GQG PARTNERS

India In Focus

Do Fundamentals *Trump* Valuations?

Let's Talk Stocks will be a periodic discussion on GQG's favorite subject—stocks! Dictated by global events rather than by the calendar, we will make our best effort to explain the thinking behind GQG's investments in as transparent a manner as possible.

India is considered a bright spot in the global economy. It is emerging as the fastest growing major economy in the world, unlike just a few years ago when serious questions seemed to loom over India's growth prospects. Interestingly, our market exposure is the lowest in over a dozen years. In fact, we have more exposure in China and Brazil and nearly the same in Russia as we do in India in all three strategies! This is the basis for our second edition of *Let's Talk Stocks*: to provide insight into how we reconcile fundamentals in India with recent macro events and current valuations.

As we have mentioned in the past, there are so many things that we, as long-term investors, like in India. Among them, favorable demographics and a policy environment where, irrespective of the ruling party dispensation, there is consensus on continuing liberalization and strong management teams with good corporate governance, all of which have ultimately led to relatively predictable double-digit EPS growth with high returns on capital. Thus, I have had meaningful exposure in my Emerging Markets, International and Global strategies for years.

In this context, we are optimistic about the long-term benefits of India's demonetization. On November 8, 2016, Prime Minister Modi—in a sudden and shocking move—mandated that the Rs. 100 and Rs. 500 notes, which account for the bulk of currency value in circulation, were to be replaced.[1] By many accounts, India has a sizable parallel, undeclared economy that is cash-based (this is known as a black economy).[2] Demonetization now forces these monies to be brought into the formal economy and exchanged for the new currency notes. Nevertheless, I suspect many who have vast illegal currency holdings will figure out a way to break down their currency assets and get them exchanged.

A far more significant effect that few discuss is that demonetization is forcing the country to move to a digital economy. In retrospect, the Modi government's efforts to provide bank accounts for the unbanked makes sense in light of these efforts. As more people move money into banks, the deposit base is strengthened. Shopping behavior will change as people use digital wallets and credit cards. Tax evasion will be much less of a possibility. We see all these as a long-term trend (along with the goods and services tax), where companies in the formal portions of the economy who play by the rules are not shortchanged by well-connected operators in the unregulated economy. This is truly a watershed moment for India.

There is nevertheless going to be short- to medium-term pain, with many parts of the economy that are cash-based being affected. The approximate third of the economy that is undeclared and operating in a black economy will be impacted by the overnight shock to the system. Real estate transactions, for example, which by western standards are surprisingly dependent on black money, will be hit. Higher-end consumption and trading will be impacted, including consumer staples, which have already seen meaningful slowdown over the last 18-24 months.[3] (We reduced our exposure further after this event.) And these factors will have a dampening effect on the economy. There is a massive transition being forced on the system which, like any transition, can take longer to recalibrate.

We started writing this paper before the demonetization move, as our exposure in India has gone down meaningfully over the last 12 months. I want to talk about—specifically—why we exited our holdings in IT services, pharmaceuticals and the consumer sectors. Some of the biggest investing mistakes have been to confuse growth in the overall economy (in terms of high GDP growth rates) with good investment opportunities as an equity investor. Unfortunately, investing is rarely that simple or else all we'd have to do is invest in countries with the best GDP growth rates. As illustrated in the chart below, GDP growth rates do not correlate well with stock market returns.

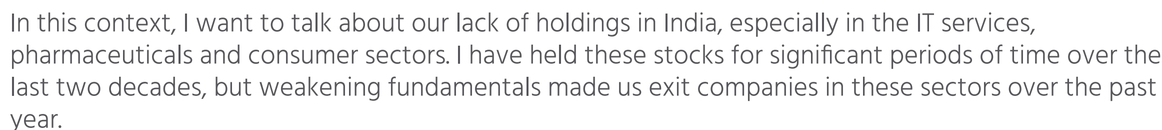
Comparison of annualized GDP growth and real stock returns across countries

Country data start when available from 1970 and extend through 2012

Business Insider (November 6, 2013), "Chart of the Day: The Stock Market is Not the Economy Anywhere in the World" (S. Ro). Note: this is the most current chart readily available.

