FSSA Investment Managers

August 2021

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Monthly Manager Views

FSSA Regional India Strategy

Mahindra CIE Automotive: A transformation in progress

As with global automotive manufacturers, several Indian automotive original equipment manufacturers (OEMs) including Maruti Suzuki, Mahindra & Mahindra (M&M), Tata Motors and Eicher Motors have recently announced that the shortage of semiconductor supply has impacted their production schedules. This has added to the persistent challenges faced by the industry over the last few years. The introduction of new safety and emission regulations, higher insurance costs and an increase in road taxes in several states have raised vehicle ownership costs substantially over the last three years. A funding crisis among non-bank finance companies reduced financing available to buyers. The disruption from Covid-19 exacerbated the impact on industry sales. In fiscal year (FY) 2021, passenger vehicle sales in India were only 8% higher than a decade ago, while commercial vehicle sales have declined by 16% over a decade[1].

We have found investing in high-quality suppliers to automakers, including bearing manufacturers, automotive paint companies and critical component suppliers, to be more attractive than investing in OEMs. One such component supplier which is a large holding in our portfolio is Mahindra CIE Automotive. We have followed the company for almost two decades, since the Mahindra Group acquired Amforge, a forgings manufacturer in which the portfolio was invested. Following this, the Mahindra Group acquired various other component suppliers in India as well as Europe and consolidated these businesses into Mahindra Systech. Many of its acquired entities had high cost structures and the company struggled with poor profitability. CIE Automotive of Spain acquired a controlling stake in Mahindra Systech in 2013 and merged its highly profitable European business with the company. The Mahindra Group's shareholding fell to 20% and the company was renamed Mahindra CIE Automotive. We purchased a holding for the portfolio after this change in ownership.

Since it was founded, CIE Automotive has consolidated several global component suppliers through mergers & acquisitions (M&A). The management teams of the acquired entities are given operational autonomy, while CIE's financial discipline, focused on earning high returns on capital (20% return on net assets), consistent cash flows (60% of EBITDA[2] to be converted into operating cash flow) and low leverage, is imposed on all companies. This has been rewarding for shareholders. An investment in CIE has earned 19% annualised total shareholder returns (in USD terms) since it listed in 1995.

Ander Alvarez, who has led several CIE group companies since 2006, was appointed to lead the turnaround of Mahindra CIE as group CEO. The new management has led several changes to the business.

- As several small component suppliers have struggled amidst the weak industry environment, Mahindra CIE has gained substantial market share. Several large new customers such as Bajaj Auto and Maruti have been acquired. Its share of revenues from M&M and Tata Motors has declined from almost 30% in past years to around 15% now.
- The efficiency of Mahindra's Indian plants have improved significantly. Its plants in Europe which were structurally challenged were shut down. The company's operating margin has more than doubled from 4.6% in 2014 to 10% in 1H 2021 and its profit before tax (PBT) margin

[1] Source: Society of Indian Automobile Manufacturers (SIAM)

[2] Earnings before interest, taxation, depreciation and amortisation

has improved from 2.2% to 9.3% over the same period. As automotive volumes normalise in India, there is potential for continued improvement in profitability from operating leverage.

- The company has also acquired high-quality businesses such as Bill Forge, a manufacturer of high-precision automotive components. These acquisitions have helped Mahindra CIE to gain new customers and products. With consistently strong cash flows, its Net Debt / EBITDA has declined from over 2x to below 1x despite the acquisitions.
- The company's return on net assets has increased to 12% from 4% in 2014. The management and its parent's target is to improve this to 20% in the coming years.

During our call with Ander Alvarez recently, we found him to be more confident about the company's prospects than he has ever been in the past. Mahindra CIE is now running its Indian factories at full capacity and expanding most of its businesses, backed by customer orders (as demand revives) and market share gains. Despite inflation in raw material costs, the management expects to continue improving its profitability as it cut costs aggressively over the last year. In this context, its valuation of 13x forward price-to-earnings (P/E) appears compelling to us. Its parent, CIE Automotive, seems to agree, having increased its stake in the company by almost 5% during the past year through market purchases. Its turnaround has taken longer than we expected due to the challenges faced by the industry. But the company has grown stronger over this period, while its competitive environment has weakened. We believe it is now poised to reap the benefits of its transformation over the medium term.

Performance commentary

The FSSA Indian Subcontinent strategy rose in August. The key contributors to performance were **Godrej Consumer Products**, **HDFC Bank** and **ICICI Bank**. Each of these is among the top five holdings of the strategy.

Godrej Consumer Products Limited rose after it reported growth of 24% in revenue and 38% in recurring profit in Q1 of FY 2022 compared to the same period last

year. Its business in Africa which has struggled in recent periods is witnessing a substantial improvement in growth and profitability.

HDFC Bank benefited from the regulator's decision which allowed the lender to issue new credit cards. The regulator had previously directed the bank to stop issuing new credit cards after outages on its internet banking platform. The company's management has been investing aggressively to strengthen its technology infrastructure. This regulatory approval should improve the bank's growth prospects.

ICICI Bank rose after it reported strong quarterly results, with loan growth of 17% and lower provision costs which led to net profit growth of 78% in Q1 of FY 2022 compared to the same period last year.

The key detractors were **Mahindra CIE Automotive**, **Blue Star Limited** and **Bosch Limited**.

Mahindra CIE Automotive and **Bosch Limited** declined due to expectations of weaker growth following a shortage in the supply of semiconductors affecting production of major automotive OEMs.

Blue Star declined after it reported lower revenue and profit compared to the previous quarter due to the movement restrictions. The company has gained market share and raised prices across its product portfolio. Its growth and profitability should improve in the coming periods.

* Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 August 2021 or otherwise noted. This stock information does not constitute any offer or inducement to enter into any investment activity.