FSSA Investment Managers

For institutional/adviser use only

Client Update

Quality at any price?

December 2022

"I am not aware of us getting into EV chargers, actually. I really don't know where you're getting this information. At this point of time, these are all in the developmental category. We have not come to a stage where we'll be able to report anything solid. [..] There are no products, no revenues, nothing!"

That was the exasperated CFO of an Indian electric motor company trying to tell the sell-side analysts who were attending his company's recent quarterly update that, despite their vehement assertions, his business had little to do with Electric Vehicles (EVs). At least, not for the foreseeable future. However, this didn't deter the brokerages who seemed determined to fit the company into their narrative about the upcoming exponential growth in the EV sector — whether the company's management agreed with them or not!

In a missive last year, we wrote about the bubble we were witnessing in the initial public offerings (IPOs) in India, where business models that had some sort of comparable peer in the US or China were being touted as the "XYZ of India" (where XYZ was inevitably a massively overvalued, profitless business). That mania has since subsided and we are seeing the detritus float around now. Apparently, in just four of these newly-listed companies, there are around USD 11bn worth of shares that will come out of the IPO lock-in period this month and that is after share prices have fallen 50% from their recent peaks — happy holidays!

We are waiting for the other shoe to drop now, in companies such as the electric motor business mentioned earlier, which has now been bid up to an eye-watering prospective price-to-earnings ratio (PER) of 60x. This is a different type of bubble — in these cases, the business is often a proven one, with a strong track record and high return profiles. The management teams running these kinds of businesses are also of high calibre. In short, these are mostly our kind of companies. Over the last few years, several such stocks in India have been catapulted into the rarefied valuation orbits that are usually only inhabited by the latest SaaS[1] wunderkinds (or EV start-ups). A water pipe company, notwithstanding its amazing return on capital employed (ROCE) profile and strong compounding track record, is now valued at an incredible 64x PER. India's leading adhesives manufacturer, who we have long admired and have been shareholders of in the past, trades on 73x PER. One of the country's best grocery retailers, one that we were sufficiently impressed with that we made the rare exception of becoming an anchor shareholder five years ago but sold on valuation grounds, has gone up another four-fold since then and now trades at a scarcely believable 90x PER. India's largest Non-Bank Finance Company (NBFC) is no longer the trusty HDFC Corp, but rather one that trades on an incredible 8x price-to-book (PB). We could go on and on.

As in the case of the IPO bubble, we are staying disciplined. We believe there is substantial downside in these companies if (when?) shareholders head for the exits. The important difference with these "high-quality bubbles" is that we would happily own them on behalf of our clients for the long term after the valuations come back to earth.

But this not to say that we've drawn a blank with regards to finding interesting new investments in India. The market is huge (over 5,000 listed stocks) and the watch-list of companies that meet our quality criteria keeps growing (over 200 now). For example, instead of the pipe company

[1] Software-as-a-Service

that trades on 64x PER, we own one of India's leading air-conditioner manufacturers. Given the low penetration (only 5% of Indian homes have an air conditioner vs. more than 90% in developed markets like the US[2]) and its track record of market share gains, we think the opportunity for this company over the next decade is even more compelling. More importantly, its valuations are far more reasonable. The mania that has resulted in the electric motor company (supposed EV beneficiary) trading on 60x PER, has also thrown up opportunities at the other end of the spectrum, e.g. India's leading engine lubricant company, Castrol India, which has been de-rated significantly because investors are certain that its entire franchise, based on Internal Combustion ("IC") engines, is ending imminently. However, this is a business that depends on the stock of vehicles rather than sales of new ones. For decades to come, we believe the composition of India's vehicles will still remain overwhelmingly in favour of the traditional IC type and Castrol's volumes will likely grow at a steady rate. Meanwhile, the company has already launched a full range of EV fluids and is contemplating forays into EV charging stations — i.e. this is a management team that is likely to transform the company over the long term. For now though, Castrol India seems a bargain — it generates over 200% ROCE, has a net cash balance sheet, grew earnings per share (EPS) at 7% CAGR[3] over the past decade, pays a healthy dividend (5% dividend yield) and traded at 11-12x PER when we first invested. There are several such examples in our portfolio and watch-list.

In fact, as noted in our recent letter (Aug 2022), the portfolio has, over the past decade, never looked in better shape as it does now. With portfolio-weighted earnings growth in the range of 18-20% over the coming two years, average ROCE of more than 35% (3-year average) and portfolio PER at 21x, we feel confident about the portfolio's prospects.

[2] IEA, Percentage of households equiped with AC in selected countries, 2018, IEA, Paris https://www.iea.org/data-and-statistics/charts/percentage-of-households-equiped-with-ac-in-selected-countries-2018, IEA. Licence: CC BY 4.0
[3] Compound annual growth rate

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 November 2022 or otherwise noted.

Important Information

References to “we” or “us” are references to First Sentier Investors (**FSI**). The FSSA Investment Managers business forms part of First Sentier Investors, which is a global asset management business that is ultimately owned by Mitsubishi UFJ Financial Group, Inc (**MUFG**), a global financial group.

In Hong Kong, this document is issued by First Sentier Investors (Hong Kong) Limited (**FSI HK**) and has not been reviewed by the Securities & Futures Commission in Hong Kong. In Singapore, this document is issued by First Sentier Investors (Singapore) (**FSIS**) whose company registration number is 196900420D. In Australia, this information has been prepared and issued by First Sentier Investors (Australia) IM Ltd (ABN 89 114 194 311, AFSL 289017) (**FSI AIM**).

This document is directed at persons who are professional, sophisticated or wholesale clients and has not been prepared for and is not intended for persons who are retail clients. The information herein is for information purposes only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs. Before making an investment decision you should consider, with a financial advisor, whether this information is appropriate in light of your investment needs, objectives and financial situation. Some of the funds mentioned herein are not authorised for offer/sale to the public in certain jurisdiction. Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. All securities mentioned herein may or may not form part of the holdings of First Sentier Investors’ portfolios at a certain point in time, and the holdings may change over time.

Any opinions expressed in this material are the opinions of the individual authors at the time of publication only and are subject to change without notice. Such opinions: (i) are not a recommendation to hold, purchase or sell a particular financial product; (ii) may not include all of the information needed to make an investment decision in relation to such a financial product; and (iii) may substantially differ from other individuals within First Sentier Investors.

Please refer to the relevant offering documents in relation to any funds mentioned in this material for details, including the risk factors and information on requirements relating to investor eligibility before making a decision about investing in such funds. The offering document is available from First Sentier Investors and FSI on its website and should be considered before any investment decision in relation to any such funds.

Neither MUFG, FSI HK, FSIS, FSI AIM nor any of affiliates thereof guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investment in funds referred to herein are not deposits or other liabilities of MUFG, FSI HK, FSIS, FSI or affiliates thereof and are subject to investment risk, including loss of income and capital invested.

To the extent permitted by law, no liability is accepted by MUFG, FSI HK, FSIS, FSI AIM nor any of their affiliates for any loss or damage as a result of any reliance on this material. This material contains, or is based upon, information that we believe to be accurate and reliable, however neither the MUFG, FSI HK, FSIS, FSI AIM nor their respective affiliates offer any warranty that it contains no factual errors. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of FSI.

Any performance information has been calculated using exit prices after taking into account all ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.