First State Stewart
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First State Stewart Asia - India Equities

India Update

February 2016

- The First State Indian Subcontinent Fundinvests in securities issued by companies established or operating or have significant interests in the Indian subcontinent. Countries of the Indian subcontinent include India, Pakistan, Sri Lanka and Bangladesh.
- The Fund invests in emerging markets which may involve a greater risk than developed markets including sharp price movements, liquidity risk and currency risk. The value of the Fund may be impacted by risks associated with investing in the Indian Subcontinent including changes in tax law and the political, social and economic environment. It is possible that the entire value of your investment could be lost.
- You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

This is the fourth semi-annual update on the First State Indian Subcontinent Fund. Our aim is to provide a general update on some of our current thoughts and views, insights about existing holdings and changes to the portfolio over the period.

The Spotlight

In our previous update, we discussed many aspects of our investment process, highlighting some of the mistakes we try not to make. In our experience, a rigid, black and white approach does not necessarily fit with the chaotic nature of markets; sometimes it is just as important and crucial to understand the various shades of grey. In that context, we had promised to outline the imperfections in some of our own holdings and perhaps explain how we go about mitigating our concerns in that regard.

Before we do that, it is only right and fair to turn the spotlight to ourselves. Our organisation, First State Stewart Asia, is owned by First State Investments (which itself is owned by the Commonwealth Bank of Australia). Generally, bank-owned fund management companies suffer from the perception of being sales-driven organisations that often face a conflict between asset growth (and therefore higher fee income) and the fiduciary responsibility of being long-term stewards of clients' assets. A cynic might therefore wonder why we should be any different. Indeed, if we were hypothetically analysing ourselves for inclusion into one of our portfolios, we would certainly create a lively team debate in trying to make the case.

But then, wearing our grey hat, we think that our relatively long history under the bank's ownership (over 15 years) and the fact that a number of our funds have been closed to new investors for the past five years are evidence of the way we protect our clients' interests. Another way to achieve alignment with our clients has been through our team's remuneration policy, which is structured to encourage a long-term investment horizon (a part of it is based on the three and five-year performance of our funds), with a large proportion of the compensation comprising deferred incentives that are co-invested alongside our clients (for at least three years). In addition, our business is managed by a team board comprising of members of the investment team, with little oversight from the bank. First State Investments has been a model parent in many respects, providing critical assistance in areas such as compliance and administration, but happy to allow the investment teams to drive the business forward.

Lastly, it would be hypocritical of us to expect the highest standards of governance and alignment of interest from our investee companies if our own clients were at odds with us as their fund managers. Therefore, whilst our structure seems 'imperfect' to a casual observer, we believe that looking closer would reveal quite a different picture.

In this context, similarly, there are a number of investments in the First State Indian Subcontinent Fund (the "Fund") which may be deemed imperfect at first, but which we believe are worthy candidates on closer inspection.

The faults in our folios

Container Corporation of India (Industrials), one of the top 10 holdings in the Fund at the end of 2015, is a state-owned company. We typically avoid most state-owned entities for fear of a lack of autonomy and transparency. In our 20 meetings with the management over the past five years, our focus has been on establishing the degree of alignment of minority shareholders with the government. We have gradually come to the view that

government ownership here is not a deterrent to the investment case, which is primarily based on its dominant franchise. Because it is a division of the Indian Railways, where the focus of most bureaucrats is on passenger trains, it has largely been left alone to manage the freight business. For example, over the past five years, freight haulage costs (set by the Indian Railways) have been hiked by around 100% in total. Despite this, Container Corporation's EBITDA per TEU of freight has actually increased by 5% in this period, whereas it would have been all too easy for the government to allow the company to take a hit in profitability to serve 'national interests'. It still remains the most profitable logistics company in India (17% net margin in FY2015) and our most recent meeting with the management suggested that the focus on returns would only improve. In this sense, it is two steps removed from the politics of New Delhi.

