REPORT H2, 2019

Mumbai's street side restaurants allow locals and foreigners to sample the culinary delights of the city in a far more presentable way

INSIDE THIS ISSUE

PG. 2

Mumbai's Metro, meeting the challenges of congestion

PG. 3

The tricks of the trade – stock picking essentials in India - from our discussions with 30 boutique managers

PG. 4

A very Indian Company, with a highly localised product driving success - **Marico**

GRASSROOTS INDIA

INTRODUCTION

Our Grassroots Publication (half-yearly) 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 towards 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. However, it's understanding the ecosystem in greater depth which 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 us at info@indiaavenueinvest.com if you have any questions.

LINE 3 UNDERGROUND DEVELOPMENT AT BANDRA KURLA COMPLEX. SOURCE: INDIA AVENUE

Funding

Given the large scale, size and money required to build such a large infrastructure project, funding needs to come from a variety of sources. The Mumbai Metro Rail Corporation Ltd was set up as a JV of Government of India and Government of Maharashtra (State) to build, project manage and provide funding. Different lines are being funded differently. For example, Line 3 (the fully underground line) is being funded by variety of local as well as international sources (i.e. Japanese International Cooperation Agency) as can be seen in the table below. The Asian Development Bank has also provided debt funding of $A1.3bn for 2 other lines.

Source	Amount (in A$m)	% Contribution
Equity by Centre	481	10.4
Equity by State	481	10.4
Sub Debt by Central Govt.	205	4.4
Sub Debt by State Govt.	323	7
Property Development + Impact Fee	200	4.3
Stakeholder Contribution (MIAL)	155	3.4
ASIDE Funding / MMRDA Grant	136	2.9
JICA loan	2,647	57.2
Total Project Completion Cost	4,627	100

The expansion of the Mumbai Metro network will provide a huge windfall for companies in the EPC, systems and rolling stocks space. The benefit of undertaking metro projects lies in the relatively better working capital cycle for these projects. With funding secured (from government and multilateral agencies), agencies generally pay contractors on time. Our portfolio has several names that are large beneficiaries of this large infrastructure roll out.

The Wall Street Journal produced a short 4.5-minute clip of the progress made so far on Line 3 that you can view here. It is a fascinating watch.

https://www.youtube.com/watch?v=yPsgQIT4k58

MUMBAI METRO

CHANGING MUMBAI TO A BETTER CITY

India's financial capital, Mumbai is underway, constructing its biggest-ever infrastructure project – a metro system connecting the entire city. This is a much needed and welcome upgrade for a city classified as the second most densely populated city in the world, where more than seven million commuters cram onto its old suburban railways.

The Mumbai Metro is a transit system being built in three phases over a 15-year period, with overall completion expected in 2025. A total of 12 lines have been approved with two more waiting approval. The total length of the metro system in Mumbai will span 259km and have 205 stations with an estimated infrastructure cost of A$26bn.

The first line (Line 1) was completed on a public-private partnership model and opened for service on 8 June 2014. It covers 11.4km and is fully elevated. It carries over 500,000 passengers a day and has reduced travel time along its east-west route from 71 minutes to 21 minutes.

The next 11 lines will connect many parts of Mumbai, with 24% of it underground. In fact, line 3 will be fully underground, stretching over 33km connecting Colaba to Bandra to Seepz passing Mumbai's main CBD, Bandra Kurla Complex (commonly known as BKC). This will include 26 underground and 1 at-grade stations and is estimated to cost $A4.6bn. It will be India's first fully underground metro line, carry an estimated 1.6m people per day and be operational by 2021.

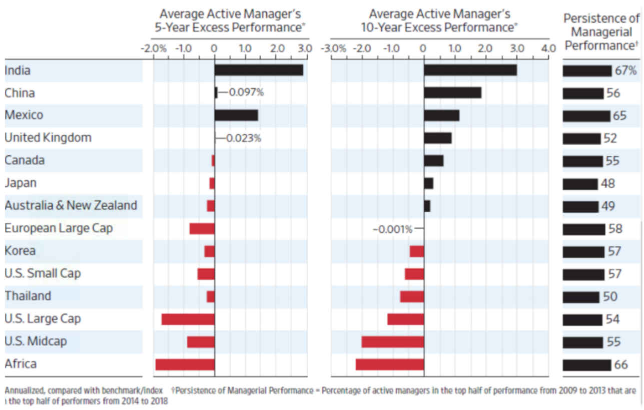
While Mumbai is quite late compared to other global major cities as far as development of a metro rail network is concerned, the scale and speed of the network is remarkable. This is despite several obstacles such as land acquisition (where the Government had to acquire land and disturb many parts of Mumbai in terms of business, traffic, religious sites etc. Furthermore, Mumbai sits on a special type of rock, basalt which is very hard to dig and requires special machines to bore through.

