FSSA Investment Managers

February 2023

Manager Views

Heroes and villains – our views on India's business families

"For everything you say about India, the opposite is also equally true," said a senior corporate executive, paraphrasing a quote from the British economist Joan Robinson, when we met him in India recently. This rings true in our minds, particularly these days as the world looks at India's business families with a tinge of suspicion following the recent wall-to-wall media coverage of a short-seller's report on a large Indian business group. For our part, we are quite happy with our investment biases that, in fact, favour backing some of India's best business families. However, it is true that for every Indian family-owned business that has high standards of governance and has created enduring shareholder value over decades, there are several that we would never think about investing in.

We like family-owned businesses because they take a long-term view about their business — they think in terms of multiple generations, as good stewards of capital must. They think of long-term headwinds and tailwinds and adjust their business models on that basis, paying attention to capital preservation and staying in the game for decades to come. We have often found this aspect lacking in businesses where there are no long-term stewards; and in effect, they simply become management enrichment schemes that are run on the basis of perverse short-term incentives. This has been one of the reasons why we have remained on the sidelines with new listings over the last two years, where businesses that are majority-owned by private-equity funds (which themselves are constrained by the time horizon of their funds) have grown too quickly in some cases, perhaps without the conservative mindset that we like.

Generally, over the past 20 years governance standards in India have improved across various aspects. This process has been punctuated by occasional stock-market scams or corporate failures, which have served as catalysts for regulators to design better rules to protect minority shareholders. For example, regulations improved in the aftermath of a rash of privatisations by the listed

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subsidiaries of multi-national corporations (MNCs) in India during 2003-2007 at low-ball prices. Now, minority shareholders are protected from predatory privatisation attempts, as these require the approval of a majority of minority shareholders (at 2:1) and price discovery for privatisations is via a reverse book-building process. Tag-along regulations also exist, preventing the owners of businesses selling their stakes at preferential prices. Similarly, related-party transactions are closely monitored and need the approval of minority shareholders beyond a certain threshold — this means that practices such as parent companies charging excessively high royalty/ license fees to local subsidiaries are not possible in India. Further, the role of the board has been continually strengthened — current laws require majority independent boards and nudge them to split the role of chairperson and CEO. In addition, there are limits imposed on the tenure of independent directors and auditors.

All of this, and much more, has meant that Indian equity markets are actually among the best-regulated across comparable emerging markets. This is reflected in increased institutional and particularly foreign ownership. Around 20 years ago, only 70 or so Indian companies had a foreign shareholding of more than 1%, a number that stands at over 700 today. Generational change is another driver of higher governance standards — children of first-generation entrepreneurs are typically better educated and have some work experience in large organisations, where they observe the benefits of good governance (better talent, valuations, lower stress). When they take over the family operations, they tend to improve governance standards — e.g. whereas the previous generation might have obsessed about saving (evading) tax, the next generation would see the benefits of compliance in terms of raising external capital etc. During our recent research trip to India, most corporates said to us that India is now a third-world country with first-world compliance, which favours businesses operating in a sustainable manner. Finally, India's pool of managerial talent has greatly benefited from the existence of well-established multi-national subsidiaries, such as Hindustan Unilever, which have been operating in the country for many decades. Apparently, today there are some 500 CXOs[1] in Indian companies from Hindustan Unilever alone. Over the years, thousands of young managers have travelled extensively to other markets and learnt best-in-class management techniques, all of which they bring to local family-owned companies looking to professionalise — we have seen this first-hand in several instances and are always on the lookout for such investment opportunities.

However, these are still exceptions and not the rule. It would be a monumental mistake to think that all business families in India are so forward-thinking and considerate to stakeholders. Any investor with such notions would find themselves staring at several write-offs in their Indian portfolio. Our investment process is designed to eliminate such risks. For instance, when we meet a company for the first time, we hardly discuss the business itself. Instead, we focus on the key people and their journeys. Quite often there is an "Original Sin" (an outright crime or a grey area from which the founder benefited), from which a business is born, and we delve into the changes in mindset since then. It is a question of judgement, as with most things in our profession. In other instances, we spend time meeting the independent directors of a company, to assess whether they are truly performing their duty as a check against the (sometimes unfair) wishes of the founders/ family. Reputation checks via asking trusted business owners and managers is also important, and we have side-stepped many a landmine over the years in this fashion. So, before we even start to analyse the business model of a company, there are several important questions that need to be answered satisfactorily. Otherwise, in our view, we might end up failing to protect our clients' capital.

As we have mentioned in previous letters, one of the core beliefs of our team is that not everything has a price. If our assessment of a company's owners and managers is not up to the mark, we simply will not invest, regardless of the valuation or seeming strength of the franchise.

Returning to our meeting with the senior executive, he concluded, "If you take a picture of India, it always looks chaotic and ugly, but if you view it as a movie, it is a good one. And in Bollywood, there is always a happy ending!" We think along the same lines when it comes to investing in India. At any given point of time, the companies we meet and invest in don't always "look" good. But, as we often say when referring to companies, one must travel and not arrive. The direction of travel and the spirit with which the owners and managers are making decisions is more important than how good the narrative is or how glossy the Sustainability Report. We love the movie that is India — it is long, it never goes in a straight line (and sometimes even backwards), but in the end, the good guys always win!

[1] CXOs: c-suite executives

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 14 February 2023 or otherwise noted.

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