Looking beyond the headlines in India

According to the headlines, India is in trouble. Press reports over the past year have highlighted a catalogue of problems: inconsistent government policy leading to a deteriorating economy – growth in 2012 has slowed to the lowest level in a decade; inadequate infrastructure causing widespread power cuts; and a corruption scandal rocking the telecoms industry. The challenging macroeconomic backdrop and accompanying newsflow has had a knock-on effect on investor sentiment.

As one of the largest emerging market economies, and one of the original ‘BRIC’ nations, investors have always had high hopes for India. Given its favourable demographics and significant potential for economic development, valuation of the country’s stockmarket has historically been relatively high. More recently, however, the deteriorating economic picture has shaken investors’ confidence in India’s prospects and share prices have been volatile, particularly in economically sensitive areas such as banking.

Notwithstanding the current uncertainty around India’s shorter-term growth trajectory, we believe there are good reasons to take a closer look at India. Historically, capital has been relatively expensive and hard to obtain, which has forced firms to be innovative and invest sensibly. In our opinion, there is a very entrepreneurial corporate culture in India and many companies have strong management teams with a track record of creating value and generating returns for shareholders.

As long-term, bottom-up stockpickers, rather than concerning ourselves too much with economics beyond our control, we are more interested in how individual companies are performing. In our view, what matters is whether companies are creating value by generating returns above their cost of capital. The present environment where investors are influenced by sentiment and tend to overlook company fundamentals is providing us with attractive investment opportunities.

In our experience, perceptions can change quickly. The Indian government has recently introduced bold reforms, easing restrictions on foreign direct investment in the retail sector, and inflationary pressures have abated, allowing the Reserve Bank of India more flexibility in stimulating expansion. These factors may foster a more benign environment for companies and alter investors’ view on India.

CESC – restructuring on track

CESC is a power company that supplies electricity in and around Kolkata, the principal commercial centre in east India and the country’s third-most populous metropolitan area. Five years ago the company strayed from its main activity and purchased a retail chain called Spencer’s. This proved a costly acquisition with CESC’s returns on capital and valuation deteriorating significantly. A subsequent change in management attracted our attention.

Prior to initiating a position in the company, we visited its utility business in Kolkata to gain confidence in CESC’s core business and understand the new management team’s plans to improve the operations at Spencer’s. In our view, executed well, grocery retail can be a very powerful, value-creating business model and the valuation of CESC discounted any potential for improvement at Spencer’s. Investors were also assigning little value to the utility business, which has a century-long track record of generating cash and stable returns on capital, a position our visit to Kolkata had illustrated was sustainable. During this trip we wanted to see how effective CESC’s efforts to improve Spencer’s have been, and we spent a day in Bangalore with the head of supply chain and IT management. After a thorough review of the business, we could see that Spencer’s is driving through a lot of changes. Importantly, it has realised that the company cannot successfully be a
pan-Indian retailer and is shrinking its business to focus on the regions and formats where it is most profitable. At an operational level, the business is also undergoing substantial changes to improve efficiency and close the gap with global best practice in retailing.

A smaller, more efficient Spencer’s should deliver higher returns and be more valuable in time. In our opinion, this outcome is still not reflected in CESC’s valuation and we have increased our investment in the company following our visit on the basis of the encouraging steps it is taking.

**Axis Bank – a quality bank**

The Indian banking sector was nationalised in the 1960s and private banks were only licensed to operate from the mid 1990s. As such, the sector is dominated by the large state banks, which tend to trade at a discount to private banks because they are considered to be less efficient and less innovative.

Axis Bank was one of the first private banks to enter the market; it provides both retail and corporate banking services to clients across India and overseas, and has grown through a successful strategy of delivering a superior customer service experience. We have followed the bank’s development closely over the past few years and initiated an investment in the company in September 2012 when its valuation became attractive as shares in Indian banks fell.

Given concerns about slowing economic growth and deteriorating loan quality in the banking sector, we were reassured to hear that Axis Bank is making good progress. As a private bank Axis has greater flexibility to manage the quality of its loan portfolio in light of the broader pressure on the industry. In addition, Axis’s focus on promoting the growth of its retail franchise should gradually deliver higher returns and can be accelerated by cross-selling services to what is now a well-established client base. As with CESC, we were encouraged by what we saw at Axis Bank and added to our investment in the company after our meeting.

**Cautiously optimistic**

While the near-term economic environment in India is clearly challenging, our visit revealed that there is reason for cautious optimism. We believe that companies such as Axis Bank have great business models and exciting growth prospects, while CESC is implementing a sensible strategy that should result in a more focused, higher returning business in time. When other investors focus on macroeconomic headlines, it can provide opportunities to us as long-term stockpickers. We remain confident that over the long term, Indian companies can create value and generate wealth for investors, be it by growing existing high return on capital franchises, or by shrinking to improve returns on capital.

Past performance is not a guide to future performance. Prices may vary and you may not get back your original investment. The value of overseas investments may be affected by currency exchange rates.

**Glossary**

**Bottom-up selection:** Selecting stocks based on the attractiveness of a company.

**BRIC:** Brazil, Russia, India and China

**Capital:** Refers to the financial assets, or resources, that a company has to fund its business operations.

**Emerging market:** Economies in the process of rapid growth and increasing industrialisation. Investments in emerging markets are generally considered to be riskier than those in developed markets.

**Macro/Macroeconomic:** Refers to the performance and behaviour of an economy at the regional or national level. Macroeconomic factors such as economic output, unemployment, inflation and investment are key indicators of economic performance. Sometimes abbreviated to ‘macro’.

**Valuations:** The worth of an asset or company based on its current price

**Volatile:** When the value of a particular share, market or sector swings up and down fairly frequently and/or significantly, it is considered volatile.