

# Nepean Capital

## 2Q CY23 Investor Newsletter

*“PM Modi is a man whose time has come when India’s time has come. The potential of India is enormous, and you now have a reformer who has the ability to transform. The country is at a juncture where a lot of opportunities will be created.”*

- Ray Dalio after meeting India’s Prime Minister, Narendra Modi, on June 21

The Nepean Long Term Opportunities Fund II has given a return of 8.1% (in US\$, net of fees) since inception, having outperformed our benchmark NIFTY500 by 1160 basis points.

Performance (in US\$), Net of Fees			
Period	Fund	NIFTY 500	Outperformance (bps)
Since inception (October 13, 2021)	+8.1%	-3.5%	1160
YTD	+8.7%	+7.3%	140

India’s NIFTY500 closed the 2Q CY23/1Q FY24 with a new all-time high of 19,185, +6.55% YTD. Its market cap is now \$3.7 Tn, the 5<sup>th</sup> largest in the world. Investors seem to have gotten tired of waiting for that elusive U.S. recession and have ploughed back aggressively into global equity markets. While the S&P is up 16.5% YTD, the NIKKEI and DAX have hit all-time highs. In the last quarter India was up 11% in US\$ terms, making it the best performing equity market in the world and reversing its dismal performance in the 1Q CY23.