Here, for context, we need to revisit our thinking on sustainable earnings growth and multiples paid when investing. As long-term, fundamental investors, we realize that what ultimately drives how much money is made in an investment is crucially dependent on the company's performance during the time the stock was held, coupled with the price initially paid for the stock. Beyond a certain level, valuations become even more important: they are less relevant in the middle ground but critical at the tails. In other words, in our view, valuations are always approximate. So when stocks trade at reasonable levels, a small difference in earnings multiples will have a lesser effect on long-term returns than will sustainable earnings growth and the returns on capital.

However, once we get to very high earnings multiples, let's say to 28x-35x levels, the dependability and rate of earnings growth become far more important because of increased valuation risk. But one should not be dogmatically focused on any specific earnings multiple—multiples must be considered in the context of the underlying earnings growth potential. A 30x multiple may be reasonable while a 20x multiple may be very expensive. This kind of thought process has been critical for our longer term performance. Clinging to a rigid view that a 15x is always cheaper than a 20x multiple is too simplistic and has done a lot of damage to many investors.



In this context, I want to talk about our lack of holdings in India, especially in the IT services, pharmaceuticals and consumer sectors. I have held these stocks for significant periods of time over the last two decades, but weakening fundamentals made us exit companies in these sectors over the past year.

Here, a little bit of history is helpful. Both the IT services and the pharmaceutical industries were enormously helped by the partial liberalization of the Indian economy in the early 1990s. As is so well documented, the IT services industry grew from its infancy in the early 1990s into a global powerhouse, employing about 3.7 million and aggregating $108 billion of exports (more than 45% of the country's services exports in the year ending March 2016).[4] The success of the industry demonstrated that liberalization works. And especially relevant in the Indian context was the widely disseminated lesson that entrepreneurs can create wealth in an ethical and legal manner.

However, the very success of the Indian IT firms now creates challenges. First is the issue of scale; the four largest Indian IT companies now employ nearly a million people. The situation of these companies reminds us of Lewis Carroll's Red Queen telling Alice, "Now, here, you see, it takes all the running you can do, to keep in the same place." For instance, Infosys in the last six months hired nearly 26,000 employees, but in turn 20,000 employees left, resulting in the firm increasing its employee base by less than 6,000.[5]

The second challenge is that offshoring is now mainstream. Nearly every Fortune 500 company has experienced more than a decade in offshoring. This means that literally everything that can be offshored has been. The easy days of the past, when Indian IT services companies could find clients who were just beginning to offshore, is history. Now, companies have to win deals at the expense of other vendors. All these companies employ the same talent base with similar cost structures, hence the zero-sum dynamics result in industry-wide pricing pressures, again contributing to the Red Queen effect.

When we look at the Indian pharmaceutical industry, we find a similar though less spectacular success story. Liberalization enabled the pharmaceutical industry to enter developed markets. Indian companies realized that their competencies in chemistry (again thanks to India's demographics and talent pool) provided significant cost advantages. Initially, Indian pharmaceutical companies manufactured APIs (Active Pharmaceutical Ingredients) for their global clients, but soon they moved to manufacturing generic medicines for the U.S. and European markets. Success was dramatic. Indian companies now account for 19% of generic drugs in the US.[6] In addition, the Indian domestic market also appeared to have attractive growth prospects given the low spend on healthcare and rising incomes. So investors bought into these stocks, impressed by the Indian pharmaceutical achievements in the U.S. and enticed by their prospects in the Indian market. But now, we see challenges that make us uncomfortable with investing in these companies.

First, we are skeptical of the attractiveness of the domestic Indian market. This is largely driven by regulatory risk—Indian policy makers still look suspiciously at pharmaceutical companies. In a still predominantly poor country, politicians realize that these companies are soft targets to further populist goals. Hence, the regulatory framework stipulates price controls on several drugs deemed essential for public welfare and weakens intellectual property (IP) protection. This has a perverse effect on the industry. It provides an opportunity for pharmaceutical companies in India to monetize their existing (and many times outdated) products, but stifles innovation. In fact, most multinational corporations do not introduce their latest drugs into the country on account of concerns regarding IP piracy, though the official reason touted is that the Indian market will not bear the expensive cost of leading-edge drugs.