Around 10 years ago, new licenses were given to private operators and it was widely expected that these private companies would eat into the monopoly holder's market share aggressively. But a decade later, Container Corp's market share in rail containers has not only remained at 74% but has actually risen in the past five years. The industry has been going through a cyclical downturn – cumulative earnings for the company since 2008 have only grown by 27%, but in this period its fixed asset base has gone up by 150%. All of this capex was funded from operating cash flows and yet the company still has a net cash balance sheet (~USD 500 million; 15% of its market cap). We believe that in the coming years, its asset utilisation will go up and there will be a strong growth in its earnings. Any cyclical tailwinds will be a bonus.

Another of our holdings has witnessed four CEOs in period of five years. What's more, the main shareholder extracts a royalty fee set at 5% of the company's sales. These are warning signals we usually never ignore. Despite this, we are not alarmed, because the company in question is **Colgate Palmolive India** (Consumer Staples). Among the four recent CEOs, one has been made the global Chief Marketing Officer (Mukul Deoras) whilst another (Prabha Parameswaran) has been elevated to the role of President, Africa and Eurasia – so the churn in top management is not because of incompetence, but rather because Colgate regards managers from this region as high quality. Whilst we have made our opinions heard with respect to the need for more stable leadership, it is obvious to us that the quality of the franchise is so good that it could probably run itself. Indeed, despite the churn at the top, Colgate India's market share has consistently risen (now close to 60%) and with an ROCE of over 180%, there is no other business in India that is more cash generative. By spending close to 16% of sales on advertising and on educating the population (especially school children) about good oral care habits over the years, the company has built a rather wide moat – one that even multinational corporation (MNC) giants like P&G have failed to breach (P&G has less than 1% market share despite launching in India two years ago). It is only the nose-bleed near-term valuation that it trades at (over 40x PE ratio) that curbs the size of our holding.

In a similar vein, we have explored the risk presented by way of royalties and other related-party transactions in MNC subsidiaries like **Nestle India** (Consumer Staples), **Hindustan Unilever** (Consumer Staples), **SKF India** (Industrials), **Linde India** (Industrials) and most recently, **BASF India** (Materials). In doing so, we acknowledge that in some cases, the arrangement is not 'perfect', but in most cases, precluding ownership of the stock purely because of such arrangements would deny us some of the best managed franchises in India. In this regard, we must applaud the regulator, SEBI, for implementing several laws that increase transparency and add to the power of minority shareholders (e.g. delisting prices are discovered via reverse book-building; related-party transactions above a certain size need to be ratified by minorities etc.).

We could probably pick faults in most of our holdings – be it the reputational risk of the **Infosys** (Information Technology) board because of its Chairman's past affiliation with certain business groups (or a recently appointed director's political affiliations), or the mismatch between **Dr. Reddy's Laboratories'** (Health Care) culture/trust based response to the USFDA's expectation of automation/process-led factory management, or **Housing Development Finance Corp of India's (HDFC)** (Financials) accounting treatment of their Employee Stock Option Plans (ESOP), or the Godrej family's leveraging of **Godrej Industries** (Materials) as a holding company whilst they shuffle their shareholdings in **Godrej Consumer** (Consumer Staples) and **Godrej Properties** (Financials), or the aircraft on **Bajaj Auto's** (Consumer Discretionary) balance sheet, and so on.

These are the kind of grey areas that we focus on during our team discussions and in our engagement with the management teams of these companies. It is usually the quality of the response in these engagement points that get us past the imperfections in the businesses we own in the portfolio. It is the spirit and not the letter that we focus on, with our spotlights.

Portfolio moves

We previously discussed the benefits of generational change in companies like Eicher Motors and the Godrej Group. Last year we bought a small position in **Skipper** (Materials), which is in the early stages of a similar journey as the next generation of family members play a larger role in its management.