### NIFTY500 vs. S&P500

#### S&P 500 Index

.SPX:INDEX

RT Quote | Exchange | USD

Last | 07/03/23 EDT

**4,455.59** ▲ +5.21 (+0.12%)

52 week range

3,491.58 - 4,458.48

1D 5D 1M 3M 6M YTD 1Y 5Y ALL

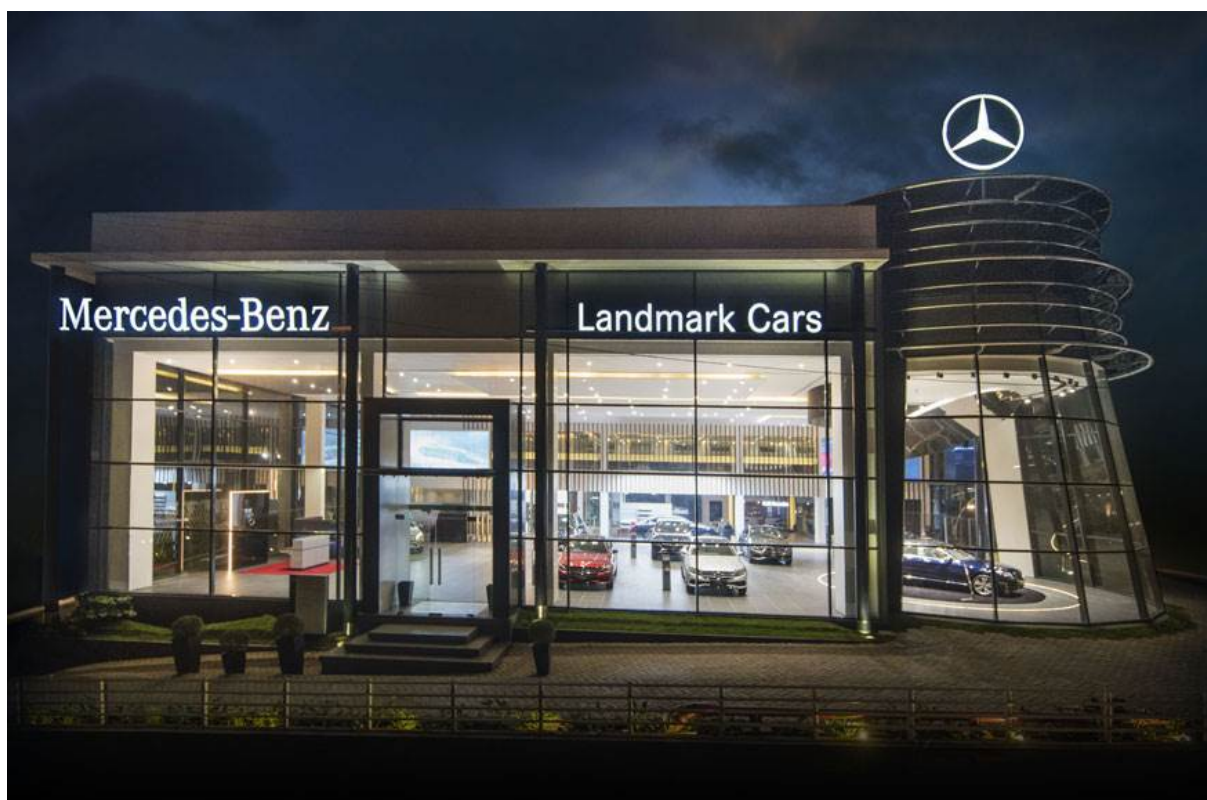


And this is despite the fact that foreign portfolio investor (FPIs) inflows into India this year have only been the third highest in Asia i.e. +\$9.7 Bn, after China Northbound +\$28 Bn, Taiwan +\$11.5 Bn. FPIs are the second highest owners of India Inc., after founders (aka promoters) who own around 42%.

While India's Large Caps rose 9%, it was the Mid & Small Caps that shined, up 18% and 20% respectively. In the quarter gone by, FPIs continued selling Indian IT (-\$1.9 Bn) and Energy (-\$564 Mn), while loading up on Financials and Consumer Discretionary (+\$3.6 Bn each). Of the \$605 Bn of FPI holdings in India, Financials are their single largest holding at 33%, followed by Consumer Discretionary at 15% and IT at 10%.

On the ground, we do see some signs of a consumer slowdown with end of season sales by most retailers kicking off two weeks early. Rural India has been struggling for the past year and the impact of El Nino could hurt demand further. India's (and the world's) largest motorcycle manufacturer, Hero Motocorp, saw June sales fall 10% YoY and 16% MoM.

Some sectors seem to be more resilient to a slowdown, such as real estate and premium/luxury cars. The first half of CY23 saw Mumbai, India's biggest and most expensive real estate market, post record sales of 62,285 units even though mortgage rates have risen from 6.6% YoY to around 9% today. As per RBI data, over the last 3 years (April 2020 to April 2023), vehicle loans are up 137% and are now the second largest category after housing loans. Last month's car sales were 327,700, the best ever, and 1HCY23 sales crossed 2 Mn. We are playing this opportunity with our investment in **Landmark Cars**, India's largest and only listed automobile dealership (#1 for Mercedes Benz, Honda Motors, VW, Jeep and BYD, #3 for Renault and just partnered with MG Motors in Central India).



Many Indian companies are investing heavily for future growth. For example, IndiGo Airlines (61% share of the aviation market) has placed an order for 500 Airbus A320s. This aircraft order is not only IndiGo's largest order, but also the largest-ever single aircraft purchase by any airline with Airbus. The planes will be delivered between 2030-2035. Separately, Air India placed an order earlier this year to purchase 470 new aircraft valued at \$80 Bn. Passenger load factors (PLFs) in India improved for all airlines in May to above 90%. Similarly, the CEO of LG Electronics India said last week that this year India will be their fastest growing market globally. This is not surprising given that the penetration of air conditioners is a mere 8%, washing machines is 16% and refrigerators is 30%.

As the Modi government's efforts to boost manufacturing in the country have borne fruit, and more recently in light of the China +1 strategy, India's merchandise exports in CY22 crossed \$453 Bn, up from \$267 Bn in CY15. India's share of world merchandise exports rose from 1.62% to 1.79%. If you add services then the figure in FY23 rises to \$770 Bn (+13.4% YoY). Also India's electronics exports have soared from \$7.9 Bn in CY15 to \$26.6 Bn in CY22.