On the other hand, the success of the Indian pharmaceutical industry in the U.S. and other developed markets is commendable. However, the U.S. generics industry itself faces headwinds thanks to the slowing patent cliffs. With fewer drugs going off patent, opportunities to make new generic drugs will decline and industry growth rates will slow. Furthermore, there remain technology limitations for the Indian firms. Most of the generic drugs launched by Indian companies have been oral formulations. Only recently have there been some efforts to broaden these into injectables and inhalers. We also believe the pricing environment should continue to worsen in the U.S. Sun Pharma, a name we had a large position in for a long time, was recently served a subpoena for price gouging. The pharmaceuticals benefits managers are getting aggressive, and, we believe, for the right reason. We don't see how it gets better. This is a classic case where a meaningful part of the pharmaceutical industry looks cheap, but the longer term fundamentals are looking worse than most sell-side analysts perceive.

We've concluded that this model is largely dead. In the longer term, the only way out will be for the Indian pharmaceutical companies to develop innovative drugs. That, however, requires a cultural change that we feel these companies will not be able to undertake, due in part to the perverse incentives of the Indian regulators. Fundamentals are now superseding valuations, just as we saw in IT services companies.

Finally, we move on to the consumer staples sector. As you know, this has been a favorite hunting ground for many of our core investments for a very long time, and the thesis from a long-term perspective is still somewhat compelling. As poor countries with large populations become richer, consumption increases manifold and so leading companies in the consumer staples sector tend to perform exceedingly well.

But right now in India, we find valuations for these companies to be extraordinarily high, especially when many of these companies have been unable to deliver more than single-digit growth rates and have shown a distinct lack of pricing power. This performance is truly disappointing in an economy where nominal GDP tends to be in the low- to mid-teens![7] There are structural reasons for our skepticism—we feel that the moats that Indian consumer staples companies enjoyed in the past are drying up as ecommerce and new local competition emerges. Hence, our decision is to sit on the sidelines for now.

So, as I take a look back, it is interesting that we do not have a single position in three of what have historically been my favorite sectors in India. But investing is about anticipating changes and being one step ahead of the market and fellow investors. We remain committed to our bottom-up stock picking process and, to use a familiar hockey analogy, continue to look to invest where the puck is going, not where it has been.

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[1]*The New York Times* (November 8, 2016), "Narendra Modi Bans India's Largest Currency Bills in Bid to Cut Corruption" (G. Anand, H. Kumar)

[2]*The New York Times* (November 14, 2016), "How Narendra Modi of India Plans to Wipe Out 'Black Money'" (G. Anand)

[3]For greater insight into this topic, please review the first edition in this series: "Let's Talk Stocks: Do Multiples Matter?"

[4]NASSCOM (February 2016) Executive Summary, "The IT-BPM Sector in India: Strategic Review 2016": http://www.nasscom.in/download/summary_file/fid/124730

[5]Infosys, "Investor Sheet" (Q2 2016): https://www.infosys.com/investors/

[6]*Fortune* (February 25, 2016), "Indian Companies Want to Sell US Customers More Drugs" (L. Lorenzetti): http://www.fortune.com/2016/02/25/indian-drugmaker-acquisitions/

[7]CIA World Factbook: https://cia.gov/library/publications/the-world-factbook/geos/in.html

About Rajiv Jain

Rajiv is the Chairman and Chief Investment Officer of GQG Partners and also serves as the portfolio manager for all GQG Partners strategies. Mr. Jain joined GQG Partners in June 2016, with over 25 years of investment experience. Previously, Mr. Jain served as a Co-Chief Executive Officer (from July 2014) and Chief Investment Officer and Head Of Equities (from February 2002) at Vontobel Asset Management. He was sole Portfolio Manager of International Equities strategy (since 2002) and Emerging Markets Equities strategy (since 1997) and lead Portfolio Manager for Global Equities strategy (since 2002). He built the business from less than $400 million under management to just under $50 billion in 2016. He joined Vontobel Asset Management as a co-portfolio manager of Emerging Markets equities and International Equities in November 1994. Prior to that, Mr. Jain was an International Equity Analyst at Swiss Bank Corporation. Mr. Jain earned an M.B.A. in Finance and International Business from the University of Miami. He also has a Masters degree from University of Ajmer and undergraduate degree in Accounting with Honors.

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For more information about GQG investment strategies, please contact Pacific Current Group at +1 (754) 264-7475 or gqg@paccurrent.com.

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