REPORT H1, 2020

Surat is forecast to be the world's fastest growing city over the next 15 years and is now essentially slum free. The city was one of India's first "Smart Cities" and an early blueprint of Narendra Modi's development-oriented work in his home state of Gujarat. (Photo credit to Revitalization.org)

INSIDE THIS ISSUE

GRASSROOTS INDIA

INTRODUCTION

Our *Grassroots* publication (half-yearly in frequency) focuses on providing its readers with the necessary insights when contemplating, assessing or understanding an investment into India's fast-growing economy. Whilst many investors are aware of the high GDP growth, driven by the strong fundamentals of a youthful, aspirational and entrepreneurial society, it is the insights into what makes the economy tick, at a grassroots level, that helps navigate a successful path.

Indian equity markets are a concoction of companies which are generally thriving from the pace of the country's growth in consumption, banking, infrastructure amongst many other industries. Understanding the ecosystem in greater depth is more likely to lead to a successful investment outcome for Australian and New Zealand based investors.

We would appreciate your feedback on the content and quality of this publication.
Please feel free to write to me at mugunthan.siva@indiaavenueinvest.com if you have any questions.

GROWTH OF TIER 2

CASE STUDY: SURAT

TOP 10 FASTEST GROWING CITIES IN THE WORLD, 2019-35

Rank	Growth (y/y 2019-35)	City	GDP 2018*	GDP 2035*
1	9.2	Surat	28.5	126.8
2	8.6	Agra	3.9	15.6
3	8.5	Bengaluru	70.8	283.3
4	8.2	Hyderabad	50.6	201.4
5	8.4	Nagpur	12.3	48.6
6	8.3	Tiruppur	4.3	17
7	8.3	Rajkot	6.8	26.7
8	8.3	Tiruchirappalli	4.9	19
9	8.2	Chennai	36	136.8
10	8.2	Vijayawada	5.6	21.3

*GDP: $tn, constant 2018 prices — Source: Oxford Economics

FASTEST GROWING CITIESS IN THE WORLD
SOURCE: OXFORD ECONOMICS

Diamond Polishing in a core industry of Surat

Clean and growing metropolis of Surat

No, this case study isn't about a tiny rural town in Queensland, Australia of 407 people. It's about India's fastest growing city, Surat in the state of Gujarat. India's fastest growing cities have previously been the domain of its Tier I such as Delhi, Mumbai, Bengaluru, Chennai and Kolkata. However, as India's urbanisation takes place (500 million people are expected to move from rural to urban locations over the next two decades), its Tier II cities are growing at a faster pace. Tier I cities can't sustainably grow without better infrastructure and have handed over the baton to Tier II, which have less legacy infrastructure issues.

Surat is a city of approximately 6.8 million[1] and projected by Oxford Economics to be one of India's fastest growing cities (expected GDP growth of 9.2% p.a. over the next decade). Surat's major industries are dominated by textiles, silk and diamond polishing (accounts for 90% of the world's diamond exports). Information Technology and its emergence is also behind Surat's growth. Surat was selected as one of India's Smart Cities and is listed as the 3rd cleanest city in the country.

Surat now has a GDP of approximately of US$57bn. From 2001 to 2008 the city recorded a growth rate of 11.5% p.a. (in the period when now Prime Minister Narendra Modi, became the Chief Minister of Gujarat).

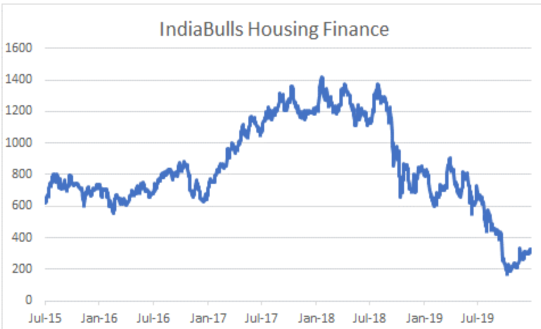
The vision for Surat as a smart city was *"Smart Utilization for enhancing quality of life for the citizens by providing equal access to best quality physical and social infrastructure and mobility through leveraging state of the art technology; thus making Surat a futuristic global city, with a focus on enhancing the economy, protecting the ecology and preserving the identity and culture of the city"*

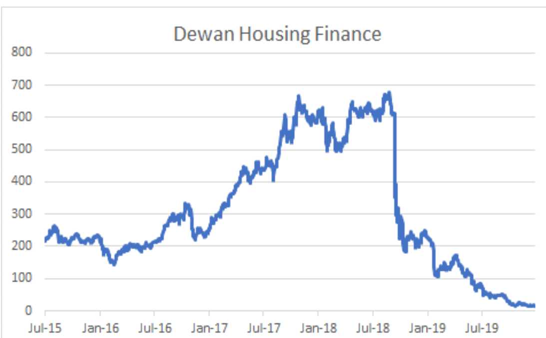
If we consider why Surat has grown at a rapid pace. Firstly, its population growth is high at 4-5% p.a. and close to triple pan-India growth. Surat is also renowned for its Diamond Processing industry of A$31bn (comparative advantage) as well as its technology (close to being tech-enabled). A significant build out of affordable housing has also taken place (200,000 homes in five years). Given its growth, Surat's employment has been strong from 1.7m jobs in 2008 to 2.7m jobs in 2018 (and predicted to rise to 3.3m by 2023).