### PORTFOLIO UPDATE:

**HDFC Bank**, one of our core holdings, has finally merged with its parent HDFC Ltd., effective July 1. As a result, it has become the fourth largest bank in the world as measured by its estimated combined market cap of \$172 Bn. Only 2% of HDFC Bank's 80 Mn customers have housing loans from the former parent and an additional 5% have housing loans from other lenders. Hence the opportunity to sell more mortgage loans is huge. We believe this merger will also help tap into a huge deposit pool (fuel for bank growth) as 65-70% of HDFC Ltd.'s customers do not have bank accounts with HDFC Bank. As HDFC Bank moves from a product sales culture to a relationship-based structure, this merger offers strong cross-selling opportunities across product segments.

**Eureka Forbes** is the new addition to our portfolio. Its best-selling brand, *Aquaguard*, is synonymous with water purifiers in India. In addition, it is a leader in vacuum cleaners and has recently launched air purifiers. Over the past few years, the company lost its way and as a result gave up market share (to new entrants like Kent RO and Unilever's *Pureit*), the RoE dropped to 2.4% and EBITDA margins fell to 4.5% (vs. 23% for Kent RO). Last year, PE fund, Advent International, bought out the erstwhile owners (the Shapoorji Pallonji group) and now owns 72.5% of the company. We like companies where private equity funds do a buyout of the founders' stakes *and* keep the company listed. (In Fund 1, we did very well with four buyout plays, J.B. Chemicals, Aavas Financiers, Sequent Scientific and Spandana Sphoorthy). We believe Advent will be able to turn this company around as it has successfully done with its previous Indian buyouts, namely Crompton Greaves Consumer Electricals and DFM Foods. The early signs of this can already be seen in their appointment of Pratik Pota, the former CEO of Jubliant Foodworks (master franchisee of Domino's Pizza in India), to run the business.



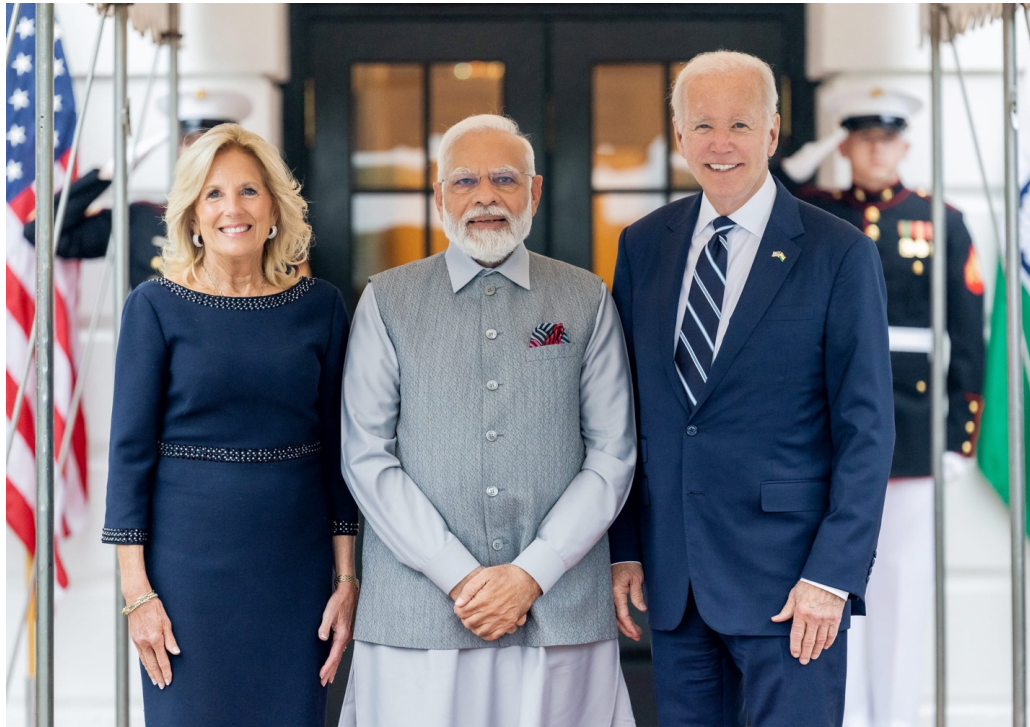
Our bet on **IDFC Ltd.**, which owns 36.4% of IDFC First Bank, has played out well. The long pending merger finally got announced with a swap ratio of every 100 shares of IDFC, investors will get 155 shares of IDFC First Bank. Therefore, the holding company discount collapsed giving us an over 100% return (inclusive of dividends) over 18 months, aided by a 65% rise in the underlying.

