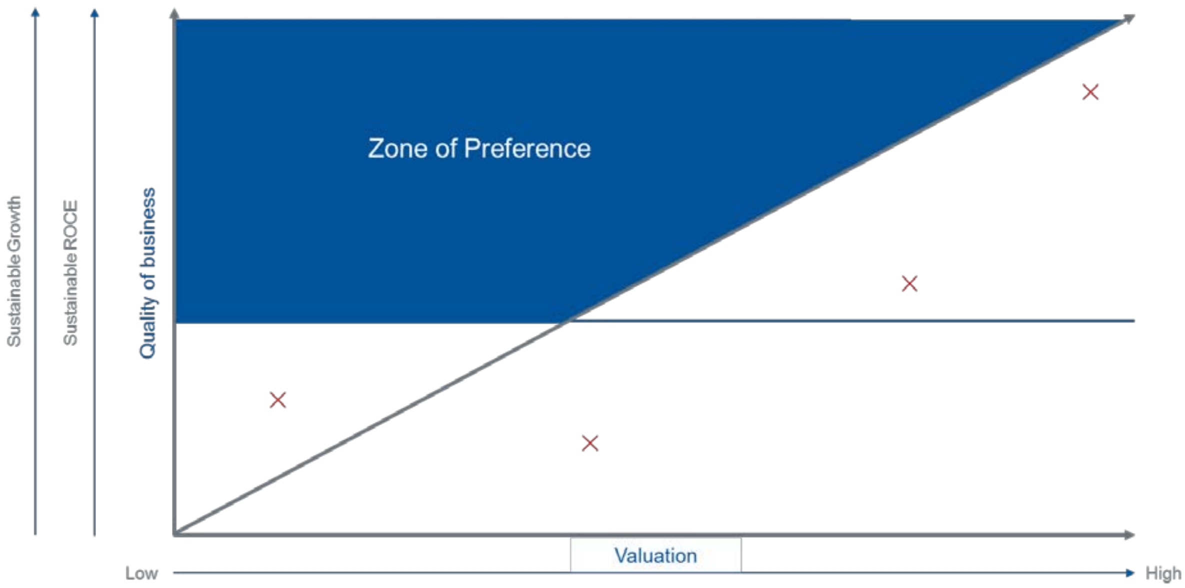
In November 2019, we re-examined and enhanced our investment process. 850 companies with a market capitalisation higher than US$100m were whittled into a shortlist of 140, giving us our Coverage Universe. Businesses that we feel are unscalable, capital inefficient, conglomerated, overcomplicated, driven by commodity prices, have governance concerns, are exposed mainly to overseas retail consumers, or where we don't have enough knowledge to have an informed view on any of the above were excluded.

Just as *Howard Marks* explains in *'The Most Important Thing Illuminated'*, our investment approach rests on the belief that investing is as much art as it is science. Thus, our investment approach is both intuitive and adaptive (Art) as well as fixed and mechanistic (Science). We expanded our analyst team from three to five and are in the process of adding one further. Each member now covers 25-30 names. Coverage entails detailed financial modelling, one-to-one corporate interaction at least once annually and a final valuation based on relative and absolute metrics. The universe is ranked on a live basis in descending order of expected return over the next 2 years. This then not only helps guide where to direct deeper due diligence but also provides a platform for us to use judgement, experience and even gut feeling.

In terms of stock selection, we prefer allocating to companies that exist within a *zone of preference*. See Figure 1 below. Companies which appear statistically expensive on traditional valuation metrics are not excluded should the Economic Value Add (EVA), business quality, sustainability of growth and return on capital be sufficiently compelling. At the other end of the zone of preference, optically cheap stocks are not seen necessarily as value traps, and are investible as long as a minimum threshold of EVA, business quality, growth and capital efficiency is met. There is twin objective out here - not to compromise on the quality of business, but at the same time not to compromise on valuations as well.

So, we start with *focus* i.e. Coverage Universe of ~ 140 companies and end with *conviction* i.e. a Portfolio of 25-30 businesses. But, why go for such concentration? Analysis of the Indian markets over the last 5 to 20 years substantiates the fact that beyond this number the benefits of 'diversification' wither away (please ask for the case study if you'd like to see it). More so, restricting the portfolio names to around 25, compels us to further climb the 'ladder' of conviction with a full position equating to roughly an 8% weighting.

Figure 1



We are also market cap, benchmark and style agnostic. We like to focus more on 'businesses' rather than statistical representations of stocks in terms of size, style or presence in benchmarks. As the portfolio is reasonably concentrated in number of names, we ensure that we diversify the portfolio well across sectors, trends and themes. Importantly such high conviction ideas that are agnostic to business size must also scale as the fund grows – alpha delivered today must be repeatable with more assets tomorrow (again, please request our liquidity analysis that informs the capacity of this strategy).

What was the result?