Ask locals about why Surat has been successful in its growth agenda and the response revolves around comparative advantages, forward planning, favourable location (port city) as well as "trust" in business, with a large part of the diamond business being conducted on this principle. Additionally, a good transport system and a good university help. A strong blueprint indeed for other cities in India to emulate.

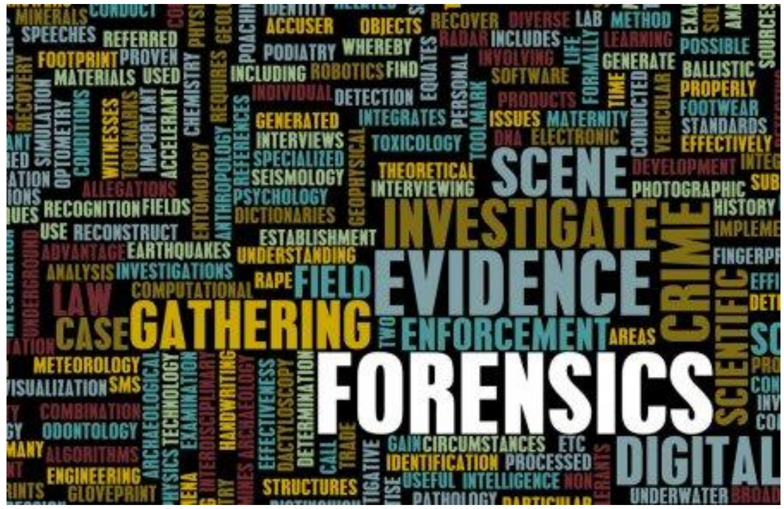
[1] UN World Urbanisation Prospects

Two such companies, which prior to any issues were in the Top 100 by market capitalization, were India Bulls Housing Finance and Dewan Housing Finance. These companies have seen their share prices fall 88% and 98% respectively from their peaks.





1) *IPO Documents were very vague. It was not possible to identify where relatives had interests in competing companies (a SEBI requirement to disclose this information). Upon deeper analysis the manager identified these interests.*
2) *The company's growth projections were completely out of whack with the market and competition. They claimed they had an all India presence despite having small advertising budgets.*
3) *Unusually low pay for senior staff. The CEO was being paid 4.5 lakhs (A$9,000) and other senior staff less than 10 lakhs (A$20,000).*
4) *The company was also raising several rounds of capital through Qualified Institutional Placements (QIP's), despite having cash on their books. In fact, their QIP raise was the fastest raise post IPO on record for India. The management was also very flippant around the wording regarding the use of proceeds in the QIP document.*



FORENSIC ACCOUNTING

UNDERGOING A BOOM

Over our last two trips to India in June and September 2019 we met with 29 boutique investment managers across India (Mumbai, Pune, Ahmedabad, Chennai). One of the major themes we picked up in our discussions was the increasing focus on forensic analysis on companies. This was driven primarily by the growing number of financial shenanigans that many corporates are using to inflate their financial statements. To get on top of this involved having well educated, CA qualified analysts to plough through company documents looking for financial irregularities. For others, not only was this a necessity, but they hired forensic accounting firms to verify key numbers as well as untangle very complicated holding structures (for e.g. several subsidiaries, JV's, related entities and offshore trusts.)

What was also very interesting was the fact that many of these managers stated that this was not just a small and mid-cap company issue but also quite common amongst some of the large cap companies as well! Over the last couple of years, we have seen several companies that experienced significant share price falls as a result of poor governance (refer to the two charts in the side bar).

We have also seen many auditing firms resign from auditing jobs given reputational risks for being associated with dubious firms. Both the Reserve Bank of India and SEBI (regulator) have banned audit firms due to malpractice. In fact, a record number of auditors have resigned from NSE-listed firms in the first six months of financial year 2019-20. The independence of audit and rating firms is questionable.

One boutique manager stated that corporate governance and deep forensic analysis on the quality of the reported financial statements was at the heart of their investment process. In fact, they wrote a piece publicly (The full article can be read here) on a company prior to its demise, where they claimed several irregularities with the company as **listed as points 1-4 on the shaded left hand column**.