Over the next 4-5 years, construction of approximately 125km of rail line is being targeted in Mumbai. This is amongst the fastest rate of metro network development compared with other major cities across the globe. In fact, it is at par with the pace witnessed in some major cities in China, such as Shanghai and Shenzhen.

One of our portfolio companies (NCC) is an Engineering, Procurement and Construction (EPC) company. Construction work within the metro space is a key source of revenue for the company. Conversations with the company and our fund manager on the ground said that their part of the underground section was completed 9 months ahead of schedule.

Mumbai metro has over 520,000 passengers a day – and we are just getting started!

India has been recognised as a great market for active management. This chart from the Wall Street Journal, illustrates stock pickers have added value relative to benchmark with strong persistence of outperformance.



Active Manager Excess Performance Over The Last 10 Years

1. India's economy and business owners have often emerged from smaller family business structures which may have been set up to line the family pockets as a participant in a cash based, non-tax paying economy. As significant fundamental tail winds have pushed companies to greater market capitalisation, they have not necessarily built better governance structures to deal with external shareholders. It is critical to identify stock pickers who understand the local business ecosystem and have insights into management and their focus on minority shareholders' interests.
2. Certain transactions of assets are intentionally traded at different prices to their economic value to related parties who may not necessarily be at arms-length
3. Perusal of accounts can indicate anomalies such as payment to staff. Excessively low or high payments can provide insight on the thought process of management. Low wages may not always be an indication of sweat capital, but may highlight misappropriation elsewhere
4. Related party transaction to those service providers who are less than arms-length. Several businesses have emerged over time where contracts originally provided to private businesses linked to the promoter are now increasingly being scrutinised as a larger company
5. Cash flows provide far better insight on the health of a company, given potential siphoning of money. An annual report is a gospel document check as a discussion with ex-employees, suppliers, customers, competitors and service providers
6. When businesses require capital, they are more likely to provide a picture which maximise profitability and when they do not require funds, more likely to showcase lower profits to minimise taxes.