With the revamping of our investment process, we initiated changes to the portfolio in December. Just as we were in the middle of it all the economy was shut for nearly two months from April and the stock markets fell nearly 40% in a short span of 30 days. As long-term investors, our natural response was to try and work this to our advantage. We used the vast fluctuations in prices to benefit from market-wide stock opportunities and further sharpen our portfolio. As the dust settles, we are comfortable with our portfolio positioning, since its restructuring came to a conclusion in May.

So, what does our portfolio stand for, and how does it capture the India opportunity? While it is difficult to explain each business idea in the portfolio in this note, as each of them are unique, we will make an attempt to characterise the stocks in our portfolio. Before that, please refer to Annex on page 6 which describes our Top 10 Holdings.

One cohort of stocks we have invested in are quality businesses where we find a ***'change'*** in fundamentals is underway that will help the business perform far better than what it has done in the recent past. Two examples - ***Bharti Airtel ($32bn)***, India's second largest telecom company which is set to benefit from the explosion in data usage and is expected to see increased pricing power in a sector which is fast becoming a duopoly and ***ICICI Bank ($38bn)***, India's second largest private sector bank which has vastly improved its asset quality and is set to gain market share.

Beyond this we have a number of attractively valued, but dominant businesses with high capital efficiency and strong visibility of growth in the next few years. For instance ***Aegis Logistics ($1bn)*** – a leader in LPG terminals that is entering the highly profitable retail LPG distribution space - potentially tripling its sales volume growth in the next five years. Similarly, ***MCX ($1bn)*** – India's largest commodity exchange with a 93% market share which is witnessing deepening and broadening of the commodity market aided by regulatory support giving it long term visibility of growth.

This year's market volatility enabled us to capture a number of 'domestic cyclicals' at deep value. We believe as India bounces back fast to normalisation, these businesses will have high operating leverage benefits. In this, we have been careful that we invest only in those with a strong balance sheet with high cash and capital efficiency. Two examples. ***ACC ($4bn) –*** India's second largest cement manufacturer belonging to the Holcim group, undergoing a large cost cutting initiative which is already showing results, and ***Hero Motocorp ($8bn)*** – India's largest two-wheeler company. It is entrenched in rural India, the relatively more insulated part of the Indian economy in these COVID times. Both these companies are exceptionally well managed and trading at a free cash flow yield of higher than 5%. Our exposure to banking stocks is also, in a way, a domestic cyclical exposure – something I'd like to delve deeper into for my next note.

The next cohort is one where many of the previous companies mentioned have the potential to end up in – consistent quality compounders. This includes businesses which are leaders or have a niche positioning which gives them a double-kicker of gaining market share in an already growing market. ***ICICI Lombard ($8bn)*** – India's largest private sector general insurance company in an underpenetrated sector is on-boarding first time insurance customers whilst also winning market share from capital constrained public sector incumbents. Similar names include, ***HDFC Bank ($92bn)*** – India's largest private bank which continues to grow consistently and is expected to double its market share in the next five years, ***Computer Age Management Services ($889m)*** – a registrar and transfer agent servicing 70% of the Mutual Fund industry and ***Divi's Laboratories ($11bn)*** who has long standing relationships with the top twenty pharmaceutical MNCs for custom research and manufacturing services.

Irrespective of COVID…

Investors are one of the few stakeholders in society that are able to benefit when placed at the intersection of a global pandemic, recession, supply chain disruption, and market volatility. Not by being able to predict the unpredictable (e.g vaccine success or infection trajectories) but by building a portfolio that can thrive in multiple futures. Our main observation so far is the acceleration of many trends which were expected to play out otherwise over the longer term. Digitalisation is becoming mainstream in India with faster adoption by consumers and businesses, shifts in global supply chains are encouraging manufacturing outsourcing within India, households are increasingly focusing on health and wellness, and consolidation is gaining pace with the big getting bigger. We are focussed on businesses which can benefit from these accelerated trends.

India's largest company, ***Reliance Industries ($181bn)***, and our third largest holding, is rapidly transforming into a digital ecosystem and a consumer play. ***Westlife Development ($771m),*** a McDonald's franchisee in West and South India, is bouncing back with its use of digital platforms to deliver its products as consumers veer towards more branded and hygiene assured food consumption. As businesses globally undertake a digital transformation journey with particular focus on cloud and cyber security, IT services companies in our portfolio – ***Wipro ($26bn), Infosys ($63bn) and HCL Technologies ($31bn)*** – are already gaining traction.