There were several other managers who seek to complement this work by hiring an external forensic party to conduct and verify:

- **Shareholding structure,** especially ultimate shareholding of corporate shareholders, drilling down to the **individual shareholders** behind these companies
- **Changes in shareholding** of the company
- **Interlinkages** between shareholders, promoters (founders) and suppliers, vendors of the company through an understanding of the individuals behind all the companies
- **Existence of any other promoter companies** in the same line of business
- ***Verification*** of ***export*** billings of the company, this included verifying numbers independently of the company by visiting ports
- Drill down ***working capital*** analysis
- ***Tax records*** analysis – Indirect taxes (mainly GST, Customs)
- ***Promoter holdings*** *in other businesses which may impact shareholdings due to pledges on stock to fund these holdings*

The Indian corporate landscape is an exciting one, but also a very complex one given the nuances of promoters, conglomerates and family holding structures etc. Bull markets create a perfect environment for short cuts and frauds as money is plentiful and the need to chase returns, often leads to investing down the quality curve. Indices are agnostic to this and systematic strategies that buy on perceived quality assume that the financial numbers reported are accurate. Hence it is paramount that extensive on-ground checks and forensic analysis are done to substantially reduce such risks. Without an on the ground presence, this cannot be achieved.

INGREDIENTS FOR SUCCESS

POLYCAB INDIA

As we have mentioned many times before, the key ingredients for corporate success in India are understanding the **comparative advantages** of the business, **inelastic demand** to government policy changes**, distribution channel penetration** and **operational leverage**. In an ecosystem which is challenging, those able to thrive have focused on their strengths, kept debt at a minimum and generated strong cash flow from the scale advantages which exist due to India's demographics.

Polycab India, a company incorporated in 1996 and listed in 2018, is engaged in the business of manufacturing and selling wires and cables and fast-moving electrical goods e.g. electric fans, LED lighting, switches and gears and solar products.

The business has essentially leveraged off its strengths in the wire and cable business and is using its brand leadership to build a broader multiproduct company. This has been achieved by a strong business model, superior reach and strong brand recall.

Strong Franchise: the company is the market leader in wires and cables, with 12% market share (18% in organized – which is growing much faster). This component of the business provides the cash flow generation and has strong product recall amongst its customers. W&C is growing at 14% p.a. over the last five years.

Growth Engine: Fast moving electrical goods has exhibited 51% CAGR over the past 5 years and involves a diverse product range built on customer knowledge, innovation and technology

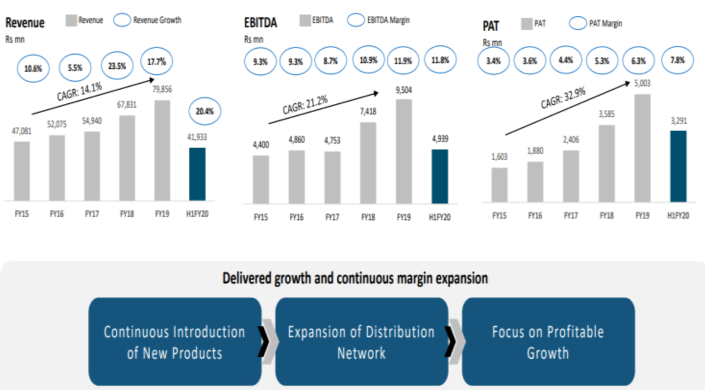
Manufacturing Capability: the company has over 25 locations for manufacturing, which allows it to produce its own product in an efficient and effective manner. Capacity is being expanded to meet the needs of customers. With the advent of GST organized pan-India players are benefitting from adding capacity

Distribution: the supply chain comprises of authorized dealers, distributors and retailers (3,400). These dealers then supply product to 100,000 retail outlets across the country. Products are also exported to close to 40 countries.

Investment in Technology: investment in R&D has continued to increase to continue strong innovation in product

With the Government of India's push for infrastructure as well as a focus on rural electrification and energy efficiency, products such as premium fans, switches and energy efficient lighting are very much in demand. Additionally, the W&C business is likely to thrive in an environment where Infrastructure and Industrial growth is significant.