STOCK PICKING

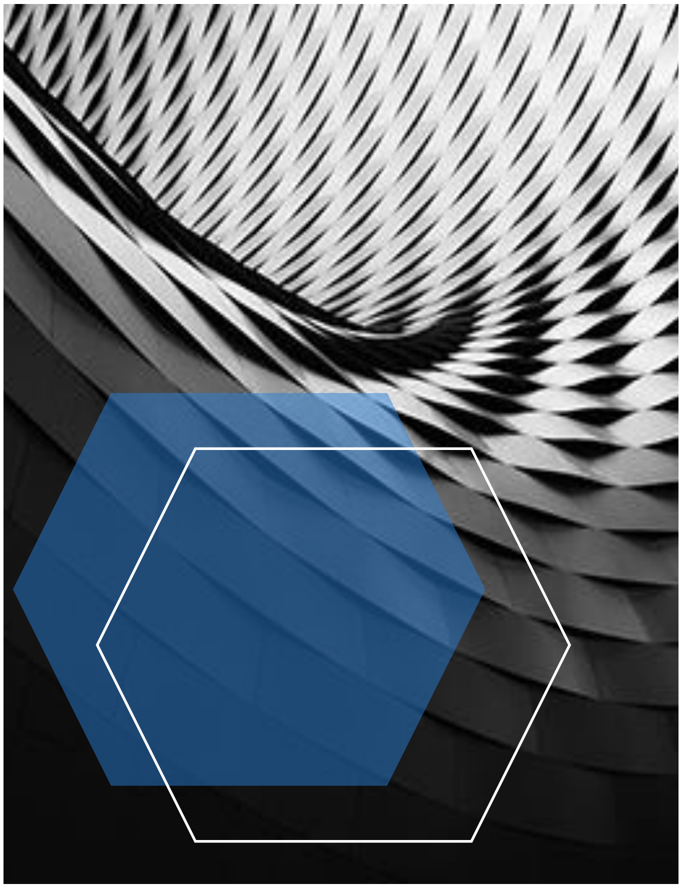
UNDERSTANDING INDIA'S ECOSYSTEM

India's stock market, via the Bombay Stock Exchange (BSE) was founded in 1875. India stock market opportunity has been significant, particularly over the last 30 years since economic and capital market reforms were unleashed in 1991. However, there has been significant dispersion of stock market performance between well and poorly managed companies. Of India's 6,000 plus listed companies today, only a few have been able to navigate the ecosystem, regulation, competition and the cost of doing business in a way to generate profit for not only the family, but also for minority shareholders.

Stock prices are a function of not only fundamentals of the business, but also supply and demand of shares. Despite India's stock markets being 50% owned by local or foreign promoters, external shareholders play a significant role in driving share price direction.

In our recent visit to India we conducted due diligence on 30 boutique investment managers operating within India's stock picking ecosystem. From this exercise, which is a core part of India Avenue's proposition (i.e. selection of high quality skilled stock pickers to help us build a robust portfolio), we found some very interesting insights which are not necessarily synonymous with stock picking globally, but more nuances of the local business ecosystem (refer to the left column highlight).

Whilst several of these can be factors to consider for stock pickers regardless of the market, in India is takes an understanding of the cultural nuances to grasp where fraud or misappropriation might occur. Where promoter ownership is significant, it can be a blessing or not, depending on moral fibre, business ethics and need for external capital.



A VERY INDIAN COMPANY

MARICO

The 21st Century has quite often been coined the "The Asian Century". By saying this, we admit that consumption patterns are likely to be dominated by our Asian neighbors, over the remainder of this Century.

On our recent Grassroots India Tour, we met with management of Marico, one of India's leading consumer products companies, operating in the beauty and wellness space. The company was founded in 1990 by Harsh Mariwala (who still holds 60%) and has built its success thus far primarily around a product called Parachute, a market share leader in coconut hair oil (36% of revenue) plus value added hair oil products (26%).

On our Tour, most of our delegates questioned how coconut hair oil could be a product category which helps build a sustainable growth business. It's not typical for those from the West to use hair products to nourish and revitalize the hair. However, Parachute being the flagship brand of the company, enjoys enormous brand loyalty in urban, semi-urban and rural markets in India. It is an example of how the consumer preferences in Asia might not reflect exactly what we are used to in Anglo-Saxon dominated economies.

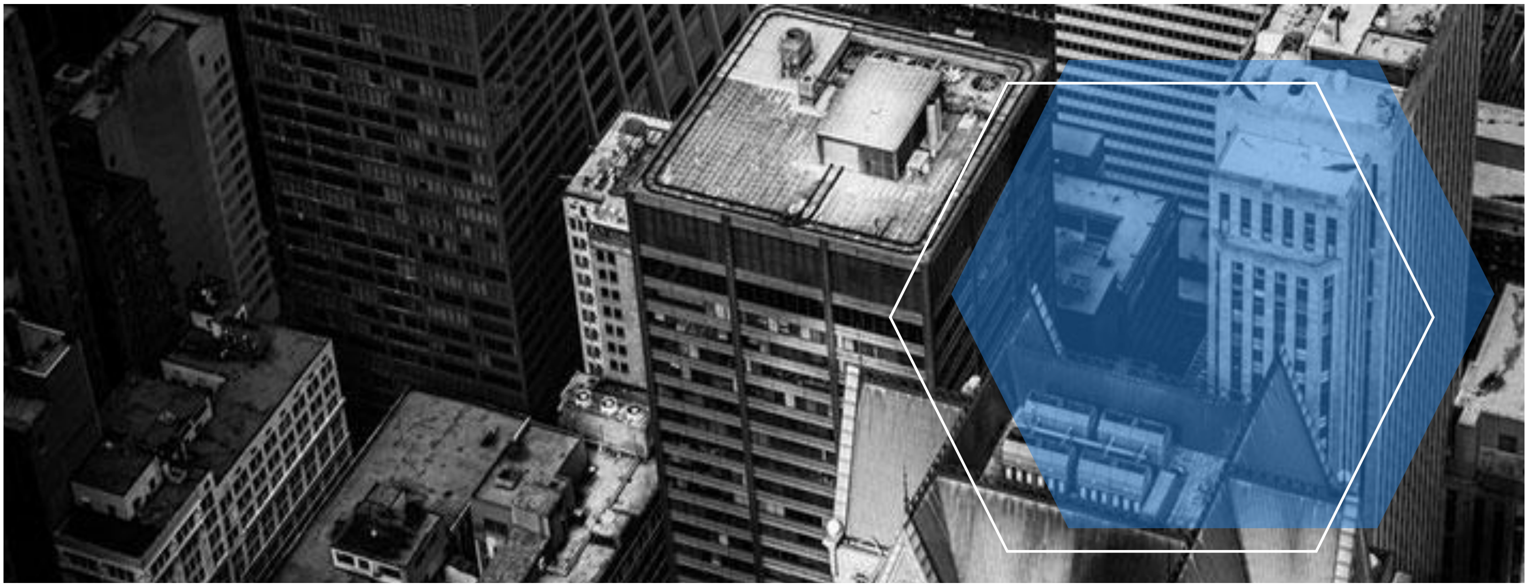
Marico is amongst the leading beneficiaries of the changing preference of the Indian consumer for better personal care and food products. The company has established strong ground in its core category (hair oil and edible oil) with a dominant market share.