### **What can impact the India story in the near term ?**

1. Agriculture accounts for 18% of GDP but still employs more half than the population. Every year the sword of Damocles hanging over the Indian economy is the outcome of the monsoon. The season which usually runs from mid-June to mid-September, has had a late start this year. The good news is that as I write this, it's thundering and pouring (equal to a *Typhoon 8* warning in Hong Kong). The cumulative rainfall so far has been 13% below normal but it's early days. It will be hard to estimate what El Nino might bring to India and the world over the next few months.
2. The probability of a U.S. recession, based on consensus estimates, is still as high as 65%. This May, I spent a month in the U.S. and found little evidence of any looming downturn. Inflation was raging and omnipresent. From \$6.00 lattes to packed flights to congested airports (June 30<sup>th</sup> witnessed a record 2.9 Mn Americans take flight) to a one way Uber ride from midtown Manhattan to Newark airport that cost me a whopping \$100! And hence no surprise that last week Fed Chairman Powell talked tough on inflation and warned of more hikes coming. Logically a recession in the U.S. would be a dampener for commodities and hence positive for India, but it would also be negative for foreign flows into EMs, including India.
3. I met a cross section of asset allocators and investors in the U.S., all of whom said that they have been burnt in China. They agreed that this was a seminal moment for India as it strives to attract more FDI into manufacturing and as a greater percentage of the population moves up the per capita income curve. However, their #1 concern was whether PM Modi would secure a third term in next year's general election.
4. While India's valuations have historically been high among Asian/EMs, they have started creeping back up to expensive territory. MSCI India is now trading at 20x CY24 P/E vs. MSCI AEJ which is at 12.4x. This equates to a premium of 62% vs. a 5-year average of 48% and a 10-year average of 31%. Also 64% of the BSE200 stocks are trading at 52 week highs. It's comforting to see that India's consensus CY24 earnings growth is estimated at 16.2% (the third highest in Asia after Korea and Taiwan) vs. MSCI AEJ at 17.4%.

Having said that we continue to focus on finding bottom up stock picks like Eureka Forbes, Sapphire Foods, Spandana Sphoorthy, Syrma SGS and Landmark Cars.

India's Prime Minister, Narendra Modi, concluded a three-day state visit to the U.S. in June where he signed partnerships for semiconductors, drones and defence. Soon after, Micron Technology announced that it will invest \$825 Mn in a new \$2.75 Bn chip assembly, testing and packaging plant. Semiconductor equipment maker Applied Materials plans to invest \$400 Mn over the next four years to build a collaborative engineering centre in Bangalore.



*“We are focusing on infrastructure development. We have given nearly 40 million homes to provide shelter for over 150 million people. That is nearly six times the population of Australia. We run a national health insurance program that ensures free medical treatment for 500 million people. That is greater than the population of South America. Today, there are more than 850 million smartphones and internet users in the country. This is more than the population of Europe.”*

- PM Modi, while addressing the joint session of the U.S. Congress on June 22

It is great to see foreign media focusing more positively on India than ever before. *Barron's* June 2 edition listed ‘a fast-growing India’ among its *5 Trends to Bet On Now*. The other four included water shortages, medical miracles, energy transition and artificial intelligence (AI). Similarly the *Harvard Business Review* dated June 27 published an article titled *Does Your Company Have an India Strategy?* (<https://hbr.org/2023/06/does-your-company-have-an-india-strategy>) Their analysis explains why the Indian subs of multinational companies trade at huge premiums to their parents. For example: Nestle SA has a P/B ratio of 6x but Nestle India trades at 82x. The study states: “Indian firms have better growth prospects, higher profitability, and more efficient asset utilization. That’s why every multinational must have an India strategy, or else it will miss out on one of the most promising market opportunities in the world today.”

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