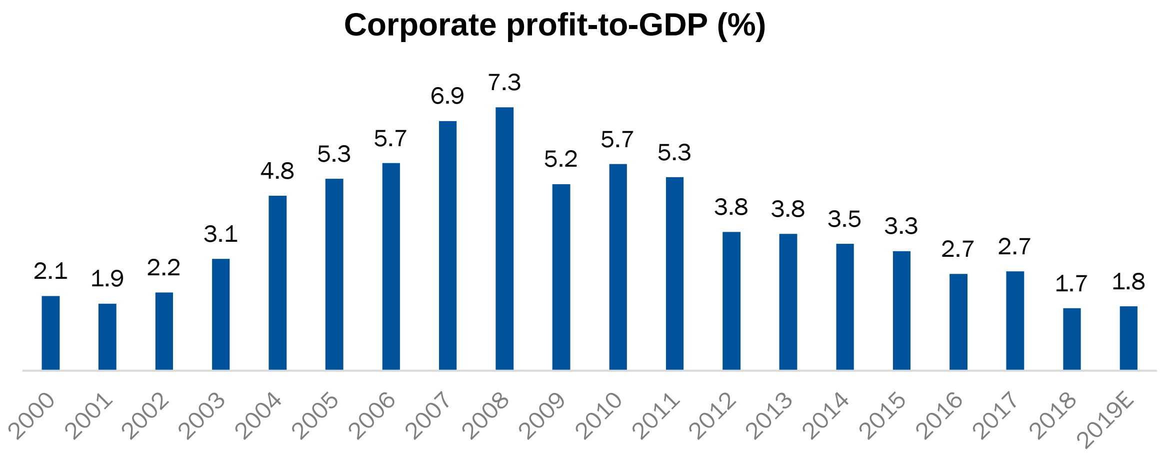
Dixon Technologies ($1bn), India's largest electronic manufacturing services company is expected to undergo a step-change in the scale of its business as manufacturing outsourcing within India lifts-off aided by government policy. ***Aarti Industries ($2bn)*** – a niche speciality chemicals business and ***Divis Laboratories***, mentioned earlier should benefit from the global shift in supply chains. With 45% of its sales coming from health and wellness related FMCG products, ***Emami ($2bn)*** is well placed to provide for the growing health consciousness amongst customers.

There is much to add beyond this but in summary the portfolio reflects our assessment of the best combination of businesses that India has to offer from both a risk and opportunity perspective.

A view from up high

India appears to be a market forgotten by foreign portfolio investors. This is in part due to muted earnings growth (pre-COVID), caused by structural reforms mentioned earlier which necessitated near term disruption to economic activity. No wonder Corporate profit to GDP has hit such all-time lows (see figure 2). This should turn now. Data on COVID-19 is taking an encouraging turn with active cases having fallen 40% in the last month and recovery rates scoring amongst the highest globally. Economic resumption is gaining ground with most high frequency indicators already equal to or higher than pre-COVID levels. As India's economy normalises, the benefits of monetary easing and government action should start showing up, with headroom for fiscal stimulus, which has thus far not been forthcoming.

Figure 2



Source: Bloomberg

Meanwhile, we are confident that our focus on businesses means the portfolio is attuned to economic realities in India. Known risks such as a COVID second wave alongside unknown ones are ever-present but we are prepared to respond appropriately to the emerging economic environment through our bottom-up stock selection framework. **My experience spanning thirty years tells me however that today the main risk the team faces is one of opportunity cost through being too cautious.**

To conclude, I can't say that my first year working on this strategy hasn't been without surprises but there's nothing else I'd rather be doing. I look forward to updating you for many more years to come.

Tridib Pathak
Principal Advisor
Gateway to India Fund

Annex

Top ten	Weight	Category	Characteristics	Market Cap
HDFC Bank	8.6%	Compounder	Largest private sector bank, set to gain further market share	$92bn Large Cap
Bharti Airtel	6.5%	Quality business with change in fundamentals	Strengthened survivor in a consolidating market, set to grow ARPU and market share going forwards	$32bn Large Cap
Aegis Logistics	6.4%	Attractively valued with growth and capital efficiency	Leader in LPG logistics with high growth visibility	$1bn Small Cap
ICICI Lombard General Insurance	6.2%	Compounder	Largest private sector general insurance company in an underpenetrated sector	$8bn Large Cap
ICICI Bank	5.3%	Attractively valued with growth and capital efficiency	Second largest private sector bank, well poised to capture recovery in credit growth	$38bn Large Cap
Indusind Bank	4.8%	Deep value cyclical	Fifth largest private sector bank in India poised to gain market share. Value play with ebbing asset quality concerns	$6bn Midcap
Reliance Industries	4.7%	Emerging business model	Business transformation of India's largest company into a new economy play	$182bn Large Cap
Emami	4.7%	Attractively valued with growth and capital efficiency	Dominant player across multiple niche consumer product categories, attractive valuations	$2bn Mid Cap
Aarti Industries	4.5%	Emerging business model	Dominant player in niche speciality chemicals segment, with structural tailwinds	$2bn Mid Cap
MCX	4.4%	Attractively valued with growth and capital efficiency	Monopoly commodity exchange with network effects and regulatory tailwinds	$2bn Mid Cap

As at 27 October 2020

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