You may question if the aspiring youth of India may use coconut hair oil to maintain their hair like their prior generations or whether they will seek to emulate their western peers. However, the company is now intelligently diversifying into food categories, whilst continuing to pursue other markets which are down at the nascent end of the aspirational curve i.e. Bangladesh, Africa, Middle East (foreign revenues are now 22% of business).

Marico's share price over the last 5 years

The companies stock price has appreciated by 23% p.a. over the past 10 years. There are many such companies, which may look like they lack a moat, but in fact it's their local market appeal and strong distribution roots which lead to a premium stock market valuation. The stock trades at close to 40x one-year forward PE.

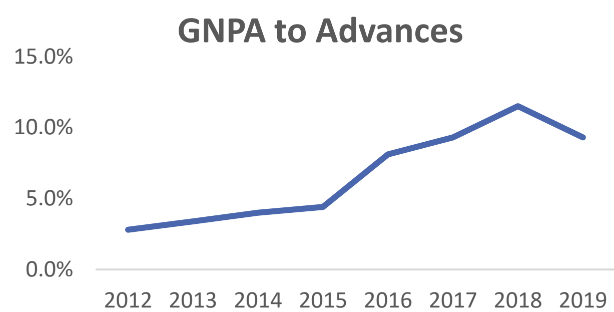
Our preference has generally been for localised consumption plays rather than a global consumption business with a listing in India e.g. Nestle, Colgate. We feel there is value in emerging from the local ecosystem rather than a scale advantage seeking to understand and grasp local dynamics and distribution.



INDIA’S FINANCIAL SYSTEM

CHANGING FACE OF BANKING

India’s financial system has been discussed at length over the last decade. In a growth economy, a strong and smoothly functioning financial system is required to facilitate the direction of capital towards productive areas to be supportive of economic growth.



Lending has a legacy in India of being predominantly controlled by the public sector (70% of banking assets, but currently only 43% of profit). These state-owned banks have the greatest exposure to bad loans, made during the credit boom of 2006-2011 around the peak of the business cycle in 2008 for steel, power, construction, infrastructure and capital goods businesses (bank lending was growing at 20% p.a. in this period). 21 state-owned banks now have bad loans on the books of about US$120bn.

Prior to 2015, several of the Banks were under-reporting problem loans or “ever-greening” them. However, the Reserve Bank of India (RBI) stepped up its supervisory role, implementing the following changes; creating a repository of information, a review of asset quality, Introduction of the Insolvency and Bankruptcy Act (2016) and tightened norms for recognition of a bad loan. This led to a spurt in the recognition of bad loans (2016) and action towards resolution. The largest 12 loans were set aside for resolution through an independent committee. A further 28 are set aside the next round.

In the last few years the sector (and particularly state-owned banks) have had to deal with, deteriorating asset quality leading to higher provisioning requirements, falling profitability and a weak capital position. As a result, their capacity to provide funding for growth has been poor. State-owned banks are now in the process of forced consolidation (to improve capital position) and “Corrective Action” with supervised lending practices. **We estimate the process of cleansing and corrective action could take 1-2 years from here, to allow these banks to be a funding option again**.