The business was founded in 1981 and manufactures power transmission infrastructure and water pipes and undertakes engineering, procuring and construction projects. The founding family, now in its third generation, is focused on 'professionalising' the organisation. Over the last few years, they have implemented SAP enterprise management systems, introduced their first ESOP and have sought to partner with larger global companies. We also engaged with the management about the structure of their ESOP, in order to create greater alignment between the professional managers

and minority shareholders. Their positive response to our queries was indicative of a management that is willing to listen and is long-term minded. Over the last five years, the company's revenue has grown at a compounded rate of 26%, net profits at 46% and operating cash flow at 43%. Their ambition is to build a much larger, global business over time. It is still a relatively small business (current market cap of US$238 million) and we see tremendous growth potential.

We initiated a position in BASF India (market cap of US$476 million) during the year. BASF (listed in Germany with a market cap of US$61 billion) recorded its first sales to India in 1890 and has owned an operating entity in the country for 73 years. Over this time, they have built India's largest specialty chemicals franchise and BASF India remains the parent's only listed subsidiary.

What caught our attention in 2012 was that the company began its most significant capital expenditure program to date. In fact, investments made over the last three years have exceeded the cumulative capex in its history (but still, at ~US$200 million, the amount is not unreasonable). In our experience, the best franchises tend to exhibit this sort of counter-cyclical "moat-building" expenditure, which pays rich dividends over the long term. Since the additional capacity has not yet translated into revenues, negative operating leverage has led to poor short-term earnings. However, when industrial growth does recover, we believe BASF India would be well positioned.

Our meeting with the management gave us a sense that minority interests would not be abused. The culture at BASF India did not seem to be one of 'kowtowing' to the parent entity. Indeed, we learnt that royalties paid to the parent are a keenly debated topic at Board meetings. Top management has typically enjoyed long tenures. We also gain comfort from the company's intention of moving towards operating a single legal entity in India, through which minority shareholders of the listed business should benefit from higher growth.

Earlier in the year, we also initiated a position in **Delta Brac Housing Finance** (Financials), the first private sector housing finance institution in Bangladesh. It was formed as a joint venture between three local financial institutions and two international sponsors: International Finance Corporation (IFC) and HDFC, which we know well from its position among the largest investments in the Fund.

With a population of 160 million, Bangladesh is among the world's most densely populated countries. Consequently, the opportunity for a housing finance company is substantial – in fact, the Mortgage-to-GDP ratio in the country is only 4%, less than half that of India's and one-quarter of China's.

Our discussions with management confirmed that this opportunity is backed by a conservative lending culture – which we view as essential to our investments in financial institutions. While non-performing loans (NPL) were over 25% for state-owned banks and over 10% even for the best private sector banks, Delta Brac Housing has managed to achieve an average gross NPL of just 0.2% over five years. It is therefore no surprise that their market share has more than doubled over 10 years while delivering an average Return-on-Equity of 24%. Although valuations have appreciated significantly since we initiated the position, it remains a small company with a market cap of ~US$200 million. We remain happy shareholders of the business for the long term.

A significant portfolio change in the recent months has been the exit from **Mahindra & Mahindra (M&M)** (Consumer Discretionary), **M&M Financial Services (M&MFS)** (Financials) and a significant reduction in our holding in **Tech Mahindra** (Information Technology). As we explain below, whilst we remain believers in the way Anand Mahindra has built and run the group, our convictions have been slightly dented through various meetings that we have had with the group's companies and some of their recent acquisitions.

M&M's core businesses of tractors and SUVs face significant challenges. Tractors are among the few product categories in India where penetration is higher than in more developed markets like China and even the USA. Their market share in SUVs has also fallen from 55% to 36% since 2012, as several global players have launched new products in this segment.

As a holding company for the group, M&M also plays the role of allocating capital across the group's businesses. Over the years, they have deployed capital generated by the core SUV and tractor segments to fund investments in industries ranging from 2-wheeler manufacturing to baby-care retailing. In fact, the company now has over 110 subsidiaries (for which they publish a mammoth 2,600-page annual report!). Even after accounting for the significant profits from Tech Mahindra and M&M Financial Services, net profit of the standalone business (SUVs and tractors) is higher than that of the consolidated entity (including their share of profits from all subsidiaries and associates). We believe these challenges are not reflected in valuations, which remain at a significant premium to those of most auto companies globally.