Polycab India IPO on the NSE was 52x oversubscribed. Its issue priced was Rs.538

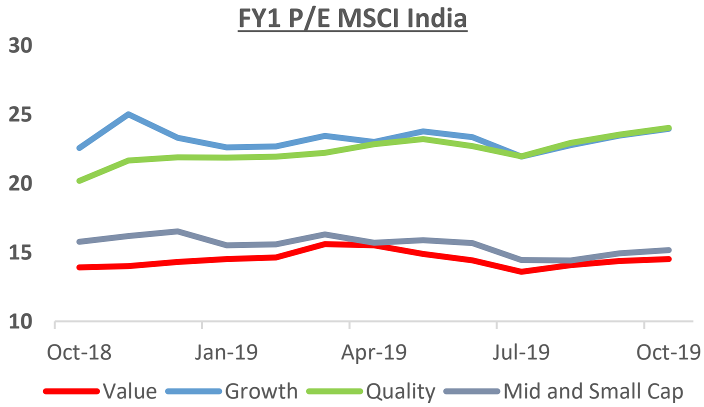


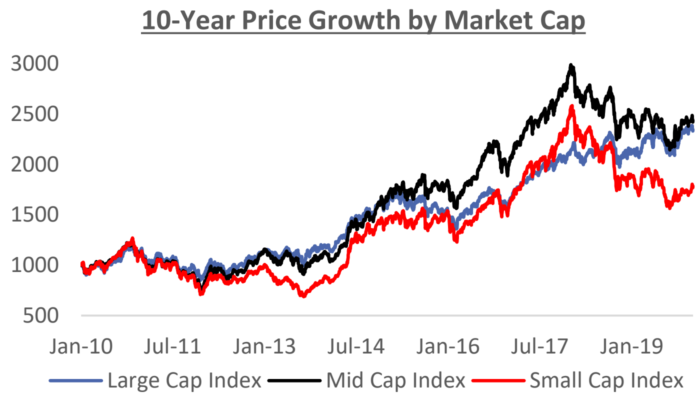
In India, buying "quality" companies has provided superior results in 2018-2019, regardless of valuation

CORRELATION OF SUCCESS AND QUALITY

INDIA'S BEST PERFORMING MANAGERS HAVE A HIGH P/E – WHAT NEXT?

The Indian economy and markets are experiencing a dichotomy on multiple fronts. Firstly, some market indices are hitting all-time highs despite economic growth falling to below 5%. Secondly, within financial markets, there has been significant divergence between the Nifty 100 (the Regulator defines large caps as the top 100 largest companies in India) and the rest of the market. To visualise the difference, the Nifty 100 hit an all-time high during the month of December whereas mid and small cap indices peaked over two years ago and are currently where they were 3 years ago. Since then the Nifty 100 is up 30% over this time. Finally, even within the Nifty 100 there has been significant divergence between companies driven by a handful of companies that have witnessed high valuations for such a long and unprecedented period. These companies trade at a premium as investors pay up for stable predictable high earnings growth. Typically, these companies are sector leaders with a very competitive position justifying their premium valuation. However, the premium has been stretching over 2019 and is now more than 10 multiple points more expensive than value and small and mid-caps. (25x vs. 15x). So, the question is not whether quality deserves to trade at a premium or not, but whether the premium is sustainable or not. For some "Quality" stocks, to justify current valuation multiples, they must grow at double digit growth for 35 years[2].





In India, Value has underperformed Growth, particularly over the last 12 months. In AUD terms, the MSCI India Growth Index has outperformed MSCI India Value Index by 8.3%. MSCI India Quality (which has some overlap to both Growth and Value indices) has outperformed by 9.9%. Quality typically describes companies that tend to have high ROE, stable earnings that are uncorrelated with the broad business cycle and low financial leverage. MSCI Value which focuses on Book value to price ratio, 12-month forward earnings to price ratio and dividend yield whereas MSCI Growth looks at the long-term and short-term forward EPS growth rate, long-term historical EPS growth trend and long-term historical sales per share growth trend. Quality and Growth styles are perhaps significantly correlated, given they both incorporate growth characteristics.

[2] Abakkus, "The Big Call – Bubble in Quality", 30th Oct 2019

Whilst “Quality” and large cap companies have outperformed of late due to fundamental reasons, a large part of this can be due to other non-investment related factors that are not sustainable. These include

- Inflows due to excessive liquidity are the major reason for expensive multiples. There has been skewed inflows into large cap companies over the last few years. To put this into perspective, in 2013/14, 31% of total flows from domestic investors went into the top 100 companies and now that is 84%. For FPI’s, this has risen from 48% to now 88%[3].
- The Securities and Exchange Board of India (SEBI) changed the regulation for mutual funds on the minimum % of stocks to be held, depending on the category of the respective fund (i.e. large cap, small and mid-cap, multi cap). This resulted in funds being forced to buy and sell companies based on market cap, ultimately resulting in a sharp selloff in mid and small cap names. According to our network in India, SEBI are currently revising this rule.
- Self-fulfilling prophecy from fund’s that are performing well continue to receive flows and topping up their current holdings further. Unsurprisingly, fund’s that are less valuation focused and quality aligned have performed very well over this period. When we ranked multi cap mutual funds over the last couple years, the top quartile funds have philosophies that align with either “Quality and Growth” and have average 12-month historical P/E’s now approaching 40x!

[3] Abakkus, “The Big Call – Bubble in Quality”, 30th Oct 2019