India’s private banks have emerged as the winner in terms of market share and given less of a legacy, only account for about 10-15% of the overall estimated US$150bn problem. Private Banks have had better governance, more dynamic management, better lending practices and technology. It is unlikely that Private Banks can plug the hole of lending capacity on their own. There is a need to grow and develop the corporate bond market to meet the needs of borrowers.

Finally, another factor which has led to tight liquidity conditions since September 2018 is the weakness of the Non-Bank Financial Companies (NBFC's). These businesses play a key role in the financing given their complementarity to banks and catering to a wide variety of customers in urban and rural area. NBFC's currently are 16% of the balance sheet of Banks and were growing at a fast pace with an NPA of 6.6%. With a debt default of one of the highly profiled NBFC's (IL&FS in September 2018) came a weakening of confidence and a lack of liquidity. The RBI has been busy working on a regulatory, supervisory and liquidity frameworks for NBFC's.

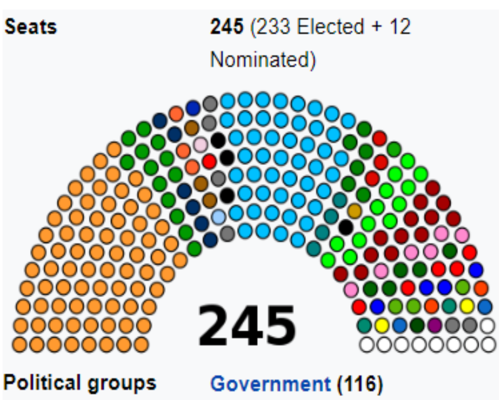
As a result of the issues faced by India's Banks and NBFC's, the Central Bank has been developing the governance reforms:

- Stronger governance, including quality and stability of the Board
- Review and KPI setting for management of Banks / NBFC's
- Audit and Risk Management Committees, including effective controls and risk management
- Banks to build new sources of mobilisation of capital, rather than relying on infusion
- Create a pool of insolvency professionals to assist in arbitration and to build a process
- Supervision and regulation of exposure concentration, non-transparent market practices and potential sources of contagion
- Creating an enabling environment for growth of digital technology for new financial products and services
- Address the existing inadequacies in customer service and benchmark it against international standards

A sound and resilient financial system is a prerequisite for a modern economy that involves all sections of its society in sharing equitably the benefits of economic and social progress.

ROAD TO SUCCESS

MODI'S BJP PARTY LOOKING FOR A MAJORITY AT THE UPPER HOUSE, ALLOWING FURTHER REFORM



The National Democratic Alliance (NDA) which includes Modi-led BJP won a resounding majority at the 2019 elections of the Lok Sabha (India's Lower House) in May this year. However, several of the reforms proposed by the current Government, will also need a majority at the Upper House, Rajya Sabha (a council of the States). During Modi's last term, several land and labour reforms were held back by a lack of a majority. Land reforms can unlock ownership and allow for greater utilization in developing smart cities, infrastructure and hence strong economic growth. Additionally, several of India's archaic labour laws don't allow for the most efficient utilization of resources.

The Upper House has a maximum membership of 245, of which 233 are elected by the legislatures of the states and union territories using single transferable votes through Open Ballot while the President can appoint 12 members for their contributions to art, literature, science, and social services. Members sit for staggered terms lasting six years, with elections every year, with almost a third of the 233 designates up for election every two years, specifically in even-numbered years.

PRS Legislative Research, a research company tracking the functioning of India's parliament, suggests the NDA could win up to another 10 seats by next year. With the support of parties in the South and East of India this could achieve close to the 122 seats needed for a majority. In his first term, Modi struggled to push legislation that would make it easier to hire and fire factory workers and buy farmers' land. He's also faced hostility from unions and his party's allies since he first sought to reform labor laws after coming to power in 2014. There are now elections in 3 states in October 2019 (Maharashtra, Haryana and Jharkand). If Modi can get closer to a majority by 2020, he may hold off on reforms. Hence the expected significant reform at the front end of the 2nd term seems unlikely, with priority given to infrastructure and rural welfare in the first year.

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