In the case of M&MFS, it seems that its role as the largest financier of M&M's vehicles takes precedence over returns to minority shareholders. Over five years, the proportion of Mahindra vehicles financed versus its total loans has remained the same. In the product categories of its parent (tractors and SUVs), the company's loan portfolio almost exclusively comprises M&M vehicles. Following our discussions with management, we think this is unlikely to change even over the long term.

As discussed, we pay close attention to the risk appetite of finance companies. M&MFS' gross NPL of over 10% suggest that the management's approach to risk has also been less conservative than many of its peers. In the years when rural areas benefited from the SOP-driven largesse of the previous government, the company could have perhaps been more cautious in our view, especially after a similar asset quality cycle

had played out for them in 2008-09. To us, it seems as if they have not learnt from their mistakes in the past.

We became shareholders in Tech Mahindra a few years ago when it acquired a near-bankrupt Satyam Computers. The margin expansion, led by synergies of the acquisition and the consequent expansion in its valuations have been played out. We do not like some of the recent acquisitions that Tech Mahindra has made (one of them jointly with the parent M&M – albeit small, we fail to see the rationale in both M&M and Tech Mahindra jointly acquiring an auto design company).

We prefer to have a larger position in Infosys, which should continue to reap the benefits of its new leadership. We have also discovered some smaller IT companies where we are finding more value and stronger growth potential (in some cases led by a management change). We are currently building our stake in these businesses.

Portfolio and performance

Whilst the relative performance in the near term may not be sustainable (not that we care about it much, not in the short term anyway), we have not been able to protect capital as we should have in the recent period. Having said that, we remain excited about the long-term prospects of each of the businesses that we own in the portfolio. The correction in recent weeks has allowed us to buy some of our favoured names. For most of the last 18 months, our cash positions were nudging 10% on average – but we have been buying recently and it has now dipped closer to 5%. This does not mean that we are abandoning our cautious outlook but rather that we see more margin-of-safety in stocks that we have been patiently eyeing from the sidelines.

First State Indian Subcontinent Fund

Cumulative performance (%)

	Since Inception	5Y	3Y	1Y	YTD	3M
First State Indian Subcontinent Fund	674.6*	65.7	64.1	5.1	5.1	0.6
MSCI India Index	368.8	-11.5	11.8	-6.1	-7.6	-0.9

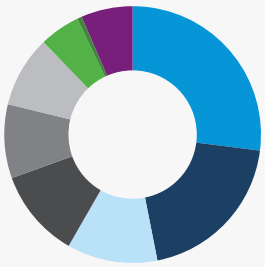
Calendar year performance (%)

	2015	2014	2013	2012	2011	2010
First State Indian Subcontinent Fund	5.1	45.6	7.3	29.9	-22.3	30.7
MSCI India Index	-6.1	23.9	-3.8	26.0	-37.2	20.9

Holdings (%)

	Fund Weight
Infosys	6.6
HDFC Bank	6.0
Nestle India	5.8
Marico	5.3
Dr Reddy's Laboratories	4.1
Godrej Consumer	4.1
Housing Development Finance	4.0
Kotak Mahindra Bank	4.0
Kansai Nerolac	3.8
Container Corp Of India	2.8
Top 10	**46.5**
Top 20	**69.0**
Total Holdings (47)	**93.5**
Liquidity	6.5

Sector breakdown (%)



Consumer Staples	27.0
Financials	19.9
Industrials	11.4
Info. Tech.	11.2
Health Care	9.3
Materials	9.0
Consumer Discret.	5.1
Utilities	0.6
Liquidity	6.5

Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 December 2015.
* The First State India Subcontinent Fund Class I (USD - Acc) - inception date: 23 August 1999.

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